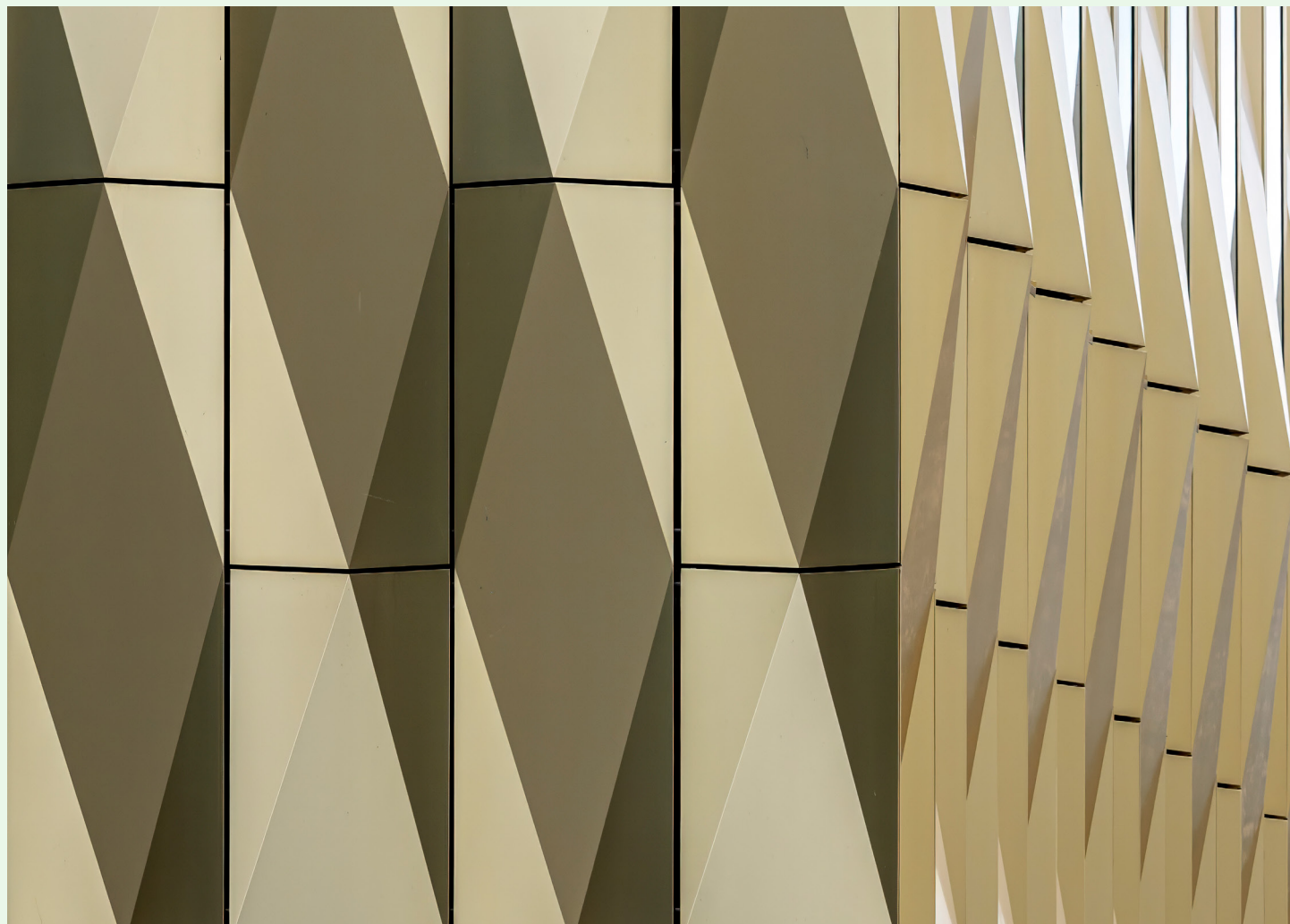


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Thought leadership

Restructuring and insolvency: liability management exercises and their alternatives

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Restructuring and insolvency: liability management exercises and their alternatives

Key takeaways

- 1 Liability management exercises are becoming more common in the US and Europe, creating new opportunities and challenges for companies, creditors and investors.
- 2 A growing range of restructuring strategies, from LMEs to court-led processes in various jurisdictions, is giving stakeholders greater flexibility to reshape capital structures and protect value in distressed situations.
- 3 Forum choice and cross-border recognition and implementation are critical considerations.

