Hastings Business Law Journal

Volume 5
Number 2 *Spring 2009*

Article 4

Spring 1-1-2009

Working through a Workout: A Practitioner's Guide from the Perspective of Private Equity Sponsors, Venture Capital Funds and Other Significant Equity Investors

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WORKING THROUGH A WORKOUT: A PRACTITIONER'S GUIDE FROM THE PERSPECTIVE OF PRIVATE EQUITY SPONSORS, VENTURE CAPITAL FUNDS AND OTHER SIGNIFICANT EQUITY INVESTORS

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I. INTRODUCTION

These troubled economic times present numerous concerns to the ongoing business. One, the dreaded "workout" scenario that arises when a corporation breaches its debt covenants, often need not be so dreaded. A workout does not necessarily spell the failure of a borrower, as practical realities more often than not prevail. Getting to that point requires a careful understanding of the parties and their objectives in the workout process. In particular, the typical negotiation dynamic between a corporate borrower and its lender, where the lender is the only significant source of potential financing, may differ significantly from the dynamic in a workout scenario involving the lender on the one hand and, on the other hand, a private equity sponsor, venture capital fund or other significant investor (such investors referred to herein as the "sponsor"). In such cases, the sponsor represents another deep pocket or additional significant source of potential capital and negotiating leverage. The authors guide the reader through the stages of a workout from the perspective of a sponsor. In order to successfully achieve the goals of the sponsor, particular attention is given to common lender behavior and perspective while addressing the unique tensions facing the sponsor. This Practitioner's Guide will provide insight

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on how a sponsor can negotiate with a lender and address the most common negotiating points in a workout, from the infusion of new capital to restructuring the borrower's business operations.

A. THE PARTIES AND THEIR GOALS

1. Why a Workout?

The leveraged buyout, or LBO, through which a sponsor often acquires a company results in the company owing obligations under a credit facility, as the borrower, to finance the acquisition and provide for future working capital. Alternatively, a sponsor's unleveraged company may also enter into credit facilities to finance growth and/or working capital liquidity. Any such credit facility will typically contain financial covenants that establish the minimum level of financial performance on the part of the borrower that the lender is willing to accept.[1] These covenants are mutually agreed upon in the process of negotiating the credit facility and, as a result, they should also represent a level of financial performance that the sponsor and borrower are confident they can comfortably achieve.

Problems arise, however, when unanticipated economic difficulties occur and the borrower finds itself having failed to reach projections and, consequently, in breach of its financial covenants,[2] resulting in a default under the credit facility.[3] As a result of this or any other default (subject in some cases to grace periods or cure periods), the lender will typically have the express right to accelerate the maturity of the loan. In that circumstance, if the borrower does not have the ability to immediately repay or refinance the outstanding balance of the loan, the lender has the right to foreclose on its collateral, which often includes substantially all assets of the borrower. The only alternative to foreclosure for the borrower at that point is bankruptcy[4] unless the parties can agree to a workout.

1. Such financial covenants might include minimum adjusted EBITDA (earnings before interest, taxes, depreciation and amortization and such other addbacks that the parties agree upon) levels, maximum capital expenditures, maximum leverage ratios, minimum interest coverage ratios or minimum fixed charge coverage ratios to name a few.

2. In an economy experiencing tight liquidity in credit markets, which limits the borrower's ability to obtain replacement financing, looming maturity dates also become a real issue. *See* David Gaffen, *Debt Concerns Put Brakes on Lending*, WALL ST. J., April 8, 2009, at C1.

3. In the present economic environment, this is occurring with greater frequency. *See* Michael Aneiro, *Corporate Defaults May Rise—Airlines, Car Makers Called Trouble Spots with More Debt Due*, WALL ST. J., June 12, 2008, at C6. Borrowers are even tripping covenants in so-called "covenant-lite" loans. *See* Peter Lattman, *"Covenant-Lite" Loans Face Heavy Hits*, WALL ST. J., March 18, 2009, at C1.

