

DEBT IS THE NEW EQUITY: HOW PRIVATE EQUITY FUNDS WILL SPONSOR BUYOUTS THROUGH CHAPTER 11

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In the current distressed economy, private equity funds are having difficulty purchasing companies through traditional leveraged buyouts. One solution to this problem is for a private equity fund to sponsor the chapter 11 plan of reorganization of a highly leveraged (but operationally sound) target company. This discussion describes the process by which a private equity fund can effectively acquire a highly leveraged target company through a sponsored chapter 11 plan transaction structure.

INTRODUCTION

An opportunity currently exists for private equity funds to purchase good but undervalued companies at an attractive price. That opportunity is for private equity funds to sponsor a chapter 11 plan of reorganization. In doing so, the private equity fund can work with the management team of the target company to determine an appropriate post-restructuring balance sheet. Upon emergence from chapter 11, the private equity fund will own the target company with an appropriate capital structure.

This chapter 11 process creates an opportunity for a private equity fund to employ capital and to use the target company balance sheet as leverage to magnify its return when the private equity fund exits the investment. The plan sponsor transaction, which we will describe below, is smack in the middle of the typical private equity fund's sweet spot. This is because such a transaction is very similar to a going private transaction.

In today's distressed economy, where debt is the new equity, the plan sponsor transaction will play a major role in restructurings and in private equity.

CHALLENGES CURRENTLY FACING MANY PRIVATE EQUITY FUNDS

Private equity funds currently have over \$1 trillion of committed, but unused, capital. Yet, the collapse of the credit markets and the synchronized global recession are stymie-

ing the ability of many private equity funds to purchase companies through traditional buyouts.

Specifically, the private equity business model faces three principal challenges. These three principal challenges are described below.

- First, the private equity business model is based on leverage, i.e., the target company borrows funds from banks, the loans are secured by the target company assets, and the borrowed funds constitute a part of the purchase price.

For all intents and purposes, however, the credit markets remain crippled. Notably, other than loans guaranteed by the government, banks effectively are not lending. The liquid leveraged loan market of the pre-sub-prime bust era, which led to the plethora of companies needing to delever, is closed.

In the United States, the total volume of leveraged loans issued over six months spanning from late 2008 through early 2009 was one-tenth the volume of leveraged loan issuances over the first six months of 2007. Consequently, private equity funds cannot borrow to fund going private transactions.

- Second, private equity funds focus on purchasing the equity of target companies. However, today, many potential target companies do not have positive equity value. From 2002 to 2007, many of these companies borrowed huge sums of money and, as the global recession hammered consumption and spending, the companies' EBITDA decreased dramatically.

This leverage decreased the target company's equity values and increased leverage ratios to absurd levels. The consequence of this leverage is that the total value of many distressed companies is in their debt, leaving no value for the equity holders.

- Third, because many of today's distressed companies have no equity value, the control play is through the target company's debt. In other words, the play is to purchase the debt of a distressed company and then convert that debt to equity in connection with the restructuring process.

This debt for equity conversion transaction generally is not in the comfort zone of many private equity funds.

Taking each of the three dynamics together, private equity funds have "dry powder," but the markets are preventing them from engaging in plain vanilla going private transactions. Accordingly, private equity funds need to embrace the economic downturn and the constrained credit markets. And, private equity funds need to find investment opportunities in the world of distressed companies.

THE DISTRESSED COMPANY ACQUISITION MARKETPLACE

Today's typical distressed company actively participated in the credit frenzy, borrowing vast amounts of money in an attempt to (1) grow its businesses and (2) increase its shareholder wealth. The debt of choice was the leveraged loan. As a result, the capital structure of the typical distressed company is weighted heavily towards secured debt.

At the time that the distressed company borrowed, its leverage ratio was high based on normal credit standards. As today's global recession is hammering consumption and spending, the distressed company's earnings before interest, taxes, depreciation and amortization (EBITDA) is falling dramatically.

This decreased EBITDA has the effect of (1) decreasing value and (2) increasing leverage ratios. The consequence of this situation is that the value of the typical distressed company is in its secured debt.

This, in turn, has led to rising defaults on these leveraged loans, which has led to an increased number of chapter 11 filings. In the first quarter of 2009, approximately 79 public companies with prepetition liabilities in excess of \$100 million commenced chapter 11 cases. And, this increase in chapter 11 filings in 2009 is not predicted to slow anytime soon.