As companies and investors navigate an increasingly complex restructuring environment, liability management exercises (LMEs) are playing a prominent role in managing balance sheets, avoiding or preparing for restructurings and providing an opportunity to deploy capital. In this briefing, we examine the growth of LMEs, the opportunities and challenges they present and the continuing role of court-led restructurings and security enforcement strategies.

“The term ‘LME’ is nothing new – when I started working in law in the years shortly after the post-Lehman global financial crisis, liability management exercises were pretty much the only thing going on in the debt capital markets,” says Tim Lees, a Partner in Clifford Chance’s Restructuring & Insolvency practice, based in London.

“Back then, the term referred principally to a discounted tender offer – a company offering to buy back its debt at a discount and improve its balance sheet,” he says. “Today, the term LME can encompass discounted debt buybacks and exchange offers, traditionally understood to be available under the same terms to all creditors. But it more commonly refers to transactions that improve the position of consenting creditors, and often new money providers, relative to the position of other creditors, by making use of contractual flexibilities.”

LMEs are highly topical in the US and are increasingly common in Europe. “We are also seeing a lot more LME-related litigation – a non-exhaustive list would include Optimum, Selecta, Hurtigruten and Antolin among others, and there are lots more claims that get considered or are resolved in the background without making the news,” Lees says.

Lisa Gundy, Vice President – Senior Officer Legal Review at ratings agency Moody’s says that LMEs are a hot topic. “The first question we ask ourselves is, ‘is there a default?’ And that default could be a missed payment, a bankruptcy, a change in the payment terms or a distressed exchange. There can be a range of transactions that fall within that distressed exchange criteria. You could have an extension, an amendment a payment-in-kind or discounted buybacks,” she says.

“What we’re really talking about when we talk about LMEs is where someone in the capital stack gets shunted aside, moved down or has their recovery reduced to their detriment. Often that detriment is to the benefit of the equity holders or the senior creditors. We’re really looking at where someone’s expectations have been altered from a non-consensual perspective.”

What are the most common types of transaction?

The transactions outlined below are most frequently used, often in combination with each other:

- **Drop-downs:** where valuable assets held by obligor entities are transferred to non-obligors, permitting fresh finance to be raised by entities which are not bound by the existing debt covenants. This is typically possible using contractual baskets agreed when financing was put in place.
- **Up tiers:** where intercreditor arrangements are amended to provide an enhanced ranking to consenting creditors. Such amendments often require the consent of holders of only 50% of the relevant bond issuance or loan.
- **Double-dips:** typically involve lending to an SPV, which then on-lends the proceeds to the operating group. Both the loan to the SPV and the proceeds loan will be guaranteed by the operating companies – meaning that in an insolvency, creditors would recover once under their guarantee claims, and again from the SPV.
- **Pari-plus:** a financing structure where consenting creditors or new money providers get the benefit of a common collateral package, and additional security reserved just for them. Pari-plus transactions are not always considered an LME but are increasingly referred to in this context.

“LMEs are increasingly popular in the US, the UK, Europe and elsewhere. But by no means are they the only game in town.”



Tim Lees
Partner, London

“LMEs are increasingly popular in the US, the UK, Europe and elsewhere. But by no means are they the only game in town,” says Tim Lees. “We still see companies using schemes of arrangement and restructuring plans in the UK – and in the case of schemes these needn’t be insolvent or distressed transactions. We are increasingly seeing companies use scheme-like processes in EU jurisdictions. And in the US, Chapter 11 bankruptcy is still alive and well. By using a court process, issuers and their supportive creditors are aiming to bring forward potential disputes and close out their potential to create trouble down the road.”

Why restructure in this way?

