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# THE GUIDE TO CORPORATE CRISIS MANAGEMENT

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# Publisher's Note

Latin Lawyer and LACCA are delighted to publish *The Guide to Corporate Crisis Management*. Edited by Sergio J Galvis, Robert J Giuffra Jr and Werner F Ahlers, partners at Sullivan & Cromwell LLP, the fifth edition of this guide brings together the knowledge and experience of leading practitioners from a variety of disciplines and provides guidance that will benefit all practitioners.

We are delighted to have worked with so many leading individuals to produce *The Guide to Corporate Crisis Management*. If you find it useful, you may also like the other books in the Latin Lawyer series, including *The Guide to Mergers and Acquisitions*, *The Guide to Restructuring* and *The Guide to Corporate Compliance,* and our new tool providing overviews of regulators in Latin America.

My thanks to the editors for their vision and energy in pursuing this project and to my colleagues in production for achieving such a polished work.

## CHAPTER 10

# Restructuring and How to Manage Threats to Solvency

Timothy Graulich, James Florack, Angela Libby and Joshua Sturm[1]

Companies navigating solvency challenges must make high-stakes decisions, fighting for survival while balancing the interests of their various stakeholders. That typically begins with considering operational changes, possible debt management, capital raises and other potential transactions that can improve solvency. And if those approaches fail, the company needs to be prepared for a comprehensive restructuring solution that maximises its future value.

This chapter summarises select tools and considerations distressed companies and their managers can apply in the face of potential insolvency.

### Diagnosing the issue

Developing a plan to manage or mitigate solvency risk should be informed by an understanding of the nature and scope of the challenge. The company should fully understand its liquidity profile and capital structure to determine whether the issue is a short-term difficulty in meeting near-term cash needs – really, a liquidity risk that might be managed before it threatens solvency – a deeper operational or business plan challenge, a structural balance sheet issue, or a combination of these. Resolving each type of issue could require a different approach.

1 Timothy Graulich, James Florack and Angela Libby are partners, and Joshua Sturm is counsel, at Davis Polk & Wardwell LLP. The authors would like to thank associates Jinhe Hu, Eric Hwang and Kate Fine for their assistance with this chapter.

To accurately and efficiently diagnose the challenge, most distressed companies will hire legal and financial advisers with expertise in restructurings, who will then work with management to identify the relevant issues and develop a strategic review of the company's options.

One of the first things that a restructuring adviser will do is work with the company to develop a near- to medium-term cash-flow projection, taking into account capital expenditure needs, debt maturities and interest payments, and other upcoming payment obligations. That liquidity forecast is critical for a company closely managing its own cash. But it can also be an important tool for a company facing a liquidity crunch to use in negotiating with financing parties; with creditors, vendors and customers; and potentially with employees and other stakeholders in any restructuring negotiation.

Another gating item is a comprehensive review of the company's capital structure, including the financial terms, restrictive covenants and other terms in the company's existing debt, and other contractual obligations. Any such analysis should identify near-term triggers (such as an upcoming financial maintenance test or amortisation requirement) and significant limitations (such as a change-of-control event or debt or lien restrictions) to provide sufficient time to prepare meaningful and informed contingency plans. These can include cash-flow shortfalls, defaults under maintenance covenants in debt documents, potential adverse litigation outcomes or upcoming contractual renegotiations with material counterparties.

As set out in the remainder of this chapter, once the challenge has been identified, there are various tools that may be available to address a solvency challenge. However, it is critical that companies understand that risks associated with effectuating transactions will increase significantly when a company is distressed. The particular risks, and potential means to mitigate risks, will vary depending on the nature of the transaction, the governing law applicable to the company and the facts and circumstances of each case. Any company seeking to use any of these strategies for addressing solvency should retain experienced counsel.

## Operational tools

As a company seeks to manage solvency concerns, its first and primary area of focus will be on identifying and optimising areas of concern in its cash forecast and business plan. This exercise is typically undertaken with the support of an experienced financial adviser who will help the company develop a tailored plan to address areas for improvement.

