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A Playbook for Borrowers Facing Economic and Debt Market Pressures

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Key Points

- Common borrower-friendly terms in loans and bond indentures can provide struggling companies with a number of options to extend their runway in a distressed environment.
- Options include swapping existing debt for new loans or bonds with higher payments or lien priorities, transferring assets to subsidiaries that can borrow freely, and buying existing debt at a discount to reduce a company's leverage and interest cost.
- Winning support from creditors can be difficult, and holdouts can complicate the process.

The U.S. capital markets have experienced significant volatility since the arrival of COVID-19. After lockdowns resulted in a short recession in early 2020, the markets reopened in booming fashion, with M&A, equity and debt issuances reaching record levels from mid-2020 through 2021. The pace then abruptly slowed in 2022, with high inflation and rising interest rates. New debt issuances fell and IPO markets ground to a virtual halt.

While nontraditional sources of capital are expected to fill a portion of the lending gap (private credit funds are estimated to have $150 billion in dry powder), capital costs are likely to continue to climb, and debt terms are expected to become less borrower-friendly.

If this trend continues and the economy transitions into a recession, borrowers will need to maximize optionality by accessing additional funding and addressing obstacles such as shrinking profits and impending maturities. Lenders and bondholders, meanwhile, will try to assert themselves to ensure repayment, to the extent that they have rights under covenant-lite and permissive debt documents that impose few restrictions on borrowers.

Below, we outline key items and issues for companies and their boards and management to consider in the event the economic environment gets worse before it improves.

Liquidity and Business Plan Scenarios

Having access to sufficient cash reserves expands a company's ability to weather recessionary pressures and preserves optionality for restructuring or acquisition transactions. Before the onset of a potential economic downturn, companies should examine their business plans and potential sources of capital to maximize liquidity and anticipate legal issues they may face if economic headwinds persist. Planning well in advance (*i.e.*, several months before a debt becomes due for repayment) is important so that companies can avoid losing out on certain options, as each takes time to implement.

Representation and Warranty 'Bringdowns'

In tightening credit markets, borrowers should evaluate their ability to access undrawn credit lines. Lenders that previously were accommodating may resist a draw request if they perceive that the borrower is headed toward a default. Revolving credit facilities typically include a "bringdown" condition to borrowing, requiring the borrower to reaffirm all the representations and warranties it made when the loan was extended, in addition to there being no default. For borrowers in a distressed or deteriorating financial situation, lenders may cite the solvency and no "material adverse change" representations as reasons to resist funding the revolver

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draw. For the solvency representation, the borrower typically represents that it and its subsidiaries are solvent on a consolidated basis. For the no "material adverse change" representation, the borrower typically represents that there has been no material adverse change in its business, assets, operations or condition — financial or otherwise — since a certain date (usually the most recent fiscal year end date prior to the effectiveness of the credit agreement).

Borrowers weighing a drawdown of their credit line should closely examine the representations and warranties in their credit agreements and make sure those continue to remain accurate.

Financial Covenant Compliance and EBITDA Add-Backs

Before accessing additional debt, borrowers need to assess whether they are in compliance with any required financial maintenance covenants (which may include maximum leverage, minimum coverage and liquidity). Leverage-based covenants are the most common and are generally tested at the end of each fiscal quarter to the extent there are any revolving loans outstanding or, in some cases, when a certain percentage of revolving commitments has been utilized. Borrowers will need to make sure that they have a sufficient cushion to satisfy the covenants, taking into account both changes in EBITDA (earnings before interest, taxes, depreciation and amortization) and the debt component of the leverage calculation.

Many credit agreements allow myriad borrower-friendly "add-backs" that can result in a higher EBITDA for covenant purposes than would be calculated using GAAP (generally accepted accounting principles) measures alone. In addition, leverage ratios are often calculated on a "net" basis, allowing all or a portion of a borrower's unrestricted cash to be subtracted from the amount of debt. Borrowers should review their credit agreements and cash positions to take maximum advantage of these favorable provisions if they appear in their agreements when calculating their leverage ratios.