LMEs are not new. What is new is the frequency and creativity with which they are being used and the disparity of treatment amongst creditors.

LMEs of the type increasingly seen today, emerged in the US as an alternative to Chapter 11 bankruptcy. Chapter 11 is one of the most powerful restructuring tools available, offering a worldwide automatic stay, the ability to make amendments with the consent of two-thirds by value and one half in number of a consenting class, cross-class cramdown and the scope to raise debtor-in-possession (DIP) financing. “Chapter 11 can be the best, and sometimes, the only tool to restructure. However, Chapter 11 has at least three issues that an LME avoids,” says Maja Zerjal Fink, a Partner in Clifford Chance’s Restructuring & Insolvency practice, based in New York.

First, unlike in the UK, there is the absolute priority rule. If the board votes to commence a Chapter 11 case, shareholder value is at risk because unless all classes accept the Chapter 11 plan, creditors must generally be paid in full before shareholders can recover value. An LME, by contrast, preserves that value, at least until the next crisis or milestone, and for boards of directors, the ability to extend runway and preserve shareholder value can be a key consideration. Second, some of the defining features of Chapter 11, the automatic stay and the scope of the Chapter 11 case, can be a disadvantage. Unlike a scheme, you cannot pick and choose what to restructure and all liabilities are brought into the process with the automatic stay applying to all such liabilities – even if they are not impaired in the process. Finally, Chapter 11 is court-intensive, and therefore expensive – a Chapter 11 case can easily cost tens of millions of dollars.

“When a company is in distress, a key question is ‘can you restructure less expensively while preserving optionality for shareholders?’ LMEs are not cheap, but they can be less expensive. Sometimes an LME can be ‘good enough.’ Of course, if an LME doesn’t work it can simply add another layer of cost when a company files for Chapter 11, and for a variety of reasons, including often a more complicated capital structure, the resulting Chapter 11 case may prove more expensive than it would have been without the LME,” says Zerjal Fink.

From a creditor’s perspective, an LME can also help mitigate the risk of, or prepare for, a Chapter 11 filing. Companies sometimes require further restructuring and an LME can give lenders the confidence to provide new money that allows for breathing space without incurring the full cost of Chapter 11 upfront. It can also improve or enhance their position or priority in the event of a future in-court process.



Why are LMEs growing in Europe?

Typically, European financing structures have not given debtors the flexibility needed to use an LME. Traditional LMA-style financings tend to have maintenance rather than incurrence-based covenants (tested on an ongoing basis with more limited headroom compared with covenants that are tested only when the company seeks to take an action, such as incurring debt or making dividends). Relationship lenders also tend to expect an ongoing dialogue with their borrowers, whereas high-yield investors have a more arm's-length relationship with issuers – as bonds are freely tradeable, issuers may not know the identity of their bondholders.

“We’ve increasingly seen European debtors borrowing under US-style incurrence covenant packages. One attraction of these structures is their greater flexibility, which in turn makes US-style LMEs more feasible.”



Jill Concannon
Partner, London

“We’ve increasingly seen European debtors borrowing under US-style incurrence covenant packages. One attraction of these structures is their greater flexibility, which in turn makes US-style LMEs more feasible.” If you give companies US-style tools to restructure contractually, it shouldn’t be a surprise that they get used in US-style ways,” says Jill Concannon, a Partner in Clifford Chance’s high-yield practice based in London.

Strong sponsors and corporate debtors in Europe have also negotiated significant flexibility to preserve their runway. “As we saw in our work on the restructuring of chemicals company Synthomer, having the flexibility to make adjustments for a rainy day can be very helpful in achieving a transaction that gave the company a stable platform to operate their business,” Concannon adds.

LMEs in Europe respond to different challenges from those seen in the US. European issuers often are not worried about the cost of Chapter 11. Instead, there is a greater concern about the taint associated with bankruptcy. For that reason, completing a restructuring out of court can be attractive.

Europe also lacks a single Chapter 11 equivalent. Instead, there are multiple jurisdictions, with multiple restructuring regimes. A contractual LME under a single governing law – typically New York law – can provide a common framework for all stakeholders.

