Global Restructuring Review

Is it the structure? Chinese onshore bankruptcies and offshore bond default

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Recent harsh results in the onshore bankruptcies of Chinese operating subsidiaries belonging to offshore holding companies have led to market speculation that the fault lies with the PRC's insolvency system. **Mark Fucci** and **Naomi Moore**, partners at Akin Gump Strauss Hauer & Feld in Hong Kong, consider whether this is correct.

Similar questions about the adequacy of onshore insolvency systems have been raised about Indonesia and other jurisdictions in the Asia-Pacific region. Limiting the focus to onshore challenges may obscure larger problems, warning signs and potential advantages that offshore bond purchasers and distressed-debt investors do not want to miss.

The PRC and other issuers of US dollar bonds most often employ holding companies (holdcos) established in the Cayman Islands or British Virgin Islands. These entities generally have listed shares – Hong Kong being preferred – and own no assets other than shares in subsidiaries. Their lower-tier operating companies (opcos) conduct business and possess the enterprise's "real value", in the form of assets and business operations.

A typical org chart can be found on the following page.

Structural subordination

Opcos, as independent legal entities, invariably owe substantial sums to onshore banks (usually secured) and trade and other unsecured claimants. They also incur tax, employee benefit and other "administrative" obligations. All of these parties have direct claims against the opco. Bondholders, on the other hand, find recourse only at the holdco level and are structurally subordinated to valid onshore claimants. If the enterprise is healthy, the opco generates enough cash flow to pay dividends that allow the holdco to repay its bonds.

When an opco suffers financial difficulties, however, PRC banks do what secured lenders do the world over: tighten credit lines, restrict upstream funding, pressure management and otherwise attempt to exert control in preparation for the worst. When things fail to improve, banks can push defaulting opcos into insolvency proceedings.

This kind of creditor action is not surprising and does not result from inherent flaws or biases in the PRC insolvency regime. That being said, as discussed more fully below, PRC insolvency laws and procedures can be frustratingly opaque and subject to political influence and other manipulation. The PRC regime, nonetheless, embraces a priority ladder that will be familiar to those experienced in US Chapter 11 and English-law administration and liquidation proceedings: secured and administrative – ahead of unsecured; all creditors – ahead of equity. An insolvent liquidation, wherever in the world, by definition means that creditors do not receive payment in full, and when that occurs, there is no return for the equity holder or its creditors.

The result will likely be the same when a business is sold as a going concern under a court-supervised auction. The 2013 Chinese insolvency proceedings of the onshore subsidiaries of Suntech Power Holdings Co provide a stark example. These operations were sold in a process that appears to have been aimed at achieving the best available price through an auction (a proper result for creditors in any insolvency process). Unfortunately, no process can make a business or assets worth more than what the market is willing to pay. In Suntech, that price resulted in severe losses for both secured and unsecured creditors, with nothing flowing out of China for the holdco or its bondholders. Indeed, the holdco bondholders had no claim against any of the bankrupt entities and effectively no right to be heard in the PRC proceedings.

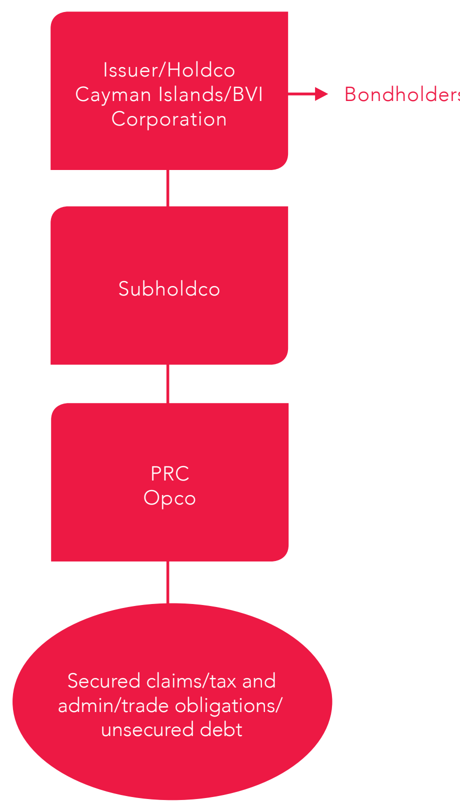
Sometimes bondholders benefit from a holdco's pledge of shares in its opcos. Such pledges provide bondholders with the power, at least on paper, to reconstitute opco boards of directors after a holdco default. In the more common case where no pledge benefits the bondholders, these bondholders nonetheless ordinarily have the right, after default, to initiate court action to put the holdco into liquidation, after which the liquidator can reconstitute the opco boards. Generally, however, such default remedies only allow the bondholders to exercise rights as an equity holder of the opcos. These rights, depending on the circumstances, can be of limited value.

