

Public Debt

Due to legislative omissions and a lack of case law, investors cannot collect their corporate bond receivables

Ivana Bliznakova, July 3th, 2010, Capital newspaper

Individuals and companies act quite similarly when facing financial woes. Most are punctual and do everything they can to pay their dues; sometimes, though, they are unable or unwilling to do so. That is why banks have different tools to guarantee credits are paid back: collateral, surety, etc. These methods have been established in statutory and case law so that banks can effectively claim their receivables.

When it comes to corporate bonds, the procedure has not been established as firmly. Corporate bonds are a comparatively new way of financing that blossomed during the few years before the economic crisis. Many companies issued such bonds which attracted institutional investors (especially pension funds) with a higher yield on deposits. However, many companies are currently experiencing difficulties paying back their debt. Some of the issuers renegotiated their agreements or requested a rescheduling, but others went into default (see attached table 1). Both companies and investors faced the underdeveloped legal framework for bonds and the lack of relevant case law. Along with mistakes made during the conclusion of the contract, these conditions seriously hamper the ability of bondholders to collect their receivables and underline the necessity of a legislative overhaul.

The Paths of Protection

Of bondholders when issuers have not done the required payments are two: individual enforcement proceedings that sell the assets of the company (if there are any left) or insolvency proceedings.

An individual enforcement proceeding can develop in two ways. In the first option, bondholders (or the bondholder' trustee chosen to monitor the financial health of the debtor and protect the interests of the creditors) request in court an enforcement order and a writ of execution. Then, in a relatively short period, the issuer sells as much (or all) property that is necessary to cover the required payments towards the creditors. The other option – safer when it comes to unsecured bonds and lasting much longer – is a precautionary proceeding. It involves imposition of a preventive attachment of a corporeal immovable and a garnishment of receivables and other assets, which are followed by a court case. Both options have their positives and negatives and must be carefully considered by bondholders and their legal consultants before being accepted as a final strategy.

During insolvency proceedings, the goal of bondholders is primarily to get involved in the company's management and, if at all possible, to craft a plan for the reorganization of the issuer. As a part of this plan, the bondholders can even consider selling all the business activities of the issuer, since it is in their financial interest for the company to get healthier and continue generating yield on bonds, not stop production and disappear. That is why I advocate for a change in the Law on public offering of securities that will enable a pledge on business to be established as bond collateral. In this way, bondholders, through the bondholders' trustee, can undergo the sale of business of the issuer in a quicker, cheaper, and more direct way; in addition, the unwieldy and unclear insolvency procedure gets avoided.

So far, there are no indications of bondholders who chose the first path of protection. The bondholders of “Alen Mak” and “Royal Potatoes” decided to request that insolvency proceedings begin. The management team of “Alu Plast” assessed that the company was financially destabilized and requested, by its own volition, that insolvency proceedings begin.

One of the first

Gaps in the Law

That companies often exploit during insolvency proceedings is the lack of an explicit definition in the relevant regulations of a corporate bond as a commercial transaction. In order for the issuer company to be declared insolvent (the quickest way to be declared bankrupt), there must have been an overdue receivable from a commercial transaction related to its business activity. Even though legal theory strongly argues that a corporate bond can be viewed as a commercial transaction, until that supposition can be grounded in longstanding case law, issuer will only be able to speculate on the matter.

Another ambiguity common to both pathways of protection and to the transfer of bond obligations in general, relates to the unpaid interest on a past period for an investor who has already sold his bond. In the financial world, it is quite obvious that the unpaid interest is owed by the issuer company to the investor. Legally, however, that is not the case – since interest is an ancillary to the principal, it is always transferred together with the principal, unless otherwise negotiated. Therefore, legally speaking, if a bond is sold with an ordinary exchange deal, the first bondholder transferred not only the principal on the bond, but any unpaid interest still left. In this case, that bondholder is not allowed to participate in a trial against the issuer company and is not, legally, a creditor of the company, despite the unpaid interest.

