Guide to representing bondholders in a restructuring

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High yield bondholders have been playing an increasingly significant role in restructurings. In previous cycles, even though high yield bonds have featured in some larger European corporate capital structures, restructuring negotiations had been primarily driven by senior bank or other syndicated lenders. This is mainly because high yield bonds were often unsecured, with little or no prospect of any real recovery in a liquidation, unlike leveraged loans which are usually secured. Consequently, high yield bondholders typically had limited influence on restructuring negotiations.

Strategy and types of holders

Since the global financial crisis, the leveraged finance market has experienced a shift towards the use of high yield bonds, partly due to tightened leveraged lending guidelines applicable to leveraged loans. Coupled with strong M&A activity fuelling the continued growth of the market, European borrowers have increasingly turned to the high yield bond market to refinance their senior, mezzanine and second lien leveraged loans. Such refinancings often resulted in the new high yield bond taking the benefit of similar security and guarantee packages to the loans being refinanced, with senior secured high yield bonds becoming more common than unsecured bonds. Commercially, because the holders of a secured bond may be more likely to have a real economic interest in the outcome of a debt work-out, high yield bondholders now enjoy a much stronger negotiating position compared to before, and may play a greater role in the restructuring negotiations alongside other secured lenders. This has become more evident in the ability of the bondholders (for a period of time) to control the decision to take enforcement action and most suitable manner and method of enforcement under the 'super senior intercreditor agreement' in the event the security agent receives conflicting instructions as to enforcement from the super senior lenders and senior secured bondholders.

This shift in the market has changed the role of 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 high yield bonds represent a broad spectrum of investors. Some may be long-term investors, some may be investors buying bonds at a discount with a view to converting their bonds into a controlling equity position in a restructuring, while others may be smaller investors relying on larger holders to guide the process or holders with short positions or credit default swaps who will only 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 apply to them.

The diversity to be found among bondholder groups, both in the type of institution and their investment strategy may also vary according to the type of issuer which is undergoing restructuring, and the degree to which the bonds have traded on the secondary market. For example, a significant proportion of the holders of bonds issued by GRAND plc, the Deutsche Annington securitisation vehicle restructured by a Part 26 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 Part 26A restructuring of restaurant chain Pizza Express in late 2020, many of the bondholders were capital funds who took equity in the restructured company (for further reading, see News Analysis: PizzaExpress—Part 26A restructuring plan sanction hearing).

References:

Re PizzaExpress Financing 2 plc

[2020] EWHC 2873 (Ch), [2020] All ER (D) 126 (Oct)

First steps

Before taking on any mandate to represent bondholders in a restructuring, at the outset you should try to understand:

- what information is available to you and your bondholder clients
- who the bondholders are
- the existing transaction structure
- who the trustee is
- what the triggers for a restructuring are
- who has control of the process
- 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 to them. 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)*. The lack of information may seem particularly problematic to those who ordinarily operate in the US restructuring market, where more information is generally available.

References:

Highberry Ltd v Colt Telecom Group Plc (No.1

[2002] EWHC 2503 (Ch)

Where the issuer instigates engagement with bondholders regarding a potential restructuring, the issuer is often more willing to provide information in order for the bondholders to properly evaluate the proposal being put to them. A company proposing a scheme of arrangement or restructuring plan under Part 26 or Part 26A of the Companies Act 2006 must provide a comprehensive explanatory statement to its scheme or plan creditors prior to the relevant class meetings, but information is often provided at a much earlier stage, at least to the group of bondholders that the company engages in negotiations with, in order that the issuer can agree support or lock-up agreements with the bondholder constituencies so that they may maximize the chances of a successful transaction. For further reading on schemes of arrangement and restructuring plans, see: Restructuring plan—overview and Schemes of arrangement—overview.

However, in the case of information that is not made publicly available by the issuer (such as management accounts, business plans, strategic initiatives) but which may be necessary for investors to properly assess the viability of a restructuring proposal, bondholders may nonetheless prefer not to receive it in case it compromises their ability to trade the bonds and other securities of the company due to rules and regulations against trading in securities while in the possession of such material non-public information or 'MNPI'. However, it is possible for a group of holders to mandate financial and/or legal advisors to receive such MNPI and negotiate a potential restructuring through them, without ever coming into contact with any material non-public or price sensitive information until the restructuring negotiations have reached an advanced stage. Usually, this would not happen until there is a detailed term-sheet that the advisors can recommend to the bondholders and upon which bondholders would be willing to be locked-up and restricted from trading until the restructuring is completed. This approach minimises the time that bondholders will be restricted from trading, but involves the bondholders delegating control of negotiations to their financial advisors. Alternatively, certain bondholders may be willing to sign up to the lock-up agreement on the condition that from time to time, certain MNPI information is made public and 'cleansed' in order to permit trading.

