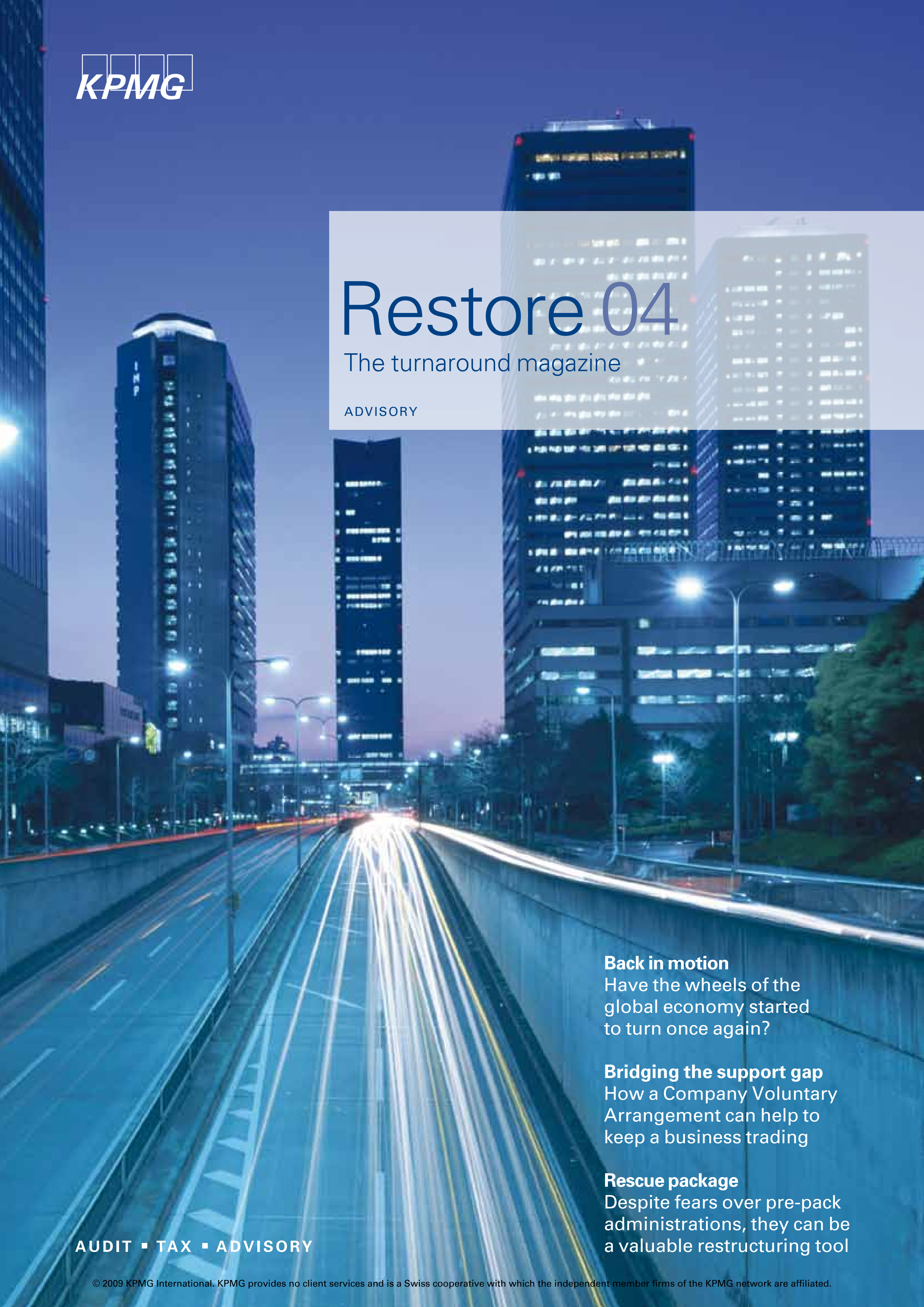


KPMG

Restore 04

The turnaround magazine

ADVISORY

Back in motion
Have the wheels of the global economy started to turn once again?

Bridging the support gap
How a Company Voluntary Arrangement can help to keep a business trading

Rescue package
Despite fears over pre-pack administrations, they can be a valuable restructuring tool

AUDIT ▪ TAX ▪ ADVISORY

Welcome

A huge amount has happened since the last issue of *Restore* a year ago. There has been the collapse of global banking group Lehmans and the Chapter 11 filings of both Chrysler and General Motors. But it hasn't all been negative. The banking and financial services industry now appears to be stable, rather than critical. Plus, there has been a lot of co-operation between governments and their agencies, from co-ordinated interest cuts through to a G20 summit that hammered out a broad agreement on economic stimuli.

The IMF is predicting that the global recession is to continue through 2009, before slowly recovering next year. Given the huge uncertainty over the near term future, we have devoted our lead feature to exploring the views of a number of professionals in the field. Turning to a sharp rise in insolvencies worldwide, we also take a close look at how differing jurisdictions affect the work of insolvency practitioners. Meanwhile, we follow the work of KPMG in China, restructuring Lehman's Asian operations, and KPMG in Spain, working on Martinsa Fadesa, a Spanish property company. Finally, back in the UK, we investigate the potential of pre-pack administrations and Company Voluntary Arrangements as rescue tools.

Welcome to the latest issue of *Restore*.

Mick McLoughlin
Global Head of Restructuring,
KPMG in the UK
mick.mcloughlin@kpmg.co.uk

Contents

Feeling the difference

The laws and practices governing insolvency vary enormously from country to country, and, as *Restore* discovers, multi-national cases can throw up real challenges for insolvency professionals.

This year's retreat into Chapter 11 bankruptcy by car giants General Motors (GM) and Chrysler hit employees, creditors and trading partners worldwide, as did the collapse of global investment bank Lehman Brothers in 2008. Yet, despite living in a globalised economy, we have no standardised international approach to insolvencies. Under some jurisdictions, the interests of creditors are key, while in others more emphasis is on rescue and recovery. Consequently, local laws, customs and practice can affect the outcome of an insolvency case.

