Proskauer

Private Credit Deep Dives – Change of Control (United States)

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After an unprecedented post-COVID boom, M&A activity has slowed in recent months, with overall global M&A value down as much 44% in the first five months of 2023, according to a recent report by Bain & Company. Against this backdrop, private equity sponsors looking to create liquidity for their funds may need to consider more creative solutions rather than simply selling their portfolio companies in full to third parties. As a result, lenders should understand what exactly constitutes a “change of control” in their credit agreements and what rights they have in the event one occurs.

This deep dive with Bharat Moudgil (Partner) and Kathryn Potter (Associate), lawyers in Proskauer's Private Credit Group in Los Angeles and Boston, will explain the philosophy behind “change of control” protection, the triggers and how common loopholes and exceptions may be particularly relevant in today’s market.

Click here to read how the "change of control" protection is relevant in the current European Market, as explained by Daniel Hendon (Partner) and Phil Anscombe (Associate).

When conducting due diligence on a prospective financing opportunity, a lender will typically speak to both the existing and prospective equityholders and management to assess their business plan and financial projections for the target. Lenders are, in essence, underwriting a particular vision and strategy for the business going forward. As a result, if there is a change in who controls the business (and those persons are in theory able to use their control to change that business strategy), then the thought is that there has been a fundamental change in the dynamics of the investment, and the lender should have the option of exiting the deal.

There are a number of different principles that feed into both how a “change of control” is defined and what its consequences are for the parties, which can broadly be described as follows:

1. **What constitutes a "change"** – Traditional loan documentation operates so that if a specified group of permitted controlling investors ceases to exercise control over the credit party group, then that is considered a "change" in the control of the group. Conversely, high yield bonds consider a "change" to have occurred only when a certain new investor or new investors acting together in concert (which are, in each case, not permitted controlling investors) obtain control of the group. This is a subtle yet important distinction – the latter construct would allow multiple minority equity stakes to be sold (which in the aggregate could mean the original investors no longer actually control the operations of the credit party group), while the former construct would consider this a fundamental "change" in who controls the credit parties, which is the approach that private credit lenders most often take.

2. **What constitutes "control"** – The most sponsor-friendly documents will solely define "control" as being the beneficial ownership of a simple majority (being more than 50%) of the issued voting equity in the parent company of the credit party group. This threshold is typically the level of equity ownership required in order to exercise key shareholder rights in order to maintain operational control (in particular, the right to pass resolutions to hire/fire board members). However, it is not necessarily the case that beneficial ownership will always carry these rights – for example, proxy voting rights may be granted, or contractual arrangements may be entered into that give such rights to other persons. Traditional LSTA style loan documentation treats "control" as the possession, directly or indirectly, of the power to direct or cause the direction of the management or policies of a Person, whether through the ability to exercise voting power, by contract or otherwise. US private credit providers have largely retained this formulation in their credit agreements. Conversely, in Europe, while some providers have pushed for similar language, others have been more willing to rely on the test looking solely at voting share ownership (on the basis that sponsors are perhaps unlikely to give away such control rights while they still hold a voting majority). It should be noted that in this context, control is ordinarily expressed as being "direct or indirect" control – the reason being that in most structures the relevant equity vehicle will sit above (and outside) the lender's credit party group, and so what is really at issue is being able to exert these powers by way of indirect control down a chain of wholly owned subsidiaries sitting below the equity vehicle.

3. **Are there additional triggers** – Certain other trigger events lenders may push for include the following:
    a. While often not described as a "change of control" for purposes of the definition itself, a sale of all or substantially all of the assets of the credit

party group may be treated the same way as a “change of control” for purposes of the loan documentation, i.e. it is not permitted absent the lenders’ consent. This is to address a situation in which the equityholders try to exit by way of an asset sale rather than an equity sale.

2. In order to protect a “single point of enforcement” at the top of the structure, US deals will usually include a requirement that the topco “holdings” entity retain ownership of 100% of the issued and outstanding equity of the opco / borrowing entity – this holdings entity then pledges the equity it owns in the borrower to the collateral agent as part of the overall security package. Rather than having to affirmatively exercise its rights as it pertains to pledged equity at each level of the credit parties’ structure, the “single point of enforcement” facilitates an enforcement by the secured party and, if necessary, a sale of the entire credit party group as a going concern on an out of court basis in a downside scenario, by the exercise of so-called pledge rights that holdings grants to the secured party at the top of the structure. So, to maintain the sanctity of the secured party’s pledge rights through the life of the deal, it typically constitutes a “change of control” if the pledgor ceases to hold (directly) the entirety of the issued equity in the entity over which it is granting security. In lower middle market transactions or in structures where there are material operating entities that sit underneath the primary borrower, lenders may push for additional ownership prongs with respect to those subsidiaries as well, but that is a negotiated point and atypical in larger deals.

