Representing bondholders in a restructuring

KEY POINTS
- Lawyers should be aware of both the contractual and statutory mechanisms available to the issuer to restructure bonds, and, importantly from the bondholder’s perspective, the limitations of those mechanisms.
- Technical and procedural considerations may be as important as the commercial terms of a restructuring, for example working with the clearing systems, trustees and depositaries to ensure that the commercial terms can in fact be implemented in the manner envisaged.
- Aside from legal and technical matters, timely, clear and effective communications and strategy will also be fundamentally important in advising bondholders and groups of bondholders, as is a deep understanding of the broad range of players and interests involved in an increasingly complex bond market.

INTRODUCTION
The current restructuring cycle has featured bondholders playing a significant role in many restructuring cases. In previous cycles, high yield bonds featured in some larger European corporate capital structures, but most restructurings were driven by banks or other syndicated lenders. Historically, high yield bonds would often be unsecured, with little or no prospect of any recovery in a liquidation, and holders would have limited influence on restructuring negotiations. Over the last few years, market conditions led to European companies issuing more high yield bonds, the proceeds of which were used to refinance senior, mezzanine and second lien leveraged loans. Bonds issued to refinance secured loans often have the benefit of similar security and guarantee packages to the loans they refinanced. In the current cycle, senior secured bonds are more likely to have a real economic interest and, therefore, a stronger negotiating position. Although the trend may reverse, at the time of writing it is estimated that around half of all leveraged finance in Europe takes the form of bonds.

STRATEGY AND TYPES OF HOLDERS
This shift in the market has changed the role of advisers to bondholders, as well as the identity of the bondholders themselves. Traditional strategies for ‘out-of-the-money’ bondholders included making use of whatever negotiating leverage could be found, with a view to securing a nuisance payment for consenting to an ‘out-of-court’ restructuring, thereby saving the debtor the cost and inconvenience of an ‘in-court’ scheme of arrangement, chapter 11 or other process. These unsecured distressed bonds were attractive to the more opportunistic funds with an appetite for litigation.

Today, holders of bonds may be long-term investors, investors buying bonds at a discount with a view to converting their bonds into a controlling equity position in a restructuring, smaller investors relying on larger holders to guide the process, holders with short positions or credit default swaps who will be paid if the bonds fall in value or default. The range of bond investors and strategies employed are limited only by the creativity of the investor and by the laws and regulations which govern them.

The diversity to be found amongst bondholder groups, both in the type of institution and their strategy may also vary according to the type of company which is undergoing restructuring. For example, a significant proportion of the holders of bonds issued by GRAND plc, the Deutsche Annington securitisation vehicle restructured by a scheme of arrangement in late 2012, were large institutional investors such as pension funds and insurance companies, many of whom had held the notes since their issue. By contrast, in the more recent restructuring of the insurance intermediary Towergate Partnership Ltd, many of the bondholders were private equity and debt funds who took equity in the restructured company.

FIRST STEPS
In any restructuring where you represent bondholders, at the outset you will need to understand:
- the information available to you;
- who are the bondholders;
- what the deal structure is;
- what are the triggers for a restructuring;
- who has control of the process; and
- who will pay the legal fees.

What information is available to you?
A key difference between bondholders and syndicated lenders is the amount of information available. Bond documents usually grant far fewer rights to bondholders to receive and request financial and other information, whereas syndicated lenders may have a comprehensive package of information rights, including the ability to appoint accountants to conduct independent financial reviews at the issuer’s expense. Attempts by bondholders to use the court to obtain information and documents in excess of what can be contractually requested under the bond documents have not been successful, for example see Highberry Ltd v Colt Telecom Group Plc (No 1) [2002] EWHC 2503 (Ch). The lack of information may seem particularly problematic to those who ordinarily operate in the US restructuring market, where more information is generally available.
Where information is not publicly available, bondholders will not usually wish to receive it in case it compromises their ability to trade the bonds and other securities of the company. However, it is possible for a group of holders to mandate financial advisers to receive information and negotiate a potential restructuring without passing material non-public/price sensitive information to the bondholders until the restructuring negotiations have reached an advanced stage and there is a term sheet that the advisers can recommend to the bondholders. This approach minimises the time that bondholders will be restricted from trading, but involves the bondholders delegating control of negotiations to their financial advisers.