"The UK is creditor-friendly," says Samantha Bewick, a director in the UK firm's London Restructuring practice. "Control is taken from the directors and given to an insolvency practitioner. Poor public perception of this can make the process very value-destructive. Spain, on the other hand, has moved to a more rescue-focused approach." The change in Spanish law has created a new landscape for administrators. As the recent fall of Spanish property company Martinsa Fadesa shows, it can allow companies the breathing space they need to restructure their operations.

Global contrasts

There is also a lot of variation in the Asia Pacific region. "Those countries with legal systems based on English law, such as Australia, Singapore and Hong Kong, tend to be creditor-friendly,"

Picture and cover image: Getty images

says Eddie Middleton, KPMG in China's Head of Restructuring. "In countries like Japan, Korea and the Philippines the emphasis is more on rescue."

Even where legal systems are based on the English model, customs and practices can vary. This can make restructuring complex, particularly when working with a group that has interests spanning several countries. "You can find yourself in a battle between local and overseas creditors," says Middleton.

"The UK is creditor-friendly. Spain, on the other hand, has moved to a more rescue-focused approach"

Samantha Bewick, Director, KPMG in the UK

The US is often cited as an exemplar of a system where insolvency is geared towards rescue. Rather than spelling the end for GM and Chrysler, Chapter 11 was seen as the start of a viable future. But the US system does have its drawbacks. "It's expensive, court-driven and doesn't always work," says Bewick.

Differing legal systems can create real challenges when insolvency practitioners are working on cases involving multi-national companies, with assets and liabilities spread over several jurisdictions. When KPMG in China was appointed to act as provisional liquidator for Lehman's business in Hong Kong and Singapore, it was clear the team would be working in jurisdictions across the Asia region. To be effective across borders, office holders in an insolvency need to have their authority recognised in jurisdictions other than their "home".

"If you enter into an insolvency process in one EU country, it is recognised by the others, with the exception of Denmark," says Bewick. "But if you're dealing with a group and want to make all the companies within it part of one insolvency process, you will have to prove their centres of main interest are all in one country. For large groups of autonomous companies, this may not be possible, and insolvency procedures may have to take place in several centres."

In contrast, in Asia, Middleton does not enjoy the mutual recognition Bewick has in Europe. "There is no equivalent to the EU Insolvency Regulation in Asia, so cross-border recognition remains a problem. Practice varies, some countries will recognise the authority given to liquidators by the Hong Kong courts, while others require us to bring ancillary winding up proceedings."

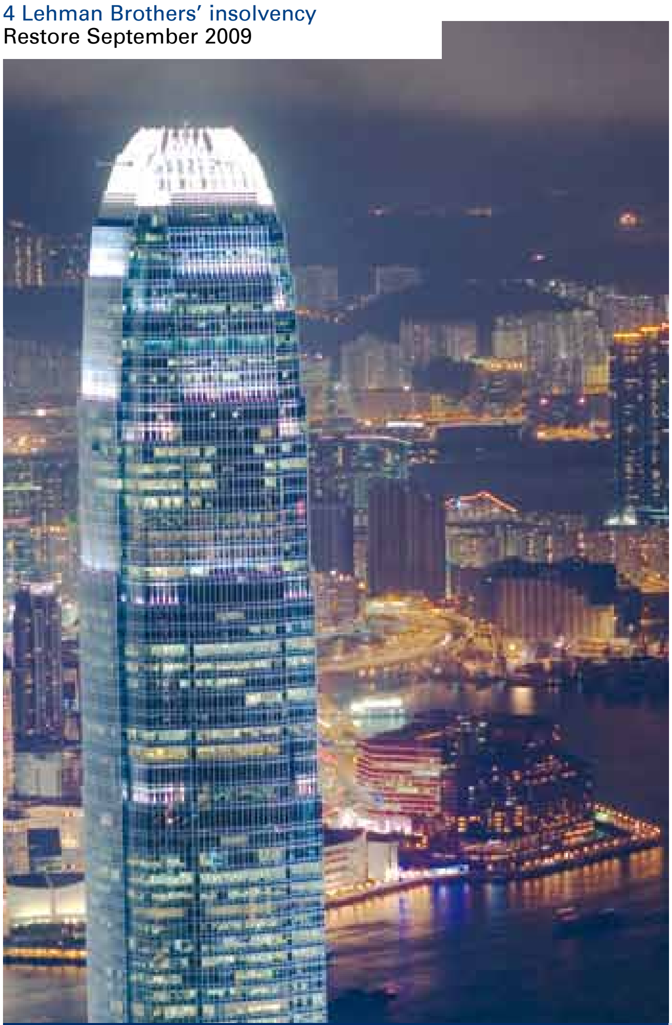
Complex structures

In an effort to improve cross-border insolvency, the UN's UNCITRAL framework has developed a 'model law' which can be incorporated into countries' existing insolvency systems. Its aim is to facilitate recognition of, and give powers to, an office holder in a foreign insolvency proceeding. Although some major countries such as the USA, the UK, Japan and Australia have now adopted the model law, it is not yet universal. Even where it is adopted, recognition may be dependent on court rulings. For example, if a company based in Europe has US assets, insolvency practitioners will have to seek recognition under Chapter 15 (the USA's implementation of UNCITRAL) from the US courts.

Clearly, when dealing with complex insolvencies, it's vital to have a thorough understanding of how local laws could affect the outcomes. On the following pages, *Restore* examines the cases of Lehman's Asia Pacific operations and Martinsa Fadesa in Spain, which presented two very different challenges to the insolvency teams involved. R

Samantha Bewick
Director, Restructuring, KPMG in the UK
samantha.bewick@kpmg.co.uk

Eddie Middleton
Head of Restructuring, KPMG in China
edward.middleton@kpmg.com.hk



Living with Lehmans

It's a year now since the bankruptcy of Lehman Brothers, but KPMG in China's partners appointed to liquidate the bank's eight Hong Kong entities foresee no easing of the challenges facing them.