So structural subordination poses stark challenges regardless of the insolvency regime involved.

Tilted playing fields

The problem doesn't stop there, however. Infirmities in insolvency regimes in China and elsewhere in the region can make matters even worse for the offshore creditor. Excepting Singapore, Hong Kong and Australia, a number of the region's other jurisdictions have given rise to the perception that the local playing field favours onshore interests over offshore creditors. Creditors used to having Chapter 11 rights are often surprised to encounter the following problems, among others:

- Insufficient disclosure of a debtor's financial condition and operating performance while under court supervision.
- Political influence and other interference in the process to further non-creditor interests.
- Courts approving significant transactions without notice to creditors or the right to object at a hearing.
- Ex parte court hearings and conferences of which creditors have no knowledge.
- Court rulings rendered under "seal" and thus kept secret from creditors
- Bankruptcy auctions that prefer holdco-friendly bidders and exclude other bidders or make it impossible for them to obtain information necessary to make a viable bid.
- Inability to file a competing reorganisation plan.
- Lack of statutes and precedents that allow creditors to obtain equity ownership of the reorganised holdco.



Art of the possible

Given the onerous combination of structural subordination and unfriendly laws and courts, issuers and their legal and financial advisors often have an advantage in restructuring engagements with offshore creditors.

Bondholders must show great patience and determination in the face of delaying tactics, lack of transparency and other bad behavior. Without recourse to a Chapter 11-type court, restructurings in the region often must be settled at the negotiation table.

Hooks?

Offshore creditors, however, need not always have to concede to inferior positions. When trouble arises, bondholders are well served to work early with legal advisors to develop a proactive strategy that exploits, whenever available, "hooks" that can create a better environment for negotiations, more reasonable issuer behavior and – ultimately – enhanced creditor recovery. Issuers with international operations may be particularly at risk of enforcement remedies and other creditor options that might alter restructuring dynamics.

Every situation must be assessed in the context of the issuer's unique circumstances, but we have found that the following hooks can prove valuable when pursued aggressively:

(a) Does the issuer have US operations or assets that it cares about?

- If Chapter 15 recognition is sought, creditors will have access to a court that will require reasonable disclosure, and listen to reasonable objections.
- Offshore creditors, in the proper situation, may be able to convince the US court to delay or deny recognition of the issuer's foreign proceeding – a very powerful lever.

(b) Does the issuer have assets in other jurisdictions where courts can provide meaningful remedies?

- Arresting of vessels
- Reconstituting boards of directors

(c) Do independent directors have influence on the issuer's board?

- Experience demonstrates that boards controlled by founding families, whose individual directors reside onshore, can be dismissive of and hostile to offshore creditors.
- Independent directors who reside offshore and have reputations to care about are more likely to be mindful of proper corporate governance and good faith standards.

(d) Does the issuer operate in an industry where the government must be concerned about access to the international markets? Or where a sovereign wealth fund or development bank of a "consumer" nation are creditors of an issuer that is a key supplier of a "supplier" nation?

(e) Is the "world watching"?

- Many observers believe that the PRC government appreciates the role the offshore bond market plays in financing Chinese real property companies, and the resulting reduction in lending needs from onshore banks that are already greatly exposed to that sector. As a result, there is the assumption that the government may "rein in" particularly bad issuer behavior.
- If other creditors in the capital structure have influence at a "macro level", offshore bondholders might see a more orderly and negotiated arrangement in an onshore restructuring proceeding. A good example of this is a commodities company indebted to government institutions of a nation that is a major consumer of the commodity.

Conclusion

Offshore bondholders in restructurings of PRC issuers face a double-edged sword of structural subordination and often hostile insolvency regimes. This combination usually makes restructuring more challenging than what unsecured creditors face in Chapter 11. Bondholders may be able to use hooks, if available, to enhance recovery and, in our experience, are best served by organising themselves at an early stage and pursuing a consensual restructuring in parallel with effective contingency planning in case such a solution proves to be elusive.