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Turnaround Topics

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# Are DDEs More Likely to Avert or Delay a Bankruptcy?

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Distressed-debt exchanges (DDE) have been around for several decades in various forms and names (*e.g.*, coercive exchanges). However, they have never been more prevalent and relevant in restructuring circles as they are today, consistently having accounted for approximately one-half of all rated debt default events in recent years.

DDEs are often referred to as distressed-debt restructurings, out-of-court restructurings or workouts, but whatever name is used, they have the effect of providing some degree of financial relief or breathing room for a distressed issuer without requiring a formal (in-court) restructuring. Given the considerable cost of a large corporate bankruptcy and the outcome uncertainties inherent to any protracted chapter 11 proceeding, it is little surprise that a distressed issuer would prefer the out-of-court route — at least initially — and there are also strong motivations for impacted creditors to opt for this path. The ascendance of private equity this past decade, and the likelihood of major ownership dilution or wipeout for a sponsor in a portfolio company bankruptcy case, motivate sponsors to pull out all the stops before resorting to a formal restructuring and is a contributing factor to the uptick in DDEs in recent years. The underlying belief of any DDE participant is that the financial challenge confronting a distressed issuer is either temporary or remediable and that the DDE will get them to safer ground until the storm has passed.

Moody's defines a DDE as having occurred when (1) an issuer offers debt-holders a new security or package of securities that amount to a diminished financial obligation (such as preferred or common stock, or debt with a lower coupon or par value, lower seniority, or longer maturity); or (2) the exchange had the apparent purpose of helping the borrower avoid default.[1] DDEs are almost always considered default events by the three leading credit-rating agencies, along with missed or delayed payments of interest or principal, and bankruptcy filings, receiverships or other administrative or regulatory proceedings initiated by or against a rated issuer. Standard & Poor's (S&P) considers a completed distressed-debt restructuring as "a *de facto* default with respect to the debt involved."[2]

A key determinant of whether a distressed exchange is considered a default event is whether any investors in a distressed exchange ultimately will receive less economic compensation than they were originally promised, which could occur if, for example, coupon rates are lowered, paid-in-kind interest is introduced, maturities are extended, scheduled principal amortization is lowered or pushed off to maturity, or lien-subordination occurs. (Less common, a tender offer or open-market purchase of a material amount of distressed debt by the issuer at a significant discount to par value could also be considered a distressed exchange and a default event.)

Such features of a DDE almost always will result in a default designation by the rating agencies, but their treatment of other measures might not be as obvious.[3] For example, an issuer might propose to exchange a security for one with a longer-dated maturity but provide a coupon boost as well, or a more senior position in the capital structure, in which case it would be up to the judgment of the rat-

1 "Frequently Asked Questions," Moody's Investors Serv./Moody's Corporate Default Risk Serv. (March 2007).
2 "S&P Global Ratings Definitions," S&P Global Ratings (June 9, 2023).
3 This uncertainty of treatment by the rating agencies extends to liability-management transactions (LMEs or LMTs), which come in several varieties. An LME might not be considered a default event if economic diminution does not occur and/or if assets transfer away from secured creditors, or if lien subordination or collateral-stripping/sharing is permitted by provisions of the underlying credit documentation — the rationale being that impacted creditors would be getting what they contracted for.

ing agencies to decide whether economic diminution occurs and whether the debt exchange is considered opportunistic rather than distressed.

The other requirement for a DDE to be considered a default event besides economic impairment for a creditor group is that in the absence of the DDE transaction, "there is a realistic possibility of a conventional default ... on the instrument subject to the debt restructuring over the near-to-medium term."[4] In other words, the issuer is at heightened risk of insolvency, or a missed payment or bankruptcy in the foreseeable future, without the DDE. If that condition is not met, S&P could consider the debt exchange to be opportunistic (*i.e.*, not distressed) and therefore not a default event.

