KEY POINTS

- Debt for equity swaps can be used to restructure both shareholder and third-party lender debt to resize the borrower's balance sheet and reduce the pressure of excessive debt service requirements.
- The shape of the debt will naturally depend on the negotiating positions of the various stakeholders including the existing shareholders, the borrower and the lender, who will each have their own agenda. The parties will need to agree on a number of commercial and technical issues including size of the debt written off, how much equity is issued in return and the rights associated with it, and what pricing and covenant package will accompany the residual debt going forward.
- The borrower will also need to consider the various consents required from existing shareholders, noteholders and any third parties such as key contract counterparties and regulators.

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Debt for equity swaps: a key restructuring tool in the post COVID-19 era

In this article the authors discuss why a debt for equity swap is likely to play a role in many restructurings that result from the downturn triggered by the COVID-19 pandemic. They explain how such transactions are structured, the likely motivations of key stakeholders and the tax and regulatory implications of such transactions.

A CLIMATE RIPE FOR DEBT RESTRUCTURINGS

In the current market of economic uncertainty and significant trading and economic challenges presented to companies by the COVID-19 pandemic, many companies will be looking to restructure their balance sheets and reshape their financial obligations in order to ensure their survival. An increasing number of companies will require some kind of restructuring, whether that is a formal insolvency process, accelerated M&A, rescue financing or a financial restructure.

In response to the liquidity crisis resulting from COVID-19, the government introduced a range of loan guarantee schemes to promote lending to companies. Many of these loans will start to fall due for payment in 2021 and a recent report by TheCityUK[1] warns of the urgent need to take action to tackle the projected £35bn of unsustainable debt deriving from such loans. The report highlights that some sort of equity investment by existing stakeholders will be a likely long-term recapitalisation solution in many cases.

However immediate the concerns faced, a debt for equity swap is one of many options that may be available to right size the balance sheet or to alleviate cash flow pressures created by excessive debt service obligations.

At its simplest, a debt for equity swap is an exchange of debt for shares. This is a common tool used by companies and shareholders to recut shareholder debt; however it is also used as a way of restructuring third party lender debt to improve the capital position of the borrower. Debt is effectively written off, (thereby reducing leverage and debt service requirements) in return for offering the lender a share in the upside when the restructured business recovers, is eventually sold or floated.

Not all lenders will have an appetite for a debt for equity swap. In previous downturns, lenders faced few documentary restrictions on transfers and could transfer debt holdings to avoid navigating a prolonged debt restructuring. Increasingly, however, lenders are being restricted from transferring their debt, as loan documentation terms requested by private equity sponsors are increasingly likely to have transfer restrictions to prevent transfers to, for example, certain categories of distressed debt investor ("loan to own" investors) who may seek to use insolvency processes or debt for equity swaps as a means of taking control of the borrower's business. This could prove counterproductive in a restructuring as the initial lender group may include entities without the appetite or resources for a full-blown restructuring; lenders with little opportunity to sell down their positions may feel compelled to pursue shorter-term (or harsher) options.[2] It remains to be seen how this factor will impact on restructurings occurring post COVID-19.

BRINGING THE STAKEHOLDERS TO THE TABLE

Whilst a debt for equity swap is a consensual process, a borrower may be able to persuade a reluctant financial creditor to agree to the restructuring if it can demonstrate that the alternatives (which may include an insolvency process) would produce a worse outcome for the financial creditor. Conversely, if a lender is willing to restructure but the existing shareholders are resistant to the process, perhaps because they are unwilling to see their equity stake diluted, a valuation may demonstrate that the shareholders are unlikely to have an economic interest in the outcome of an alternative insolvency process.

Where members of the same class of debt fail to agree on the best course of action, a scheme of arrangement under Pt 26 of the Companies Act 2006 (CA 2006) could be used to facilitate a debt for equity swap. It remains to be seen whether the new restructuring plan mechanism introduced by the Corporate Insolvency and Governance Act 2020 will be used to implement debt for equity swaps. The cross-class cram down feature of the new "plan" could prove useful in situations where more than one layer of creditor has an economic interest in the outcome. This new tool is only available to a company that "has encountered or is likely to encounter financial difficulties that are affecting, or will or may affect its ability to carry on business as a going concern".[3]

Whilst most companies that need to implement a debt of equity swap will be distressed to some extent, it is currently untested as to what level of financial difficulty this condition requires.

KEY COMMERCIAL ISSUES

The fundamental commercial issues will be:

- how much and which tranche(s) of debt will be converted to equity. This is primarily determined by the (often differing) views of how much debt the business can sustain going forward; and
- the class and number of shares to be issued in exchange.

There are a number of other commercial and technical issues on which the stakeholders, each with their own agenda, will need to reach agreement.

WHAT WILL THE NEW EQUITY LOOK LIKE?

Most aspects of the new capital structure will depend on, amongst other things, the respective negotiating positions of the parties (in particular arising from the level of financial distress the company is facing, time pressures and the value break), the nature of the debt and the extent to which it needs to be converted. Some of the key aspects that the parties will need to agree are as follows:

In which company will the shares be held?