While the scope of such financial adviser-assisted tools falls outside this chapter, a few that are often deployed by companies facing distress include:

- *Liquidity management and vendor negotiations*: If the challenge is primarily near-term liquidity, careful cash management and implementation of operating efficiencies can mitigate, or even solve, that problem. The company may also press its vendors to extend payables (and shorten receivables) temporarily. But seeking these types of concessions for an extended period can strain otherwise healthy business relationships, so a company and its advisers must balance the advantages against any friction they might cause in core business relationships.
- *Renegotiating contract terms*: If the company has identified burdensome contracts as the source of its solvency woes, it may seek to renegotiate terms. The likely success of negotiations will vary based on the practical negotiating leverage of each party as well as the terms, in particular duration, of the existing contracts. In negotiating for concessions, the company should understand the rights remedies that it would have in the event of an insolvency filing, and how those rights may impact a counterparty's own analysis of the risks and benefits of accommodating or denying a request for assistance. Most notably, under the US bankruptcy regime, the debtor is generally permitted to assume or reject its uncompleted business contracts and unexpired leases. This gives the company the ability in many cases to shed contracts that cost above market rate or that are otherwise unprofitable, and vendors would not be able to enforce the terms of any rejected contract against the company following a bankruptcy filing.[2] This dynamic can provide important leverage to the company in negotiations with vendors, who face the prospect of receiving a far smaller recovery in the event of a bankruptcy, in addition to losing a long-term customer.
- *Headcount reductions*: Companies undergoing a restructuring often focus on headcount as a source of operational savings. However, such reductions may come at the cost of employee morale and long-term growth. It is important that the company consult with both financial and legal advisers to understand the short-term costs of any lay-offs (i.e., severance, deferred compensation), impact on a long-term business plan and any potential legal risks associated with the reduction. In most jurisdictions, there are heightened protections for

2 If the debtor rejects a contract, the vendor can file a claim for breach-of-contract damages as a result of the rejection. However, breach-of-contract claims are treated as unsecured claims, and unsecured claims can often receive a low recovery in bankruptcy as they are last in priority and must share recoveries with all other unsecured claimants, which can be a large pool of creditors.

claims arising from employment obligations, and in some jurisdictions unpaid labour claims may give rise to personal liability on the part of equity sponsors or directors and officers.

- *Capital expenditure reductions*: A company facing a near-term liquidity issue may scale back or even completely cease capital expenditure projects. While this may address an immediate liquidity crunch, a company should consider whether a deferral of capital spending for too long – or even simply cancelling planned growth – will risk starving its business to the company's long-term detriment.

## Traditional divestment solutions

Distressed companies often raise additional capital or de-lever their balance sheets by selling businesses or assets. This is often done in conjunction with a strategic business plan review that has identified non-core or underperforming assets. To that end, sales can sometimes be a step in a necessary operational restructuring and a solution to a liquidity challenge.

A few key considerations become more relevant in the distressed context than in an ordinary divestment. In a distressed asset sale, the company will need to understand whether it has the time and liquidity to run a regular-way marketing and auction process, while continuing to run the business long enough to receive sale proceeds at a projected closing date. The market for distressed assets can also be less liquid, and in marketing the asset, the company may need to look to alternative investors with experience in valuing and monetising distressed assets.

Financial creditors may also be involved in a distressed transaction to a greater degree than usual. Debt documents will often contain provisions requiring that the proceeds of asset sales be used to pay down debt in certain circumstances. If the transaction is not expected to repay or refinance existing debt in full, the company may need to obtain consents or waivers from its creditors to effect the transaction.

While divestment is often a viable means to raise additional liquidity, sellers and buyers of assets bear increased risk if the sale is conducted against the backdrop of a liquidity crisis. The contours of that risk vary depending on the governing law applicable to the transaction and, if the company ultimately files for an in-court proceeding, the jurisdiction in which the company files. In broad strokes, however, the consequences can range from additional claims against the company or the buyer, or both; the transaction being subject to unwinding; and even personal liability for directors and officers. Therefore, any transaction contemplated as a tool for managing solvency risk should be structured with the aid of experienced advisers.

