

## REGIONAL ANALYSIS: LATIN AMERICA

### The new LatAm restructuring landscape

BY [STEVEN KARGMAN](#)

With the global credit crisis in full swing and the global economy slowing down, it may only be a matter of time before a new round of corporate defaults and restructurings hits LatAm. This new round of restructurings may differ from earlier workout cycles due to three new sets of dynamics at play: new creditor dynamics, the use of new financial instruments, and the changed cross-border restructuring and insolvency landscape.

#### New creditor dynamics

Achieving effective creditor coordination is rarely easy or straightforward, but it may become even more daunting in the next round of restructurings. When forming steering committees in the past, the major players were often recognised financial institutions, such as bank lenders or more recently bondholders. Bank lenders in particular may have been competitors in the origination of loans, but they often found a way to work together in restructuring situations where they had common exposure.

By contrast, today's creditors are a much more varied lot, and hedge funds have entered the picture in a major way. In the last round of restructurings in the late 1990s-early 2000s, hedge funds might have been waiting in the wings, even for a period of a few years, to buy distressed debt at a deep discount from the original lenders. The original lenders might have lost patience with the way a given restructuring was progressing and sought a way out, and hedge funds provided an exit strategy for these lenders. However, now, in many cases, hedge funds may have stepped in early on as lenders in their own right.

Thus, in certain cases arising in the new round of restructurings, hedge funds may take on certain characteristics of par lenders where they were original lenders to the borrower. In other situations, hedge funds may continue to act as distressed investors where they have purchased the company's debt at a discount in the secondary market.

Depending on which of these roles hedge funds play in a particular restructuring – and at times there may be overlapping roles – there

may be a critical impact on the recovery expectations of hedge funds and thus how they approach the overall restructuring. The behaviour of hedge funds may also be affected by situations in which they hold positions in several layers of the debtor's capital structure, such as second lien loans.

It is not unlikely that hedge funds will find it more difficult to coordinate among themselves than did commercial banks in earlier rounds of restructuring. Will hedge funds be able to form (or be able to work with others in forming) steering committees or other similar coordinating mechanisms that exhibit some form of cohesiveness and whose members can work together and pursue a common agenda? Will hedge funds be able to work well on steering committees with other types of institutions that have been some of the more traditional lenders in the emerging markets, such as banks, export credit agencies, multilateral institutions, and host government development institutions?

Another complicating factor is that, in the current credit crisis, certain hedge funds may be facing their own liquidity and funding constraints due to declining asset values for their portfolios, margin calls and the need to post additional collateral, or the need to deal with redemption calls from investors. Also, certain hedge funds may, at a minimum, simply be in a preservation-of-capital mode.

All of this could affect how hedge funds position themselves in the next round of LatAm restructurings. Specifically, it might impact the ability or willingness of hedge funds to provide additional capital to a troubled company, as well as the ability of hedge funds to take a longer term view of the debtor and its prospects. (Obviously, in light of the impact of the financial crisis, many major international banks will enter the next round of LatAm restructurings with their own serious financial constraints.)

A further major development on the creditor side has involved the agent bank dynamic as to syndicated loans. In the past, agent banks could be expected to play a major leadership role on steering committees, particularly in coordinating the interests and views of the members of

their syndicate. But in recent years, agent banks may have sold off a good deal of exposure over the course of a restructuring, and thus may have a somewhat limited financial stake in the outcome of a given restructuring.

Moreover, another important creditor dynamic to bear in mind has been the use of credit derivatives whereby original creditors to a company attempt to lay off some of their economic risk on a credit derivative counterparty. As has been noted in the bankruptcy literature, there remains the possibility that in a default situation a creditor sitting on a creditors or steering committee may act contrary to its putative self-interest in order to trigger a 'credit event' under a credit default swap. If this were to happen, it could potentially undermine the transparency or even the effectiveness of the restructuring process.

#### Derivatives complexities

For this next round of restructurings, creditors and other stakeholders will need to understand not just the terms of traditional debt instruments such as loan agreements, bond indentures and other familiar lending instruments, but also complex derivatives. Specifically, several major corporations in both Brazil and Mexico have recently reported serious financial losses due to their exposure to complex foreign currency derivatives. These losses were apparently triggered when the local currencies such as the Mexican *peso* and the Brazilian *real* depreciated sharply against a strengthened US dollar and thereby fell below a preset level set forth in the derivatives contracts.

In light of the complex financial instruments now being used by LatAm corporations, it will be critically important for those involved in the next round of restructurings to have a thorough and complete understanding of these financial instruments. This will require a full review and due diligence investigation of any derivatives transactions that may have been entered into by the debtor, including any off-balance sheet transactions, as well as a comprehensive and detailed review and analysis of the relevant derivatives documentation itself and the specific terms and structure of the

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 For further information on FinancierWorldwide and its publications, please contact James Lowe on  
 +44 (0)845 345 0456 or by email: [james.lowe@financierworldwide.com](mailto:james.lowe@financierworldwide.com)

individual derivatives transactions.

Among other issues, creditors and other parties to a restructuring will need to examine issues such as the following: Who is the precise counterparty? If the derivative was terminated, would the debtor owe money to the counterparty (i.e., be 'out of the money') or would the debtor be owed money by the counterparty (i.e., be 'in the money')? What are the applicable termination events for the derivative? Is there any possibility for early termination of the derivative, and if so, will the debtor be 'in the money' or 'out of the money' on early termination? What are the conditions for posting of collateral – what type of collateral needs to be posted, how much collateral, and what are the specific triggers for its posting? What rights of setoff and netting do the parties have on termination of the derivatives contracts between them?

