Bond restructurings Implementation mechanisms: schemes vs. exchange offers

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In this bulletin, we evaluate the use of schemes of arrangement and consent solicitations / exchange offers as alternative mechanisms of delivering a bond restructuring. We outline the nature of distressed exchange offers before taking a closer look at:

- the Edcon and Ukraine restructurings;
- the pros and cons of schemes vs. exchange offers;
- setting consent thresholds for exchange offers; and
- the possibility of twin-tracking a scheme with an exchange offer.

This bulletin builds on our series of scheme hot topics bulletins earlier this year, available here.

Nature of distressed exchange offers

A distressed exchange offer is an offer by an issuer to swap its outstanding bonds for new bonds with different terms that amount to a diminished financial obligation. Such terms may include, for example:

- a principal haircut;
- extended maturity; and / or
- a change in coupon (rate and/or whether the coupon is cash-pay or PIK).

Exchange offers are based entirely on voluntary participation. They can only succeed if a critical mass of bondholders agrees to participate. A "carrot and stick" approach is used to incentivise participation and penalise holdouts.

For background on the use of schemes of arrangement as restructuring tools, see here.

Carrot and stick approach

Possible "carrots" offered as relative benefits to the consenting noteholders include consent fees, structural seniority for the new notes and new or enhanced security and guarantees. Sometimes equity or warrants are offered together with the new bonds.

Possible "sticks" designed to penalise non-participating noteholders include:

- stripping out the covenants and other protective features of the existing notes by means of a consent solicitation accompanying the exchange offer (so-called "exit consents");
- rendering the existing notes junior to the new notes, whether structurally or through layering; and / or
- the threat of the issuer filing for insolvency proceedings.

Case studies

Edcon

Edcon, the South African retailer, restructured its €425m senior notes via an exchange offer, back-stopped by a South African compromise arrangement. The exchange offer made use of flexibility in the debt baskets of the senior secured high yield notes to offer senior noteholders an attractive exchange that layered the senior secured notes, together with coercive measures to dissuade hold-outs.

Senior noteholders were able to exchange their notes for new super-senior PIK notes at a discount to face value but at a premium to market value. Importantly, the new super-senior notes offered an elevated priority position. Noteholders were also offered a share of the equity in the form of non-voting exit warrants.

The exchange offer utilised coercive exit consents and game theory to discourage hold-outs. At a consent level above 50%, the exit consent would operate to covenant strip the senior notes. Above 90%, the exit consent would reduce the principal by 35% and the interest rate to 5%, introducing a real risk of value destruction. In the event that 75% of noteholders consented, the company would implement a South African compromise arrangement to bind all noteholders.

The exchange offer also permitted a "Warehouseco" structure, which provided that senior notes tendered for exchange might not be cancelled, but would rather be held by an affiliate Warehouseco. This meant that Edcon would not be delevered by the exchange offer, denying potential dissentients a key benefit of holding out.

Ukraine

In Ukraine, the restructuring of c.US$18bn sovereign and sub-sovereign Eurobonds was being effected pursuant to 14 simultaneous exchange offers. The existing notes will be exchanged for new notes and GDP-linked securities. The exchange included the following coercive elements:

- a "most favoured creditor" clause which prevents Ukraine from settling with hold-outs on more favourable terms than those available under the new notes;
- hold-outs not receiving GDP-linked securities; and
- Ukraine passing legislation to prevent the form of hold-out strategy pursued by certain funds in Argentina.

The Eurobonds contained collective action clauses ("CACs") which allowed a 75% majority by value in each series to pass an extraordinary resolution effecting the restructure which would then bind the minority in that series. The CACs did not operate across the series, however, so a scheme of arrangement was also considered in order to seek to bind the minority across all series. This raised interesting questions of whether (and how) a scheme could be used to compromise sovereign obligations, including the possibility of interposing a corporate entity into the structure based on the Affinion scheme precedent.

CACs are usual in the sovereign debt world, but less so in the private debt world - a change to the economic terms of non-sovereign debt usually requires a much higher threshold or unanimity under the terms of the indentures (although a scheme of arrangement may be used to bring that consent threshold down, where a scheme is possible). CACs have been recently extended in the sovereign world to operate beyond series and the Ukraine exchanged notes incorporate cross-series CACs to reduce the impact of minority hold-outs in any future restructurings. See our previous article on sovereign debt restructuring and collective action clauses for further information.

