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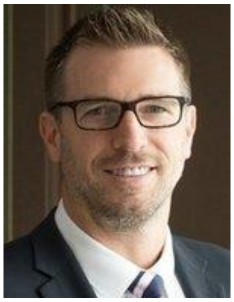
A Faster, Cheaper, More Efficient Way To Restructure

By **Kurt Mayr and David Lawton** (June 3, 2020, 5:10 PM EDT)

Kurt Mayr



David Lawton

While the full extent of COVID-19's effect on the economy remains to be seen, the pandemic will likely create significant restructuring activity for companies already experiencing financial distress and otherwise healthy companies distressed by the pandemic. We have already seen an increase in Chapter 11 filings, and more will follow.

Chapter 11 can be an expensive, time consuming and disruptive process for a company, its management, counterparties and stakeholders. Chapter 11 is useful and necessary where the requisite contractual consents cannot be obtained to restructure out of court. Bankruptcy binds stakeholders to a restructuring pursuant to supermajority class voting and court order.

Where requisite consensus can be obtained, however, the benefits of an out-of-court restructuring are clear. It is usually a faster, cheaper and more efficient method to adjust a capital structure for the benefit of all stakeholders compared to a formal in-court process like a Chapter 11 filing.

Out-of-court restructurings allow the parties to negotiate in a private arena instead of airing the company's distress publicly and risking further complications and costs of statutory committees, discovery, litigation and claims resolution. The broad economic dislocation created by COVID-19 should cause parties to thoroughly explore the possibility of out-of-court restructurings in an effort to find the quickest and least expensive restructuring alternative.

As discussed in our prior article[1] regarding efficient uses of Chapter 11 restructurings, the sudden and substantial loss of revenues due to the pandemic has incentivized borrowers and their stakeholders to find restructuring solutions that can be consummated quickly with the least cost possible. Many companies lack sufficient liquidity (from revenues or debt) to afford a lengthy — or expedited — bankruptcy process. An out-of-court restructuring may be a feasible, and less public, solution.

What Is an Out-Of-Court Restructuring?

An out-of-court restructuring is a comprehensive capital structure adjustment that addresses the financial distress of a business in the short and long term on a consensual basis. Out-of-court restructurings require compliance with the distressed company's existing contractual terms to its lenders and other stakeholders, including contract counterparties, suppliers, employees and stockholders.

If the debtor cannot comply, it must obtain the consent of its relevant stakeholders to implement the transaction. Out-of-court restructurings must also comply with applicable law and regulations, including state and federal securities laws and the rights of existing equity holders.

Out-of-court restructurings are most efficient where the number of parties or groups of parties is limited. The more parties at the table, the greater the complexity, number of consents required, and the potential for competing interests and hold-up. Simple capital structures are more easily adjusted out of court than larger capital structures with multiple tranches of debt with different rights with respect to collateral, priority and maturity.

Common out-of-court restructurings include the following.

- *Loan Workouts.* Companies with a single loan facility are prime candidates for an out-of-court solution because they often only require a discussion between the lender group/syndicate and the company. Often referred to as a "workout" in which the lenders and borrower agree to adjust payment terms (e.g., maturity extension or interest payment schedule) to avoid bankruptcy, while compensating the lenders for their accommodation (e.g., new or additional collateral/guaranties, improved interest rate or fees, and new/better covenant protections). Often existing shareholders contribute to the solution to justify their continued stake in the business.

- *Public Debt Exchanges.* Companies with public bond debt may offer to exchange old bonds for new bonds with different payment terms (new maturity date and/or different interest rates) to relieve financial trouble while compensating bondholders for the adjustment through improved rights (e.g., new or additional collateral/guaranties, improved priority, covenant protection, interest rate and fees).

  These exchange transactions often include a coercive tactic (known as "exit consents") whereby a majority of bondholders accept new bonds under a new indenture with the improved rights and amend the original indenture with majority consent to remove covenants, which leaves holders of the old bonds with minimal protections if they refuse to participate in the exchange.

- *Debt-for-Equity Exchanges*. Where an adjustment of public bond debt obligations requires a reduction in the principal amount, companies may offer bondholders equity in exchange for existing bonds (or a combination of equity and new bonds).

- *Capital Raises*. Companies often offer existing lenders/bondholders the opportunity to participate in a new financing that is implemented contemporaneously with a loan workout or public bond exchange. In these situations, existing creditors lend "new money" on attractive terms to support the restructuring and their continuing investment in the restructured company.

- *Asset Sales*. Selling existing assets to generate cash to fund operations and repay debt is a common restructuring technique. Credit facilities and bond indentures contain covenants that condition material asset sales on lender consent or the satisfaction of certain conditions, such as applying proceeds to pay down or repurchase debt. Creditors may consent to waive or amend such conditions to implement an out-of-court restructuring.

- *A Combination of Transactions*. Out-of-court restructurings often involve multiplied components from the above list: a bank debt workout may require a bond debt accommodation via an exchange; asset sales may be paired with a workout or exchange to provide liquidity and adjust for future debt capacity. For example, bondholders might support an asset sale as long as they can exchange for new bonds and receive a partial payment from the sale proceeds.

