How to raise capital for a financially troubled company

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In recent years companies experiencing solvency or liquidity problems were able to raise new capital in the debt and equity capital markets with relative ease. The markets were flush with liquidity,- due in part to the proliferation of non-traditional lenders such as hedge funds and others willing, and in some cases eager, to invest in distressed situations. In fact, the competition among lenders to provide capital in distressed situations enabled companies to increase their leverage at a relatively low cost.
As has been widely reported, capital market conditions in 2008 and beyond might not be as favourable. According to Standard & Poor's, the ratio of distressed corporate debt to all speculative grade debt rose from 6.1 per cent in December 2007 to 11.1 per cent in January 2008, making it the highest percentage since September 2003. Standard & Poor's also reported that nine leveraged loans defaulted in January 2008 compared to only two during 2007. Moody's Investors Service has projected that the global speculative default rate will rise substantially in the next 12 months from the 1.1 per cent prevailing in December 2007 (the lowest level since March 1982).

In addition, it appears that liquidity in the capital markets might not be as available as it was in the past few years. Traditional and non-traditional lenders alike seem to have become more conservative in their lending practices for several reasons, including concerns about a possible recession in the US economy, market volatility, weakness in consumer spending and the subprime mortgage and housing crisis and its effect on financial institutions worldwide. The tightening in the credit markets has already affected many transactions ranging from private equity-sponsored leveraged buyouts to exit financing arrangements for companies seeking to emerge from their reorganisations under Chapter 11 of the US Bankruptcy Code.

In this challenging environment, a financially troubled company that is able to identify the source of its distress, formulate a strategy to raise new capital and execute quickly might be able to prevent further deterioration to its financial health. This chapter begins with a discussion of financing alternatives and potential sources of capital, and then discusses the issues that a company might confront as it formulates its business objectives and legal strategies.

Financing alternatives

In general, a financially troubled company might raise much-needed capital through various types of debt or equity financing. The cost of each of these types of capital depends primarily on the perceived risk of repayment, which is contingent not only on company and industry-specific risk, but also on priority of repayment if the company fails. The Bankruptcy Code, as well as applicable non-bankruptcy law, sets forth a priority scheme whereby:

- secured lenders are entitled to a distribution up to the value of their respective collateral;
- unsecured creditors are entitled to the value of any unencumbered assets, including any surplus value in the secured lenders' collateral; and

- equity interest holders are entitled to whatever is left after all secured and unsecured creditors have been paid in full (including accrued and unpaid interest).

Accordingly, higher-priority claims such as secured debt financings are generally less expensive to the company than lower-priority claims such as unsecured debt. An equity holder – whether it holds preferred or common stock – is the least assured of receiving a return of or on its investment, so it usually demands the highest risk premium. In addition, a company might consider selling hard assets or a business segment or monetising other property, such as accounts receivable. Later insolvency can create legal risks for the buyer, which might affect purchase price or structure.

Debt financing

A company might be able to raise debt capital if it can assure the lender that it will repay the new loan. A lender might seek assurances through the company's pledging of some or all of its property as collateral. A lender might also insist that any financial covenants in the debt documents be tight so that it has sufficient warning of declines in the company's operating performance. For example, a leverage ratio covenant measuring debt to free cash flow (ie, earnings before interest, taxes, depreciation and amortisation) for a financially troubled company might be set at close to 90 per cent of the company's projected cash flow, instead of 75 per cent to 80 per cent for a more financially stable company.

A company without any unencumbered assets must explore other options, each of which becomes more expensive as the uncertainty of repayment increases. For example, if all the company's assets are already encumbered, it might consider a financing secured by a lien junior to the existing secured lender's lien. Depending on the severity of the financial distress, the company could also explore raising unsecured or subordinated debt, which is more difficult and expensive the more leverage the company already has. If these options are not viable, the company might refinance its existing debt from new investors.

In addition to the lower risk premiums associated with debt, debt is less expensive to the company than the equivalent amount of equity due to the better tax treatment of debt under US law. In general, the company can deduct the interest to be paid on debt, lowering the actual loan cost, whereas dividends are taxed as profit before they can be returned to the equity interest holder.

Equity financing

As a financially troubled company might be insolvent, it is usually very difficult to raise equity capital. An equity interest holder is entitled to distributions only after all creditors have been paid in full. Accordingly, the risk of an equity investor losing its investment is relatively high.

