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Trends in Private Credit Restructuring: Out of Court "Change of Control" Transactions

December 4, 2023

Restructurings defy a one-size fits all approach because every deal is unique and different tools are required to solve different problems. At one end of the restructuring continuum is the so-called "amend and extend," where the credit agreement is amended to provide incremental liquidity, extend near-term maturities, modify covenants or some combination of the foregoing. This approach is fast and cost-efficient, but limited in its impact. At the other end of the spectrum is a restructuring through chapter 11. Bankruptcy is expensive, time-consuming and introduces significant legal, financial and operational uncertainty. In the middle of these scenarios are debt for equity transactions that can be implemented out of court through different legal structures. A company facing declining revenue, increasing costs, liquidity constraints and significant debt service obligations may have a viable restructuring path by working with its lenders to raise additional capital to bridge its liquidity needs and to eliminate funded debt from its balance sheet. Such businesses — those suffering from a broken balance sheets but with a viable business model — may be a candidate for an out of court change of control transaction. While this type of transaction can fix a broken balance sheet more quickly and cost effectively than chapter 11, it will not fix a broken business.

There are at least seven factors that drive the success of an out of court change of control transaction involving a debt-for-equity swap between a distressed borrower and its first lien secured lenders.

1. **Consent.** Out of court change of control transactions are *generally* a consensual path between borrower and lender.[1] Borrower consent and cooperation are critical features of an out of court change of control transaction. A borrower owned by a private equity sponsor might be willing to consent to change of control transaction when, for example, the borrower is facing a liquidity crisis and its existing equity sponsor is no longer willing to invest additional capital and sees no path to recover on account of its existing equity stake. In these circumstances, it is far easier to achieve consensus with a borrower that is majority owned by a

private equity sponsor as compared to a public company with a widely held shareholder base. That said, recent amendments to Delaware law have made it easier to consummate change of control transactions without seeking shareholder approval. Lender consent is preferred because the conversion of debt to equity triggers a "sacred right" in nearly all loan agreements and requires the consent of every affected lender. It is far easier to achieve consensus in a private credit club deal where consensus is forged among a group of like-minded investors as compared to a more disparate group of lenders in a broadly syndicated facility. The consent of all lenders is "preferred," but it is not required. In the absence of 100% consent, the "required lenders" (usually 50.1%) can direct the collateral agent to exercise remedies to consummate an out of court change of control using the strict foreclosure remedy under Article 9 of the Uniform Commercial Code.

2. **Scope of Problem: Debt v. Operations.** A debt for equity change of control transaction can effectively de-lever a balance sheet, but it will not — without more — fix a company's operational problems. For example, a debt for equity transaction will not help a "brick and mortar" business improve the operating performance of a retailer with a sprawling geographic footprint that needs to exit unprofitable store locations (e.g., WeWork). In that example, the business likely needs the "contract rejection power" in the bankruptcy toolbox to fix the operational problem. Thus, an out of court change of control transaction is best suited for fundamentally sound companies that have an excessive debt relative to earnings capacity.

3. **Existence of Legacy Liabilities.** A debt for equity transaction is equally ineffective at addressing the needs of companies suffering from so-called "legacy liabilities," such as a significant money judgment, underfunded pension plans or arcane collective bargaining arrangements. Swapping first lien debt for equity will not address legacy liabilities, which can only be addressed with consent or in a chapter 11 bankruptcy with a "free and clear" sale under Section 363 or a discharge under a chapter 11 plan.

4. **Limited Change of Control Consequences.** An out of court change of control transaction must navigate change of control implications in key contracts or in highly regulated industries like healthcare, communications and gaming, where state or federal regulators have the right to approve a change of control of the business. Again, the change of control may still be possible, but execution is more challenging to manage.

5. **Managing Elevated Risk Profile.** Most debt-to-equity transactions result in a lender-owned acquisition vehicle that carries some amount of "take back" debt, i.e., term loans representing some portion of the amount formerly owed by the

original borrower. As a result, the lenders will be the equity owners and primary lenders to the newly formed acquisition vehicle. Of course, the lenders will also control the appointment of a new board. There is no per se rule prohibiting lenders from acting in multiple capacities (e.g., shareholder, lender and even director), but this scenario creates an increased risk profile. If the underlying business fails to succeed, and the company subsequently files bankruptcy, the lender will be viewed as a statutory "insider." As an insider, there will be (i) enhanced scrutiny for all insider transactions; (ii) a more lenient standard for equitable subordination (compared to a non-insider); and (iii) an extended avoidance period of one year for any payments received from the business. In addition, insider votes are excluded for determining class acceptance under a plan of reorganization. There are also other risks to consider, including claims for successor liability and fraudulent transfer. In most cases, these risks can be managed and are not an obstacle for consummating an out of court or in court restructuring, but they are factors to be aware of when formulating the initial change of control transaction.

6. **Aligning Employment Incentives.** The restructured company must be positioned in a manner to retain talented management teams (or attract new talent) to maximize value. Unfortunately, there may be very few incentives in place at the time of a negotiated restructuring to retain and motivate management. The outstanding equity incentives may have little to no value and existing performance goals are unlikely to be met. Further, the transaction may trigger change in control payments and severance rights in existing management contracts that could encourage executive departures. Accordingly, lenders engaging in debt for equity transactions must negotiate with management to recalibrate and restructure equity awards, bonuses and change in control payments. These new incentives should be tailored to the company's particular financial circumstances and designed to balance the goals of encouraging profitability, avoiding liquidity drain and providing management with market compensation. The substitution, design and implementation of these incentives should be done with careful consideration of the tax, employment and securities law effects and limitations on the changes made to the company's previous incentive plans, if any.

7. **Tax Efficient Structuring.** The success of an out of court transaction may depend on whether tax risks can be successfully neutralized in a tax efficient structure. In general, out of court change of control transactions are taxed like any other acquisition transaction — which is to say, the tax consequences will depend on (i) whether the change of control is structured as an equity or asset purchase and (ii) the amount of debt relieved, either directly or by use as "currency" to acquire assets or equity. The most common tax considerations in

an out of court change of control transaction are (i) legacy tax liabilities of the borrower group and transfer taxes (which cannot be avoided outside a Section 363 or chapter 11 plan), (ii) cancellation of debt income (CODI) and other tax consequences to the borrower group and its legacy equityholders resulting from the transaction; (iii) timing of taxable gains or losses as a result of the change of control for all parties, (iv) taxation of the business going forward and (v) structuring the capital stack of the post-change of control borrower group. Note that in most out of court change of control transactions, the U.S. federal tax attributes of the borrower will either be eliminated or subject to significant limitations, and in rare circumstances, the value of those tax attributes will be so large and important to the business going forward that a so-called "G" reorganization (which can only be done pursuant to an in-court bankruptcy process) may need to be carefully considered.

In summary, out of court change of control transactions are an effective means to restructure a distressed company. That said, it's not the right tool for every situation and, in order to be effective, care must be taken to address the potential risks inherent in these transactions.

[1] There are paths for non-consensual change of control transactions where discussions between the lenders and borrower reach impasse. Those transactions, which often involve exercising the voting proxy in a stock pledge or foreclosure sales, involve a higher degree of complexity, costs and execution risk.

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