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## **CORPORATE DEBT RESTRUCTURING<sup>1</sup>**

### **WHAT IS CORPORATE DEBT RESTRUCTURING?**

Corporate Debt Restructuring (“CDR”) provides a platform for corporate borrowers and the lending banks to work out feasible debt resolutions without having to resort to legal proceedings. The key features of the CDR are (i) it is voluntary and extrajudicial, (ii) NPLs owed by a large debtor who has a viable business but is experiencing liquidity issues, (iii) multiple creditors who have lent to the same debtor and (iv) who face actual or potential cross-defaults under their loan facilities. Despite its voluntary and out-of-court feature, CDR is usually binding under the intercreditor agreement. Also, CDR is one of the few specialized mechanisms of dealing with NPLs.<sup>2</sup>

### **BACKGROUND**

CDR has developed largely after the Asian financial crisis of the late 1990s as an evolution of the so-called London Approach<sup>3</sup>. Countries facing wide-scale corporate

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<sup>2</sup> Other mechanisms of addressing NPLs include, *inter alia*, funds/SPVs specialized in investing in distressed debts and assets, asset-management companies, or asset-disposition agencies.

<sup>3</sup> The London Approach is an informal framework developed by the Bank of England in the early 1990s. In particular, under the leadership of the Bank of England, UK banks developed the

debt distress turned to the London Approach as a basis to develop their own guidelines to encourage out-of-court corporate debt workouts.

For instance, in Indonesia, Korea, Malaysia, and Thailand, the London Approach was modified through enhancing the centralized role of government agencies to provide incentives for restructurings. CDR is administered by “Corporate Debt Restructuring Committee” (the CDRC) in Malaysia<sup>4</sup>, “Corporate Debt Restructuring Advisory Committee” (the CDRAC) in Thailand<sup>5</sup> and “Corporate Restructuring Coordination Committee” (the CRCC) in Korea<sup>6</sup>.

## **OBJECTIVES OF CDR**

The objective of CDR at micro level is to provide a mechanism for corporate borrowers and their lenders to work out feasible debt resolutions without having to resort to legal proceedings (e.g., court or bankruptcy).

At macro level the objective of CDR is to assist the government stabilize and restructure the financial system, support economic-wide recovery through facilitating a timely and orderly restructuring of debt of viable borrowers. This way, CDR aims to help sustain economic activities and preserve employment by expediting debt restructuring of viable businesses.

## **ADVANTAGES OF CDR**

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London Approach as a set of informal guidelines on a collective process for voluntary workouts to restructure debts of companies in distress, while maximizing their value as going concerns. The initiative grew from the recognition that creditors would likely achieve better returns through collective efforts to support an orderly rescue of a firm in distress, instead of forcing it into a formal insolvency.

<sup>4</sup> <http://www.cdrc.my/>

<sup>5</sup> <https://www.dlapiper.com/en/asiapacific/insights/publications/2012/03/thailand-develops-court-supervised-restructuring/>

<sup>6</sup> <https://www.imf.org/external/pubs/ft/spn/2010/spn1002.pdf>

Some of the advantages CDR offers include:

- Alternative for distressed corporate borrowers to resolve its debt obligations with their creditors in an effective and efficient manner;
- Results in preservation of “going concern” (vs. insolvency, dissolution or weakening of the borrower);
- At the same time, results in preservation of interests of creditors by way of minimizing their losses;
- Shorter and less costly than debt recovery process under Mongolian law;
- Alternative to court process with limited capacity to handle large number of cases;
- Involvement of all creditors. If CDR is not supported by all, the matter would be submitted to the next possible resolution method (e.g., litigation, AMC etc.).

## **STRUCTURE OF CDR FRAMEWORK**

The CDR mechanism has a several-tier structure.

1. The CDR Committee (“CDRC”) is the representative general body of banks participating in the CDR framework. CDRC's role is to mediate between the borrower and its lenders in arriving at a viable debt restructuring arrangement. It is a body which lays down the policies and guidelines, such as the timeframe within which a borrower must become viable. The CDRC also monitors the progress of CDR. The CDRC consists of 5-7 members, mostly from the banks and preferably from the Government (such as the Bank of Mongolia).
2. The CDR Working Group (“CDR WG”) is the general body of the participating banks agreed and constituted under the CDRC framework. It consists of representatives of banks. The CDRC WG would usually form the following bodies to undertake the workout:
  - **Steering Committee.** The function of this Committee is consider the applications made or referred cases to the CDRC and review whether the

eligibility criteria is met, mediate in disputes, if any.