## Monetising non-traditional pockets of value

While traditional business or asset sales may be a solution in some cases, in others, the more obvious pockets of value within a company may have already been monetised or may be too central to the core operations to be divested. In these circumstances, the company facing a near-term liquidity issue will often consider pockets of liquidity or value that they may have previously overlooked as they seek to raise new capital or supplement the collateral package for their existing lenders in connection with a negotiation over new capital or covenant relief. For example, two structures that may be considered are as follows:

- *Receivables financing*: The company may be able to enter into receivables financings, where all or a portion of the company's receivables are transferred to a special purpose entity, which then pledges such receivables as collateral for secured financing. The amount that can be borrowed under the receivables facility will typically be based on a percentage of the value of the pledged receivables. Depending on the availability of receivables that can be segregated and transferred – and any limitations imposed by the terms of the company's other existing debt instruments – this structure can be a meaningful avenue for liquidity.
- *Sale and lease back transactions*: The company may also have other assets, such as real estate or equipment, that could be used in sale and lease back transactions to raise near-term liquidity, where the asset is sold to a counterparty and simultaneously leased back to the company over a period. In some jurisdictions, these transactions may be subject to re-characterisation in an insolvency proceeding and should therefore be structured to address such risks. As with other transactions discussed in this chapter, a company's existing debt instruments will often impose limitations on the amount and nature of these transactions.

Asset-backed financings that leverage intellectual property and other intangible asset classes have also become increasingly common as a source of financing on favourable terms because, if optimally structured, they can provide lenders and investors with comparatively robust protections through both collateral and structure. Some may even be structured off the balance sheet from the company's perspective. The asset classes (ranging from traditional registered IP to unregistered IP such as proprietary technology, trade secrets, software and databases) have the benefit of being highly divisible – they can be split, transferred and licensed in ways other forms of collateral cannot. And this allows for more flexibility and creativity when structuring an IP financing transaction. For example, a recent secured notes offering by Azul SA in 2023[3] involved financing secured by assets and receivables of Azul's airline loyalty programme, travel package business and other brand IP.

The market for IP financing transactions continues to develop as such financings gain more prominence. One way in which such transactions have been structured involves a pledge by the company of its intangible assets to special purpose vehicles whose shares are pledged as collateral. The vehicle serves as a grantor of security interests and licenses the intangible assets back to the company exclusively. Owing to this licensing agreement, the company is largely in the same position and is able to use the intangible assets, while the transfer of the assets to the special purchase vehicle provides secured parties with an increased ability to foreclose on the collateral in an event of default.

Alternatively, the company may directly provide an exclusive licence to the intangible assets to the collateral agent, and the collateral agent would then sublicense the intangible asset back to the company. The financing provided by the secured parties to the company under this structure can serve as consideration for the licence grant, as the exclusive licence serves as a form of credit protection for the secured parties who may terminate the exclusive licence in the event of a default pursuant to the terms of the financing.

## Debt buy-backs

As a company with publicly traded debt faces financial challenges, its debt will typically trade at a discount to the face amount of the claim. If the company (or its equity sponsor) has sufficient liquidity, it may seek to capture that discount by purchasing the debt at a discount and then retiring it and in turn de-leveraging the company's balance sheet.

The debt buy-back may be effectuated through purchases in the market, through negotiated purchases with select creditors or through a generally available tender offer or exchange. In considering whether a buy-back makes sense and, if so, how to effectuate the buy-back, it is crucial that company consult with legal counsel as debt buy-backs implicate a host of potential legal issues. For example, loan documents will often govern the terms of buy-backs, sometimes treating them as restricted assignments, limited in nature or amount, to the company-borrower. And repurchases of debt securities will need to be effected in accordance with

3 Davis Polk & Wardwell LLP acted for the dealer managers on the senior notes exchange.

applicable securities laws as well as the related indenture. In short, the company will need to carefully review its debt agreements before undertaking any buy-back or redemption exercise.

## Liability management transactions

A comprehensive liability management transaction may also be a tool for the company to restructure funded debt. In recent years, companies in distressed situations with significant funded New York-law governed debt obligations have increasingly turned to complex liability management transactions to manage their debt capital structure. Liability management transactions, like refinancings and debt buy-backs, can permit a company to increase liquidity, reduce leverage, reduce cash burn or extend maturities.

