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IN THIS ISSUE:

DEPARTMENTS:

REVERSE M&A:

STRUCTURAL AND LEGAL CONSIDERATIONS

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Lenders and debt investors who are faced with a potential conversion of their debt holdings in a distressed borrower into controlling equity interests of such borrower need to prepare well in advance in order to achieve an efficient and orderly conversion, and should prepare for the conversion with all the attendant diligence and structural considerations present in an M&A transaction. This article addresses the major issues to be considered in advance of a debt for equity conversion.

The Credit Crisis of 2007-2010 caused a paradigm shift in how bankruptcy proceedings were conducted. Most debtors could no longer afford to reorganize, and faced immediate liquidation. More than in any previous bankruptcy cycle, debtors, creditors and other parties in interest had little choice but to either conduct an immediate liquidation of assets or implement a prearranged or prepackaged bankruptcy plan of reorganization pursuant to which creditors converted all or a portion of their indebtedness into equity in order to preserve their investment until the markets improved. The precipitous drop in asset values from the lofty levels against which borrowers had previously leveraged their business steered many lenders and debt investors to choose the conversion option over the liquidation option.

Since mid-2010, there have been signs of economic recovery and liquidity has returned to the markets. Asset values have improved, but have not returned to pre-crisis levels. Borrowers can refinance and extend maturities, but cannot delever. As a result, lenders are still faced with the "convert or liquidate" conundrum, for those distressed borrowers who survived the last cycle, but still cannot access the capital markets or should the capital markets dry up. Postponement of a recognition of loss appears to be an important consideration for financial institution lenders in today's regulatory and capital-reserve-driven environment.

Conversions are a function of the absolute priority rule in bankruptcy, meaning that the senior most ranking class of creditors holding a deficiency claim (i.e., a claim equal to the difference between the allowed amount of the class's claim and the value of the debtor's assets) are entitled to receive the proceeds of liquidation, with junior classes receiving no distribution. The class of debt holding the senior-most deficiency claim is often called the fulcrum security or the fulcrum debt. In effect, in a conversion, all of the debtor's assets are being conveyed to the fulcrum creditors in satisfaction of the debt of that class.

A decision to implement a conversion is often a function of a particular lender's corporate culture – certain debt investors, such as hedge funds, large bondholders and distressed investment funds actively pursue loan-to-own strategies whereas other debt investors, such as commercial banks or CLOs, are less inclined to do so.

There are numerous scenarios under which a lender can either effectuate or be compelled to implement a conversion. The most common and least risky method is through either a consensual or cramdown bankruptcy plan of reorganization. The estate's assets, and the debtor's business as a going concern, can be distributed to the fulcrum creditors in satisfaction of all or a portion of their debt. The fulcrum creditors can be undersecured [secured], senior subordinated or unsecured creditors. A conversion can also be accomplished where the debtor's assets are sold in a sale pursuant to Section 363 of the Bankruptcy Code and secured creditors determine to credit bid in their debt and effectively purchase the assets necessary to operate the business.

Lenders can also effectuate a conversion outside of the bankruptcy court, but it is far less common. Creditors holding liens can foreclose upon their liens in a public or private sale. The secured creditors will credit bid in their debt and convey the assets to an entity which is owned by such secured creditors. A borrower and creditors can also negotiate for a consensual turnover of assets in satisfaction of obligations. Neither the foreclosure of liens nor the consensual turnover enjoy the benefits of a bankruptcy court order in terms of protections for lenders, and both methods are subject to scrutiny if other creditors of the borrower commence an involuntary chapter proceeding to attack the transfer. The plan of reorganization method provides the most safeguards for the converting debt holders because the confirmation order approving the plan will provide for clear title, generally cutting off prior liabilities.

Once lenders determine that they will own a majority of new equity in the reorganized entity, regardless of method, the lender must begin to consider issues and develop terms regarding:

1. the post-reorganization capital structure;
2. the post-reorganization ownership structure;
3. post-reorganization corporate governance;
4. post-reorganization management; and
5. tax consequences of the conversion and potential debt forgiveness.