Many out-of-court restructurings are coupled with a potential prepackaged Chapter 11 filing as further incentive to garner creditor support for the out-of-court solution. Creditors are given the choice of approving the out-of-court transaction or, if creditor support is insufficient to implement the deal consensually, it can still be implemented through a Chapter 11 prepack.

For example, if an out-of-court exchange offer requires the participation of bondholders holding 90% of the original bonds, but only 80% of the holders consent, the transaction can still be implemented through a Chapter 11 prepack, which requires two-thirds consent for court approval.

Because an out-of-court transaction is less expensive and carries less execution risk, borrowers will often offer creditors better economic recoveries in an out-of-court deal. If bondholders know that the deal can be implemented without their support via a prepack, they will often consent to the out-of-court transaction and take the better recovery.

Challenges to Out-Of-Court Restructurings

High Levels of Consent Required

Credit agreements and bond indentures require 100% creditor consent for fundamental amendments, including changes to maturity date, interest rate and principal amount owed. Transactions designed to reduce payment obligations through an exchange or new financing therefore require very high participation rates to avoid the free-rider dynamic.

For example, bondholders are unlikely to support an exchange for new bonds with a later maturity date or reduced principal amount if a substantial amount of bondholders will keep their original bonds and maintain a preferred position. For this reason, most exchanges are conditioned upon a high level of creditor consensus, typically 95% to 98%. Failure to meet the condition may result in a bankruptcy filing or alternative transactions.

Complex Capital Structures

Capital structures with multiple layers of debt and creditor constituencies with different rights present a more challenging path to consensus. A company with senior and junior secured debt and unsecured debt will need to reach consensus with each class of debt and the more junior debt is almost always the hardest to please because it usually is asked to bear the most burden in the restructuring.

Junior creditors may be skeptical of an economic proposal based on austere financial projections and significant junior debt reduction that grants senior lenders additional fees and collateral.

By contrast, companies with a single credit facility or other financing are prime candidates for an out-of-court solution because they often only require a discussion between the lender group/syndicate and the company. In these workouts, the lenders and the company can agree to adjust payment terms — extend maturity or defer interest payments — to avoid bankruptcy.

Operational Restructuring Needs

If financial distress is not simply a matter of too much financial debt and external circumstances, out-of-court workouts may pose challenges that are avoidable in bankruptcy. For example, if a company is burdened by off-market long-term contracts, the company will have to renegotiate the contracts contemporaneously with the renegotiation of debt terms with lenders.

If contract counterparties refuse to cooperate, the company may need to file for bankruptcy where it will have the power to reject unprofitable contracts to save the business. Often contract counterparties benefiting from above-market terms will disregard the threat of bankruptcy and maintain aggressive positions in out-of-court negotiations, which can force a bankruptcy filing with its attendant costs and lower recoveries for the counterparty.

Major Disputes/Litigation

If litigation is a major contribution to financial distress, an out-of-court restructuring is unlikely to succeed absent a settlement or viable settlement strategy. Major disputes among creditors — like those about valuation or the validity of secured lenders' liens — may be difficult to settle outside of bankruptcy.

Public Versus Private Companies

If a company's financial distress requires a restructuring that significantly impacts shareholders, it may be difficult to achieve without a bankruptcy court order enforcing the restructuring. Obtaining shareholder consent may be particularly difficult for a public company. By contrast, closely held companies and private-equity-owned portfolio companies have readily identifiable shareholders who may be willing to support an out-of-court restructuring and financially contribute to the solution to maintain a stake in the reorganized company.

New Financing

If substantial new financing is required to facilitate a company's return to financial health, it can be difficult to obtain outside of bankruptcy. Bankruptcy financing, known as debtor-in-possession financing, is a court-approved funding generally entitled to significant legal protections and super-priority over other creditors in a bankruptcy case.

Lenders lending into a distressed situation often prefer the certainty of debtor-in-possession financing over the more risky out-of-court rescue financing option. Rescue financing may be available, but lenders to distressed companies may be particularly hesitant to extend financing for out-of-court solutions under current pandemic circumstances with major revenue reductions and significant uncertainty about the economic future.

Conclusion

Bankruptcy is not the only option for companies in pandemic-related distress. Out-of-court restructurings will be an essential tool for companies and their stakeholders during the wake of the pandemic. The efficiency, flexibility and simplicity that often characterize out-of-court restructurings may outweigh one or more of the challenges noted above.

While Chapter 11 offers debtors a global automatic stay, the ability to cram down creditor classes, and sell assets free and clear of liens and other interests, it also opens the door for expensive and time-consuming complications such as increased litigation, discovery and public disclosure obligations.

Borrowers and their stakeholders should consider the possibility of saving time and resources through a consensual out-of-court process — especially where a compromise between the borrower and one or two lender groups would provide sufficient consent to right-size the capital structure, authorize strategic assets sales or undertake a capital raise — without court oversight.

Kurt Mayr is a partner and the leader of the firm's bankruptcy and restructuring practice at Morgan Lewis & Bockius LLP.

David Lawton is of counsel at the firm.

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[1] https://www.morganlewis.com/pubs/bankruptcy-during-covid-19-three-expedited-options-cv19-lf.