# Restructuring Emerging Markets High Yield Bonds: An Issuer's Roadmap

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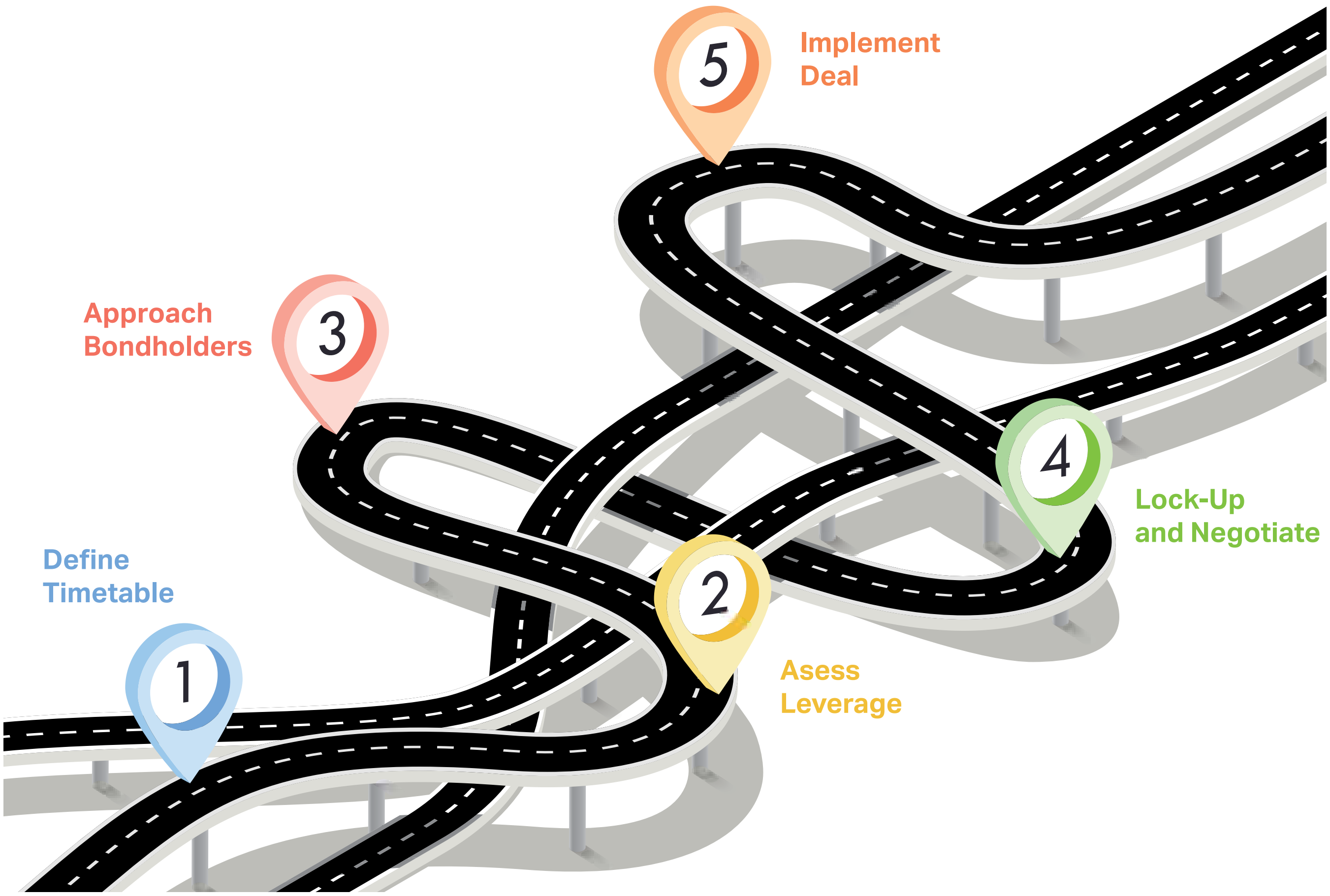
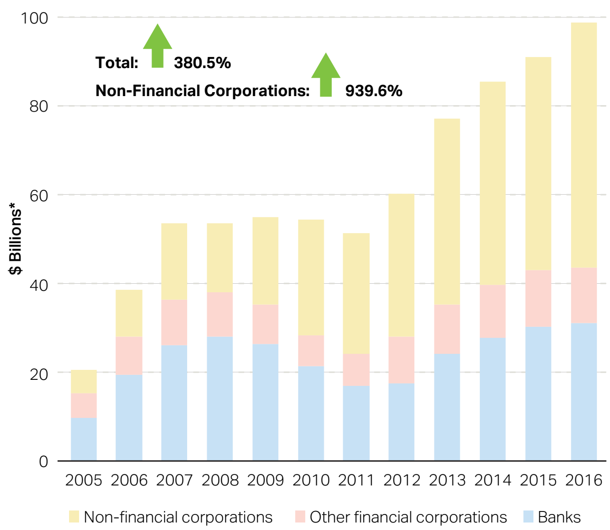



