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SPECIAL REPORT

FORUM: Pre-insolvency reorganisation and restructuring

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FORUM

Pre-insolvency reorganisation and restructuring

FW moderates a discussion on pre-insolvency reorganisation and restructuring between Simon Granger at FTI Consulting, Elaine Nolan at Kirkland & Ellis, and Van Durrer at Skadden, Arps, Slate, Meagher & Flom.

THE PANELLISTS

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Simon Granger is a senior managing director in FTI's Corporate Finance practice based in London. Mr Granger has 16 years of experience, providing restructuring solutions and financial advice to a wide range of stakeholders. He has acted on a number of high profile restructurings, including Quinn Group; Ballantyne Re; Heijmans; Deutz AG; Jost Werke AG; Kodak; Seat Pagine Giallie; and Landsbankinn.

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Elaine Nolan is a restructuring partner in the London office of Kirkland & Ellis International LLP. She advises strategic investors, sponsors, insolvency practitioners, turnaround managers, directors, debtors and creditors in all forms of national and international financial restructurings and insolvencies. Ms Nolan has acted on a number of high profile restructurings including ATU; Tele Columbus; Monier; European Directories; and Fitness First.

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Van Durrer leads Skadden, Arps' corporate restructuring practice in the western United States and advises clients in restructuring matters around the Pacific Rim. He regularly represents public and private companies, major secured creditors, official and unofficial committees of unsecured creditors, investors and asset-purchasers in troubled company M&A and financing and restructuring transactions, including out-of-court workouts and formal insolvency proceedings.

FW: In your experience, are failing companies often reluctant to admit to underlying problems and act quickly to solve them with decisive reorganisation and restructuring action?

Granger: Management teams may lack the skills and experience to see and act upon difficult restructuring decisions, instead adopting a wait and see approach with the hope that a business will trade out of the issues it is facing. Benign economic conditions and a low interest rate environment have exacerbated this tendency. It can be difficult for a board to prioritise stakeholder interests and effectively manage competing agendas. This is where advisers can bring real value to the restructuring process. With extensive situational experience the adviser can act as an impartial ringmaster in stakeholder negotiations and drive the restructuring to its conclusion. Management teams which take the lead in proactively driving the process forwards and delivering a credible and coherent restructuring solution are often able to achieve a more successful outcome than those which take a passive role, allowing stakeholders to play out their negotiations before them.

Nolan: Our clients include sponsors and strategic investors who are experienced and adept in monitoring business performance and the financial obligations of their portfolio companies. Typically, they will have strong management teams in place who are fully aware of the company's financial covenant tests and reporting obligations pursuant to their loan facility agreements. In my experience, our clients think creatively to solve future problems and do not shy away from any underlying liquidity or financial issues. Instead, they use their extensive market and commercial know-how to explore feasible options with their advisers. This can also include appointing interim management, for example turnaround specialists, to assess the business.

Durrer: It is a natural human instinct for people to avoid conflict or stress. The situation is no different for the managers of companies that are in distress. As advisers, it is important for us to remind the officers of the company that challenges confronting the company do not represent personal failings. Rather, they are often cyclical issues faced by almost every business from time to time. Of-

ten, we try to introduce real world solutions into the equation so that officers of distressed companies can better visualise the road ahead, as opposed to the pathway that led up to the distress.

FW: What types of fundamental problems or characteristics at a struggling company make for a successful reorganisation or restructuring? Are some companies simply poor candidates for this process?

Nolan: Typically, problems at a struggling company include a highly leveraged balance sheet, operational inefficiencies and non-performing management teams. Any company with a sound underlying business, producing a product or supplying a service with a genuine market demand, is a good candidate for restructuring. If a company has an outdated business model, does not have any value creating assets, or is restricted by regulatory and political constraints, it may be a poor candidate for this process.

Durrer: In terms of an out of court restructuring, there are definitely a set of characteristics that make a company a better candidate for such a solution. For instance, a sound underlying business is helpful. Specifically, if the business requires a fundamental operational restructuring – including dismantling underperforming divisions or selling non-core assets – an in-court process may be more efficient. Also, for an out-of-court restructuring, it is important the company be able to identify and negotiate with at least a critical mass of its creditor constituents and other key stakeholders. When that is not possible, an in-court process enables the company to bring all of its stakeholders into one process to engage in a restructuring. Finally, assuming that the business is sound, and the company can identify its creditors readily, it helps, but is not essential, that its creditors be reasonably sophisticated – this ensures a more efficient negotiation of a restructuring.