This question is likely to arise where the borrower was previously acquired pursuant to a leveraged acquisition finance transaction involving a stack of holding companies incorporated for the purposes of the acquisition. On a typical triple newco acquisition structure the borrower sits further down the capital structure such that to issue shares in the borrower directly to the lender will compromise that structure, causing de-grouping and other issues. In such cases it is customary for the shares to be issued by the borrower and then "flipped up" by way of share for share exchange so that the lender ultimately holds shares in the parent company alongside the existing investors. This will generally necessitate amendments to any investment agreement and the parent company's articles of association.

What percentage of the overall shareholding will the lender take?

This will depend on how large a proportion of the debt will be converted; however lenders generally want the ability to exert as much control as possible, and maximise their return from an anti-embarrassment perspective. They may seek a larger than 50% stake, which will enable them to push through or block ordinary resolutions of the company. However, a stake of this size is likely to require consolidation in a lender's accounts and consequently most lenders will take a lower initial percentage and instead require enhanced voting/veto rights to be afforded to their shares to enable them to exercise the requisite control.

What type of shares will be issued?

Lenders may seek a mixture of ordinary shares and preference shares. However, 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 (eg a change of control, a sale of all or substantially all of the business). Lenders may also require warrants to subscribe for further ordinary shares in the company, exercisable upon a change of control or other triggers (for example in exchange for additional financial support) and which (when exercised) increase the lenders' stake. The parties may agree that such warrants will lapse if, for example, a certain proportion of the preference shares are redeemed within a certain period.

What rights will attach to the shares?

- **Income rights**: A lender is likely to require that its shares produce dividends, although dividend rights may be suspended, for example, following a default under the banking documents. If the lender holds warrants, it may require that, on an exit, it is paid an amount equal to any dividends which would have been received had it exercised its warrants on day one.
- **Director/observer rights**: A lender may ask for the right to appoint a director (depending on the financial position of the company such a position will involve an inherent level of risk) or an observer to the board of the issuer. They may require that the articles of association of each such company be amended such that board meetings are not quorate unless the nominee director attends. 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.
- **Veto/information rights**: If a lender has accepted a lower shareholding to avoid consolidation, it may require veto rights to enable it to exercise the requisite level of control. These will generally extend beyond those rights it has under the banking documents, and may cover the appointment and removal of directors, disposals or acquisitions of assets, establishment or variation of any management incentive or pension scheme, the alteration of accounting policies, settling litigation, approval of budgets or business plans and the right to appoint investigating accountants at any time. Some or all of these rights may lapse upon a redemption of all (or a proportion) of the preference shares.
- **Swamping rights**: A lender may also seek "swamping rights", whereby its voting rights are enhanced so that it controls the company in circumstances of financial distress (for example where the company has defaulted under the banking documents or the company's headroom under its financial covenants has been eroded beyond a certain level).
- **Transferability**: Given the significant rights from which the lenders' shares are likely to benefit, borrowers will be keen to ensure that any transfer of the lender's shareholding is subject to its prior consent. In practice, this is likely to be an area of close negotiation.

A compromise may be that 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.

- **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.

DILUTION AND OTHER CHANGES TO THE CAPITAL STRUCTURE

Consideration will need to be given to the dilutive effect of the new shares and the impact of other changes being made to the capital structure to accommodate it. It will also be important to follow proper processes for such changes under the existing equity documents as a matter of company law.
The key issues to consider include:

- **Pre-emption/"catch-up" rights**: Do the existing shareholders benefit from pre-emption rights (whether statutory or contractual) or "catch-up" rights which would need to be disapplied? If pre-emption rights do apply, what impact will the procedural requirements under the constitutional documents and the CA 2006 have on timing?
- **Class consents**: Is it necessary to make changes to the rights attaching to any existing classes of shares in order to accommodate the new shares within the capital structure? If so, are any class consents required and can they be obtained? Whatever the consent threshold, it should be considered whether it is possible to obtain consent from 85% of affected classes to prevent the risk of subsequent challenge under s 633 of the CA 2006 (s 633 Challenge).
- **Authority to allot**: Do the directors have the requisite authority to allot new shares under s 551 of the CA 2006? The allotment of shares may be covered by a pre-existing authority in the articles or agreed to by the shareholders under a previous resolution, but an ordinary resolution will be required if there is insufficient headroom under such authority or if it has expired (noting the five year maximum period for such authority under s 551 of the CA 2006).
- **Minority challenge**: Minority shareholders may be able to bring an unfair prejudice claim under s 994 of the CA 2006 if they can demonstrate that the changes to the capital structure are unfairly prejudicial to their interests. Alternatively, if class consent is required in respect of any existing class of shares, the holders of 15% or more of that class may be able to seek to reverse the changes by way of a s 633 Challenge. Given the circumstances in which debt for equity swaps are typically carried out (where the value of the business breaks in the debt and there is no value in the equity), the risk of successful challenge is often low and the likely consequences of a successful unfair prejudice claim are often acceptable (the most likely remedy often being the compulsory purchase of the claimant's shares for market value) but the risk of challenge should always be carefully considered taking into account the specific nature of the restructuring and shareholders involved.
- **Differential treatment**: Are existing shareholders able to influence the structure of the transaction by virtue of controlling any required consents or approvals? If so, will it be necessary to treat the share class(es) held by them more favourably than others? This should be confirmed as early as possible in the process and factored into any analysis regarding the risk of minority challenge (which may be increased as a result). The existing equity documentation will need to be considered carefully to ascertain whether they allow for such differential treatment.