Furthermore, on the legal front, the parties may also wish to explore how derivatives are treated for purposes of insolvency under the laws of the specific LatAm jurisdiction in question, including whether such laws would or would not prevent the exercise of various contractual rights of the non-debtor counterparty.

### Cross-border dimension

In today's global economy where companies increasingly operate across borders, it is becoming more common to see situations involving cross-border insolvencies and restructurings. In the future, this cross-border phenomenon may also manifest itself more often with respect to LatAm restructurings and insolvencies as LatAm companies continue to expand their business operations internationally and as they continue to tap the international capital and credit markets. These developments could increase the need for cross-border insolvency proceedings held outside of the debtor's home jurisdiction, apart from any insolvency proceedings that are brought in the debtor's home jurisdiction.

The cross-border nature of future LatAm restructurings and insolvencies may arise in cases involving Mexico, given that its economy has such close links to the US economy and that a number of companies operate both in Mexico and the US. Also, US creditors and other foreign creditors are obviously very deeply involved in lending to Mexican corporations. But this cross-border restructuring phenomenon may also become apparent with respect to other LatAm jurisdictions as well.

A few years ago, Satmex was a high-profile example of this cross-border phenomenon and involved an interplay of both Mexican and US

insolvency proceedings beginning with an involuntary Chapter 11 filing in the US by Satmex noteholders followed shortly thereafter by a *concurso mercantil* filing in Mexico by Satmex itself. Most recently, Corporacion Durango filed a *concurso mercantil* proceeding in Mexico, which it then followed with a Chapter 15-related preliminary injunction filing in the US bankruptcy court in New York.

Moreover, in recent years, there have been cross-border cases from other LatAm countries as well. There have been several cases in which the US bankruptcy courts have granted recognition to foreign proceedings in LatAm under the former Section 304 of the US bankruptcy code (such as in the *Multicanal* and *Telecom Argentina* cases from Argentina and *Varig* from Brazil) as well as a case in which the US bankruptcy court allowed a plenary Chapter 11 proceeding for a foreign debtor to go forward in the US (the *Avianca* case from Colombia).

In the past, prior to the enactment of the 2005 amendments to the US bankruptcy code, the vehicle for foreign insolvency proceedings to obtain recognition in the US was through Section 304 of the US bankruptcy code. However, the 2005 amendments introduced a new Chapter 15 to the US bankruptcy code which replaced Section 304 and which provides a more streamlined process for the US bankruptcy courts to grant recognition to foreign proceedings. Based on the UNCITRAL Model Law on Cross-Border Insolvency, Chapter 15 is fundamentally designed to facilitate cooperation and communication between the US and foreign jurisdictions in connection with cross-border insolvency cases.

Since its enactment in 2005, there have been many Chapter 15 filings by foreign representatives located in Canada, Europe and Asia, but very few so far from Latin America, possibly due to the lack of major LatAm defaults in recent years. However, perhaps this will change in the next round of LatAm restructurings.

In addition, there may also be greater judicial cooperation between the courts of one LatAm country and courts elsewhere, including courts in the US, such as happened in *Varig* where the respective Brazilian and US bankruptcy judges for the separate Brazilian and US proceedings held a joint hearing in September 2005 in the US bankruptcy court in New York. As the use of protocols between courts of different jurisdictions gains greater worldwide acceptance, it will be interesting to observe whether there is a greater use of such protocols by courts in one LatAm jurisdiction and courts in other LatAm

jurisdictions or elsewhere.

Parties to LatAm restructurings should also bear in mind one other interesting cross-border twist. To date, while it has been adopted by at least fifteen or so countries around the globe, only two LatAm countries according to UNCITRAL's tally have adopted the UNCITRAL Model Law, namely Mexico and Colombia. Thus, cross-border insolvencies in Mexico and Colombia may not only have an outbound dimension via Chapter 15 in the US or similar statutes in other countries, but cross-border insolvencies in these two countries may also potentially have an inbound dimension via the local version of the UNCITRAL Model Law adopted in Mexico and Colombia, respectively.

For example, if a US company has operations or assets in Mexico or Colombia, the US company might consider the possibility of looking to the Mexican or Colombian courts for assistance on matters that could help effectuate a US reorganisation. Of course, before foreign parties resort to local courts in the emerging markets in situations such as this, they should most definitely exercise an appropriate degree of caution and planning, including consulting closely with local counsel in the relevant jurisdiction.

### Conclusion

In sum, the next round of LatAm corporate restructurings will present stakeholders with a new set of challenges and opportunities as described above. Parties to these restructurings will also have to factor in the changing insolvency landscape in several countries throughout the region, such as the new insolvency laws that have been enacted in recent years in Argentina, Brazil, and Mexico, as well as any amendments that are subsequently made to these new laws.

Another key variable in past LatAm restructurings has been the critical role played by controlling shareholders of debtor companies, particularly in family-controlled or owned companies. In certain cases in the past, the controlling shareholders were a major impediment to achieving a successful and timely restructuring. Time will tell whether controlling shareholders in future LatAm restructurings continue to exercise the same degree of control over the restructurings as certain controlling shareholders have exercised previously or whether changes in local insolvency laws and corporate governance laws and practice will blunt their ability to do so. ■

Steven T. Kargman is president of Kargman Associates.