

HONG KONG APPROACH TO CORPORATE DIFFICULTIES

In April 1998, the Hong Kong Association of Banks (HKAB) issued guidelines codifying the principles governing corporate debt restructuring and workouts. These have been recently been revised and extended and re-issued in the form of joint guidelines by the HKAB and the HKMA. The text of the guidelines is reprinted below. The HKMA is a strong supporter of the guidelines and is prepared to act as a mediator if differences of views threaten the successful conclusion of a workout.

Introduction

- (a) This Approach to Corporate Difficulties is issued jointly by the Hong Kong Monetary Authority (“HKMA”) and The Hong Kong Association of Banks (“HKAB”). It consists of formal but non-statutory guidelines covering how institutions should deal with borrowing customers in difficulties where the borrower is dealing with multiple banks. There have been many instances where the constructive approach suggested below has made possible the survival of businesses which otherwise would have failed. Although compliance with the guidelines is voluntary, the guidelines are strongly supported by HKMA and HKAB, and they would expect all members of HKAB to use their best endeavours to follow them on the basis that they represent accepted practice of the banking community.
- (b) The stakeholders in a business can comprise its shareholders, directors, employees, creditors (including bankers, bondholders and suppliers) and customers. It is in all their interests that the business should survive if there is a reasonable possibility that it may be viable. Only where there is not or where it proves difficult to form a view should it be liquidated. All concerned will prefer the borrowing company’s bankers to opt first for a work-out (a process whereby, a borrower having acknowledged that it is in financial difficulty and working in co-operation with the banks is nursed back to health by the addition of

capital or re-scheduling its debts). Other creditors will have to co-operate by not demanding repayment.

- (c) This revision replaces the previous edition of the Guideline issued by HKAB dated 3.4.98 (S/98/067).

Underlying Principles

- (a) When it becomes generally known that the borrower may be experiencing financial problems, banks’ initial attitude should be one of support. They should not withdraw facilities or hastily put the borrower into receivership, or issue writs demanding repayment. Instead they should endeavour to ensure that the borrower has sufficient liquidity to continue trading until a considered view of its prospects can be reached.
- (b) Further decisions should only be made based on information that is reliable and shared fully with all banks. It is the responsibility of the borrower to make information concerning its affairs wholly available to the banks.
- (c) The decision to offer the borrower financial assistance — or not — should generally be a collective one by banks.
- (d) The later stages of a corporate collapse can be rapid and it is essential that all banks act in a co-operative and expeditious manner in order to agree a restructuring plan.

Implementation

Work-out-General

- (a) The underlying objectives of any work-out should be to enable well-informed decisions to be reached on a borrower's long term future, that no bank gains an unfair advantage over the other banks and to obtain for banks and the borrower the best deal that can be achieved.
- (b) The work-out will need unanimity. Where however a clear majority of banks is agreeable to a stand-still and/or work-out, other banks should carefully review their position and explain their objections clearly. Banks should be aware of the need to work to the overall good of the banking group rather than purely individual interests in the knowledge that if they fail to co-operate in a work-out, they may suffer a similar disadvantage if in a subsequent case the roles are reversed.
- (c) As part of the stand-still process, and in order to consider any work-out arrangements, banks will normally require an assessment of the borrower's position by independent financial advisers.
- (d) The arrangement between banks must provide a mechanism for enforcing any "breathing space" for the borrower which is initially agreed. During this period, the banks may agree to a stand-still on repayments of principal and possibly also of interest to allow the borrower to formulate a restructuring plan, assuming that the borrower appears salvageable. In exchange for such an agreement the borrower should accept restrictions on his business activities and should agree to the monitoring of cashflow.
- (e) Banks should liaise, where appropriate with other financial creditors involved in the work-out, e.g. bondholders and holders of commercial paper.
- (f) A careful watch must be kept on costs. The expenses of a work-out, e.g. for advisers and banks, should properly be for the account of

the borrower but banks should take care that they are reasonable.

- (g) The demands on the borrower for information must be reasonable.
- (h) Any conflicts of interest within banks e.g. a bank acting as an adviser to the borrower should be declared openly and promptly.
- (i) Banks' personnel handling work-outs should be familiar with these guidelines and adequately senior to appreciate the underlying issues. Preferably banks should have a dedicated unit handling work-outs. There should be internal procedures in place so that responses required from offices outside Hong Kong can be obtained in a timely manner.
- (j) Confidentiality should be maintained by all parties during the course of a work-out.
- (k) Care should be taken in relation to listed borrowers to avoid breaching securities laws.

Role of the lead bank and other banks

- (l) The role of the lead bank in a work-out is of prime importance. It should lead but not dominate excessively. It must ensure the provision of adequate information to all the banks involved on a basis to be agreed. The lead bank should be remunerated for this task by the borrower.
- (m) Correspondingly other banks must be constructive and play their part by participating in meetings and providing comments promptly.
- (n) The banks should be prepared to provide an indemnity to the lead bank and/or steering committee members to indemnify them against expenses and liabilities arising from negotiations in good faith. This indemnity should be agreed by banks in the early stage of negotiations with the borrower, to enable the restructuring to move forward quickly. A standard form of indemnity is set out in the Appendix.

