

Chapter 15

Structural Issues: Amendments, Waivers, and Consents

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WHEN A COMPANY wants to change the terms of its debt, it can refinance the existing debt with new debt that has the terms it wants, or it can try to get an agreement to change the terms of the existing debt. Trying to do a refinancing requires a new round of legal, accounting, and financing fees and exposes the company to market risk on interest rates when setting the new coupon for the new financing. The second method is to approach the debt holders and negotiate an amendment or a waiver to the terms that the company needs to change. This usually involves paying the debt holders a fee or giving them an improvement in the terms of their debt. There is a difference between an amendment and a waiver. An amendment is a permanent change to the terms of a debt agreement. A waiver is a one-time or event-specific change to the covenants.

The Process of Amending Terms

Within the terms of the debt securities are details of how changes to the covenants, or other terms, can be made. Generally, the changes require a simple majority of the loan or note holders to approve them based on holdings. (This means that if it is a \$1 billion bond, holders of \$500.1 million of the bonds would need to approve a change.) Sometimes terms require a supermajority, such as 67%. There are other situations where the terms specify that certain changes require one percentage, and changing another term would require a different amount. It is important to note that what are commonly called money terms require a 100% affirmative vote for any adjustments considered negative for the debt holders (e.g., increasing a coupon is allowed; decreasing the coupon is not). It is difficult to get a 100% vote on anything. Money terms are usually the principal amount due, the interest rate, and the maturity, including principal amortization requirements.

Because bank agreements tend to have more covenants, bank loans more commonly see requests for amendments and waivers than bondholders. This is especially true of affirmative covenants because companies get hit with some disruptions to their plans, and growth trajectories can change. It is generally considered easier to get amendments and waivers done in the bank market. In the loan market, the agent bank keeps track of all holders of the loans. Given that bank lenders usually enjoy the most senior position in the debt structure, they also tend to be more flexible on changing terms in exchange for fees. The concept of lender liability in the bank market comes into play in the context of adjustments on affirmative covenants. Bank lenders have an obligation to not act in a manner that is detrimental to the company they have lent money to.

The agent bank is equivalent to a lead underwriter on a bond but continues to have obligations after the placement is completed. Generally, it maintains communications with all the holders. Because of the nature of how the debt trades (every trade usually has to be approved by the agent bank), the agent bank usually knows who all the holders of the debt are. The agent bank is also often a holder of the debt and is usually the logical entity for the company to use as a lead negotiator on any changes to the debt terms the company wants to make.

The types of holders of bank debt can matter in the process of getting amendments and waivers completed. For example, if the majority of the holders tend to be traditional commercial banks, it is generally believed that they are more focused on the relationship with the company and are more willing to reach reasonable agreements quickly. When aggressive, stressed, or distressed investors tend to hold much of the bank debt, they have a reputation for being more concerned about near-term returns. Other investors, such as structured CLO types and other institutional holders of bank debt such as mutual funds, view this process in many different ways.

Tenders and Exchanges

Other options are available if covenants or structural changes are needed and the bonds are not callable. These commonly involve the use of tenders and exchanges, which are used for permanent changes to the covenants, not for waivers.

A tender is a company's offer to purchase securities. For example, if a company wanted to change a covenant, it could make an offer to buy at least 51% of a bond issue outstanding at 110. Part of this price would include a consent fee for agreeing, almost simultaneously, to the waiver or amendment, and then the bond would be sold back to the company at that price. These transactions are actually a two-step process even though they happen simultaneously, involving a tender to purchase the debt, and a consent. This requires the company to have either existing liquidity or new financing in place. The price for the tender can be expensive for the company, too.

When doing a tender, the company must have cash or raise financing to pay for it. The company's financial team and advisors must weigh the expense of the new debt versus how high a consent fee might need to be to get the transaction done. The bonds' callability, or how close they are to maturity, also becomes a factor in the ability to do this. In bank debt, because of the callability and the requirement to make all prepayments pro rata, tender and consent transactions are not as common.

Another alternative to a straight consent, waiver, or tender is an exchange offer. Debt holders receive an offer to exchange into a new note with the changes in the covenants that the company needs. As opposed to a tender, an exchange

allows the company to avoid having to raise new financing or use cash. And unlike a tender, the bondholders are not offered cash, but a new security.

The exchange offer typically offers some incentive to the holders to exchange rather than not exchange (or hold out). Exchanges and tender offers can be coercive by potentially leaving any holdouts with a much weaker position in the credit if they don't tender or exchange. If the company gets the requisite amount to undertake the exchange or tender, all the protection of the old covenants from the notes that do not exchange is sometimes stripped away. In an exchange offer, the new exchange could also be senior to the old notes, thus priming the old notes. The new notes could also have a bigger coupon or a shorter maturity. Or they could even exchange into more debt. Perhaps the holder exchanges \$1 worth of old bonds and gets back \$1.05 of new ones. These exchanges usually have a minimum acceptance rate. Keep in mind that 100% acceptance is unlikely. Therefore, both the old outstanding issue and the new issue will probably be smaller and may have less trading liquidity.

One type of amendment common in the loan market is an amend and extend. This is actually a new issue that looks a bit like an exchange offer that is negotiated with the banks. In a simple form, the company negotiates with the banks to agree to keep in place the basic terms of the bank agreement and perhaps make a few changes to the covenants; this is the amend part. Then the company also gets holders to extend the maturity and issues a new loan with these terms, using the proceeds to retire the old loans. But even if the company gets 90% of the bank debt to agree to this, it cannot force the other 10% to accept the extended maturity date. This type of transaction effectively works as an exchange does. There are often two tranches of the loan after the amend and extend transaction; or if the new loan is in demand, the company might be able to raise enough to retire any outstanding old loans.