Who are the holders of the bonds and what is the nature of their holding?

Unlike most leveraged loans, it is difficult for a bond issuer to identify the holders of its bonds, as a bond is almost always held in a global form in a clearing system such as Euroclear/Clearstream. A relatively small number of institutions who act as custodians will hold accounts directly with the clearing systems, and those custodians will in turn hold the bonds on behalf of their clients, or in some cases for other intermediaries in a chain which ultimately ends with the beneficial owner of the bonds. Custodians will not identify their clients without consent, so the trustee or issuer may not be able to see past the first or second link in the chain of intermediaries.

In a restructuring of a large issuer, which is likely to have multiple issuances of different types of bonds, it is also necessary to try to establish the identity of at least some other beneficial owners of bonds, so that ad hoc groups or committees can be formed. Holdings are rarely reported publicly, so this is usually achieved by bondholders working through their network of contacts, or by law firms or financial advisers acting as a hub for forming a bondholder group.

In a restructuring, it will become important at an early stage to try to establish the identity of at least some other beneficial owners of bonds. This is because it is impossible to establish the identity of all holders. Bonds could be divided into a number of different tranches or structured as senior, mezzanine or junior bonds. Some bondholders may have the benefit of a security package, whilst others are unsecured. Some may have cross-holdings across the entire suite of an issuer’s bonds. It is possible that some holders may have other interests within the issuer and are key stakeholders. All of this will impact on both legal and commercial negotiating leverage during the restructuring, so it is important to have a full understanding of the extent and nature of those holdings in order to be able to advise the relevant bondholders accordingly. Different classes of bonds may be able to realise almost a full return in a restructuring, whilst some junior bondholders could end up with nothing, so this will affect the approach taken.

What is the deal structure?

There are no standard terms for bonds or notes, with terms being negotiated on a deal by deal basis.

It is also worth starting discussions with, or encouraging the issuer to start discussions with the trustee at an early stage. Trustees often operate very strictly within the terms of their appointment documents, so a full understanding of those terms (and who has the controlling power, as noted above) is crucial. Where a trustee is uncertain, they might seek to apply to the court for directions or to require substantial indemnities, both of which could have timing and other consequences for the proposed restructuring. An early dialogue with the trustee is therefore important to understand how it views its role in the restructuring, and if it is likely to seek directions or an indemnity.

What are the triggers for a restructuring?

Bond documents will usually comprise a much more ‘covenant light’ package of fairly market standard terms than leveraged loan documents. Typically, high-yield bond covenants are less restrictive than those in leveraged loans, being ‘incurrence’ not ‘maintenance’ covenants. Incurrence covenants are tested only when the issuer actually takes an action, such as sell an asset or issue new debt, whereas maintenance covenants must be tested on set dates prescribed by the loan documents whether or not the issuer has taken any actions. Compared with syndicated lenders, bondholders may have fewer opportunities to instigate restructuring negotiations, and ultimately exercise enforcement rights. Many bond restructurings are, therefore, related to payment events such as missed coupon payments or an upcoming maturity.

Aside from such standardised features, the covenant package will reflect the state of the market when the bonds were issued, and it is possible that the current group of bondholders had little or no input at that time. At times, the market has been so favourable to issuers that bonds with very weak covenant packages have sold strongly. It is therefore vital to understand the key deal documents in order to determine what contractual strengths and options the bondholders have in the restructuring.

Most bondholders operating in today’s market are sufficiently sophisticated to inform themselves about the high-level terms of their bonds, and a number of information services now summarise bond terms and conditions as well as providing a comparison to market standard terms. However, the information provided by such services is often insufficiently detailed to form a proper view as to restructuring options, and it will be important to undertake a full legal review in order to understand the bonds and the consequences of their terms and structure. For example, the rights under the bond documents may affect whether or not the issuer could combine two or more different bonds into a single class for the purpose of voting to approve a scheme of arrangement.