Liability management transactions often rely on provisions (or the lack of them) in debt documents to structure financing transactions negotiated and effectuated with a subset of lenders, and can involve non-pro rata treatment of lenders. Many liability management transactions will result in winners and losers among the company's different creditor groups where some creditors benefit while others are left worse off. Liability management transactions can also be effectuated with third parties, such as direct lenders, where value in the guarantor and collateral package is diverted away from the existing lender base.

Although liability management transactions can be structured in a variety of ways, two basic approaches are drop-down financings and up-tiering transactions. The market for liability management transactions continues to evolve, driven by the needs of particular companies and limitations in their credit documents.

### Drop-down financings

In a drop-down financing, the company identifies assets that may be readily separated from the rest of the business (such as a separate business line or IP) and transfers the assets to a subsidiary (often referred to as an 'unrestricted subsidiary') that is not subject to the covenants contained in the company's debt documents. Any lien on the transferred assets for the benefit of the existing lenders is typically automatically released pursuant to the terms of the debt documents (so long as the transfer itself complied with the covenants), and the assets become unencumbered (i.e., outside the existing lenders' collateral package).[4] Such newly unen-

4 A variation of this drop-down financing structure involves an automatic release of liens on assets by converting guarantor subsidiaries to non-guarantor subsidiaries. This

cumbered assets can then be used by the company to secure new debt, either provided by a subset or all of the existing lenders or new third-party creditors, and such new debt is then structurally senior to existing debt with respect to the value of the transferred assets. Existing lenders may also seek to participate in the transaction by exchanging their existing debt into such structurally senior debt. Companies will often extract a discount to the principal amount of the claim in connection with the exchange into the structurally senior debt, thereby achieving both immediate liquidity and a longer-term liability reduction.

In the US, the prototypical drop-down financing was effected in the *J Crew* financing, where J Crew was able to, under its debt documents, ultimately transfer its valuable IP to an unrestricted subsidiary (i.e., an entity outside of the existing creditors' credit support package). The unrestricted subsidiary was able to raise liquidity by issuing notes secured by the transferred IP and licensed the IP back to J Crew for continued use in its normal business operations. The US credit market has responded by imposing additional restrictive covenants on a company's ability to undertake such transactions, and leveraged and high-yield debt documents will often contain, to varying degrees, '*J Crew*-blockers' to limit the extent to which valuable assets can be transferred outside of the credit support and collateral package.

## Up-tiering transactions

In an up-tiering transaction, the claims of existing lenders on the guarantee and collateral package become contractually subordinated to the claims of newly issued debt, typically through an intercreditor agreement or amendment to the priority waterfall in the existing debt documents. Up-tiering transactions will typically be offered to at least a majority of lenders (to obtain necessary consents under the debt documents). Participating lenders provide all or a portion of the new super-priority financing and will typically be permitted to exchange existing debt into the new super-priority debt. Similar to exchanges in a drop-down financing, such exchanges are often made at a discount, enabling a company to de-lever its balance sheet.

The *Serta* financing transaction exemplifies a typical up-tiering transaction, where Serta effectuated a transaction that was offered to certain majorities of its first lien and second lien lenders (but not to all lenders). Under the transaction,

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mechanism was used in the *Chewy* financing, where the debt documents provided for the release of guarantees and liens in the event a guarantor became a non-wholly owned subsidiary.

participating first lien and second lien lenders provided new money financing in the form of first-out super-priority term loans, which were senior in priority to (and subordinated) the existing first and second lien loans. Participating lenders were also permitted to up-tier their existing loans (at a steep discount) into second-out super-priority term loans. Through this transaction, Serta was able to raise additional liquidity, as well as de-lever its balance sheet through the participating lenders' exchange and cancellation of existing debt at less than face value. The market has also reacted to such non-pro rata up-tiering transactions, and debt documents may contain 'anti-*Serta*' protections to require, for example, the consent of all lenders in order to subordinate – whether contractually or through lien subordination – existing loans to new financings.