3. Depending on the size of the deal and business dynamic, some lenders will take the view that, in addition to ensuring that the original equityholders maintain operational control, the “change of control” definition should also look to ensure that those original investors maintain sufficient economic skin in the game. The purpose of this would be to ensure that the sponsor cannot materially reduce the extent of its financial investment and realize value (e.g. by way of a secondary sale to a third party) by disposing of non-voting equity without triggering a “change of control”. As a result, lenders will often also push to include a prong that the sponsor retain ownership of a majority of *all* equity (voting or non voting) or all voting and economic interests.

4. **Who is a permitted controlling investor** – Traditionally, the permitted controlling investors (that are required to retain control of the credit party group at all times) are the sponsor funds investing in the transaction at closing of the deal. However:

1. In recent years, this has been extended to the sponsor's "controlled investment affiliates" (i.e. so as to include any other vehicles established now or in the future, provided they are managed and controlled by the same sponsor). This flexibility has arisen because if the lenders are backing a sponsor's vision, and the sponsor as an institution remains in control, that should be sufficient from the lender's perspective to remain in the deal. This is particularly topical in the current market as, given the subdued M&A environment, there has been an increase in GP-led secondary trades as a method of generating liquidity for sponsor funds. In such an instance, where a particular sponsor fund is nearing the end of its life cycle and requires liquidity (but conditions are not optimal for a widely marketed sale process of a particular portfolio asset), the sponsor may set up a new and separately capitalized vehicle to acquire the asset from the original fund, so it can continue to be managed and sold at a later date. Although the sponsor technically retains control of the business, an exit has nonetheless been achieved for the original fund (and value/upside realized by the investors in that fund) – in this context, certain lenders have queried whether in fact this should constitute a "change of control", so that lenders can recover value concurrently or otherwise discuss new terms to reflect the new sponsor vehicle's new investment horizon. In the US, the market has largely accepted that the "sponsor" for purposes of the "change of control" definition will include a hardwired closing date fund and its "controlled investment affiliates" to account for this flexibility, but this remains a hot topic of discussion in the current economic climate.

2. In more aggressive transactions, sponsors commonly request an expansive list of permitted controlling investors. They will often push for all institutional equity investors at closing (e.g. any seller that is rolling over all or a portion of its investment into the new structure but as a minority shareholder or any other new minority co investor introduced by the sponsor) and all management shareholders to be included in the numerator of the calculation. This technically does not require that the sponsor itself retains control and calls into question what happens if the sponsor's equity "hold" dips below 50% and subsequently has a fall out with management (for example) over the future strategy of the business. This could lead to a dead lock situation that would be value destructive. Sponsors would argue that they are aligned with lenders in protecting their controlling voting rights going forward. Where it is requested that co-investors (or, more generically, limited partners of the sponsor) be included, lenders will often request that they be explicitly named in the documentation to ensure it is clear who has been approved. Where that is

not possible (for example, where the sponsor intends to syndicate a portion of its equity post closing or between commitment and completion) and lenders are willing to accommodate that flexibility, lenders will pre-approve a “white” list of investors who may come in, or they will generally offer a time capped period only in which such co investors can be brought in (e.g. 6 months from closing). Lenders also sometimes agree for LPs/co investors to count as permitted controlling investors but only to the extent all of their voting rights are at all times controlled and exercised by the sponsor (i.e. they are fully silent and passive co investors only). The purpose of these various parameters is to ensure that there are no significant loopholes in the construct – given the diversity of the LP base in many private equity funds (many of which LPs may well also have a direct investment arm themselves), it would otherwise be difficult to regulate whether this flexibility could inadvertently permit what would otherwise be considered a true third party sale.

5. **Is it a “control” investment** – It should be noted that the above analysis assumes that the relevant transaction is a regular “control” majority equity investment by a private equity sponsor. A sponsor-less transaction will require more tailored analysis and drafting. If the transaction in question still represents an investment of private equity capital but on a minority basis, lenders (including in the middle market) are generally more willing to including specified co investors or members of management as at closing alongside the sponsor in the “permitted controlling investors” definitions. However, lenders may look to supplement this by requiring an additional limb of the definition, stating that the sponsor itself must retain a certain proportion of its own original equity investment. In certain deals where specific individuals are important to the ongoing business, lenders may sometimes push for prongs requiring that such “key” individuals either retain some portion of the equity or retain certain positions or responsibilities. This is particularly relevant where a lender’s underwriting is focused on an individual officer’s relationships with customers or vendors, for example.

