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20 September 2015

CFO
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And to: The Ad-Hoc Committee for New Debt Restructuring Legislation

Re: Debt Settlement Law (Legislative Amendments), 5775 – 2015 (the "**Draft Law**") and the report (the "**Report**") of the Committee for the Assessment of Debt Settlement in Israel (the "**Committee**")

Ladies and Gentlemen:

We have reviewed a translation of an extract of the Report entitled "Main points of the Draft Law" and at your request have set out below some observations on the Draft Law as set out in that extract.

1. Background

As a firm we have advised companies and creditors (including institutional creditors and bondholders and creditor committees) on some of the largest international restructurings, including Kodak on its global restructuring (the largest ever Chapter 11 restructuring), Fiat/Chrysler and Fiat's acquisition of Chrysler out of bankruptcy, American International Group on its restructuring, bank creditors in the $24 billion Dubai World restructuring, creditors of CIFG in its 2009 restructuring, the creditors of Energy Future Holdings, Pershing Square and Fairholme funds in the largest Chapter 11 real estate restructuring, Metrovacesa in the largest Spanish restructuring, Eksportfinans ASA in its contingency planning and defence against hedge funds seeking to trigger a restructuring of its $23 billion balance sheet, and the Zim restructuring. Our focus as a firm in distressed situations is on achieving restructurings and rescues rather than insolvent liquidations.

Our firm regularly advises almost every major financial institution including Allianz, American Express, Bank of China, Bank of Ireland, Bank of New York, Bank of America/Merrill Lynch, Bank Hapoalim, Barclays Bank, Bear Stearns, BNP Paribas, Citigroup, Deutsche Bank, General Electric, Goldman Sachs, HSBC, ING Groep, Israel Discount Bank, JP Morgan Chase, Morgan Stanley, National Australia Bank, Royal Bank of Canada, Royal Bank of Scotland, Standard Chartered, UBS and American International Group.

Our observations are based on our experience advising on international restructurings rather than on the laws of Israel (on which we are not qualified to advise).

While we cannot advise on Israeli law, during our representation of Zim on its restructuring we became somewhat familiar with Israeli restructuring law and practice. In our view, Israel has a highly sophisticated community of restructuring professionals and innovative restructuring legislation – such as the section 350 process. Israel also has a concept of directors' liability for wrongful trading in the zone of insolvency, which provided considerable comfort to Zim's international creditors during Zim's restructuring. We fully support the Committee's goal to further enhance Israel's restructuring legislation, but existing professional practice and legislation means Israel is starting from a position of strength. We cannot emphasise too strongly our respect and admiration for the sophisticated restructuring and insolvency regime that already exists in Israel, and our observations should be read with that in mind.

2. General Observations

In our experience:

- a restructuring under which a business continues as a going concern normally preserves more value than an insolvent liquidation – an insolvent liquidation destroys value not only for financial creditors, but also for employees, pension funds, customers, suppliers and trade creditors;
- when a company first gets into financial distress (or is perceived through rumour, press coverage or creditor agitation to be in financial distress) customers, suppliers and employees will first ask whether the business is stable and viable. If not, everyone will be looking for an exit – fast;
- a company in financial distress will often have an acute liquidity need – both because of circumstances which led to the distress and because trade creditors and credit insurers will often withdraw credit or credit insurance to distressed companies, thereby creating an immediate increase in working capital needs;
- a company which fails to achieve stability (including new liquidity) quickly and to retain the support of its customers, suppliers and employees will often sleepwalk into an insolvent liquidation;
- directors of a business are generally better able to make decisions and execute strategies which preserve value for creditors and other stakeholders than creditors (especially institutional creditors) or courts – the key question is when as a matter of law do directors owe duties to creditors when making these decisions;
- many restructurings fail for lack of time: creditors and other stakeholders negotiate and consider their positions, and in the meantime the company's key customers, suppliers and employees abandon the company, the company runs out of liquidity and is forced to file for liquidation. So restructuring rules should not shorten the time stakeholders have to agree a restructuring by forcing court filings prematurely. At the same time, restructuring rules should incentivise boards of directors to engage with their creditors early rather than postponing engagement until there is no time to execute a value-preserving restructuring. In our experience, directors' duties to creditors when companies are in the zone of insolvency compel directors to engage with creditors, and many creditors successfully invoke these duties when seeking engagement with companies;

- each restructuring is different – both because of the complexities of different businesses and the stage of their business cycle and because of the infinite variety of capital structures and financial creditors. Financial creditors include secured creditors, secured but lower ranking creditors, finance or asset creditors secured on individual assets, receivables financiers, unsecured creditors, bilateral and syndicated lenders and institutional bondholders. There is no "one size fits all" template that can maximise value in every distress situation; and
- countries with insolvency regimes perceived to be unfriendly to creditors or borrowers have forced creditors and borrowers to lend and borrow financial debt outside the country. For example, debtor-friendly laws in France have resulted in "double-Luxco" structures where lenders to French businesses have required Luxembourg share pledges and Luxembourg holding companies to avoid debtor-friendly provisions in France.