Schemes vs. exchange offers: pros and cons

	Schemes	Exchange offers
Binding minority holders	Ability to bind all dissenting minority bondholders with majority consent (75% by value, and a majority in number, of those bondholders actually voting on the scheme)	Based entirely on voluntary participation. Consent threshold likely to be set at a very high level (see "Consent thresholds" below) Even with use of coercive elements, issuer may end up with holdouts holding the original notes (albeit amended via exit consents) For Sovereign bonds, check whether there is a CAC at a 75% threshold, in which case, scheme is not necessary unless seeking to bind across series with no cross-series CAC.
Getting the deal through	Availability: need sufficient connection to English jurisdiction and (probably) also (a) at least one English-domiciled bondholder or (b) submission to English jurisdiction by bondholders	Contractual process therefore no such limits on availability
	Very flexible procedure, but there are some limits on what a scheme can achieve e.g. regarding imposing new obligations on creditors[1] and granting third party releases[2]	Flexibility, albeit only within the terms of the existing credit documents
	English court has broad discretion as to whether to sanction the scheme	Automatically effective (once conditions to effectiveness satisfied)
	For bonds governed by NY/other US laws, likely need to seek Chapter 15 recognition in the US	Generally, no need to seek specific recognition of the exchange offer in other jurisdictions
Risk of challenge	Formal court process with two court hearings – provides ready forum for dissenting noteholders to challenge	Challenge possible but generally thought less likely as process does not involve the need for court sanction
Timing	Relatively lengthy: court process usually takes 6-8 weeks	Relatively quick: for bonds governed by NY/other US laws, usually minimum offer period of 20 business days for non-investment grade debt[3]
Cost	Relatively more expensive, given court process	Relatively cheaper, given contractual process
Other	Likely to trigger events of default in other credit documents[4] and/or other material agreements e.g. leases	US tender offer rules apply for bonds governed by NY/other US laws May require registration, depending on type of exchange offer These would apply to an extent to a scheme process, albeit scheme would obviate need for certain disclosure requirements if securities SEC registered etc.

[1] See our Scheme Hot Topics Bulletin: Part I, pages 3-4.

[2] See our Scheme Hot Topics Bulletin: Part II, page 3.

[3] This period can be shortened to 5 business days if the exchange offer falls within the SEC's guidance for accelerated debt tender offers (issued January 2015). However, the availability of this accelerated process is limited in the context of distressed exchange offers. No "5 Day Tender Offer" can be made:
(a) if a default or event of default exists;
(b) if the issuer's board has authorised discussions with creditors to effect a consensual financial restructuring; or
(c) in connection with the solicitation of exit consents.

[4] It may be possible to structure the scheme to avoid triggering events of default. For example, the Affinion scheme used a novel structure to avoid triggering an event of default under Affinion's NY-law governed debt. An SPV, AI Scheme Limited, executed a deed poll under which it assumed joint and several liability to all of Affinion's scheme creditors. It did so for the sole purpose of implementing the scheme, which included third party releases granted to Affinion in respect of its liabilities to the scheme creditors. This approach has recently been the subject of greater judicial scrutiny in the *Codere* scheme.

Consent thresholds

Debtors are likely to set the voting threshold for their exchange offer at a very high level (over 90% by value), even if the relevant Notes indenture technically requires a much lower level of creditor consent to effect the amendments required to implement the restructuring.

The rationale for doing so is to mitigate the risk of smaller noteholders holding out (reasoning that the exchange offer would be successful despite the lack of their consent and that they would therefore be paid out in full on maturity – whilst other, larger noteholders would receive reduced payments under the terms of the exchange offer).

Edcon set an unusually low minimum participation condition for its exchange offer, of a simple majority (>50%) of the notes by value. Crucially, the offer had already received the support of holders of nearly 49% of notes by value when it was announced. This gave significant momentum to the deal and lent credibility to its coercive features.

The exchange offer was ultimately consummated on the basis of acceptances from noteholders holding over 97% of the notes by value; the back-stop of the compromise arrangement was not required. Even though the offering memorandum was ambiguous as to where the new notes would sit within the group's capital structure, noteholders' fear of being left behind – and hunger to receive the relative benefits offered to participating noteholders – was too great.