Despite this risk, a non-traditional lender such as a hedge fund often pursues opportunities where it might be able to acquire an equity position in the company. Thus, a hedge fund might provide rescue financing to a troubled company in the form of debt and equity financing. Such rescue financing often contains a requirement that the hedge fund be permitted to participate directly or indirectly in the company's governance – for example, by having the right to designate one or more directors. The debt/equity financing arrangement provides the lender with the greater certainty of repayment that debt offers and the potential upside and control of an equity investment. As a result, the total cost of these types of arrangement to the company is often very high.

Asset sales

A company can also sell assets or monetise other property such as accounts receivable to raise capital. Selling assets such as property, plant and equipment might also reduce operating and overhead expenses. Selling accounts receivable at a discount to a factor that assumes receivables collection risk also might provide quick cash to the company, although the discount for non-recourse factoring is often quite high. Selling assets might be preferable to debt or equity financing because the company might obtain the necessary capital without incurring the ongoing financing costs. There are no interest payments or risk premiums owed to an asset purchaser.

However, if the assets are already pledged as collateral, the company may have to persuade the secured lender to permit the company to retain the net cash proceeds for working capital purposes instead of using it to reduce the secured debt. In addition, the purchaser may be concerned that the transfer might be attacked as a constructively fraudulent transfer, which occurs if the company was insolvent at the time of the transfer or was

rendered insolvent by the transfer and the company received less than reasonably equivalent value or fair consideration. Few options are available to the purchaser to mitigate this risk. For example, opinions from well-established financial firms that the company was solvent or that the consideration was fair might be second-guessed in a later bankruptcy case, particularly to a court reviewing the situation with the benefit of hindsight.

Sources of capital

Identifying a capital source that is ready, willing and able to infuse new capital on acceptable terms and conditions is challenging. The company must consider all possible sources, including existing and new lenders and investors, its customers and any combination of these sources. This section describes some of the issues that the company should consider in pursuing these different sources of capital.

Existing investors

A financially troubled company searching for new capital usually turns first to its existing investors, for several reasons. First, existing investors should be familiar with the company, its business and its management, and should therefore require less time to conduct due diligence. The company can often prevent the expense, distraction and delay of making management presentations and providing extensive due diligence material, which could be advantageous where the company faces an imminent liquidity crisis.

Second, under existing debt documents the company might need its existing creditors' consent to a capital infusion. The company might obtain consent more easily from existing creditors, or even a subset of that group, if they are the new investors. Existing creditors might still demand a consent fee and amendments to their existing debt documents enhancing the credit as the price of their consent. If capital market conditions remain challenging, such amendments could result in increased pricing and the elimination of any borrower-friendly provisions.

Finally, unlike new investors, existing investors often have an interest in protecting their investment. If the investors believe the company's survival is the best way to maximise recovery on the existing investment, they may have little choice but to provide additional capital, albeit on expensive terms.

New investors

While existing investors might have an advantage and an interest in providing new capital, the company should still explore opportunities with new investors. New investors looking at a situation for the first time might be able to offer different or creative types of capital that could fit within the confines of the company's existing capital structure. Furthermore, non-traditional investors such as hedge funds and private equity firms have expanded their focus to include investments in distressed situations. In 2006 and the first half of 2007 private equity firms and hedge funds specialising in distressed situations have raised more than $40 billion. As a result of their expertise and available capital, these non-traditional lenders have become an attractive source of financing.

In addition, new investors provide the company with negotiating leverage over recalcitrant existing investors. Even if the company has no intention of moving forward with a new investor group, its negotiating leverage with its existing investors should be enhanced if it can show that it has a credible alternative.

Existing customers

In a more modest way, existing customers may also serve as a source of capital. A customer might agree to accelerate payment on an existing accounts receivable or to provide a lump-sum subsidy to provide much-needed liquidity to protect its supplier. These types of arrangement are more common in the automotive industry, for example, where the failure of a single company in the supply chain as a result of financial troubles to provide parts just in time could cause a ripple effect, potentially shutting down manufacturing operations until an alternative supply is obtained. As a result, some companies have implemented vendor rescue programmes to provide financial or operational assistance to a distressed supplier.

