Restructuring bond debt in the global marketplace

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There is no over-the-counter, one-type-cures-all pill that troubled companies can swallow when they are in financial difficulty. Every company is unique and the factors that lead to financial problems, as well as the formulae for renewed financial health, are as varied as the companies themselves. One common challenge for nearly every company with outstanding public debt, however, is the need to develop a strategy for negotiating with bondholders.

Negotiations between a company and its bondholders will proceed in a way that is distinct to the specific pressures facing the company. But there are certain steps a company can take to achieve an outcome that will allow it to maximise its chances of achieving a successful restructuring while keeping control of the process and keeping the company’s business intact.

Management needs to:

- Be prepared to recognise problems early.
- Take steps to determine the most suitable approach to the negotiations.
- Know when and how to open the dialogue with bondholders.
- Choose between a number of restructuring mechanisms.
- Be able to overcome the “free-rider” problem.

Recognising problems

Successful relations with bondholders on a restructuring depend to a large extent on a commitment on the part of management to being proactive in recognising potential financial problems before they arise, and to assembling a restructuring team that is focused on preserving value and maintaining business operations.

Anticipating major financial events is key. The timing of a large principal or interest payment coming due on bond debt, for example, should be flagged up well in advance. Management would not wish to discover on the eve of an event of this kind that the company had used precious cash by funding operating losses or meeting other expenses, had suffered a tightening of trade liquidity, and therefore had limited options or leverage in negotiating with its bondholders, who would be more than happy to take advantage of the situation.

If, instead, management can initiate discussions with bondholders and creditors when there is still cash to use as a bargaining chip, or at least enough fiscal breathing space to fund operations during longer-term negotiations, the company’s leverage and flexibility will be much improved.

Determining a suitable approach

Management needs to be able to distinguish between an organised restructuring and a financial crisis or admission of business defeat.

Increasingly, CEOs and other high-level managers, both within and outside the US, are abandoning two outdated views that:

- Restructuring automatically leads to an insolvency filing.
- An insolvency filing would mean the end of the business or should be perceived as a business defeat.

Developing and implementing a restructuring philosophy is increasingly viewed, by both management and sophisticated creditors such as institutional bondholders, as a positive step towards managing financial problems because:

- A restructuring does not always lead to a Chapter 11 or insolvency filing, and there are many tools that can and should be considered long before the in-court option in order to diminish the negative effects on the business.
- A filing under Chapter 11 or other restructuring statutes should be considered as one of many useful tools in the restructuring toolkit, and as such is not an admission of defeat but rather, often, a creative and aggressive restructuring alternative.

Out-of-court vs judicial proceedings

In the vast majority of circumstances, restructuring out of court is the preferred approach, for a number of reasons:

- Transaction costs are less than on court proceedings.
- It is easier for existing management to control the process.
- Publicity will be avoided or at least reduced.

Unfortunately, too many US restructuring professionals believe that a Chapter 11 filing “cures all ills” and fail to explore adequately a consensual out-of-court agreement.

Non-judicial options are particularly desirable in cross-border transactions because, to date, no comprehensive worldwide judicial restructuring scheme has emerged. Currently, insolvency regimes differ widely from country to country, both:
- In substantive approach (including whether a management-controlled restructuring is even an option).
- With respect to concerns of sophistication and predictability.

Many jurisdictions lack a well developed set of laws or are structured less to favour rehabilitation under existing management and more to facilitate an orderly liquidation. This approach poses significant practical challenges to a restructuring because trade creditors or customers may lose confidence in a business that files an insolvency proceeding in such a country. In addition, courts in some jurisdictions often refuse to recognise bankruptcy rulings from other jurisdictions, leading to the possibility of inconsistent results, multi-jurisdictional litigation, or a longer and more complicated insolvency proceeding that could damage business operations and become very expensive.

