

Equity Kickers: Extra



point for lenders



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Unprecedented numbers of borrowers will be unable to make payment on their loans in 2009, providing lenders with opportunities to participate in amendments, restructurings and refinancings. Borrowers may offer equity kickers to lenders as incentives. Lenders need to focus on certain key issues to receive the full benefit of their bargain.

Unprecedented numbers of corporate borrowers will be unable to make interest payments on their outstanding loans in 2009. In addition, over \$700 billion of corporate loans will mature in 2009, and many borrowers will not have the cash to repay their loans or be able to obtain takeout financing. Consequently, lenders will have a variety of opportunities (some voluntary, some involuntary) to participate in loan refinancings, restructurings and amendments. We expect borrowers to offer equity kickers to existing lenders as incentives to agree to proposed restructurings or amendments of defaulted loans; in other situations, we anticipate new lenders will demand equity kickers as part of their refinancing proposals.

In the current financial environment, we expect lenders to demand more disciplined credit terms from borrowers than those offered during the height of the credit boom, such as more restrictive covenants, additional undertakings to perfect the lenders' security interest in certain collateral, and better economic terms in the form of higher interest rates and fees (including prepayment premiums and interest make-whole provisions). Sophisticated lenders will recognize, however, that many financially stressed borrowers will be unable to bear increased cash payments.

There are alternatives that creative borrowers and lenders may explore in lieu of additional cash payments. A borrower unable to pay sufficient cash interest may offer to pay a portion of the interest on a payment-in-kind (or PIK) basis. Alternatively, the borrower may offer an equity kicker — typically in the form of warrants — to its lenders.

Borrowers and sponsors may be interested in granting equity kickers in



order to reduce payments of significant additional cash or PIK interest, or in lieu of granting prepayment and make-whole premiums. Equity kickers may be attractive to lenders because they permit lenders to participate in any upside of the borrower. Equity kickers can be attractive both in troubled companies that seem likely to recover and in companies where recovery may be less certain. Even in situations where lenders believe the existing equity is underwater, lenders may take a “venture capitalist” view: one should not expect to make a good return on every investment, but one can hope to hit a home run one or two times out of every 10 investments.

Lenders focused on the key terms of an equity kicker from the outset are more likely to receive the full benefit of their bargain. This article identifies important issues to consider when negotiating equity kickers, including the

terms of the equity kicker, equityholder protections, exit rights and regulatory and other legal issues.

Types of Equity Kickers

The most common form of equity kicker is a warrant. Borrowers may also offer lenders other forms of equity or instruments with equity-like returns. Equity kickers in limited liability companies can take an even greater variety of forms and should be negotiated with the assistance of tax counsel to avoid unintended tax consequences.

Terms of the Equity Kicker

Class of Equity Security In companies with complex equity structures — such as corporations with multiple layers of existing common and preferred stock or limited liability companies with complicated distribution waterfalls — understanding the rights of the class of

equity security to be received is critical to negotiating terms that will protect a lender’s upside if the company rebounds and the equity has value.

Exercise Price If a lender will be receiving warrants, it is important to determine upfront whether the warrants will have a substantial exercise price or will instead be “penny warrants,” exercisable for a nominal amount. The exercise price of the warrant will depend on the class of equity security for which the warrant can be exercised. A lender should consider whether it is more valuable to such lender to receive penny warrants for common stock or warrants for senior preferred at a negotiated exercise price.

Warrant Shares It is also important to determine early in the negotiation process the number of warrant shares the lender will receive and the percentage ownership of the company that such

warrant shares constitute. In negotiating the number of warrant shares, a lender may consider the size of the warrant coverage relative to the principal amount of the loan, the percentage ownership the lender wishes to receive and/or the rate of return the lender wishes to achieve on the combined loan and equity transaction.

Equityholder Protections

Antidilution Protection The primary protection that a lender should demand in its warrants is antidilution protection. At the very least, a lender should receive protection against reduction of the ownership percentage in the borrower as a result of stock splits, stock dividends or other transactions that increase the number of shares outstanding.

Preemptive Right If a lender is unable to negotiate robust antidilution protection, it should insist on a preemptive right to purchase a pro rata share of any future equity issuances, so that the lender can choose whether to participate in any such issuance and thereby maintain the percentage ownership represented by its warrant shares.

Minority Consents If a lender will receive a minority equity interest in a private company, the lender should consider asking for typical consent rights granted to minority equityholders. Particularly in a company with a controlling sponsor, a lender should consider whether to ask for a consent right with respect to affiliate transactions in order to prevent value leakage to the sponsor after the lender no longer has covenant protection on its loan. Similarly, a lender may want consent rights to any non-pro rata distributions to, or redemptions of, any equity. Finally, a lender will want to make certain that the borrower cannot amend the rights without the lender's consent.

Right of First Offer or Right of First Refusal If the borrower is a private company, or even a public company with a controlling shareholder, a lender may want to ask for a right of first offer or a right of first refusal with respect to any sales of the controlling shareholder's

equity. The lender may not want to permit a competing financial investor to pick up the controlling shareholder's position at a fire sale price.

Exit Rights

Permitted Transfers No matter what type of equity a lender receives, a private company will likely insist on a number of transfer restrictions with respect to the equity instruments issued to the lender. A lender should consider whether it wants its equity position to be freely transferable or whether the lender can agree to transfer restrictions, or borrower consent, so long as there is a carve-out permitting the lender to transfer its equity instrument to its affiliates, partners or shareholders, or to purchasers of some or all of its loan position.