4. The automatic stay that arises immediately upon commencement of a bankruptcy case would

The foreclosure or bankruptcy scenarios presented above often benefit none of the parties more than an appropriate workout solution. The goal of a workout is to reach a consensual, value-preserving and quicker alternative to avoid the cost, reputational effects and pressure on business relationships generally associated with a public bankruptcy. It is unlikely, however, that a lender will waive the existing defaults without exacting a price. In order for the sponsor and the borrower to come out of the workout with a positive result, the strengths and weaknesses of the sponsor and the lender that may have an impact on the negotiations should carefully be considered.

2. The Lender

Although the lender may appear to hold limitless leverage when the borrower defaults, it is important to consider the lender's goals. In general, the lender is looking for a return on its investment, and of course it also expects to recoup its invested principal.[5] By continuing to collect principal and interest payments until maturity, the lender may realize more that it would by forcing a foreclosure or bankruptcy. First, the lender may be under-secured. While the lender could collect the full value of its claim up to the value of its collateral, in a bankruptcy the lender would be considered unsecured with respect to any deficiency.[6] The lender may collect only pennies on the dollar for such deficiency and, as an under-secured creditor, would not be entitled to collect interest on *any* part of its claim after the bankruptcy petition is filed.[7] Second, the borrower will likely lose further value as a result of the bankruptcy either because it loses vendors and customers or because the liquidation of its assets yields a lower price than the sale of the borrower as a going concern—not to mention that the cost of administering a bankruptcy is expensive and will be borne substantially by the borrower, reducing the value available to the lender. Third, the lender may be subject to "cram-down" in bankruptcy. In a cram-down scenario, the debtor may be able to confirm a plan of reorganization over the objection of its creditors as long as the plan is fair

prohibit the lender from taking any action to collect its debt or foreclose upon its collateral. *See* 11 U.S.C. § 362(a) (2006).

5. Where a borrower has defaulted on payment (rather than merely defaulting under a covenant), the policy of many banks requires shifting the administration of the debt to a different group within the bank, with which the sponsor likely has no existing relationship. Consequently, the existence of a payment default, in addition to establishing grounds for immediate acceleration of the outstanding debt, can create administrative difficulty for the sponsor, requiring increased substantive attention to the borrower. Moreover, the existence of a payment default may give the lender more leverage in a bankruptcy as a bankruptcy court may be more likely to find that the lender is not adequately protected and that cause exists for granting the lender relief from the automatic stay or other similar relief. *See* 11 U.S.C. §§ 361, 362(d) (2006).

6. 11 U.S.C. § 506(a)(1) (2006).

7. § 506(b).

and equitable and does not discriminate unfairly among classes of creditors.[8] This may be true even though the creditors are impaired under the plan. As a result, in a bankruptcy, the lender may be forced to accept the alteration of its pre-petition rights including, among other things, the extension of the maturity date or modification of the amortization schedule of the debt, reduction of the applicable interest rate or reduction of the principal amount of its secured claim to the value of the collateral. If the sponsor continues to believe in the financial viability of the borrower contrary to the view of the lender, the sponsor can wield the cram-down possibility as a persuasive tool. Accordingly, the lender faces a number of risks should the workout fail and the borrower enter bankruptcy.

Notwithstanding the benefits of a workout to the lender, continued forbearance when dealing with a financially distressed borrower has its obvious risks. The lender likely will view the workout as an opportunity to rein in the borrower or gain tighter control while also potentially improving its financial position through additional collateral, if available. This is particularly true in the current environment in which the present economic crisis was immediately preceded by unprecedented looseness in the credit markets and correspondingly loose credit terms. As a condition to waiving defaults and adjusting financial covenant levels during the borrower's period of financial distress, the lender often will be looking to align the terms of the credit agreement with current economic conditions and market standards.

Some lenders, however, may be looking for more. While the above discussion is reflective of the typical goals of a traditional bank lender, the sponsor should also be wary of the goals of another type of lender. So-called "loan-to-own" funds or distressed debt investors may be less interested in preserving the long-term value of and relationship with the borrower.[9] This type of lender is looking for a high return over a short period, which it may be able to realize by, among other possibilities, foreclosing upon default or perhaps negotiating a conversion of its debt to equity with a threat to foreclose.[10] The best practice from the sponsor's perspective may be to build protections, such as a consent right, into the credit agreement in the first instance to ensure that these sorts of funds cannot become part of the lender group. However, these funds may be the only option for liquidity at a critical time, and as a result, the sponsor may

8. 11 U.S.C. § 1129(b) (2006).

