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A New Approach to Out of Court Restructuring

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Reorganization under Chapter 11 of the U.S. Bankruptcy Code was designed to provide an alternative to receivership and liquidation. Successful cases are a transfer of the reorganized company as a going concern to the existing claim holders, who effectively exchange their existing interests for interests in a new entity. However, the very premise of the Chapter 11 process is flawed as a result of its adherence to a perception of ownership rights that in most cases no longer exist.

Because the value of the reorganized enterprise must be agreed upon by multiple constituents before it can be redistributed, the law has transformed the intricate task of fairly dividing the reorganization pie into a brutal process of bargaining and litigation among multiple classes of creditors and owners. This frequently results in significant deviations from claim holders' contractual rights and the absolute priority rule, major delays and litigation costs, and an inefficient capital structure for the emerging company. For example, of the 57 bankrupt public companies that had confirmed reorganization plans in 2005, 26 were in bankruptcy for over a year, and one was in bankruptcy for almost seven years.[1]

Enacted 25 years ago, the Bankruptcy Code continues to assume that all creditors are interested in liquidating their claims, but with the increasing prevalence of non-bank lenders and claims traders, this is no longer the case. Far from having a liquidation bias, hedge fund lenders often pursue a reorganization plan in which they end up as the controlling shareholder. The 2005 revisions to the Code reduced the Chapter 11 reorganization process to little more than a massive, federally funded unified foreclosure system for the benefit of secured creditors pursuing a prompt sale of their collateral.[2]

Debt renegotiation prior to a default is faster, easier and can preserve more value for both lender and debtor if the actual decline in market value is proactively recognized, accepted, and replaced with a claim on any future increase in the value of the company. Renegotiating the terms of debt in a distressed situation has historically taken the form of a value redistribution using one of two techniques. One is strategic debt service, in which the debtor temporarily stops making payments when the value of its assets fall below a negotiated limit, and resumes making payments when fortunes improve. The other is the debt for equity swap, in which debt holders are offered a proportion of the debtor firm's equity to replace their original debt contract.

The anticipated advantage of restructuring with a strategic debt service plan is that the firm will not lose the present and future tax benefits of financing the firm with debt. However, the potential tax benefits associated with debt financing may turn out to be immaterial or nonexistent if operating losses continue and there is no taxable income, or if operating loss carry forwards are reduced by a change of control event.

In July 2009 Professor Nassim Taleb co-authored an article urging governments and lenders to execute debt for equity swaps without delay as the only effective means to avoid hyperinflation.[3] In the article, the authors assert that "Debt has a nasty property: it is highly treacherous. A loan hides volatility as it does not vary outside of default, while an equity investment has volatility but its risks are visible. Yet both have similar risks." They conclude with "[t]he only solution is to transform debt into equity across all sectors, in an organized and systematic way . . . banks should reach out to borrowers and offer lower interest payments in exchange for equity. Instead of debt becoming 'binary'—in default or not—it could take smoothlyvarying prices and banks would not need to wait for foreclosures to take action." This suggests that the restructured debt should take the form of a hybrid security that accommodates elements of both strategic debt service and a debt-equity swap.

Conversion of debt to equity is not a new idea, but beyond an academic exercise it has proven to be impractical for both lenders and shareholders. For over 25 years, professors and economists have argued that conversion of debt to equity is the cheapest and fastest way to reorganize a company.[4]

In a 1988 article, Harvard University Professor Lucian Bebchuk proposed a redesign of the method by which the reorganization pie is divided in Chapter 11 bankruptcy cases. He envisioned that each of the debtor's claimants would be granted a transferable option on the debtor so that, whatever the reorganization value is, no participant would have a basis for complaining that he is receiving less than the value to which he is entitled. The option would entitle the holder to buy a portion of all higher priority claims or interests, with the lowest priority claimants having the first opportunity to exercise their options. If the members of every tranche of debt and equity failed to exercise their options before they expired, the highest priority claimants would obtain ownership of the debtor.[5]

Under Bebchuk's variation of the debt-equity swap, there is no need to agree on the current fair value of the enterprise because creditors and shareholders would receive a relative portion of the total recovery when it is realized. Creditors that don't have the liquidity or desire to wait for the value of the reorganized company to improve could sell their options to other creditors, shareholders or third parties. Presumably, the most optimistic creditors and shareholders would eventually become the company's new owners.

While considered one of the few alternative approaches that is theoretically feasible within the constraints of the current bankruptcy laws, several weaknesses of using straight options to replace debt and equity have been identified by practitioners. These include contractual complexities related to selling and exercising the options, setting expiration dates, and difficulties determining the value of multiple classes of options on the same company.