Tag-along Rights If the borrower is a private company, or in some circumstances a public company with a controlling shareholder, a lender should negotiate tag-along (also called co-sale) rights for its equity. Tag-along rights give the holder the right to exit in the same

transaction on the same terms (including price) as the controlling shareholder.

Acquisition Transactions If a borrower is unwilling to grant tag-along rights to the lender or is a public company for which such rights are inappropriate, the lender should at least make certain that its warrants have the right to participate in mergers, consolidations and other acquisition transactions on the same terms as the class of equity security for which the warrants may be exercised.

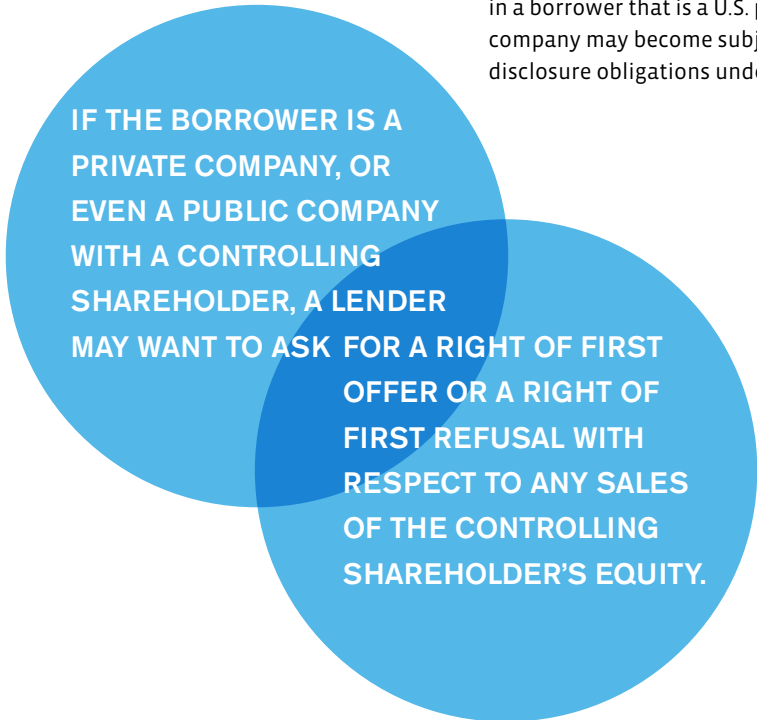
Registration Rights Whether a lender receives warrants in a public company or a private company, the lender will want to receive registration rights.

Cashless Exercise If a lender receives warrants, the warrants should always include a "cashless exercise" feature so that the lender can take advantage of Rule 144 immediately upon exercise. This prevents needing to wait at least six months after exercise before being able to sell the warrant shares in the public market under Rule 144.

Regulatory and Other Legal Issues

Disclosure Obligations

A lender that takes a minority equity position through an equity kicker in a borrower that is a U.S. public company may become subject to disclosure obligations under the





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Securities Exchange Act of 1934 (the “Exchange Act”). Under Section 13 of the Exchange Act, a beneficial owner of more than 5% of any class of an issuer’s registered equity securities must make a public filing to alert the market to stock accumulations that may signal an incipient change of control. Under Section 16 of the Exchange Act, corporate “insiders,” including beneficial owners of more than 10%, executive officers and board members (and potentially any entity or “group” appointing one or more board members), are required to make public filings to reveal their trades in the issuer’s securities and may potentially be required to disgorge certain resultant profits. A lender holding convertible or exchangeable instruments, such as warrants, is generally deemed to own the underlying equity securities beneficially if the lender has the right to acquire them within 60 days.

“Group” Issues If a lender does not have 5% or 10% beneficial ownership of a public company, it may nonetheless become subject to the Section 13 or Section 16 disclosure requirements through membership in a “group” that has crossed the relevant ownership threshold. A group is formed when two or more persons agree to act together

for the purpose of acquiring, holding, voting or disposing of an issuer’s equity securities. Once a group is formed, each member’s beneficial ownership position is attributed to every other member.

Regulated Industries Lenders to certain regulated industries (such as aviation, banking, communications, gaming, insurance, transportation and utilities) may face additional ownership restrictions and regulatory review processes depending on whether the equity the lender received may be deemed, under the particular regulations, to confer ownership of the borrower.

Equitable Subordination Claims A lender that receives equity in a borrower should be aware that, if the borrower files for bankruptcy, the lender’s actions may put its loan claims at risk of equitable subordination. Under the U.S. Bankruptcy Code, a court may subordinate a lender’s claim to other creditors’ claims if the lender engaged in misconduct that resulted in injury to other creditors or conferred an unfair advantage to the lender. If a lender is deemed an “insider” or fiduciary, then such lender is subject to a greater degree of scrutiny vis-à-vis noninsiders. However, if a lender receives less than 20% of the outstanding voting securities, does not receive the right to appoint any directors or officers

and does not otherwise exercise control or authority over the borrower, then the lender would likely not be deemed an “insider” or fiduciary under the U.S. Bankruptcy Code.

Conclusion

It is natural for lenders and their counsel to focus on downside protection, such as ensuring that loan covenants are fully protective and eliminating the opportunities for value leakage that permeated “market” loan agreements during the credit boom. Nonetheless, the focus with respect to equity kickers should not be on downside protection but rather on making sure lenders are able to capitalize on their investment in an upside scenario. This article is only a summary discussion; in any transaction, there will be specific legal, regulatory and tax issues that counsel needs to consider. Lenders should discuss these issues with their counsel early in the process so that the terms of any equity kicker received reflect the understanding of the parties and protect the lenders’ ability to capture the upside of a recovered borrower. **TSL**

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