Who has control of the process?

High yield bonds are often governed by New York or English law, and important provisions are likely to be set out in terms and conditions of the bonds, as well as the Indenture (New York law)
or Trust Deed (English law). These documents will set out what constitutes an event of default, who can direct or block enforcement action and voting requirements for issuer proposals.

Individual enforcement action may be restricted under the documents, with holders required to collectively pass a resolution directing the trustee to take action. Where bondholders are divided into different tranches, a ‘controlling’ or ‘directing’ class of holders may be able to direct the trustee without regard to other tranches of holders. These provisions are often complex, and vary enormously depending on the type of bonds and issuer. Bondholder decisions are made by voting and there will be varying thresholds depending on the type of decision or direction, for example, New York law bonds often require a simple majority for most decisions but require 90% or even unanimous consent in respect of certain entrenched or reserved matters such as amendments to the coupon/interest rate and tenure of the bonds.

Who will pay the legal fees?
Whereas senior syndicated loan documents often contain provisions requiring the issuer to reimburse lenders for professional fees associated with defaults and restructurings, these provisions are often absent from bond documents. Professional fees incurred by the trustee are usually covered, but not those incurred by individual holders. In cases where the bondholders have some negotiating leverage, it is often possible to agree with an issuer that legal and other professional fees incurred by a bondholder group are covered, usually subject to terms intended to promote efficiency. This will of course depend entirely on the strength of the bondholders’ bargaining position, for example the number of holders represented by the group, and the issuer’s need to engage with the group.

IN-COURT RESTRUCTURING
Bondholders’ rights and leverage are not limited to the terms of the documents. In a formal insolvency or restructuring proceeding, a formal creditor may be appointed, which in some jurisdictions may have enhanced access to information and a role in driving the restructuring. Also, these in-court restructuring proceedings may have different voting thresholds and requirements to those set out in the contractual bond document which could furnish bondholders with either positive powers or blocking rights. A full examination of such tools is beyond the scope of this article, but for example a scheme of arrangement needs approval of a majority in number and 75% in value of each class of creditors. A scheme could therefore be used by an issuer to restructure bonds where the bond documents may require 90% or unanimity to achieve the same result. In a chapter 11 proceeding, subject to certain safeguards, only 66.6% of one impaired class are required to approve a plan of reorganisation. Accordingly, consideration must be given to the insolvency and in-court restructuring tools potentially available to the issuer in all applicable jurisdictions and the role that bondholders have in such processes.

STRATEGY: IDENTIFYING COMMON OBJECTIVES
For any restructuring of a significant entity, particularly one whose bonds are regularly traded on the secondary market, it is unusual that one single bondholder will have sufficient holdings to take control of the restructuring process. Often bondholders will organise into informal or ad hoc groups, which have collective negotiating power notwithstanding that the members are not contractually bound to collaborate.

In a complex restructuring, it may be unlikely that the interests of even a small group of bondholders will be completely aligned, and part of the role of those advising a group of bondholders may be to facilitate and chair discussions as to common ground within the group, and to flush out areas where the group is not in agreement in order that they can be addressed. Lawyers and financial advisers should seek to resolve issues through creative solutions that work for as many group members as possible. For example, in a recent out-of-court restructuring where bondholders were converting into a payment in kind (PIK) instrument, certain holders could not accept an instrument which did not pay at least a small cash coupon. The legal team devised a mechanism which enabled a small cash income stream to be paid to such holders without compromising the treatment of the instrument as a PIK.

In many cases, groups of bondholders will find sufficient common ground to work together, but bondholders should be cautious of groups where the path chosen by the group is not consistent with their own interests or goals, and in such cases may wish to appoint their own lawyers to either work alongside the group’s lawyers or behind the scenes. Lawyers advising groups should be mindful that some group members might well have their own lawyers, either in-house or external.