European high yield bond issuance over the last 10 years has grown enormously, maturing into a market that has proved more resilient to volatility than many expected. There are a number of reasons for this, not least the ECB's bond buying programme which has driven yields down and encouraged investors to look at riskier asset groups in the search for returns.

The maturation of the European high yield market in a low-yield macro environment has, in turn, encouraged large numbers of overseas companies to sell bonds in Europe. Many of those companies are based in (or have businesses in) emerging market jurisdictions. Many issued bonds when the commodities boom seemed set to continue indefinitely.

**Developing Markets Private Sector Aggregate Euro-Denominated Bonds Outstanding: 2005-2016**




Source: Bank for International Settlements. Data reflects total Euro-denominated bond debt outstanding as of Q4, except 2016 for which data is only available as of Q2.

*Figures reflect total Euro-denominated bonds, expressed in $USD based on prevailing exchange rate.

The slowdown in China at the start of 2016 has led the issuers of many of these bonds to look at their terms in a new light. How can the issuer negotiate a restructuring with a disparate group of creditors whose identity can often be difficult to establish, when cash reserves may be getting low? This article sets out the key challenges of restructuring emerging market high yield bonds from an issuer's perspective.

## Timing is everything

One of the great advantages of a high yield bond over a syndicated loan is that high yield bonds don't typically contain 'maintenance' financial covenants. That means the financial performance of the issuer's business is not subject to any minimum or maximum levels below or above which the bondholders can call a default. The financial covenants in a high yield bond are only tested at the time the issuer takes certain steps (for example, paying a dividend or incurring more debt). Assuming the issuer doesn't need or want to take any of the steps that would trigger the covenant test, when should it approach bondholders if it wants to negotiate a restructuring?

**Key variables affecting timing of issuer's approach of its bondholders:**

1. **If it ain't broke, don't fix it.** Absent an impending default, bondholders may be unwilling to engage in a restructuring discussion with the issuer, even if they know the capital structure is unsustainable in the long term. So there usually needs to be some impending trigger point in order to convince bondholders that action is required. That said, in most circumstances it is usually better to negotiate a restructuring before a default actually occurs[1], so discussions should ideally start whilst a default is on the horizon but not imminent.

2. **Defaults and Cross-Defaults.** Without maintenance financial covenants, the most likely trigger point under the bond terms would be either a failure by the issuer to pay the coupon when due, or (if the issuer has other debt owed to third parties) a cross default. Most high yield bonds will allow for a 30-day grace period for missed coupon payments, but that is unlikely to be a sufficient time period to identify and negotiate a deal with bondholders from scratch. Cross default provisions in high yield bonds tend to require the relevant creditor to have accelerated their debt, and will usually have fairly large 'de minimis' exceptions. But there could be a 'domino effect' if a default under a small piece of debt is sufficient to trip a cross-default in a larger piece of debt that is big enough to trip the cross default in the bonds.

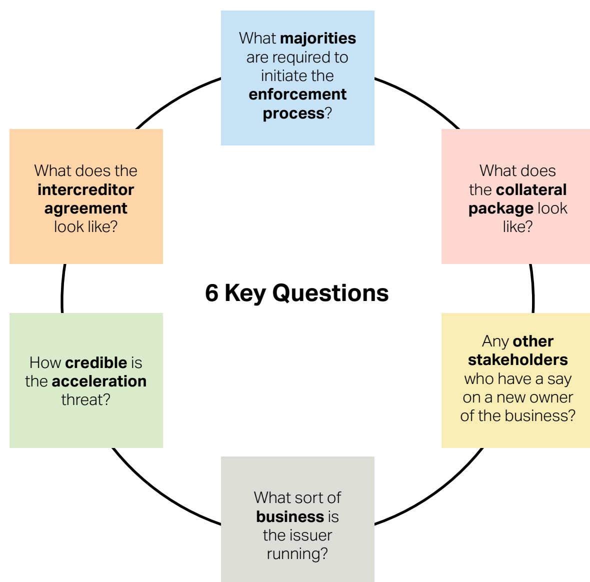
→ *Engaging with the creditors at an early stage is critical, and may well be a legal duty for the board of directors of the issuer. If distress is on the horizon, issuers should seek advice from legal and financial advisors and work out a clear timetable, working backwards from the date on which a trigger point could occur.*

## What power do the bondholders really have?

Before engaging in a restructuring negotiation with bond-holders, it is important for an issuer to know the strength of its bargaining position. As noted above, there is often a perception that once an event of default has occurred, all the power lies with the bondholders and the issuer will have to take whatever deal it can get. In our experience, that is not always the case.

