Debt to Equity Swaps

In the current global financial crisis and economic downturn, where existing sources of finance are under threat due to principal and interest repayment defaults and/or their associated costs are becoming increasingly burdensome and where new sources of finance are hard to secure on economically viable terms, proactive companies are, as part of their short to medium term corporate strategies, seeking to reorganise their business affairs in order to cut ongoing costs (including interest financing costs), maintain the lifeblood of the company (namely cash flow) and ultimately ward off the threat of insolvency. One way of doing so is via a debt to equity swap which benefits a company through the boost to cash flow which results from the reduction or elimination of financing ongoing principal repayments and interest costs.

A debt to equity swap is where a lender agrees to reduce the amount of debt it is owed by the borrower by agreeing to subscribe for new shares in the borrower equal to the value of the reduction of the debt. As a consequence, the borrower will issue new shares to the lender (thereby increasing the total number of shares in issue in the borrower) and the outstanding debt will either be reduced or eliminated depending on the agreed level of swap.

There is nothing new about the swap proposal. They were a feature of several high profile financial rescues in the early 90s and are a legacy of the highly leveraged culture of the late 80s and the difficult economic climate of the early 90s. From the outset, however, it should also be noted that debt to equity swaps can be complex and time-consuming and they should not be seen as a panacea for all of a company’s financial problems. Any decision to proceed with a debt to equity swap should therefore involve a review of the potential benefits that may arise, which should exceed the costs involved if it is to be a worthwhile exercise. Alternatives should also be considered before proceeding down this restructuring route. For example, conversion of debt to limited recourse or subordinated debt or debt rescheduling may be more appropriate alternatives in the circumstances.

Usually, a debt to equity swap between a lender and borrower on arms’ length terms would derive from the mutual interest of the borrower and the lender to safeguard the borrower against the threat of insolvency, which in all likelihood would mean that the borrower would not recover the full amount of the debt due to it in any event. Usually, the proposal for a swap arises when a borrower is struggling, often due to cash flow problems, to finance interest payments on borrowings but the value of its underlying assets is sufficiently robust and attractive to the lender to take an equity stake in the borrower in exchange for a commensurate reduction in the total outstanding debt. However, in the current economic climate, debt to equity swaps are more commonly being considered by companies who are not necessarily on the brink of insolvency but who are taking this approach (subject to lender consent) as part of a package of pre-emptive measures to shore up their finances.

It should be noted however that if a lender is fully or partially secured on the assets of the borrower they will have little incentive to support the company by taking equity because this will involve a loss of priority on any subsequent liquidation of the company as shareholders rank behind creditors for recovering monies on a liquidation. The main justification therefore for a lender to swap debt for equity will be a belief that, if they take equity, this will ultimately achieve a greater return. Indeed, a swap does offer a lender the opportunity to share in any future upturn in the company's financial fortunes. The strengthened balance sheet which should result from the swap may also give management a real incentive to work to bring about that upturn because their efforts will translate into and be recognised as future profits (and possibly profit-linked bonuses for management) rather than be drained away in their attempts to support a substantial interest burden.

In a situation where a company's debt exceeds its assets, an important resulting benefit of a debt to equity swap for the company's directors can be the avoidance of a wrongful trading situation under the insolvency regime, when a company continues to trade in the knowledge (imputed to its directors) that it will be unable to meet its debts as and when they fall due. Where the debts of a company are significantly greater than its underlying assets, this is a significant personal risk for the directors (because they may be held personally liable for the company's debts) and a debt to equity swap may help to alleviate this risk and lift the company to a more secure financial footing in terms of its balance sheet and the reduction in or elimination of interest costs.

The removal of debt from a company's balance sheet will improve its financial profile in terms of gearing and other important balance sheet ratios, thereby removing or minimising any competitive disadvantage and providing scope for the company to attract new business and secure continuing credit from suppliers. A debt to equity swap may even improve a company's prospects of obtaining new finance. If the company's bank has been persuaded to demonstrate its medium to long term commitment by taking equity it may also be willing to commit further finance with a view to ensuring the company's continuing viability and maximising any upside potential it stands to gain from as an equity holder.

