Pre-emptive restructuring: guidance for corporate advisers

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The financial markets experienced a dramatic reversal in 2007. The first half of the year was marked by unprecedented availability of cheap credit that fuelled a refinancing and M&A boom. However, the year ended with the most significant credit crisis in years. Now, faced with the combination of high leverage, poor liquidity and limited access to the capital markets, the focus for many companies in 2008 will be avoiding financial distress, or even worse, a bankruptcy filing.

A few figures demonstrate just how significant the problem could become. A total of approximately $1.6 trillion in combined leveraged loans and high-yield debt was outstanding as of September 30 2007. At the 2007 default rate of 0.35 per cent, only about $5.6 billion of the total debt would default in 2008. But if, as many predict, the default rate rose to the 6 per cent to 8 per cent range – levels typical of past downturns in the cycle – over $100 billion in defaults would occur.

Well-managed companies will take pre-emptive steps to anticipate and restructure to avoid financial distress, even in the absence of current defaults. A number of tools are available to enhance liquidity and avert problems, and the earlier a company begins to restructure the greater the likelihood of success.

Being proactive is especially necessary because of the 'covenant-lite' loans made available to many companies in the past boom. These issuers are less likely to default in the near term because their debt lacks the early warning triggers that help to focus management on addressing leverage and liquidity problems before it is too late. Paradoxically, covenant-lite loans might mean that the default rate does not rise as quickly as might be expected, but ultimately more value could eventually be lost because companies delay their restructuring efforts.

The new corporate reorganisation environment

Companies that proactively anticipate financial distress may be able to take advantage of changes that have occurred in the environment for corporate restructurings. Twenty years ago major creditors were largely banks and public bondholders, and reorganisations were typically accomplished through protracted Chapter 11 proceedings. The process focused almost exclusively on restructuring the existing business through a conventional Chapter 11 plan rather than through a swifter and more value-preserving sale or change of control transaction. Today, reorganisations are far more market-driven and transactional. Increasingly, Chapter 11 is seen as a vehicle for binding hold-outs in a restructuring or carrying out a quick sale, to be utilised only if a restructuring negotiated among the company and its major creditors and investors cannot be accomplished out of court. This market-driven process means that distressed companies are in play as acquisition targets as soon as their financial distress becomes apparent, no matter whether Chapter 11 protection is sought.

Impact of the claims trading market

Banks used to retain their financial claims throughout a restructuring, but now they tend to sell them off in the capital markets either before or during the restructuring process. The result is that the debt claims, both public and private, across the entire capital structure are actively traded and it is becoming easier for investors to purchase effective control of a distressed business through the acquisition of claims likely to be equitised in a restructuring. Market forces are driving the company's 'fulcrum' debt obligations (the marginal claims that cannot be paid off in full and are likely to be satisfied through the issuance of equity in a restructuring) into the hands of the investors, which want to decide whether to own the company or to sell it to a third party.

Creditors with a private equity perspective

Hedge funds and, increasingly, private equity firms are active in trading distressed claims. Some are simply looking to buy and sell undervalued securities, while others have a private equity perspective on their investment. Rather than looking to turn a quick profit, they seek to become owners of the enterprise. In fact, restructuring negotiations today often resemble negotiations among private equity investors, with emphasis on post-restructuring corporate governance and minority protections typical of non-distressed buy-outs.

New opportunities for value preservation

The market-based approach to restructuring can preserve substantial value that might otherwise be lost in a conventional Chapter 11 process, which can become bogged down in inter-creditor disputes and disagreements over valuation of the enterprise. The large amount of capital expected to be dedicated specifically to distressed investing in the next round of corporate restructurings ($100 billion now versus $5 billion in 2001 to 2002) is expected to be deployed by activist investors which would prefer to restructure companies out of court and avoid the costs and uncertainties of court intervention. The bargaining process is aided by the ability of companies and their creditors to push for a market test by soliciting purchase offers for the business in parallel with a standalone reorganisation plan. To the extent that a restructuring or sale negotiated out of court cannot be implemented without court intervention (because of hold-outs or a purchaser's desire for the protection of a court order), Chapter 11 remains available to facilitate implementation of the transaction.

