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Distressed Mergers & Acquisitions

Credit Crisis Enables Bold Strikes by Investors

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The credit crisis has notably impacted certain sectors, such as home building, monolines and subprime mortgage servicers. What is less recognized, but perhaps more significant, is that the credit crisis is creating vulnerabilities in many companies that may be exploited by distressed investors. Clear evidence of the evolution of the "new and improved" hostile takeover orchestrated by leading members of the distressed investing community can be found in the increasingly steady stream of headlines announcing the assertion of an event of default by debt holders or the assertion that bondholders are "special" or different[1] despite substantial caselaw limiting debtholders to their contractual rights.[2] Assuming that realized financial distress is the predicate for this activity grossly understates the scope of potentially targeted companies. Rather, the overall characteristics of the capital structure may be the most significant factor contributing to a distressed investor's interest in a particular target company. Failing to anticipate the impact of the credit crisis and the reaction of the well-advised, well-funded distressed investing community may yield a series of value-destructive events, including an unwanted takeover, a very expensive waiver, or even an unnecessary chapter 11 case for the unprepared and unwary company. Refinancing—the usual antidote for difficult debt holders—may not be available in sufficient time or amount. Similarly, proposed asset divestitures may not be realized due to buyer difficulties in borrowing money. In the current financial climate, management of companies with leverage ratios in excess of current market levels must be prepared to confront distressed investors who may hold substantial positions in their capital structure.

Basics about the Distressed Investor Community. The distressed investing community is well funded with billions of dollars at its disposal. Equally important, most distressed investors are smart, well advised, nimble and organized, and rely heavily on a robust secondary market for bank as well as bond debt. Often, distressed investors thrive in a realm where hedge funds overlap with private equity funds, serving as a hybrid of the two. They tend to retain the event-driven behavior model as well as the trading and liquidity aspects of a hedge fund. Yet, like their private equity counterparts, they have the ability to take over and operate a major enterprise for a term of years. Often working together as a self-proclaimed "Ad Hoc Committee," distressed investors are served by a number of nationally recognized investment banks and a handful of national debt rating and reporting services, as well as a tight-knit community of brokers who solicit interest in the debt securities of multiple companies.

Getting on the Radar Screen. Typically, the distressed investor's interest in a company is motivated by the market's perception of an upcoming event, such as a default, maturity or a need for consent to a strategic move by the company in question. The investment banks and debt rating and reporting services identify "stressed" and "distressed" companies. Such designations are not simply a reflection of a particular credit rating, although a downgrade would certainly be one of the frequently cited criteria. Financial metrics such as yield-to-maturity and credit default swap pricing also play significant roles in determining if a company is "stressed" or "distressed," as do leverage levels above the current market standards, litigation—particularly shareholder derivative actions—and customer or industry-related problems. In addition, financial reporting restate-

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ments, pension-funding waivers, asset dispositions and debt reduction programs are key magnets for the distressed investing community. Many distressed investors rely on sophisticated investment banks to provide them with real-time information on the occurrence or prediction of such events in the marketplace. If a company has attracted enough interest there will likely be an organizing call hosted by an investment bank about the "stressed" or "distressed" company in which there is an effort to organize a position and, thereafter, select attorneys. The professionals will look to the company, rather than their clients, to pay their fees, leaving the distressed investor with a well-advised, cost-effective position in a company that is already recognized as vulnerable. Even if the label is wrong, it may not matter. News of that label travels fast.

Oft Used Tactics: The bad news is that the company has attracted the distressed investing community, but the good news is that the investors are interested because they see value. Unlike their colleagues operating in equity markets, debt investors are subject to minimal disclosure requirements regarding the accumulation of debt positions. Consequently, distressed investors avoid disclosing their presence until they are organized, hold targeted debt percentages, and the company has little time left for alternatives. They rarely declare their intentions prior to assembling a significant position in a company's debt structure. For distressed investors, accumulating debt positions means reaching key thresholds, such as holding at least 25 percent of a bond issue, which allows a distressed investor to accelerate and direct an indenture trustee to notice a default, or acquiring 33 percent or more of overall bond debt, which may allow the investor to block a chapter 11 plan. While critical threshold positions in bank debt are typically deal specific, in publicly reporting companies distressed investors have access to the information needed to gain strategic control of various parts of the capital structure.

