

Meeting Challenges 'Head On' — What it Takes to Ride Out This Storm

BY GARY B. ROSENBAUM AND JEAN B. LEBLANC

Companies with bad business models as well as strong ongoing businesses burdened by overlevered balance sheets need to confront the reality of today's frozen credit environment and other recessionary pressures. To adopt a wait-and-see approach is extremely risky; savvy borrowers need to meet head on the current challenges by exploring the deleveraging devices and other options that will be evolving during the remainder of this restructuring cycle.



GARY B. ROSENBAUM
Partner/Corporate
Department,
McDermott Will & Emery LLP



JEAN B. LEBLANC
Partner/Corporate
Department,
McDermott Will & Emery LLP

Advisors and attorneys to companies suffering through the current recession find themselves experiencing the same fears as the main character in J.D. Salinger's classic novel, *The Catcher in the Rye*. While Holden Caulfield was dealing with a symbolic danger (the "cliff" from childhood to adulthood), today's financial advisors and restructuring counsel are being called on to rescue their clients from a much more real threat: the looming precipice arising from existing or anticipated financial covenant defaults under, or the upcoming maturity of, their loan facilities. In these circumstances, companies need to proactively seek deleveraging opportunities to minimize the risk that they will fall off of that precipice and to maximize their chances of surviving this recession.

Historical Perspective

Many of the businesses that are currently experiencing financial covenant defaults under their credit facilities can trace their problems to the abundant availability of financing in the leveraged debt markets during the period from 2003 through early 2007.¹ Debt issuances for leveraged buyout (LBO) transactions surged from \$71 billion in 2003 to \$669 billion in 2007. The majority of these LBOs were "covenant-lite" deals, meaning that the loan documents contained few or no financial covenants.² The ready availability of financing and other permissive or "pro-borrower" features of that era, such as low interest rates, permissive financial covenant structures, "PIK toggle" notes and equity cure rights, resulted in a record volume of buyout transactions by financial sponsors and dividend recapitalizations in which companies borrowed money in order to pay dividends to their equity holders. These buyout transactions created a huge demand for both traditional and non-traditional financing. This demand was met by a flood of capital that became available as a result of investments in hedge funds, private equity funds and other

non-traditional investment vehicles such as collateralized loan obligations (CLOs).³

Trouble began to surface in the credit markets in the United States and Europe in mid-2007 and continued during 2008 and 2009, with most lenders losing interest in financing LBO transactions by mid-2008. Amidst a steady drumbeat of announcements of ailing and failing financial institutions — Bear Stearns, Lehman Bros., Freddie Mac, Fannie Mae, Washington Mutual, Wachovia and AIG — there was a dramatic tightening of the funding that previously flowed freely from banks and other financial institutions, and covenant-lite loans quickly disappeared from the market.⁴ According to Thomson Reuters LPC, syndicated loan issuance in the United States plunged from \$1.7 trillion in 2007 to \$764 billion in 2008, a 55% drop to the lowest level since 1994.

The 2008 credit freeze has not shown any signs of thawing in 2009. Thomson Reuters LPC reported that leveraged loan issuance in the first quarter of 2009 fell to \$27.26 billion, representing a 57% reduction from the same period of 2008, and concluded that "it appears that 2009 will be more about surviving."⁵ Depressed earnings due to the recession led to a gradual rise in default rates on leveraged loans in 2008, reaching a 57-month high of 4.35% by the end of 2008, according to Standard & Poor's Leveraged Commentary and Data unit. Absent the breathing space provided by the trailing 12-month covenant calculations and the wide financial covenant cushions of the covenant-lite structures, the default rates would have risen much more dramatically.

Borrowers will be facing a decidedly different environment as their 2005- and 2006-vintage credit facilities mature during the next few years. First, they will find fewer refinancing options as the above-referenced volume contractions have been matched by a decrease in the number of potential providers of new loans. CLOs,

business development companies and other investors that previously provided a significant amount of liquidity to fund the proliferation of acquisition loan facilities are no longer actively participating in the lending market. In addition, not all of the top ten lead arrangers in the U.S. in 2007 (according to Thomson Reuters LPC, these were JP Morgan, Bank of America, Citi, Wachovia, Credit Suisse, Deutsche Bank, Goldman Sachs, Lehman Brothers, Merrill Lynch and Wells Fargo) are still around, and most of those that remain are experiencing financial difficulties of their own.

Second, Standard & Poor's reports that approximately \$430 billion of debt of rated, non-financial corporate borrowers is scheduled to mature in 2009, and debt maturities will continue to increase each year until they peak in 2012.⁶ Lenders are showing extreme caution in refinancing many of these loans, leading to more defaults and bankruptcy filings by those borrowers that find themselves without any realistic refinancing prospects. On the other hand, borrowers that are able to refinance their loans will find substantially higher pricing and tighter leverage requirements.