Before engaging with bondholders, the issuer and its advisors should conduct a thorough default analysis, to establish precisely what action can be taken, when, and by whom. Often the bondholders' position is not as strong as it initially appears. The following factors need careful examination:

— First, what are the majorities required for bondholders to initiate an enforcement process? Typically in European high yield bonds the holder of 25% of the bonds can accelerate (and more than 50% can rescind an acceleration), but often a majority is required in order to enforce security, if any. If the security is shared with other creditors (e.g. lenders under credit facilities) who is entitled to direct the enforcement? If they do, is it likely that those majorities can be brought together from the disparate group of bondholders and agree on an enforcement strategy? Will they have to indemnify the bond trustee or security trustee before action can be taken?




— Secondly, what does the collateral package, if any, look like? Invariably a creditor would want to sell the entire business as a going concern rather than pick off individual assets—is there a share pledge at the holdco level? If so, what is the law governing that pledge? Is it easy to enforce share pledges in that jurisdiction and within what period of time? Does the court need to be involved? Will the pledged shares have to be sold to a third party via an auction or other competitive process? Are there likely to be any interested bidders? Are there regulatory requirements limiting the number of possible bidders?

— Thirdly, if the bonds are unsecured, such that the only remedy of the bondholders is to accelerate the principal and sue for payment, how credible is the acceleration threat? How easily will a judgment issued by the English courts be enforced in the emerging market jurisdiction where the assets are located? Will the directors of the issuer (or any of the guarantors) feel compelled to file for insolvency? If they do, what are the consequences and how will this affect the bondholders position and security enforcement process? Are there significant contingent liabilities (e.g. performance bonds, unsubordinated intercompany debt, severance payments) that would become due in this event and, if so, how do they rank compared to the bonds?

— Fourthly, what sort of business is the issuer running? Does it require skilled and experienced management? Does the existing management have special expertise or relationships with customers, suppliers or other stakeholders (see next bullet) that are difficult to replace? What about the existing shareholder—is their involvement critical to the business?

— Fifthly, are there any other stakeholders who could make life difficult for a new owner of the business? In some jurisdictions the issuer will need a licence to conduct its business (especially if it is a mining company) and sometimes its entire business will depend on a concession it holds to exploit certain natural resources (as in the case of an oil drilling company). Would the relevant government be receptive to a change in ownership, or could it revoke the licence or concession? Does the licence or concession revoke (perhaps automatically?) if the issuer were to enter an insolvency proceeding? Are there other relationships that the existing shareholders have with the government that would make it difficult for the bondholders to enforce their security and either run or sell the business? Can capital controls be imposed which will prevent or delay repatriation of the funds? Are there restrictions on foreign investment in the relevant jurisdictions?

— Sixthly, if the bonds are junior to other debt, does the intercreditor agreement permit the reimbursement of fees of advisors to a committee of the bondholders' during negotiations (see below)?

→ *Working out the true commercial position (not just the legal position) is the key here. If the bondholders are unlikely to want to exercise their legal rights to enforce they will be much more likely to take a reasonable approach in any negotiation.*

## We need to talk

Once the issuer has established the negotiating power of the bondholders, the next step is to initiate a discussion with them. That is often easier said than done.

In most cases, there will only be one 'official' or registered bondholder of a high yield bond—the common depository which holds a physical bond for the clearing systems[2]. The holders of beneficial interests in that bond will have their interests shown in individual accounts with the clearing systems (or, more often, in the accounts of intermediaries such as broker dealers etc, which may be several levels below the clearing system). There are a couple of ways of finding out who the beneficial owners are:

— have the issuer publish a press release asking the holders of beneficial interests in the bonds to make themselves known to the issuer's advisors; or

— hire an information agent, who can work with the clearing systems to identify bondholders.

Once the ultimate bondholders have identified themselves, they need to decide which of them will take an active role in negotiating the deal. Sometimes a formal committee of bondholders is appointed, with a detailed appointment letter setting out the committee's role, an indemnity and an agreement from the issuer to pay the costs of the committee's advisors. In other cases, the committee is formed ad-hoc without a formal appointment, and the issuer will enter into arrangements directly with the committee's advisors regarding payment of costs.