Role of the Steering Committee

- (o) For larger lender groups, it may be useful to consider establishing a steering committee which should be chaired by the lead bank. This can facilitate communications and provide quicker, representative feed-back than consultation with the entire group. It may also be the body to enlist expert assistance, e.g. of financial, legal or technical advisers or investigating accountants. The steering committee may need to make decisions without consulting banks but no action to implement such decisions should be taken without prior ratification of the relevant decisions by all banks. Neither the lead bank nor the steering committee will have the capacity to bind any individual bank to any course of action unless otherwise agreed.
- (p) The steering committee should consist of a small number of banks who have sufficient staff and experience to undertake this role.
- (q) When the steering committee recommends a restructuring plan to the banks as a whole which wins the support of the majority of banks, every effort should be made to resolve differences within the banking group. If following all such efforts agreement has still not been reached, the steering committee may exceptionally request mediation from the HKMA. All approaches to the HKMA should be made as far as possible through the lead bank.

Role of the financial advisors and/or investigating accountants

- (r) Reputable financial advisers and/or reputable investigating accountants should be appointed by the banks or the borrower when necessary but in all cases at the cost of the borrower. Such persons should have no conflicts of interest, e.g. investigating accountants should be other than the borrower's auditors. Duties of the financial advisers and/or investigating accountants will be set out in a mandate letter, and should normally include but not be limited to the following aspects :-

- (i) Reviewing and evaluating the financial information, business forecasts as well as the cash-flow analysis etc. as provided by the borrower on an agreed basis;
- (ii) Providing an investigation report or situation analysis of the borrower;
- (iii) Preparing a liquidation analysis of the borrower and providing a basis for the banks to assess the restructuring plan put forward;
- (iv) Advising the banks on any restructuring plan;
- (v) Reviewing the financial monitoring system of the borrower and reporting thereon to the banks;
- (vi) Providing a cash monitoring system to protect the interests of the banks; and
- (vii) Maintaining transparency between the financial advisors and/or investigating accountants and the banks.

Provision of new money

- (s) Borrowers may require new monies, either to support their business going forward, or to achieve a more orderly wind down of their business. New money is defined as any increase in drawings or contingent liabilities that the bank allows over that outstanding as at the date of the calling of the initial meeting of all banks. Banks should consider the provision of new money if they believe the requirement for new money may be commercially sound.
- (t) Acknowledging that the need for new monies is sometimes urgent, new monies may be provided bilaterally by a bank to the borrower, and this bank may take a charge over unencumbered security, so long as by so doing the bank does not prefer itself in relation to other lenders in respect of old monies it has advanced.

- (u) In the absence of unencumbered security banks may also consider providing new money against a priority charge over security already pledged or other arrangements acceptable to all the banks. This priority would only apply to new monies advanced and interest thereon. Within a stand-still the terms for the provision of such new monies, including priorities as to payment and security, must be agreed with the borrower and all banks.

Obtaining a preferred position


- (v) No bank should try to obtain a preferred position after the borrower or bank or group of banks have communicated their request for a formal or informal stand-still. Fair treatment to all banks should apply to the payment of interest, repayment of principal or obtaining of security as well as the provision of information, either from the company or its shareholders. Any benefit as a result of a preference obtained by a bank during a stand-still should be equitably shared among the banks as a whole. Banks should not seek an unfairly high interest margin, including default interest, which is not beneficial to the conclusion of a restructuring. Banks are entitled to charge fees for rescheduling debt or providing new monies. The payment of fees should have due regard to the available cashflow of the borrower, and may therefore become payable once the rescheduling has been successful.

Miscellaneous

- (w) The sale of debt to a third party can be positive and can provide an exit for unwilling lenders. However, care must be exercised regarding such sales of debt, particularly to parties who have not been involved, previously. Sellers of debt should ensure that the buyers are aware of the guidelines in place and that they will be expected to adhere to them.
- (x) On the suspicion of criminal activities of the borrower or its shareholders, the banks should share information and act quickly to enable a fruitful investigation by the

authorities, including but not limited to the SFC, the CCB and the ICAC.

Role of the Hong Kong Monetary Authority

The HKMA is a strong supporter of the work-out concept and of the above guidelines. The HKMA will, in appropriate circumstances, if requested, try to help resolve differences of views which threaten a work-out and the achievement of an acceptable compromise by acting as a mediator between the parties involved. In this connection, the HKMA is prepared to listen to any involved party, irrespective of size or national affiliation. 

FORM OF INDEMNITY TO LEAD BANK/STEERING COMMITTEE

From: [Banks]

To: [Lead Bank/Members of Steering Committee]

Dear Sirs,

Re: [] (the “**Borrower**”)

We understand that you are prepared to act as [the lead bank] [a member of the steering committee] in relation to the proposed restructuring of the Borrower.

In consideration of your agreement to act in this capacity, each of us agrees severally to indemnify you and hold you harmless from and against all liabilities, losses, claims or demands which may be incurred, suffered by or made against you as a result of actions bona fide taken by you in your capacity as [lead bank] [a member of the steering committee] [Provided that you will not voluntarily incur a liability in excess of HK\$[] without our prior written consent].

Our liability hereunder is several and is in proportion to the amount which each of our outstandings to the Borrower bear to the total outstandings of the Borrower.

This letter shall be governed by the laws of the Hong Kong Special Administrative Region.

Yours faithfully,