Proskauer

Private Credit Restructuring Trends: Sponsor Capital Infusions in Times of Distress

October 14, 2024

One common denominator links nearly all stressed businesses: tight liquidity. After the liquidity hole is identified and sized, the discussion inevitably turns to the question of who will fund the necessary capital to extend the liquidity runway. For a PE-backed business where there is a credible path to recovery, a sponsor, due to its existing equity stake, is often willing to inject additional capital into an underperforming portfolio company. Having established its willingness to provide support to the business and communicated it to the other stakeholders (most notably, the lenders to the business), the conversation pivots from *who* will fund to *how* the capital will be infused. Sponsors considering rescue capital during times of distress have an array of options on how to inject capital. Existing creditors, however, have strong views on where that capital is invested. As a result, the infusion of rescue capital is often the product of negotiation. In this article, we discuss the common forms of sponsor capital support and the key considerations from the creditor's point of view.

1. Equity Capital

The first and best option is sponsor capital in the form of equity. This is the simplest and least complicated entry point. Moreover, it provides the most downside protection for the existing creditors because, in the event the turnaround fails, creditors recover their loan before equity receives a distribution. Notwithstanding the simplicity of this path, creditors must nevertheless review the documentation and should also consider if the equity injection should be deemed a usage of an equity cure (if applicable) under their credit agreement and understand whether the injection builds capacity under the negative covenants (including under an "available amount" basket). Equity cures are generally subject to certain limitations on their use, including as to timing and number of uses; available amount builders and similar features provide for dividends, payments on junior debt and investments to the extent of sponsor equity contributions, and lenders may question whether rescue financing should add to such capacity. From the sponsor's perspective, incremental equity capital may be the least desirable attachment point for new capital because the incremental capital is most at risk if the turnaround fails. As a result, sponsors often insist that their capital be invested as debt.

2. Loan Participation

Where equity capital is not viable, creditors may consider allowing a sponsor to contribute debt in the form of a loan participation (as opposed to a direct loan). A loan participation agreement is an agreement between a lender, on the one hand, and a party who purchases an interest in an underlying loan (the participant), on the other. In a participation agreement, the lender maintains control over the loan and manages the relationship with the borrower. In a standard LSTA-style[1] participation agreement, the grantor/lender continues to hold legal title to its loan to the borrower, but the economics of all, or a portion, of the loan are sold to the sponsor/participant. The sponsor acquires solely an economic interest in the loan with very limited voting or other rights. Importantly, the sponsor/participant is not a "Lender" of record under the credit documentation. Existing creditors must pay close attention to the substance of the participation agreement to ensure the sponsor does not obtain material voting, informational, or other rights that could restrict the creditors' flexibility or rights in a potential restructuring. Participations in this context are often structured as a "last-out" participation where the sponsor's economic rights kick-in only after the existing lenders are paid in full on their first-out tranche.

3. Direct Loan

Direct loans by a sponsor to its portfolio company are a less desirable form of sponsor capital support from the existing creditors' perspective because the sponsor becomes a creditor of the borrower. Even though sponsor direct rescue loans are often structured as subordinated in right of payment relative to the existing lenders,[2] the mere fact that the sponsor is now a creditor of the borrower has implications in the event the borrower subsequently files chapter 11. These consequences must be considered and addressed to avoid problems down the road. For example - will the sponsor debt have any voting rights in a chapter 11 plan? Will the sponsor debt be classified in the same or different classes from existing creditors under the same facility? Even if the quantum of sponsor debt is below the 33.33% class veto threshold for a reorganization plan, can the sponsor nevertheless engineer a class veto by holding the debt in multiple funds to frustrate the requirement in chapter 11 that class acceptance also require acceptance by more than 50% of the number of creditors voting in the class.[3] Careful drafting of subordination and intercreditor arrangements vis-à-vis the existing creditors is critical when the sponsor injects capital in the form of a direct loan. The information rights, expense reimbursement, indemnity, and agency provisions of the sponsor debt must also be evaluated.