Third, companies are finding that the decline in consumption by consumers during this recession is leading to flat or decreased earnings and will ultimately lead to defaults under their financial covenant packages. As a result, the latest Standard & Poor's estimate is that the rate for corporate loan defaults (meaning that a company cannot meet interest or principal payments on borrowed money) will skyrocket from around 4.5% in 2008 to 14% or higher by April 2010.⁷

In order to protect against downside scenarios generated by this confluence of factors, and to successfully navigate the challenges presented by the recession, companies need to evaluate their available options to preserve equity value, extend maturities of outstanding indebtedness and avoid potential covenant defaults. Four of these options are discussed below.

Covenant Amendments

During the high point of the credit cycle, companies regularly sought, and lenders typically granted, covenant relief at little or no cost. However, the illiquidity in the current credit markets allows lenders to be opportunistic in connection with any requested waivers or amendments. Thus, any borrower requesting a modification of its financial covenants, or any other form of covenant relief, should expect some or all of the following:

- A hefty amendment fee;
- An increase of its interest rate to the current market-based pricing;
- The imposition of a LIBOR floor;
- The termination of any incremental or accordion facilities;
- The curtailment or elimination of other features of its credit facility that provided flexibility to the borrower.

At the same time, lenders want to avoid taking additional loan loss reserves due to an increase in non-performing loans, so borrowers that either can point to updated projections demonstrating aggressive cost cutting and improved profitability or can avail themselves of new equity investments will likely increase their chances of obtaining covenant relief. Notwithstanding the potentially high cost

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of obtaining covenant relief, many borrowers are choosing this route as evidenced by Standard & Poor's Leveraged Commentary & Data unit's report that 50% more covenant amendments closed in the first quarter of 2009 than in the previous quarter.

Prudent borrowers should not be spooked by increased pricing and should commence a dialogue with their lenders as soon as they become aware of potential default(s). Given a credit environment in which refinancing is not a likely option, a borrower with a cooperative incumbent lending group should resist quibbling about the "current market" for amendment fees and rate increases and instead focus on the need to get a deal done that will provide it with the necessary latitude to survive the long haul.

Term Loan Buybacks

Term loan buybacks became popular in 2008 due to the proliferation of leveraged loans that were trading below par. In these transactions, borrowers used excess cash flow, equity infusions and/or the proceeds from asset sales to repurchase term loans at a discount on a non-pro rata basis as a means of reducing leverage and lessening the interest burden. From the borrower's perspective, the repurchase of term debt at a discount strengthens its balance sheet by lowering its debt level and is obviously more advantageous than making a voluntary prepayment at par (which often will involve a prepayment premium). Although lenders historically would not permit a borrower to buy back its debt at less than par, current lender illiquidity problems have made such a transaction attractive to those lenders that would prefer to redeploy the sale proceeds to make loans to other borrowers (generally at a higher interest rate) or to use those proceeds to reduce their loan loss reserves.

The Stimulus Bill enacted earlier this year provides additional incentive for companies to pursue a loan buyback, by allowing them to repurchase their indebtedness (or whose debt is cancelled) during 2009 and 2010, and to elect to defer until 2014 payment of taxes on the income recognized from forgiven or cancelled indebtedness and to spread the taxes to be paid on the deferred amount over a five-year period from 2014 to 2018.

Since term loan buyback transactions are a recent phenomenon, most credit agreements either do not contain provisions that address those transactions or expressly prohibit companies or their equityholders from acquiring company debt. Therefore, there are few instances in which a borrower or its affiliate will be able to acquire its own loans without amending its credit agreement. The following provisions in the loan agreement, among others, are implicated in a loan buyback:

- Assignment restrictions (including "Eligible Assignee" definition) and related agent consent rights;
- Negative covenants relating to restricted payments, investments and liens;
- Pro rata sharing provisions with respect to loan repayments;
- Lenders' voting provisions.

Ultimately the term loan buyback decision will require that the borrower ascertain whether its financial resources are optimized by the buyback, which should include an analysis of the liquidity that it will retain to confront unforeseen challenges in this recessionary environment.

Debt-for-Equity Exchanges

The combination of the frozen debt market and the increasing corporate loan default rate has resulted in a shift in strategy by private equity firms,⁸ many of which are now unable to obtain financing for the buyouts and dividend recapitalizations that were popular in the middle of this decade. Some private equity firms that have a desire to engage in turnaround situations are pursuing a “loan-to-own” strategy by making loans to, or buying the debt of, distressed companies and then taking over those companies.⁹ Other private equity firms are being forced to proactively engage in debt-for-equity exchanges in order to avoid having their equity interests in their portfolio companies wiped out by lending syndicates after those portfolio companies default on their financial covenants.¹⁰