IFC2 Building – former office location of Lehman Brothers

Picture: Getty images

The failure of global investment bank Lehman Brothers has led to one of the most complex international bankruptcies in history. Around the world, administrators are unravelling a daunting portfolio of financial products, as well as massive proprietary interests spanning many geographies and industry sectors. Plus, there's a very large and unhappy creditor population.

Patrick Cowley, a partner in KPMG in China's Restructuring practice and one of the liquidators of the eight Lehman Hong Kong entities, recalls the huge uncertainty that surrounded the future of the bank's Asia Pacific operations. "New York had collapsed, as had London," he says. "Asia, meanwhile, was somewhat orphaned. Lehman's regional management were under the regulatory spotlight and needed to move quickly and independently. They immediately appointed us to the regulated Hong Kong entities and asked us to conduct an Asia-wide solvency review covering 120-odd operating entities, which we pulled together in a week."

That review saw KPMG firms take control of Lehman's businesses in Hong Kong and Singapore, a brief that covered 14 of the group's regional entities. One of those, Lehman Brothers Asia Holdings (LBAH), was the group's funding entity for the Asia Pacific region, while another, Lehman Brothers Commercial Corporate Asia Limited (LBCCA), was responsible for most of the group's proprietary investments in the region. Together, these funds and investment arrangements have meant that the KPMG teams are working on a canvas that extends far beyond Singapore and Hong Kong.

A major challenge for liquidators is the extent to which Lehman entities moved billions of dollars and assets round the world. "Lehman Brothers raised funds in the New York markets, which were then dispersed globally," says Cowley.

Liquidators in Hong Kong and Singapore also had to consider a sharp fall in asset values, due to the downturn, which had a direct impact on how they handled the insolvency process. "We quickly saw that fire sales in a dysfunctional market were very destructive of value," says Cowley. Despite the dismal climate in the financial sector, the KPMG team has avoided fire sales, while securing a significant amount of cash for creditors.

The first disposals

In September, the Lehman's franchise in Asia – including 2,950 staff – was sold to Nomura, benefiting creditors of the Hong Kong entities to the tune of US$164 million. More recently, LBCCA has secured more than US$200 million for creditors from Chinese real estate positions, through the sale of seven of Lehman's property-related loans in China. The transactions, which achieved an average

Pictured from left to right are: Patrick Cowley, Warren Philips, Edward Middleton, Paul Brough, Bonn Liu, Mike Lindsay, Walkman Lee (in the far corner), Richard Poon and Fergal Power

recovery rate of 80 cents in the dollar (US), represented the first major disposal from the extensive global real estate portfolio built up by Lehman.

While most of the Chinese-related property is now off the books, the liquidators are looking to sell around 30 real estate positions in Thailand, which have a combined par value of about US$850 million. To date, two have been settled and an agreement is in place with an additional borrower.

However, Thailand-related loans may take longer to sell. "In Thailand, we have loan positions with around 10 other parties within the Lehman's group," says KPMG in China partner Paul Mitchell. "The equity on these companies is held by Lehman Brothers Holdings Inc (LBHI), the US entity that is in Chapter 11 bankruptcy, and are being managed by the US administrators Alvarez & Marsal. With an insolvency situation, the general principle is that the group concept disappears, and we start negotiating with once-related parties on an arms-length basis. That is creating a different set of issues to deal with."

Elsewhere in the Asia Pacific region, there has been scope for restructuring. A KPMG in Australia's restructuring partner, Damien Hodgkinson has brokered a 'company arrangement' to prevent legal action by creditors seeking to recover debts. Creditors have backed the plan, although a minority group is now seeking to have the vote overturned. In Japan, Lehman Brothers' Hong Kong operations funded some US$6.7 billion of Lehman's investment, with a heavy weighting towards the Japanese real estate sector, which the liquidators are now working to recover.

Cross-border co-operation

The process of winding up Lehman's global assets has been complicated by the number of jurisdictions involved. "We are currently restructuring our loan position with a company that has facilities in China and Thailand, which involves liquidation proceedings in Mauritius versus litigation in other regions," says Warren Phillips, who heads up Transaction Services for KPMG in China's Hong Kong office. "We have to navigate through all of this to protect our security and realise the asset."

"Working out who owes what, even who actually owns the assets involved, is almost frighteningly difficult"

Eddie Middleton, Head of Restructuring, KPMG in China

Cross-border agreements among administrators have become increasingly important. The liquidators in Hong Kong and Singapore are among a group of Lehman affiliates to have agreed a Global Cross-Border Insolvency Protocol ('Lehman Protocol'), in order to facilitate co-operation between the various Lehman entities. The protocol was devised to help speed up the unwinding of the former bank's positions and avoid litigation between the affiliates who operate under a raft of differing national laws. All the major Lehman affiliates have signed up to the protocol, with the exception of Lehman Brothers International (Europe), but the task ahead remains daunting.

"The Lehman companies owe each other billions of dollars arising out of complex trading and financing structures operating across borders," says Eddie Middleton, Head of Restructuring at KPMG in China. "They also traded on behalf of each other, as well as clients, on all of the major exchanges around the world. Working out who owes what, even who actually owns the assets involved, is almost frighteningly difficult. There were stock borrowing and lending, repos [repurchase agreements], reverse repos, and the like, which makes that question very difficult to answer."

But as Middleton observes, there is a real commitment on the part of the office holders around the world to achieve as much as possible through a collaborative approach.

"If we can meet the objectives that we have now set for ourselves, and keep to the aggressive timetable to which we have committed, then creditors will see a direct benefit in terms of significant savings in professional fees," he says.