There is an inflection point in a conversion where the fulcrum debt holders have asserted that they are the economic parties in interest, the existing equity holders have conceded that the conversion will occur and the management team recognizes that they will be reporting to a new board of directors and equity group. It is at this time that the fulcrum debt holders must start planning for the post-reorganization regime.

On the conceptual side, fulcrum lenders need to restructure the transaction so as to avoid incurring liability by virtue of the conversion. The post-reorganization corporate structure and governance are critical areas for planning.

Lenders must next establish the reorganized entity as profitable and stable, so the fulcrum lenders can realize on the value of converted equity and debt holdings in the reorganized entity. Establishing an appropriate capital structure, selecting an independent and experienced board of directors and appointing an effective management team are key to success here. The timeline to develop a corporate structure, negotiate a shareholder agreement, identify and vet an independent board, identify and hire a new or supplemental management team and negotiate an incentive compensation plan for such team is anywhere from two to six months, during which the converting debt holders should conduct themselves as if they were acquiring the entity in an acquisition.

Post-Reorganization Capital Structure

Lenders should consider how much debt, if any, should be placed on the reorganized entity. As equity holders, lenders can choose not to place any debt on the reorganized entity, although converting lenders will usually opt to cause the reorganized entity to carry some debt in order to reduce the recognized loss arising from the original transaction. Often, a portion of the prepetition debt can be rolled into post-reorganization debt.

The post-reorganization debt can be structured into tranches with a senior current pay tranche and a junior non-current pay tranche in order to create instruments that may be more or less liquid in the secondary markets. In fact, the implementation of post-reorganization debt is a means of providing liquidity to the post-reorganization debt holders through the secondary debt market. In credit facilities in which a portion of the lenders are CLOs, the CLOs will require a number of structural features in order for such post-reorganization debt instruments to qualify as eligible holdings in their portfolios, including having some percentage of cash pay interest, certain maturity durations, use of ratings and other items.

If the conversion is being effectuated through a plan of reorganization, the amount of debt placed on a reorganized entity will directly affect whether a plan of reorganization is confirmable as there is a direct correlation between the amount of debt placed on a reorganized entity and the feasibility requirement of plans of reorganization.

The creative use of a capital structure is often needed where a consensual plan of reorganization is necessary to implement a conversion. Creditors who fall below the fulcrum line, but whose consent is needed in order to resolve litigation or valuation fights, may be granted junior equity warrants, which will be in the money only after the initial converted debt is repaid in full. Out-of-the-money creditors can be slotted in as nonvoting equity, and fulcrum creditors may retain the predominant upsale value through preferred equity or PIK notes.

Post-Reorganization Structure

To limit potential shareholder liability, the reorganized entity should be organized as a corporation or a limited liability company.

The lenders can either hold the shares in the reorganized entity directly or through a holding company structure. In some circumstances, lenders may want to hold shares in the reorganized entity if the shares will be registered with a view to selling them in the public market. This is another way to provide liquidity to a lender that has converted its debt.

Most financial institutions that participate in conversions prefer a C corporation structure because of familiarity with the governance issues, i.e., use of a board of directors and well-established law governing various issues. LLC structures require appointment of a managing member, which is not conducive to lending syndicate dynamics and, as such, are less attractive to financial institutions.

Additionally, if CLOs are present in the lender group, a blocker corporation will be required in order to allow the CLOs to maintain certain foreign taxation attributes. Private equity and hedge funds which hold the entirety of a debt issuance that is being converted are much more amenable to use of an LLC structure.

Corporate Governance Issues

In order to shield equity owners who are also lenders from liability, a qualified and independent board of directors should be appointed. In a situation involving a distressed borrower with weak or ineffective senior management, the lenders will want to bring in several independent board members with relevant industry expertise. It is not uncommon for the largest lenders to seek a director position in order that the interests of the lender group are taken into account. The CEO, whether newly appointed or already in place, is often granted a board position. If, as part of the reorganization process, other creditors obtain a portion of the equity in the reorganized entity, there is likely to be a negotiation regarding board representation.

