

Debt Finance 2024

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Law and Practice

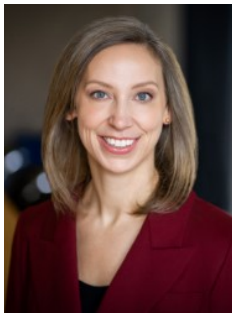
Trends and Developments

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Authors



Gregory E Pessin



Emily D Johnson



Joel M Simwinda

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State of the Financing Markets

Following an uneven year of deal activity in 2023, as we enter the second quarter of 2024, the US financing markets – across both syndicated and leveraged loans, and both investment grade and high-yield bonds – are, as a general matter, the most bullish they have been in two years (or more), with spreads tight, and repricing and refinancing activity spiking.

Meanwhile, however, sustained higher interest rates continue to pressure already challenged businesses that incurred (too much) debt in the days of “lower for longer”. Some challenged companies that are unable to access regular-way debt at a workable price – or at all – are turning to “liability management” (a growing practice that involves complex structuring of new financing options within the limitations imposed by a company’s existing capital structure). And those companies least equipped to navigate the current environment are ending up in Chapter 11, as sustained higher rates have driven a notable uptick in corporate bankruptcy activity, which increased over 70% year-on-year from 2022 to 2023.

It will be interesting to see whether the general surge in market optimism continues, and perhaps results in some challenged companies regaining access to the “regular-way” financing. But in any event, with the curious co-occurrence of booming markets and rising defaults, it is an interesting moment in the world of finance. As always, evolving markets result in evolving trends – here are some that the authors find most notable.

Direct Lenders Eye Investment-Grade: Banks Flex Balance Sheets and Target Private Lending

Recent years have seen rapid and consistent expansion in the size and role of direct lending in financing markets, and 2023 was no exception. The size of the direct lending industry is now estimated to be USD1.5 trillion (up over 70% from 2020) and in the first three quarters of 2023, 86% of LBOs were financed through private credit (compared with 62% in 2020 and roughly 40% in 2018). Direct lenders continued to grow their capital, whether from traditional fundraising, consolidation with other asset managers, or investments in (or alliances with) insurers looking for sophisticated partners to manage their investments.

Historically, direct lenders catered to smaller, riskier companies that could be compelled to accept higher borrowing costs, while investment-grade credit and large-cap acquisition financing were the exclusive domain of the traditional bank and bond financing markets. Today, direct lenders increasingly seek to deploy capital in transactions with companies of all types and sizes, including public borrowers, and have even begun to take aim at investment-grade issuers (though investment-grade financing, so far, remains almost entirely the purview of the traditional markets).

At the same time, banks have taken note of private credit’s ascendance – and its returns, which, on average, exceeded those offered by equity buyout funds since the beginning of 2022 – and have begun expanding into the space. Some announced partnerships with existing alternative asset managers, such as Wells Fargo’s strategic relationship with Centerbridge Partners and Société Générale’s global partnership with Brookfield. Others, including JP Morgan, are reported to have set aside significant amounts of their own capital for direct lending efforts. In this sense, what is old is new again, and banks, which moved out of the business of “storing” leveraged loans decades ago and into the business of “moving” them, have started to get back into the storage game.

Direct lending offerings also continue to evolve, with increases in “mezzanine” finance options, as well as the availability of some features not often seen in traditional markets, such as PIK (payment-in-kind) interest and “portable” loans that can ride through a change of ownership in the underlying business.

Competition among lenders breeds choice among borrowers, and borrowers today would do well to cultivate relationships across the spectrum. The right financing solution for a given borrower at a given time will depend on both borrower needs and market dynamics, and maintaining optionality today will position borrowers to seize on optimal solutions tomorrow.

Low-Rate Debt in a High-Rate World: An Uptick in Debt Default Activism

A higher interest rate environment (compared with the late 2010s and the first couple years of the 2020s), has made previously existing low-rate debt more valuable to borrowers; but it has also made such debt more burdensome for lenders. As a result, 2023 saw a meaningful increase in “debt default activism”, as debtholders deployed legal arguments and manoeuvres to seek to force borrowers to refinance existing, low-rate debt on new, market-rate terms.

Historically, debtholders have been reticent to assert technical or dubious breaches of debt documents. But in today’s markets, debtholders have proven eager to scrutinise contracts for purported breaches. To guard against such challenges, borrowers would do well to think of long-term, low-coupon debt as a valuable asset that must be tended carefully. When assessing new corporate transactions, borrowers should build a record with defence in mind and regularly and carefully review both obviously applicable provisions and those that might seem like insignificant “boilerplate,” since debt default activists will later scour such provisions for potential slip-ups.

Relatedly, borrowers of all profiles with low-rate debt trading at below-par levels should mind their covenant analysis on an ongoing basis. A “look out for number one” attitude prevails in today’s debt markets, and debtholders may conclude that sending a default letter is an effective weapon even when their underlying claims are weak.

Acquisition Agreement Financing Provisions: More Important Than Ever

As conditionality in acquisition agreements has generally become tighter and tighter, acquirers with buyer’s remorse have searched for new ways to force renegotiations and terminations of pending acquisition agreements. Financing co-operation covenants in acquisition agreements can provide buyers with arguments to help them try to leave targets at the altar. In the Twitter litigation, for example, Elon Musk fixed his case on a financing co-operation covenant, arguing that he should be able to walk away from the transaction because Twitter did not satisfactorily reply to his extensive information requests between signing and closing, purportedly amounting to insufficient cooperation under the merger agreement governing the transaction.

