JONES DAY

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COMMENTARY

Are You Ready for the Emerging Market Credit Bust?

In Brief

Many commentators predict that a wave of emerging market ("EM") credit defaults will cause the next financial crisis. Despite being only a few days old, 2016 has already seen a major wobble in Chinese stocks and a second default by Puerto Rico. EM corporate debt outside the financial sphere rose sharply from about $4 trillion in 2004 to well over $18 trillion by 2014. With EM debt levels soaring to unprecedented highs and the inevitable cross-border repercussions of defaults, creditors are going to need a well-planned, multijurisdictional strategy to avoid being outflanked by debtors and better-prepared investors.

A decade ago, the market for EM hard currency corporate bonds hardly existed. Today, it is bigger than the U.S. high-yield corporate bond market and more than four times the size of Europe's high-yield bond market. After the subprime crisis and the euro zone's agonies sent interest rates to historic lows in the developed world, investment money flowed to emerging markets in search of higher yields. The corporate debt of non-financial firms across major emerging markets rose sharply in consequence—from about $4 trillion in 2004 to well over $18 trillion in 2014. But many commentators say this now appears to have been an imprudent binge, with much of this debt having been incurred to finance speculative projects or to purchase what are now overpriced assets. Overall, EM debt has risen from 150 percent of GDP in 2009 to more than 195 percent. Corporate debt has surged from less than 50 percent of GDP in 2008 to almost 75 percent. China's debt-to-GDP ratio has increased by nearly 50 percentage points in the past four years. Brazil's corporate-bond market has grown 12-fold since 2007.

1. EM Corporate Debt and Market Capitalization (Billions of U.S. dollars)

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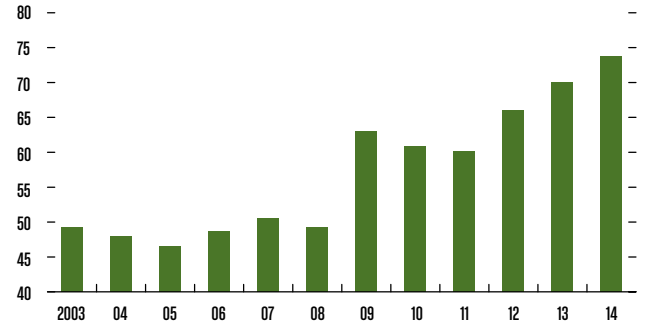
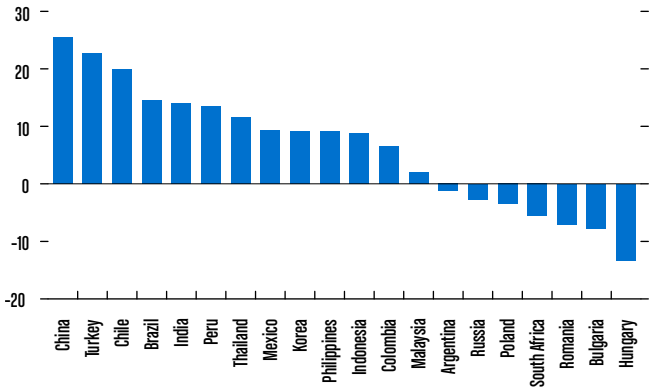
2. EM Corporate Debt (Percent of GDP)



3. Change in Corporate Debt: 2007–14 (Percent of GDP)



Source: IMF, Global Financial Stability Report, Oct. 2015.

Now this boom appears to be coming to an unhappy end. With EM corporate profits falling, economic growth and commodity prices running at much lower levels, and local currencies sliding against the U.S. dollar, some investors have already experienced events of default, and more will inevitably follow. According to the Institute of International Finance, non-financial firms in the developing world need to pay back some $375 billion in hard currency loans between 2016 and 2018. The scale of the EM credit boom suggests that its bust will be of similar proportions, with some commentators predicting that it could be the cause of the next global financial crisis.

Experience learned during the financial crisis dictates that global problems require an awareness of global solutions. Any creditor looking to maximize recoveries and not lay itself open to being outmaneuvered by the debtor or other creditors needs not only to be proactive but also knowledgeable of all the available options. Many of those options lie outside the four corners of the transactional documents and in countries different from the one those documents specify as the dispute resolution forum.

For example, many EM debt structures involve the debt being issued by a holding company ("holdco") set up in jurisdictions other than the EM country in which the operating subsidiaries trade (e.g., China). These are usually "offshore" tax-efficient jurisdictions such as the Cayman Islands, the British Virgin Islands ("BVI"), Jersey, Mauritius, or even places like the Netherlands or Luxembourg. The value of a bond purchased at the holdco level, therefore, reflects the value of subsidiary companies operating in EM countries. The creditors will often be able to invoke rights in those offshore jurisdictions that are sometimes much more powerful than those available in the EM country in which the operating companies trade (e.g., China, Brazil) or in the country specified in the transactional documents. For example, creditors of a Dutch holdco often turn to the Enterprise Chamber of the Amsterdam Court of Appeal, an activist court that can grant all manner of wide-ranging corporate law relief, including removing directors, appointing neutral directors, ordering investigations into corporate behavior by appointing expert investigators with very wide powers under the supervision of the court, etc. Creditors of Cayman or BVI companies often seek the appointment of provisional liquidators to take charge of the company, sometimes with a parallel appointment in Hong Kong over companies at the Chinese operating level to make sure that any coup is an effective one.