The number of companies that are approaching a default or that are already in default is staggering. Standard

& Poor's estimates that 209 companies could default in 2009. And, Moody's predicts that the global default rate for speculative grade companies will be 15.1 percent in 2009 and could be higher in 2010.

If these predictions are right, this would mean that over \$1 trillion of corporate debt could be in default by 2010. This is an overwhelming amount of debt coming due.

NEED FOR CHAPTER 11 BALANCE SHEET RESTRUCTURINGS

Many companies that face the approach of debt covenant defaults are not operationally stable companies. And, such companies will likely be forced to liquidate. However, many operationally stable companies with bad balance sheets will survive. And, when the economy improves, such operationally stable companies will thrive—after they achieve a significant deleveraging of their debt-burdened capital structures.

The winners in this scenario will be the distressed company itself and the investors who own the equity of the restructured distressed company. Chapter 11 provides the distressed company with the tools to accomplish the necessary deleveraging transaction.

Specifically, chapter 11 provides distressed companies with a breathing spell from their creditors. And, chapter 11 allows distressed companies to:

1. right size their balance sheets and
2. emerge from bankruptcy stronger and leaner.

To successfully emerge from chapter 11, a distressed company needs to confirm a plan of reorganization. That plan of reorganization is a court-sanctioned contract between a debtor and its creditors that modifies and supersedes the debtor's pre-bankruptcy obligations upon its exit from chapter 11.

A plan of reorganization must designate classes of claims and interests for treatment under the reorganization. Generally, a plan of reorganization will classify claim holders as:

1. secured creditors,
2. unsecured creditors, and
3. equity security holders.

The Bankruptcy Code provides that, to confirm a plan, the plan must:

1. be accepted by at least one class of non-insiders who hold impaired claims (i.e., claims that are not going to be paid completely or in which some legal, equitable, or contractual right is altered),
2. not discriminate unfairly, and
3. be fair and equitable.

For a class of claims to approve a plan, more than 50 percent in number and at least two-thirds in dollar amount of voting creditors must vote in favor of the plan. The unfair discrimination test prevents creditors with similar legal rights from receiving materially different treatment under a plan of reorganization, absent a compelling reason for doing so.

A plan is fair and equitable to a class of creditors so long as (1) the class receives the full present value of its claim or (2) no junior class receives anything on account of its claims. In other words, if the bankruptcy court determines that the value of the estate does not extend to certain junior classes, then the bankruptcy court may confirm a plan of reorganization that provides no distribution to those junior classes.

THE PLAN SPONSOR TRANSACTION

Sponsoring a plan of reorganization is a way for a private equity investor to take control of a target company when the target emerges from chapter 11. A plan sponsor invests “new money” in conjunction with a plan of reorganization. And, the new money is distributed to certain creditors in exchange for (1) their claims and (2) an affirmative vote on the plan.

In many situations, the plan sponsor is a friendly suitor. The plan sponsor works with the debtor company management pre-restructuring to:

1. determine an appropriate capital structure for the company after it emerges from chapter 11,
2. develop tactics for gaining approval for the plan of reorganization, and
3. establish (in general terms) a new equity incentive plan for management.

As such, the plan sponsor is able to:

1. provide flexibility and optionality to a distressed company and
2. help lead the distressed company through the restructuring process.

PLAN SPONSOR TRANSACTION HYPOTHETICAL EXAMPLE

To understand the plan sponsor transaction, a simple hypothetical example is in order. Let’s assume the following scenario: The target company (“Distressed Company”) has a \$1.2 billion capital structure. The first \$1.0 billion is comprised of leveraged loans secured by liens on substantially all of the assets of Distressed Company. The leveraged loans are trading in the secondary market at 40 cents on the dollar.

The other \$200 million of the Distressed Company capital structure is comprised of \$100 million of high yield bonds and \$100 million of equity. Finally, let’s assume that the “fulcrum” security of Distressed Company is the leveraged loans.

Here is how the plan sponsor transaction works:

- Step 1: The private equity fund approaches management of Distressed Company to express its interest in sponsoring Distressed Company’s plan of reorganization. The private equity fund will work with Distressed Company to negotiate a deal with the holders of the leveraged loans.

Specifically, the private equity fund’s purchase price will include (1) a cash investment and an (2) exchange of prepetition debt for new debt with new terms.