Eddie Middleton
Head of Restructuring, KPMG in China
edward.middleton@kpmg.com.hk

Patrick Cowley
Partner, KPMG in China
patrick.cowley@kpmg.com.hk

Paul Mitchell
Partner, KPMG in China
paul.mitchell@kpmg.com.hk

Staying alive

Operational restructuring has given property group Martinsa Fadesa the time to formulate a recovery plan to help secure its survival.

Spain's property market grew rapidly in the years following the country's accession to the European Union in 1999. Interest rates were low, opening the door for a growing number of Spaniards to take out mortgages and buy property for the first time. Further expansion was fuelled by a booming economy that sucked in overseas workers, many of whom were also keen to buy houses and apartments. All that changed with the crisis in the financial sector. "There was no liquidity," says Ángel Martin, Head of Restructuring for KPMG in Spain. "People could no longer obtain mortgages, and work in progress in the real estate business got no additional funding." The downturn also depressed demand for housing, as unemployment rose.

For property company Martinsa Fadesa, the timing of the global credit crunch couldn't have been worse. In 2006, the fast-growing business Martinsa made a bid for its larger competitor Fadesa. The deal, creating a group with assets of €10,000 million and a listing on the Madrid stock market, went through the following year. But by 2007 Spain's real estate market was beginning to contract and the enlarged business faced acute financial problems. "The merger was financed by debt," explains Martin. "Within six months of the deal, they had to refinance that debt."

But the company owed money to around 45 institutions and a deal could not be reached. "It was being asked to guarantee all of its financial debts with assets, with a cash sweep to banks each time an asset was sold," says Martin. "This would have left the company unable to go on trading unless new money had come in, which it didn't."

In a surprise move, Martinsa Fadesa sought protection from its creditors by filing for bankruptcy. In line with Spanish law, three insolvency practitioners were appointed. One was a lawyer appointed by the court, a second represented creditors, and a KPMG in Spain team, led by Martin, was put in place by the Spanish Government's Securities and Exchange Commission. KPMG in Spain's objective was to save Martinsa as a going concern. However, the value of the company's assets had slumped by 35 percent in 2008, and most were pledged for the repayment of debt. The major challenge was finding a way to meet the demands of creditors, while also ensuring there would be enough money for operations.

Operational restructuring was a priority, says Martin. To reduce costs, staff numbers were cut from 800 to around 200 and several projects were cancelled. "By reducing Martinsa Fadesa's costs to a low level, and selling some assets at a discount, we have been able to keep the business alive," says Martin.

This has provided enough breathing space for Martinsa to come up with a business plan to help keep the company running and repay its debts over an eight-year period. If the strategy is to continue as a going concern, asset sales and costs must be kept to a minimum for three years, allowing time for the Spanish property market to recover and values to rise. This will require the support of the banks, and, to date, 50 percent have agreed. Some of the banks are foreign, with a different perspective from those based in Spain, making Martin's familiarity with financial institutions key to gaining support. Even so, negotiations are still ongoing.

Martin says that KPMG in Spain's approach to the case has already had an impact on the way insolvency proceedings are carried out in Spain. Historically, they have tended to result in liquidation. But by advising on a wide ranging operational and financial restructuring, the administrator has given the property company a real chance of survival. R

Ángel Martin
Head of Restructuring, KPMG in Spain
amartin@kpmg.es

"By reducing Martinsa Fadesa's costs and selling some assets, we have been able to keep the business alive"

Picture: Getty images

Cover story

The international financial crisis has had a major impact on the life insurance sector. *Restore* talks to KPMG in the UK's Mike Walker about the industry's problems and the outlook for the coming year.

Why has the life sector been particularly badly affected by the financial crisis?
The answer lies in the triple whammy of asset, liability and demand pressures that many life insurers are facing simultaneously. Their capital bases are being eroded by the decline in equity markets and impairments in bond holdings. Many are also coming under pressure on the liability side from guaranteed annuity rate products and the affect of an ageing population on long-term healthcare books. Furthermore, from a revenue perspective, the demand for certain types of investment business has dropped significantly with returns falling.

Non-life insurance has not faced the same problems. Why is this?
I think there are several reasons for this. First, most non-life insurers appeared to enter the financial crisis with strong balance sheets. Second, for reasons of maintaining liquidity, non-life insurers did not generally invest heavily in toxic high-yielding financial products. Third, many regulatory regimes and rating agency models tend to discriminate against insurance companies holding significant equity portfolios. As a result, the industry has been less affected by the significant volatility and declines in equity markets. Finally, on the claims side, there has been a relatively benign environment.

From the perspective of lenders and other creditors, what are some of the indicators that suggest an insurance group may be stressed?
As with any other business, direct evidence is likely to come in the form of covenant breaches, request for debt restructure and asset value write-downs. More specifically for the insurance sector, however, a firm's rating can play a significant part in its economic health. Falling below certain points in the grading ladder can lead to serious consequences for a business, including significant collateralisation calls and removal from client security listings.

How do you see events panning out through the rest of 2009 and into next year?
It is difficult to predict, because the economic climate is so uncertain. However, the longer asset values remain depressed, the more likely it is that companies will pull out of certain lines of business. This is especially the case in the life sector, where more life insurers could follow XL Capital into run-off, particularly as this will eliminate the contribution to capital requirements from the 'new business strain'. On the non-life side, the level of disturbance to the relatively benign claims environment will be key. How significant will the impact be of a severe 2009 storm season, for example? Furthermore, what level of claims will we see from the anticipated wave of filings under Errors & Omissions and Directors & Officers policies due to the credit crunch? R

Mike S. Walker
Head of Restructuring's Insurance Solutions practice, KPMG in the UK
mike.s.walker@kpmg.co.uk

Back in motion

Just how likely is a global economic recovery? To find out, the Economist Intelligence Unit asks a range of specialists for their views.

Jim Rogers is wary of talk about green shoots. "I am sceptical about the rally in the world economy for the next year or so," says the veteran investor, who co-founded the Quantum Fund with George Soros in the 1960s.

