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9 Liability Management Tips As Debt Maturity Cliff Looms

By **Keerthika Subramanian, Justin Hoffman and Jacob Tabman** (September 4, 2024, 3:08 PM EDT)

The COVID-19 pandemic coincided with a large uptick in corporate borrowing, as public and private companies opportunistically borrowed at low interest rates.

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Additionally, companies in industries destabilized by the pandemic incurred significant debt to address liquidity shortfalls. Much of this debt will mature between 2025 and 2028.

While some borrowers have successfully refinanced their debt ahead of the maturity cliff, others have struggled due, in part, to macroeconomic headwinds, such as the high cost of capital and market volatility.

Accordingly, to address debt maturities in this challenging environment, borrowers are exploring bespoke liability management transactions, such as tender offers, exchange offers, consent solicitations and complex financings.

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Here we provide top 9 considerations for company boards of directors, management and finance professionals, including lenders and restructuring advisers, when structuring and executing transactions.

1. Review Capital Structure

First, stakeholders should review a borrower's capital structure to understand:

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- The aggregate amounts outstanding under existing instruments;
- The maturity profile and repayment schedules of such instruments;
- The legal classification of such instruments — i.e., preferred stock and convertible bonds are legally classified as equity despite functioning like debt and may be treated as such under debt covenants; and
- The priority of existing instruments, i.e., preferred stock ranks junior to bonds.

Second, stakeholders should review a company's debt portfolio to understand vulnerabilities. Key areas of focus include, but are not limited to:

- The types of debt instruments;
- The structural and contractual subordination of such instruments;
- Current and projected future interest expense;
- Key covenants and provisions; and
- The interplay of debt instruments — i.e., debt instruments may have provisions, such as springing maturity, which implicate other debt instruments.

2. Evaluate Debt Covenants

Next, stakeholders must analyze relevant restrictive covenants set forth in debt instruments to ensure that a potential transaction is permissible under such covenants as noncompliance could have serious consequences for a borrower, including default and acceleration of debt.

Key covenants include, but are not limited to, the following:

- Debt service coverage ratio: Requires a company to maintain a minimum ratio of cash flow available for debt service, ensuring sufficient cash generation to cover debt payments.
- Leverage ratio: Limits the ratio of a company's total debt to its equity or earnings, preventing excessive borrowing that could increase financial risk.
- Interest coverage ratio: Mandates a minimum ratio of earnings before interest and taxes to interest expenses, ensuring that a company can meet its interest payments.
- Negative pledge clause: Restricts a company from pledging its assets as collateral for other loans, protecting the interests of existing lenders by ensuring that they are not subordinated.
- Restrictions on additional indebtedness: Limits a company's ability to incur additional debt beyond a certain threshold, controlling overall leverage and financial risk.
- Restrictions on restricted payments and investments: Limits a company's ability to repurchase equity, repurchase potentially junior or unsecured debt and transfer collateral assets to unrestricted subsidiaries or affiliates.

Stakeholders should also review covenants when structuring drop-down transactions — transactions in which a borrower uses basket capacity under existing covenants to move collateral outside the credit group to an unrestricted subsidiary, thereby releasing existing liens on such collateral and using it to secure new senior debt.

3. Examine Key Provisions in Debt Instruments

Change-of-Control Clauses

Stakeholders should evaluate change-of-control clauses in debt instruments when structuring transactions to ensure that a potential transaction does not run afoul of such clauses.

The triggering of a change-of-control clause could have adverse consequences, including mandatory repayment, a bondholder put and/or an event of default.

Debt Prepayment Provisions

Stakeholders should also review debt prepayment provisions in debt instruments when structuring transactions.

Understanding the types of prepayment options available — i.e., voluntary or mandatory — and their conditions, is important. Key considerations are set forth below.

- Penalty and premium: Evaluate whether prepayments are subject to penalties and premiums, and compare interest savings from retired debt to costs associated with penalties and premiums.
- Cash flow management: Assess whether a company has sufficient cash flow to cover prepayments or new debt interest expense.
- Conditions and pro rata payment provisions: Evaluate prepayment conditions, such as consent. If consent payments are offered, consider whether payments are required to be offered to all holders or whether the loan agreement permits pay down of the loans on a non-pro rata basis or open market repurchases of the loans. These provisions have come under significant scrutiny by nonparticipating creditors.

Consent Requirements

When structuring transactions, stakeholders must review the terms of debt instruments to understand the consent requirements a proposed transaction may trigger, including thresholds.

4. Review Collateral

When contemplating a secured financing, stakeholders should heed the below considerations.

- Inventory: Review existing collateral and assess adequacy for securing additional financing. Identify additional assets that could be pledged.
- Valuation: Obtain current valuations of pledged collateral to ensure that it meets the requirements for additional secured financing.
- Security: Evaluate the impact of additional secured financing on existing secured creditors and their rights to collateral, including all intercreditor agreements and any restrictions on layering of lien priorities or "first-out" tranches.
- Documentation: Ensure proper documentation for any new or modified collateral arrangements.

5. Evaluate Tax Consequences

When evaluating a proposed transaction, stakeholders must consider its tax implications and, in particular, the possibility it may trigger cancellation of indebtedness income, or CODI, to a company.