Lender Resistance and Shareholder Delay

The unknown quantity in any restructuring plan is what the value of the company will be in the future, which depends on many unpredictable events that people often believe they can predict. Lenders tend to underestimate the variability of future cash flows and debt service capacity, while owners tend to overestimate cash flows in their effort to attract capital. As Professor Taleb concludes in the previously cited article: "Thus debt is the province of both the overconfident borrower who underestimates large deviations, and of the investor who wants to be deluded by hiding risks."

Most debt-equity swaps that actually do occur typically follow liquidity-induced defaults. That is, they are restructurings forced by an event of default in which either a maximum leverage ratio, minimum current ratio, or minimum earnings requirement in a loan covenant is not maintained. Often, the point of insolvency has also been reached, and the swap is agreed to as a last resort in an effort by both lender and debtor to avoid liquidation. Without the urgency of an impending liquidation however, a proposed debtequity swap is not easy for creditors or shareholders to accept.

The experience of the Industrial Revitalization Corporation of Japan (IRCJ) demonstrates the difficulties confronting a proposal for an immediate wholesale conversion of debt to equity. [6] 14 months after the IRCJ opened for business in April 2004, its president Atsushi Saito delivered a progress report in which he pointed out that only seven of 100 distressed firm candidates fit the eligibility criteria for restructuring assistance. He described Japan's management culture as having created a "complete disregard" for capital efficiency, a corporate governance philosophy based on internal information sharing, and irreconcilable differences between published financial data and actual company value.

Saito explained that IRCJ's mission was to reveal the true state of a firm's health to the business community through precise asset valuation methods, and this dictated a response of quality over quantity. Some of the 83 candidate firms were rejected because no matter how the free cash flow was valued, it was insufficient to service the interest-bearing debt within 10 years. In other cases, the executives of small, privately owned companies were unwilling to accept early retirement. "Since we use tax payers' money and ask senior lenders to forgive debt," Saito reasoned, "we cannot accept these conditions." The IRCJ experiment illustrates the two major reasons why an immediate debt for equity swap is often objectionable to both lenders and owners:

1. If the equity received by the lender is an equivalent value claim against the same assets and earning capacity of the same company, the debtor's illiquidity problem has merely been transferred to the lender. While near term cash flow may increase by the elimination of debt service payments, the claim on assets remains, and the time until which the value of the claim can be realized has simply been extended. Lenders are notoriously averse to owning nonmarketable equity or other financial assets with indefinite lives.

2. In a widely held company, stockholders are averse to ceding a controlling equity interest to a lender having neither the skills or experience required to operate the company. Owners who actively manage a closely held company are similarly reluctant to surrender a

management position that provides their major source of income and various non-monetary benefits. The owners often simply want to deny or delay the recognition of a decline their company's value that an immediate debt-equity swap represents.

Creating Value with Redemption and Conversion Options

A remedy to such resistance can be devised by using embedded options to increase the value of both stock and debt enough to compel both shareholders and lenders to swap debt for equity. The essence of such a plan is for the debtor company to exchange the time value of an option on the company's value for time itself, while allowing the lender to effectively retain liquidation rights similar to those inherent in the original debt instrument. That is, the value of the additional potential future claim against the company's assets must be large enough to induce the lender to wait longer than the original term of the debt to liquidate its claim. From the shareholders' perspective, the value of the additional time the company has to earn its way out of the debt obligation must be long enough to induce shareholders to exchange their current subordinate claim on the current value of the enterprise for a security that retains long term control over a potentially higher future enterprise value.

Bankruptcy law developed in a world of limited financial instruments, consisting of secured debt (generally held by banks), bonds, trade receivables, and publicly traded stock.[7] Of all the forms of hybrid debt and equity securities that have been created since the Bankruptcy Code was enacted 25 years ago, the favorite of venture capital and private equity funds is convertible preferred stock with a cumulative 'paid-in kind' dividend (i.e., accrued and paid in the form of additional shares of stock). This versatile instrument offers its owner the attractive benefit of a choice among several ways to liquidate the value of the preferred claim upon occurrence of a liquidity event. These typically include a first priority claim on equity that is equal to some multiple of the original investment plus all accrued dividends, or if worth more, an option to convert to a specified number of common shares. In the event that no liquidity event occurs within a specified time, a typical third option is a cash redemption of the original investment plus whatever accrued dividends can be paid.