While it is possible for multinational companies to consider a US Chapter 11 filing even for their operations outside the US, the restructuring team must address difficult issues relating to:
- Jurisdiction over assets and parties.
- Comity with foreign courts.
- Heightened public relations challenges related to a reduced level of understanding of the Chapter 11 process outside the US.

An out-of-court restructuring is therefore preferable if it can be achieved, and restructuring professionals, and the company must be prepared to convince the bondholders that they are not necessarily better off if they force a bankruptcy.

At the same time, the possibility of an in-court restructuring must not be ignored. Either side in a restructuring (the company or the creditors) can place the company into bankruptcy if it is unhappy with the result of out-of-court negotiations. Any out-of-court agreement must therefore be constructed with an awareness of all parties’ potential rights and leverage in a bankruptcy case.

A company can use the threat of an insolvency proceeding, for example, to gain significant leverage in out-of-court negotiations, but this strategy will be successful only if there is a degree of credibility in that threat, which is best accomplished by demonstrating a genuine readiness to begin an in-court proceeding.

**Putting together a team**

As a company recognises its financial problems and moves into the zone of insolvency, management needs to fully understand its fiduciary duties. The board’s focus must now be to work for the overall good of the enterprise by seeking the best resolution to satisfy creditor and shareholder needs.

In preparing for negotiations, it is important to construct a team of restructuring advisers who are:
- Sensitive to the nuances of negotiating with particular types of investors (see below, Focusing the negotiations).
- Sufficiently familiar with the insolvency regimes of the jurisdictions involved (see above, Out-of-court vs judicial proceedings).

**Preparing disclosures**

Many factors can lead a company to financial difficulties, such as changing conditions in the economy or industry, simple over-leverage, misconduct on the part of past management, or well-thought-out business decisions that, with hindsight, have proven to be erroneous.

A company challenged by excessive debt may still have a good chance of rehabilitation if systemic changes can be made to correct or adapt to the factors that caused the adverse financial condition.

Once the company and its financial advisers determine that there is an enterprise value to the business, the company must develop a restructuring plan that identifies the systemic changes necessary to make a credible showing to bondholders of the company’s future ability to pay its debts.

**Focusing the negotiations**

In addition to developing its own plan, the company must evaluate the relative positions and negotiating strengths of its bondholders before taking steps to initiate negotiations. Where there are different series of bonds, some holders may have greater or lesser bargaining power than others. The speed and tenor of negotiations will depend in part on the relative sophistication and position of the bondholders, for example:
- Individual holders who have bought their bonds at par value will be looking for a different resolution (and may take longer to accept the company’s challenged financial position) than experienced traders in distressed securities who have acquired their bonds in the after market at a deep discount.
- Similarly, experienced bondholders who are familiar with the variety of insolvency proceedings available to a multinational company, or who have retained sophisticated global counsel, are more likely to be comfortable reaching a quick out-of-court solution than holders with a more localised level of experience.
- If any holders have acquired a controlling block of securities, they may seek to exert additional concessions in return for their co-operation.

Any successful restructuring, whether in or out of court, will require the consent of some portion of the bondholders. In order to reach a deal, the restructuring team will need to understand what is driving everyone at the bargaining table. Importantly, management must be aware of the company’s own bottom line and not be afraid to walk away if the deal is not good enough – there is little point in achieving a consensual bond restructuring that does not solve the company’s financial problems.

In order to move swiftly towards restructuring, the company should identify areas of mutual interest on which to base a negotiated resolution that leaves everyone in a better position than possible alternatives, such as an insolvency proceeding without a pre-negotiated restructuring in place (a “free fall”).

For the company, the focus of the negotiations should be on:
- Preserving economic value by maintaining the company as a going concern.
Ensuring the uninterrupted flow of products or services to customers.

Rebuilding, preserving the core business.

Creating a debt structure in which interest and principal can be paid as they become due.

The company must position itself to drive the negotiation process and remain in control, so as to avoid becoming bogged down in drawn-out discussions while the business struggles and deadlines loom closer.