9. *See* Cynthia Futter & Anne E. Wells, *What to Expect from Hedge Funds Today and in the Future: An Overview and Insolvency Perspective*, 29 CAL. BANKR. J. 213, 231 (2007).

10. *See id.* at 218; Jonathan M. Landers, *Reflections on Loan-to-Own Trends*, AM. BANKR. INST. J., Oct. 2007, at 1. Such lenders may also have purchased loans at a discount in the secondary debt market, altering their economic motives such that they can obtain a profit by foreclosing or taking other enforcement actions for a profit even in cases where they settle for recovering less than 100 percent of the face value of the loan.

find itself negotiating with such a lender.[11]

Regardless of whether the lender is a more traditional bank or a loan-to-own fund, the lender will want to ensure that none of its actions during the workout process put it at a disadvantage in a possible future bankruptcy case. The bankruptcy will subject the lender's actions to heavy scrutiny by, among others, the unsecured creditors' committee that is looking to create value for the unsecured creditors by effectively taking value away from the secured lender. The committee will be looking for preferential and fraudulent transfers to the lender that can be recovered for the benefit of the bankruptcy estate.[12] The lender is at risk if it is seen by the committee or trustee as overreaching and if it has not clearly provided value in exchange for the borrower's concessions during the workout.

If a lender holds equity or a position on the board of the borrower, which many loan-to-own lenders may seek as part of their ultimate goal of controlling the borrower, such a lender in particular should be concerned with the possibility that a bankruptcy court could equitably subordinate its claim or recharacterize its debt as equity. Such recharacterization will have the effect of putting the lender last in line in a bankruptcy distribution, as a result of wrongful actions taken in carrying out its duties.[13] Along a similar line, such lender's representative on the board may also face individual liability for breach of fiduciary duty claims if, in the course of negotiating the workout, it failed to adequately consider all options available to the borrower, improperly valued the borrower, worsened the borrower's financial solvency (i.e., "deepening insolvency), or even benefited from a conflict of interest.[14] These considerations should serve to constrain the lender to some degree.

11. Typically borrower consent rights do not apply when a default exists under a credit agreement. Thus, even when the borrower has negotiated consent rights, they will usually be ineffectual to block such assignments once default has occurred and is continuing.

12. A preferential transfer is one made to or for the benefit of the creditor within the 90-day period prior to the bankruptcy petition date on account of an antecedent debt that enabled the creditor to obtain more than it otherwise would have in a chapter 7 proceeding. 11 U.S.C. § 547(b) (2006). Note that the preference period reaches back one year with respect to transfers to "insiders," which may include a loan-to-own fund that managed to obtain control of the debtor during the workout process. *See* 11 U.S.C.§ 101(31)(B)(iii) (2006) (defining "insider" to include a "person in control" of a debtor corporation). A fraudulent transfer is one made within two years of the petition date with either actual intent to hinder, delay or defraud other creditors or for less than reasonably equivalent value. 11 U.S.C. § 548(a)(1) (2006). Unless the creditor can establish a valid defense, the bankruptcy trustee or debtor-in-possession "may recover, for the benefit of the estate, the property transferred." 11 U.S.C. § 550(a) (2006).

13. *See* Landers, *supra* note 10, at 46 (noting that such remedies are available but drastic and rarely imposed).

14. *See id.* at 44-46; Futter & Wells, *supra* note 9, at 229-30.

3. The Sponsor and its Company

A sponsor generally invests in a company with a view to capitalize upon potential efficiencies it has perceived, thereby increasing the value of the company and selling it at a profit within a period of years. As with the lender, the sponsor is looking to obtain a return on its investment. The sponsor's investment, however, is at greater risk if the company were to enter bankruptcy as equity holders have the lowest priority in the distribution scheme created by the Bankruptcy Code.[15] Moreover, the sponsor is frequently viewed by the company's creditors as a deep pocket in a bankruptcy proceeding.[16] Consequently, the sponsor becomes a highly visible target for breach of fiduciary duty claims. In addition, just as bankruptcy carries a stigma for debtors, so too does the bankruptcy potentially tarnish the reputation of a sponsor, deterring the sponsor's potential fund investors. For all of these reasons, the sponsor may have a significant incentive to avoid the bankruptcy of its portfolio company.

