TRAVERS SMITH

A more equitable solution for everybody?

An analysis of debt for equity swaps

In the second of a series of briefings that looks at financial management in a downturn, this note considers the many aspects of debt for equity swaps.

As an increasing number of companies find themselves staring down the barrel of a formal insolvency process, buy-out houses, management, corporates, borrowers and their bank and other financial creditors should consider whether all of their interests would be better served by implementing a debt for equity swap. At its simplest, a debt for equity swap is an exchange of (usually lender) debt for shares in the borrower, and has the advantage of improving the capital position of the borrower – as it results in reduced leverage and a lower interest bill – whilst offering the lender a share in any upside when the restructured business is eventually sold or floated. Whilst the principal commercial issues revolve around how much and which tranche(s) of debt is converted (which will, in part, be driven by the level of debt that the business can sustain going forward) as well as the class and number of shares to be offered to the lenders in exchange, there are numerous other issues on which the various stakeholders – with their differing agendas – will need to reach agreement.

"A debt for equity swap has the advantage of reducing the leverage of the borrower whilst offering the lender a share in any upside."

Restructuring the equity

Many aspects of how the equity is to be restructured are deal specific and will depend upon, amongst other things, the respective negotiating positions of the parties and the nature and extent of the debt which is to be converted. However, some of the key considerations are as follows:

- What percentage of the overall shareholding will the lenders require? A lender will want the ability to exert as much control over the company as possible, and may therefore seek a >50% stake (which will enable it to push-through and block ordinary resolutions of the company). However, a stake of this size is likely to require consolidation in the lender's accounts, and consequently most lenders will take a lower initial percentage (although even a 20% shareholding may constitute a presumed participating interest and require consolidation under international accounting standards) and rely on enhanced voting/veto rights to enable them to exercise the requisite control.

- What class of shares will be issued? A lender may seek a mixture of ordinary shares and preference shares, although shares which do not constitute "ordinary share capital" for tax purposes may trigger adverse tax consequences for the borrower. If the preference shares are redeemable, the parties will need to agree the circumstances in which they are redeemable (will these be limited to a change of control and a sale of all or substantially all of the business, or will there be others?). Lenders may also require warrants to subscribe for further ordinary shares in the company, which are exercisable upon a change of control and which (when exercised) increase the lenders' stake in the company. A borrower may be able to persuade the lenders that the warrants should lapse if a certain proportion of the preference shares are redeemed within a specified period of time following completion of the debt for equity swap (and, in any event, before the warrants have been exercised).

- What rights will attach to the shares? These may include some or all of the following:

  (a) *Income rights* – A lender is likely to require that its shares produce dividends, although there may be circumstances in which its dividend rights are suspended – for example, following a default under the banking documents. If the lender also holds warrants, it may require that, on an exit, it is paid an amount equal to any dividends which would have been paid to it had it exercised its warrants on day one.

  (b) *Director/observer rights* – A lender may ask for the right to appoint a director or an observer to the board of the company and/or its subsidiaries, and require the articles of association of each such company to be amended such that board meetings are not quorate unless the nominee director is in attendance. If, in the case of a public company, a lender seeks to appoint a nominee to one or more of the committees of the board, corporate governance issues will need to be scrutinised.

  (c) *Veto/information rights* – If a lender has accepted a lower shareholding to avoid consolidation, it may require certain veto rights to enable it to exercise the requisite level of control over the company. These will almost certainly extend beyond those which it has in its capacity as lender under the banking documents, and may include veto rights over the appointment or removal of a director, the establishment of (or variation to) any management incentive or pension scheme, the alteration of accounting policies, the settlement of any litigation, the approval of the budget or business plan and/or the right to appoint investigating accountants at any time. Some or all of these rights may lapse upon a redemption of all (or an agreed proportion) of the preference shares.

  (d) *Swamping rights* – A lender may also seek "swamping rights", whereby its voting rights are enhanced so that it controls the company in circumstances where the company has defaulted under the banking documents or the company's headroom under its financial covenants has been eroded beyond a certain percentage.

  (e) *Transferability* – Given the significant rights from which the lenders' shares are likely to benefit, borrowers may require that any transfer of the lender shares is subject to its prior consent. In practice, this is unlikely to be acceptable to the lenders and as a compromise certain of the rights (for example, veto and information rights) could fall away if the shares (or a proportion thereof) are transferred outside of the lender group.

  (f) *Other rights* – These may include tag/drag rights (which will enable the lenders to either participate in any proposed sale by other shareholders or force other shareholders to sell their shares on a sale by the lenders – although this would be very unusual in a public company context) or priority on a winding-up of the company.