Therefore, in preparing for negotiations, the company should establish a realistic but ambitious timeline and milestones to keep control of the process. The quicker the parties can achieve a meeting of the minds, the quicker the turnaround will take place, which will provide all parties – including directors, shareholders, lenders, employees, customers, vendors and regulators – with certainty that there is a plan for moving forward and a settled future for the company.

Once a tentative deal is reached, the company should insist on reducing the deal to a binding term sheet as soon as possible and have the parties agree to hammer out the full documentation later. Early certainty is desirable, because it preserves the value of the business.

OPENING THE DIALOGUE

Armed with advisers who have gathered the facts, analysed the company’s financial position and created a restructuring plan, the company next needs to open the dialogue with its bondholders and begin negotiations, a process that must be handled with subtlety to avoid pitfalls.

Organising the bondholders

In order to negotiate with bondholders, a company must determine who the bondholders are and, given that any out-of-court or pre-negotiated settlement will require some consensus, attempt to organise them into one negotiating group.

When the bonds are concentrated in a few hands or represented by joint counsel, it is much easier to reach agreement than when holders are numerous, widely dispersed and not legally represented.

Identifying the bondholders to begin this process, however, can be a challenge where the bonds are held through banks and brokers rather than in the name of particular owners. This challenge may, as a practical matter, be even more difficult for eurobonds because of certain practical difficulties associated with notifying and communicating with bondholders.

Efficiently identifying actual bondholders is best accomplished by using several methods at once:

- The company’s financial advisers, if sophisticated, may be able to identify funds or institutions with large bond holdings both through informal connections and through a search firm service that can identify consenting bondholders.
- A public filing or press release announcing that the company is considering a restructuring can serve as a catalyst for bondholders to organise themselves into an ad hoc committee and then contact the company.
- The company should be responsive to bondholder inquiries. At times in a distressed situation, sophisticated bondholders may identify the company’s financial difficulty at the same time as management and attempt to initiate discussions by themselves, with the aim of either restructuring the entire issuance or toward negotiating an individual buyback deal.

Disclosure and confidentiality agreements

Once a group of some or all of the bondholders has been organised, disclosure and confidentiality become sensitive issues.

At the outset of negotiations, the company and its restructuring team must educate the bondholders about the company’s financial position and proposals for restructuring. The more information the company can provide, the quicker the bondholders will be able to grapple with economic realities and reach a deal that reflects their concerns. To achieve effective negotiations, it is important to gain bondholder trust by providing full and open communication and accurate financial reports.

The company should consider in advance appropriate levels of disclosure of:

- Existing operational and balance-sheet issues.
- A detailed business restructuring plan, including solutions to operational difficulties, measures to strengthen capital, projections of the company’s future performance, and a debt repayment plan.

Where the bonds are publicly traded, and where material and non-public information must be provided to facilitate discussions, appropriate confidentiality agreements must be negotiated and entered into to protect against:

- Disclosure of sensitive information.
- Insider trading and violation of other securities laws.

For bondholders who wish to negotiate but also remain free to sell their bond holdings, the receipt of confidential information can become a sticking point. The company and its restructuring advisers must be prepared to find creative solutions, including, for example, keeping discussions to the level of professional representatives rather than individual bondholders for a certain time, in order to allow negotiations to continue while facilitating the legal needs of all parties.

Lock-up and standstill agreements

In certain circumstances, it may be desirable for the company to bind bondholders with which it is negotiating to more than just confidentiality agreements.

If the bonds are in default or if a default is imminent, a standstill agreement is likely to be appropriate. Under the agreement the bondholders would agree not to exercise enforcement rights,

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CASE STUDY: MULTINATIONAL CORPORATION WITH EUROBONDS

The following case study of a recent restructuring highlights the process of bondholder negotiations in a cross-border transaction.

Background

A US corporation was facing financial difficulty and was planning for an imminent Chapter 11 filing.