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

Unlike most leveraged loans, a bond is almost always held in registered global form with a depositary adn settled through 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. As such, it is difficult, if not impossible,

for a bond issuer to know who its bondholders are unless they voluntarily come forward and identify themselves. There are service providers in the market that can assist with a bondholder identification exercise (based only on publicly available information) and the issuer would be well-advised to engage such service providers at an early stage should it become evident that identifying and bringing bondholders to the negotiating table could be challenging.

To the extent bondholders do come forward (and often it may be in their interest to do so early on to ensure a prime position at the negotiating table), it will become important at an early stage in an issuer's restructuring 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 to help streamline the restructuring negotiations. Holdings are rarely reported publicly, so ad-hoc groups are usually formed by bondholders working through their own network of contacts, or by law firms or financial advisors acting as a hub for forming a bondholder group.

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 not just who the bondholders are but the nature of their holdings. 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, while 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 the 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, while some junior bondholders could end up with nothing, so this will affect the approach taken (for example, whether certain equity may be available for such junior bondholders).

References:

Re Southern Pacific Personal Loans Ltd; Smith v Information Commissioner

[2013] EWHC 2485 (Ch), [2013] All ER (D) 63 (Aug)

Green v SCL Group

[2019] EWHC 954 (Ch), [2019] All ER (D) 114 (Apr))

What is the existing transaction structure?

The existing structure can vary greatly from transaction to transaction, depending on the issuer's corporate and broader capital structure and this will determine the rights and interests of the stakeholders going into a restructuring. It is also likely to influence what the issuer and its stakeholders would be seeking to achieve through the restructuring. Whereas certain trends appear in bond documents over time, there are often significant negotiated differences and it is vital to carefully review the transaction documents. For an explanation of the main documents in an issue of high yield bonds see Practice Note: Bonds and notes.

Who is the trustee?

As well as gaining an understanding of the capital structure of the issuer about to go through a restructuring, it is also worth identifying and potentially starting discussions with, or encouraging the issuer to start discussions with, the trustee(s) of the outstanding bonds 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, to require substantial indemnities, or to resign (in which case the issuer will have to appoint a new trustee), any of which could have timing and other consequences for the proposed restructuring. An early dialogue with the trustee(s) is therefore important to understand how each trustee (as appropriate) views its role in the restructuring and identify any potential issues in advance.

What are the triggers for a restructuring?

High yield bonds are considered 'covenant-lite' compared to traditional leveraged loans in the sense that bond covenants are typically 'incurrence-based' only and do not contain 'maintenance' covenants which require an issuer's financial condition (eg with a debt/EBITDA ratio as a proxy) to be tested on a regular basis. In contrast, incurrence covenants are tested (eg by way of a pro forma leverage ratio) only when the issuer actually takes an action, such as when it sells an asset, incurs new debt or makes a dividend payment. If an issuer does nothing, and provided that it continues to make interest payments, bondholders have no means to trigger a restructuring even as the issuer's financial performance deteriorates, unlike leveraged loan lenders who may be able to take enforcement action if a borrower fails its periodic financial performance 'maintenance' test. Many restructurings instigated by bondholders are, therefore, related to payment events such as missed coupon payments or result from discussions with the issuer regarding an upcoming maturity.

In addition, the covenant package of a high yield bond would have reflected the state of the market at the time the bonds were issued, and it is possible that the bondholders facing a restructuring had little or no input at that time. The prevailing trend in the high yield and leveraged finance market has been increasingly issuer-friendly covenants and there are a fair number of bonds in the market with weak covenant protections. This has proven to represent significant pitfalls for unwary bond investors, with issuers and sponsors taking advantage of permissive documents to weaken the quality of the credit group or the underlying collateral package by moving assets out of the grasp of bondholders (and raising new priming debt against those assets). 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. Advisors should undertake a full legal review of the capital structure in order to understand how the terms of one bond may impact those of an-other. For example, the rights that holders of different bonds have under their respective 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 usually governed by New York law (though a fair number of English law governed bonds exist in the market), with the primary operating contract being the indenture (or the trust deed in the case of an English law governed high yield bond). Where there are different classes of creditors (for example, secured bank lenders and other secured bondholders) within the capital structure, there will also be an inter-creditor agreement in place, which in the European market is typically governed by English law. These documents will set out what constitutes an event of default, voting requirements for issuer proposals and who can direct or block enforcement action.

Under typical high yield bond documents, Individual enforcement action is usually restricted, with a certain percentage of holders (usually holding 25 or 30% of the outstanding principal amounts) being 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 bondholders 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 subject to voting 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 (ie usually referred to as 'money terms').

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 bondholders. 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 amount of debt 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, pre-insolvency or restructuring proceeding a creditors' committee may be appointed, which in some jurisdictions may have enhanced access to information and a role in driving the restructuring.

