MERGERS AND ACQUISITIONS WEBINAR SERIES

Session One:
Sales of Private Credit Lender Collateral

Sales of Private Credit Lender Collateral

- Quick overview of terms/strategies
  - To Third Party
    - Traditional asset purchase agreement ("APA")
      - Agreement to release liens; receipt of seller notes, earnouts
    - Note Sale
    - Strict foreclosure and simultaneous sale to third party via APA
  - To existing lender only
    - Debt to equity conversion
    - Strict foreclosure – Article 9
  - Optionality
    - Credit Bid
      - Chapter 11/363 sale
      - Article 9 (partial satisfaction)
- What's the Goal?
  - Does the lender want to acquire the business?
    - Loan-to-own strategy
      - Third party purchase of secured facilities followed by one of these techniques
    - "Reluctant" owner
      - Typically, when the owner can't or won't support the company any longer
  - Does the lender want to maximize recovery but "wash its hands" of the borrower?
- Sale marketing process
  - Required or not? Benefits?
  - Market test

    - “Commercially reasonable” standard – is there one?
- Which method is best for the seller/lender – why one versus another?
    - Public/private sale considerations
- Which method is best for the buyer
    - Successor liability
        - “Is this even real?”
    - Fraudulent conveyance risk
- Techniques
    - Is the sponsor/owner cooperating or not?
        - Dealing with other stakeholders in the capital stack
        - Shedding other liabilities
    - Consent
        - Trends in tips & releases to equity
        - Unanimous versus Required Lenders to direct collateral agent
    - Who (which lender) credit bids and why?
        - Pro-rata or not? Ability/reasons to “leave behind” participants
    - Proxies/Board flip
        - Mechanism to acquire collateral
        - Advance notice provisions
            - Does it matter?
    - Acquisition vehicle considerations
        - Governance of acquisition vehicle
            - Board composition
            - Minority equity protections
        - NewCo financing
            - Have to offer to everyone?

            - Takeback/rollover debt versus new issuance
        - Does the credit agreement address? What if the credit agreement is silent?
- Public versus private borrower considerations
    - Does it matter?
- What to do with the Oldco entity after asset sale?

Proskauer

Trends in Private Credit Restructuring: Out of Court "Change of Control" Transactions

December 4, 2023

Restructurings defy a one-size fits all approach because every deal is unique and different tools are required to solve different problems. At one end of the restructuring continuum is the so-called "amend and extend," where the credit agreement is amended to provide incremental liquidity, extend near-term maturities, modify covenants or some combination of the foregoing. This approach is fast and cost-efficient, but limited in its impact. At the other end of the spectrum is a restructuring through chapter 11. Bankruptcy is expensive, time-consuming and introduces significant legal, financial and operational uncertainty. In the middle of these scenarios are debt for equity transactions that can be implemented out of court through different legal structures. A company facing declining revenue, increasing costs, liquidity constraints and significant debt service obligations may have a viable restructuring path by working with its lenders to raise additional capital to bridge its liquidity needs and to eliminate funded debt from its balance sheet. Such businesses — those suffering from a broken balance sheets but with a viable business model — may be a candidate for an out of court change of control transaction. While this type of transaction can fix a broken balance sheet more quickly and cost effectively than chapter 11, it will not fix a broken business.

There are at least seven factors that drive the success of an out of court change of control transaction involving a debt-for-equity swap between a distressed borrower and its first lien secured lenders.

1. **Consent.** Out of court change of control transactions are *generally* a consensual path between borrower and lender.[1] Borrower consent and cooperation are critical features of an out of court change of control transaction. A borrower owned by a private equity sponsor might be willing to consent to change of control transaction when, for example, the borrower is facing a liquidity crisis and its existing equity sponsor is no longer willing to invest additional capital and sees no path to recover on account of its existing equity stake. In these circumstances, it is far easier to achieve consensus with a borrower that is majority owned by a

private equity sponsor as compared to a public company with a widely held shareholder base. That said, recent amendments to Delaware law have made it easier to consummate change of control transactions without seeking shareholder approval. Lender consent is preferred because the conversion of debt to equity triggers a “sacred right” in nearly all loan agreements and requires the consent of every affected lender. It is far easier to achieve consensus in a private credit club deal where consensus is forged among a group of like-minded investors as compared to a more disparate group of lenders in a broadly syndicated facility. The consent of all lenders is “preferred,” but it is not required. In the absence of 100% consent, the “required lenders” (usually 50.1%) can direct the collateral agent to exercise remedies to consummate an out of court change of control using the strict foreclosure remedy under Article 9 of the Uniform Commercial Code.