Its Belgian subsidiary, with an outstanding eurobond issuance, had sufficient cash on hand to make up-coming interest payments on its bonds and faced no imminent financial crisis of its own. The subsidiary’s eurobonds, however, were guaranteed by the US parent and, by their terms, would go into default and automatically accelerate if the parent company filed bankruptcy. Because it lacked the resources to immediately pay the bond principal on acceleration, the Belgian subsidiary would have to either negotiate relief from its bondholders or prepare for a bankruptcy filing of its own.

Management decisions

Under the specific circumstances, there were grave concerns about the operational consequences of a bankruptcy filing, either in the US or in Belgium. Substantial businesses have had limited success attempting to reorganise under Belgian insolvency laws, and experience showed that trade creditors and customers might perceive such a filing as the first step towards liquidation.

The company recognised that there was a risk that Belgian courts would not uphold the automatic stay of a US bankruptcy filing by the Belgian subsidiary, leaving the company vulnerable to a number of creditor actions against its estate.

Management decided that the company would be better off restructuring out of court because the subsidiary:

- Was cash flow positive.
- Was current on all of its debt obligations.
- Had a solid business plan.
- Had no independent need for a bankruptcy filing.

including declaring an event of default or beginning involuntary bankruptcy proceedings, during the negotiation period. The company’s restructuring advisers and management should determine the time period necessary to accomplish the goals of the restructuring, and then negotiate with the bondholders’ representatives towards a stands till agreement of that duration. In exchange, bondholders may request certain benefits, such as information access rights or an agreement that the company will pay their expenses.

In other circumstances, the company may wish to insist that the bondholders with which it is negotiating agree not to sell their holdings for a certain negotiated period of time (a lock-up agreement), so the company is assured that it is negotiating with the same group of bondholders that will be closing the deal.

After preparing projections of potential creditor recoveries under a US bankruptcy filing, a Belgian judicial composition or a forced liquidation, management believed it could convince its bondholders that an out-of-court consensual restructuring was in their interests as well.

Restructuring mechanism

After retaining US counsel and Belgian restructuring counsel to review all options, the company realised that a little-used provision of the Belgian Companies Code provided a very favourable out-of-court alternative. Under Article 568 of that code, a company can call a general meeting of its bondholders to effect comprehensive changes in its bonds, including reducing the interest rate, extending maturity dates and removing security (including guarantees). The terms of the company’s eurobonds, although issued under US law, recognised that this amendment mechanism could apply.

Using Article 568, the Belgian subsidiary:

- Could amend its bonds to remove the parent guarantee and provide other useful flexibility with the affirmative approval of 75% of the bondholders (or, under some circumstances, even less).
- Could even bind holdouts to the agreed restructuring.

No in-court proceedings were required, so long as appropriate notice (about one month before the transaction) was given by publication to bondholders.

Implementation

After identifying Article 568 as an attractive restructuring mechanism, the company knew that it needed to contact at least some of its eurobond holders and begin the negotiation process.

After the parent publicly expressed an interest in restructuring its bond debt, the company’s financial adviser was contacted by an ad hoc committee of eurobond holders, and learned that more than 75% of its bonds – enough to approve amendments in an Article 568 proceeding – was already concentrated in the hands of a few US distressed trading funds.

While bondholders are likely to be reluctant to enter into lock-up agreements at early stages in negotiations, this is one area in which the company may wish to consider holding strong.

Without an adequate lock-up agreement, the company may negotiate a bond restructuring agreement only to find that the parties with whom they have been negotiating have traded to a new group of bondholders with completely different goals and objectives, so that negotiations must begin all over again. Discussions regarding lock-ups are extremely sensitive and may result in lock-up agreements of limited duration, to be extended only on written agreement of the bondholders, the successful achievement of certain milestones, or a meeting of the minds on the restructuring.
A creative solution

After consultations with the restructuring teams in the US and Belgium, the company and the bondholders worked together to find a creative two-step process that would allow the subsidiary to avoid a bankruptcy filing:

- At an initial Article 568 bondholders’ meeting before the parent’s Chapter 11 filing, the bondholders and the company approved a term sheet for the restructuring and the bondholders agreed to a six-week waiver of the default that would be caused by the parent’s bankruptcy in exchange for payment of a restructuring fee.
- After the parent’s filing, the subsidiary and bondholders used the six-week waiver period to negotiate detailed documentation and call a new Article 568 bondholders’ meeting at which it was approved.