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While debt-related covenants for bonds are typically measured only at the time the company seeks to take on new debt and do not require maintenance of specified ratios or the bringdown of representations and warranties over the lifetime of the bond, issuers should carefully assess any bond terms that could affect debt exchanges or buybacks, such as debt incurrence or restricted payment covenants. Often the timing and structure of such transactions is impacted by the release of the issuer's financial statements, which may determine whether such covenants are satisfied.

Liability Management and Other Liquidity-Enhancing Techniques

In addition to maintaining ample cash, companies with leveraged balance sheets may find opportunities to explore holistic capital structure solutions during a downturn. They may have multiple means to deal with looming maturities and to right-size their capital structures.

Uptier Exchanges and Unrestricted Subsidiary Transactions

Borrowers may consider a so-called "uptier" exchange, in which a portion of existing secured or unsecured debt is exchanged for new "superpriority" debt. Uptier transactions allow borrowers to issue new debt or exchange existing debt to access additional liquidity or address impending maturities. These transactions can also be attractive to participating lenders, as they usually offer improved terms for lenders, enhanced priority and sometimes premiums on the debt being exchanged.

Companies may also look to their subsidiaries that are not subject to covenants under the loan documents. In recent years, for example, some borrowers have taken advantage of standard credit document "baskets" to transfer assets to unrestricted subsidiaries, increasing the amount of debt those entities can support. Other borrowers have designated existing asset-owning subsidiaries as unrestricted pursuant to the applicable credit documents.

These types of transactions can lead to litigation, however. Lenders may allege that an asset transfer was actually or constructively fraudulent, or did not comply with the applicable credit documents. In response to several high-profile cases involving the use of unrestricted subsidiaries, including a transaction by the retailer J. Crew, some recent credit agreements and indentures limit a borrower's ability to transfer material assets outside of the credit group covered in the loan documents. Similarly, as a result of the Serta transaction in 2020, where the company repurchased existing debt for new superpriority loans, some recent credit agreements now require unanimous lender consent with respect to any subordination of existing debt or any changes in waterfall provisions. However, such provisions are not yet widespread, and most earlier agreements do not include such restrictions and protections.

The consent needed to amend a credit agreement (unanimous versus majority) can have a significant impact on the ability to complete an uptier exchange or an unrestricted subsidiary transaction. For example, while a borrower typically only needs "required lender" consent (*i.e.*, consent of lenders holding more

than 50% of commitments and loans) to amend existing loan documents, certain changes — such as modification of principal and interest rates, extensions of maturity and amendments to pro rata sharing provisions — are typically treated as "sacred rights" requiring unanimous lender consent. As a result of companies using the flexibility in their agreements to do uptier transactions with only required lender consent, certain recent credit agreements now limit the ability of borrowers to undertake such uptier transactions by requiring unanimous consent, and borrowers need to be cognizant of the consent thresholds required in their specific agreement.

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In bond transactions, exchanges are often structured as exchange offers to comply with securities laws and are coupled with an "exit consent" that allows participating bondholders to simultaneously provide a consent to amendments to the existing bond documents that would bind any nonparticipating bondholders, further incentivizing participation. Like credit agreements, however, certain "sacred rights" require unanimous bondholder consent.

Debt Repurchases/Buybacks

Companies with sufficient liquidity may consider repurchasing debt to reduce leverage and interest expense, and potentially to capture discounts in debt trading prices. Many credit agreements permit borrowers to repurchase debt through open market purchases or a Dutch auction, but open market purchases of bonds may be limited by securities laws regulating tender offers. Borrowers should also be aware that the meanings of "open market purchase" and "Dutch auction" have been the subject of recent litigation. They also will need to weigh the risk of a ratings downgrade if the repurchase price is so low that it is considered a "distressed exchange." Repurchases below par may also result in the company realizing taxable cancellation-of-indebtedness income.

Legal Considerations

Minority lenders and bondholders who opt not to participate in the liability management transactions described above increasingly resort to litigation against borrowers and participating creditors. (This has given rise to the term "lender-on-lender violence.") In several cases in recent years, nonparticipating creditors challenged uptier transactions, alleging that they constituted breaches of contract and violations of the implied covenant of good faith and fair dealing. A number of those suits survived motions to dismiss, creating the prospect of protracted litigation that effectively ensured the plaintiffs a seat at the table.