2. **Scope of Problem: Debt v. Operations.** A debt for equity change of control transaction can effectively de-lever a balance sheet, but it will not — without more — fix a company’s operational problems. For example, a debt for equity transaction will not help a “brick and mortar” business improve the operating performance of a retailer with a sprawling geographic footprint that needs to exit unprofitable store locations (e.g., WeWork). In that example, the business likely needs the “contract rejection power” in the bankruptcy toolbox to fix the operational problem. Thus, an out of court change of control transaction is best suited for fundamentally sound companies that have an excessive debt relative to earnings capacity.

3. **Existence of Legacy Liabilities.** A debt for equity transaction is equally ineffective at addressing the needs of companies suffering from so-called “legacy liabilities,” such as a significant money judgment, underfunded pension plans or arcane collective bargaining arrangements. Swapping first lien debt for equity will not address legacy liabilities, which can only be addressed with consent or in a chapter 11 bankruptcy with a “free and clear” sale under Section 363 or a discharge under a chapter 11 plan.

4. **Limited Change of Control Consequences.** An out of court change of control transaction must navigate change of control implications in key contracts or in highly regulated industries like healthcare, communications and gaming, where state or federal regulators have the right to approve a change of control of the business. Again, the change of control may still be possible, but execution is more challenging to manage.

5. **Managing Elevated Risk Profile.** Most debt-to-equity transactions result in a lender-owned acquisition vehicle that carries some amount of “take back” debt, i.e., term loans representing some portion of the amount formerly owed by the

original borrower. As a result, the lenders will be the equity owners and primary lenders to the newly formed acquisition vehicle. Of course, the lenders will also control the appointment of a new board. There is no per se rule prohibiting lenders from acting in multiple capacities (e.g., shareholder, lender and even director), but this scenario creates an increased risk profile. If the underlying business fails to succeed, and the company subsequently files bankruptcy, the lender will be viewed as a statutory "insider." As an insider, there will be (i) enhanced scrutiny for all insider transactions; (ii) a more lenient standard for equitable subordination (compared to a non-insider); and (iii) an extended avoidance period of one year for any payments received from the business. In addition, insider votes are excluded for determining class acceptance under a plan of reorganization. There are also other risks to consider, including claims for successor liability and fraudulent transfer. In most cases, these risks can be managed and are not an obstacle for consummating an out of court or in court restructuring, but they are factors to be aware of when formulating the initial change of control transaction.

6. **Aligning Employment Incentives.** The restructured company must be positioned in a manner to retain talented management teams (or attract new talent) to maximize value. Unfortunately, there may be very few incentives in place at the time of a negotiated restructuring to retain and motivate management. The outstanding equity incentives may have little to no value and existing performance goals are unlikely to be met. Further, the transaction may trigger change in control payments and severance rights in existing management contracts that could encourage executive departures. Accordingly, lenders engaging in debt for equity transactions must negotiate with management to recalibrate and restructure equity awards, bonuses and change in control payments. These new incentives should be tailored to the company's particular financial circumstances and designed to balance the goals of encouraging profitability, avoiding liquidity drain and providing management with market compensation. The substitution, design and implementation of these incentives should be done with careful consideration of the tax, employment and securities law effects and limitations on the changes made to the company's previous incentive plans, if any.

7. **Tax Efficient Structuring.** The success of an out of court transaction may depend on whether tax risks can be successfully neutralized in a tax efficient structure. In general, out of court change of control transactions are taxed like any other acquisition transaction — which is to say, the tax consequences will depend on (i) whether the change of control is structured as an equity or asset purchase and (ii) the amount of debt relieved, either directly or by use as "currency" to acquire assets or equity. The most common tax considerations in

an out of court change of control transaction are (i) legacy tax liabilities of the borrower group and transfer taxes (which cannot be avoided outside a Section 363 or chapter 11 plan), (ii) cancellation of debt income (CODI) and other tax consequences to the borrower group and its legacy equityholders resulting from the transaction; (iii) timing of taxable gains or losses as a result of the change of control for all parties, (iv) taxation of the business going forward and (v) structuring the capital stack of the post-change of control borrower group. Note that in most out of court change of control transactions, the U.S. federal tax attributes of the borrower will either be eliminated or subject to significant limitations, and in rare circumstances, the value of those tax attributes will be so large and important to the business going forward that a so-called "G" reorganization (which can only be done pursuant to an in-court bankruptcy process) may need to be carefully considered.

In summary, out of court change of control transactions are an effective means to restructure a distressed company. That said, it's not the right tool for every situation and, in order to be effective, care must be taken to address the potential risks inherent in these transactions.

