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Expert Q&A on Out-of-Court Restructurings

An out-of-court restructuring of a financially distressed company can be a simpler and more efficient way to modify a company's capital structure than a bankruptcy proceeding. Determining whether an out-of-court restructuring is appropriate depends on the circumstances and requires consideration of various factors. Practical Law asked *My Chi To* of *Debevoise & Plimpton LLP* to discuss her views on out-of-court restructurings and how they may be used as an alternative to a Chapter 11 proceeding.

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What is an out-of-court restructuring?

An out-of-court restructuring is a transaction that modifies a company's capital structure outside of bankruptcy. In an out-of-court restructuring, the company cannot bind non-consenting parties on many important issues, as it can in Chapter 11. Therefore, the company has to obtain the support of affected stakeholders or find a way to implement the transaction in compliance with their legal rights. A critical mass of creditors must be willing to engage with the company because they believe that an out-of-court restructuring is preferable to bankruptcy.

Out-of-court restructurings are always negotiated against the backdrop of what would happen in a bankruptcy proceeding. Apart from the impact a bankruptcy proceeding might have on the value of the business, as well as the added costs and delay generally associated with a bankruptcy proceeding, a creditor assesses its own leverage to object to unfavorable treatment in Chapter 11 and the risk of challenges that might be brought to its claim.

Companies often negotiate out-of-court restructurings in parallel with prepackaged bankruptcy plans. This discourages creditors from holding out by refusing to provide their consent, and allows the company to be adequately prepared in case it does not obtain the required creditor support. If the restructuring cannot be consummated out of court, the company can instead quickly pivot to an orderly bankruptcy filing to implement the transaction negotiated with key stakeholders notwithstanding the existence of holdout creditors.

Search The Prepackaged Bankruptcy Strategy for more on the prepackaged bankruptcy process, including how "prepacks" are implemented, when they are most useful, and their advantages and disadvantages.

There are no blueprints for out-of-court restructurings because each transaction depends on the particular challenges a company faces. Out-of-court restructurings run the gamut from surgical covenant amendments and targeted maturity extensions to extensive recapitalizations involving debt exchanges, new debt issuances, debt-for-equity conversions, friendly foreclosures, and other highly negotiated transactions. In any given transaction, a company might also need to obtain concessions from stakeholders other than its financial creditors, such as equity holders, key trade creditors, landlords, and litigation claimants.

A company may employ a combination of carrots and sticks to induce creditors to support an out-of-court restructuring. For example, it may offer fees, increased interest rates, additional collateral, enhanced covenants, enhanced priority, or other consideration. More coercive tactics, such as "exit consents," are also often used in bond exchanges as a disincentive for creditors to hold out. In particular, exchanging bondholders are often asked to consent to indenture amendments removing material covenants or permitting transactions that significantly impair the value of non-exchanging bonds. Holdout creditors are effectively forced to either exchange their bonds or lose any meaningful covenant protection.

What factors should companies consider when deciding whether to conduct a restructuring in or out of court?

Companies often use their best efforts to restructure out of court because it is generally quicker and less expensive than bankruptcy and less disruptive to the company's business. However, an out-of-court restructuring may not always be possible. For an out-of-court restructuring to be successful:

- **The company must have enough liquidity to operate while it negotiates with its creditors.** If it does not, the company might be forced into bankruptcy to access debtor-in-possession (DIP) financing using inducements such as priming liens and priorities available under the Bankruptcy Code.
- **Key stakeholders must be willing to negotiate with the company.** Constructive discussions generally require that creditors have confidence in the company's business plan and its capacity to execute on it.
- **The number of parties at the negotiating table must be manageable.** While there are examples of successful out-of-court restructurings of large companies with complex capital structures, consensus is easier to achieve with fewer parties. Negotiating with holders of public debt presents unique challenges because they can be difficult to identify, they might change over time, and they are often not willing to become restricted (limiting their ability to trade) for long periods, which complicates negotiation dynamics and information sharing. Even with a small number of creditors, there is always a risk that one party holds out to extract additional value from the company or other creditors.
- **The company's problems must be addressable without resorting to bankruptcy.** An out-of-court restructuring is generally a more effective tool to delever a balance sheet than to remove burdensome contract obligations or resolve other operational issues.
- **The advantages of an out-of-court restructuring must outweigh the unique advantages of a bankruptcy filing.** The Bankruptcy Code provides a company with a variety of tools that can facilitate the formulation and implementation of an operational reorganization, including, most notably, the time and respite offered by the protection of the automatic stay. The Bankruptcy Code also empowers debtors to reject uneconomical leases and executory contracts. Moreover, in some instances, there can be material tax advantages if a proposed restructuring is implemented in bankruptcy.

What are the main advantages for companies proceeding with an out-of-court restructuring?