Distressed Exchange Offers

Exchange offers are also quite common in distressed situations. They are usually attempts to improve a troubled or stressed situation. Often, they are structured in hopes of avoiding a bankruptcy and are often structured to be coercive to debt holders. If the debt of a stressed company starts to trade at a significant discount, it may increasingly tempt a company to make a distressed exchange offer to capture some of this discount.

In a distressed exchange offer, the debt holders agree to an exchange that negatively impacts some of the critical money terms but does give them some other advantage in the new security. As an example, debt holders may own \$10,000,000 of distressed 6% subordinated bond that matures in two years and is trading at 60. They may accept an exchange offer for 70% of the face amount of their bonds in a new bond that has an 8.625% coupon, is senior secured, and has a five-year maturity. The bondholders have sacrificed a considerable amount of principal but improved their ranking in the capital structure and maintained about the same level of annual interest income. The company has reduced its overall debt and moved out a maturity. Debt holders that didn't exchange have been primed and are now junior in priority, but their full principal matures earlier than the new debt if the company does not default. Some studies and ratings agencies will consider the bonds that were exchanged as having defaulted because they permanently impaired critical money terms of the debt.

Some Examples

The need to change affirmative covenants can be driven by a poor economy or a change in competition. The need to change negative covenants, such as the ability to issue more debt or waive a change of control, is usually driven by an unforeseen event, such as a merger or acquisition or a shift in expansion plans. It is not uncommon to see a company undergoing a transaction to pursue a waiver for the change-of-control covenant. This example focuses on a waiver for the bonds, but it could just as easily apply to loans as well.

Sometimes it appears obvious that a change-of-control put would not be exercised by any holders, but it can still matter. Assume that a company has a 10% senior note outstanding and that the company's bond has a change-of-control put covenant that requires the company to make an offer to purchase the bonds at 101% of face value. Then assume that this company is being bought by a much stronger credit, maybe even an investment-grade company that has bonds that trade at 5%. This implies that those 10% bonds will be trading significantly over 101 when the acquisition closes. Even though a 101 offer to purchase may be made, it is unlikely that any bondholders would sell the bonds, because they would be trading at a higher price than the change-of-control put of 101. However, acquisitions can take a long time from the time they are announced until they actually close, and market conditions can change rapidly. The board of directors of the selling company will want to

protect shareholders and will likely require the acquiring company to arrange some kind of financing that can be utilized, if needed, to pay for the change of control in case market conditions vary greatly by the time the transaction closing finally occurs. Then the company management must decide which is more cost-effective: 1) arranging some type of draw-down option for financing the change-of-control put (in case the change-of-control offer gets hit), or 2) trying to get a waiver from bondholders on the change-of-control covenant.

The acquiring company must weigh what it will cost to secure this financing commitment—usually some form of bridge loan fees to a bank or other institutional lenders—versus what it is willing to pay the bondholders to agree to waive this right to put. The bondholders have to weigh how much they can get the company to pay them versus the company walking away from the waiver negotiation and using other financing. In that case, the bondholders would get nothing and would give up a chance to get paid an extra fee in what already appears to be a good transaction for them. The bondholders also have to weigh their assessment of the current fee being offered to them versus the chance that the bonds might trade below the 101 put they could have been offered at the time the transaction closes. With all of these considerations at play, the company will likely make an offer to the bondholders to waive the change-of-control put for this merger, and negotiations will begin. Bondholders will want to make sure that the language of the waiver is very specific and is only a waiver for this transaction and not a permanent amendment to the agreement.

Sometimes a company foresees that it will violate one of the financial maintenance covenants. Because bank holders can be private as opposed to public, the company can start discussing its issue with the agent bank, and hopefully, some of the largest holders, before a violation occurs. The company may be seeking an amendment to the test, or perhaps just a one-time waiver. The company will typically have to pay a fee for the debt holders' consent. The size of the fee will likely depend on the reasons for the request, the company's performance, and to some extent, the makeup of the holders of the bank debt. The fee may not always be an immediate cash outlay; it could be a temporary or permanent adjustment to the coupon payments on the debt. Typically, if a company violates one of these terms, the bank agreement gives it thirty days (or some other set amount of time) to fix the problem before officially causing a default. This is called a grace period. The same is true for a missed coupon payment. Temporary waivers can be passed while negotiations are ongoing for

a more permanent amendment or a longer-lasting waiver. Theoretically, these technical defaults could cause a bankruptcy, but it is hard to think of a case where such a technical default has been the sole cause of the bankruptcy.

Another way to cure a technical default is through an equity cure. A covenant may allow a company's owner to cure a financial technical default simply by putting more equity capital into the company. For example, suppose a company is in violation of a debt/EBITDA test, and a reduction in the debt of \$50 million would keep the company out of the violation. The company's owner would be allowed to invest another \$50 million into the company's equity to cure this default.

Bank covenants often require paydowns of all or a large portion of the proceeds from actions such as asset sales and equity offerings. In the case of asset sales, the company may actually require the bank lender's approval. In reality, the company often negotiates with the banks on what it can do with the proceeds before agreeing to the transaction. It is easier for the company when bank lenders are private because these negotiations may be done well before any transaction is finalized or announced publicly. The bank lenders will often agree to some form of partial payment and then give the company more leeway in what to do with the balance of the proceeds.

Closing Comment

Consents, tenders, and exchanges often come into play because an event occurs or appears likely to occur. The event is often a merger or acquisition, but it could also be the risk of an impending maintenance covenant violation or a default. Similar to covenant analysis, examining these types of transaction involves careful reading of the terms, as there is no standard format. It also involves the use of scenario analysis. When the economy is going through a period of stress or a specific industry is struggling, stressed exchange offers become increasingly common.