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Private-sector rescue financing to mitigate impact of outbreak

BY CHEW SENG KOK, ANG SIAK KENG AND JUDSON LIM

Covid-19 has permanently reshaped our economic landscape. For the first time in our modern globalised history, an object no larger than 125 nanometres has brought human productivity to a standstill across the globe, collapsing market supply. This is the reverse of the economic crises of the last few decades (for example, the 1997 Asian financial crisis or the 2008 subprime mortgage crisis), which were spurred by valuation bubbles and erupted when markets realised that supply grossly outweighed demand.

For this reason, it is becoming the global economic consensus that, unless the appropriate measures are put in place, what is now a recession may very well become a depression. To that end, we propose that Malaysia must undertake immediate insolvency law reform to create an environment that will both allow and better encourage private rescue financing initiatives to support and sustain the business sector.

Why we need rescue financing

As we begin to "flatten the curve", we can legitimately hope for the gradual restoration of economic activity, but we must not delude ourselves into thinking that all businesses can return to the same commercial model they had prior to the lockdown. The challenges for businesses go beyond short-term cash flow problems and a temporary shortfall in supply. The pandemic is likely to bring about a new market order that disincentivises economic activity that relies too much on physical interaction and travel. Businesses will need to adapt to these new market conditions and, to that end, will need new capital.

What we propose with private rescue financing does not supplant the unequivocally critical public policy and stimulus plans that the Malaysian government has already put in place. The government's policy focus is on alleviating the temporary liquidity challenge and it has rightly done so, as this is the most pressing concern. Soon, loan repayment moratoriums must be lifted and, for financial prudence, bank capital reserves must be rebuilt. Our proposal is that, moving forward, the businesses community needs opportunity and support to survive in the new competitive environment. As we look to the future, we foresee an important role for private capital to play in rebuilding the economy.

Advantages of private capital

Markets and revenues for businesses are expected to be volatile as businesses begin to adapt to new conditions. Unlike traditional financial institution debt, which ordinarily requires a predictable and consistent repayment schedule and return, private capital can be employed to sustain businesses through such volatile markets, as their repayment and returns can be deferred wholesale to a much later period in time.

Private rescue initiatives also introduce additional accountability on management and provide critical business advisory to assist rescued businesses to adapt to the post-Covid-19 market. We believe that not only must a business survive a shortfall of cash or supply, they must also gain a sustainable competitive advantage on the global scene to be viable in the long term. Private equity, in particular, has proven itself to be efficient in bringing about this advantage.

As it so happens, private-equity firms began 2020 with a record US$1.5 trillion (RM6.54 trillion) in "dry-powder" cash. We anticipate there will be global competition for these funds in merger and acquisition (M&A) and rescue deals. Jurisdictions that offer rescue mechanisms that allow investors to appropriately manage their risk of loss and incentivise employment of private capital into rescue schemes will obtain a competitive advantage in attracting this large reserve of funds.

Inaptitude of current infrastructure

In Malaysia, our existing insolvency framework is unfavourable to private rescue financing. Despite recent reforms in 2016, our insolvency laws are too heavily focused on the fair distribution of the assets of failed businesses and do not provide commercially practical options to businesses that are viable, but face a temporary liquidity challenge because of an unforeseen crisis and, in our circumstance today, the potential onset of a new economic environment. These businesses, which form the bulk of the victims of the novel coronavirus, need an avenue by which they can negotiate a fair restructuring of debts and attract investors (white knights) or new lenders.