Granger: Although certain types of businesses do make poor candidates for a restructuring, there is almost always some form of restructuring activity which can help enhance value or minimise loss to creditors in any kind of business. 'Asset-light' businesses can typically prove difficult to restructure – for example, professional services firms and other people businesses – where the assets necessary to secure the future of the business leaves the building each day and are highly transferable. Long term contracting businesses also pose a number of restructuring challenges, such as the length of time it can take to work out problem contracts, reputational risk to the ability to win new work and maintaining contract uncommitted bonding and guarantee lines which can quickly unravel and destabilise a restructuring. Those businesses which find themselves unable to react to a fundamental structural change to the market or industry within which they operate and risk their products or services becoming obsolete are also likely to be poor candidates for a restructuring process. The incidence of fraud is often a very significant hurdle to overcome in a restructuring as stakeholders typically lose faith in any financial information prepared by the company and find it highly challenging to extend further credit. At the same time, third party solutions often become limited and customers also lose confidence.

FW: What practical restructuring strategies and options are available to failing businesses prior to bankruptcy proceedings?

Durrer: In the US in particular, there are several tools available to a company prior to bankruptcy, depending a bit on its capital structure. If it has closely held debt – such as in the case of a small syndicated bank facility – the company can often renegotiate the terms of such facility to better meet its cash flow and liquidity needs while still protecting the lender base. With more widely held public debt, the company has different ways to explore an exchange offer where existing holders swap their instruments for new, different instruments or even a different security altogether, like equity in consideration for debt. Finally, sometimes a company is able to retire bank debt with alternative financing, such as tiered bonds or high yield debt.

Granger: Consensual restructuring options will inevitably be benchmarked against a bankruptcy alternative and therefore it is important that this option and its implications are understood before commencing restructuring negotiations. A truly successful restructuring solution will typically require some form of strategic change and performance improvement. Practical operational restructuring solutions can utilise a range of mechanisms to restructure operations – for example, Company Voluntary Arrangements in dealing with UK lease liabilities. Amendment and extension of existing facilities, refinancing, debt for equity swaps or scheme of arrangement – or other cram down procedures – can all be utilised to varying degrees in order to address balance sheet liabilities and avoid bankruptcy. However, where bankruptcy is inevitable, the options for directors are sometimes limited – particularly in continental Europe. In the UK, the commencement of an accelerated M&A process is often a helpful tool in ensuring that stakeholder value is maximised in the event that a company has to enter bankruptcy as it is then more easily able to pre package a sale solution before value is destroyed.

Nolan: A company with unanimous consent from its lenders could use an 'amend and extend' which has been a popular option for businesses in the current cycle. This works to extend the finance facility maturity dates and amend financial covenants or obtain a covenant 'holiday'. If unanimous consent cannot be obtained from lenders, a scheme of arrangement, which is a court approved process, can be used to implement the 'amend and extend' with only 75 percent consent in value and majority consent in number of each class of creditor, outside of bankruptcy proceedings. Other options include operational or management reorganisations. This may take the form of streamlining the business, implementing an asset disposal program, or, for example, compromising leasehold obligations for those companies with a large leasehold portfolio, possibly by using a Company Voluntary Ar-

rangement. A more full blown restructuring – for example, a debt for equity swap – could be implemented outside a bankruptcy process with the unanimous support of lenders.

FW: Could you outline any reasons why a pre-insolvency reorganisation might be preferable to a court-directed process, where outside forces intervene?

Granger: In many jurisdictions outside the US, it is hard to coordinate a court-directed restructuring process over multiple jurisdictions due to the different legal frameworks in place. Managing a court-directed process with a number of different processes operating side by side is certainly more challenging and potentially more expensive than an out-of-court process. The business risks associated with a court directed process such as PR risks, reputational damage, cost and contract risk are all well publicised. A pre-insolvency reorganisation would minimise some of these risks – although out of court restructuring options are not without risk and, with increasingly complex stakeholder dynamics implementing consensual restructuring deals is becoming more and more difficult to achieve. Court directed restructuring processes can be an important restructuring tool to implement a financial restructuring, for example in dealing with hold-out financial creditors, but also to expedite an operational restructuring or reorganisation. The insolvency options should be developed upfront rather than seen as a fall back option when a consensual restructuring has failed.