CODI can arise as a result of an actual debt-for-debt or debt-for-equity exchange but can also arise in the context of an amendment to an existing debt instrument — if such amendment results in a deemed exchange for tax purposes. Additionally, due to the limitations on interest deductibility under provisions of the Internal Revenue Code, interest payments on new or amended debt instruments may not result in a current tax benefit to a company.

Finally, stakeholders should consider the impact of any transaction on a company's net operating losses. If the transaction affects the equity ownership of a company, consideration should be given to whether the transaction triggers an ownership change under Section 382 of the Internal Revenue Code, which could reduce the NOL carryforward benefits available to offset future taxable income.

Additionally, the recognition of CODI generally would absorb some or all of a company's existing NOLs, rendering them unavailable for future use.

6. Assess Equity Offering Feasibility

In addition to debt solutions, liability management can involve the issuance of equity securities, such as the offering of shares in either a public or private offering or the resale registration of shares initially offered in a private placement. When evaluating a proposed transaction involving equity,

Stakeholders should first determine whether such offering is feasible by reviewing a company's authorized capital and shelf registration statement availability and eligibility.

Authorized Capital Review

Stakeholders must assess whether the company's pool of authorized, unissued shares of common stock are sufficient for an equity offering.

If not, a company's organizational documents should be amended to increase the authorized capital ceiling — a process that typically requires stockholder approval.

Obtaining stockholder approval can be onerous as it involves the filing of proxy materials with the U.S. Securities and Exchange Commission and the convening of a special meeting of stockholders.

Shelf Registration Statement Considerations

First, stakeholders should examine whether a company has an existing shelf registration statement on file with the SEC. If so, the expiration date of such shelf registration statement should be assessed.

Second, a company's continued eligibility to use such shelf registration statement must be evaluated, as well as the capacity remaining under such shelf registration statement.

If there is no existing, suitable shelf registration statement on file with the SEC or if eligibility has been lost, then stakeholders should allocate sufficient time to make alternative arrangements, including filing a new shelf registration statement with the SEC.

7. Heed Applicable Stock Exchange Rules

When structuring transactions involving equity, stakeholders should also heed applicable stock exchange rules, as discussed below.

20% Rule

Stakeholders must exercise caution to avoid triggering Nasdaq and New York Stock Exchange rules requiring stockholder approval of issuances of equity or securities convertible into equity that would result in the issuance of more than 20% of a company's common equity or voting power, subject to certain exceptions.

It is important for stakeholders to understand these exceptions. For example, under NYSE rules, shareholder approval is not required for any greater than 20% issuance involving a public offering for cash or any other financing in which the price is at least as great as the minimum price, as defined under NYSE rules.

Should a proposed transaction implicate the 20% rule, a company must engage in a cumbersome proxy statement process and hold a special meeting of stockholders to vote on the transaction.

Substantial Security Holders

Stakeholders should also evaluate the applicability of other stock exchange rules, such as NYSE rules requiring stockholder approval for issuances to substantial security holders under certain circumstances.

Continued Listing Requirements

Additionally, stakeholders must assess the potential impact of a proposed issuance on a company's stock price and other metrics that a company must maintain to comply with continued-listing requirements.

8. Recognize Key Public Reporting Issues

When executing transactions for public companies, stakeholders should be mindful of the below public reporting issues.

Going-Concern Analysis

Going-concern analysis involves evaluating factors such as liquidity, profitability and operational stability to determine whether there are significant doubts about a company's ability to continue as a going concern.

In connection with the preparation of a company's SEC annual and quarterly reports, management, together with the auditors and the audit committee of the board, must undertake a going-concern analysis and include related going-concern disclosure in such reports if it is probable that the company will not have sufficient liquidity to pay its obligations within 12 months from the date of such report.

A going-concern qualification can have serious implications for a borrower. For example, a going-concern opinion from the auditors can in some cases trigger an event of default under a company's credit agreement, which can trigger other cross-default provisions.

Effective liability management can improve a company's liquidity and solvency, reducing the risk of a going-concern qualification in a company's financial statements.

Stakeholders, and in particular, management and the audit committee of the board, should keep the auditors apprised of a proposed transaction, especially if such transaction is intended to prevent a going-concern qualification.

Material Nonpublic Information

When marketing a transaction, stakeholders often confidentially share material nonpublic information with prospective investors.

A company must ensure that such information is either already publicly disclosed or ceases to be material. In some cases, a company may be forced to agree to cleanse such investors so that they may trade the company's securities without restriction.

Risk Factor Disclosures

Prior to executing a transaction, stakeholders should update existing risk factors in SEC reports and transaction offering documents, if applicable, to address the risk of the maturity cliff or the inability to execute on deleveraging or refinancing transactions.

Robust risk factors can prove useful in the event a company is subject to litigation.

9. Implement Governance Safeguards

When transactions involve potential conflicts of interest, a board must implement safeguards to ensure that directors can carry out their fiduciary duties of care, loyalty and good faith.

For example, in transactions involving related parties, care should be exercised to ensure compliance with a company's related party transaction policy.

In particular, the board should delegate approval authority over the material terms of the related party transaction to a committee consisting of independent, disinterested directors.

Conclusion

As the maturity cliff looms, effective liability management is critical. When structuring and executing complex transactions, stakeholders should heed the considerations presented herein.

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