4. Future Support

Instead of an immediate infusion of equity or debt capital, some deals are structured with conditional sponsor financial support. More specifically, the sponsor promises to inject equity or debt capital in the future subject to the occurrence of negotiated triggering events, most often tied to leverage or liquidity conditions. In this context, careful planning is again required to clearly define the trigger events and to assess the creditworthiness of the entity providing the future commitment. So-called "keep-wells" and sponsor guarantees are just naked promises to provide future capital.

These structures have execution risk because the sponsor's future promise to provide capital is unenforceable if the borrower subsequently files for bankruptcy before the trigger event occurs.[4] To mitigate this risk, creditors should insist on a letter of credit, which offers multiple benefits. First, the letter of credit eliminates sponsor credit risk or the risk of breach because the issuing bank must honor of the draw conditions in the letter of credit irrespective of the issuer's financial status. The letter of credit also eliminates the bankruptcy enforcement risk because it can be structured to re-route the funds flow in the event of a borrower bankruptcy. In other words, the letter of credit proceeds can be made payable to the creditor and used, for example, to buy a last-out participation. Key points of negotiation include the conditions to draw on the letter of credit and any requirements on how the funds must be applied (e.g. to paydown the existing debt). The main cost to the sponsor is that it must pay the fees associated with the issuance and maintenance of the letter of credit. That said, most PE sponsors have fund-level financing, which typically includes a letter of credit facility. Another way to mitigate the risk regarding the enforceability of a keep-well agreement or sponsor guarantee in the event that the borrower files for chapter 11 is to re-route the commitment. More specifically, the documentation can provide that in the event of a chapter 11 filing (or other triggering event) the sponsor's commitment to provide debt or equity capital into the borrower can pivot to a commitment to purchase a last-out participation in the underlying loan.

In some instances where a sponsor's credit support is contingent on future events, creditors may insist on an equity commitment letter. This option is less desirable than the letter of credit path because, like the keep-well and sponsor guarantee, the equity commitment letter is unenforceable in a bankruptcy. In deals where this risk is acceptable, the lenders should be certain that they can enforce the commitment either as (a) a party to the equity commitment letter, or (b) a third-party beneficiary with consent rights over amendments.

Conclusion

As with most aspects of any financial restructuring, the devil of sponsor capital support is in the details. If a borrower has a clear path to rebound, creditors may be more likely to be willing to accept less advantageous forms of sponsor capital infusions or other credit support. On the flip side, where recovery is less certain, creditors are more likely to insist on more immediate support with the greatest degree of down-side protection. In private credit deals, lender/sponsor relationships will play a significant role in the negotiations. Sponsor credit support for a struggling business is valuable, but if structured incorrectly it can exacerbate the problem and lead to issues in the subsequent stages of the restructuring. That means be prepared. Hope for the best – but prepare for the worst.

---

[1] LSTA-style participation agreements, more common in US credit facilities, are typically drafted as "true sales," whereas LMA-style participation agreements, more common in EU/UK credit facilities, are more typically drafted as loans from the participating lender to the originating lender. The importance of those differences is beyond the scope of this article.

[2] It is unlikely that pre-existing creditors would consent to a sponsor injecting *pari passu* debt into a company, but not all credit documents require lender consent for the sponsor to provide such "incremental" indebtedness – larger credit facilities with documents that tend to advantage the borrower sometimes do not restrict a sponsor from providing incremental debt and there are rarely prohibitions on the sponsor or its affiliates providing sidecar, "incremental equivalent" debt.

[3] A class of creditors has accepted a plan if at least two-thirds in amount and more than one-half in number of the allowed claims of the class are cast in favor of the plan. *11 U.S.C. 1126(c).*

[4] Section 365(c)(2) provides that a debtor cannot enforce ("assume or assign") a "contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor." *See Greenwich Insurance Co. v. Greenwich Street Capital Partners II, L.P. (In re Metro Affiliates)*, 2008 WL 656788 (Bankr. S.D.N.Y. Mar. 6, 2008) (denying a creditor's motion to enforce a commitment letter provided by the debtor's majority shareholder on the basis that the commitment letter constituted a financial accommodation that was barred by Section 365(c)(2)).

Related Professionals

- **David M. Hillman**
  Partner
- **Matthew W. Levy**
  Partner
- **Michael M. Mezzacappa**
  Partner
- **Charles A. Dale**
  Partner