Rogers is particularly doubtful about the ability of policymakers to steer the global economy in the right direction. "US leaders have been saying: 'Everything's going to be alright in the next quarter,' for two and a half years," he cautions. He also expects "more bottoms this year and next" and, even worse, believes there will be widespread currency crises "maybe this fall or next".

This prediction is based on the belief that measures, such as printing money, taken by recession-hit Western countries to spur growth, could lead to a loss of faith in governments' ability to service their debts. His sentiments find an echo in the demand made in May by German chancellor Angela Merkel that central banks return to "independent and sensible monetary policies".

These views, however, look increasingly out of kilter with popular opinion amid a stream of data suggesting the global economic freefall is over. Manufacturing, professional services and banking have all given off positive indicators in the first half of this year. While the Economist Intelligence Unit (EIU) remains cautious, it has revised its US forecast for 2009 to a contraction of 2.9 percent (up from -3.2 percent previously). Its forecast for 2010 is now for 1.0 percent growth in the US economy, up from 0.6 percent previously. In addition, it has upgraded its forecast for Japan in 2010 to 0.8 percent, from 0.4 percent, reflecting the expected impact of the forthcoming fiscal stimulus. China is predicted to grow by 6.5 percent this year, compared with a previous forecast of 6.0 percent, and 7.3 percent in 2010. But the euro zone and the UK are forecast to contract next year.

Despite widespread belief that the worst is over, businesses face a new challenge: to judge whether a recovery has really begun and, if so, to assess its strength and longevity. Robert Ward, Director of Global Forecasting at the EIU, comments: "Last September it was easy to predict that markets would go into freefall. Now we have a mix of signals and visibility is actually lower than it was six months ago."

So how do specialists view the outlook for the key components of the

Picture: Getty images

global economy – banking, industrial production, global trade and services?

Banking: credit markets thawing

Despite substantial improvement in liquidity in money markets and considerable issuance of corporate bonds, credit conditions remain strained for most companies. Nevertheless, they could be categorised as 'testing' rather than 'dire', as was the case six months ago.

Nick Minogue, Chief Risk Officer of Macquarie Bank in Australia, comments: "The response from central banks and government has now been tested and is largely seen as effective. We are currently increasing our lending activity."

In fact, Macquarie believes there are now fewer credit risks than before the collapse of the Lehman Brothers last September. "There are many more lending opportunities that meet our criteria for acceptance than pre-downturn," says Minogue.

Companies do seem to be benefiting from a relaxation of credit conditions. "Credit availability is still a concern, but the severity of the situation is easing compared with a few months ago," notes Ian McCafferty, Chief Economic adviser at the Confederation of British Industry. "Big companies that were encountering serious problems getting credit at the start of the year are still finding it difficult, but they expect the supply of existing credit to get slightly easier over the next few months."

Manufacturing still in the doldrums

The greatest level of fear surrounding funding seems to be coming from Manufacturers. The EEF, which represents British manufacturers, says its members are still seeing "few benefits" of government action to reflate the economy. "It is important that the Bank of England continues with its quantitative easing programme to prevent higher borrowing costs weakening the recovery that we hope to see later in the year," says Steve Radley, EEF's Chief Economist.

Industrial production, however, appears to be close to turning round. In the US, the manufacturing index of the Institute for Supply Management (ISM) rose by 2.7 percentage points in May, the fifth consecutive monthly rise. This shows that the US's battered factory sector is scaling up orders and production. At 42.8 percent, the purchasing managers' index (PMI) still indicates manufacturing is contracting for the 16th consecutive month, according to the ISM Report on Business, but the measure has reached its highest point since last September. "The index has risen rapidly after bottoming at 23.1 percent in December," says Norbert Ore, Chairman of the ISM's survey committee.

A composite measure of factory activity in the US, Japan, Germany, France, the UK, China and Russia also shows that manufacturing declined at its slowest pace for nine months in May. The global index, produced by JP Morgan, rose to 45.3 in May, up from 41.8 in April.

Picture: Getty images

China's vast manufacturing sector appears to be recovering rapidly after a downturn that cost an estimated 20 million jobs. The sector expanded for the third consecutive month in May, according to the country's PMI. Indeed, emerging Asia will again be the world's fastest-growing region between 2010 2013, predicts the EIU, reflecting strong growth in China and India.

Rogers argues that the trend will endure far longer than the next four years. "The 21st century is going to be the century of China," he says. "It is time to teach your children Mandarin."

Emerging Asia to lead global trade

In the short term, the contribution to world trade made by China will not help to reverse the downturn. Global trade will shrink by 8.2 percent in 2009, as all regions of the world experience a recession simultaneously. The financial crisis has also reduced the availability of trade finance. However, according to several surveys of exporters, this has been only a secondary factor in the downturn in trade, and government intervention has reduced the strains on trade finance to some extent.

Growing protectionism is exacerbating the situation. A World Trade Organisation report, published in March, stated: "The danger is of a build-up of restrictions that could strangle international trade and undercut the effectiveness of policies to boost demand and restore growth globally."

The G7 has stressed the need for a concerted effort to avoid protectionism, following growing discord over the Buy American clause in the US stimulus plan, and measures by individual European governments to shore up particular industries and banks.

Global trade will remain weak in 2010, growing by just 1.3 percent as a result of tepid growth. An average growth rate of more than 5.0 percent in world trade between 2011 and 2013 will be driven by much faster growth in developing countries, as they continue their integration into the global economy. Emerging Asia is expected to see the fastest rates of export growth, led by China, the exports of which will recover relatively quickly. However, China's performance will not match the spectacular growth rates of recent years, when foreign sales rose regularly by more than 20 percent a year.

Commodity prices to surge

Global trade has a direct impact on, and is also affected by, the price of commodities. Oil prices, which sank from a high of US$147 a barrel in mid-2008 to just US$32 in February this year, are now rising steadily. The market has chosen to brush off data showing the accumulation of stocks and weak demand, and has instead focused on nascent signs of improvement in economic data releases, particularly from the US and China. This optimism has led to some return of investors' appetite for risk, which has boosted commodity prices.