3. Observations on Point 1 of the Report – Proposed Stages

We understand that Point 1 recommends two stages. In the first stage, debenture holders nominate a special representative to act as a board observer who passes on information to bondholders concerning steps the company proposes to take that may harm creditors as well as information on planned general and administrative spending. In the second stage, once a company is 45 days behind in the payment of a financial debt, the relevant financial creditor must file a petition with the court for either a recovery process or liquidation. The purpose of the second stage is to bring forward the time at which the court effectively takes control of the relevant company.

Observations on the first stage

- A board observer appointed by debenture holders to attend all board and committee meetings may have a chilling effect on board behaviour – board members may be reluctant to discuss rescue or restructuring options in front of a board observer appointed by debenture holders, and rescue options that would preserve value for all stakeholders may not be pursued as a result. This chilling effect is exacerbated by possible full public disclosure of information known to the board observer.
- To the extent debentures are publicly traded, having a board observer would effectively make all board and committee deliberations public. The observer would need to disclose information to its debenture-holder constituency. At the same time, debenture-holders would not want non-public information which would restrict them from trading their positions – so they would insist on information they receive being made public. This would effectively make all such information public. In our experience, to carry out a restructuring step-by-step in the full glare of the press destroys value and inevitably leads to a run on the company.
- Even if debentures are not publicly traded, or debenture-holders agree to receive private information and therefore become restricted from trading, it is inconsistent with good restructuring practice to provide information to some affected creditors and not others. The INSOL principles (principles five and seven) recognise that information should be shared equally with affected creditors.
- To preserve value, a distressed company will normally need to pay trade creditors, key suppliers and employees on time and in full, and to raise liquidity from other sources to achieve this. It is unclear how a board observer would report on this to debenture holders, or how debenture holders would be expected to react to this or to form a view on this in sufficient time to preserve liquidity.

- The objective of ensuring that the distressed company does not take actions to harm creditors can in our view be better achieved by relying on directors' duties to take creditors' interests into account when the company is in the zone of insolvency.
  - For example, there is case law in England and Australia which stands for the proposition that directors' duties to creditors intrude on their duties to shareholders when a company is in the zone of insolvency.
  - In our experience, creditors and their legal counsel rely heavily on directors duties' to creditors to ensure that directors give due regard to creditors' interests in their decision-making, and it would be highly unusual in those jurisdictions for directors, properly advised, to take actions such as paying a dividend or paying unjustified "General and Administrative" costs when the company is in financial distress.
  - Directors' actions in England and Australia are judged with the benefit of hindsight, and personal liability for wrongful trading inevitably leads directors to take full account of creditors' interests.
- Creditors are always free to insist on board observer rights as they negotiate interim waivers during times of financial distress, but we are unaware of any situation where creditors are required to appoint board observers in legislation. In our experience debenture holders seek to avoid board observer rights both to avoid being tainted with inside information as described above, and to avoid any risk of them being held to be shadow directors.
- In certain cases, especially when creditors have lost confidence in management or feel that management need to be supported by specialists during a restructuring process, we have seen creditors require the appointment of chief restructuring officers (or "**CROs**") as a condition of continuing restructuring negotiations where creditors feel the additional costs are justified. A CRO is tasked with preserving cash and negotiating debt settlement arrangements, and owes duties of good faith and loyalty as a company executive officer. To the extent the CRO also has a board-level position, the CRO would also owe duties to the company's stakeholders – i.e. shareholders and (where applicable) creditors. However, CROs are appointed contractually and not as part of mandatory legislation. Directors' duties to act in creditors' interests when a company is in the zone of insolvency often force directors to comply with creditors' requirements to appoint CROs. So where restructuring law and practice and directors' duties provide a flexible framework for specialists to be appointed, appointments need not be mandatorily imposed.