- **Operations team** in charge of operational and administrative functions such as keeping registers of applications, handling enquiries, conducting initial screening of applications.
- **Creditors Committee.** This Committee is formed in respect of each successful application. Thus, it consists of all or substantial classes of creditors. The function of this Committee is evaluate and negotiate proposed CDR, finalize and recommend a CDR proposal for approval.

## **KEY RESTRUCTURING PROCESSES**

**Application.** An application may be made to the CDRC by an eligible debtor or a creditor.

**Eligibility criteria.** Examples of eligibility include minimum threshold for aggregate indebtedness, at least two creditors, viability as a going concern post- restructuring etc.

**Viability Assessment.** Upon receipt of the application, the CDRC conducts assessment on the debtor to determine the viability of a restructuring of the debt.

**“Standstill” Period.** All creditors allow a “standstill period” to give time to the debtor in financial difficulties to propose resolution of its difficulties. The workout will only proceed upon the standstill agreement being executed by all creditors.

**Restructuring Proposal.** In consultation with the Creditors Committee, the debtor proceeds to prepare a proposed debt restructuring scheme. The proposal usually:

- (a) contains comprehensive terms and conditions of the proposed CDR scheme sufficient to be incorporated into a final restructuring agreement;
- (b) conforms to the restructuring principles (please see the next section below);

(c) is accompanied by necessary legal documentation (or drafts thereof).

**Formal Notification.** Upon finalisation of the proposal, the CDRC seeks from each creditor its official confirmation and agreement.

**Final Agreement.** Upon the CDRC's receipt of confirmation from majority of creditors (e.g., 66% or 75%), the CDRC notifies the debtor and the creditors that the proposed CDR scheme is binding on all parties and that they may proceed to execute the final restructuring agreement.

## **KEY RESTRUCTURING PRINCIPLES**

**First Loss Principle.** The losses incurred by the debtor must always be borne firstly by its shareholders and providers of subordinated loans.

**Ranking.** The restructuring scheme recognizes and acknowledges the existing priority and status of claims of the creditors at the time of application.

**New Monies.** Any claims by creditors in respect of additional funding, if any, provided to sustain the viability of the debtor's business must be accorded a senior ranking status to the existing debts of the debtor.

**Operating Accounts.** There should be consolidation of the accounts of the debtor, if possible, in order to promote transparency to creditors of the debtor's actual cashflows.

**Post-Restructuring Level of Borrowing** must be set at a level that is commensurate with the debt servicing capability of the debtor, such as its expected future cashflows and the value of its assets.

**Shortfall to Creditors.** Any shortfall borne by creditors must be compensated by way of

issuance of equity, equity hybrids or any other type of instruments.<sup>7</sup>

## **ROLE OF GOVERNMENT**

On most occasions, the CDR scheme is sponsored or supported by a government. While consisting of private members, CDR administrators in most countries enjoy strong government commitment and even participation - Thailand's CDRAC is established and operated under the aegis of the Bank of Thailand; Korea's CRCC had close ties with the then Financial Supervisory Commission of RoK; Malaysia's CDRC defines itself as "a pre-emptive measure by the Malaysian Government".<sup>8</sup>

Often the central bank comes across as being a more disinterested party and therefore commands more credibility in the market. There may be, however, potential conflicts of interest if the central bank is also the bank supervisor (depending on the exact role of the central bank in the CDR framework).

CDR is naturally driven by creditors together with the debtor. However, government's role is indispensable to CDR – governments provide support and moral suasion to CDR, sets up regulatory framework, incentivizes the lenders to negotiate/mediate, if necessary, steps as a mediator in disputes. In particular, an appropriate prudential guidance with regard to the restructured assets under CRC such as provisions reversal is important. If the provisioning rules are too stringent, they discourage a creditor's incentive to engage in workouts. If the provisioning rules are too lax, they may similarly discourage a workout – this arises when a bank's required provisioning at the outset of the workout is less than the loss it would have to absorb during the workout through

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<sup>7</sup> These principles evolve from the out-of-court restructuring guidelines encapsulated in highly regarded "INSOL Global Principles for Multi-Creditor Workouts" (<https://www.insol.org/pdf/Lenders.pdf>.)

<sup>8</sup> <http://www.cdrc.my/>

debt forgiveness and loan reduction.<sup>9</sup>

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<sup>9</sup> For example, if the provisioning requirements for restructured loans do not allow for improved prospects of the eventual loan recovery, the bank may not be willing to enter into the workout with the debtor, especially if the workout may entail additional lending from the bank (which may also be subject to provisioning). (<https://www.imf.org/external/pubs/ft/wp/2000/wp0033.pdf>)