The EIU expects a rise in agricultural prices, owing to an ongoing structural shift upwards in demand given the growth in emerging-market consumption – particularly for livestock feed – and the impact of biofuels production.

"The 21st century is going to be the century of China. It is time to teach your children Mandarin"

Jim Rogers, veteran investor and co-founder of the Quantum Fund

Rogers, a renowned commodity bull, believes commodities are the only asset to show an improvement in fundamentals. "Farmers can't get loans for fertilisers now, even though inventories of food are the lowest in decades," he notes. "No one can get a loan to open a mine. So supplies of everything will continue to decline."

Service providers will diversify

The impact on services during the recession is expected to be severe, given that so much of the service sector has developed alongside banking and capital markets, where much of the pain is concentrated. Indeed, ISM figures show the US service sector, which represents about 80 percent of the country's economic activity, was still contracting in May, albeit at a slower pace. The index rose to 44, from 43.7 in April – any number below 50 indicates contraction.

In Europe, 39.5 percent of service providers expect business volumes to improve in the next 12 months, with 21.5 percent forecasting a decline, a positive balance of 18. This is far higher than the -2.9 figure last October, but is still well below the +30 level a year ago.

Most service providers expect to cut prices, a move that would put downward pressure on profits. "There are simply fewer clients now, and they want to pay less," says Sir Nigel Knowles of DLA Piper, an international law firm with more than 68 offices worldwide. "Lehman Brothers, for one, spent hundreds of millions of dollars on legal fees in 2007, but it's not around any more."

DLA Piper, which achieved a 16 percent increase in turnover in 2008 despite the turmoil in capital markets, believes that the way for service firms to ride volatility is to have a diversified business model, both by location and service line. "If you have a niche in London or in corporate finance and capital markets, your business model may be stressed at present," confirms Knowles. "Those areas of our business are way down on last year. But, at the same time, we are doing a lot more in China and Continental Europe, and we are more active in restructuring, intellectual property, litigation and regulatory work."

The firm is continuing to invest and expand in areas where it feels growth will be highest. It has focused particularly on China and Middle Eastern countries, including Kuwait, Qatar, the United Arab Emirates and Saudi Arabia. Although this is partly predicated on rising oil prices, Knowles believes that the perception that globalisation has been dealt a blow by the crisis is overstated. He notes that a number of companies, such as Barclays with its purchase of Lehman Brothers' assets, have taken the opportunity to expand globally by investing in cheap or distressed assets, and they expect their service providers to match their ambition. "We need to prove to company general counsels that we can cover all areas and business lines," he says. "That way we can win business by saving them money."

The future

The risks to the global economy remain exceptionally high. The most benign outcome is that governments' efforts to reflate will produce a recovery that can be managed by reining in the supply of cash and by steadily increasing taxes before the economy overheats.

"This is a delicate balancing act, and there are concerns that the massive liquidity injections could prove inflationary," cautions the EIU's Robert Ward. Policymakers, at least in the major advanced economies, will be on their guard against renewed inflationary pressures.

The most serious concern is that the stimulus packages will not be sufficient to trigger autonomous recovery. As government fiscal positions deteriorate, they may not be able to continue to support reflationary efforts, and an increasing number may be forced to tighten fiscal policy in order to avert a sovereign crisis.

Although the fiscal stimulus already in place will provide a temporary boost, the risk is that the global economy will fall back into decline once it fades. Alternatively, policy measures to stabilise financial markets may simply fail, causing a renewed deepening of the financial market crisis.

Knowles believes a benign scenario is plausible. "Individuals and companies are coming to the point where they believe there is little point in putting money in the bank, particularly given the low rates of return," he says. "They are not going to sit around forever, and that is what we are seeing. Business is starting to move again." R

Bridging the support gap

If a consensus can be forged between a company and its creditors, a Company Voluntary Arrangement can help to keep the business trading.

Picture: Getty images

When British retailer JJB Sports secured an agreement with its creditors in April, the significance of the deal went far beyond the company's successful efforts to avoid administration through a Company Voluntary Arrangement (CVA). There was a lot at stake. To avoid administration, maintain the business as a going concern and save more than 7,000 jobs, JJB and KPMG in the UK had to convince a range of retail landlords to support a plan following the closure of 140 stores. Furthermore, some landlords would be affected financially, as JJB was seeking to reduce its liability on the shops that had been closed down.

The success of the deal was by no means a given. JJB proposed to honour the rent in full on the 250 shops that remained open, albeit paying monthly for a limited period rather than quarterly in advance. However, for those that had been closed, JJB was offering £10 million compensation – the equivalent of six months rent. Normally, full rent would be payable for the entire period remaining on the lease.

There was a sweetener, however, as Richard Fleming, Head of Restructuring at KPMG in the UK, explains. "The broad terms of the leases would stay intact, as JJB was offering to pay the business rates until the properties were re-let," he says.

In the end, 99.7 percent of the landlords agreed to the proposal and the deal was cemented by a CVA. This was an achievement in itself, but the successful outcome also represented a first in UK insolvency. "Never before had there been an insolvency process on a fully listed plc with no suspension of shares," says Fleming. "That provided clear evidence that an insolvency process could be part of a rescue process."

Behind the CVA

The JJB deal also highlighted what is possible under the umbrella of a CVA. A CVA is a binding contract between a company and its creditors, under which those that are owed money agree to a debt restructuring plan. To set up a CVA, 75 percent of creditors who vote (as measured by money owed) must be in favour. If that threshold is met, the arrangement is binding on all unsecured creditors.

To date, CVAs haven't proved popular with creditors. According to the UK's Insolvency Service figures, the process was only used 587 times in 2008, compared with 3,000 administrations. That's partly because the first hurdle of securing enough creditor support can be a difficult one to jump.