Challenges to successful restructuring

Private restructurings among investors and companies are not without their challenges. More creditors are hedging their exposures with credit default swaps, resulting in less transparency over the real parties of interest with decision-making authority. This makes communication more difficult and creditor behaviour less predictable, especially if creditors with credit default swaps stand to benefit from a default or bankruptcy. Some creditors are also hedging their risks by purchasing claims at multiple levels of the capital structure, which can create divided loyalties and unpredictable behaviour as an investor uses its rights in one class of claims to benefit its position in another.

Lesson for management – be proactive to preserve value

The principal lesson for managers of distressed or near-distressed companies in today's restructuring environment is that creditors and other investors – or at least some of them – can, more than ever before, be partners in the restructuring process. Even if management does not engage them, these investors will be active in exerting their influence over the restructuring process. However, by working with the investors early on and anticipating their expectations and needs, management may well be able to engender a cooperative restructuring environment that maximises value and minimises delay and disruption to the business.

Managers have a number of restructuring options at their disposal, although these tend to dwindle as time passes and the situation becomes more severe. It is always advantageous to sell assets, restructure contracts and liabilities and seek new financing from a position of relative strength. However, deciding which of these actions are optimal should be done in conjunction with a strategic review of the company's objectives and where pockets of value lie.

Divestitures

Evaluating the company's portfolio of assets is the first step in the restructuring process. This entails

identifying those assets that are core to the business and will generate the most value over the long term, while divesting or shutting down businesses that do not fit with the company's long-term plans or are draining cash or reducing value. Divestitures can provide a capital infusion when liquidity is scarce, providing more time for an operational and/or balance-sheet restructuring plan.

Restructuring existing operations and obligations

Restructuring existing operations, including the terms of existing operating contracts, leases and agreements, can provide the company with flexibility and lessen the immediate financial drain that may be causing the distress. There are also options for addressing near-term debt maturities or defaults, including:

- amendments and/or waivers of covenants and maturities;
- exchange offers modifying the terms of existing bonds or notes;
- tender offers for debt, especially if trading below par; and
- use of Chapter 11 to implement a pre-arranged or pre-packaged reorganisation.

Combining refinancing and other deleveraging techniques

Despite the problems facing companies seeking to raise capital when market conditions are difficult, refinancing is always a tool to explore as part of a debt restructuring plan. Sometimes, for example, a combination of existing creditors and new investors may make capital available to a distressed company even under difficult market conditions. Additional debt or equity capital can provide the liquidity necessary to avoid distress, or more often, for an integral part of a restructuring that also involves debt modifications or conversions. In connection with a restructuring, new capital can be used to accomplish part of the necessary deleveraging or to repurchase outstanding debt and reduce debt service going forward. Deleveraging and liquidity enhancement should explore a combination of techniques:

- debt refinancing;
- modification of existing debt or conversion of debt to equity;
- equity financing;
- private placements of debt and equity or registered direct offerings;
- rights offerings;
- securitisation of unencumbered assets; and
- cuts in dividends and suspension of stock repurchases.

The Chapter 11 option

For most companies, Chapter 11 should be a last resort. It imposes incremental transaction costs and unpredictability, and is best avoided if an out-of-court restructuring can be accomplished. Many fundamentally sound but financially distressed companies should be able to negotiate a restructuring of their liabilities outside Chapter 11 if they anticipate distress and take pre-emptive steps as described above. Optimally Chapter 11, if needed at all, should be used as a tool to implement an orderly restructuring or sale, the terms of which have been pre-emptively negotiated, rather than as a last-ditch life preserver when all else has failed. Recent changes to the federal Bankruptcy Code have limited the relative attractiveness of a free-fall Chapter 11 by favouring selected creditors and by reducing the amount of time a company has to develop its own plan of reorganisation. In light of these changes, Chapter 11 is best viewed as a tool to finalise negotiations with disparate creditor groups, rather than a means of commencing a reorganisation process.

Implications for corporate advisers

The likelihood of facing a period of financial distress is increasing for many companies. However, proactive measures can diminish the impact of financial distress and help to avoid the loss of value and costs associated with restructuring to address it. Active trading of distressed debt and the evolving attitudes of distressed investors should enhance the likelihood that pre-emptive strategies can succeed. Given this reality, it is up to corporate advisers – including bankers, lawyers, consultants and accountants – to help their clients to anticipate financial difficulties and navigate the rough seas ahead by providing the necessary perspectives about the company's financial needs in today's difficult markets, as well as sound guidance on which of the numerous restructuring options are most appropriate under the circumstances.

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