During this process, the subsidiary’s restructuring team and the ad hoc bondholders committee worked co-operatively to resolve various challenges that arose in translating the broad scope of the term sheet to the detailed language of an indenture and collateral pledges under the laws of several European countries.

Win-win

In this out-of-court restructuring everyone came out ahead:

- The subsidiary was able to avoid the significant risks of an in-court insolvency proceeding and was effectively insulated from the parent’s Chapter 11 filing.
- The bonds began trading at higher levels than before the restructuring deal was announced.
- All parties understood their relative leverage and the risks involved in an in-court proceeding, and they all therefore recognised that out-of-court restructuring was preferable.

This common interest encouraged the parties to overcome the significant challenges involved in the details of the cross-border deal.

Waivers and supplemental indentures

If the company is facing a short-term financial difficulty but appears capable of an imminent turnaround on an operational level, such that it ultimately will be able to repay the principal and all interest on the bonds, the best solution may be a short-term waiver or amendment of the issuing documents (such as the indenture or fiscal agency agreement) that can be quickly accomplished out-of-court.

Most bond issuances (including all US law indentures) require unanimous consent of every bondholder in order to amend or modify monetary terms of the bonds (such as principal amount, interest rate and term). However, the non-monetary covenants that restrict various activities of the issuer can be amended by a vote of a controlling majority.
Similarly, it is often possible for a controlling block of bondholders to agree to refrain from declaring a default or taking collection action over certain covenant defaults. If such a modification is sufficient to solve the company’s financial difficulties (for example by allowing new borrowing, eliminating troublesome financial covenants or allowing sales of assets), the company can negotiate to pay a consent fee to a controlling block of the bondholders in exchange for their agreement to the proposed amendment.

Repurchase of bonds

When a non-monetary covenant modification or waiver is not sufficient, a company may achieve relief from temporary liquidity problems by offering to repurchase sufficient debt securities, which will undoubtedly be trading at a discount from the face amount, in order to clean up its balance sheet.

A buyback can be accomplished in an open market purchase, through private negotiations with large holders, or using a public tender offer. Common strategies include:

- Selling non-essential assets and using the proceeds to repurchase debt.
- Raising funds for a discounted debt repurchase by issuing new debt securities or obtaining new bank financing.

If turnaround does not occur through the bond buyback alone, the company may still be in a better position (as a result of its improved balance sheet) to obtain additional financing, through, for example:

- Traditional debt offerings.
- Loans or hybrid debt instruments such as convertible preferred stock.

The additional financing can be used to support continuing operations and to pay the remaining bondholders in the class on maturity.

Exchange offers

When more far-reaching relief is needed and the company does not want to spend the cash necessary for a bond repurchase, an exchange offer should be considered. An exchange offer is an offer by the company to exchange new debt or equity securities for the existing bonds.

In the exchange, the company can offer:

- A new debt package with some combination of reduced principal, reduced interest rates, an extension of maturity or debt amortisations, and improved covenants that allow more flexibility to accommodate an operational restructuring.
- Collateral in exchange for concessions on other terms or, depending on the exact exchange mechanism, a small current cash payout.
- Particularly where the company’s equity market capitalisation is high, a debt-for-equity swap that takes advantage of high equity trading values to retire bond debt without a cash outlay.

OVERCOMING THE “FREE-RIDER” PROBLEM

In deciding on an implementation strategy, the management team and its advisers should be prepared to consider and proactively address several potential obstacles that may complicate efforts to finish the restructuring out of court.

One of the most significant challenges in restructuring most bond debt can be described as the “free rider” problem. The consent of each individual bondholder is generally required if critical terms of the bonds are to be modified (see above, Waivers and supplemental indentures).