When a distressed exchange is deemed a default event, the rating agencies will typically downgrade the impacted security to a default (D) rating, while the issuer will be downgraded to a selective default (SD per S&P) or restricted default (RD per Fitch) rating. For a large majority of issuers that complete a DDE and receive a default downgrade, the issuer is re-rated within weeks of the deemed default event, typically to the CCC/C rating category from a D rating to reflect the improved capital structure or liquidity profile of the issuer resulting from the completed DDE, which still will leave the re-rated issue in "deep junk" territory.

DDEs are like a game of chicken between a distressed issuer and investors, which are often junior creditors, with the prospect of a bankruptcy filing looming in the background. Neither wants to undertake a restructuring in a bankruptcy proceeding if it can be avoided, particularly subordinated or unsecured investors, who would very likely fare much worse under a recovery scenario in a chapter 11 filing compared to a DDE scenario. Investors often are willing to take a haircut under a DDE if it provides an issuer with sufficient liquidity or time to avert a bankruptcy filing, knowing that the latter would reduce their recovery prospects even further.

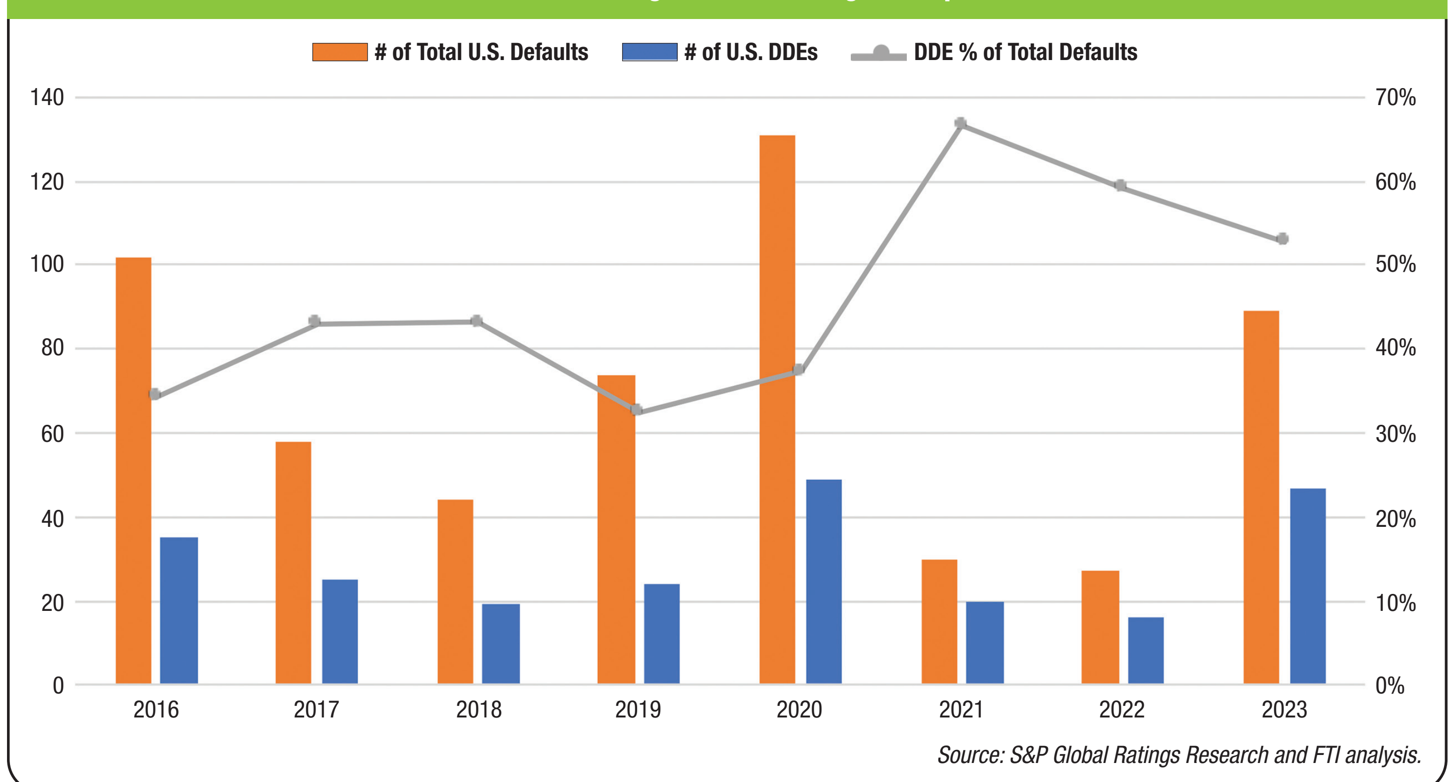
Impacted creditors might get equity warrants or some other contingent remuneration as part of a DDE for their accommodation that will have a payoff if the issuer can implement a turnaround. However, therein lies the rub: There is no assurance that a DDE will adequately address an issuer's business performance challenges or financial standing. In fact, many DDEs will later result in repeat defaults,[5] either subsequent DDEs or, worse, a chapter 11 case where recoveries for junior creditors likely will have deteriorated further since the original DDE. Participating in a DDE is a calculated gamble for impacted creditors.