The main advantages of an out-of-court restructuring include:

- **Potential time- and cost-savings opportunities compared to a bankruptcy proceeding.** Preparing a Chapter 11 filing, even a prepackaged one, can be disruptive to the business and involves substantial work and distraction for management. Certain types of businesses can experience substantial value erosion as a result of a bankruptcy proceeding.
- **Less publicity than a bankruptcy proceeding.** A bankruptcy proceeding is conducted in an open courtroom and requires broad disclosures from the company. Moreover, parties in interest may request discovery and generally be heard on any issue in front of the court.
- **More certainty regarding the outcome.** An out-of-court restructuring involves fewer parties and allows the company more control. Unlike a bankruptcy proceeding, there is no unsecured creditors' committee, judge, or US Trustee second-guessing the result negotiated among key stakeholders in an out-of-court restructuring.

What are the main disadvantages for companies proceeding with an out-of-court restructuring?

By restructuring out of court, companies forgo the considerable powers granted to debtors under the Bankruptcy Code. Bankruptcy offers various advantages, including:

- Improvement in a distressed company's liquidity because the debtor:
  - is prohibited from paying claims arising before the bankruptcy filing, thereby freeing up more cash; and
  - may seek court approval to obtain DIP financing or use secured creditors' cash collateral (for more information, search DIP Financing: Overview and Cash Collateral: Overview).
- The ability to impose a plan of reorganization on non-consenting creditors (for more information on confirmation of a plan of reorganization and cramdown plans, search Chapter 11 Plan Process: Overview).
- The automatic stay, which is triggered by the filing of the bankruptcy petition and stops substantially all creditor acts and proceedings against the debtor and its property (for more information, search Automatic Stay: Lenders' Perspective).
- The power to assume, assign, or reject burdensome and unfavorable executory contracts and unexpired leases (for more information, search Executory Contracts and Leases: Overview).
- Authorization for the debtor to sell assets free and clear of most liens and claims, including fraudulent conveyance claims (by contrast, if an out-of-court restructuring requires asset sales, fraudulent conveyance concerns might deter potential purchasers).

How will recent legal decisions impact out-of-court restructurings?

While not a court-issued opinion, the examiner's report in the bankruptcy proceeding of Caesars Entertainment Operating Co., Inc. and certain affiliates highlights many mistakes that distressed companies and their advisors should avoid in formulating and implementing an out-of-court restructuring. For example, the examiner found that material transactions consummated by Caesars prior to its bankruptcy gave rise to billion dollar claims against the debtors, their directors and officers, and the parent company for actual or constructive fraudulent transfers and breaches of fiduciary duty, and against the sponsors of Caesars' leveraged buyout and directors of the parent for aiding and abetting breaches of fiduciary duty (*In re Caesars Entm't Operating Co., Inc.*, No. 15-01145 (Bankr. N.D. Ill. Mar. 15, 2016)).

The examiner's report reinforces for distressed companies, as well as their boards, sponsors, and advisors, the critical importance of observing corporate governance best practices when contemplating an out-of-court restructuring. Taking steps such as exploring alternative transactions, evaluating all options while keeping fiduciary duties in mind, negotiating affiliated transactions at arm's length, and fully documenting the decision-making process, all serve to protect the board and minimize litigation risk.

Another important legal development is the ruling of the US Court of Appeals for the Second Circuit in *Marblegate Asset Management, LLC v. Education Management Corp*. This ruling overturned a lower court's decision that had created significant uncertainty about the legality of distressed exchange offers, particularly those with coercive features. The Second Circuit held that Section 316(b) of the Trust Indenture Act of 1939 does not prohibit exchange offers that arguably impair the practical ability of non-consenting bondholders to be paid, but not their legal right to payment. While the Second Circuit reaffirmed the viability of exchange offers as an out-of-court restructuring tool, it also noted that dissenting bondholders can still challenge those transactions under various state laws, including fraudulent conveyance and successor liability theories. (846 F.3d 1, 6-17 (2d Cir. 2017).)

Like the examiner's report, the *Marblegate* ruling serves as a reminder that companies and other parties engaged in an out-of-court restructuring must consider its impact on all stakeholders, including potential holdout creditors actively seeking creative avenues to attack the transaction.

PRACTICE NOTES

The following related Practice Notes are available on Practical Law.

>> Simply search the resource title

- Out-of-Court Restructurings: Overview
- Methods of Restructuring Outstanding Debt Securities
- Debt Exchange Offers: Purpose and Process
- Intersection of the Trust Indenture Act and the Bankruptcy Code
- Restructuring Outstanding Debt Securities: Cancellation of Indebtedness Income for Issuers

Search Marblegate Asset Management v. Education Management: Second Circuit Reverses SDNY and Clarifies Right to Payment Under Section 316(b) of the Trust Indenture Act for more on the *Marblegate* decision.

Looking ahead, do you expect an increase in out-of-court restructurings?

Distressed companies have been restructuring out of court for decades and are incentivized to do so when feasible and where the potential benefits of bankruptcy do not clearly outweigh the significant associated costs and risks. More companies are proactively addressing challenging capital structures well in advance of a default through debt exchanges and other creative transactions. This might signal an increasing appreciation of the flexibility and efficiency of out-of-court restructurings. By tackling a fragile capital structure early, companies might be able to buy time and potentially avoid the need for a more comprehensive restructuring down the road when they have fewer options available or run out of time to negotiate with their creditors.