References:

Companies Act 2006, Pt 26

Importantly, 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 control rights or rights to block a restructuring.

The most commonly used tool in the European market is the English law Part 26 scheme of arrangement, which needs approval of a majority in number and at least 75% in value of each class of creditors. A Part 26 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 US chapter 11 proceeding, subject to certain safeguards, only 66.6% of one impaired class are required to approve a plan of reorganization, which allows for other classes to be 'crammed down', in the sense that the restructuring can be achieved without the consent of those other classes.

In 2020, the UK introduced the Part 26A restructuring plan, which gives an issuer a means to cram-down entire classes of creditors provided certain conditions are met, including that the restructuring has been approved by at least 75% of one class that would have a genuine economic interest in the case of the relevant alternative to the proposed restructuring (often, but not always, a liquidation). This legislation has a profound impact on the rights of bondholders, in that a restructuring implemented by a Part 26A restructuring plan can no longer be blocked by a holder of over 25 percent of one class. The law does impose safeguards against abuse of the restructuring plan, including the court's discretion not to sanction a plan if it is not just and equitable (see the Explanatory Notes to the Corporate Insolvency and Governance Act 2020, in particular paragraphs [190] and [192] and the judgment of Trower J. in Re DeepOcean). For further reading, see Practice Notes: Corporate Insolvency and Governance Act 2020—restructuring plan provisions and Cross-Class Cram Down under a Part 26A restructuring plan.

References:

Re DeepOcean 1 UK Ltd and other companies [2021] EWHC 138 (Ch), [2021] All ER (D) 08 (Feb) CA 2006, Pt 26A

The availability of 'cross-class cram down' is a feature of the Directive (EU) 2019/1023 on Preventive Restructuring Frameworks and as such is being implemented in restructuring laws introduced in various EU Members States (for example the Netherlands and Germany).

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.

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.

For further reading, see Practice Note: Informal bondholders' committee.

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 negotiations with key stakeholders. The structure will be negotiated among the law firms and advisory firms advising the issuer and its key stakeholders. The commercial terms of the restructuring are often agreed at an early stage in the restructuring process, and documented in a term sheet and/or a restructuring support agreement. Due to the democratic nature of most restructurings, if the bondholders' negotiating position is weak, they may benefit from working with other stakeholders, and thereby identifying potential allies may important.

Other stakeholders may include the issuer, its sponsor or owner, more senior or more junior ranking lenders or other bondholders, and in some cases other specific groups such as pension funds, swap providers, commercial and trade creditors.

References:

Re gategroup Guarantee Limited [2021] EWHC 304 (Ch)

Re DeepOcean 1 UK Ltd and other companies [2021] EWHC 138 (Ch), [2021] All ER (D) 08 (Feb)

An important part of understanding the parties' negotiating leverage is establishing the likely classes that will be required to approve a scheme or restructuring plan, or equivalent process in other jurisdictions. A bondholder should not assume that the issue, tranche, class or series of bonds that it holds will make up a single class, as there may be other bondholders or creditors whose rights are sufficiently similar that they could reasonably consult with those bondholders regarding the restructuring. Classification of creditors in both schemes and restructuring plans appears to be coming under closer scrutiny in the courts. In *gategroup* the company proposed a single class meeting of senior lenders and bondholders to consider a restructuring plan, but Zacaroli J required that the senior lenders and bondholders meet as separate classes, due to their existing rights and treatment under the scheme being materially different to each other. Conversely in DeepOcean, Trower J commented that whereas a company proposing a scheme of arrangement may create more classes than is strictly required, the availability of cross-class cram down in a restructuring plan requires the court to take a more active role in ensuring the company is not proposing too many, smaller, class meetings, and thereby making the plan more likely to be approved by the required majority of one of those class meetings.

As mentioned above, the negotiating landscape has been altered by the introduction of cross-class cram down proceedings in Europe (for example the Part 26A restructuring plan in the UK), with cram-down having been a possibility in the *Virgin Atlantic* and *Pizza Express* and restructuring plans, and actually used in the *DeepOcean* restructuring plan. For further reading on case law developments in this area, see Practice Note: Cross-Class Cram Down under a Part 26A restructuring plan.

Secured noteholders will often have a more significant role in negotiations than unsecured noteholders, depending on the corporate and capital structure. Guarantees can also play a key role in negotiating leverage. For example, in the restructuring of Hertz Group in 2020/21, the European noteholders held guarantees from the US parent company, but the US noteholders were not guaranteed by the European subsidiaries, resulting in the European and US noteholders being in different negotiating positions.

Security packages have also become more complex as a result of the pandemic, as issuers and sponsors have sought to improve liquidity by issuing debt secured on previously unencumbered assets, or a combination of existing collateral and previously unencumbered assets.

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 outweighs 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 bondholder 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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