Briefly:

MECHANISM	WEAKNESSES
Corporate voluntary arrangement	This mechanism was intended as a cost-efficient out-of-court process, where the existing management of a private company may appoint an insolvency practitioner to draw up a proposal to all the creditors as a single class and bind all creditors with 75% approval. It has been effectively neutered, however, as any private company with secured lending is unable to have access to this mechanism.
Judicial management	Insolvent private companies have the option of placing the management of their company with an independent court-appointed restructuring specialist and to negotiate a settlement with a 75% binding threshold. This mechanism is unattractive for rescue financing, as it does not make commercial sense to owners of viable businesses to opt to lose management control to a professional who does not share their "skin-in-game". Furthermore, this mechanism can be ineffective, as secured creditors have an absolute veto against the appointment of a judicial manager.
Scheme of arrangement	Unlike the above, this mechanism is open to all companies. Any company can apply to the court to hold meetings for each separate class of creditors to approve a scheme provided it obtains 75% approval from each class. Schemes are currently ill-suited for rescue financing, however, as any one class of creditor can prevent the success of the proposal. Unlike in the US and Singapore, Malaysia does not have a mechanism to "cram down" on dissenting classes of creditors where the overall scheme is fair and equitable. Often, negotiations for schemes collapse, as overcollaterised secured creditors are not incentivised to ensure business continuity.

Furthermore, the moratoriums afforded in the existing regime focuses on the prevention of legal action by creditors when a company seeks to negotiate but fail to address the need for maintaining supply chains in ensuring business continuity. Also, in the case of schemes of arrangement, a moratorium against legal action is not automatically granted, further adding to an already intricate and costly process.

Proposed reforms

So, what do we recommend that Malaysia do?

Reform agenda

SAFE HAVEN
Establish a "safe haven" to give viable businesses breathing room from creditor insolvency action and legal assurance to businesses and their suppliers so they can continue to maintain their supply chain

CROSS-CLASS CRAMDOWN RESTRUCTURING PLAN
Introduce power of courts to enforce settlement on dissenting class of creditors where proposal is fair and equitable

SUPER PRIORITY RESCUE FINANCING
Allow companies to attract white knights with court application to grant priority to the rescue money over existing debt, equity and other securities.

EXPAND ACCESS
- Expand access to existing regimes and introduce virtual settlement procedures
- Encourage direction of private capital into rescue financing with double deduction tax incentive for impairment and loss.

First, following the lead of many governments in the global community, we should begin with establishing a "safe haven" to give viable businesses some breathing room and assure suppliers that their transactions with such businesses will not be avoided by law. We do this by imposing a conditional moratorium on creditor action and suspending the operation of certain facets of our "undue preference" and "wrongful trading" laws.

The general legal position in Malaysia is that suppliers who supply to insolvent companies risk their transactions being voided by the courts if they have knowledge of the insolvency. Equally, directors who allow a company to continue trading while insolvent face penalties. This is no longer tenable if we wish to maintain supplier confidence and the integrity of our supply chain in the light of the liquidity crunch that has affected almost everyone. The "safe haven" should also include the suspension of ipso facto clauses in contracts, that is, those provisions that allow suppliers to terminate their supply in the event of insolvency or restructuring by the customer company.

Second, we should introduce two new rescue mechanisms into our insolvency laws that are critical to enabling rescue financing:

Cross-class cramdown	Enact a new restructuring plan or modify existing schemes to allow our courts the power to "cram down" on dissenting creditors where the 'absolute priority rule' is met, that is, at least one class of impaired creditors has accepted the plan and the dissenting secured class of creditors is satisfied in full before a junior class receives distribution. Courts will be allowed to overrule the absolute priority rule if it is necessary to achieve the aims of the restructuring and if it is fair and equitable to the dissenting creditors.
Super priority rescue financing	Introduce a mechanism that will allow white knight rescuers priority for the amount invested against existing debt, equity and other securities in the company. This means that if the company were to fail, notwithstanding the rescue, the white knight would be afforded priority to recovery of its investment during the distribution of the company's assets. Different levels of priority can be afforded to the white knight, depending on the ability of the company to obtain less disruptive financing. White knights are central to any successful rescue operation, and this mitigation of risk is necessary to allow businesses to assuage prospective rescuers.

These mechanisms are not entirely novel; they are found in the US' Chapter 11 bankruptcy laws and have already been implemented in Singapore. The UK is now pursuing implementation of a cross-class cram-down restructuring mechanism as part of its response to Covid-19.

Third, we need to amend our existing insolvency infrastructure to expand access to its mechanisms to companies while balancing the rights of creditors. The corporate voluntary arrangement regime should be expanded to allow companies with secured borrowings to negotiate voluntary arrangements binding all unsecured creditors (and binding secured creditors only if they consent).