In a widely-held issuance, it is virtually impossible to achieve unanimous consent – one holdout (a party that refuses to agree) or unidentifiable bondholder can block an otherwise consensual deal. Similarly, in an exchange offer or buyback situation, any single bondholder may choose not to exchange, tender or sell its bonds and will be left with the old securities that it held before the exchange.

This situation could benefit the holdouts. Many investors assume that once the restructuring transaction is completed, their old unmodified bonds will be more valuable because:

- The issuer’s balance sheet will have improved and there will be cash available to satisfy the bonds in full instead of at the discount that consenting bondholders agreed to.
- The more stringent covenants or other requirements of the holdout’s unmodified bonds may even force the company to retire the bond debt early through payment in full.

The holdout problem can cause significant execution risk for a restructuring because:

- A company often will not want to complete the deal if there is a large block of holdout debt still outstanding.
- Bondholders who otherwise would have agreed to a restructuring deal may not want to shoulder the burden of that deal while others have a free ride.

The use of an “exit consent” element in an exchange or tender offer can shift incentives to ease the free rider problem. Most bond indentures include a provision permitting a majority or supermajority in principal amount of the bonds to amend certain indenture provisions.

The company can therefore make the tender or exchange of bonds conditional on an agreement (the exit consent) to the elimination of certain covenants in the existing bonds. Exit consents create a “prisoners’ dilemma” for bondholders:

- Each bondholder must consider that if a sufficient majority of the other bondholders accept the deal, the covenant changes will become effective.
- If the bonds are stripped of their protective covenants, the bondholders who do not tender could be left without a remedy if there is a subsequent sale, refinancing or recapitalisation of the company.
Therefore, where there is a risk of covenant-stripping, there is a powerful incentive to participate in the tender or exchange. This in turn minimises the likelihood of free riders.

If the company cannot successfully overcome the holdout problem through a consensual restructuring, the company can team up with the consenting bondholders to arrange a pre-negotiated plan of reorganisation (often called a “pre-packaged” plan, or “pre-pack”) that can be forced on the holdout minority in a bankruptcy proceeding, usually under US Chapter 11.

For the company, a pre-pack:

- Offers many of the advantages of a bankruptcy filing, such as:
  - the automatic stay of actions against the company;
  - the option to accept or reject executory (not fully performed) contracts; and
  - a moratorium on debt and interest payments during the proceeding.
- Minimises a number of the disadvantages of a bankruptcy filing, such as a potential loss of control and prolonged judicial and creditor scrutiny.
- Is easier to negotiate because it requires consent of only two-thirds of the bondholders in principal amount, plus a majority in number of those who vote on the plan, to agree to the treatment. By contrast, an out-of-court exchange offer typically requires approval by 80% or more of the bondholders in order to resolve the holdout problem.
- Most importantly, solves the holdout problem because it binds all bondholders, whether or not they voted in favour of the plan.

A pre-pack also offers advantages to bondholders. As a pre-pack is typically much shorter than a non-negotiated Chapter 11 filing, it reduces transaction costs of the bankruptcy, meaning that there are more funds available for distribution to bondholders.

In order to effectuate a pre-pack, the company negotiates an acceptable plan with its bondholders and puts it to a vote before entering bankruptcy. Pre-bankruptcy acceptances can count towards the plan acceptance requirements of Chapter 11, so long as they are solicited in accordance with applicable non-bankruptcy law (section 1126(b), US Bankruptcy Code). The company can therefore essentially “lock up” the bondholders by stating that any holder that votes affirmatively for the deal will be deemed to have voted in favour of that economic treatment in a Chapter 11 plan.

In this way, before the company takes the step of filing for Chapter 11, it can be sure that it has sufficient creditor consents to have its plan confirmed. This strategy generally minimises both the time that the company spends in Chapter 11 and the impact of the bankruptcy filing on business operations.
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insolvency-related cases and transactions of the last decade,

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