- How will any existing loan notes be treated? As debt, loan notes will rank ahead of equity and the lenders will almost certainly insist that they are either written-off or converted into equity (a capitalisation may be required for tax purposes). If there are vendor loan notes in the structure, the vendor will need to be involved in the decision-making process – clearly, he will have his own agenda.

- How will management be incentivised? Once the percentage of shares available to management under the incentivisation scheme has been agreed, consideration will need to be given to the basis on which awards will be made (for example, will awards be subject to leaver provisions and/or performance criteria) and the level of lender approval required (if any).

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- In which company will the shares be held? On a typical double/triple newco acquisition structure, the shares will probably be issued by the borrower and then "flipped up" by way of a share for share exchange so that the lenders hold shares in the parent company. This will almost certainly necessitate amendments to any investment agreement and the parent company's articles of association.

Restructuring the remaining debt

Any debt which is to remain in the business following completion of the debt for equity swap will need to be restructured or refinanced. Borrowers should ask themselves the following:

- What will the lenders require? Typically, a lender may require the payment of a restructuring fee, an increase in the margin, further de-leveraging or the granting of further guarantees and/or security. A lender may also seek to tighten general documentary terms by reference to what it now regards as "market".

- What can the borrower ask for in exchange? A borrower should seek a standstill agreement whilst the terms of the debt for equity swap are being negotiated (which will prevent the lenders from taking action to accelerate the facilities during such negotiations, save in very limited circumstances) as well as a permanent waiver of all subsisting events of default. A well-advised borrower will also seek to negotiate other amendments to the terms of the banking documents, such as a financial covenant holiday and a rescheduling of any repayment instalments and the final maturity dates.

- What is the impact on the financial covenants? The financial covenants will almost certainly need to be reset to take account of the revised capital structure. Particular consideration will need to be given to the accounting treatment of the new equity and, consequently, whether any amendments are required to the financial covenant definitions – for example, if redeemable preference shares are issued, they may be treated as debt rather than equity for accounting purposes which will impact upon the cash cover, interest cover and leverage covenants.

Consents

Unanimous senior (and, if any part of any subordinated debt is being converted into equity, unanimous subordinated) lender consent is likely to be required, as is shareholder consent. Regulatory consent may also be necessary if the business is a regulated entity. If the business has key contracts which contain change of control provisions, the consent of the counterparties to those contracts will need to be sought if those provisions are triggered.

"Plan B"

Whilst a debt for equity swap is a consensual process, a borrower may be able to persuade a financial creditor to agree to the proposals if it can demonstrate that the alternatives (which may include a sale, possibly as part of an insolvency process) would produce a worse outcome for the financial creditor. This can be an effective way of forcing a reluctant financial creditor to the table.

UK Tax

The key UK tax issues in the case of corporate lenders, are as follows:

- Upon completion of the debt for equity swap, a lender will want tax relief for its bad debt, but the borrower will not want to suffer a tax charge. Generally, this should be achievable where the lender and borrower are not already connected, provided that the borrower only issues ordinary shares.

- Going forward, the lender should continue to get bad debt relief unless the lender has become connected with the borrower, in which case no further bad debt relief will be available.

- In addition, if the lender becomes connected with the borrower, a further tax charge could be suffered by the borrower on a deemed release – this depends on the particular facts but is most likely to arise if the remaining debt (after completion of the debt for equity swap) is still impaired.

- The lender and borrower will be "connected" if one controls the other or both are under common control. "Control" for these purposes refers to the power to secure (broadly by share or other voting rights or pursuant to any document regulating any company, such as the articles of association) that the affairs of the controlled company are conducted in accordance with the controller's wishes. It will be important to establish whether a connection exists or will arise in determining the tax treatment both of the debt for equity swap and after the swap.

- If the lender is subject to capital gains tax, the tax base cost in the shares will often be less than the face value of the debt capitalised, and a clearance may be required for any "flip up" of the shareholding from borrower to parent.

- Warrants can raise issues for the borrower (which depend in part on the accounting treatment and documentation), but these are usually manageable.

- The tax treatment of individual lenders (for example, individual investors in funds or individual partners in private equity partnerships) is more complex.

How we can help

We can assist you in structuring a debt for equity swap, such that the rights of the corporate, buy-out house, management and other shareholders are preserved as far as possible whilst ensuring that any remaining debt is restructured or refinanced on terms which are appropriate for the business going forward.

If you would like to discuss any of the issues covered by this note, please contact any of the following members of our Banking or Tax Departments:

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