"A CVA can't alter the rights of secured creditors," says Richard Heis, a partner in KPMG in the UK's Restructuring practice. "So unless you get all their support, it won't work." Equally, the 75 percent threshold for all unsecured creditors who vote can be hard to achieve.

management team, the chances are that resignations from the board will be required if the CVA is to succeed.

Improving operations

A CVA can also drive change, as those owed money are unlikely to give their support unless the factors leading to the company's financial problems are addressed. As Heis observes, creditors can play a key role in helping to solve any operational issues that are affecting performance. "By reaching agreement on the money they are owed, they are facilitating a financial restructuring," he says. "But they can also help with operational restructuring."

> **"Never before had there been an insolvency process on a fully listed plc with no suspension of shares"**
>
> **Richard Fleming**, Head of Restructuring, KPMG in the UK

The circumstances can also be critical. "CVAs can work if there's time to get an agreement. If you're faced with a burning ship, it can be difficult," adds Heis.

However, in the right circumstances, a CVA can offer real benefits. Contracts and suppliers often fall away when a company goes into administration. Avoiding this puts the business in a better position to carry on trading and maintain its market position. A deal that is agreed outside of administration has the potential to preserve both the company itself as a legal entity and the business. In contrast, when a company is sold out of administration, it will emerge as a new legal entity.

That's not to say there won't be casualties. If creditors analyse the situation and conclude that a company's problems were caused in full or part by the actions of the

Fleming predicts CVAs will become more common among larger corporates, particularly if the UK Government presses ahead proposals to allow a moratorium on debts during the negotiations with creditors. Currently, only very small companies can apply for a moratorium to protect themselves from creditors ahead of a binding agreement.

A change in the law would help to give businesses and administrators more time to come up with proposals, which would widen the scope for using CVAs as a corporate rescue tool. "A moratorium would provide a boost for the use of CVAs, resulting in them being a credible alternative to 'pre-pack' administrations," says Fleming.

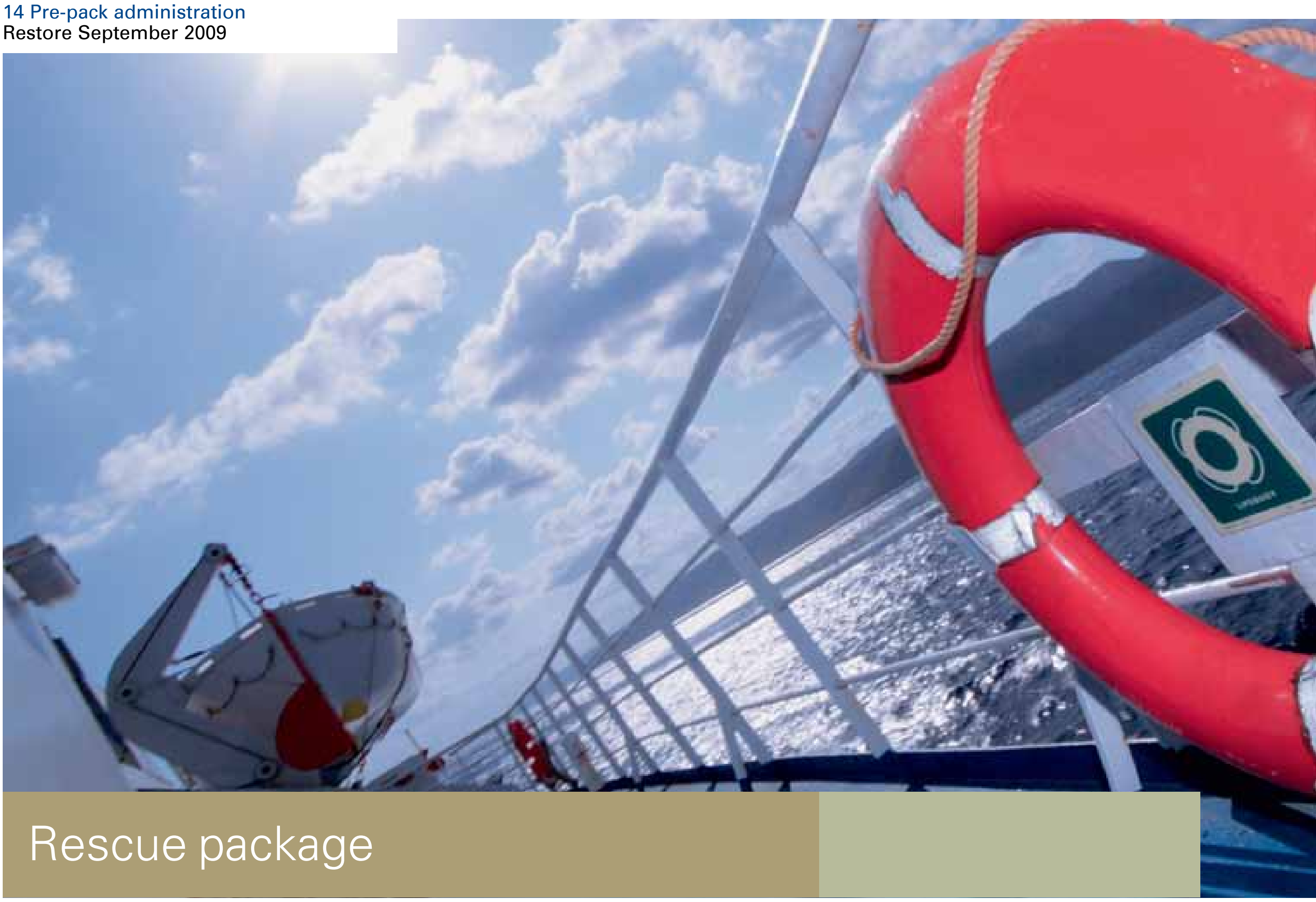
Richard Fleming
Head of Restructuring,
KPMG in the UK
richard.fleming@kpmg.co.uk

Schemes of Arrangement

Schemes of Arrangement provide an alternative to Company Voluntary Arrangements.