Given these dynamics, borrowers considering these types of transactions should combine a transactional legal review with a litigation strategy. Having a strong record demonstrating why a particular transaction complies with applicable credit documents can help lessen the likelihood of litigation and increase the chances of winning dismissal should a complaint be filed.

Practical Considerations

In addition to potential legal hurdles, there are important practical factors to consider in evaluating a strategic transaction.

Debt terms are expected to become more lender-friendly. It is important for borrowers to evaluate potential changes to debt market dynamics — in particular, the risk that debt will become more expensive and that lenders and bond investors will push for lender-friendly credit terms, especially in exchange transactions. It is therefore important for borrowers to establish competitive processes to obtain the best possible terms.

Know your creditors. Another important consideration when structuring strategic transactions is the identity of the creditor base, and any institutional or contractual limitations. Some financing vehicles such as collateralized loan obligations (CLOs) may be prohibited by their terms from receiving certain types of debt or equity instruments. Other institutions may not be strictly barred from receiving certain consideration, but they may have a strong preference for either cash, debt or equity. Understanding these dynamics enables borrowers and issuers to maximize negotiating potential.

Strong nondisclosure agreements with potential transaction partners are also important because, if news of a prospective transaction leaks, some lenders might seek to block it. Borrowers should also be aware that cooperation agreements among lenders are becoming more prevalent. They can establish required lender blocks to protect lenders from transactions that freeze some of them out.

Addressing Bond Maturities

Companies with outstanding bond debt face an additional layer of complexity because, in many cases, they must negotiate refinancings or exchange transactions with a highly dispersed creditor base, particularly if there are retail holders. Seeking consents in such cases can be extremely burdensome and costly as well as time-consuming, and issuers are frequently forced to negotiate with holders of relatively small positions — often distressed debt investors who purchase bonds at heavily discounted prices with a view toward short-term gains.

Exchanges. Traditional tools such as bond tenders and exchanges generally are available to issuers facing maturities. However, these transactions may take substantial time to negotiate and document, and many tender offers for bonds must remain open for at least 20 business days. Additionally, bondholders may face restrictions on trading for a lengthy period during the negotiation, and it is imperative to properly time the request for restriction to avoid the need for public disclosures before a transaction can be announced.

In light of these constraints, some issuers have turned to private transactions to address pending maturities. But these require a careful review of the indenture's consent provisions and applicable securities laws.

Staple Chapter 11 pre-packs. Even in exchange transactions that enjoy strong support from the holder base, some bondholders may hold out and not participate in the transaction simply to try to extract additional value from the issuer. In these instances, issuers might consider the "staple Chapter 11 pre-pack" — a consent solicitation distributed to bondholders along with a pre-packaged Chapter 11 bankruptcy plan. Holders that participate in the exchange also vote in favor of the pre-packaged plan.

If acceptances exceed a specified threshold (usually above 90% of outstanding bonds), the borrower closes the exchange, and the Chapter 11 plan is disregarded. If the issuer fails to reach its threshold but receives the participation of over 67% of the issuance, it can opt for an expeditious pre-packaged bankruptcy, using the votes of the participating holders to bind holdouts. Often the staple pre-pack, and the pre-negotiated support of over 67% of the holders, is enough to dissuade them. And if not, the Chapter 11 case can still be completed within a short period of time (one to 60 days, depending on the facts and circumstances).

In Sum

Years of generous credit terms have left many companies with flexibility to adjust their debt structures should they find themselves under financial stress. However, creditors may resort to litigation if they believe a borrower is sidestepping minority creditors' legal protections and jeopardizing those creditors' security or priority. Borrowers also need to consider that, in a tightening credit market, lenders and bondholders may insist on greater protections in any new debt that is extended or when asked to consent to amendments or refinancing of existing debt.

(See also "UK-Listed Issuers Under Financial Stress Gain Latitude in Secondary Capital Raisings" and "HKEX Initiatives Present Opportunities Even in a Down Market.")