Observations on the second stage

- In our experience, companies only stop paying their financial debts as a last resort, and then only to preserve much-needed liquidity to pay key suppliers and employees to maintain the business as a going concern. Normally companies will only suspend financial debts unilaterally if there is not time for agreement and if payment would trigger a liquidity crisis.
- When a company does not pay a financial debt, then as a matter of contract creditors normally have the right to accelerate their debt and demand immediate repayment. However in our experience creditors only accelerate when acceleration will preserve value. Acceleration without a plan will almost always lead to a disorderly insolvency filing. Legislation which forces creditors to apply to court within 45 days of a non-payment, when creditors have the right to accelerate in any event, will in our view make disorderly liquidation and consequent value destruction for creditors more likely rather than less.

- We understand that the Draft Law suggests that a court could postpone liquidation proceedings if it is convinced by clear proof that the company is not insolvent. But in our view it is likely that by the time of the creditors' court petition, other stakeholders will choose to abandon the business rather than wait for the court to determine whether the business should succeed, and liquidation will be the likely result.

4. Observations on Point 3 of the Report – Cancellation of the possibility to stop payment to creditors unless the company is insolvent

We understand that Point 3 will prohibit a company from ceasing to pay a financial debt unless the court has granted a "protection from creditors" order. In other words, the Draft Law will compel companies to pay their financial debts.

- As discussed above, in general there could well be circumstances in which a company preserves value by paying trade creditors and employees to preserve the business rather than paying financial creditors.
- Creditors always have the option of accelerating their debt and forcing the company into liquidation if they are not paid – but creditors should be the ones to take the decision to accelerate. By making payment of financial debts mandatory the Draft Law would change forced liquidation from a decision of the unpaid creditor to an automatic outcome – thereby increasing the risk of disorderly liquidation and consequent value destruction.
- In addition, there may well be circumstances where value is preserved by paying one creditor and not others. For example, if a payment is due to an unsecured creditor on Day 1, and a payment is also due to a finance lessor secured on equipment essential to the business on Day 5, it may preserve value for the unsecured creditor for the company not to make the Day 1 payment to the unsecured creditor but to make the Day 5 payment to the finance lessor. Keeping essential equipment in the business preserves the going concern value of the business, which benefits all stakeholders, including the unsecured creditor. So restructuring legislation should not impede flexibility to manage a restructuring in a way that both preserves value for all stakeholders and takes account of the unique circumstances of the debtor company. As we said above, each restructuring is different.
- Due to the unlimited complexity of capital structures, there is no "one-size fits all" – and a rule requiring financial debts to be paid regardless of priority and regardless of their recovery value in liquidation would confer on creditors with the earliest maturities negotiating leverage disproportionate to the value of their claims and incentivise companies to prefer some creditors to others.

5. Observations on Point 4 of the Report – Obligation to take decisions following breach of the condition for immediate payment

We understand that Point 4 will oblige a trustee to convene a meeting of debenture holders within 45 days of the occurrence of a default which obliges immediate prepayment (or which would oblige immediate prepayment following a decision of the debenture holders through the trustee).

In our experience bondholders tend to form ad-hoc bondholder committees, and a bondholder trustee will only take action on instructions, and at the time of enforcement, so such a provision would not normally be necessary in an international restructuring. At the same time, trustees are normally very reluctant to call meetings or to take action absent express instructions and indemnities from bondholders.

If the purpose of Point 4 is to force a decision, or to force a forum for discussion among bondholders, then this provision would be useful because it would establish a timetable for bondholders to create a committee and for opinion formers to organise. In our view the utility of the provision could be enhanced by allowing a majority of the bondholders to give alternate instructions to the trustee, so that the 45-day timetable provision for the trustee would only apply if the trustee has not in the meantime received alternate instructions from a majority of bondholders.

6. Observations on Point 5 of the Report – Imposing a debt settlement on a company

We understand that Point 5 will offer creditors, as an alternative to filing for liquidation proceedings, the option of petitioning the court to impose a debt settlement on the company.

We agree with the principle of Point 5: if creditors are permitted to petition for liquidation, then as an alternative to liquidation they should be permitted to propose an alternative solution (i.e. a debt settlement) which preserves more value than liquidation.

While we understand that mechanics of Point 5 are still being discussed, we note that for the court to impose a debt settlement, it must be satisfied as to the valuation of the business at the time.

Valuation is at the heart of every restructuring, and valuation has been the subject of extensive litigation in both the US and the UK. Valuation issues include the following:

- equity and out-of-the-money creditors will insist that they should not be penalised by having a valuation done at the trough of the business cycle, and that the court should adopt a through-the-cycle valuation; in-the-money creditors will argue the opposite;
- some stakeholders may have control over key intellectual property or information technology which gives them claims which are disproportionate to the value of their equity or debt claims – how should these be valued?
- who will the management team be for the new business and how should that be taken into account for the new valuation?
- what if a well-capitalised bidder with a proven management team offers to acquire the business so long as existing debenture holders keep their debt in place with a small write-down – how should this option be valued?