Essentially they are agreements between a company and its creditors or shareholders. As with CVAs, they are binding agreements that can be used to keep a business trading after an agreed financial restructuring. However, they can also be used to tie shareholders into deals on other aspects of corporate activity, such as takeovers or the cancellation of shares.

Schemes of Arrangement can be unwieldy, as voting rights are assigned on a class basis, which can be complex. In addition to the UK, they are used in areas, such as the Caribbean, where local law is derived in part from the British Legal System.



Rescue package

As the recession continues, a rise in pre-pack administrations in the UK has raised fears over so-called phoenix deals. But as *Restore* discovers, pre-packs can actually be an important restructuring tool.

Every so often the arcane language of the business professional passes into common usage. Prior to the summer of 2007, few people outside the banking community had heard of the sub-prime mortgage. However, as the crisis in the financial sector unfolded, those words became shorthand for lending practices that threatened the global economic system.

The term 'pre-pack administration' may not have quite the same resonance, but in the face of a deepening recession, growing numbers of people outside business and finance have become aware of a procedure that is increasingly being used to rescue struggling companies in Britain.

The appearance of the words 'pre-pack' on the front pages of the UK's national newspapers has coincided with a wave of high-profile insolvencies, notably in the retail sector. As the banking crisis evolved into a full-blown recession, retailers were among the first to suffer, and some of the most prominent names on the British High Street were placed in the hands of administrators. A few, such as Whittards of Chelsea, Oasis and Warehouse, were sold through pre-pack deals.

Planning ahead

Throughout 2008 and 2009, the use of pre-packs has been burgeoning across just about every industrial sector, and it's not hard to see why. When a company collapses into administration, insolvency professionals are working against the clock in a bid to secure the sale of the business or its assets before too much value is destroyed. Under a pre-pack arrangement, negotiations for the sale take place in advance of the company being declared insolvent.

When a deal is agreed, the business is placed in administration and sold shortly afterwards. Following the sale, the management team can then work free of any liability to pay off the old company's creditors. But the growing use of pre-packs has raised concerns at the highest level. In May, a report from the House of Commons Business and Enterprise Committee attacked pre-packs. It claimed that they were damaging to the interests of unsecured creditors, which were often told nothing about impending deals until debtor businesses were placed in administration and then sold in a fait accompli. The committee called for further action from government to prevent abuses of the system.

According to Richard Heis, a Partner in KPMG in the UK's restructuring practice, creditors do have some legitimate concerns, particularly in the case of many so-called phoenix deals. This is when a business emerges from administration as a new company under the old management team and the same ownership. "Unsecured creditors aren't aware of what's going on ahead of the pre-pack," he explains. "But they see a management team rising from the process unscathed, while they are taking a financial hit."

However, Heis recommends not tarring all pre-packs with the same

Picture: Shutterstock

"There are some businesses – very often people businesses – where two or three weeks in administration would bring about a collapse"

Richard Heis, Partner, KPMG in the UK

brush. Often, shares in a holding company or the assets of companies within a group are transferred to third parties. This can save the business (or parts of it), while avoiding the suggestion that incumbent managers or owners will carry on as before, as unsecured creditors suffer. Despite the controversy surrounding phoenix deals, transacting a sale back to the original management can often be the best option. For many creditors, maintaining a trading relationship helps compensate for writing off debts.

The potential benefits of pre-packs

Heis also argues that, in the right circumstances, pre-packs can be an important restructuring tool. For instance, pre-packs are particularly useful when an extended period spent in administration would prove fatal to a company. "There are some businesses – very often people businesses – where two or three weeks in administration would bring about a collapse," says Heis.

Pre-packs can also prove useful when the enterprise value of the company is lower than its debts. "Selling the business is not possible in a normal corporate finance transaction as there is no equity," says Heis. "In these cases, it is often better for creditors to go ahead with the sale, and the best way to do this is through a pre-pack."

Once an insolvency practitioner has been appointed, the secured creditors will be closely involved with the negotiations. Their view of how best to protect their own interests will dictate whether or not a pre-pack arrangement is desirable or feasible. As Heis acknowledges, "unsecured creditors will usually have no input" in this process.

However, the administrator has a responsibility to get the best deal for all creditors – secured and unsecured. What's more, under the recently introduced SIP 16 practice statement, insolvency practitioners must provide a detailed account of why they opted for a particular deal. "SIP 16 tries to think of all the questions that creditors will want to ask, and requires a comprehensive disclosure from the administrator," says Heis. He adds that this transparency assures creditors that administrators are acting in their best interests.

US comparisons

A key theme of the UK Government's approach to insolvency has been a desire to balance the interests of creditors against those of other stakeholders, such as staff. Vehicles such as pre-packs and Company Voluntary Arrangements (CVAs) have proved effective as rescue tools. However, as Heis points out, the UK system contrasts with that of the US, where Chapter 11 legislation means companies can use insolvency as a shield from creditors during restructuring. In terms of facilitating corporate rescue, Chapter 11 is often held up as an example for other jurisdictions to follow, but it can lead to frustrations for creditors, especially when they don't trust management.

It's unlikely the UK will move in Chapter 11's debtor-friendly direction. As Heis says: "Chapter 11 is a creature of the US legal system. To graft it onto the UK's, which is very different, would not work." However, while the British system is tipped towards the creditor, pre-packs offer a way to rescue going concerns, while CVAs provide breathing space for existing companies to restructure.

According to Heis, the outlook for the CVA is very positive and it is likely to become the preferred rescue tool. However, it will not be suitable for every case, and where decisive action is needed to preserve value, the pre-pack can still have its role to play. R

Richard Heis
Partner, KPMG in the UK
richard.heis@kpmg.co.uk

kpmg.com

Published by Crimson Business
Publication name: Restore
Publication number: 906-071
Publication date: September 2009