Restructuring & Insolvency Alert

"Loan-to-Own" in an Evolving Debt Market

WHAT YOU NEED TO KNOW

- The "Loan-to-Own" structure is gaining momentum as a preferred restructuring technique used by participants in the secondary debt market.
- Loan-to-Own strategies are used by financial investors seeking to take control of a target by converting debt obligations into an equity stake in the post-restructured entity.

WHAT YOU NEED TO DO

- If appointing receivers to effect a non-consensual loan-to-own, lenders will need to be mindful of the receivers statutory and general law duties, in particular, the receivers' duty to take reasonable care in selling the property imposed by section 420 of the *Corporations Act 2001*.

Introduction

Due to ongoing liquidity constraints and an explosion of activity in the secondary debt market, financial investors are considering a number of consensual (and, where necessary, non-consensual) restructuring options to manage their distressed and non-performing credits. Initially, it was the secondary debt players (namely, the special situation or hedge funds) that were pursuing consensual restructuring outcomes. However, "par" or "original" lenders are now embracing this shift in the landscape and are becoming more comfortable with contemplating the receipt of equity as part of the restructuring of a particular credit.

Is it surprising that financial investors are considering equity or ownership alternatives? Of course, not. Where there is a lack of confidence that the market can produce an "acceptable" bidder for assets, financial investors must consider alternative realisation techniques or accept immediate write-downs of their exposures. What is interesting are the structures being used to effect these transactions having regard to the provisions of Ch 5 of the *Corporations Act 2001* (Cth) (the "Act").

One such structure is the "loan-to-own". The concept may not be new, but as a toolbox favourite of participants in the secondary debt market, it is gaining momentum as a preferred restructuring technique. Loan-to-own strategies are used by financial investors seeking to take control of a target by converting debt obligations into an equity stake in the post-restructured entity. The intention is ordinarily to de-lever the company in question, returning it to a position of financial health, then realising value in a subsequent sale of its equity.

If all relevant parties consent, the loan-to-own strategy may be implemented through a series of contracts between the company, its secured lenders and its key stakeholders. However, in a non-consensual context, secured lenders will generally appoint an insolvency practitioner to control the transaction, or, as more recently seen in *In the matter of Nine Entertainment Group Limited (No 2)* [2013] FCA 40, instigate a scheme of arrangement to force dissenting lenders into the proposed transaction (click here to view our article regarding this decision, discussed in our 30 January 2013 *Restructuring & Insolvency Alert*).

Implementing the "Loan-to-Own"

In order to manage a consensual loan-to-own process, there are a number of steps that financial investors and insolvency practitioners need to be mindful of. One key element is the introduction of a standstill agreement, usually providing the company with a moratorium against lender actions. This will not only provide necessary assistance to the company's board in managing their risk of insolvent trading under section 588G of the Act, but it will also provide financial investors with time to work with the company's management to achieve an optimal outcome.

Some have suggested that a consensual strategy should be favoured, as the process can be implemented more swiftly (through a series of contracts), is more cost-effective, and can be controlled by the financial investors and the company (as opposed to an independent insolvency practitioner and/or the courts). In addition, the company can continue trading without the "insolvency" stigma, which has the potential to impact adversely on goodwill and employee and customer retention.

While financial investors in a consensual loan-to-own transaction should be mindful of the directors' obligations to prevent insolvent trading, it is the non-consensual approach where the statutory minefield becomes apparent. In this context, secured lenders may choose to appoint an insolvency practitioner (normally a receiver), who is subject to several general law and statutory duties, to effect the restructuring. Such duties include the receiver's:

- primary duty to their appointor;
- agency obligations to the company;
- duty to act in good faith; and
- statutory obligations under the Act.

As agent of the company, the receiver's principal duty is to gather in and realise the company's assets and apply the proceeds to reduce the debt owed to the appointing institution(s). This duty must be balanced against the statutory duties prescribed by Pt 2D.1 of the Act, which oblige receivers to exercise their powers and discharge their duties:

- with a degree of care and diligence that a reasonable person would exercise if they were a director or officer of the company;
- in good faith in the best interests of the company; and
- for a proper purpose.

A receiver is also prohibited from using their position as officer of the company (or the information obtained in that position) to gain an advantage for themselves or someone else or to cause detriment to the company. In addition, a receiver must not engage in conduct that is misleading or deceptive or likely to mislead or deceive.

In a traditional receivership, these duties need to be managed carefully. However, because the objectives of the secured lenders and the company are usually aligned (that is, both aim to seek the most value from realising the company's assets the subject of the secured lenders' security), this balancing act is achievable.

This is in contrast to a loan-to-own transaction, where the secured lenders who have appointed the receiver may end up being the receiver's counterparty. In this instance, their objectives may be conflicting. To implement the loan-to-own transaction, secured lenders will typically seek to effect a transfer of the company and/or its assets to a special purpose vehicle sponsored by the secured lenders. In this situation, receivers must have paramount regard to section 420A of the Act in order to avoid potential liability and criticism.

Section 420A

Section 420A of the Act imposes a duty on receivers when exercising a power of sale. It requires a receiver to take all reasonable care to sell the property in relation to which the receiver is appointed, if it has a market value, at not less than its market value, or, otherwise, for the best price that is reasonably obtainable, having regard to the circumstances existing when the property is sold.

It is settled law that the focus of section 420A is not on the price ultimately obtained, but on the process the receiver followed to effect the sale. The courts will have regard to the individual circumstances of the case when determining compliance with this duty. To date, the courts have been reluctant to impose a prescribed set of principles to which a receiver must adhere, but it is clear from the case law that, in a loan-to-own context and otherwise, a prudent receiver should:

- have a clear understanding of the market value of the property to be sold, which will include:
  - being familiar with the market and, if unfamiliar, taking (and following) professional advice from local and experienced agents;
  - obtaining an up-to-date valuation of the property;

  - investigating potential or actual litigation that could affect the market value of the property,
- investigate all potential and recent bids for the property;
- ensure the receiver is fully informed of any pre-appointment sales processes (such as the secured lenders involving the receiver as an investigative accountant or consultant prior to appointment); and
- exercise caution if expected or requested to sell the property to a related party. Although a sale to a related party is not prohibited, such a sale could give the impression that the receiver's independence has been compromised. It is imperative in a loan-to-own situation that a receiver can demonstrate transparency in the sale process and establish that the receiver sought to achieve the market price or the best price reasonably obtainable in the circumstances.

Conclusion

There is little doubt that the marketplace is changing in relation to financial investors' options for the management of their non-performing credits. The emergence of an active secondary debt market has meant that the realisation and restructuring strategies of the "original" lenders are being exchanged for the opportunistic and alternative methods of the secondary market players. However, as this market develops, "original" lenders are also steadily embracing this new landscape.

For insolvency practitioners (and their respective advisors), the pressure is on to be innovative within the framework of their existing statutory duties. This can only translate to a more sophisticated approach to restructuring, where the ultimate winners will hopefully be the companies themselves, reshaped for a healthy future.

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