➔ *In both situations, the key is ensuring that the committee represents a sufficiently large proportion of the bondholders for them to be able to negotiate a deal that has a good chance of being approved by the broader bondholder group. The ability to terminate the discussions (and the obligation to pay the committee's advisors) if the committee's holdings fall below a certain level is crucial. The issuer needs to know it is talking to the right people.*

## Information flows

Now that the committee has been formed and their advisors have been appointed the negotiation can start, right? When restructuring publicly listed securities, it is not as simple as that. If the bondholders receives any inside information during the course of the negotiation, they will be restricted from trading their bonds until that information is made public. But how can they negotiate a restructuring proposal without receiving inside information?

This catch 22 situation is typically resolved by having the committee's legal and financial advisors conduct due diligence and pre-negotiate a restructuring deal (based on their understanding of the interests of the bondholders and any general guidance they have received initially), at least until a short 'go-private' period during which the bondholders themselves are brought in. Each bondholder and the issuer will sign a confidentiality agreement which has a 'cleansing' mechanic.

That mechanic will require the issuer to make public (or "cleanse") any inside information that is provided to the bondholders after the 'go-private' period has ended (whether or not a restructuring deal is agreed). So care should be taken to ensure that only information which the issuer is happy to publish will be made available to the committee during the negotiation phase. If a deal is agreed, the committee and the issuer would usually sign a lock up agreement whereby they agree to support the transaction and take whatever steps the agreed implementation method requires (as to which, see below). The lock up agreement will also:

— prevent the consenting bondholders from selling their bonds, except to another bondholder that has signed the lock up agreement; and

— contain a 'standstill' provision, whereby the consenting bondholders agree not to take enforcement action in respect of any existing defaults, or any that would be caused by implementing the deal. They also agree to rescind any enforcement action taken by other bondholders (to the extent possible). This is why it is critical to ensure that the committee represents a sufficient majority of the bonds to make the standstill meaningful.

At the same time, the terms of the agreed deal are announced publicly along with the other inside information that the committee has received, and the parties move to the implementation phase of the transaction.

➔ *These procedures are typically sufficient to satisfy European and U.S. securities laws but care should be taken to ensure they do not run afoul of more stringent insider trading laws of the jurisdiction of the issuer or policies of local securities regulators who may be less familiar with international restructuring practices.*

## How do you implement a deal?

There are a number of options here. Which method is chosen is entirely dependent on what the deal is and the corporate and capital structure of the issuer's group. The basic goal of any implementation method is to ensure that the agreed deal is imposed on all of the bondholders, even if they are not in favour.

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| **Consensual Amendment** | The terms of most bonds will have built in to them a cram-down procedure in the 'collective action clause'—the clause that sets out how amendments can be made to the indenture or trust deed.<br>In most emerging markets high yield bonds the non-fundamental terms can be amended with the support of a simple majority of bondholders. But in a restructuring the changes are likely to affect the fundamental terms—principal amount, interest, maturity. Those terms are subject to a higher threshold—often **90% in New York law** governed bonds issued by a non-U.S. company, and **75% in English law** governed bonds.<br>— English law governed bonds tend to provide for amendments to be made by bondholder meetings with quorum requirements, which can alter the voting dynamics if there is a low turnout.<br>— New York law governed bonds often provide for a more straightforward consent solicitation process without quorum. In both cases bonds held by the issuer or its affiliates will likely not count in the vote. |
| **Exchange offer and exit consent** | This is where the issuer offers new bonds (with the amended terms) and possibly some cash in exchange for the existing bonds.<br>Often the existing holders are encouraged to tender their bonds by a combination of carrots and sticks, where the carrots can consist of a higher interest coupon and/or a more senior ranking in the capital structure for the new bonds, and the sticks an impairment of the terms of the existing bonds (which impairment is implemented by coupling the offer with an 'exit consent', whereby tendering bondholders are deemed to vote in favour of a set of amendments to the terms of the existing bonds).<br>Failure to tender in the exchange could thus leave a holder with a bond that has basically no covenant protection, is effectively subordinated to the new bonds, has a reduced principal amount and/or only accrues PIK interest[3].<br>A couple of issues:<br>— It is unlikely that 100% of the holders will tender, so there will be a 'stub' of holders with the old bonds. Even though the covenants may have been stripped from those old bonds, the rights to interest and principal may remain in place, leading to cash leakage until the old bond matures.<br>— If another restructuring is required at some point in the future, you would have 2 classes of creditors, which can make a scheme of arrangement (see below) more challenging. |
| **Scheme of arrangement** | A scheme is an English court-based process which allows a restructuring to be imposed on all creditors in a class if at least 75% by value and a majority in number of the creditors in that class vote in favour.<br>Schemes can be used by English companies and, crucially, foreign companies with a 'sufficient connection' to England. Sufficient connection is not the same thing as centre of main interests (or 'COMI'), and has been established in some cases simply by having the main debt documents governed by English law.<br>The courts have even allowed companies with foreign law governed debt documents to change the governing law to English[4] in order to establish jurisdiction for a scheme.<br>At the time of writing the English courts seem to be stepping back somewhat from the expansive jurisdiction they have established in recent years, but it should still be viewed as a viable option for consideration in most emerging market restructurings where the laws of the jurisdiction of the issuer do not have their own cram down procedures. |