It should be said, however, that these swaps are still relatively unusual and would normally only be considered where a lender has an existing equity interest in the borrower, usually deriving from a previous transaction which involved the provision of a mix of debt and equity funding by the lender to the borrower. That said, given that we are in highly unusual economic circumstances with an unprecedented level of credit scarcity and dislocation of global financial markets, the normal parameters required for lenders to be amenable to these swaps may no longer apply and they may be more willing to consider them as part of their own corporate strategy.

From the perspective of the existing shareholders of a company entering into a debt to equity swap, since there will be a fresh issue of shares (which will only be offered to the lender in exchange for the reduction or elimination of debt) they will see their equity interests diluted down to a greater or lesser extent, depending on the level of debt that the swap is intended to cover. However, whilst this apparent negative may be true, shareholders may view it in a positive light if it means that they continue to hold a stake in a viable entity going forward (with potential for future capital growth) rather than in an entity which may otherwise struggle to maintain its financial viability and from which they would presumably be unlikely to receive any return on their shares in an insolvency.

The swap would in any event require the approval of shareholders of the borrower and therefore the majority of shareholders would need to be satisfied with the proposal before the company could proceed. In addition, for bank lenders in particular, there may be certain regulatory issues to consider and address as well as dealing with the cultural shift from being a holder of debt to an equity holder, which many UK banks are unfamiliar with. The situation is further complicated if a company has several bank lenders with competing interests. The consent of all the banks will be necessary in order to effect a debt to equity swap in such circumstances and the process of achieving consensus between the banks on the terms of the swap is not an easy one.

Clearly, depending on any existing equity stake that the lender has in the borrower and/or will have following the swap, this could affect the company's shareholding base (and therefore the concentration of control) if certain equity thresholds are reached or surpassed. For example, a 25% stake would enable the lender to block special resolutions in the future and a 75% stake would enable the lender to pass special resolutions by itself. Furthermore, a 90% stake would enable the lender to force through a sale of the entire issued share capital of the company in the event of an offer being made to purchase all the shares in that company, since the 90% shareholder can under UK company law force the remaining 10% shareholders to sell their shares to the offeror at the same price.

It is also likely that a bank lender will want to be issued with preference shares in any debt to equity swap so that it ranks for dividends and (on a liquidation) for capital, ahead of ordinary shareholders. Either in addition to or as an alternative to preference shares, a bank lender may wish to be issued with warrants which can offer many of the advantages of an equity holding including the opportunity to share in any upturn in the company's fortunes.

A number of other issues may arise if the company that is considering a debt for equity swap is public. For example, if the company is on the main market of the London Stock Exchange the UK Listing Authority will probably review the transaction closely to ensure that the company remains suitable for listing after the debt to equity swap – the Listing Rules require that 25% of a company's listed shares remains in "public hands". Furthermore, if the City Code on Takeovers and Mergers applies, Rule 9 of the City Code may be relevant in the context of a debt to equity swap. Rule 9 requires that, except with the consent of the Takeover Panel or where a whitewash is obtained (i.e. shareholder approval is obtained to waive the mandatory offer requirement), a mandatory offer shall be made to acquire the company when a person acquires or persons acting in concert acquire an interest in shares which carry 30% or more of the company's voting rights or an interest in additional shares carrying voting rights, where such person or persons already have an interest in shares carrying between 30% and 50% of the company's voting rights.

Whilst the use of the debt to equity swap is in normal economic conditions an unusual tool to employ between an unconnected lender and borrower, in the current economic climate where turnover is decreasing substantially in many industries, there is the possibility that this sort of proposal will be seen more frequently as a genuine and commercially realistic middle ground to lending further funds or seeking to call in loans, especially in circumstances where the lender is unlikely to be able to recover its loan funding upon the insolvency of the borrower.