With a view toward preserving its investment, the sponsor has multiple goals during the course of the workout. First and foremost, it wants to ensure the portfolio's emergence from its short-term financial difficulty by obtaining a waiver of existing defaults under the credit facility and resetting or waiving the borrower's financial covenants for the foreseeable duration of the borrower's financial troubles. The sponsor's priority in a poor economic environment is to seek breathing room for the borrower while the borrower looks to re-establish covenant compliance and address upcoming maturities, if necessary.

Second, the sponsor wants to establish a record of successful and good faith negotiations. This serves to preserve its relationship with the lenders both for the purpose of maintaining good will in the deal at issue and to maintain the lenders as a source of financing for future deals. Relatedly, it also serves to preserve the sponsor's public reputation. "A private equity owner's reputation attracts investors and gives it leverage at the bargaining table" in future deals.[17] Finally, by acting in good faith in a manner that is in the best interests of the borrower and keeping a careful record of the negotiations and the borrower's financial solvency, the sponsor will be working toward establishing a defense to many of the causes of action that the sponsor could face in the event of a bankruptcy. It would be prudent for a sponsor to take care to document that its management of the workout process is consistent with its directors' duty of

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15. *See* 11 U.S.C. § 507(a) (2006).

16. Evan Weinberger, *In Bankruptcies, Private Equity Becomes the Target*, LAW360, Aug. 6, 2008, http://www.law360.com/articles/65132.

17. *See* Brendan Pierson, *More Cos. Restructuring Out of Court: Experts*, LAW360, Oct. 6, 2008, http://bankruptcy.law360.com/articles/71657 (quoting Michell Harmer).

care and loyalty to the company.

The sponsor is not without leverage in the workout. Just as the sponsor is looking to preserve relationships, so too are any lenders. As the sponsor will inevitably be seeking financing for the acquisition of new portfolio companies in the future, the lender may view the sponsor as a potential source of future business. As a result, a lender that is also a loan originator will often want to continue to be seen as flexible to attract future lending relationships.

The sponsor may be able to enhance the lender's interest in workout alternatives if the sponsor can offer some level of new equity or debt financing (or credit support) to help the borrower's liquidity during a time of financial difficulty. For this reason, the sponsor's very presence in a transaction alters the dynamic of the workout. The sponsor, however, faces tension in its role because, while it wants to convince the lender that the borrower is a safe investment that the lender should continue to stand behind, the sponsor may be concerned that it could be throwing good money after bad.

With the perspectives, strengths and weaknesses of each of the parties in mind, the sponsor can approach the negotiation of the specific terms of the workout with a realistic view while maximizing its leverage against the lenders.

II. THE NEGOTIATION

Although the course of a workout will vary depending on the many factors that may lead to financial distress, there are certain terms that the sponsor should expect and the lender most likely will seek to renegotiate during the course of the workout. In general, the lender will seek some form of consideration for its consent to a workout. In the current economic environment, the lender is also going to attempt to bring the terms of the credit facility in line with current market standards, which can prove to be a significant difference from the existing terms if such terms were negotiated in a time where market standards were significantly looser. The discussion below highlights the common terms that will be put at issue during a workout and possible responses from the sponsor with regard to each.

A. FINANCIAL COVENANTS

To ensure that the borrower is no longer in default as result of a breach of financial covenants, the sponsor must successfully negotiate at least two issues in the workout. First, the sponsor must obtain a waiver from the lender with respect to the existing defaults, effectively wiping the slate clean for the borrower. However, the borrower's financial troubles are likely not simply a historical relic. Projected performance for the fiscal quarters immediately following the effective date of the workout is likely to fall short of the targets set at the time the underlying credit facility was negotiated.