The post-reorganization shareholder agreement is one of the most important documents to be negotiated as it governs how the entity is managed and the terms under which the entity can be sold. The converting lenders must develop terms regarding the ownership and transfer of shares in a sale scenario, such as drag along and tag along rights, right of first refusal, the stapling of the equity to any debt instruments, director appointments and voting percentages for major transactions, the incurrence of debt above a certain predetermined level or a sale of the company. Where the debt to be restructured is held by a syndicate of lenders, the administrative agent and a steering committee of lenders will negotiate such terms before the conversion.

Post-Reorganization Management

There are no hard and fast rules as to whether the converting lenders keep or replace existing management. Given that the entity is distressed and unable to pay its obligations, senior-level management has likely been appointed during the restructuring or will be appointed as part of the conversion.

Incentive compensation is a key tool for lenders to align the interests of post-reorganization management with the lenders. Incentive compensation can include cash-based performance bonuses, or grants of equity or options. Anywhere from 4-10% of equity in the reorganized entity can be earmarked for management (with even higher levels if senior management controls revenue and business relationships). Two to three percent is usually awarded upon conversion with the remaining portions awarded with time or performance or both. As, with corporate acquisitions, negotiations around vesting, anti-dilution and change of control triggers will occur. Sophisticated management will actively negotiate, for upside potential, the form of incentive compensation. Outright grants of stock or capital interests are taxable at vesting or at the time of the grant, at the recipient's option. If the value of the equity grant is low enough (which may be affected by the amount of debt retained by newco), then the recipient may choose to recognize the gain as ordinary income at the time of grant. Appreciation from that point can qualify as capital gain, desirable to the recipient.

If the incentive compensation takes the form of options, converting lenders must keep in mind that options are taxed at exercise, not grant. Only the appreciation is taxed. A valuation will be necessary at the time of exercise to measure the appreciation, and some equity holders may not want to have a valuation conducted periodically or at all. Also, in order to receive capital gain treatment on the appreciation, an option must be a qualified option under IRS regulations.

As a general proposition, the interests of debt holders and equity holders are usually aligned, with parties acting in concert at the conversion date. Depending on how long the debt and equity are stapled, if at all, the debt and equity holders' interests can diverge. For instance, if a majority of the equity is bought by non-debt holders, such equity holders can pursue strategies that are inconsistent with the debt holders' interests. Careful consideration of these dynamics is essential.

Tax Issues

Debt modifications can have consequences for creditors if the modification is considered a taxable exchange. The creditor would have to recognize a gain or loss to the extent that the amount realized on the deemed exchange differs from the creditors' basis for the original debt instrument. In a nonbankruptcy scenario, creditors who are converting their debt into equity cannot ignore the borrower's tax consequences arising from the exchange, since adverse tax consequences and liabilities can affect the creditworthiness of the converting lenders' new entity. If the debt for equity conversion is effectuated outside of a bankruptcy, the borrower may have significant tax consequences to the extent the amount cancelled or forgiven is less than the amount of the debtor's liability (IRC § 61(a)(12)), which basis is often equal to the debt's original principal amount. Converting creditors in this scenario must take into account that the restructured entity could face significant tax consequences in that year.

In a bankruptcy scenario, debt for equity swaps can qualify as a tax-free recapitalization if the debt instrument being exchanged qualifies as a security for income tax purposes. The definition of a "security" for these purposes is not the same as for securities law or other purposes. In such case, the creditor generally avoids the recognition of gain or loss on the treatment of its debt. The debtor also avoids recognition of gain or loss to the extent that the amount being exchanged for equity is no greater than the creditors' adjusted tax basis for the debt instrument. Distressed debt investors need to be mindful of this rule if they purchased the debt being exchanged at a significant discount. However, a tax-free recapitalization is not without tax consequences. To the extent the amount of debt being converted exceeds the fair market value of the equity issues in exchange, the debtor must reduce certain favorable tax attributes going forward, e.g. NOLs, general business credits, capital loss carryforwards and foreign tax credit carryovers.

In sum, the plan of reorganization process is an efficient way for creditors to convert their debt to equity and limit liability. **TSL**

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