GROUP RULES
Whereas it is important to have a clear common vision as to the group’s objectives, many bondholders have internal processes which can make signing up to complicated committee documents problematic. It is often preferable to keep any group rules as simple as possible.

It may be easier to advise the group by way of one or two elected spokespersons within a set mandate (with regular updates to the group as a whole), rather than communicating with each and every member. If a group is large, smaller sub-committees or working groups can be set up to negotiate specific items or documents. This approach is often helpful with information management. As mentioned above, most bondholders will not wish to become restricted until the last possible moment, so each member should understand the nature and extent of the information they will receive as part of the group.

Where sensitive information is being shared the issuer will require the committee members to sign up to confidentiality agreements, and to understand the issuer’s proposals for publishing the information.

It may also be sensible for other committee members to require confidentiality and cost sharing provisions to facilitate holders joining and leaving the group where necessary.
NEGOTIATING AND WORKING WITH OTHER KEY STAKEHOLDERS
Having worked out what the strengths of the bondholder or collective bondholders in the committee are, the next step is to enter into negotiations with key stakeholders. This will be a gradual and ongoing process, and a collaborative, but firm approach is usually more likely to yield results. Due to the democratic nature of most restructurings, if the bondholders' negotiating position is fairly weak, they may benefit from working with other stakeholders, and identifying potential allies may be a priority.

Other stakeholders may include the issuer, its sponsor or owner, more senior or more junior ranking lenders or other bondholders, monoline insurers, pension funds or swap providers.

CROSS-HOLDINGS
It is likely that some bondholders have cross-holdings (eg holdings in other parts of the capital structure), which may present conflicts of interest with their position as bondholders. This can sometimes be advantageous to a bondholder group, as it may enable the bondholder group to make use of the stronger negotiating leverage of the cross-holder, but caution should obviously be exercised due to differing interests. Conflicts can sometimes be dealt with by confidentiality restrictions discussed above, and larger institutions may put up internal walls between those dealing with different holdings. It is important for members of bondholder groups to be somewhat flexible about conflicts of interest, as in reality many holders will have different motivations and strategies. The benefits of forming groups and working together often outweigh the negative impact of the more minor conflicts.

POST-RESTRUCTURING MATTERS/LOCK-UP PERIODS
It is also worth noting that the strategy of many bondholders involves improving the liquidity and value of their position so that they can trade out of it. The negotiation of the restructuring may take time, and bondholders could be prevented from trading for the period of the restructuring and possibly beyond. An adviser representing bondholders will seek to keep such lock-up periods to an absolute minimum so that the bonds, or whatever instruments replace them, can be traded as soon as possible. Bondholders should also be mindful that the consideration distributed to them in the restructuring might not be bonds of the type held before the restructuring. For example, in a debt for equity swap, the bondholders will be distributed company shares, which might not be admitted to trading on an exchange straight away or even at all. This consideration might therefore be quite illiquid. There might also be regulatory or other restrictions on certain persons holding equity and tax consequences of doing so. These issues should be considered both when negotiating and when considering the practicalities of distributing and holding the restructuring consideration.

CONCLUSION
To effectively advise a group, lawyers should be aware of both the contractual and statutory mechanisms available to the issuer to restructure the bonds, and, importantly from the bondholders perspective, the limitations of those mechanisms. Similarly, technical and procedural considerations may be as important as the commercial terms of a restructuring, for example working with the clearing systems, trustees and depositaries to ensure that the commercial terms can in fact be implemented in the manner envisaged. Aside from legal and technical matters, timely, clear and effective communications and strategy will also be fundamentally important in advising bondholders and groups of bondholders, as is a deep understanding of the broad range of players and interests involved in an increasingly complex bond market.

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Further reading
- High yield bonds: restructurings in a new era (2015) 4 CRI 151
- LexisPSL Restructuring and Insolvency: Practice notes: Identifying bondholders and effective communication
- LexisPSL Restructuring and Insolvency: Practice notes: Bonds and notes

Biog box
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