



Dealing with China-related NPLs and Investments: Strategic Considerations

Client Alert 1—The Starting Point

Over the last ten years, Chinese companies have lent and invested extensively outside of China. A number of these off-shore investments have under-performed or even failed, raising concerns amongst banks and creditors but also creating opportunities for investors. This series of alerts discuss key considerations when dealing with such non-performing investments, the challenges and opportunities they present, and some of the innovative and practical solutions that in our experience will make a real difference to investors, lenders and creditors.

Introduction

The measures in recent years to curb the informal shadow banking sector in Mainland China and to improve market discipline has led to greater urgency in resolving difficult and long-running non-performing situations. Recovering loan and investments outside of China, however, can present additional challenges compared to purely domestic recoveries.

For example:

- there will often be complicated cross-border questions. For example, the investment may be in a Chinese business, held by a Caribbean holding company, with some assets outside China, and potentially listed in Hong Kong;
- the structure may not be a straightforward loan; it may be a bespoke equity or pseudo-equity investment or may involve complex funds structures;
- the management of the borrower may be uncooperative; and
- it may be difficult or even impossible to obtain information about the investment from public sources.

The scenarios we have encountered are varied, but they share common features. In this first alert, we look at:

- the early warning signs of an investment that may become distressed; and
- the core actions that can significantly improve recovery opportunities.

Early signs of trouble

A default or non-payment of interest/coupon is rarely the first sign of trouble. Other factors to look out for include:

- a sudden and unexpected slowdown in business - such as we are currently seeing with the COVID-19 outbreak;
- an over-stretched business that is heavily dependent on liquidity;
- delay in producing accounts;

- stress in other parts of the business under the common control of senior management;
- sudden changes to the board of the borrower, particularly resignations of key executives;
- a slowing down or even stopping of the information flow from the borrower;
- unexplained or not fully-explained connected party transactions, possible rumours of dishonesty or regulator interest in the company; and
- an important transaction fails to complete or is delayed.

Time is of the essence

The warning signs need to be recognised and addressed in a timely manner. Speed is not always feasible for internal or external reasons, but grasping a problem early has real advantages. In particular, any delay may not only narrow the options available but may often reduce total recoveries.

The initial steps: a roadmap

Recovery efforts without a carefully considered roadmap from the outset can be highly inefficient and can lead to disappointing, if not disastrous, results. The assessment process should begin at the earliest possible moment and normally involves the following key initial steps.

1. Review your transaction documents

The first port of call will usually be the terms of the transaction documents. There are at least five initial key questions that ought to be considered:

- **Do you have all the relevant documentation?** In our experience, one familiar problem that is only discovered when something goes wrong is that you may not have all the relevant documents. Proactively dealing with document or information gaps is something we will address in a later alert.
- **Are the parties' rights and obligations clear?** Our experience with China-related contracts suggests that transaction documentation can often be defective and imprecise, which underscores the importance of an effective roadmap to overcome such challenges.
- **Has an event of default or other trigger event occurred?** Checking this is not always straight-forward, because default clauses can be extensive and heavily-negotiated in complex transactions and may need to be analysed together with other relevant clauses, eg, grace periods, cross-defaults and materiality thresholds of breaches of the transaction documents.
- **What jurisdictions and laws govern the transaction documents?** In offshore investments, there is the potential for a complex web of different jurisdictions and laws. Understanding which laws/jurisdictions are relevant is important as your rights and the procedural tools under different laws/jurisdictions vary considerably. When multiple laws/jurisdictions are at play, there will be risks of parallel proceedings and challenges in coordinating the enforcement efforts, but also opportunities for strategic leverage. We will discuss this topic in greater detail in our next alert.
- **Are there any immediate steps to take to protect your position?** This may include issuing a default notice, refusing further drawdowns under a facility, or accelerating outstanding debt. You will want to avoid waiving (inadvertently or otherwise) rights that may arise from the borrower's default or non-performance.

2. Assess your security package

Next, assess the security package under the transaction. The parties may have created security interests over real estate, other physical property, financial instruments, claims and receivables, and intellectual property, or over all assets of an entity (ie, a floating charge). The security package may also include guarantee or quasi-security (eg, sale and leaseback, factoring).

Generally, for any security, you should check:

- whether the security has been duly perfected under applicable laws;
- whether all preconditions for enforcing the security have been fulfilled;

- what procedures are to be followed to enforce the security – in particular, whether self-help without involving the courts is an option;
- whether the security is sufficient to cover the exposure;
- what jurisdictions are involved, the practicalities of enforcing your rights in multiple fora, and which fora to prioritize;
- whether urgent injunctive relief is necessary; and
- whether it is necessary and possible to obtain additional securities.

Guarantees are also commonplace, although a frequent challenge is ensuring the guarantor is still good for the money, if all their businesses are struggling and over-leveraged. A particular dilemma for our clients is ensuring they act early enough to enforce their rights (before too many creditors emerge), but not jumping the gun if the businesses can still be salvaged. Personal guarantees can also offer real leverage in a distressed situation and assessing their strength should be a priority in any enforcement process.

3. Get to know the position of the other creditors

It is also important to understand your relative position against other creditors or shareholders. That can inform critical decisions regarding recovery options and timing.

This involves:

- obtaining information on the borrower's other debts;
- monitoring the protective and enforcement measures taken by other creditors or potential judgment creditors; and
- considering the possibility and benefit of cooperating with other creditors.

4. Evaluate and prioritise your options

The findings from all the above steps will then feed into your case assessment and recovery planning. In most scenarios, you will likely have numerous options, as well as choices on whether to pursue such options concurrently or sequentially. Weighing up:

- the legal and other costs;
- the chances of success;
- the speed of the proposed approach;
- any collateral consequences; and
- other factors such as publicity,

for each option is the most effective way to formulate a recovery roadmap. Of course, the roadmap should be under constant review as the situation evolves.

Coming up ...

In our next alert, we discuss jurisdictional issues, including how more jurisdictions than you expect may become relevant, why you should consider forum shopping for some enforcement options, and how to coordinate cross-jurisdictional recovery efforts.

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