Racing to 50.1% of the vote

Expert comment by **Bryan High**, **Mark Liscio** and **Sanjeev Khemlani**

Liability management transactions are undertaken by companies to restructure liabilities on their balance sheets. Bryan High of Barings, Mark Liscio of Freshfields and Sanjeev Khemlani of FTI Consulting explain their current popularity

The recent spate of high-profile liability management transactions, where existing lenders provide liquidity to distressed borrowers through the creation of priority tranches of debt, are not new financing structures. They have, however, moved into new territory by being proposed and consummated on a non-pro-rata basis, as was the case in the Serta Tri-Mark, and Boardriders priority financings.

The rise in pandemic-related distress on highly levered companies has led issuers, restructuring advisors and opportunistic existing lenders to develop and consummate transactions that benefit both the issuer and the new capital provider. The company receives much needed liquidity and the new lenders get favourable terms, such as priority liens or claims and enhanced treatment for their existing debt. This amounts to a favourable exchange of some or all of their existing debt at a premium to existing debt trading levels.

The nature of the priority facility and the favourable exchanges often have the potential to provide the participating lenders with a greater overall return on their original debt than non-participating lenders would receive.

Priority facilities have long been accomplished with a majority lender vote to amend the debt and lien covenants to the extent that the pro-rata sharing and waterfall provisions permit the interposing of a senior tranche. In the past 10 years, there were numerous debt exchange transactions where unsecured note issuances were layered into secured first lien facilities with the consent of the borrower and a majority of lenders.

Traditional bidding

Those types of transactions were often advanced by crossover lenders that had a majority of the secured debt and significant amounts of the unsecured bonds, such that it was in their economic interest to elevate their unsecured notes into the secured facility at the expense of diluting their secured holdings.

Likewise, there have been numerous high-profile transactions where issuers have spun out assets and financed them, either with new lenders or existing lenders that exchange debt at a discount in order to get first priority liens against the spun-out assets.

One can take the position that both the issuers and lenders participating in these types of transactions are exercising their duties on behalf of shareholders and LPs – the companies by extending their liquidity runway in a distressed environment and potentially avoiding bankruptcy and the credit investors by enhancing their returns through the extension of new loans to a distressed borrower, which in certain instances defends their existing credit investments.

Lenders not afforded the opportunity to participate in such non-pro-rata exchanges often say that these transactions violate the terms of their credit documents. In some cases, these lenders either withhold consent, seek to block the administrative agent from consummating amendments or oppose them through litigation. Numerous transactions have been consummated, several transactions have been blocked or modified as a result of opposition and numerous transactions – for example, Serta, Travelport, Revlon, and Boardriders – are the subject of ongoing litigation.

The ‘fear of missing out’ nature of these transactions often make the race

to amass the 50.1 percent of the vote necessary to effect a liability management transaction. It is common that the first group to propose terms acceptable to the borrower and achieve 50.1 percent (sometimes facilitated by the borrower) will be the party to provide the new financing. Sophisticated borrowers and their advisors have adopted traditional competitive bidding processes for these financings and often seek proposals from third-party new money lenders and from ad hoc groups within a credit facility on a simultaneous basis.

It seems the leveraged loan market is developing a split personality. In some transactions, lenders are proponents of priority facilities (or financing of spun-out assets coupled with a favourable debt exchange) and those same lenders are sometimes opponents of other transactions. This reflects the fact that a credit investor more often than not would rather be a participant in a priority liability management exercise than an excluded minority holder.

The attention these recent transactions has garnered raises the question of what steps a debt holder should take when a distressed borrower is seeking to raise liquidity through a liability management transaction and the debt holder may be excluded from participating.

Lender beware

The lender should promptly evaluate what is permissible under the loan documents: the ability to designate unrestricted subsidiaries, make open-market debt purchases, and the modification of pro-rata and waterfall provisions are some of the main facilities to be reviewed. Several of the recent liability transactions that have been advanced by parties on a majority basis were possible because the amendment sections permitted modifications to one or both of the pro-rata and waterfall provisions with a simple majority vote or the documents permitted the transaction to be implemented outside the scope of the existing documents.

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Permissive credit facilities, when coupled with open market debt purchase provisions that allow borrowers to buy back debt on a non-pro-rata basis, create fertile ground for transactions that can be implemented by majority lenders. A common thread in transactions that have been successfully opposed through US state and federal court litigation, or where ad hoc groups formed to oppose the borrowers and were able to negotiate more favourable terms for the minority, turned on overly optimistic interpretations of the existing loan documents by the issuers and the proposed new lenders through careful analysis by minority lenders and their willingness to litigate.

Potential minority lenders might propose their own transactions which, if more favourable to the issuer than might otherwise be offered, could gain traction. Early opposition or clear, written communication to the company and its advisors may be a positive factor in subsequent litigation as to whether the transaction is permitted under the document.

Takeaways

A different variation is where borrowers and majority lenders strip covenants or other protections for remaining, non-participating lenders. Some of the takeaways from these transactions are:

- Lenders should be constructive in their discussions with stressed borrowers. The days of sending threatening letters to the board may be behind us. Also, being a small holder in these loans carries an extra layer of risk, and firms will be well served having experienced distressed employees and professionals in their corner.
- Lenders should be aware of the risk that other creditors in the capital structure will be looking for ways to gain advantage for their own interests over the interests of others.
- Ad hoc groups or large lenders (and sometimes the issuers and their advisors) more often than not are driving these transactions.
- The evolution of priority facilities has caused large institutional players to become proactive and to seek out distressed opportunities within their portfolios, both to be opportunistic and defensive. If an institutional investor is not bringing a potential capital solution to its distressed borrower, another co-lender or a third party is likely to be doing so. The motivation for the 'race to 50.1 percent' is largely driven by the mantra 'hunt or be hunted'. ■

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