Out-Of-Court Debt Restructuring And The Problem Of Holdouts And Free Riders

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Restructuring professionals often promote the benefits of Chapter 11 of the United States Bankruptcy Code for restructuring the debts of insolvent or financially distressed businesses. Among its virtues, Chapter 11 provides a reasonably well-defined set of rules, a developed body of judicial law interpreting those rules, an automatic stay prohibiting creditors from exercising remedies outside of the bankruptcy process and a central forum (the bankruptcy court) where all parties can be heard and disputes can be resolved either consensually or, when necessary, by decision of a single judge who presides over the entire process.

One of the most appealing features of Chapter 11 is the ability to bind minority creditors to a restructuring plan that is accepted by a statutorily defined majority. Section 1122(a) of the Bankruptcy Code permits a proponent of a Chapter 11 plan to place creditor claims into classes of substantially similar claims for purposes of voting on a plan. General unsecured claims can be placed together in a single class regardless of the nature or origin of the claim. For example, an unsecured lender or bondholder may be placed in the same class as landlords and trade vendors. Whether a plan is accepted by creditors is determined by whether the class of claims, as a whole, has voted to accept it.

Section 1126(c) of the Bankruptcy Code provides that a class of claims has accepted a plan if the plan has been accepted by creditors in the class representing at least two-thirds in amount and more than one-half in number of claims held by creditors that vote. Only claims of creditors that vote are counted for purposes of determining acceptance. Therefore, unlike requirements in other creditor voting contexts, such as where a threshold percentage of debt outstanding is required, a creditor’s failure to vote on a Chapter 11 plan will not count as rejection – it simply will not count at all. As a result, a restructuring plan can be confirmed and become binding on all creditors, even those who object to the plan and those who did not vote on it. In a sense, class voting under Chapter 11 can replace voting requirements in bond indentures and syndicated credit agreements, thereby making a restructuring more likely when there is a sufficiently large number of holders or lenders that could successfully block restructuring outside of bankruptcy.

In contrast, restructuring debt outside of a bankruptcy case requires coordinating and motivating disparate groups of creditors, careful examination of different default triggers and voting requirements in multiple financing documents, creditors’ voluntary forbearance from exercising default remedies, formation of steering committees, governance structures, confidentiality, and generally keeping parties engaged in a restructuring process when they are not forced to. Among the principal issues that arise in out-of-court restructurings are the problems of holdouts and free riders. Holdouts are creditors that are in a position to block a restructuring and use that leverage to extract additional value for themselves (i.e., payment in full from the debtor, other creditors or a hedge counterparty). Free riders are creditors that do not contribute to a restructuring but obtain the benefit of a financially healthier debtor at the expense of those creditors that made concessions. The two are not mutually exclusive; holdouts that ultimately are unable to prevent a restructuring become free riders when the restructuring is completed.

There are advantages to out-of-court restructuring over a Chapter 11 case. It’s a much more flexible process that allows the participating parties to define the parameters of the negotiation including what payments the debtor can continue making, disclosure of confidential information limited to just participating creditors, allowance of interest and other amounts that would be subject to disallowance or subordination in a formal bankruptcy case, short-term extendable forbearance instead of a broad stay, avoidance of public reputational damage to the company, and the avoidance of an uncertain judicial process that is adversarial, invites all parties to be heard and is constrained by the availability of court time and other judicial resources.

An out-of-court restructuring may be initiated by the debtor or by one or more creditors. The debtor may initiate the process by approaching one or more of its largest financial creditors in an effort to engage the creditors in discussion, persuade them that an out-of-court restructuring is desirable to formal bankruptcy and encourage them to marshal other

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large financial creditors to form a steering committee. The largest financial creditor usually will chair the steering commit-
tee. There is no need to involve non-
financial creditors, and it is often better to
permit the debtor to continue paying trade creditors, employees, landlords and
other debts in the ordinary course while
restructuring discussions are proceeding.

At the onset of an out-of-court restruc-
turing, the participating creditors must
agree to a standstill or forbearance that
prohibits each creditor from exercising
default remedies or otherwise taking
action against the debtor outside of the
restructuring process. Forbearance
agreements are short-term to keep pres-
sure on all the parties and allow creditors
to abandon restructuring and pursue
remedies if progress is not being made at
an acceptable pace. A typical initial for-
bearance period may be two to three
weeks and a second term may be 30
days. If discussions are going well, the
term is extended and the periods between
terms may be increased. Forbearance
typically terminates automatically if any
creditor (on the steering committee or not) takes action to enforce its rights
against the debtor.