The right to veto an appointment of a judicial manager by a secured creditor should be removed unless the secured creditor can show that the appointment will cause disproportionately greater prejudice. Also, companies should not be insolvent or beyond rescue before they can apply for these measures. Company law should be amended to allow companies that are likely to become insolvent to already seek them before it is too late. Further, to ensure that these mechanisms can be practically effective in the era of social distancing, amendments should be made to

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Challenges in planning for a sharp recovery

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how GDP is looked at. Assuming the MCO stopped only half the economy from functioning, a two-month MCO is the equivalent of a loss of income of RM133 billion for households, firms and owners of capital and land. That is a contraction of 8.3% of total output, which clearly suggests that the full-year 2020 GDP will also shrink as a third of the year is almost done. It is only a question of magnitude, which depends on the ability of the economy to pick up again.

No matter how one slices this, the economic costs of containing this infection is staggering. The question is not just the extent of how businesses are being impacted by the MCO, which gets worse the longer the period is, and the interventions that are necessary to mitigate its negative effects, but more importantly, what should be done to ensure that businesses, the ones still standing, are in the position to rebound when the MCO ends.

Spending and investments will take time to normalise. Households with higher incomes but with relatively less propensity to consume would cut back spending the most, given these same households would have also suffered the most negative wealth effects from the fall in asset prices. So, consumption expenditures will have to depend on households with a higher propensity to consume — the ones below median household income — to prop up aggregate demand on the consumption side, but these are households that are vulnerable to losing their jobs. Unemployment in the post-MCO period will rise as there will be businesses that will fold and there will those that will be forced to scale down.

The challenge is to put in place incentives and resources that will induce a sharp recovery in the next 12 to 24 months. There are two considerations that can guide these initiatives.

The economics of this pandemic is global in nature, and given the interconnectedness as well as the breaking up of supply chains across the world, the pace of recovery, even if a vaccine were to be found, will take some time as businesses figure out the way forward. One consideration, given the disruption that arose from the interdependencies in the supply chains is some consolidation and localisation of parts of supply chains. Thus, a reversal of the past trend of fragmenting and globalising supply chains is a growth opportunity in the post-Covid world.

This is especially true for fresh produce and food products and presents an opportunity for the modernisation of local production, processing and distribution. There are major hindrances for the growth of these businesses ranging from state-federal issues around land tenure and access to water to the lack of compliance with food safety standards, which entails the adoption of technology and which must be resolved. The MCO experience also revealed weaknesses in the distribution channels for agricultural produce as local growers suffered from the inability to get their produce to consumers.

Technology adoption becomes a key enabler to fulfil standards as well as to broaden reach. As with other goods, agri-produce distribution and market reach have to be augmented by access to digital platforms. The digitisation agenda needs to be part of the Covid intervention — targeted to shape participation in the post-Covid environment. All micro and small businesses must be digitally equipped and have a presence on digital platforms. Any assistance should be predicated on fulfilling this requirement.

Finally, this business of delivery, that last mile — a ubiquitous presence during the MCO — must be properly formalised. This is not a "gig" done on a part-time basis. The workers have to be properly protected, fully insured via Socso and subscribe to EPF. In fact, it is about time to think of consolidating the two funds to fully address the significant number of workers who have neither protection nor adequate retirement benefits as the nature of work itself has changed. ■

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We can have hope

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allow creditor meetings to be hosted virtually.

Finally, an infrastructure is complete only with an incentive to use it. To encourage participation of private capital in rescue financing, we propose the creation of a double deduction tax incentive for losses incurred by white knights arising from impairment or total loss of their debt or equity in the rescued company, should the rescue operation fail. Safeguards can be included to prevent abuse and ensure that this deduction is available only to genuine rescue deals carried out in good faith.