[1] There are paths for non-consensual change of control transactions where discussions between the lenders and borrower reach impasse. Those transactions, which often involve exercising the voting proxy in a stock pledge or foreclosure sales, involve a higher degree of complexity, costs and execution risk.

Related Professionals

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Proskauer

Private Credit Restructuring: Strict Foreclosure Spotlight

April 15, 2025

Chapter 11 is expensive and not always the right tool, particularly for a restructuring of a company with a broken balance sheet, as compared to a business with a broken business model. We have seen a significant uptick in out-of-court activity and clients frequently ask us about foreclosure options. In this post, we highlight a page in the foreclosure playbook — strict foreclosure — and discuss its advantages and challenges.

Strict Foreclosure

Strict foreclosure is a secured creditor's post-default remedy. In its simplest form, strict foreclosure swaps debt forgiveness for collateral ownership. Strict foreclosure is sometimes called "friendly foreclosure," because it typically requires the consent (or, in some instances, non-objection) from the borrower, guarantors and any other creditors with liens on the subject collateral. Strict foreclosure is a state law remedy under Section 9-620 of the Uniform Commercial Code ("UCC") and does not require any judicial process or public notice. If executed correctly, it's entirely out of court. This means there is another added benefit — it's private.

As a threshold matter, the speed and efficacy of strict foreclosure depends on whether the lender is foreclosing on assets of an operating company or equity held by a holding company. Let's use a simple hypothetical to highlight the differences. Assume the following facts:

- A lender ("Lender") made a $100 million loan to an operating business ("Borrower"), which is secured by a first-priority security interest on substantially all of the Borrower's assets ("Assets").
- The loan is guaranteed by the Borrower's parent ("Parent"), which is secured by a pledge of the Parent's equity in Borrower ("Equity").
- There is no other secured debt, and the loan is in default.
- The Borrower needs incremental liquidity, which Parent will not fund. Borrower and Parent have exhausted efforts to refinance the debt or find a strategic or financial

buyer to acquire the business.

- The Borrower's business plan is viable <u>if</u> it can reduce its outstanding debt.

Based on this fact pattern, the Lender has two potential paths for strict foreclosure — it can foreclose on the Equity (owned by the Parent) or the Assets (owned by the Borrower). In either scenario, the Lender (or more technically, the collateral agent) would form a wholly owned acquisition vehicle ("<u>NewCo</u>") to either own the Equity or the Assets.

Equity-Level Strict Foreclosure

Strict foreclosure on the Equity (pledged by Parent to secure its guarantee) is faster, easier, and less complex than a strict foreclosure of the Assets (pledged by Borrower to secure the loan). That said, an Equity foreclosure is not always the right tool.

Strict foreclosure on the Equity is the preferred path when the Lender is prepared to own the Borrower on an "as is" basis with no restructuring or compromise of any kind of other debts owed the Borrower. However, if the Borrower has material "legacy" unsecured liabilities (i.e., liabilities that are not critical for the go-forward business and which, if not addressed, will impair the ability to execute on the business plan), then an equity foreclosure would not be an effective tool because an equity-level foreclosure does nothing to address the Borrower's other liabilities.

A strict foreclosure on the Equity must also navigate "change of control" implications in key contracts or licenses. For example, if the Borrower operates in a regulated industry (*e.g.*, health care, gaming or broadcasting) or has material contracts with unmanageable consequences for changes in control (*e.g.*, franchise agreements), then an equity-level change of control must comply with applicable contract provisions and other requirements. In other words, the business plan must remain viable after the change of control is consummated.

Because an Equity-level strict foreclosure is the preferred path for a downside scenario, at the outset it is important to consider structuring the loan parties to include at least one intermediate holding company between the private equity sponsor vehicle and the operating business.

Asset-Level Strict Foreclosure

The primary reason to consider a strict foreclosure on the Assets is the existence of material legacy liabilities at the Borrower. An Asset-level strict foreclosure allows the Lender to acquire the Assets with all legacy liabilities remaining with the Borrower ("RemainCo"). While this result may be desirable, an Asset-level strict foreclosure presents an additional set of obstacles to navigate, including, among others, (i) successor liability risk at NewCo, (ii) the risk of an involuntary bankruptcy chapter 7 case filed against RemainCo and the resulting appointment of a chapter 7 trustee to investigate transfers and (iii) fraudulent transfer risk for NewCo if the strict foreclosure was, for example, a lopsided exchange of value.

