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Turnaround Topics

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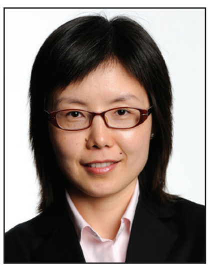
Can We Get Along? Trading and Restructuring



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Secondary-market credit-trading and out-of-court restructurings have co-existed for many years, but while the relationship is close, it is far from collaborative. New restructuring professionals are often surprised to learn that loans and claims trade extensively through the course of a restructuring, often impeding efficient negotiation and quick implementation of the restructuring. Likewise, from the perspective of lenders and claim-holders trading in the robust secondary-market, restructurings often impair liquidity, increase volatility and otherwise wreak havoc with orderly trade settlement, and have the knock-on effect of increasing counterparty credit and performance risk.

This article briefly describes the issues inherent in secondary trading of loans or claims of companies undergoing a restructuring. Two intertwined problems are highlighted: (1) Record-owners might not be economic owners of the loans and claims due to secondary trading; and (2) the success of a restructuring requires achieving and maintaining the broadest support from creditors in a compressed time frame at the lowest cost to the restructuring company. After describing the problems in detail, several paths forward are described for professionals on both sides.

Trading Loans and Claims in the Secondary Market

Trading loans and claims in the secondary market allows parties to de-risk and diversify portfolios, express fundamental credit views, identify and explore price-dislocation-induced opportunities, and facilitate market liquidity. Loans start to trade shortly after (if not before) syndicated credit facilities close, and mostly on standardized documents. Claims-trading is less standardized, but generally follows the loan-trading framework of risk-allocation between a buyer and seller, with bespoke provisions considering the unique and varied characteristics of the claims.

Secondary trades are confirmed on a "trade date" and paid on a "settlement date." The settlement date might follow long after the trade date. A buyer enjoys the economic benefit and takes the downside risk of the loan or claim from and after the trade date. Between the trade date and settlement date, however, the seller is entitled to control the vote on any amendment, waiver, forbearance or restructuring activity. Notwithstanding this general rule, as a courtesy sellers often consult with buyers to accommodate their voting preferences.

The majority of loan and claim trades settle as assignments: The buyers become lenders of record under the relevant credit facility or record-owners of the traded claims. As owners by assignment, buyers will exercise voting rights from and after the settlement date. A minority of trades settle as participations, a contractual arrangement where the seller remains the lender of record or claim-holder but agrees to pass through all economic benefits and risks, and (in the U.S.) "beneficial ownership" of the loan or claim.

If an amendment, waiver, forbearance or restructuring occurs after a trade has settled by participation, the participant directs the seller's vote, subject to contractual limitations set forth in the credit documents or the participation agreement. Voting control is subject to a "majority vote" limitation; if a seller has sold less than all of its loan or claim in a participation or has sold multiple participations in the same claim, and is required to cast a single vote for all of its ownership position, then the majority stakeholders (including participants and possibly the seller itself) will control the vote.

Out-of-Court Restructurings

Stressed and distressed companies often need lender consent for amendments, or waivers or forbearance for defaults, under credit agreements. Borrowers may also try to restructure their existing debt or, with existing lenders' consent, incur new debt with a priming lien on their assets. Companies with multiple credit facilities and debt securities quickly discover that these processes are complex, pressured and sometimes chaotic.

For a pre-packaged chapter 11 filing, the borrower and its advisors seek consent to restructuring terms from different stakeholders under a restructuring support agreement (RSA). Invariably, the RSA provides that all present and future claims of a consenting stakeholder will be governed by the RSA, and requires that a consenting stakeholder only transfer its claims to a stakeholder who is or becomes a consenting stakeholder. The RSA framework presents several important issues for the borrower's stakeholders:

- The RSA might require a consenting stakeholder to release its claims against the company or its affiliates and other related parties;
- If the restructuring involves a credit facility or indenture, a fee might be paid to consenting stakeholders or those stakeholders that provide early consent; and
- There might not be information about the restructuring available in the public domain, so stakeholders who decline non-public information in order to preserve their ability to trade securities without potential insider-trading issues will not be able to evaluate the proposed restructuring.

Secondary-Market Considerations for Restructuring Companies

The prevalence of secondary loans and claims-trading requires restructuring companies and their advisors to acknowledge that the identity of lenders of record or claimholders will be fluid throughout the restructuring process. Because settlement times are long and settlement structures are varied, the list of lenders of record or claim owners might not accurately represent the universe of underlying true economic owners.

That important modern reality should cause companies and restructuring professionals to fine-tune their methodologies for obtaining consensus. If a company's goal during a restructuring is to achieve the broadest consensus at the lowest cost in the shortest amount of time, then finding and negotiating with the true economic stakeholders is key. It is also important to design consent mechanics to maximize direct participation by all underlying economic owners. Simply polling current record-owners (who might be voting on behalf of other stakeholders as a matter of contract or courtesy, or who might be required to underreport minority views due to majority voting frameworks) will frustrate stakeholders and ultimately delay the restructuring process. Here are some simple suggestions that should help harmonize the goals of both restructuring companies and stakeholders participating in an increasingly liquid secondary-credit market.

