

Debt-for-equity swaps

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1. Introduction

The principal element of any debt-for-equity swap is a restructuring of the balance sheet of a corporate debtor so that the relevant participating creditors (often, only financial creditors) receive equity interests in a reorganised capital structure in consideration for reducing their debt claims against the company. In its simplest form, it may be a route by which a company can avoid an imminent or prospective insolvent liquidation caused by prolonged negative cash flows and/or balance-sheet solvency issues. In either case this may be due to the company's inability to service a relatively high level of debt, a situation which may have arisen because of the debtor's poor operational and financial performance. Alternatively, such conversions have been used opportunistically by creditors that purposefully acquire sub-performing debt for the sole intention of gaining corporate control of a debtor (a so-called 'loan to own' strategy).

From a debtor's corporate perspective, such balance-sheet restructurings can have a significantly positive impact by enabling it to continue to trade and compete more effectively on the basis of a significantly reduced debt burden. A debt-for-equity swap may be the stimulus for effecting a corporate and/or operational restructuring which may provide further benefits for the restructured debtor and its stakeholders. While the time and resources invested in a formal procedure-based debt-for-equity restructuring can be considerable, the resulting benefits can create a valuable business in the medium to longer term for the resultant equity holders. The traditional alternative for 'over-indebted' debtors is to cease trading and accept an inevitable full insolvency procedure, which might take the form of a liquidation or the enforcement of security by secured creditors. That alternative may realise some value for certain creditors, but often destroys an opportunity to rescue a business and so create further appreciation value in the longer term.

In the UK lending market, by the early 1990s many bank lenders had become more willing to continue to fund stressed borrowers rather than pursue enforcement strategies if they were given an opportunity to increase their returns on a turnaround of the borrower by receiving equity or equity-like rights (usually in the form of convertible warrants or via synthetic instruments). Consequently, when economic conditions deteriorated across a number of sectors in the early years of this century and lenders were presented with numerous borrowers whose balance sheets required a reduction in debt, many lenders already understood the practical implications of holding equity in such enterprises. This created an environment in which lenders

were reasonably receptive to the reality of needing to write down debt for an equity stake in borrowers' groups as the only alternative to insolvency. A simultaneous catalyst to this trend was provided by an increasingly liquid secondary market in the expanding European leverage loan and high-yield bond markets. Many secondary creditors had purchased debt exposures at deeply discounted prices and so could profitably afford to accept substantial write-offs on the ostensible face value of that debt, while gaining an opportunity to acquire substantial equity-like returns in restructured debtor companies.

Certain other markets have been less receptive to lenders taking actual or quasi-shareholder roles due to the doctrine of equitable subordination, whereby on any subsequent insolvency lenders' debt claims may be regarded as a loan by a shareholder which should be accorded treatment as equity and are thus repayable only once all debts to 'true' creditors are discharged.

There are a number of common factors to be addressed with any debt-to-equity swap. This chapter seeks to focus on these factors and how they are typically addressed by debtors, the converting creditors and other stakeholders. In particular, they include whether:

- the swap can be effected on a purely consensual contractual basis;
- a statutory cram-down mechanism needs to be utilised so that the will of a majority or super-majority of relevant creditors can bind a dissenting creditor minority; and
- a formal enforcement needs to occur to enable a class of creditors to gain equity control.

The key elements in any debt-to-equity swap may be categorised as follows:

- agreeing the basis for, and ascertaining, the valuation of the debtor's group;
- assessing how much debt (and of what classes) must be converted to equity;
- agreeing the type and terms of equity or quasi-equity that should be issued to the converting creditors;
- quantifying the allocation of the final equity value between converting creditors, existing equity holders and any other relevant stakeholders; and
- choosing a suitable mechanism that delivers the necessary debt-to-equity conversion in view of the respective rights of relevant stakeholders, tax considerations and the jurisdiction of the debtor.

2. **Impetus for debt-to-equity swaps**

The board of directors, being the executive representation of a company, should in theory be the first constituency to identify the need to restructure the company's balance sheet. In reality, it may be the company's financial advisers that identify a likely need for such a financial restructuring, and they may need to convince the board that such a restructuring should be pursued. It may be less fortunate for the debtor's board if the need is credibly suggested by a disgruntled creditor group once the pricing of the debt or other indicia trigger market interest in what may be a debtor in incipient distress. As with any other form of restructuring, such a need can arise unexpectedly – for example, when a sector suffers a crisis of investor confidence

with lenders and purchasers of debt securities becoming unwilling to refinance companies. Equally, a business that has pursued an aggressive expansive phase, incurring relatively high levels of debt, may find that on a sudden slowing in the pace of expansion or indeed a contraction of its market, it struggles to service that debt burden.