How will any existing loan notes be treated?

Shareholder debt would ordinarily be structurally and contractually subordinated to a lender's debt. However, following a debt for equity swap, existing shareholder debt would (if not otherwise dealt with) rank ahead of the lender's equity. Lenders will almost certainly require that any existing shareholder debt is written off or converted into equity (a capitalisation may be required for tax purposes). If there are investor or manager loan notes in the structure, the terms of such loan note instruments, and any investment agreement will need to be examined to ascertain what noteholder resolutions or consents will be required and how these will be obtained. Care should be taken to minimise the risk of any oppression of the minority type claims by noteholders, particularly if there will be differential treatment between, for example, investor and management loan notes.

Will the management incentive package need to be revised?

Consideration will need to be given to how management incentives are preserved, as management's shares are likely to be diluted as a result of the debt for equity swap. Once the percentage of shares available to management under the incentivisation scheme has been agreed, 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) may need to be revised.

RESTRUCTURING THE RESIDUAL DEBT

Once the quantum of the resized debt has been agreed, the terms that apply to the remaining debt may need to be amended. Revised terms will reflect the equity package offered to the lenders, and borrowers should consider the following issues:

- **Fees and pricing**: What is the price of doing the deal? The lenders are likely to charge a restructuring/refinancing fee as part of the overall package. They may also require an increase to the interest rate margin.
- **Guarantees and security**: The lenders may require additional guarantees or security, particularly where the finance documents are being heavily amended.
- **Existing shareholder investment**: Will the existing shareholder also be required

Feature

Biog box

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to invest further capital? This may be applied to pay down part of the debt or be required to implement the turnaround plan.

- **Amendments to covenants and undertakings:** It is likely that the financial covenants and other undertakings will need to be reset to align with the new level of debt and the projected performance of the company. Lenders may require additional rights in the facilities agreement, depending on the levels of control afforded to them in the equity structure. Other changes may be required to update the finance documents to reflect current market positions.

Borrowers should consider what protections they need in light of the current and projected position of the company over the medium term. Initially they should ensure that a waiver or standstill agreement is entered into to give breathing space whilst the debt for equity swap is being negotiated (this would prevent the lenders from accelerating the facilities and taking enforcement action). This is particularly important from the directors' perspective, as the directors will inevitably be judged with the benefit of hindsight if the debt for equity swap is not agreed and the lenders' support falls away. Beyond this, the borrower should also consider what amendments it requires to make the banking documents workable going forward in light of the turnaround plan (for example, any asset disposals or changes to the business that are planned) as well as securing any necessary financial covenant holidays and rescheduling repayments to align with projected cash flow forecasts.

Amendments may also be required to the financial covenants to take account of the revised capital structure. Particular consideration should be given to the accounting treatment of the new equity – for example, if redeemable preference shares are issued, they may be treated as debt rather than equity for accounting purposes which would impact on any cash cover, interest cover or leverage covenants.

CONSENT REQUIREMENTS

A debt for equity swap will undoubtedly require a number of consents from various stakeholders. Under the finance documents, unanimous senior lender consent will likely be required, as the transaction could result in a change of control triggering mandatory prepayment provisions and is also likely to breach key negative undertakings. To the extent that any shareholder or other subordinated debt is also being amended or converted to equity, consent from those debt providers will also be required. As explained above, consents may be required in the context of the creation and issue of the new equity.

If the business is regulated, regulatory consent may also be necessary. Key contracts should be reviewed to ensure that the debt for equity swap would not trigger any change of control provisions under those contracts, and if they do, consent from the relevant counterparties should be sought.

TAX CONSIDERATIONS

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. ■

1 'Supporting economic recovery: recapitalising businesses post Covid-19', published 16 July 2020 by *TheCityUK*.

2 *Private Equity: A Transactional Analysis* (Fourth edition, 2020), published by Globe Law and Business 'Private equity restructuring' (p 277-306).

3 Section 901A(2) of the Companies Act 2006.

Further Reading:

- How will direct lenders manage distressed credits? (2020) 6 JIBFL 384.
- Business as "usual": how leveraged borrowers can seek a stable platform for negotiations in stressed credit scenarios (2017) 7 JIBFL 422.
- LexisPSL: Banking & Finance: Practice Note: Debt for equity swaps.