Raising capital

Raising capital poses special challenges for a financially troubled company because it is often a multilateral, complex negotiation involving the company's most important constituencies, including existing and prospective investors, customers, suppliers and employees. During these negotiations the company must know its business objective and the legal means for accomplishing it,

which is usually an out-of-court restructuring or a Chapter 11 case. This section describes some of the dynamics and considerations that might affect the outcome of these negotiations.

Identifying the cause of financial trouble

Before a company begins discussions with existing or prospective investors, it must identify the cause of its financial distress. Causes of financial distress vary widely among companies and industries. For example, airlines have suffered from:

- competition from low-cost carriers;
- reduced air travel after the terrorist attacks of September 11 2001; and
- most recently, escalating fuel costs.

Automotive parts manufacturers have suffered from:

- increasing commodity prices;
- greater competition; and
- greater legacy liabilities, such as pension and retiree healthcare costs.

The sub-prime mortgage crisis has already hurt home building and weak consumer spending will hurt retailers.

Regardless of the cause, a company must understand why its financial performance has deteriorated. A clear understanding of the cause of the financial distress indicates to existing investors, customers, suppliers, employees and prospective investors that management is in control and can address the problems. Maintaining these constituencies' confidence helps to prevent losing key customers and employees to competitors and the imposition of tougher credit terms by suppliers. Furthermore, where several financially troubled companies might be competing for capital, investor confidence in senior management can be crucial to a company's efforts to distinguish itself.

Reviewing the capital structure and existing debt documents

While a company diagnoses its financial troubles, the company and its legal counsel should review the capital structure and the covenants and restrictions in the company's existing debt documents. This information will help the company to identify which capital-raising activities it can pursue without the consent of its existing stakeholders. If consent is required, creditors can and often do require consent or similar fees and impose other conditions, making the process more expensive and onerous for the company. Accordingly, a company's ability to navigate around these potential hurdles is crucial to its rehabilitation.

The ability of existing stakeholders to oppose new financing or other capital-raising activities depends primarily on the limitations in the existing debt documents. Debt documents commonly restrict the ability of a company and usually its direct and indirect subsidiaries to incur secured or unsecured debt, refinance existing debt with more senior debt, sell core or non-core assets, engage in affiliate transactions, amend or waive certain junior debt document provisions or repay junior debt. Financial maintenance covenants periodically measuring a company's leverage, interest expense or fixed charges against its earnings before interest, taxes, depreciation and amortisation (usually each fiscal quarter and at fiscal year-end) also limit a company's debt capacity. In addition, many debt documents require a company to use a minimum percentage of net cash proceeds from new debt, new equity or asset sales to pre-pay existing debt. As a result, many capital-raising activities might not actually yield additional liquidity. Failure to comply with these provisions could trigger an immediate event of default, thereby permitting the lenders to accelerate the debt and exercise rights and remedies.

Similar capital-raising limitations exist even in so-called 'covenant-lite' deals, which often include incurrence-based financial covenants with which the borrower must comply to incur debt, sell assets or engage in specified other activities. Thus, a financially troubled company might be unable to satisfy the incurrence-based covenant at the very time that it needs to enter into that type of transaction to raise new capital.

Obtaining the requisite consents

Most debt documents require at least a simple majority consent to amend the restrictions discussed above or waive any events of default. However, obtaining those consents at a reasonable price might pose a challenge for the financially troubled company. The dynamics in consent negotiations have changed during the last few years, in part due to the prominence of hedge funds and other non-traditional lenders in the credit markets.

Identifying the right lender or bondholder group with which to discuss restructuring options has become substantially more complicated. More

financial institutions invest strategically in different securities in a company's capital structure to hedge their risks and obtain more access and input in any restructuring process. However, the company might not even be aware of which securities a particular entity holds because certain instruments (eg, credit default swaps, total return swaps and participations) entitle the investor to, or protect the investor from, the economic value of the security without being identified as the beneficial holder on any official register of lenders or security holders. Institutions often say that they hold or have the economic interest in more securities than is reflected on any register, and the company has to do its best to try to verify that information.

Further, the interests of an institution holding a particular class of securities might not actually be aligned with other holders of the same class. In the past, it could generally be assumed that existing secured lenders would oppose certain actions taken by unsecured bondholders and vice versa. However, as a result of the cross-holdings between classes, some secured lenders which are also bondholders or equity interest holders might use their secured lender position to protect their bond or equity investment. The negotiation process is thus somewhat less predictable.

