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GUEST ARTICLE

Preparing For A Downturn

By Stan Johnson and Greg Schwed, Loeb & Loeb LLP

No one knows when or how the private equity market will slow down, but most suspect that eventually it will. This article outlines some steps that equity sponsor groups, senior secured lenders and subordinated lenders can take to prepare for a downturn.

As multiples increase in this sellers' market, sponsor groups are raising more debt and contributing more equity to their deals. Thus, while debt/equity ratios remain pretty much consistent with historical norms, there is more debt per deal and more equity at risk, leaving less margin for error. In addition, simply being the highest bidder is often not enough.

In order to win a bid in this market, some sponsors are offering to close without escrows and, increasingly, without any indemnification at all except for manifest fraud. Sponsor groups try to cover themselves by sending due diligence SWAT teams to the target company. Heavy due diligence is always helpful, but can be of limited value if the seller's representations, warranties and related disclosure schedules are too watered-down, thus shifting the burden of identifying risk to the buyer.

On the debt side, competition for deals means lenders are more likely to accept this lack of indemnification; to commit to provide all tranches of the debt structure; to accept weaker covenants; and, in some instances, to live with no financial covenants whatsoever.

As deals become more pricey and risky, and as loans have fewer default triggers, a downturn in a portfolio company's business sector or the overall economy creates greater risk for private equity players. Here are some protective steps to consider.

Stan Johnson

Equity Sponsor Groups

To keep a portfolio company afloat in hard times, sponsor groups may be called on to contribute additional equity or deeply subordinated debt to improve the company's balance sheet and cash flow. In entering into co-invest arrangements at the time of the initial acquisition, sponsor groups should obtain commitments of their co-investors, including management, to contribute additional capital on a pro rata basis with the sponsor group, if the sponsor group later decides that an influx of cash is needed to stave off a loan payment default or other crisis affecting the portfolio company. Sponsor groups that are currently in the fund formation stage should attempt to obtain the most liberal provisions relating to follow-on investments.

When selecting lenders, sponsor groups should consider whether the lender is likely to be flexible in the event of a payment default by the portfolio company. Lenders in the private equity business for the long haul often accommodate sponsor groups with which they have close relationships.

However, to cover the situation where a particular lender in a syndicate is not willing to waive defaults or otherwise work with the portfolio company and other lenders, it is advisable to insist on so-called "yank-the-bank" and "fish-or-cut-bait" provisions in the loan documents. "Yank-the-bank" provisions permit a borrower (or other lenders) to pay off dissenting lenders at par to get them out of the syndicate. "Fish-or-cut-bait" provisions prevent a minority lender in the syndicate from gaining leverage by stalling on the decision of whether to waive a default and amend the loan documents. This restriction is typically accomplished by requiring all lenders to make that decision within a short time period (say,

ten business days). If the minority lender fails to exercise its independent rights within that time, the lender is deemed to have consented to any waiver and amendment supported by the agent and the majority of the other lenders.

Senior Secured Lenders

While default rates on loans are currently low, a disquieting possibility is that low default rates may be due in large part to less stringent loan covenants or, in some cases, the absence of financial covenants altogether. Traditional financial covenants serve as early warning indicators that the borrower is tottering. Even though senior secured lenders have the first claim on the company's assets, weakened covenants can put that collateral base at risk. Senior secured lenders should accordingly become more vigilant in their monitoring of borrowers. Essential steps are more frequent discussions with and visits to the borrower and more detailed review of the borrower's monthly and quarterly financial statements.

Senior lenders may also become more exacting in terms of which sponsor groups they deal with. An equity sponsor group that is known to roll up its sleeves and help its portfolio companies in times of crisis, including the infusion of additional capital if necessary, is obviously a more desired sponsor than a more passive equity holder.

Subordinated Lenders

Second lien and mezzanine lenders can find themselves in an awkward position if their borrower is approaching insolvency and their debt is, in effect, looking more and more like equity. In a bankruptcy or foreclosure proceeding, second-lien holders are, of course, secured lenders. However, they come behind the senior secured lenders in terms of a claim on the debtor's assets. In a disaster scenario, the asset base of the debtor can deteriorate so much that second-lien debt can be entirely underwater.

This problem is even more acute for mezzanine lenders because they have no collateral to rely on, and they have only the same relatively low priority as trade and other unsecured creditors. However, mezzanine lenders and undersecured second-lien holders may dominate the unsecured creditors' committee and obtain substantial leverage in Chapter 11 plan negotiations.

In making the initial loan to a borrower, second-lien and mezzanine lenders should

Greg Schwed

consider whether they would be prepared to convert all or a part of their debt to equity if the borrower spirals toward insolvency, putting the subordinated loan at risk.

In the most passive form of debt conversion, the lender converts some or all of its debt to equity but the lender takes no active role in the company's ongoing management, other than perhaps insisting that the borrower retain a crisis manager to turn the business around. A more activist alternative is for the lender to become a co-investor with the initial sponsor group and take a minority of the board seats. In the most aggressive scenario, the subordinated lender converts to equity and takes control of the company.

These more aggressive conversion scenarios are not for the faint of heart, even if the conversion price is extremely favorable. The decision to take control as an equity owner generates some significant legal risks. These risks need to be carefully analyzed before taking the conversion step.

If a lender enforces its remedies purely as a lender, in good faith and in accordance with its documentation, the lender usually incurs no additional legal risk. Officers and directors—not arm's-length lenders—are charged with fiduciary duties in managing a company. But a lender that becomes an insider will likely be deemed to have assumed those fiduciary responsibilities.

If the turnaround effort fails and the company ends up in bankruptcy despite the debt-to-equity conversion, the lender will likely face threatened legal action, including attempts to equitably subordinate any of the lender's debt that had not been converted to equity; disqualify the lender from voting on any remaining debt; and dislodge the lender from management during the bankruptcy.

An aggressive debtor or trustee may go further and claim that the lender should be liable for some or all of the losses of the other creditors. This threat is far from frivolous, because it is now well established law that management of an insolvent company takes on a fiduciary duty to creditors. Moreover, a mezzanine lender or hedge fund is usually a deep pocket, making it a tempting litigation target. Accordingly, equity issued pursuant to a conversion of debt should be held by a special purpose entity and not the fund itself.

Even in the face of these risks, motivated and aggressive subordinated lenders will still often elect to take some measure of control. After all, if the conversion price is right and the lender is successful in turning the company around, the lender will have preserved its capital and realized considerable gains.

If a lender is considering taking control, some additional safeguards should be employed. The lender should be careful about imposing fees or otherwise siphoning off company assets in a way that would raise the eyebrows of a bankruptcy judge looking back at the lender's management tenure.

The lender should act in good faith; document the fact that it is acting in good faith; conduct itself and the affairs of the company in a commercially reasonable manner; refrain from self-dealing or otherwise breaching fiduciary duties; and replace management with turnaround experts, if necessary.

Yet even in this legal climate, there is no need to be a Chicken Little and shy away from otherwise attractive transactions. If the converting lender maintains a very high standard of prudence and care, it should ultimately prevail against subsequent claims brought by third-party creditors or a trustee in bankruptcy—but perhaps not without a fight.

Stan Johnson heads the Private Equity Group of Loeb & Loeb LLP. His practice is focused primarily on middle-market private equity transactions, including the representation of sponsor groups, mezzanine lenders, and other financial and industry buyers and sellers. Greg Schwed is a partner in Loeb & Loeb's Bankruptcy, Workout and Creditors' Rights Group. His clients include institutional lenders and creditors in reorganizations, liquidations and bankruptcies.