Debt-for-Debt Exchange

In the second half of 2008, the financing market saw a resurgence of debt exchanges as companies looked for ways to delever in the midst of a market that was devoid of significant new debt issuances. Various debt-for-debt exchanges were floated in the financing market that offered investors an opportunity to improve the priority or collateral position of their debt in exchange for a reduction in the principal amount and an extension of the maturity of the debt. In most cases, the provisions in the documentation for the debt that is senior to the debt that would be exchanged prohibits the contemplated exchange, but in some instances the relevant documents provide an opening for debt exchanges.¹¹

Even though the decision by the Delaware State Chancery Court in the challenge to the Realogy debt exchange did not permit that debt exchange to be consummated, the decision presents a roadmap of the provisions in the relevant indentures and loan documents that should be analyzed in evaluating the permissibility of potential debt exchanges. Realogy Corporation, the owner of the Century 21 and Coldwell Banker real estate brokerages, had a proposed debt exchange that was intended to reduce its overall debt and interest expense by permitting the holders of its unsecured subordinated and senior notes to tender them for a smaller amount of new second lien term loans that were to be issued under the accordion facility of Realogy's senior secured credit agreement. While both the senior notes and subordinated notes would be eligible to be exchanged, the subordinated notes were to be given priority in the exchange. The cap on the proposed term loan facility limited the amount of notes to be tendered, the effect of which made it likely that the subordinated noteholders' priority would be improved, and they would also gain the benefit of the security provided under the accordion facility, while the senior noteholders would remain unsecured.

The senior noteholders sued in Delaware State Chancery Court, with the parties battling over the issue of whether the proposed exchange violated Realogy's credit agreement and note indentures. Although the court held that the proposed exchange would violate

the credit agreement and note indentures based on a technical reading of those documents, its decision left open the possibility of a borrower successfully effectuating such an exchange under the right circumstances. Thus, it is critical that all of the relevant senior and subordinated loan documents be read carefully to determine whether the proposed transaction runs afoul of any of their prohibitions, including with respect to the following matters:

- Whether the accordion or incremental loan provisions of the senior loan documents only permit newly issued loans or whether exchanged debt would also qualify;
- Whether the restricted payments sections of the loan documents permit repayment or exchange of junior debt;
- Whether refinanced debt can have a higher seniority than the debt that is being refinanced; and
- What is included in the definition of indebtedness for purposes of the financial covenants in the loan documents?

Conclusion

Companies with bad business models as well as strong ongoing businesses burdened by overlevered balance sheets need to confront the reality of today's frozen credit environment and other recessionary pressures. To adopt a wait-and-see approach is extremely risky; savvy borrowers need to meet head on the current challenges by exploring the deleveraging devices described in this article and other options that will be evolving during the remainder of this restructuring cycle. [abf](#)

GARY B. ROSENBAUM (grosenbaum@mwe.com) and **JEAN B. LEBLANC** (jleblanc@mwe.com) are partners in McDermott Will & Emery LLP's Corporate Department and are based in its Los Angeles office. Their practices are concentrated on finance and financial restructuring transactions of all kinds, including leveraged finance, commercial lending, private equity and mezzanine investments, and workouts both in and outside of bankruptcy. The authors would like to thank their former colleague Peter Kim for his research assistance.

ENDNOTES:

- 1 The Boston Consulting Group, “Get Ready for the Private-Equity Shakeout,” (December 2008).
- 2 Fitch Ratings, “Developments in the U.S. Leveraged Loan and CLO Markets,” (February 7, 2008).
- 3 According to David Preston, an analyst at Wachovia Securities LLC, CLOs purchased approximately two-thirds of the leveraged loans issued during the period from 2004-2007. See “Subprime Loans, Corporate-Style, Will Fuel Defaults,” *The New York Times* (April 24, 2009).
- 4 See e.g., Standard & Poor's, “Banks Begin to Clear the Leveraged Finance Overhang,” (November 1, 2007), at 4-5.
- 5 Thomson Reuters LPC Press Release, “1Q09 U.S. Loan Market Review: A scaled-back loan market chooses between survivors and nothing,” (March 27, 2009).
- 6 Standard & Poor's, “Amid The Credit Crunch And Economic Turmoil, Rated Corporate Borrowers May Become More Prudent,” (February 11, 2009).
- 7 Standard & Poor's, “U.S. Credit Metrics Monthly: Default Rate Rises to 8.3% in May,” (June 2, 2009).
- 8 Thomson Reuters LPC Press Release, “1Q09 U.S. Loan Market Review: A scaled-back loan market chooses between survivors and nothing,” (March 27, 2009).
- 9 “Apollo Mulls Taking Stake in Charter,” *The Wall Street Journal* (March 20, 2009 online edition)
- 10 “Buyout Cos Battle Lenders As Debt Engulfs Portfolios,” *The Wall Street Journal* (June 3, 2009 online edition)
- 11 See e.g., Neff Corp. debt exchange.