The topic of whether DDEs avert a chapter 11 filing or merely postpone a formal restructuring is an animating issue among restructuring professionals, who have varied opinions on the matter. Several hundred DDEs by U.S. companies, as rated by S&P, from 2016-23 relative to all default events in that time frame were analyzed, then their outcomes tracked over time to tabulate subsequent chapter 11 filings or other redefaults.

The most uncontroversial thing to say about these findings is that many DDEs subsequently resulted in chapter 11 filings and other redefaults. The proportion of "happy ending" outcomes should be of keen interest to academics and business professionals, as too few of those could lead one to reasonably conclude that these are band-aid remedies that too often do not achieve their intended

4 S&P Global Ratings (June 9, 2023).

5 "The Rise of Repeat Defaulters," S&P Global Ratings (April 11, 2024).



Source: S&P Global Ratings Research and FTI analysis.

results because they are incremental measures rooted in short-term decision-making and do not adequately address fundamental business challenges and embedded imbalances in the capital structure.

Conversely, a relatively high proportion of one-and-done DDEs arguably would vindicate the many heroic backroom efforts meant to avoid a formal restructuring. So, which is it? The answer is not obvious, but for the eight-year period covered — which includes the COVID-19 pandemic — the proportion of DDEs that preceded an eventual chapter 11 filing appear quite high.

Of the 555 S&P-rated debt defaults by U.S. issuers from 2016-23, 235 were DDEs, or 42.3 percent of all defaults. However, that trend has been more pronounced in recent years (see Exhibit 1), with the DDE percentage of total U.S. defaults averaging 57 percent (83 DDEs out of 146 defaults) since 2021 compared to a long-term average of 40 percent since 2009.