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| **Chapter 11** | Chapter 11 of the U.S. Bankruptcy Code provides a robust framework to facilitate the orderly restructuring of a debtor's affairs.<br><br>As a threshold matter, in order to be eligible for Chapter 11, a debtor need not be US-based or even maintain operations in the US; the Code merely requires "a domicile, a place of business, or property in the US." Courts have interpreted this standard broadly—particularly with respect to property, which has been held to include bank accounts and New York law governed debt.<br><br>Chapter 11 offers a number of distinctive advantages for debtors as well as creditors:<br><br>— offers significant optionality with respect to timing; for instance, if speed is the priority, a so-called "pre-packaged" plan can become effective in as little as 45-60 days.<br><br>— allows management to remain in control of the debtor's operations during the process—which, for some companies, may be operationally or otherwise crucial.<br><br>— facilitates financing options during the bankruptcy process through Debtor-in-Possession ("DIP") financing, which, with Bankruptcy Court approval, provides DIP lenders structural priority in exchange for the risk.<br><br>— is a well-established framework that offers all stakeholders a significant amount of clarity regarding the procedural dynamics as well as their relative positions and corresponding expectations. |
| **Chapter 15** | Chapter 15 of the U.S. Bankruptcy Code provides foreign debtors an opportunity to harmonize otherwise disjointed restructurings by granting access to US Bankruptcy Courts for the purpose of recognizing and enforcing foreign restructurings through the U.S. courts.<br><br>A gateway requirement with respect to chapter 15 is recognition of a foreign proceeding, which is granted to a debtor's foreign representative, rather than the debtor itself.<br><br>Once the foreign proceeding is recognized, the chapter 15 proceeding serves as an ancillary proceeding to further the foreign insolvency proceeding as it relates to US-based assets and claims. U.S. courts have at times reached different conclusions regarding whether the threshold requirements for Chapter 15 should be the same as those for Chapter 11 eligibility; however, for practical purposes, the standard is quite broad. |
| **Local insolvency proceeding** | As more and more countries adopt bankruptcy laws designed to facilitate the going-concern restructuring of businesses through in-court proceedings (more or less inspired by the Chapter 11 of the U.S. Bankruptcy Code), an additional option may be to take advantage of those proceedings in order to extend the deal to non-consenting creditors.<br><br>Typical issues that need to be analysed in this context include:<br><br>— can the local proceedings be used to restructure the issuer group as a whole or do they need to be implemented on an entity by entity basis?<br><br>— will the local proceeding be effective to restructure guarantees issued by entities outside of the issuer's home jurisdiction?<br><br>— will those proceedings be recognized outside of the home jurisdiction to prevent creditors attaching assets of the issuer located elsewhere?<br><br>— How will bondholders vote in those proceedings? Will their vote be taken into account individually or will the trustee vote 100% of the principal of the bonds in accordance with the instructions given by a majority of them? |

1. The reason is that once a default has occurred, the balance of power tips in favour of the bondholders—they will usually have the ability to accelerate the principal amount of the bonds and enforce any security, if any. But accelerating and enforcing may not be that attractive to the bondholders in every case, which can affect the negotiating dynamics—see *'What power do the bondholders really have'* below.
2. In some cases there may be two common depositaries if the bonds have been sold into both Europe and the U.S.
3. Usually high yield bonds are governed by New York law. However if you have English law bonds, care should be taken when structuring an exit consent as the courts have raised questions about whether such coercive tactics could be deemed to infringe the rights of the dissenting minority—see 'Exit Consents in Restructurings—Still a Viable Option?' which is available at https://www.clearygottlieb.com/news-and-insights/publication-listing/exit-consents-in-restructurings-still-a-viable-option33
4. Change of governing law is often not a fundamental amendment so can be achieved with a simple majority.

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