Either convertible debt or preferred stock can be used in a restructuring to include the cash flow and tax benefits of strategic debt service (because the payment of accrued nterest or dividends can be accrued and deferred), and can overcome some of the objections to straight debt-equity swaps and the weaknesses of a plan to issue replacement options alone. While either convertible debt or preferred stock can be used, their accounting treatment and tax implications can vary widely. The essential qualities are that the security must be redeemable for cash and convertible into voting shares at the option of both the lender and the company. For example, a simplified model plan might include the following provisions:

1. The lender exchanges an unsecured promissory note for cumulative paid-in-kind convertible preferred stock of equivalent fair value with redemption and conversion provisions that are exercisable by either the lender or the company at any time either believes the company has or can raise sufficient cash to fund the payout.

a) The lender (now preferred stockholder) can exercise its redemption right at any time, presumably after the company has improved its operating performance and financial condition to the point at which the company or its equity can be sold for enough to fund the redemption.

b) The company's option to force redemption of the preferred shares is also exercisable at any time it has the ability to fund repayment of the face value and accrued dividends of the preferred stock in cash.

2. The conversion option is exercisable by the lender at any time before the redemption option is exercised by either party, but not after.

3. The redemption option is exercisable by the company/ shareholders at any time.

4. The key condition to attach to both embedded options is that upon receiving notice of one party's intent to exercise either the conversion or redemption option, the non-exercising party has an opportunity to exercise the other option first. This arrangement is similar to those often found in buy-sell agreements in which the proposing buyer is obligated to accept the proposed buyout price if the seller believes it is too low. This version of the "shotgun clause" discourages attempts to liquidate a claim prematurely or to the detriment of the other party because it has the effect of potentially leaving the lender with one of the following after a failed redemption or conversion attempt by the lender:

a) An equity interest, if the company/shareholders convert the lender's preferred to common a) in response to an attempted cash-out redemption by the lender that could not be funded.

b) Cash, if the company /shareholders redeem the preferred and accrued dividends in response to an attempted conversion by the lender in an effort to gain control.

Aligning the Interests of Lenders and Owners

The intent of a debt-convertible arrangement is to avoid stipulating an arbitrary deadline or maturity date by which the company is obligated to fund a redemption. The expected result is a flexible liquidity date that will materialize naturally to accommodate unpredictable variations in the company's financial condition and the relative risk appetites of both lender and shareholder. Under this form of restructuring, since the initiator of an attempt to liquidate the lender's convertible interest could end up as the majority owner, preserving the value of the enterprise is in everyone's mutual interest.

A debt-convertible restructuring plan can also avoid an unnecessary acceleration of recognizing a loss in the value of the company's debt or stock because its terms actually create value that did not exist before. If not corrupted with a multitude of restrictive provisions, the adaptive nature of the simple provisions outlined above increases the probability and number of opportunities for both lenders and shareholders to realize higher value in the future. The shareholders remain in control of the company and preserve their long-term option to maintain control by paying off the lender when it becomes possible and desirable to do so.

Assuming that a future conversion of the lender's preferred shares to common will result in the lender's control of the company, the lender gains a valuable option to acquire control of the company. The "shotgun" clause ensures that the highest possible value will be realized and that neither party will intentionally exercise their rights to the detriment of the other. Creating and exchanging the options embedded in a convertible security improves both parties' prospects for profiting from an increase in the value of the enterprise and aligns their interests.

Implementation Considerations

One possible criticism of a debtconvertible swap is that it may appear to be a mere reshuffling of rights between shareholders and lenders. If properly structured however, it does increase the value of each party's claim by conveying rights that are designed to increase both parties' control over the timing and terms of liquidation of each other's claim. Further, the value of such rights can be significant in both distressed and high-performing companies, and until articulated and agreed to, they simply do not exist. From this perspective, the debtconvertible swap creates value.

Another dissent by some shareholders may take the form of their reluctance to recognize the effect of such a restructuring in the company's financial statements. In an effort to improve the accounting and reporting of the effect of hybrid financial instruments on the fair value of equity, the FASB has issued various pronouncements and interpretations intended to recognize potential gains and losses resulting from a restructuring. One of these is Statement of Financial Accounting Standard No. 15, which requires recognition of loss or gain resulting from a "troubled debt restructuring."[8]

According to FAS 15, a restructuring of a debt constitutes a troubled debt restructuring if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Whether a gain or loss must be recognized depends on numerous conditions and exceptions, such as paragraph 7 of FAS 15, which specifies that a troubled debt restructuring does not include a transaction in which "the fair value of cash, other assets or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable."

While the fair value of the securities exchanged for debt would need to be determined by a qualified valuation professional for financial reporting and tax purposes, the cost to do so is negligible compared to that of a bankruptcy filing or liquidation proceeding.

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