Given the resources available to the distressed investing community, it should be assumed that the distressed investor has thoroughly studied a company and its capital structure, identifying every maturity, every potential default and associated grace period and every cross default. For instance, is it the assertion of a default that causes a cross default or does it require acceleration? Is there a materiality threshold for a cross-default? Are the same distressed investors that are asserting a bond default also holding a position in the bank debt and urging that group to act on a cross-default? Secured debt provides for even more compelling tactics if distressed investors can freeze or otherwise interfere with the company's cash assets directly or indirectly by attacking the company's global structure through enforcing pledges of the shares of its offshore entities. Fortunately, prior to utilizing many of the tactics available to it, the distressed investor often reaches out to management and thereafter the board of directors. If these negotiations fail to produce the intended results, the distressed investor then utilizes one or more of the tactics discussed above, essentially resulting in the public announcement of the company's weakness. Even if the distressed investors are misinformed, they will persist. They are well acquainted with the fiduciary duty of directors in the so-called "zone of insolvency" and entirely familiar, if not comfortable, with chapter 11.

Facing Distressed Investor

Be Prepared. The company should be prepared to deal with the distressed investor, regardless of how misinformed the distressed investor may be in its perception of the company's financial distress. Management has to know at least as much and hopefully more about the company than the distressed investors accumulating positions in the company's debt (and likely shorting the company's stock), notably maturities, covenant compliance and anticipated compliance for the foreseeable future, cross defaults, upcoming events, including changes in the law that impact the company's financial and operating position— such as changes in the pension arena or accounting standards which may arguably cause concern about covenant compliance, timely reporting or otherwise raise waiver or consent issues. Management should have readily available (a) a complete and detailed description of the company's capital structure, including familiarity with any securitizations and credit card or vendor finance programs, (b) a recent and realistic assessment of where the company stands in terms of refinancing, including how the company compares to its competitors in terms of leverage levels and ease of obtaining finance, including knowing what recent deals in the relevant market its lead banks have completed and how much of that debt they have retained, (c) working knowledge of the various pressure points in the company's debt documents (i.e., restrictions on the use of sales proceeds absent debtholder consent, or the impact of uncontrollable external events, such as a strike, natural disaster, explosion in currency or other costs of materials on a company's borrowing base) and (d) an understanding of the company's cash management system, its requirements for daylight and overnight credit and its need, if applicable, for international accommodations and movements of cash. Monitoring movements in the holders of the company's bank debt or noting any major trades in its bonds (or major movements in the prices of either) is also recommended. Management should assume that there is little, if any, distinction between the bank syndication market and the distressed investing market. The players are the same. A realistic assessment of the company's relationship with its lead banks and auditors may also be critical. For instance, if there is an incorrect assertion of an event of default under a bond indenture, how will the lead banks and their counsel weigh in and how will the auditors react in terms of reclassifying debt?

It never hurts to listen. The distressed investing community is well advised and often smart. Though counter to traditional views of dealing with parties whose rights are defined by contract, management should consider that it rarely hurts to listen to what they have to say. Ignoring the distressed investor rarely prompts them to leave.[3] To the extent that the distressed investors want to retain their ability to trade in the company's securities and thus only want publicly available information, the distressed investors may even be at a disadvantage in a dialogue. Moreover, in creating the environment for a productive conversation, management may be able to find out who the distressed investors are, how much debt they hold and what they want. Ongoing dialogue may also provide the time to develop a realistic defense plan.