Additionally, an Asset-level strict foreclosure must address a host of complexities that are avoidable in an Equity-level strict foreclosure (in the absence of change-in-control provisions), including (i) navigating anti-assignment clauses in key contracts, (ii) onboarding employees and establishing of benefit plans at NewCo, (iii) developing a plan to acquire non-Article 9 collateral or any assets that were excluded for the collateral at origination (*e.g.*, fee-owned real estate, commercial leases, rolling stock) important for the operation of the business at NewCo, (iv) establishing new bank accounts, obtaining new insurance and (v) developing a wind-down plan for RemainCo. These challenges are not insurmountable, but they can present difficulties. When these challenges become too difficult to manage, parties will often pivot to a Chapter 11 asset sale under Section 363 of the Bankruptcy Code, which offers a host of tools to eliminate the out-of-court obstacles. For example, in a Section 363 sale, most contractual anti-assignment clauses are unenforceable, a new postpetition loan can pick-up collateral that might have been excluded from the original collateral grant, and fraudulent transfer and successor liability can be eliminated in most jurisdictions.

Required Lender Consent

Strict foreclosure is an exercise of remedies. As a result, it is almost always a "required lender" decision to direct the collateral to take remedies after an event of default. When a strict foreclosure is consummated, lenders will receive a pro rata distribution of NewCo equity to match their pro rata holdings of the loan (and, sometimes, "take back debt" of NewCo). As a result of equitizing the debt, the existing lenders will need to negotiate governance rights, board composition and whether NewCo requires (as is typical) incremental financing (and on what terms).

“Tip and Release”

As noted above, strict foreclosure requires the consent of the borrower and, in the case of a partial strict foreclosure, guarantors. In most cases, the negotiation over borrower consent focuses on two things: an equity “tip” for the sponsor, and a release of liability. There are no established rules of thumb here. While most deals include a release, the form and amount of a tip (if any) varies greatly depending on the facts and circumstances, including (i) the existing relationship between parties, (ii) the degree of distress, (iii) the amount of additional funding required for the business, (iv) the circumstances leading to distress and (v) the business need (if any) for the continued involvement and cooperation of the sponsor. Many deals have tips in the range of 2% to 5%, but others fall outside that range based on the circumstances of the particular matter. Similarly, there are often governance negotiations around the terms of minority equity holder protections, if any, offered to the sponsor.

Mechanics of Strict Foreclosure

The requirements for a strict foreclosure (regardless of whether it is an equity-level or asset-level foreclosure) are set forth in Section 9-620 *et seq.* of the UCC. The key requirement involves a written proposal (which can be electronic) and notice to and acceptance by (or no objection from) certain interested stakeholders. The secured lender must make a written proposal (“Proposal”) to the borrower after an event of default to accept collateral in full or partial satisfaction of the debt. For *partial* satisfaction, the debtor must affirmatively consent. For *full* satisfaction, the borrower must either affirmatively consent or fail to object within 20 days after it’s receipt of the Proposal. The secured lender must also send the Proposal to (x) any creditor with a junior, senior or pari lien on the collateral within a 10-day window before the borrower consents to the Proposal or (y) any other person that has notified the secured lender it has an interest in the collateral. These other secured creditors must either consent or fail to object within 20 days of receipt of the Proposal. Finally, in the case of a partial strict foreclosure, the secured lender must also send the Proposal to any guarantors of the debt. Guarantors must consent or fail to object within 20 days of the receipt of the Proposal.

Conclusion

Strict foreclosure is a powerful tool. It has significant advantages in terms of speed, privacy and cost. Private credit lenders must be adept in using these tools to minimize costs and maximize recovery.

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David M. Hillman is the global co-chair of the Restructuring Group and co-head of the Private Credit Restructuring Group of Proskauer LLP in New York. He has 30 years of experience with an emphasis on representing private credit lenders, private funds, sovereign wealth funds and other alternative lenders and distressed investors in special situations and restructurings, both in and out of court. Mr. Hillman has substantial experience in every phase of restructuring and distressed investing, including credit-bid sales under § 363, debt-for-equity swaps, chapter 11 plans, out-of-court restructurings and foreclosures, as well as navigating intercreditor issues involving liability management transactions the relative rights of majority and minority lenders. He also litigates the issues facing private credit lenders, including issues involving plan confirmation, solvency, valuation, intercreditor disputes, financing and cash-collateral disputes, fraudulent transfers, equitable subordination, recharacterization, breach of fiduciary duty and similar disputes. Mr. Hillman has been recognized as an “Outstanding Restructuring Lawyer” by Turnarounds & Workouts, and has been listed as a “leading individual” in bankruptcy/restructuring by Chambers USA and in New York Super Lawyers as well. An ABI member, he speaks frequently on bankruptcy-related topics, including recent decisions affecting secured creditor rights and preparing creditors for bankruptcy risks. Mr. Hillman received his B.A. cum laude from the State University of New York at Oneonta and his J.D. cum laude from Albany Law School, where he was associate editor of the Albany Law Review.

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