Accordingly, the second issue to address is future covenants. The sponsor could propose that financial covenants for a short term be waived entirely. In other words, the borrower would not be bound to achieve any financial targets for perhaps several fiscal quarters. The lender is not likely to accept a scenario with no financial covenants; if the financial condition of the borrower were to deteriorate drastically after the workout, the lender would have no recourse to protect its interest (assuming no other provision of the credit facility, such as making timely payments of principal and interest, is breached). The lender, therefore, will most likely respond with financial covenants reset at a level it considers appropriate. Given that the workout probably will be consummated with some set of financial covenants, it may make sense for the sponsor to propose the financial covenants in the first instance, setting the bar from which negotiations commence.

A successful result for the sponsor will feature financial covenants set at a level that provides a cushion over the borrower's projected performance. Twenty-five percent is a generous cushion and probably marks the outer bound of typical market standards, with the inner bound being closer to 10 percent.

B. LIQUIDITY

In addition to the concern that the troubled borrower may run up against its financial covenants, there is also the more fundamental concern regarding the borrower's liquidity. The borrower may not have sufficient cash to operate, in which case the risk increases that the borrower will fall into payment default under the credit agreement.

Whereas a typical public company may have only its existing lender relationships as a potential source of funds, the sponsor presents a unique resource for its borrower. A possible resolution to the borrower's liquidity crisis is the investment of additional funds by the sponsor. This additional investment may take the form of new equity. It may also take the form of debt structured in one of a variety of manners: an add-on revolver or term loan under any existing credit facility, last-out first lien debt subordinated debt, or a second lien. The sponsor might even simply provide a letter of credit or a backstop guaranty of new advances by the lender. In general, the deep pocket of the sponsor and the confidence in the borrower that a reputable sponsor demonstrates, creates leverage and may increase the willingness of the lender to continue to stand behind the borrower. The commitment level of the sponsor should be carefully measured, however. The sponsor may face a dilemma if, in fact, it isn't confident in the borrower's financial viability: on the one hand, it wants to persuade the lender to remain dedicated to the borrower while on the other hand, it wants to preserve its own investment and reputation.

If putting new money into the borrower is not an option for the sponsor, there may be several alternatives available to preserve the borrower's liquidity. The lender may agree to defer interest payments or allow all or some interest to be paid in kind (PIK interest) such that interest is accrued and added to the principal amount of the outstanding obligation to be paid when the principal is paid down at some point in the future. The lender may also be amenable to a deferral of the amortization schedule. The timing of the next payment might be pushed out long enough for the borrower to refinance or to sell an underperforming asset, in either case, the proceeds typically being applied to pay off the outstanding debt. The lender may be more willing to agree to this option if it can be assured of the borrower's performance, perhaps setting milestones (e.g., a date by which the borrower must enter into a letter of intent to sell) that the borrower is obligated to meet along the way. In short, there are a number of alternatives to preserving or improving the liquidity of the borrower in the workout.

C. FEES AND PRICING

Although, as discussed above, the lender may benefit by avoiding the bankruptcy of the borrower, it would be unusual for the lender to agree that such a benefit is sufficient consideration alone for its waiver of existing defaults. Rather, in exchange for releasing its rights and remedies with respect to those defaults, it is likely the lender will seek an amendment fee, representing some percentage (usually 0.25 percent to 1.0 percent) of the outstanding debt, and perhaps renegotiate the pricing, or interest rate margin, applicable to the debt. Indeed, in a down economy, the lender may be required to mark to market. That is, where the debt is trading on the secondary debt market below par, the lender may be incentivized to recoup the difference between the current market value of the debt and the value of the debt on its books in order to come out whole. It can do so, for example, by increasing the interest rate margins applicable to the debt. Indeed, in an environment where debt is trading downward as a mere result of market illiquidity generally and not necessarily as a result of the credit quality, the lender has an incentive to mark to market even where the borrower is not in financial trouble. And, of course, in a down economy, the lender's own cost of funds has likely increased. As a result, it is becoming more common to see such requests from lenders even where a mere technical amendment to the credit facility, beneficial to all parties, is sought.

During a workout as opposed to a mere technical amendment, however, the problem from the sponsor's perspective is that, whether in the form of fees or increased interest rates, taking money from the pocket of a borrower facing a liquidity crisis increases the borrower's financial difficulties. With this justification, the sponsor may be able to successfully argue in favor of non-current pay alternatives. If the lender insists on increasing the margins, one resolution is to designate some or all of the additional interest as PIK interest. Other non-payment consideration may also be considered. A release of the lender's liability, for example, while quite standard, may be particularly valuable where the lender itself has breached the terms of the credit agreement. Another example would be to grant additional collateral to the lender in support of obligations under the credit agreement, as discussed further below.