Nevertheless, there is a possibility in the current legal framework for the first bondholder to preserve the unpaid interest payments and to get involved into a court case against the issuer company. This is called a cession contract and establishes that the first bondholder only transfers the principal and any forthcoming interest payments. It is clear that the speed and procedures which characterize exchange transactions (where most of the time the seller does not know who the buyer is) make the signing of such a cession contract virtually impossible. Therefore, I recommend that appropriate technical decisions are made and the rules of the regulated market and the depositary institution be correspondingly amended so as to facilitate the option of a separate transfer of interest and principal. This can be done simply if, say, the order/confirmation documents that investment intermediaries use for such transactions contain a box that allows a choice: does the transfer include principal and all forthcoming interest payments or principal and all interest payments, including past ones that have not been paid yet. The regulated market and the depositary institution can then reflect those circumstances of the sale. Otherwise, fund manager ought to be obligated, when selling bonds, to calculate in the price of the transaction the potential for the owed interest payments to be collected.

Special attention must be given to the provisions regulating the decision-making process of bondholder meetings. The current legal framework redirects towards the quorum and majority conditions of shareholder meetings. Since most funds, pension insurance companies and other bondholders hold smaller packets of bonds, it would be better, having these minority bondholders’ interest in mind, to have greater required majorities for decision-making. This way, the participation of these smaller bondholders is ensured and their voices are heard when important decisions – such as payment rescheduling, permission to issue another emission of bonds, and others – need to be made. In the meantime, while

such greater levels are not required, bondholders of future emissions would do well to request that issuer companies include specific dispositions – in the company statute and/or the prospectus – related to this problem.

Around 10% of public bonds are insured for non-payment of interest and principal by the issuer company (see table 2). This is an additional measure of protection for investors, but even it cannot fully guarantee that receivables will be collected. Covering large loans would constitute a major cost for insurance companies, so they have the incentive to look for legal loopholes that allow them to refuse or reduce insurance claims that arise from a failure to pay back parts of a bond. Therefore, it is advisable that bondholders perform a proper legal analysis of their insurance contracts, so that the insurance companies can be notified in case of a “red flag” event, and the opportunities for a denial of claims are reduced.

When you cannot trust the bondholders' trustee

With secured bonds (where a real estate mortgage has been established, there is a pledge of receivables or other assets of the issuer company, or there is a concluded insurance), bondholders have an additional layer of professional protection from the bondholders' trustee (in Bulgaria trustee may be only licensed bank). The bank must analyze the given security and request that it be backed up further at certain conditions. The bank must act not only with the care of a good merchant, but in the best interest of the bondholders as well.

It would be intriguing to observe the development of the cases where the bondholders' trustee is also a creditor of the issuer company on a regular bank loan, as it presents an obvious conflict of interests. In its role as a creditor of the issuer the bank is at odds with all other creditors and, in particular, with the bondholders (whose interests she must protect as a bondholders' trustee). In similar cases, should the conflict of interests be significant, the bank must immediately inform the issuer. In case the conflict cannot be overcome, the bank must terminate its contracts. It remains to be seen whether or not in cases like that bank acted in the best interest of the bondholders, and whether or not the latter could seek compensation for damages suffered because of the bank's failure to ensure due diligence. At any rate, to avoid the risk of a potential claim by the bondholders, the bank ought to convene general bondholder meetings, where the acts of the bank with relation to the best interests of the bondholders are decided. Only then will the bank be exempt from liability should anything befall the bonds.

In conclusion, the faster the legislative framework changes towards ensuring quick and satisfactory action should the bondholders be owed money and establishing clearly unfavorable outcomes for the management team that brought the issuer company to insolvency, the quicker that not only the private, but the public interest will be protected; if a pension fund invested in a bond that suffers a payment default, everyone has their possibility for a better pension reduced. Furthermore, not paying a bond could unleash a knock-on effect from the already troubled stock industry (mutual funds, investment companies) on insurers and banks. The worst scenario in this case would include chain defaults in connection with inter-company indebtedness, plummeting investor confidence, and severely hindering the credit flow.

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