For Ukraine's sovereign restructuring, the exchange offers did not contain minimum acceptance conditions. Instead, whilst Ukraine had discretion as to whether or not to proceed with the exchange offers in circumstances where insufficient votes were cast to trigger the CACs and pass the extraordinary resolutions (i.e. less than 75% by value voted in favour of the resolution), Ukraine's discretion in this regard was fettered. In such a scenario, the exchange offers were made conditional on Ukraine proceeding either with all of the exchange offers, or none at all.

Ukraine had no ability to accept or reject the exchange offers on a per-series basis; this prevented Ukraine from "cherry picking" which exchange offers to accept (or reject). This mechanism was designed to address concerns of creditors holding bonds across multiple series, who wanted certainty as to the overall restructuring (rather than being left with partially-restructured debt across a number of different series).

In addition, the Ukraine exchange offer involved a dual mechanism in each series – an exchange offer inviting noteholders to tender their notes and a consent solicitation in relation to the extraordinary resolution. If the extraordinary resolution was approved by the 75% majority, under the CAC, all noteholders would then be subject to the exchange whether or not they voted in favour. If the extraordinary resolution was not approved, then those noteholders tendering their notes would be subject to the exchange and those who did not would be left as a hold-out. Noteholders were not allowed to "hedge their bets" – a tender was treated as a vote in favour of the extraordinary resolution (and vice versa, subject to US securities eligibility requirements). Further, hold-outs would be subject to the provisions discussed above and would not be allowed to receive GDP-linked securities after the exchange offer settled, so by not voting in favour, a noteholder took the risk that the extraordinary resolution failed but other tenders were accepted, meaning that they would be left out.

Ultimately, with the exception of the one series of bonds held by Russia, sufficient votes in favour of the exchange offers were cast to pass the extraordinary resolutions in all the other 13 series. In other words, the Ukrainian debt restructuring was approved by over 75% of creditors in 13 of the 14 series of bonds being restructured.

Whilst it's unfortunate that a holdout remains, Russia is far from a typical dissenting creditor. It is not surprising that usual (or even innovative) coercion mechanisms were insufficient to overcome the extreme geo-political dynamics between the two countries.

Game theory of dealing with hold-outs

- High consent threshold, to avoid incentivising hold-outs to "free ride" on other noteholders' participation
- Critical to align noteholder incentives with the range of possible and likely outcomes of the exchange offer
- Care required where cross-series debt (and no cross-series collective action clause). "All or nothing" approach used in Ukraine's sovereign restructuring, to make clear that hold-outs in one series couldn't stop tenders or collective action clauses in other series

Twin-tracking schemes and exchange offers

Another possible implementation route has recently emerged: a twin-tracked scheme of arrangement and exchange offer, as in *DTEK* (April 2015) and *Zlomrex* (January 2014). This entails the company launching an exchange offer under the terms of its bonds and, if the requisite consent threshold for the exchange offer is not met, using a scheme of arrangement as a fall-back.

Benefits of twin-track approach

- Possibility of avoiding a formal court process if sufficient creditors vote in favour of the exchange offer
- Efficient implementation mechanism[5], by avoiding the delay of launching a scheme only after an exchange offer has failed

Binding creditors

The twin-track arrangement can be structured such that the offering of existing Notes for exchange automatically constitutes a vote in favour of the scheme (or rather, technically, the delivery of an irrevocable instruction to the exchange agent to vote in favour of the scheme and execute necessary documentation).[6] This process proved an efficient and effective way to meet the scheme voting threshold on *DTEK*: by the time of the scheme meeting, over 91% by value of noteholders had been locked up to vote in favour of the scheme.

Alternatively, the exchange offer and scheme process can be run in parallel but quite separately (such that by accepting the exchange offer, noteholders are not regarded as having voted in favour of the scheme, and *vice versa*) – as on *Zlomrex*. This however does not offer the same efficiency of process and is likely to result in a longer restructuring timetable.

Weil's European Restructuring team is acting for the ad hoc creditors' committee on Ukraine's sovereign restructuring and acted for the largest 2019 bondholder on the Edcon restructuring. For further information on our Ukraine role, see here.

[5] *DTEK* moved through the scheme process in 3.5 weeks as opposed to the usual 6-8 weeks.

[6] The debtor may even go a step further and restrict noteholders from voting in favour of the scheme unless they also participate in the exchange offer.

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