Finally, an institution might be reluctant to become involved in restructuring negotiations because it would likely become restricted in its trading activities after it came into possession of material non-public information. Some institutions might agree to become restricted for a short-period of time, but the company has to address these issues on a case-by-case basis.

Out-of-court restructuring versus Chapter 11 case

A company unable to persuade a creditor group to support a proposed restructuring generally has two sources of leverage:

- It might be able to point to a new investor willing to provide capital within the confines of the existing debt documents and capital structure; and
- It can file a case under Chapter 11 of the Bankruptcy Code.

A Chapter 11 case has several advantages over an out-of-court restructuring.

First, the bankruptcy court may provide protections that are not available in an out-of-court restructuring for lenders providing new financing or purchasers buying assets. A company might be able to obtain a debtor-in-possession (DIP) financing at the outset. The Bankruptcy Code accords special status to the liens and claims supporting the loans. A DIP lender typically requests collateral. The Bankruptcy Code permits a new loan to be secured by a senior (or priming) or equal lien on already encumbered property if the pre-petition secured lenders consent or the DIP shows that the pre-petition secured lenders' interest in the collateral is "adequately protected" from diminution in value during the case. As a practical matter, companies often prime liens only with their pre-petition lenders' consent, but they still can provide adequate protection by paying the lenders an agreed periodic amount, granting replacement liens on property the company acquires during bankruptcy and agreeing to other concessions.

In addition, the bankruptcy court may grant a DIP lender super-priority administrative expense status, which gives the lender first priority, above other priority claimants and holders of general unsecured pre-petition claims, on any unencumbered assets if the DIP lender's collateral is insufficient to pay its full claim amount. Further, the Bankruptcy Code requires, as a condition to a company's emergence from bankruptcy, that it pay all priority claims in cash in full. The combination of the priming lien and super-priority claim often makes otherwise reluctant lenders willing to provide financing.

Similarly, the bankruptcy court can assure clean title to protect an asset purchaser in a bankruptcy case. Section 363 of the Bankruptcy Code permits a DIP to sell assets "free and clear" of interests so that liens and claims, including successor liability claims, attach to the proceeds of the sale, not the assets being sold. In addition, bankruptcy court approval of a sale should eliminate any fraudulent transfer risk in the sale. These protections mitigate the risk that the purchaser would later be burdened with unexpected liabilities or litigation.

Second, the Bankruptcy Code also provides tools to help a company in its restructuring. For example, Section 362 imposes an automatic stay enjoining most collection actions and litigation against the company. Thus, a company facing numerous lawsuits, or facing substantial liabilities stemming from product liability, asbestos or other mass tort claims, could find the structure, control and transparency that a Chapter 11 case affords to be beneficial. The automatic stay enjoins all such litigation and thus gives the company breathing space from the costs and distraction of litigation and an opportunity to compromise the litigation

claims under a Chapter 11 plan. Over the last 10 years, companies facing billions of dollars in aggregate asbestos liability have successfully pursued bankruptcy cases for that very purpose.

Moreover, a company might resolve operational restructuring issues more readily in a bankruptcy case. In addition to being able to sell non-core assets freely and clearly, a company may reject executory contracts and unexpired leases with above-market or unfavourable terms under Section 365 of the Bankruptcy Code. Rejection constitutes a court-approved breach of the contract, relieving all parties of any further contractual obligations (with very few exceptions) and treating the non-debtor counterparty claim for contractual damages as a general unsecured pre-petition claim. Retailers often liquidate inventory and reject leases for unprofitable stores; manufacturers might reject plant leases to consolidate manufacturing or warehousing operations in a better location.

The Bankruptcy Code's voting provisions are also more favourable than those in existing debt documents. Out of court, a company seeking to compromise its debt or to get its lenders to exchange debt for new equity in the reorganised company must obtain each affected lender's consent. In contrast, in Chapter 11 approval by only a majority in number of holders and two-thirds in amount of claims of those who voted on the plan in each voting class provides sufficient consent. Dissenting creditors are bound.