Don't pick a fight that the company can't afford to lose. The chapter 11 rosters are full of companies that chose to fight instead of negotiate. Assessing the accuracy of the asserted default is often secondary to assessing whether the company can survive the fight and the consequences of losing, including:

- fully addressing cross defaults, consequent liquidity limitations, and the impact on financial reporting, such as acceleration of long term debt;
- identifying, to the extent that the distressed investors have a position which is secured by the company's assets, the vulnerabilities arising from the enforcement of liens and pledges,[4] or freezing collateral accounts;[5]
- accurately projecting the size and duration of its uninterrupted access to working capital, including the specific steps to assure continuing liquidity (and, if applicable, any daylight or overnight credit);[6] and
- candidly apprising the board of directors about the distressed investor demands and management's proposed response, as well as analyses of (i) the various options that are realistically available to the company and (ii) the board's responsibilities.

Vigilance respecting potential "events" is critical. A default may come from unexpected sources, like the maturity of a small bilateral credit line or a demand on a demand line, which then crosses into major parts of the capital structure.[7]

Contingency Planning. While the asserted "event" may be something that a strong company withstands, for a "stressed" company it can be debilitating. The company should have a contingency plan with realistic time frame, scope and cost parameters. Contingency plans could involve capital market solutions such as exchange offers, refinancing, or even involve countervailing investors. Ensuring the company has the time necessary to prepare and execute the steps needed to ensure the contingency plan's success is critical. Contingency plans may be expensive and require significant cash outlays to pay for underwriting or lending commitment fees. Despite the costs, certainty has benefits in preserving the company's options and avoiding the greater costs of a default, liquidity crisis or chapter 11. Similarly, determining whether and how to involve a "white knight" or alternate investor or purchaser of all or a portion of the company is a critical inquiry, especially in a time-compressed environment. Finally, the ultimate contingency plan (and hopefully the contingency plan of last resort) is an organized, well-planned chapter 11 case that may provide the time and financing necessary to accurately explore the company's options and true value.

The credit crisis mandates that management react responsibly and prepare to meet this agressive new challenge.

1. In the much-watched litigation surrounding the BCE takeover, the Supreme Court of Canada unanimously determined that a board does not have to consider the interests of bondholders, in addition to equity holders, when analyzing potential takeover offers. See *BCE Inc., et al. v. A Group of 1976 Debentureholders, et al.* and *6796508 Canada Inc. v. A Group of 1976 Debentureholders, et al.*, [June 20, 2008] No. 32647 (Can.).

2. See, e.g. *Angelo, Gordon & Co., LP v. Allied Riser Commc'ns Corp.*, 805 A.2d 221, 231 (Del. Ch. 2002); *Metropolitan Life Ins. Co. v. RJR Nabisco Inc.*, 906 F.2d 884, 889-90 (2d Cir. 1990).

3. See "Majority of Holders of Metaldyne 11 Percent Senior Subordinated Notes Due 2012 Announce Execution of Lockup Agreement," BusinessWire Oct. 13, 2006; (Activist bondholders asserted that a proposed merger violated the bond indenture. After the merger announcement, bondholders collected $45 million in consent fees.); "Majority of Holders of Metaldyne 10 Percent Senior Notes Due 2013 Announce Execution of Lockup Agreement," BusinessWire Nov. 3, 2006 (same).

4. If there are subsidiary share pledges, the analysis must address how and when the pledges can be enforced or the associated voting rights asserted.

5. Calpine was in chapter 11 less than a month after losing a fight with its bondholders who had directed their collateral agent to freeze a cash account. See http://www.bloomberg.com/apps/news?pid=10000103&sid=aiuIPNkiCT9M&refer=news_index%252020dec2005.

6. An asserted default may impact other credit arrangements, such as revolving lenders' reliance on an MAC clause or the absence of a commitment to continue to provide daylight or overnight credit.

7. See *In re Quebecor World (USA) Inc.*, No. 08-10152 (JMP) (Bankr. SDNY Jan. 22, 2008) (Docket No. 16).