The first move by a creditor can often preclude any competing action elsewhere, and thus delay could be fatal. For example, a Chapter 11 filing in the U.S. stays all other litigation worldwide. Thus, any well-advised creditor needs to be at the vanguard of any collection strategy. He has to set the agenda, not follow it.

Effective relief may also require simultaneous action in more than one country. Filing a proceeding or obtaining interim relief in Country A may be futile if the proceeding or injunction does not necessarily have a direct effect on the companies outside of Country A that hold the key assets. Any such weakness could be exploited, for example, by the operating companies ignoring whatever relief has been granted at the holdco level and removing assets or paying creditors at the operating levels. That is why in the example referenced above,

any out-of-China action relating to investments in Chinese corporate structures may need to be coupled with simultaneous action in the courts of Hong Kong, to ensure that relief at the holdco level is not rendered ineffective by activities down the corporate chain in China that could remove any commercial benefit from relief obtained at the holdco level. In short, a creditor may need coordinated strikes in multiple jurisdictions.

The availability of summary adjudication and/or interim relief (including the availability of freezing orders to prevent the removal of assets) can be equally crucial to maximizing recoveries. Many countries have very slow judicial processes (India being a notorious example) and limited ability to freeze assets pending judgment. Others have wide-ranging powers to do both. For example, as an alternative to "full blown" substantive proceedings, more expedited and streamlined proceedings (known as "Part 8 Proceedings") in the English courts can yield declaratory decisions that improve creditors' strategic positions within months. In appropriate cases, creditors of an English issuer may seek to preserve the assets of the issuer for enforcement by way of a freezing order before (and sometimes after) the court gives judgment. The English court, as well as many other Commonwealth courts, also has the power to appoint receivers to preserve the assets of a defendant, including a defendant issuer that derives its value through an operating subsidiary.

Likewise, Dutch law provides for very quick and informal summary proceedings, with rulings often being available within weeks, days, or, if need be, hours. Conservatory attachments are also very easy to obtain in the Netherlands, often *ex parte*, including on receivables of the Dutch issuer, whether payable or not. Under certain conditions, attachments may even be granted in the Netherlands if the money is exclusively payable abroad (for example, the Dutch courts have allowed an attachment on bank accounts held abroad by a Dutch bank).

The courts in many jurisdictions are also able to grant relief in support of a foreign proceeding even though they will never determine the substantive dispute. This requires a joined-up multijurisdictional strategy to be determined from the start. For example, many investment structures designed to hold investments in China (usually through Chinese holding companies known as "wholly foreign owned enterprises") involve BVI and Hong Kong companies. If the issuer is organized under BVI (or Cayman Islands) law, an important power for creditors is their ability to apply for the appointment of provisional liquidators. Where the company is, or is likely to become, unable to pay its debts and intends to present a compromise or arrangement to its creditors, it can present a winding-up petition and make an application to the court to appoint provisional liquidators.

Hong Kong courts also regularly appoint Hong Kong-based provisional liquidators, often in conjunction with an equivalent appointment at the offshore holdco level. The appointment of independent officeholders is an important investor protection tool that can be used to achieve positive results even in unpredictable and occasionally hostile environments such as China, where there are wide-ranging administrative, procedural, and legislative barriers to seizing control of local assets.

Some defaults may be influenced or caused by local government action such as currency decisions, tariff decisions, export controls, new taxes, etc. As such, the savvy investor will always make sure that the investment is held in a vehicle incorporated in a country that enjoys investment treaty protection with the country in which the "investee" company is incorporated. That will allow a potential claim directly against the government under the treaty provisions, giving the potential for a full recovery against a deep pocket even if the company in which the investment was made has become worthless from a collection perspective. There are nearly 3,000 bilateral investment treaties and regional investment treaties that protect foreign investments against unfair or arbitrary treatment, discrimination, and uncompensated expropriation by states. The treaty route may become the only meaningful collection strategy if the debtor has gone bankrupt, with no or very limited payouts to unsecured creditors. It is never too late to restructure the way the investment is held to take advantage of treaty protection as long as the revised structure is in place before the dispute arises.

Many advisors will not be able to offer the necessary comparative and multijurisdictional advice due to a lack of geographical reach, an absence of experience allowing true comparisons to be made, and/or a lack of impartiality in their recommendations. Many firms will be motivated to push for the solution that they understand best (because it is in their home forum) or that generates the most revenue. With verein structures and separate partnerships common, even offices of the same firms are often in competition with each other for

business and revenue, dulling the ability to offer truly impartial non-self-interested advice. In contrast, Jones Day suffers none of those afflictions, being one partnership and One Firm Worldwide. As such, the focus is always on what is best for the client, enabling a truly global, independent, and knowledgeable solution to be crafted to meet the demands of any particular situation.

Five Key Takeaways

1. The EM credit bust may precipitate the next global financial crisis. Global problems require an awareness of global solutions.
2. There is often a first-mover advantage where the better-informed and more proactive creditors will take the initiative to protect their rights, to the detriment of the slower-moving creditors. Advance planning is critical. The first strike can be outcome determinative.
3. With complex cross-border structures common, effective relief may require simultaneous action in more than one country. Creditors are likely to have options in multiple countries and will not necessarily be stuck with the forum chosen in the contract documents.
4. The availability of summary adjudication and/or interim relief can be equally crucial to maximizing recoveries.
5. Investment treaty protection should be actively sought out, as it may end up being the only meaningful collection strategy.

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