Nolan: A pre-insolvency reorganisation invites less negative publicity for the company and minimises disruptions to the business by reducing the risk of triggering default provisions in key customer and supplier contracts. If customer or supplier base goodwill would be significantly impacted, greater economic value of the business can be retained by pre-insolvency reorganisation. Such solutions, when available, tend to be less costly and more efficient. The public nature of court proceedings also makes available to the public information which the company may not want available in the public domain and may invite potential litigation from stakeholders.

Durrer: There are three key ways in which pre-insolvency reorganisations are always preferred to an in-court process. First, an out of court process is simply less expensive because there is little, if any, opportunity to litigate the outcome, whereas in an in-court process there is much opportunity for litigation mischief. Second, a negotiated process allows the parties to control their own destiny through a compromise, rather than exposing it to the oversight of a court process, which always injects some measure of uncertainty. Third, an in-court process typically includes a greater degree of public disclosure and transparency which may subject a company to greater pressure from its competitors.

FW: Once the decision to undertake a reorganisation or restructuring is made, what initial steps should the company take? How important is it to engage external advisers to help guide the process?

Nolan: External advisers are essential in a restructuring process. Typically, where the company is over-leveraged or has a multi-tiered capital structure, financial advisers are required to provide a valuation of the group and assist management with a new business plan. Financial advisers also act as an intermediary in key negotiations between the company and its lender group. Such valuation confirms which lenders hold the fulcrum credit and provide a starting point for negotiations among stakeholders and the type of restructuring or reorganisation required. As leveraged structures are heavily tax driven, restructurings are too – especially where group companies are spread across multiple jurisdictions. It is important to engage tax advisers early on in the process to determine the optimal structure. Legal advisers are important as they not only advise on implementation options, but carefully guide the directors through the process, which may be a difficult time. This is especially important in multi-jurisdictional group restructurings where directors' duties are more onerous in certain jurisdictions.

Durrer: Many successful managers are not terribly familiar with turnaround management. Even for those that are, it is important to remember that they can take advantage of special legal safe harbours by seeking out and relying upon professional advice throughout the process. Consequently, one of the early steps that any distressed company should pursue is to engage restructuring advisers to assist it in connection with dealing with the source of the company's distress. In addition, because such advisers routinely confront restructuring issues, they can often be more efficient and allow managers to get back to the business of running the company more quickly.

Granger: A robust business plan and supporting financial projections is an essential precursor to restructuring negotiations. Whilst business plans may meet management's internal requirements they often, in our experience, require augmentation to be fit for purpose, particularly when subject to external diligence. External advisers can support management in this process. Once a restructuring has been decided upon, a clear understanding of the stakeholder landscape and their motivations should be developed. Legal diligence should also be undertaken to understand the structural framework within which to formulate the restructuring options and the impact of any proposals on each stakeholder. It is important that a company takes the lead and drives the restructuring process, otherwise the company risks losing control of the process to its financial creditors, who will be forced to take action in order to protect their interests. The appointment of external advisers to lead the restructuring process and support management is therefore key. External advisers also bring a wealth of experience and can be seen to bring credibility to restructuring proposals.

FW: What financing options are available to failing companies in today's market? Has it become easier to fund a significant restructuring by accessing new debt or extending an existing facility?

Durrer: In the capital markets, there are at least two opposing forces at work. First, on a combined basis, the leveraged loan market and high yield bond market are experiencing more activity than during the peak in those markets from 2007. In addition, the markets have also seen a comeback in so-called 'covenant-lite' loans as well as dividend recap loans. Both of these trends suggest that financing is abundant. However, the opposite trend is that large financial institutions themselves have worked through their own distress as well, and are therefore less willing to amend loans freely as opposed to forcing distressed borrowers to confront their distress. How troubled companies fare in this contrary environment will depend in large measure on the strength of the underlying business and the management team.

Granger: The provision of new money to companies which are stressed or distressed often requires an appetite for risk that many of the traditional lenders no longer have – due to continuing balance sheet pressures. In our view, an extension of existing facilities is becoming a less attractive option for both banks and their borrowers. Hedge funds and alternative investors are an increasing source of capital in restructuring situations. They are able to take advantage of opportunities arising from the ongoing turmoil in the financial markets and constraints on traditional lenders, and therefore investments are typically made at a discount. With fresh capital to deploy to ▸▸

fund restructurings, this can often be to the ultimate benefit of the company – simplifying existing capital structures, de-levering and providing new money to fund working capital, cost reduction and further investment.

