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GUEST ARTICLE

Keeping Up With Distressed Debt Strategies

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In the aftermath of the bubble economy of the mid-2000s, there exists a target-rich environment of companies with solid fundamentals that are, or will soon be, in distress due to debt burdens and other issues and, thus, are available for buyout shops to acquire at attractive prices.

Many of these companies will find themselves in the Chapter 11 process, forced to sell their businesses through either a so-called "363 sale" or a plan of reorganization. Both processes are court-supervised and their intent is to maximize value for the company's stakeholders by giving all interested parties a full and fair opportunity to bid for the business. However, a savvy investor, by obtaining a position in the company's capital structure through the purchase of debt, can gain an inside track in the process. This article summaries the current treatment of some of the primary "loan-to-own" strategies that can be employed at various stages of a company's sale process.

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1) Access to Non-Public Information. Credit agreements and bond indentures customarily provide debt holders under the facility, regardless of the amount of debt held, with rights of access to material non-public information about the borrower (subject to signing a confidentiality agreement). Thus, by acquiring a small piece of debt in a potential target, you've also bought yourself a useful—and relatively inexpensive—tool for gathering information on the company's operations, financial performance and management in advance of a formal sale process. The usefulness of this strategy is primarily in the period prior to a potential target's bankruptcy filing; once the company files and a sale process is formally kicked off, diligence information will be available to all interested parties and the playing field will be leveled.

Companies often seek to have "in the can" a deal that can be filed at, or shortly after, the initial filing of its bankruptcy case in order to assure trade creditors, customers, employees and others about the continuity of the business, so having prior access to due diligence information puts the recipient in a better position to be chosen as the acquirer. If all major creditor constituencies are prepared to support such a deal, a filing may even be avoided and the deal completed without the time, expense and overbid risk involved in the bankruptcy process. Furthermore, access to due diligence information prior to a bankruptcy filing can also be used to determine which layer of a company's capital structure is the "fulcrum security," the identity of which is imperative if your acquisition strategy hinges on a debt-to-equity conversion.

2) Control the Sale Process. Chapter 11 debtors finance their operations and the cost of bankruptcy with debtor-in-possession loans ("DIP loans"). The lenders of choice for these loans are the company's senior secured lenders because that avoids a fight between these lenders and a new DIP lender over priority of liens against the company's assets. As such, by purchasing a piece of the senior secured debt of the target company prior to a bankruptcy filing, you may, in addition to gaining access to diligence information, also have the opportunity to participate in the DIP loan upon a bankruptcy filing.

A DIP loan must be repaid, in full and in cash, in connection with a plan. As such, DIP lenders do not have the right to vote on any plan of reorganization. However, DIP lenders can still be a powerful voice in how debtors operate and use cash during the bankruptcy process; as a result, DIP lenders can also exercise some control and direction over the reorganization process itself. DIP lenders can deploy this control by, for example, conditioning the debtor's access to funds upon the plan of reorganization being acceptable

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to them. Recent challenges to this powerful right have been rejected by courts, and some, such as in Delaware, routinely approve providing such rights to DIP lenders. A plan-approval condition can be used as a lever to be the source of any new equity capital required by the company's plan or to drive the company toward a 363 sale in which the DIP lender can participate, potentially in the preferred position of "stalking horse" bidder.

3) Loan to Own. Loan-to-own strategies are classic distressed acquisition plays. Whether accomplished by credit-bidding secured debt in an auction, identifying the fulcrum security and seeking to convert to equity and/or frustrating the plans of others, such strategies can be used to acquire companies for pennies on the dollar.

a) Credit Bid in an Auction. Similar to taking a deed in lieu in a foreclosure action, "credit bidding" is bidding by a secured lender to purchase assets securing the debt by offsetting or satisfying the debt owed. Under Section 363 of the Bankruptcy Code, secured creditors can credit bid up to the full amount of their debt in connection with a sale of assets on which they have a lien. In other words, debt purchased at a substantial discount is valued in an auction at the full face amount of the debt. Thus, a credit bidder can have a substantial advantage over a third- party bidder because it may need substantially less cash in order to bid and win.

Prior to attempting this strategy, it is essential that potential acquirers thoroughly review the credit and security documents governing the debt to be purchased to determine what percentage of such debt must consent to a credit bid in order for the agent to be authorized to act. While this has been a hotly contested issue in the current cycle, the good news is that recent cases interpreting loan and security documents have rejected arguments that 100 percent consent to a credit bid was required, so small, hold-out lenders have not been able to block credit bids. For instance, in 2009, in the case of Greatwide Logistics, a Delaware bankruptcy court interpreted the terms of a collateral agreement to permit the first-lien lenders to credit bid the entire $366 million of debt over the objection of a lender in the credit that owned $1 million of the debt. However, supermajority consent requirements are typically required in order for a collateral agent to take action, so the bid must usually make sense for other lenders in the group.

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b) Convert Debt to Equity in a Reorganization Plan. This loan-to-own strategy requires identification of the so-called "fulcrum security." Because the fulcrum security can be either undersecured secured debt or unsecured debt, depending on the valuation of the company, fights over the company's proper valuation can occur between classes of debt vying to be the fulcrum security. Proper identification of the fulcrum security is paramount because debt senior to it will be repaid in full and debt junior to it will be wiped out.

To the extent that a plan of reorganization provides for the issuance of equity in the reorganized company in satisfaction of the fulcrum debt obligations, the affected debt holders will be considered impaired and will have the right to vote as a class to accept or reject the plan. A class is deemed to accept the plan if more than two-thirds (of the total amount of debt voted) and one-half (of the total number of debt holders casting ballots) vote to accept. However, even if a class votes to reject the plan, the plan may still be "crammed down" on the class if it does not unfairly discriminate against the creditors in the class and does not provide a recovery to any class of claims or interest that is junior to the rejecting class. As a result, similar to a credit bidding situation, a minority holder of a class of debt will not be able to block a debt-to-equity conversion under a plan simply by voting to reject the plan.

c) Create a Blocking Position. Even if your acquisition strategy is to purchase a bankrupt company with new money, rather than through a loan-to-own strategy, ownership of some of the debtor's debt can still be beneficial in achieving your objective. First, to the extent you are bidding in a 363 sale, obtaining the secured creditors' consent for the release of their liens will be required if the winning bid is not sufficient to repay such secured creditors in full. In this scenario, ownership of a position in the secured debt large enough to prevent the consent vote from being granted to a competing bidder will make your bid more attractive as a deal that can actually get done, even if it has other disadvantages. As with credit bidding, careful attention must be paid to the underlying loan documents to determine what percentage of debt must be controlled in order to compel (or prevent) the release of liens (normally the same percentage that would be required to effect a credit bid). Of course, obtaining enough debt to create a blocking position can also prevent the lenders from credit bidding against your bid.

The successful use of all of the loan-to-own strategies discussed in this article depends on a proper understanding of the underlying loan and security agreements. These agreements are intensely negotiated and it should not be assumed that key provisions, such as the requisite percentages needed to direct a collateral agent to make a credit bid, will be uniform from deal to deal. As such, a potential acquirer should carefully and thoroughly review the loan documents relating to any debt it plans to purchase for use in connection with a loan-to-own strategy prior to crafting its strategy and purchasing the debt. With careful analysis, powerful advantages may be there for the taking in many distressed situations. ❖

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