LMEs under New York law have also been litigated in the US and found to work. Again, depending on the jurisdictions involved, where there may be less precedent, the fact that particular tools have already been tested in the US can be attractive.

A new playbook for Spanish restructurings

While contractual LMEs have become more common, we have also seen court processes increasingly adopted across the EU following implementation of Directive (EU) 2019/1023 (the European Restructuring Directive).

Spain is a prime example. Until recently Spain did not offer a serious domestic restructuring process, particularly since it lacked the ability to cram-down dissenting creditors. So, when major Spanish companies such as La Seda de Barcelona, Codere, Metrovacesa and Hibu needed to restructure, the answer was, almost automatically, London. “Some Spanish companies entered into English law debt specifically to benefit from a scheme of arrangement. And even when the debt wasn’t English law, companies still chose to go to London,” says Felipe Font, a Partner in Clifford Chance’s Restructuring & Insolvency practice, based in Madrid. For example, Spanish gaming group Codere used a UK scheme to restructure its New York law-governed bonds in 2015, in a case that coined the term ‘good forum shopping’, and did so again in 2020. Things have now changed. “The UK is still an attractive forum for many reasons, but Spain now has a scheme-equivalent process which is proving robust and useful, so people are using it,” says Font.

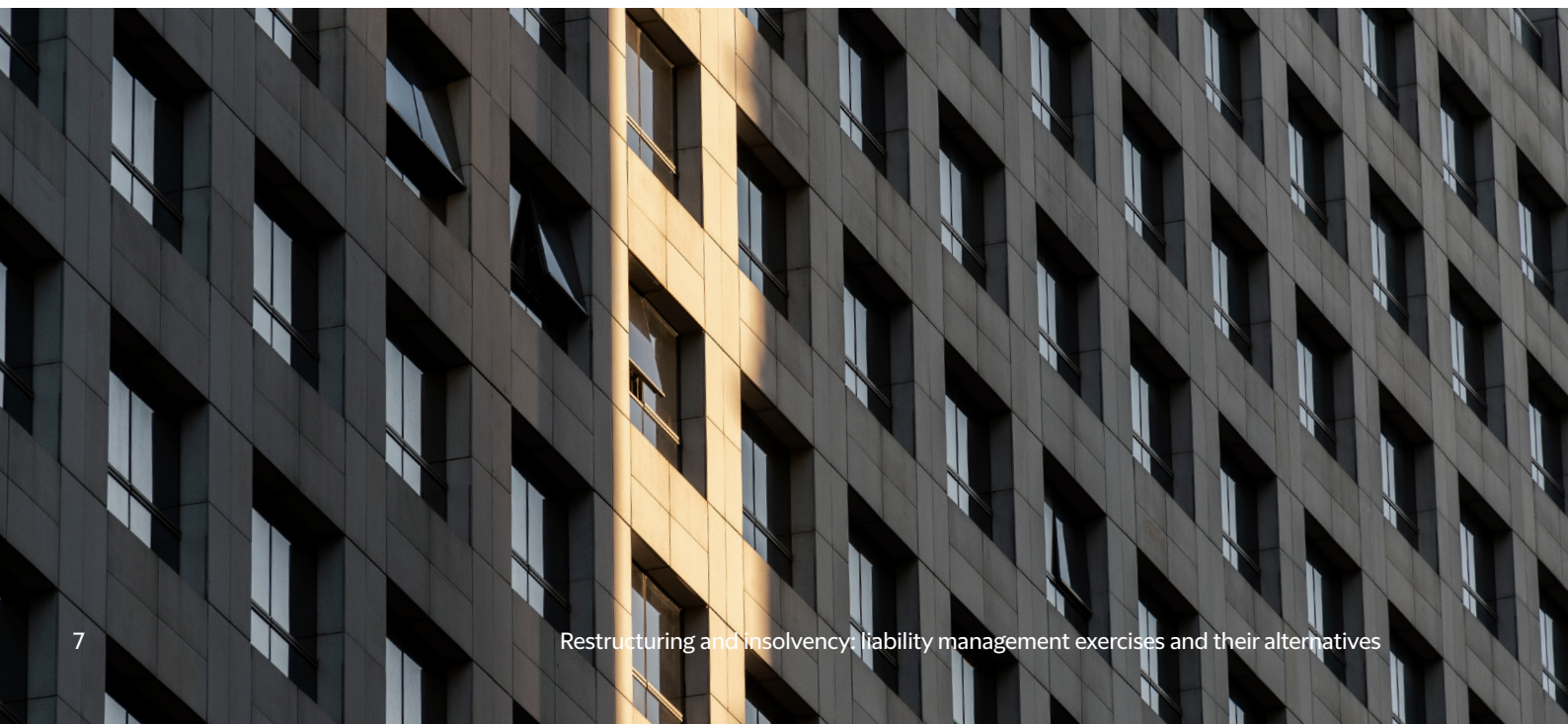
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Partner, Madrid