Now more than ever, sellers, buyers and their respective counsel should strive for as much specificity and clarity as possible when negotiating these covenants, to ensure that the parties’ expectations and needs are met, while limiting the availability of opportunistic

assertions or interpretations. This is an intricate team task that involves outside M&A and financing counsel working closely with internal financing, treasury, accounting, and business strategy teams, and should be approached early in the M&A process.

Liability Management Unleashed

“Liability management” transactions (in which debtholders co-ordinate with a borrower facing distress to provide new liquidity, maturity extensions, discount capture, or other concessions, all while working within the confines of the company’s existing debt agreements) have been on the rise in recent years, and these days are no longer limited to sponsor-backed portfolio companies. In 2023, commentators counted 21 liability management transactions (more than double the prior peak in 2020), including several by public companies. The proliferation of these transactions has fostered a new dynamic in the market, in which creditors compete to offer distressed companies the most attractive out-of-court alternatives.

In turn, liability management transactions also continue to grow in sophistication, complexity, and variety, fuelled by increasing fund participation in the space. New species of liability management transactions emerged in 2023 and quickly gained momentum, offering new pathways for borrowers to use their existing debt baskets to give extra credit support to newly incurred debt in return for correspondingly cheaper rates on such debt.

For instance, 2023 saw the emergence of the “double dip” transaction, whereby a creditor lends money to a company’s non-guarantor subsidiary, guaranteed and secured on a pari passu basis with the company’s existing debt obligations. The subsidiary borrower then on-lends the proceeds of the initial loan to the company’s credit group, again guaranteed and secured on a pari passu basis with existing debt obligations. As a result, the new creditor has (i) a direct claim against the credit group through the initial loan (“dip” one), and (ii) an indirect claim against the credit group via the intercompany loan (“dip” two). In this way, the double dip offers participating lenders enhanced credit support and dilutes existing creditors’ claims. The year 2023 also saw a number of “pari plus” transactions, in which new-money lenders receive both a pari passu claim against the existing credit group and claims against an entity or assets sitting outside the existing credit group (thereby creating an obligation that is structurally senior to those of existing creditors on a portion of the enterprise).

With an expanding toolbox, challenged companies have sought to maximise competition between (or among) their existing lenders, on the one hand, and direct lenders outside their capital structure, on the other. Direct lenders, in particular, have “played on offence,” eagerly seeking opportunities to lend at attractive rates to “unrestricted” subsidiaries, or other subsidiaries sitting outside a company’s existing credit group, to help the company raise “priming” financing. Existing debtholders, aware of this threat, have largely concluded that the best defence against getting primed by new money is to compete on offence themselves, and often make proactive proposals to provide priming financing. Put simply, liability management is a field that rewards debtholder initiative. As a result, emboldened by precedent and taking the markets “as they are,” debt investors of all stripes now initiate liability management transactions.

While liability management structures have gained broader acceptance in the marketplace, litigation challenges remain common, both in New York courts and in bankruptcy courts, in situations where the borrower has ultimately found itself in Chapter 11. The court decisions resulting from these cases increasingly shape the contours of ongoing and future transactions.

Borrowers today facing distress can find unique opportunities in the modern competitive dynamics in the debt financing markets – both among existing creditors (including within debt classes), and between existing creditors and prospective financing sources. Liability management can buy maturity and liquidity “runway” and/or capture debt “discount” (though borrowers must often choose whether to use their liability management tool kit to focus more on the latter or the former, which requires gut-checking conviction in business projections and directing efforts accordingly). Implementing liability management transactions is a complicated, time-consuming process with little margin for error, but for challenged companies, presents significant opportunity.

Lightning Round: Other Developments to Monitor

Below are several new developments in the financing markets that the authors are watching in 2024.

- Beware the boilerplate – a running theme across many of the observations in the preceding paragraphs is the tough, no-holds-barred nature of modern debt markets. When putting new debt in place, borrowers would do well to scrub and erase boilerplate provisions that create a gray area around basket usage, such as “no default” conditions on key baskets (which could arguably render basket usage prohibited solely on account of minor, disputed, or unrelated defaults).
- More convertibles – many companies – particularly in the technology sector – issued convertible notes with low coupons and relatively short maturities in 2020 and 2021. Now, as interest rates remain relatively high, some of those convertible notes are deeply out of the money, trading at considerable discounts, and even beginning to attract liability management activity. Despite this, low coupons have made convertibles generally more attractive than they were in the lower-for-longer years, for issuers across industries and credit profiles. As a result, convertible bond issuances in 2023 were up approximately 80% year-on-year. This momentum has continued into the new year, with a spate of high profile convertible bond issuances in the first quarter of 2024.
- Portability – direct lenders are increasingly allowing their debt to remain outstanding through “change of control” transactions that traditionally would have required the debt to be refinanced (a “portability feature”). Holders of “portable” debt instruments absorb the risk that new management might negatively affect its ability to collect on the debt. For protection, some lenders have started demanding a “white list” of sorts, which sets forth permitted purchasers of the applicable loans or notes in advance. It will be interesting to see if this feature finds a foothold in the traditional markets as well.
- Term loans are (still) not securities – in 2023, the Second Circuit held in *Kirschner v JP Morgan Chase Bank N.A.* that a syndicated bank loan was not a security under state securities law, reaffirming confidence in the syndicated lending regime. *Kirschner* has since

filed a petition for a writ of certiorari, but unless the Supreme Court elects to hear the case, this question is (further) settled for now.

Wachtell, Lipton, Rosen & Katz

51 West 52nd Street

New York

NY 10019

USA

+1 212 403 1340

+1 212 403 2340

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