In many jurisdictions, especially those perceived to be creditor-friendly, if a distressed company's business is capable of surviving and no consensual restructuring has been agreed, an officer of the court would be appointed by the company or its creditors, who would manage the company in the interim while conducting a full M&A process to ensure that value is maximised. This officer would normally be an accountant at one of the Big Four accounting firms with specialised expertise.

In the UK, through a company scheme of arrangement – which is a scheme initiated and led by the debtor - a class of creditors can vote in favour of an arrangement and drag the other creditors of that class into that arrangement with a vote of 75 per cent. by value and a majority in number. However, creditors in one class cannot force a restructuring plan on creditors in another class. Directors' duties often force debtors to support creditors' plans (and therefore to launch schemes of arrangement) if that is the only available (or best available) means of preserving value for creditors holding the economic value of the business. In the US under Chapter 11, an impaired class of creditors voting in favour of a plan with a vote of 2/3 can not only drag the other creditors of that class into a plan, but through the rules of cram-down can force that plan onto more senior creditors and more junior creditors. However, creditors in chapter 11 cannot impose their own plan until an exclusivity period in favour of the debtor has expired (which is usually 18 months from the point at which the debtor begins the Chapter 11 proceeding).

While we are by no means suggesting that these systems are the only solution or the best solution, if the Point 5 proposal is to have the court impose a settlement then in our view Point 5 must be accompanied by detailed provisions for ensuring that value is maximised.

7. Observations on Point 6 of the Report – Appointment of lead trustee

We understand that the purpose of Point 6 is to reduce the number of trustees with whom a company must interact, and that the company will be required to appoint a "lead trustee" across all of its debentures.

In our experience, depending on a company's capital structure, it may be difficult to conclude at the time of distress that each series of debentures has the same sorts of claims against the company and that a single trustee would feel capable representing the position of all debenture holders.

For example, a trustee may not be able to act as a trustee for all debenture holders in the following situations:

- one series of debentures is secured and one is unsecured – in that situation the secured debentures may seek enforcement to maximise early recoveries on secured debentures, while the unsecured debentures may want to wait for business to improve to increase recoveries on unsecured debentures;
- one series of debentures could have an early maturity and one could have a later maturity. Early-maturity debenture holders would want to postpone engagement with the company or any suggestion that the company is in distress in the hope of being paid out at their early maturity. But later-maturity debentures holders would want the opposite – they would want to share in any pay-out made to the early-maturity debenture holders and would be pushing for early engagement and threatened court filings to ensure that the early-maturity holders were not paid out ahead of them. Note that this conflict would be made worse if companies were required to make all debt payments at maturity as suggested in Point 2; and
- some debenture holders may seek to own the business and work with an acquirer to make an M&A bid for the business, while other debenture-holders may instead seek an early filing so they can be paid out.

Of course, on an acceleration of all debts, all debts are immediately due and previously staggered maturities become irrelevant. But a full acceleration which is not part of a pre-agreed restructuring plan is unlikely to preserve value. Value preserving restructuring is more likely to occur before acceleration – precisely the time at which it will be important to ensure that stakeholders with different interests are adequately represented with their own trustees without actual or perceived conflicts of interests between stakeholders.

One way to address conflicts is to permit a trustee to resign from representing certain constituencies or debenture series and for a new trustee to take on the role of representing those constituencies. In our experience, international trustees are very reluctant to take any action whatsoever without material indemnities from various stakeholders. In a distress situation a new trustee's demand for indemnities may be even more robust. On that basis it may be worth considering having different trustees appointed at the outset to avoid paralysis in a distress situation if a trustee feels conflicted.

8. Concluding comments

We note that Point 2 (Reduction of causes of conflicts of interest) and Point 7 (Limitation of credit to a commercial group) of the Report are driven by Israeli market issues and recent Israeli experience and we therefore have no comment on those provisions.

Thank you for giving us the opportunity to review a translation of the extract of the Report. We hope that our observations will be useful to you in your discussions with the Committee, and we are available to discuss any of our observations with you at your convenience. And as we said at the outset, given the sophisticated restructuring environment in Israel, the Committee is starting from a position of strength.

Yours truly,

Presley L. Warner

cc: Mr. R. Christian Beatty
Mr. Christopher J. Howard
Mr. Lester Su
Mr. Samuel Weinroth