The Restructuring Game
How game theory is being applied in complex restructuring scenarios

Game theory (or strategic decision theory) is defined as:

'The branch of mathematics concerned with the analysis of strategies for dealing with competitive situations where the outcome of a participant's choice of action depends critically on the actions of other participants.'

It is found in many places in the financial world but there have been few interesting examples in the financial restructuring sphere. However, with increasingly complex stakeholder dynamics in large restructuring cases, there are some interesting examples. This article focuses on the DTEK transaction, the perverse incentive that arose and how that was later amended.

Background

The DTEK group of companies ('DTEK'), a Ukrainian energy group, broke new territory when it changed the governing law of its high yield bonds from New York law to English law, in order to use an English scheme of arrangement to restructure those bonds. The case has been widely reported and paves the way for direct competition between Chapter 11 restructuring solutions and scheme of arrangement restructuring solutions – both have their respective advantages and we expect to continue to see case-by-case decisions on the most appropriate restructuring tools.

DTEK marks the first case where a change in bond law was used without a change in the relevant company's center of main interest, or COMI. It was not initially clear that a change in bond law would be capable of being used to implement the restructuring and as such, DTEK's restructuring had a twin track. An exchange offer was launched on 23 March 2015 where for each $100 of 2015 bonds, there would be consideration of $20 in cash and $80 in new 2019 bonds, subject to substantially the same terms as the 2015 bonds. A 2% fee was also on offer. The exchange was subject to a minimum participation of 85% of the 2015 bonds.

In the event that the exchange offer minimum participation level was not reached, then DTEK was running a separate process with the express intention of implementing the restructuring through an English scheme of arrangement.

The minimum participation for a scheme of arrangement is 75% in value and in excess of 50% in number of creditors (of those present and voting) and the scheme of arrangement is binding on all creditors of the same class, meaning that even those bondholders who voted against the proposals would be 'dragged through'. The exchange offer was structured in such a way that bondholders who accepted the exchange would automatically be deemed to have voted in favour of the scheme of arrangement.

The Bondholders' dilemma

The bondholders had a simple choice: they could vote in favour of the restructuring or they could 'hold-out' (or they could sell in the secondary market). If they voted in favour (in time to receive the fee) and the deal was implemented they would receive 22c/$ in cash and 80c/$ in 2019 bonds. If they held out and the deal was implemented they would receive either 100c/$ in cash (if the exchange offer was successful) or 20c/$ in cash and 80c/$ in 2019 bonds (if the restructuring was implemented via a scheme of arrangement). The secondary market was just over 60c/$ at that time. If the deal was not implemented through either route, then insolvency was likely, with a very low prospect for return, irrespective of how bondholders individually had voted.

The 2019 bonds were expected to trade at around 50-60 post-transaction, meaning that accepting bondholders were expecting overall initial value of 62-70c/$ (2c fee + 20c cash + 40-48c of value in 2019 bonds i.e. mid point 66c/$). The bondholders were facing a classic 'prisoners' dilemma' (as shown in the table below). The best outcome for bondholders was to be a hold-out (so receiving $100c/$ in cash) while the deal was implemented via an exchange offer. Downside risks were twofold – either you gave up the 2% fee (if implementation was via a scheme of arrangement) or, more significantly, there were sufficient hold-outs for the restructuring to collapse (and for the secondary market to collapse) and insolvency to ensue.

		Bondholder B decision	
		Restructuring	**Hold out**
Bondholder A decision	**Restructuring**	66/66	66/100
	Hold out	100/66	Insolvency/-2c/$

[1] Ignoring any accrued interest that would become payable

Bondholders had to estimate the likelihood of each outcome in order to decide upon their own strategy. They had to assess whether insolvency was a real risk and how much the individual voting of their stake may influence that (or whether there would be some later 'last-gasp' deal to implement a restructuring if the 75% scheme of arrangement threshold wasn't reached).

It rapidly became clear that the scheme of arrangement was going to be a tool that was capable of delivering the restructuring. At that point (and assuming you made the assessment that the voting of your stake would not be significant in the failure to reach the 75% threshold which was likely to be the case for small bondholders) the value play of a hold-out was +34c/$ (100-66 (the mid-point of our earlier range)) for 85%+ acceptances or -2c/$ (64-66) for 75%-85% acceptances. For the value to be equivalent it had to be 17 times (34/2) more likely that the outcome would end in the 75%-85% acceptances bracket than it was for the outcome to be greater than 85% acceptances.

It's tough to imagine how that could ever be the case and therefore the rational bondholder is compelled to be a hold-out, irrespective of their view on the merits of the deal. Of course, for DTEK, this was bad news – the proposed restructuring was compelling bondholders to reject it. Cumulatively, those bondholders were potentially going to cause the restructuring to fail.

The Solution

In April 2015, DTEK's offer was amended. There were some minor changes to the deal – final maturity was shortened to March 2018 and the fee was increased from 2% to 3% to make the deal more attractive. However, the most significant change was the exchange offer acceptance hurdle, which was increased from 85% to 98%. This updated the value play to +33c/$ for 98%+ acceptances or -3c/$ for 75%-98% acceptances. Equality now required that it was 11 times (33/3) more likely that the outcome would end in the 75%-98% bracket than it was for the outcome to be greater than 98%.

Each bondholder with a stake of 2% or more was now effectively compelled to vote in favour of the restructuring (or to sell in the secondary market to someone who was likely to vote in favour). But even really small bondholders were left with the likelihood that too few votes would be cast to reach the 98% threshold. It therefore became likely (if not inevitable) that the exchange offer would fail and, in turn, this increased the likelihood of the restructuring being successful, via the proposed scheme of arrangement, as bondholders were incentivised to vote in favour of the restructuring to collect the fee.

Conclusion

In following a dual-track process from the outset, this case highlights the potentially perverse outcomes that can be generated in a complex restructuring. As soon as it became apparent that the scheme of arrangement was an acceptable restructuring tool, then the exchange offer actually hindered the delivery of the deal, rather than helping it. That prompted the change of terms, and ultimately the successful implementation of the restructuring through a scheme of arrangement.

The legal risks that were overcome in achieving the implementation of a scheme of arrangement in England for a Ukrainian company that had New York law bonds should not be understated, especially given the dissenting stance taken by a proportion of the notes. But in a world of increasingly complex stakeholder dynamics and with the developments of using a restructuring jurisdiction of choice, rather than of location, increasing care needs to be taken to ensure that the proposal leads parties to the right outcome.

Contacts

Duncan Turner
Partner

T: +44 (0) 20 7804 7823
E: duncan.turner@uk.pwc.com

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