Three market trends illustrate this evolution:

1. Sponsors and creditors are deliberately opting for Spanish homologation proceedings. Even with English or New York law-governed debt, and despite the risk that proceedings would not be recognised in England under the “Rule in Gibbs” (in very simple terms, the rule that only an English process can restructure an English-law debt without the creditor’s consent), stakeholders see real value in a cheaper process, with similar results and a broader territorial reach. The new Spanish legal framework introduced through the implementation of the EU Directive in 2022 now offers a workable cross-class cram-down; a proper class formation structure; new money protection mechanisms; and already well-tested debt-for-equity options. “That said, decision makers still need to assess case-by-case the English and international angles, mainly by reference to where the group operates, where its assets are located and who its creditors are, as well as where it may need to raise money in future,” Font says.
2. There has been greater use of New York law-governed debt. This allows Spanish groups to use a local process and seek recognition under Chapter 15 of the US bankruptcy code, in the same way that schemes of arrangement have done for many years, without the ‘good versus bad forum shopping’ debate that can arise when an English connection is manufactured. Wallbox, a Spanish electric vehicle charging tech company, and Antolín, a Spanish automotive parts manufacturer, are good examples of the first two trends: a Spanish-sanctioned plan, an English law Gibbs point, and in Antolín’s case, Chapter 15 recognition in New York, all running in parallel.
3. There is growing interest in LMEs. This is particularly evident among creditors and mostly in conjunction with a court process. Antolín is a good example of this trend. Although Antolín was expected to implement an LME, concerns regarding directors’ liability, together with the comfort provided by court approval, led to a different approach. It is in the public domain that the plan extends €1.25 billion of debt maturities and injects new working capital. Bondholders choose between (i) new 2030 bonds at a 32.5% discount, or (ii) keeping existing bonds with maturity pushed to 2035. The litigation was triggered by the different treatment of stakeholders: banks get maturity extensions and first-ranking new money; bondholders get no new money and are forced to choose between a 32.5% haircut with first-ranking security or an extension with second-ranking security. Dissenting noteholders argue that the bank and bondholder class split was designed to create the impaired accepting class required for Spanish cramdown, a threshold that would not have been met in a single combined class.



“In a nutshell, the pattern we are currently seeing is: (i) do not rely on one tool; (ii) a growing appetite for LMEs with court sanction; and (iii) with multi-instrument debt stacks and multi-jurisdictional obligors / creditor bases, you increasingly end up running Spanish, English and US angles simultaneously, almost by default,” says Font.

Recognition and forum choice

Companies with debt governed by New York law will want to know that any restructuring of that debt will be effective in New York. Recognition under Chapter 15 of the US Bankruptcy Code is a tried-and-tested way of achieving that – there is no Gibbs rule, so New York-governed debt can be restructured through a foreign process and recognised under Chapter 15. “The potential to get recognition and the certainty of court order can be a real advantage for using an in-court process, rather than doing an LME out-of-court where the parties can be subject to future litigation,” says Maja Zerjal Fink.