While liability management transactions can be used to raise new money, reduce overall debt burden and build in additional covenant flexibility, the ability of the company to execute such transactions will depend on a careful analysis of the provisions of its debt documents. Financing markets have taken note of the increased frequency of liability management transactions, and lenders have sought additional protections in debt documents to limit or block such transactions. Even if permitted under the debt documents, the company will also need to take into account other strategic considerations in structuring liability management transactions, such as litigation or reputational risk.

## Negotiations with funded debt stakeholders

The tools outlined above may or may not require engagement with the company's existing lenders and investors, depending on the terms of the proposed transaction and the limitations in the company's existing debt documents.

Once a company engages with its financial creditors, various tools can be used as part of either a short-term solution or a broader restructuring. For example:

- *Covenant waivers*: If the company expects to breach financial covenants or if it needs additional covenant flexibility in undertake one of the transactions outlined above, it may need to seek a waiver from its creditors. The terms of waivers can range from a narrow agreement to provide the requested covenant relief to an agreement on a more comprehensive restructuring process. Lenders, even if supportive of the company's business rationale for the request, will often seek to increase the protections on their investment through tighter covenants, additional collateral and other concessions in exchange for the waiver. For example, if a company seeks relief from complying with a leverage ratio covenant, the lenders may ask for a liquidity test and 'anti-cash hoarding' provision as a partial *quid pro quo*.

- *Interest payment deferrals*: Companies may seek liquidity relief from their existing funded creditors through interest deferrals or an agreement to pay such interest in the form of capitalised interest, which provides near-term liquidity relief while, longer term, increasing the principal amount of the company's debt. These solutions are often valuable short-term cash management solutions, but do not, in and of themselves, resolve a balance sheet imbalance.
- *Maturity extensions*: If the company has been unsuccessful in raising capital to pay down or refinance an upcoming maturity, it may need to seek a maturity extension from its existing lenders. In evaluating a request for an extension, lenders will typically be focused on understanding both the long-term business plan and all available alternatives, including the potential for equity or third-party capital, the impact of an in-court process and potential divestment solutions. Certain investors, such as collateralised loan obligation investors, may have institutional restrictions on extending maturities beyond a certain time frame.

As the company and its advisers consider the best strategy for engaging with and making requests of its financial creditors, it is important to remember that such stakeholders can also have a wide range of goals, motivations and levels of sophistication. Financial creditors will certainly be focused on maximising the returns on their investments and loans, but may also have reputational considerations, especially in more insular financing markets where there are often repeat players or regulatory concerns. Each individual lender or shareholder will have a different risk appetite and willingness, for example, to provide incremental liquidity to a distressed company. Creditors will also have different points of leverage, depending on whether debt is secured or unsecured, the scope of a guarantee or security package, and flexibility available under debt documents, and they will also often be advised by restructuring professionals performing the same analyses as the company and its advisers.

## Insolvency proceedings

While this chapter focused on out-of-court tools to manage solvency, we would be remiss if we did not observe that an in-court proceeding can often be the most powerful tool available for a company to achieve financial solvency. Although it can be a daunting prospect, filing for an in-court insolvency proceeding can have numerous benefits that provide the company with a fresh start.

The tools available within specific restructuring regimes fall outside the scope of this chapter, but generally speaking, these include (1) a court-imposed stay that prevents a company's creditors from exercising remedies, (2) the ability to discharge or reduce certain liabilities, (3) the ability to reject economically disadvantageous contracts, (4) court-sanctioned sale transactions, sold free-and-clear of all or most existing liens and other claims and regardless of contractual restrictions, and (5) the ability to secure additional (potentially senior) financing. On the other hand, filing for bankruptcy can also have disadvantages, such as the stigma that can impact operations and possibly cause business counterparties to look to the company's competitors, heightened regulatory and judicial scrutiny, administrative and professional costs, and diverting management's attention and energy away from running the business.

The balance of these considerations will vary from company to company, from jurisdiction to jurisdiction, and with the legal rules governing the particular forum for resolution. There are great differences between the insolvency regimes of different countries, and different outcomes of the process depending on the nature of a company's particular business and financial situation. Any company considering an in-court process will need to work closely with experienced restructuring advisers to identify the pros and cons of various available jurisdictions and forums.