- Step 2: The private equity fund gets restricted from trading and obtains confidential information on Distressed Company to conduct its extensive due diligence.
- Step 3: The private equity fund proposes the terms of a plan of reorganization to Distressed Company. For simplicity, based on the hypothetical capital structure and trading prices, let’s assume that the private equity fund’s proposal will be to (1) invest \$250 million dollars and (2) exchange \$250 million of new loans with new terms for the leveraged loans.
- Step 4: Once the private equity fund, Distressed Company, and its leveraged loan holders reach an agreement on a chapter 11 plan, the three parties enter into plan support agreements.

The plan support agreements are agreements pursuant to which the three parties agree to support the plan of reorganization (and the holders of leveraged loans agree to vote for it).

- Step 5: Distressed Company commences a chapter 11 case in order to implement the terms of the chapter 11 plan. The Distressed Company informs the bankruptcy court—as well as its customers, employees, and vendors—that it has the requisite support for its proposed plan of reorganization.

This plan of reorganization will enable Distressed Company to emerge from chapter 11 quickly and with a substantial deleveraging of its capital structure.

Moreover, if the leveraged lenders do not require an auction, due to Distressed Company's exclusive right to file a plan, the private equity fund may not have to compete to be the ultimate plan sponsor.

- Step 6: The bankruptcy court, upon request of Distressed Company, establishes (1) a hearing date for the disclosure statement, (2) the date by which votes and objections regarding the plan of reorganization are due and (3) a hearing date to determine whether to confirm the plan of reorganization. The plan process could be as short as 60 days.

After the bankruptcy court confirms the plan, the private equity fund invests its cash, the new loans are exchanged for the prepetition leveraged loans, and Distressed Company emerges from chapter 11 controlled by the private equity fund.

Of course, this illustration is overly simplistic. However, this example demonstrates the powerful investment opportunity for private equity funds. Notwithstanding the potential great reward, there are also risks of which private equity funds should be aware.

These risks are summarized below.

- It is not always obvious where the fulcrum security lies. The valuation of Distressed Company is part art and part science. Obviously, the modification of certain assumptions can have a great impact on valuation.

Moreover, while Distressed Company is going through its restructuring process and negotiations, both its EBITDA and the world around it can change. Consequently, the fulcrum security can shift during the process.

- Negotiations can be difficult. Restructurings are a contact sport. The stakeholders and their advisers live in the distressed world day after day and have honed their brass knuckle tactics.

As such, negotiations may include threats and difficult conversations. To contrast that, patience is required, as is a sound understanding of the legal issues underlying the restructuring process.

- The leveraged loan holders may decide that they want Distressed Company to shop the plan sponsor proposal before or after Distressed Company commences a chapter 11 case.

While this would establish a competitive process to become the plan sponsor, the private equity fund could become a stalking horse and obtain certain protec-

tions. Such protections could include a breakup fee and expense reimbursement.

- Holders of the fulcrum security may want to own Distressed Company themselves. As a result, the fulcrum security holders may refuse to vote in favor of a plan with a sponsor. This refusal could stop the plan sponsor in its tracks.

Notwithstanding these risks, the good news is that in the plan sponsor transaction, the private equity fund does not invest any capital until the very end of the process—that is, after the plan of reorganization is confirmed and at the time the plan becomes effective.

As a result, the plan sponsor transaction is similar to the going private transaction. See Exhibit 1 for a side-by-side comparison of a going private transaction and a plan sponsor transaction.

SUMMARY AND CONCLUSION

Private equity funds are searching for investment opportunities to put their committed capital to work. Their current business model is challenged, and the plain vanilla going private transactions of yesteryear are few and far between.

A slight tilt of the head and shift in perspective may unveil a lucrative opportunity to purchase undervalued target companies. The plan sponsor transaction is, step-by-step, almost identical to the going private transaction.

The private equity funds that embrace this transaction structure will find themselves owning good companies with the potential for outstanding returns.