Nolan: We have seen a number of US funds that specialise in distressed debt investments target Europe. The funds are willing to provide rescue financing where banks are unable to provide such funding. Often funds are implementing a 'loan-to-own' strategy, buying loans at discounts on the secondary market and seeking to swap the debt for equity as well as underwrite a new capital injection. The bond markets have also continued to remain active as prices have been pushed to historically low levels. Companies are seeking to take advantage of this where they can. As mentioned, 'amend and extends' are still proving popular.

FW: What are some of the common pitfalls and risks that arise during a pre-insolvency restructuring? Based on your experience, what can struggling companies do to manage and overcome these problems?

Granger: A restructuring can be complex due to the divergent interests of different stakeholder groups, legal processes required to implement a restructuring and pressures resulting from the timescales required to conclude a transaction. Management teams often underestimate just how time consuming and demanding navigating a company through a restructuring can be. The appointment of appropriate restructuring advisers can free up management time so their attention is not distracted from the business at a time when maintaining stakeholder confidence in the underlying business is key. Adverse PR can have a detrimental impact to an underlying business and risk destabilising a restructuring. A fully developed PR and communications strategy to manage the flow of information and its timing is key to minimising this risk. Wrongful trading is often an issue of great concern to a board during a pre-insolvency phase. These issues are often complex and can pose significant legal and criminal risk on directors. Nevertheless, in most jurisdictions, and supported by strong legal and financial advice, boards are typically able to navigate through these issues, provided that they are mindful of their overarching duties to creditors. Changes to the stakeholder landscape can alter the course of a restructuring impacting timetables and optionality. This can be avoided via the use of 'lock-ups', although in our experience European banks are often unwilling to enter into such arrangements, preferring to retain the optionality for loan portfolio or single name debt sales.

Nolan: Without finding common ground, the company will struggle. The success of any pre-insolvency restructuring is entirely contingent on whether the company and its lenders can have a meeting of minds. If pre-insolvency negotiations between the lenders and the company fail, there may be no alternative but to enter into insolvency proceedings. Good advisers with sound commercial acumen and extensive market experience can facilitate such negotiations, preventing either side from suggesting overly conservative or unachievable solutions. Also having a credible 'Plan B' can facilitate obtaining a consensual deal.

Durrer: One of the keys to success in a pre-insolvency restructuring is acting early. Delay can cause the situation to deteriorate, making fewer options available. Troubled companies often need flexibility as they navigate even a consensual restructuring negotiation. Waiting too long to start that conversation with stakeholders will often serve to limit the ability of the company to confront unanticipated challenges that inevitably arise along the way.

FW: Do you expect to see more companies in need of reorganisation and restructuring solutions over the coming months? Are any particular sectors susceptible to underperformance and distress?

Nolan: With leveraged loans reaching maturity dates and companies implementing 'amends and extends', it is inevitable that full scale restructuring solutions will be required. The retail, property and shipping industries are areas to watch.

Durrer: In recent weeks, we have seen some measure of a correction going in the stock market. Some retailers had a difficult holiday selling period, so they may become more troubled in the early part of 2014. Certain industries like healthcare and defence have been impaired by cutbacks in government spending. Finally, mining endeavours have also seen a softening in commodity pricing that has negatively impacted their outlook.

Granger: In Europe, we have seen banks continue to strengthen balance sheets via non-performing loan portfolio sales and other deleveraging actions. Coupled with an increasing appetite from hedge funds and distressed investors for refinancings we expect an overall decline in restructuring cases in the coming months. That said, those businesses which have been capital constrained or those with greater working capital and investment requirements could face difficulties as they try to fund growth as the economy turns. In the UK, the improvement in the economy has been far more gradual than in previous recessions and therefore the impact on restructuring activity is likely to be more limited than we have seen previously. Those companies unable to 'trade out' of their difficulties predicted on an overall improvement in macroeconomic conditions will require some form of operational restructuring to address the fundamental issues impacting business performance rather than restructuring balance sheet liabilities. As a result, we expect those restructuring cases we do see in the coming months to be of a different nature to the 'amend and extend' financial restructurings of recent years. Businesses reliant on consumer spending – retail, hospitality and leisure – are susceptible to underperformance, particularly as the economic recovery in Europe is unproven. Industries undergoing major structural or legislative change – for example retail and energy – may also generate restructuring activity in the coming months. ■