6. **Is there a portability concept** – Occasionally loan documents will contain a “portability” concept. This is effectively an exception to the “change of control” regime, such that the debt can be “ported” and remain in place notwithstanding the sale of the credit party group to a new sponsor. Clearly, this feature is very attractive to sponsors, as it would make a sale of the business easier to manage (since an incoming buyer would not need to arrange its own package of debt financing). Given the current difficult environment for raising debt financing, it may be that sponsors in fact look for portability features more frequently than

they did when credit markets were buoyant. When accommodated, this concept is usually subject to tight parameters, which may include a time limit (e.g. the loan is only portable for the first 2 years following closing, which should ensure any incoming sponsor's investment horizon is not wildly out of kilter with the tenor of the loan), a limited list of incoming sponsors that may benefit from the portability option (typically sponsors with which the lender has a good relationship or which have strong experience in the sector), a condition requiring that the option is subject to a pro forma leverage test (e.g. set at opening leverage from the original deal, so the deal cannot be ported in a downside scenario) and that a specified minimum equity condition must be met (e.g. a pro forma equity cushion of 50% following the new sponsor's investment) and that a fee must be paid at the time of the portability option is exercised (akin to an origination/underwriting fee, though sometimes with a discount to regular new money fees). Lenders will also limit the number of so called "permitted" change of control transactions, such that only one can occur over the life of the facility, to avoid a situation in which the company changes hands repeatedly. Call protection would also typically be reset once the debt has been ported, and in some transactions, lenders might offer a tenor extension in connection with the exercise of the portability option. Requests for portability are most commonly seen on refinancing transactions, where a sponsor already owns the asset and expects to exit within a relatively short period of time after the refinancing deal (and has at least some visibility as to likely buyers) and is looking to simplify and/or reduce the cost of the debt raise process for prospective buyers. In the US, portability historically has been limited to upper market deals, particularly in prior years where sponsors had more bargaining power given the historic level of M&A activity and related competition. However, the US market has since largely pushed back on this concept, and as of now it remains rare in true middle market transactions. That being said, this may become a trend in the current market, as difficult M&A conditions have meant many sale processes have been postponed until the market recovers (but refinancings/dividend recaps may still be proceeding in the meantime). It is worth noting that, even where portability features are included, it remains relatively uncommon for them to be utilized. Where it exists, the feature forces lenders to the table, but in practice, most incoming sponsors will have their own views on appropriate terms and structure and will prefer to refinance the existing facilities under a new document, rather than rely on the prior sponsor's negotiated terms.

7. **What is the result of a "change of control"** – A "change of control" will constitute an event of default in US credit agreements, but will not trigger automatic acceleration (or an automatic "mandatory prepayment") outside of older lower middle market transactions. As such, a related prepayment will instead constitute a "voluntary" or "optional" prepayment, which can be subject to the applicable prepayment premium. However, the market has moved toward

incorporating a discount on prepayments in connection with changes of control. For example, the company may only owe 50% of the premium that would have otherwise been payable in connection with a typical voluntary prepayment. It should be noted that, irrespective of which formulation is used, in the European market, a “change of control” itself cannot be waived by the majority of the lenders and that the definition and operative provisions cannot be amended by the majority of the lenders, unlike in the US.

Given the difficult environment for raising new finance and the likelihood of private equity sponsors pursuing bespoke opportunities to realize liquidity for their funds, “change of control” provisions will remain in sharp focus for lenders and borrowers alike during the course of 2023. For any related questions on this topic, please reach out to your contact within Proskauer’s Private Credit Group.

About Proskauer

The Firm’s Private Credit Group is made up of cross-disciplinary finance and restructuring experts exclusively dedicated to private credit investors. It includes over 90 finance and restructuring lawyers focused on representing credit funds, business development companies and other direct lending funds in connection with “clubbed” and syndicated credits, preferred equity, special situations and alternative investments. Over the past five years, Proskauer has been involved in more than 1,000 deals for over 75 private credit clients across the U.S. and Europe with an aggregate transaction value exceeding $260 billion.

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