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Exhibit 1
Comparison of the Going Private Transaction and the Plan Sponsor Transaction

<u>Going Private Transaction</u>	<u>Plan Sponsor Transaction</u>
<p>1) Approach the CEO and request access for inside diligence.</p> <p>a) In the approach, emphasize the “go shop” process, with no pre-signing auction.</p> <p>b) By following this approach, the CEO will proactively influence the choice of future partners.</p> <p>c) The process is consistent with the CEO’s and the board’s fiduciary duties.</p> <p>d) The sponsor discusses management’s equity plan in general terms.</p>	<p>1) Approach the CEO and request access for inside diligence.</p> <p>a) <i>In the approach, emphasize no pre-signing auction.</i></p> <p>b) By following this approach, the CEO will proactively influence the choice of future partners.</p> <p>c) The process is consistent with the CEO’s and the board’s fiduciary duties.</p> <p>d) The sponsor discusses resetting management’s equity plan in general terms.</p>
<p>2) Execute a confidentiality agreement with an appropriate standstill.</p>	<p>2) Execute a confidentiality agreement with an appropriate standstill.</p>
<p>3) Conduct inside diligence.</p>	<p>3) Conduct inside diligence.</p>
<p>4) Prior to executing the merger agreement, the sponsor and the target agree to a support agreement with significant equity holders (if any).</p> <p>a) The holder’s support is subject to the target company board’s fiduciary out.</p>	<p>4) Prior to executing the target support agreement, the sponsor and the target agree to a support agreement with significant debt holders (if any).</p> <p>a) The holder’s support may be subject to the target company board’s fiduciary out.</p> <p>b) <i>The support agreement includes deal protection, such as breakup fee and expense reimbursement.</i></p>
<p>5) Negotiate and execute the merger agreement.</p> <p>a) The target company agrees to support the sponsor’s deal, subject to fiduciary duty.</p> <p>b) The target company agrees to the go shop / no shop provision.</p> <p>c) The target company agrees to a merger process, including</p> <p>i. filing a proxy with the SEC,</p>	<p>5) Negotiate and execute the support agreement.</p> <p>a) The target company agrees to support the sponsor’s deal, perhaps subject to fiduciary duty.</p> <p>b) The target company agrees to a no shop provision (<i>perhaps go shop provision</i>).</p> <p>c) <i>The target company agrees to a reorganization process, including</i></p> <p>i. <i>filing for bankruptcy,</i></p>

Exhibit 1 (continued)
Comparison of the Going Private Transaction and the Plan Sponsor Transaction

<u>Going Private Transaction</u>	<u>Plan Sponsor Transaction</u>
<ul style="list-style-type: none"> ii. clearing the proxy, iii. mailing the proxy, iv. holding a stockholders meeting, and v. taking all actions reasonably necessary to consummate the merger. <p>d) The target company agrees to a breakup fee and an expense reimbursement.</p>	<ul style="list-style-type: none"> ii. <i>supporting the sponsor's reorganization plan,</i> iii. <i>preparing the plan and disclosure statement,</i> iv. <i>seeking court approval of the sponsor's plan and disclosure statement,</i> v. <i>mailing the disclosure statement, and</i> vi. <i>taking all actions reasonably necessary to consummate the sponsor's reorganization.</i> <p>d) The target company agrees to a breakup fee and an expense reimbursement.</p>
<p>6) Until the stockholders approve the merger at the stockholders meeting, the target company may exercise its fiduciary out, accept a superior proposal, and terminate the merger agreement with the sponsor.</p> <ul style="list-style-type: none"> a) Prior to terminating the merger agreement, the target company will pay the sponsor a breakup fee. b) Typically, the stockholder meeting occurs 60–120 days after the merger agreement is executed. 	<p>6) Until the reorganization plan is approved by the court, the target company may exercise its fiduciary out, accept a superior proposal, and terminate the support agreement with the sponsor. (Due to special provisions of the Bankruptcy Code regarding votes and confirmation of a plan of reorganization, the sponsor may not need to engage in a competitive process).</p> <ul style="list-style-type: none"> a) Prior to terminating the support agreement, the target company (<i>and/or significant debt holders</i>) will pay the sponsor a breakup fee and expense reimbursement. b) <i>Typically, the reorganization plan will be approved 60–120 days after the support agreement is executed.</i>
<p>7) The target company stockholders may not approve the merger.</p> <ul style="list-style-type: none"> a) If another transaction is consummated within, e.g., 12 months after the “no vote,” the sponsor is entitled to a breakup fee. 	<p>7) The target company debt holders may not approve the reorganization plan.</p> <ul style="list-style-type: none"> a) <i>The sponsor would request a breakup fee if the target company emerges from bankruptcy within a limited period of time after the “no vote.”</i>