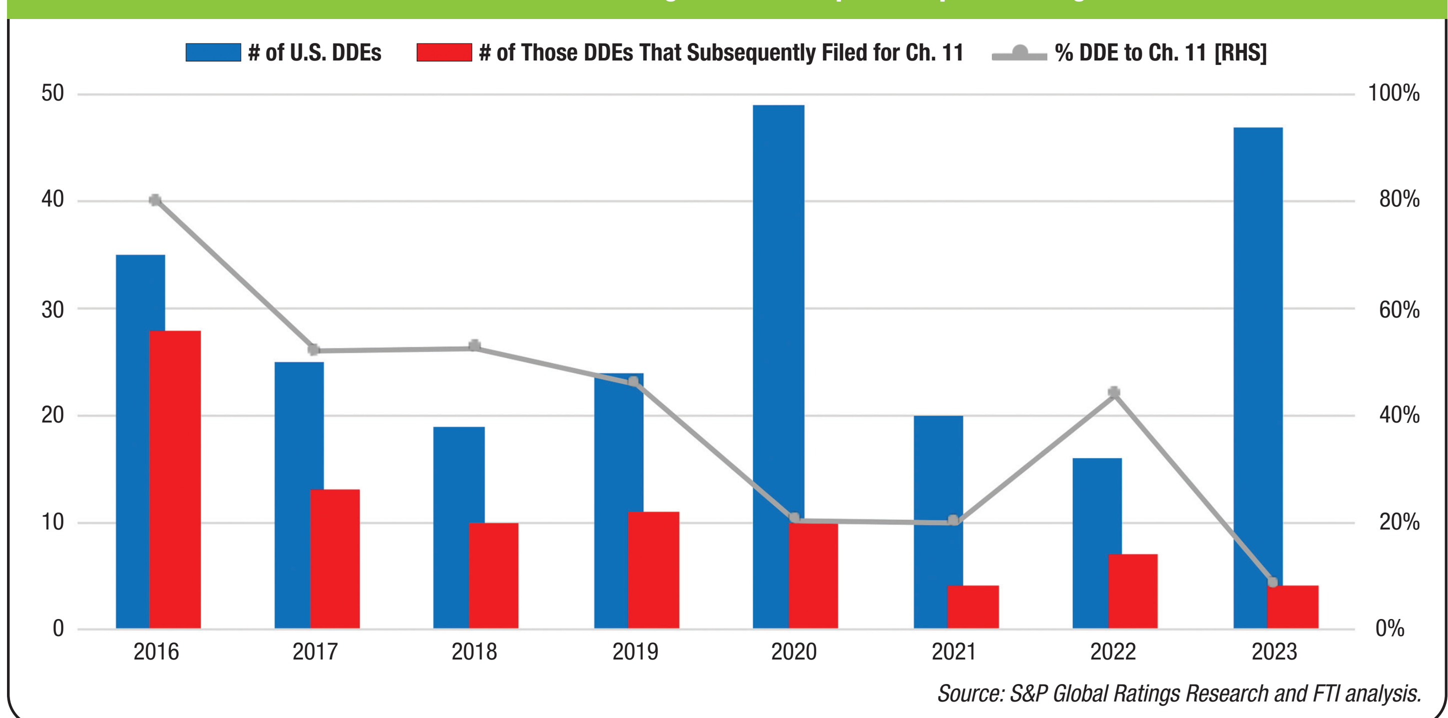
The recent increase likely is attributable to the effects of tight monetary policy and related higher interest rates since mid-2022, cutting off deeply distressed issuers from new issuances in credit markets and forcing them to be more creative in crafting balance-sheet-management solutions during such a time. This trend has continued in 2024, with just over 50 percent of U.S. default events being DDEs so far this year.

The energy sector (primarily oil and gas) easily accounted for more DDEs than any other industry sector in this eight-year time frame, with 52 total DDEs (22.1 percent), followed distantly by retail/restaurants (12.8 percent), media and entertainment (12.3 percent), consumer products (10.6 percent) and health care (9.4 percent). These five industry sectors accounted for two-thirds of all DDEs among 18 total industry sectors.

Most notably, 87 of these 235 DDEs (or 37 percent) resulted in a subsequent chapter 11 filing within the evaluated time frame, while 54 (23 percent) engaged in subsequent DDEs — with overlap between repeat DDEs and subsequent chapter 11 filings rendering these percentages nonadditive but very high nonetheless. As for timing, the median time between a completed DDE and a subsequent chapter 11 filing was 18 months, with an average of 24 months. Nearly 75 percent of these chapter 11 filings occurred within 36 months of a DDE. If this tabulation had been restricted to unique names and events (*i.e.*, not counting multiple DDEs and outcomes by the same issuer), the DDE-to-chapter 11 proportion still would have been 37 percent, with 67 out of 181 DDEs by unique issuers later resulting in chapter 11 filings.