The Bankruptcy Code also permits confirmation under the cram-down provisions on a non-accepting class of claims or equity interests of a Chapter 11 plan that at least one impaired class of creditors has accepted if the plan's treatment of the non-accepting classes does not discriminate unfairly against and is fair and equitable to the non-accepting classes. The cram-down provisions effectuate the absolute priority rule by ensuring that a junior class of claims or equity interests does not receive a distribution under a Chapter 11 plan unless the senior class has been paid in full.

Thus, a Chapter 11 case can obviate the need for creditor unanimity to effectuate the company's balance-sheet restructuring and make it binding on all creditors and equity holders. These types of restructuring are sometimes accomplished in shorter, less expensive Chapter 11 cases commonly referred to as pre-packaged or pre-negotiated cases, where the company negotiates the Chapter 11 plan's terms before filing and then uses the Bankruptcy Code's less than unanimous voting provisions to obtain creditor approval.

However, a Chapter 11 case is not a panacea for the financially troubled company. In fact, a Chapter 11 case typically imposes substantial costs, both in the impact on the business and in the professional fees a company must pay. Chapter 11 can also distract management from operations and add a layer of risk and complexity because many transactions integral to rehabilitation efforts require bankruptcy court approval. As a result, a dissenting stakeholder has a forum and an opportunity to object and be heard on matters before the court, potentially impeding the reorganisation.

Furthermore, once a company commences a Chapter 11 case, it must still formulate and execute a business strategy to emerge. This strategy could include an operational restructuring involving rejecting unprofitable leases or selling assets. A company can also use a Chapter 11 to implement a balance-sheet restructuring by exchanging old debt for new equity in the reorganised company. In either case, however, Chapter 11 is a means of implementing the business strategy, not an end in itself.

Finally, Chapter 11 cannot help a company to resolve financial distress caused primarily by external factors such as increasing commodity prices, greater competition in the industry or escalating fuel costs. These issues are outside the company's control and the Bankruptcy Code does not provide means to address them.

Despite its disadvantages, Chapter 11 might still be inevitable in certain circumstances. Whether the company is able to raise capital outside bankruptcy depends at least in part on existing investors' willingness to consent to an out-of-court restructuring and existing customers', employees' and suppliers' willingness to continue to support the business. The absence of any one of these factors might compel a company to seek relief under Chapter 11, despite its best efforts to prevent that outcome.

Obtaining the approval of the board of directors

Throughout this process, the company needs the guidance, support and approval of its board of directors for any course of action. Directors considering restructuring options should understand their fiduciary obligations in these circumstances. Directors owe fiduciary duties of loyalty, care and good faith exclusively to the corporation and, in an acquisition context, to its shareholders. A director is entitled to a legal presumption, known as the business judgement

rule, that so long as the director did not have any self-interest in the proposed transaction, he or she has acted in good faith and in the best interests of the corporation.

A director's duties do not change as a company approaches insolvency or becomes insolvent. In an insolvent company the value of a creditor's claims may be affected by business decisions, while a shareholder's interests might be at least temporarily worthless. For these reasons creditors, in addition to shareholders, have standing to bring a derivative action against the directors for breach of fiduciary duty. A director should be particularly sensitive to transactions that have the effect of benefiting the company's insiders or particularly themselves.

Even though a non-self-interested director has the benefit of the business judgement rule, a failed out-of-court restructuring strategy may cause losses that can prompt a creditor to sue for breach of fiduciary duty or other related claims based on laws relating to preferences, fraudulent transfers or illegal dividends. As a result, a director should take particular care during this process to avoid self-interest in reviewing matters presented to the board for review or decision.

Conclusion

A financially troubled company does not have an easy path to raising capital. It requires the cooperation of a diverse group of parties whose interests might not be aligned with those of the company or even each other. After a company has identified the source of distress, what its existing debt documents permit and whether existing investors will consent, it must weigh up the substantial costs, delay and risks associated with a Chapter 11 filing against the company's ability to accomplish the same business objectives in an out-of-court restructuring. This task is not easy.

If market conditions continue to deteriorate, as has been predicted, it will not get any easier. There will likely be greater competition among many highly leveraged companies for what might be a diminishing amount of available capital. As a result, capital – whether obtained in a bankruptcy or in an out-of-court restructuring – might be more expensive and the terms and conditions on which it is provided might be more onerous.