Conclusion

Even amid this harsh crisis, we can have hope. Taking law reform and active participation of the business community together, we can be optimistic for a significant turnaround. The experience with the Danaharta legislation and measures by the Malaysian government have shown that swift and proper action may be appropriate to deal with the extraordinary fallout from Covid-19. ■

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Scale up existing schemes

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tising have given rise to is the ever-increasing prevalence of consumerism in everyday life. Consumerism had given the most ordinary of people a false sense of their unique place in society. According to historian Gary Cross, "[t]he endless variation of clothing, travel and entertainment provided opportunity for practically everyone to find a personal niche, no matter their race, age, gender or class".

But consumerism in reality does not lead to happiness and satisfaction in the long run. This point can be made by referring to studies that pose the questions as to whether economic growth leads to increased happiness. Much of the evidence from comparative studies that looks at developed and developing countries suggests that the answer is no.

The current pandemic and resultant lockdown that much of the world is exercising means that more than a billion and a half people around the world are staying home. Some would be reflecting on their pre-lockdown lives as mere consumers, but families are able to spend more time with one another.

At the same time, our ecology is being given a rest from human interference and destruction. For example, there has been a fall in carbon dioxide emissions, the quality of air has improved and noise levels have fallen. Covid-19 has given us a chance to reboot ourselves. But the question now is, will we learn from this experience or go back to our old ways once Covid-19 is no longer a threat? ■

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Stable and equitable growth is possible

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allow companies to achieve external economies of scale, reducing partly the cost of businesses and allowing greater market expansion.

During the Covid-19 outbreak, certain sectors have realised that working from home and flexible working arrangements are possible and more productive. The gig economy has changed the way people consume, interact and work. Simple technologies such as online sales and marketing, online or mobile payment systems and proper delivery and logistics systems transform businesses. These should be the emphasis in reviving the economy where SMEs are largely lacking. Indeed, the over-globalised world can only be tapped faster by technology. For speedy recovery, the opportunity that technology provides should be used to its full potential.

This crisis has taught us that stable and equitable growth is possible. The shared prosperity vision should promise inclusive development that will drive the economy further. It is time the government and other economic agents put in serious efforts on operationalising this vision in greater detail to build a more sustainable economy in the future. Targeting long-term goals is more important than scoring pockets of short-term gains with easy-to-achieve targets of low-hanging fruit.

It is time to fix various policies and plans — for example, an industrial master plan, financial sector master plan or even sectorial plans that require a revisit due to the changing global environment and deteriorating competitiveness. The long-missing reform should be of immediate concern should the government think of flattening the recession curve. And Covid-19 is a wake-up call for us to think harder about the future direction of Malaysia. ■

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A Herculean task to organise 'ghost games'

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says: "I think if you polled the players, we would rather have the Masters go on without spectators than not go on at all. I think you would probably get a unanimous vote on that one. But it's a shame."

Spare a thought for Tour de France organisers who are dealing with a "venue" 3,500km long and crowds of up to 12 million. The decision to delay to a later, hotter and holiday season August start, has been called "a recipe for disaster".

That is the view of Edinburgh University professor of global public health, Devi Sridhar, who told cyclingnews.com: "There's definitely a risk that the Tour moving around and unwittingly spreading the virus could kick-start a new lockdown." Social distancing? It will need more than just those outstretched hands along the route to be kept in their pockets.

You have to ask how long fans would put up with this. "Better than nothing" seems the consensus, but what if some players do not want to play? As Harvard epidemiologist William Hanage says: "It's only getting started."

Apologies for the gloom, but if sport thinks it can ride this out and carry on as normal, it is deluding itself. It will not be normal again: It is different already. But, for fans, when an empty stadium is our spiritual home, it is easier to believe in ghosts. That may be all we have for a while. ■

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We will always have the need to stay connected

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species, we were never designed to live alone. We are mutually dependent or inter-reliant, and will always have the need to stay connected.

Granted, we must keep Covid-19 from spreading further. We must also anticipate what will happen as a consequence of our actions today — for better or for worse — way into the future.

Please stay home safely with your loved ones. Read and share. Unlearn and relearn. Produce and contribute. Evaluate and appreciate. And do not forget to exercise and rest.

(In my next article, I will write about the economic penalty of Covid-19.) ■

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