In the context of out-of-court restruc-
turing there are two separate negotiations
happening simultaneously: One is the
negotiation between the creditors and
the debtor to restructure the debt, and the
other is among the creditors inter se.
Financial creditors that participate in
restructuring may share an interest in
restoring the debtor to financial stability,
but they often have different ideas about
how to proceed and they are characteris-
tically guarded when it comes to disclos-
ing to each other information about their
exposure, the terms of their individual
agreements and whether they have credit
protection for all or any portion of the
debt. For these reasons, there is a confi-
dentiality agreement between the creditor
group and the debtor and a separate con-
fidentiality agreement among the credi-
tors on the steering committee. Steering
committees typically engage profession-
als (in addition to legal counsel), such as
accountants and financial advisors, to test
the veracity of the financial information
being provided by the debtor, as well as
to act as a confidential repository of the
steering committee members’ transaction
documents. In its capacity as confidential
document repository, the steering com-
mittee’s financial advisor has access to
information about each creditor’s expo-
sure without the creditors having to share
the information with each other. This
presumes a high level of trust in the
financial advisor to keep the information
confidential and not present it in a way
that reveals each creditor’s position. If
there are a large number of creditors on
the steering committee, the financial
advisor can present data to the group on
an anonymous basis, and it is not readily
apparent which creditor correlates to any
specific data. The smaller the group, the
easier it is to determine which creditor is
which even if the information is pre-
sented anonymously.

In light of the different rights and
interests of the individual creditors, the
negotiation among the creditors can be
more sensitive than the actual restructuring
negotiation with the debtor. Different
creditors have different relationships with
the debtor and therefore may have access to
different levels of information. Each
creditor may place conditions on any
concession it makes in the restructuring
on certain concessions being made by
other creditors. If any of the creditors
have credit protection – credit insurance
or credit default swaps – their interests
may conflict with the rest of the group,
and they may have incentives to force the
restructuring into a form that triggers
their rights against hedge counterparties
or even push the debtor into formal insol-
vency.

The goal of a restructuring is to
improve the financial condition of the
debtor so that it is able to service its debt.
To achieve that goal, participating credi-
tors have to make concessions, such as
reducing the amount of their debt,
extending maturities, reducing the
amount of periodic payments and spread-
ing out payment dates in a manner that
fits the debtor’s cash flow projections
over a period of time. The greater the
number of creditors participating in the
restructuring and making these conces-
sions, the better the debtor’s financial
condition will be coming out of the
restructuring, and the more likely the
debtor will be to perform its restructured
debt obligations. At a minimum, the
largest creditors would have to participate
for the restructuring to work. But there
may be creditors who are aware of the
restructuring but deliberately decline to
participate so that they can be paid in
accordance with their debt instruments
without making concessions and enjoy
the benefit of a financially healthier
debtor. While it is expected that partici-
pating creditors will have to tolerate a
certain amount of these “free riders,” if
there are a significant number, then the
restructuring may not succeed.

Another problem is holdouts: creditors
whose participation is necessary to make
a restructuring work but who decline to
participate in the hope that they will
recover payment in full, or at least more
than they expect to recover in the restruc-
turing. If the other creditors do not agree
to pay the holdout, the restructuring will
fail and the debtor will either liquidate or
commence formal bankruptcy proceed-
ings. This is the classic “prisoner’s
dilemma” in which the holdout must
choose between the known recovery from
cooperating with the other creditors and
the unknown recovery that will either be
better if the holdout is paid in full or
worse if the restructuring fails and the
debtor is forced into liquidation or formal
bankruptcy. The only leverage participat-
ing creditors have to persuade a holdout
to cooperate is market leverage, such as
peer pressure if the participating creditors
do other business with the holdout away
from the particular restructuring at hand.
Another factor that could persuade a
holdout to cooperate is that a holdout in
one case may be a participating creditor
in another case and need the cooperation
of the other creditors in the next restruc-
turing. Persuading a holdout to cooperate
often involves elevating the issue to the
highest levels of the institutions’ senior
management.

These are some of the more salient
issues that arise in out-of-court restruc-
turing. These and other factors must be
weighed against each other to determine
whether a restructuring should be pursued
out of court or in a formal bankruptcy
proceeding.