

BANKRUPTCY & CORPORATE RESTRUCTURING

Debt restructuring by conversion into equity under Romanian law

by Gabriela Anton

Debt restructuring is a process that allows a private or public company facing cash flow problems and financial distress to reduce and renegotiate its delinquent debts in order to improve or restore liquidity and rehabilitate so that it can continue its operations. A debt restructuring is usually less expensive and a profitable alternative to bankruptcy.

In a debt-for-equity swap, a company's creditors generally agree to cancel some or all of the debt in exchange for equity in the company. Debt for equity deals often occur when large companies run into serious financial trouble, and may result in these companies being taken over by their principal creditors, as a consequence of the fact that both the debt and the remaining assets in these companies are so large that there is no advantage for the creditors to drive the company into bankruptcy. Instead the creditors prefer to take control of the business as a going concern. Consequently, the original shareholders' stake in the company is generally significantly diluted in these deals.

With regard to the applicable Romanian laws, in what the debt restructuring by conversion into equity is concerned, Article 210 (2) of the Companies Law No. 31/1990 provides that the share capital may be increased by equity issue, by means of converting liquid and exigible debts against the company into equity. A debt is liquid provided that it is accurately determined in its value, and it is exigible when it has reached its due date. The amounts owed to the creditors, resulting from the liquid exigible debts held against the company, may serve as payment for new equity issued by the company. In exchange of their debts against the company, the creditors receive equity and consequently become shareholders. Debt restructuring by conversion into equity represents a method of capital increase which shall be made by accounting transfer of the amounts between the passive accounts, from the 'debt' account towards the 'share capital' account.

The operation shall not be treated as a debt contribution to capital increase, but a particular case when the debtor is the company itself, and not a third party. The interdiction concerning such debt contribution to the capital increase provided by the Companies Law No. 31/1990 is not applicable in the matter.

The operation itself is not a genuine compensation – which would imply the co-existence of two exigible, liquid and certain debts, both of which are simultaneously paid off, but stands for restructuring the debt held against the company by third parties into equity, based upon the agreement between the creditor and the debtor, according to which, instead of paying off the debt, by means of an objective novation, they understand to restructure the payment obligation into an obligation of the company to issue equity in favour of the creditor and with a value equal to the debt.

The debt restructuring by conversion into equity is possible provided that the creditor explicitly consents in this respect and that the General Meeting of the Shareholders of the company approves such capital increase. Considering the fact that the increase of share capital is not made against new contributions, the shareholders of the debtor company may not delegate this decision to the board of directors or management board of the company. There are no particular majority rules within the shareholders

meeting for approval of the increase by conversion of debts, so the general quorum and majority rules for approval of share capital increase shall apply, namely the quorum shall be at least a quarter of the total voting rights at the first meeting, and a fifth part in what regards the following meetings, and the majority required shall be of at least two thirds of the present or represented holders of the voting rights.

Should the debt in discussion represent a fiscal obligation, or otherwise a debt to the state, the state aid rules must be scrutinised in order to determine if a prior clearance from the European Commission is required. The debt-to-equity swap has been often used by the Romanian State in the past in the context of the privatisation of state-owned companies with significant debts to the state, where these debts have been converted into shares and subscribed by the State as creditor to be then sold to the selected investor within the privatisation procedure.

The equity to be converted shall be obtained at face value. The Companies Law No. 31/1990 stipulates in this respect that the capital increase by equity issue shall be made at face value. Such a condition is essential in order to protect the interests of the company by not allowing the creditor to impose a disadvantageous price at its sole discretion.

When discussing debt restructuring by conversion into equity, there is an important aspect to be mentioned. By converting debt into equity, the creditors automatically obtain participation into the share capital of the company, and possibly decisional rights regarding the activity of the company, should the amount of the debt be of such importance as to be converted into a significant participation. Therefore the participation of the existing shareholders shall be diluted and the existing shareholders may be directly affected by such an operation, as their power to influence the decisions regarding the company shall consequently decrease.

According to Article 216 of the Companies Law No. 31/1990, the shareholders shall have a preemption right regarding the capital increase to purchase the equity issued by the company in this respect. Such right shall be exercised during a specific term established by the General Meeting of Shareholders which may not be less than 30 days. During this period, the existing shareholders may decide to bring cash contributions in order to keep their quota of the share capital and thus avoid dilution. Such an option is applicable when the shareholders have the necessary financial power in order to sustain the purchase of new equity.

A particular situation is the possibility that the creditor of the company be the majority shareholder or another existing significant shareholder, and therefore obtaining equity by converting its debts against the company implies the fact that the participation of the minority shareholders may be consequently diminished. The minority shareholders may not block that such decision be adopted by the majority shareholder, and the only possibility they have is to exercise their preemption right (which in most of the cases does not happen).

A debt-for-equity swap is often envisaged as a takeover by the creditor, which in fact may be a competitor taking over a company in financial difficulty and turning it around. Having in view the aspects mentioned above, such a measure should be carefully analysed, so that both the best interests of company and the interests of the existing shareholders are protected.

Gabriela Anton is a partner at Vilau & Mitel. Ms Anton can be contacted on +40 21 231 41 06 or by email: gabriela.anton@vilaumitel.ro