Recognition as ‘main proceedings’ which grants certain types of relief automatically and provides the strongest foundation for wider relief on a discretionary basis, is only available where proceedings are opened in the jurisdiction where the debtor has its centre of main interests (COMI). At a minimum, to be recognised, the company’s main restructuring should be in a place where the company has an establishment to access relief available in the recognition of a foreign non-main proceeding.

Courts have tended to grant Chapter 15 recognition to restructurings under English law where jurisdiction has been “manufactured”, albeit sometimes after expressing reservations, as seen recently in the New Fortress Energy case. However, US courts take a different approach to COMI than those in Europe. While there is the presumption of the place of registration, the test is significantly broader and considers several factors.

“We’re increasingly seeing US groups look to the UK to restructure owing to the lower cost and absence of an absolute priority rule, as well as availability of non-consensual third-party releases.”



Maja Zerjal Fink
Partner, New York

“We are not saying that European companies cannot use schemes to restructure high-yield debt. Indeed, we’re increasingly seeing US groups look to the UK to restructure owing to the lower cost and absence of an absolute priority rule, as well as availability of non-consensual third-party releases,” says Zerjal Fink. In practice, rather than filing every debtor company under Chapter 11, the principal debtor company can restructure using a scheme or plan, and directors, shareholders and other third parties can also get releases. “But if there is a workable process in a ‘home’ jurisdiction, for example, Spain, it may be easier to get recognition in the US, and that should be explored as US courts become increasingly focused on the COMI analysis and good or at least acceptable forum shopping,” she adds.

Is it becoming more difficult for parties to plan ahead?

When a new money transaction is being negotiated, parties need to think about how much flexibility the documentation may need to accommodate future scenarios. Sponsors typically negotiate baskets extensively to give themselves maximum contractual freedom, while underwriters are focused on what will successfully clear the market. Meanwhile, there is more focus on what contractual flexibilities exist, and although it is often credit-specific, investors may push for so-called “blockers” against future LMEs.

“When I am advising European high-yield issuers, it’s definitely always a conversation as to whether we should include any of the ‘blocking’ language that’s become known in the market. Including those is often a judgement call – often it can improve marketing / pricing but it needs to be balanced against unintended consequences and, yes, a lack of flexibility later on – keeping in mind that bonds in particular are expensive to amend,” says Jill Concannon.

What are we seeing in the market?

“From Moody’s perspective, our analysis is focused on what happens when a company gets into difficulty,” says Lisa Gundy. “An issuer may look to move an asset or sell an asset. When we sit down to analyse that, the first thing we look at is not necessarily all the sophisticated leverage ratio tests that lawyers and financiers spend months negotiating. By the time you’re dealing with a distressed exchange, those tests often no longer matter because EBITDA has deteriorated significantly or there is simply no headroom left. So, we tend to put those to one side. Instead, we focus on what I call the ‘rainy-day baskets’. We look at the company’s actual capacity to make payments, make investments or move assets, particularly into entities outside the guarantor group.”

Moody’s data shows that some basket sizes have remained relatively stable in recent years, particularly general debt baskets and investment baskets. “If we then look at the various IP blockers, that’s where things become particularly interesting. We’ve seen blockers for material intellectual property, blockers on certain subsidiary and joint-venture structures and restrictions around unrestricted subsidiary designations. We have not yet seen every possible variation, but you can already see signals in the covenant packages of where the market is heading next,” Gundy says.

Practical considerations

For companies and their creditors there are now more options. Parties still face the classic choice between restructuring out of court and potentially avoiding litigation or using a court process to bring any potential dispute forward. This provides greater certainty of outcome, but potentially at increased cost and with reputational risks that need to be managed.

There are now more court processes available. And there are well-established contractual routes to manage liabilities, in ways that might not always be obvious from the face of the documents at the outset.

“What does that mean in practical terms? On the positive side, when things go wrong, there are more options. And if you’re looking to put new money to work in stressed situations, there are more opportunities to do so,” says Tim Lees. “But when lending money in new deal situations, if you want to understand the risks you’re taking and the opportunities that may present themselves, you need to spend more time not just reading your documents but speaking to your lawyers.”

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