D. STRENGTHENING THE LENDERS' POSITION

Upon the initiation of the workout, the lender will likely seek to shore up its position with respect to the borrower's assets. That entails at least two steps. First, the lender may seek to tighten the baskets in the credit facility. While the credit facility will generally restrict the borrower's ability to incur debt or liens or to make investments and acquisitions, the borrower will nevertheless have certain "baskets" to permit it the flexibility to incur such obligations in order to conduct its business. The lender, however, may want to reduce flexibility under those baskets in order to reduce the number of competing claims to the borrower's assets.

Second, the lender will likely want to conduct a collateral audit. That is, the lender will seek to determine the status and scope of its liens. With respect to the status, the lender's concern is ensuring that its liens are valid and perfected such that they cannot be attacked in bankruptcy. To this end, the lender conducts a lien search in appropriate jurisdictions, looking for the financing statements it filed in order to perfect its liens to be reported as properly recorded and looking for any other liens recorded against the borrower's property. With respect to scope, the senior lender's concern is to ensure that it is fully secured, having collateral in substantially all assets of the loan parties. Otherwise, as noted above, the deficiency will be unsecured, for which there may be little (if any) recovery, and reducing the risk that the lender will not be entitled to collect post-petition interest or post-petition attorneys fees.[18]

To the extent that the collateral audit reveals infirmities in the lender's security position, the sponsor can expect the lender to make every effort to tighten its collateral package. During the course of negotiating the original credit facility, the lender may have agreed to certain *de minimis* carve-outs to the perfection of its security interest. A common example is foregoing a control agreement, which is necessary to perfect a security interest in deposit accounts under the Uniform Commercial Code, with respect to deposit accounts holding a small amount of funds. Perhaps the lender did not take all steps necessary under foreign law to perfect liens on the borrower's equity interests in a foreign subsidiary. The lender may not have insisted on obtaining waivers or access agreements from the borrower's landlords. These steps may not have been taken in the first instance after an analysis of the costs and benefits of doing so in the context of a healthy borrower. Yet, dealing with third party entities such as depositary institutions or landlords and hiring foreign legal counsel to draft foreign-law governed documents can be quite costly and time consuming, placing additional strain on a struggling borrower.

When the borrower is in default, the cost-benefit calculus has changed. The benefit of being fully secured is much more apparent with a possible bankruptcy looming. As a result, the lender may condition the effectiveness of the workout on delivery of the types of agreements mentioned above. While it may be difficult for the sponsor and the borrower to resist, the same logic for foregoing such steps in the first instance still exists—these steps are costly. Particularly when the borrower may be facing a cash crunch, expending those costs without a substantial corresponding benefit makes little economic sense for both the sponsor and the lender. Such efforts, if reasonable, however, may be gestures that, in addition to shoring up the lender's collateral position, shore up its confidence in the borrower and the sponsor, making it more likely to agree to the workout.

III. CONCLUSION

More companies are restructuring out of court than ever before.[19] The costs of a possible foreclosure or bankruptcy may be high and have

18. *See* 11 U.S.C. §§ 506(a)(1), (b) (2006); United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 382 (1988); Jennifer M. Taylor & Christopher J. Mertens, *Travelers and the Implications on the Allowability of Unsecured Creditors' Claims for Post-Petition Attorneys' Fees Against the Bankruptcy Estate*, 81 AM. BANKR. L.J. 123, 139-41 (2007).

19. *See* Pierson, *supra* note 17.

increased over time.[20] While all of the parties may have an incentive to avoid a foreclosure or bankruptcy, the resources of a private equity sponsor, venture capital fund or other significant investor may provide leverage in negotiating a workout. During the course of a workout, the sponsor can wield its resources in a manner that capitalizes on the objectives of the lender, increasing the likelihood of reaching a consensual and successful workout.

20. *See* Jonathan D. Glater, *Advantage of Corporate Bankruptcy is Dwindling*, N.Y. TIMES, Nov. 19, 2008, at B1.