Very often, the difficulty in servicing such debt is due to the underperforming nature of the business, which may focus the board of a company on undertaking an operational restructuring. If a limited operational restructuring fails to yield the necessary free cash flow available to service – and indeed discharge – excess debt, the company may consider making a proposal to its financial creditors. However, where directors have been incentivised either directly by receiving equity or by reference to its value, there may be some reluctance to initiate a process that will ultimately result in such apparent value being greatly diluted or obliterated completely. The unenviable reality for directors in such a position is that the longer the process is forestalled, the fewer options are available for the debtor and the less control they may personally have in the outcome of the process.

The wealth of financial information now available to trade creditors and credit insurers means that these stakeholders may be a further constituency that applies pressure to the cash flow of a company by altering their terms of business due to a perceived deterioration in creditworthiness. In some instances these creditor groups may unintentionally be the catalyst for a restructuring that ultimately results in a debt-to-equity conversion.

3. **Recent European backdrop**

For a number of years, a key feature of the European debt markets has been the relative ease with which private equity sponsors have obtained large amounts of keenly priced leverage finance. In certain cases this debt was provided on the basis of apparently continuously improving businesses set against a benign economic backdrop. This enabled strong sponsors to obtain relatively high multiples of financial debt to the earnings of their acquired groups. Simultaneously, such sponsors could reduce the level of equity capital they injected into such structures. As a result of the magnifying effects of such leverage on equity returns, any financial underperformance by such debtor groups means that the shareholder sponsors quickly find their equity holdings to be rendered out of the money. Lenders may expect such private equity sponsors to inject promptly more capital into such structures or risk losing their investments entirely to the lenders (ie, where value breaks well into the debt capital). Where sponsors benefit from ‘covenant-lite’ terms in their finance documents, they may have more time in which to seek to turn around ailing businesses before having to decide whether to inject additional equity or otherwise cede control to the lenders. In the United Kingdom, trustees of defined benefit pension schemes in funding deficit now play a much more active role in restructuring negotiations and, under the watchful eye of the Pensions Regulator, are expected to negotiate robustly in any debt-for-equity swap. Such trustees will typically seek enhanced payment schedules to accelerate elimination of such deficits and equity in the restructured company.

4. Valuation

A significant issue in any balance-sheet restructuring is the basis for determining the value of the business. This determines how much debt it is likely to support, which financial creditor groups are in/out of the money and, crucially, the debt tranche in which the value breaks (ie, the creditor group/class that will suffer a partial loss on a formal insolvency). Creditors in that debt tranche will be the constituency expecting to receive the largest portion of equity in the restructuring. This constitutes one of the fundamental elements underpinning, and yet the most contentious issue challenging, any debt-for-equity swap. The intense debate and litigation on this issue in the European arena are addressed elsewhere in this book.

Examples of debt-to-equity conversions undertaken during last significant period of European debt restructurings

Company	Sector/ country(ies) or region	Equity acquired by existing creditors	Equity retained by existing shareholders	Key deal term
Marconi (2002)	Telecoms/ electronics UK	99.5%	0.5%	This was the first restructuring to rank bank lenders and bondholders in a single class of creditor. Bondholders and bank lenders exchanged approximately £4 billion of debt for 99.5% of the ordinary equity in Marconi. Existing shareholders received warrants giving them the right to buy an additional 5% of the firm, when Marconi's market capitalisation had risen to £1.5 billion.

