

Equity Kickers: Extra Point for Lenders

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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 the principal amount of their outstanding 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 that were 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 payment 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 borrowers 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 ten 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 memorandum identifies important issues to be considered 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

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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. If a company has multiple layers of existing common and preferred stock, a warrant entitling the holder to purchase common stock will be valued differently than a warrant exercisable for the most senior series of preferred stock. An accurate valuation requires an understanding of the borrower’s capital structure and the rights and obligations that attach to each layer of the capital structure.

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 to be received by a lender and the percentage ownership of the company that such warrant shares constitute. In negotiating the number of warrant shares, a lender may consider factors such as 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

Anti-Dilution Protection

The primary protection that a lender should demand in its warrants is anti-dilution protection. At the very least, a lender should receive protection against

reduction of the ownership percentage in the borrower represented by the warrant shares as a result of stock splits, stock dividends or other transactions that increase the number of shares outstanding. A lender may wish to take a more aggressive position and ask for anti-dilution protection against “cheap stock” issuances at a price less than the per share valuation implied in the lender’s warrants. To provide the most anti-dilution protection, a lender may ask for warrants exercisable for a certain fixed percentage of the equity outstanding at the time of exercise, so that the lender will never be diluted by any increase in the number of shares outstanding prior to the time of exercise, even fair market value issuances for cash.

Pre-emptive Right

If a lender is unable to negotiate robust anti-dilution protection, it should insist on having a pre-emptive right to purchase its pro rata share of any future equity issuance, so that the lender has the choice whether or not to participate in any such issuance and thereby maintain the percentage ownership represented by its warrant shares. A pre-emptive right can also provide some protection to the warrant holder against issuances of equity instruments senior to the warrant shares in the capital structure by permitting the warrant holder to acquire its pro rata share of such new senior equity instruments.

Minority Consents

If a lender will be receiving 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 under 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 any amendment of its rights cannot be undertaken 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. If a borrower's fortunes recover and the controlling shareholder negotiates an exit from its controlling position on favorable terms, a lender will want to have the opportunity to exit from its minority equity position at the same time and on the same terms. This is particularly true if the borrower repays the loan in full and the lender no longer has control over the borrower's conduct through the covenant package contained in the credit agreement.

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. However, the importance of registration rights differs depending on whether a lender is an affiliate or a non-affiliate of the company.

Rule 144 of the Securities Act of 1933 allows a non-affiliate holder to sell its unregistered shares into the public markets after a six-month holding period as long as public information on the company is available. Rule 144 allows an affiliate holder also to sell its unregistered shares into the public markets after a six-month holding period if public information on the company is available, but any such sales are subject to certain volume limitations and manner of sale restrictions. In either case, with respect to both affiliates and non-affiliates, if no public information is available, holders may not take advantage of Rule 144 for a period of one year.

If a lender owns, or is deemed to own through attribution due to its being part of a "group" (discussed below), more than ten percent of the voting equity of the company (or receives and exercises the right to appoint a director to the company's board), the lender will likely be deemed to be an affiliate of the company. Without the right to request that the company register its shares, an affiliate lender will need to wait for at least six months before being able to sell its unregistered shares under Rule 144 and any such sales would be subject to certain additional restrictions, including volume limitations.

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, without needing to wait for at least six

months after exercise before being able to sell the warrant shares into 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 Securities Exchange Act of 1934 (the “Exchange Act”). Under Section 13 of the Exchange Act, a beneficial owner of more than five percent 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 ten percent, 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 beneficially own the underlying equity securities if the lender has the right to acquire them within 60 days.¹

“Group” Issues

If a lender does not have five or ten percent 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. A group may be deemed to exist implicitly if two or more investors are effectively acting in concert. Once a group is formed, each member’s beneficial ownership position is attributed to every

other member. A lender must therefore be sensitive to the nature of any communications it has with the borrower’s other investors, including other lenders receiving portions of the equity kicker.

State Anti-Takeover Laws

Many state legislatures have enacted laws to impede unsolicited acquisitions of significant equity positions. So-called “control share” statutes nullify the voting rights of shares held by an investor that has exceeded a certain ownership limit (often 20 percent) unless the company’s other stockholders vote to restore the investor’s rights. “Business combination” statutes bar an investor that crosses a specified ownership level (frequently 15 percent, but as low as ten percent for certain states) from engaging in certain change of control transactions unless the company’s board has approved the equity acquisition by which the threshold was crossed.

Regulated Industries

A lender to a borrower in 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 received by the lender 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, in the event the borrower files for bankruptcy, such 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,

¹ For a further discussion of the initial and continuing public disclosure requirements under Sections 13 and 16 of the Exchange Act, please see our memorandum dated December 11, 2008, “Establishing, Maintaining and Exiting a Minority Equity Position: U.S. Securities Law Considerations for Hedge Funds” available on our website at www.rkollp.com.

then such lender is subject to a greater degree of scrutiny vis-à-vis non-insiders. If a lender is an “insider” or fiduciary, the court will rigorously scrutinize any transaction between the borrower and the lender to ensure that the transaction was fair and reasonable to the borrower. If a lender receives voting equity at certain ownership levels, or with certain control or director appointment rights, then such lender may be considered an “insider” or fiduciary of the borrower. However, if a lender receives less than 20 percent 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 of the borrower, under the U.S. Bankruptcy Code.

Conclusion

In negotiating the terms of a restructuring, refinancing or amendment of a loan, 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 that lenders are able to realize on their investment in an upside scenario. We have highlighted in this memorandum key terms lenders should consider in negotiating equity kickers and certain regulatory and other legal issues that lenders should be aware of in receiving equity kickers. However, this memorandum is only a summary discussion and is not exhaustive; in any transaction, there will be legal, regulatory and tax issues that need to be specifically considered by counsel. 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.

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