First, eliminate mismatches between economic stakeholders and eligible stakeholders when developing support for a restructuring. This approach might include incentivizing administrative agents and other parties to facilitate and expedite assignments of loans for as long as possible so that the true economic owners of the loans might be eligible to execute the RSA.

> **Careful examination of contractual provisions and limitations, and creative structuring of transactions and processes, will help both trading and restructuring co-exist in an orderly fashion.**

Second, if consenting stakeholders are incentivized to support a restructuring by a fee payment, make sure that the fee payments find their way to the true economic owners who gave the consent. It might be necessary to factor the impact of continued trading after the restructuring into the fee-payment mechanics.

Third, consider publicly disclosing the restructuring terms and support agreement early to enable "public only" stakeholders to evaluate the proposal and hopefully consent. If the company's securities are traded in the market, "public only" stakeholders are unable to consider restructuring terms that remain non-public. If a public-side stakeholder cannot vote on the restructuring, its impact on the restructuring might be magnified, as the public-side stakeholders might be the record owner only, and the economic owners cannot vote because they cannot obtain the information directly from the restructuring company. Alternatively, the public-side stakeholder might be the economic owner, but the owner might be unable to instruct the record owner, who, in turn, might be unable to vote on the restructuring — even if other economic owners also have an interest in the record position.

Fourth, adopt less cumbersome transfer restrictions. The secondary market expects to live within the transfer restrictions that are hard-wired in credit agreements and does not react well to an added layer of overly restrictive *ad hoc* transfer provisions incorporated in RSAs or other restructuring documents. While it is understandable that borrowers desire to ratchet up a consenting stakeholder's support to encompass all claims owned or acquired after signing on to the RSA, an overly restrictive provision can have the unintended consequence of dissuading stakeholders who prefer future liquidity from becoming a supporting party.

Finally, if a release from stakeholders is desirable, balance the borrower's need for a broad release against the stakeholders' inability to release claims held by affiliates and related parties. Many financial institutions are unable to give affiliate releases for legal or reputational reasons. Allowing those institutions an opportunity to opt out of an affiliate release often means more signatories to the RSA without adding material risk to the success of the restructuring.

Restructuring Considerations for Secondary-Market Traders

The restructuring process presents challenges to secondary-market traders. Record owners face operational burdens because they must manage the voting process for other parties that have an underlying economic interest in the record owner's position. An RSA divides the universe of loans and claims into those that are subject to the agreement and those that are not.

Each group will be trading under different rules once the agreement is effective. Unfortunately, a prospective buyer cannot independently verify that it is buying loans and claims not subject to the RSA, and will need to rely on representations and warranties from its seller in a final purchase agreement. Some suggestions for secondary-market traders are proffered herein.

First, each trading party should understand the current status of the voting rights of its counterparties and their participants. For example, a participant's voting rights, or the absence of such rights, are provided under the governing participation agreement, and it is important to review both the standard terms and the bespoke provisions of any participation agreement. When the trading party is not the record owner of the loan and needs to rely on the grantor of the participation or the seller of the loan to express the trading party's view with respect to a restructuring, communication of that view should be open and based on contractual provisions.

Second, record owners that are inclined to agree to support a restructuring plan should double-check representations regarding the bonds, loans and claims that will become subject to the RSA. If the record owner has an open trade (with a trade date prior to the date of the RSA), it should exclude that trade from the RSA. Record owners that become a restructuring-support party should disclose that fact in order to clarify future trading and speed compliance with applicable transfer requirements under the RSA.

Third, a buyer that does not wish to be bound by the RSA should confirm, before the trade date or the effective date of the support agreement, that the loans and claims that it intends to purchase are not subject to the RSA. While a boilerplate representation in the trade confirmation might arguably cover the issue, a prudent buyer may wish to draft a bespoke representation from the seller confirming that the loan or claim is not subject to the specific RSA in effect.

Fourth, a market-maker who utilizes the special provisions in an RSA governing trading by the so-called qualified market-makers should consider implementing additional procedures and transaction provisions designed to minimize the risk of inadvertently becoming a restructuring support party that is being exposed to trade disputes or breaching its contractual obligations.

Conclusion

Secondary credit-trading and debt restructuring troubled borrowers are two overlapping and interacting aspects of the life of a loan or claim. When they occur in tandem, secondary-trading parties need to adjust their trading activities in the context of restructurings more proactively to deal with the associated risks and challenges. Restructuring professionals need to be mindful of secondary-trading markets and practices in their approaches to restructurings in order to achieve maximum success at the lowest cost.

Record owners might not be the true economic owners of the loans and claims due to secondary trading structures and conventions, and restructuring professionals might need to work harder to achieve and maintain broad support from a fluid set of creditors in a compressed time frame at the lowest cost to the restructuring company. Careful examination of contractual provisions and limitations, and creative structuring of transactions and processes, will help both trading and restructuring co-exist in an orderly fashion. abi

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