Company	Sector/ country(ies) or region	Equity acquired by existing creditors	Equity retained by existing shareholders	Key deal term
Jazztel (2002)	Telecoms operations Spain and Portugal	88%	12%	Exchanged €676 million of its high-yield bonds for 88% of Jazztel's equity and new €75 million 12% convertible bonds due 2012.
NTL (2002)	Cable TV operator UK and Europe	100% – UK 86% – Europe	0% – UK 14% – Europe	Bondholders owed \$10.6 billion received 100% of the initial equity of NTL and approximately 86% of the initial equity of NTL Europe Inc.
Netia (2002)	Alternative fixed-line telecoms operator Poland	91%	9%	\$850 million in defaulted bonds equity stake in the company. Existing shareholders swapped for a 91% issued warrant package.
British Energy (2003)	Nuclear power UK	97.5%	2.5%	Bondholders and bank creditors exchanged £1.3 billion of debt for £425 million of new bonds and 97.5% of equity; 2.5% of equity and 5% warrants reserved for shareholders, depending on structure required.
Telewest (2003)	Telecoms/ cable UK	98.5%	1.5%	Bondholders exchanged £3.8 billion of debt for 98.5% of ordinary equity in Telewest.

Company	Sector/ country(ies) or region	Equity acquired by existing creditors	Equity retained by existing shareholders	Key deal term
Jarvis (2005)	Construction/ infrastructure projects principally UK	95%	4.75% equity 0.25% warrant holders	£350 million of debt exchanged for 95% of company's new ordinary shares. Placement of new equity, qualifying holders of old equity entitled to subscribe.
Concordia (2005)	Bus company Scandinavia	97.5%	2.5%	Holder of Concordia's €160 million 11% senior subordinated notes exchanged their debt for 97.5% of the equity in Concordia.
Schefenacker (2007)	Automotive parts manufacture	Second-lien lenders – 69.6% Subordinated bondholders – 5%	25.4% (noting the existing shareholder injected a further €20 million under a new mezzanine facility agreement)	Under a creditors voluntary arrangement, €200 million of senior subordinate bond debt was exchanged for: <ul style="list-style-type: none"> • equity representing 5% in the recapitalised company; • a €7.5 million cash payment; and • warrants to subscribe for a further 10% of ordinary equity, exercisable on further equity value thresholds.

5. Competing aims

5.1 Company's aims

As noted above, a traditional corporate borrower/issuer with private shareholdings may initially seek to forestall a balance-sheet restructuring while it reconsiders its business model and other options to the alternative of yielding control to its financial creditors. For a number of years before mid-2007, such a delay could be achieved simply by refinancing with another creditor group. In the absence of a suitable refinancing proposal, debt may be reduced from the proceeds of new equity infusions. However, many shareholders prefer to see such injections being used within the debtor's business rather than for the direct benefit of financial creditors. In the absence of a refinancing or a further equity injection, the equitisation of debt may be the only realistic alternative for a company in order to restructure its balance sheet. A company's management team may seek to negotiate some equity for themselves if they retain the support of the converting creditors so that they can share in any eventual value appreciation after the restructuring. If a company is cash-flow negative, then over time the directors may become concerned about wrongful trading-type liabilities in the event that the company were eventually to enter insolvent liquidation.¹ This is amplified in certain civil law jurisdictions such as Germany, where criminal liability² may arise for directors if they continue to permit a company to trade when either balance-sheet or cash-flow insolvent.³

5.2 Creditors' aims

The degree of jaundice with which a creditor may view a debtor group in need of a balance-sheet restructuring will largely depend on whether the creditor acquired the debt at par or at distressed prices. While traditional-par creditors may be relieved eventually to realise a par return on their exposure, distressed debt investors will be more likely to seek to engineer an opportunity to restructure the company so as to create returns well above their investment costs. This aim may be met by extinguishing the current shareholders' interests, eliminating the debt interests of more out-of-the-money 'junior' creditors and securing equity interests for themselves which may ultimately result in returns far higher than could ever be realised from a debt investment. In recent years many distressed credit opportunity funds have been founded which specifically target companies susceptible to debt-to-equity conversion. Such 'loan-to-own' strategists identify overleveraged debtor groups, particularly in jurisdictions where a cram-down procedure can be utilised to bind other out of the money and/or fulcrum creditors in conjunction with the relevant inter-creditor documentation.

1 See Section 214 of the Insolvency Act 1986.

2 Under Section 84 of the Limited Liabilities Companies Act 2006, directors of limited liability companies may be criminally liable and punished by up to three years' imprisonment or a fine for failures under § 64 I (below).

3 Section 64 I of the Limited Liabilities Companies Act 2006 imposes the duty on directors of limited liability companies to file for insolvency without undue delay, and in any event no later than three weeks, after the date on which they become aware of the over-indebtedness or illiquidity.