Moreover, the percentage of DDEs that later resulted in chapter 11 filings likely understates its frequency, as the 47 DDEs that occurred in 2023 have not had sufficient time to season into filing outcomes, with only four of these 2023 DDEs having filed for bankruptcy to date (see Exhibit 2). Surely, more filings will come from this cohort over the next year or two — even if the most favorable historical "conversion rate" is assumed. If 2023 DDEs are excluded from the calculation, then 44 percent of the 188 DDEs completed from 2016-22 have resulted in a subsequent bankruptcy filing to date.

On the other hand, this time period under review included the pandemic year of 2020, which saw a large number of DDEs (49) and chapter 11 filings by previous DDEs (25), and had the effect of inflating the overall percentage of DDEs that subsequently filed for chapter 11 due to the extraordinary event. Assuming that both the number of DDEs and chapter 11 filings in 2020 had been in line with 2018-19 average annual totals, then the DDE-to-chapter 11 percentage in 2016-23 would have been 34 percent — a slight improvement over the unadjusted numbers, but still a high "failure rate" after adjusting for the 2020 spikes. Also notable is that



the low percentage of DDEs completed in 2020-21 that later resulted in chapter 11 filings was likely attributable to the effects of COVID-19, as many impacted companies that were not distressed before COVID-19 did need some form of relief or accommodation from pandemic-related adversity that would soon pass.

As for the 87 DDEs that resulted in a subsequent chapter 11 filing, the energy (oil and gas) sector also led the pack with 32 filings (36.8 percent), followed by retail/restaurants (21.8 percent). No other industry sector accounted for more than 8 percent of subsequent chapter 11 filings. The clear indication is that a very high percentage of DDEs completed in these two industry sectors (approximately 60 percent) were inadequate and resulted in subsequent chapter 11 filings — far above the overall average. Twenty of 25 chapter 11 filings in 2020 of prior DDEs were either energy companies or retailers, as the COVID-19 pandemic hit these sectors the hardest. The energy sector also experienced a bust cycle in 2015-16, the recovery from which was slow and gradual.

As previously mentioned, a fair share of DDEs resulted in subsequent DDEs — sometimes several — some of which still resulted in a chapter 11 filing. Of the 54 multiple DDEs noted in this article, 42 were two-timers and 12 issuers implemented three or more DDEs within the time frame, including such prominent names as AMC Entertainment, Chesapeake Energy, Community Health Systems, Envision Healthcare, Murray Energy, Peabody Energy and Rite Aid. Some multiple DDEs have managed to stave off bankruptcy, while others have not.

There are two distinct ways to look at the high proportion of default events that are DDEs. One view is that DDEs primarily are financial engineering transactions that arguably cause the speculative-grade default rate to be an overstated metric of corporate failure because the default rate includes DDEs in its tabulation even though a "true" restructuring process has not occurred. Another view is to consider DDEs a pipeline of future restructuring activity given the relatively high percentage of them that likely will end up as chapter 11 filers. Both views have validity, and neither is exclusive. The latter view would bode favorably for restructuring activity over the next 12-18 months, given that only 9 percent of the 47 DDEs completed in 2023 have filed to date.

## Conclusion

The relative "success" or "failure" of DDEs in the aggregate will not likely have much impact on their prevalence going forward, as each distressed situation is unique, an elusive turnaround is seemingly always a quarter or two away from the perspective of involved parties, and distressed issuers and their impacted creditors often are inclined to believe that the quick fix will work regardless of the severity of a situation. The historical scorecard of DDEs, however uninspiring as the results might be, will not discourage distressed issuers from trying to implement them or impacted creditors from participating in a distressed exchange.

Given the trend of increasing deal leverage for over a decade, many sponsors, and undersecured and junior creditors in distressed deals, will recognize their bleak recovery prospects under a chapter 11 scenario, and they likely will be more disposed to favor improvised solutions that give them a fighting chance to stay in the game without necessarily remedying entrenched business-performance issues or an unsustainable capital structure. Those are worries for another day. abi

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