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Finance & Transactions Insights

Negotiating Sponsor Support on Distressed Deals: Lender and Sponsor Perspectives

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Similar to other market participants and advisors, we've noticed a recent uptick in defaults by borrowers on sponsor finance deals in the middle market. As a result, we're having increased conversations with clients (both lenders and sponsors) on restructuring strategies and forbearance features. Those conversations typically touch upon topics such as minimum liquidity thresholds, budget variance testing, deferred amendment fees, consultants, sale milestones and anti-hoarding provisions.

However, a major question on distressed sponsor finance deals often is whether the borrower needs additional cash capital from the sponsor. If the lenders and sponsor are aligned that this type of support is needed, then dollar amount will be a heavily debated detail. But what else should lenders and sponsors be thinking about? This article explores a host of negotiating points from the perspective of lenders and sponsors.

Timing

If the dollar amount of the sponsor's new investment is settled, then timing of the funding is the next topic up for discussion. Lenders generally would like to see the sponsor's cash infusion happen immediately. Sponsors, on the other hand, would prefer to take a patient and staggered approach—in other words, a guaranty or capital call agreement from the sponsor comprised of a firm commitment to fund cash in the future if things take a turn for the worse. Since timing of the funding will dictate the next set of negotiating points, those points are separated out below for both situations.

Immediate Infusions

In the context of immediate infusions, there are two critical negotiating points.

1. **Usage:** What will the borrower do with the money? While lenders may want all of the money to be used to pay down their debt, sponsors will typically press to strengthen the borrower's liquidity position instead. A hybrid approach that lenders and sponsors may land on is having a part of the money paid to the lenders, with the rest being allocated to the borrower's working capital.

2. **Structure:** Lenders would choose to have the sponsor's cash dropped in at the holding company level as equity. This would put the sponsor's new investment at the bottom of the capital stack. Sponsors, though, would prefer higher positioning, with prime examples being (in order of sponsor preference):
   - purchase of loans in the senior secured credit facility on a non-voting basis,
   - last out participation interest in the senior secured credit facility,
   - "silent" second lien debt at the operating company level,
   - unsecured subordinated debt at the operating company level, and
   - holdco PIK paper.

Each of these options gives sponsors a better chance of recovery, but each of them also presents varying risks and challenges to lenders that will be taken into consideration.

Sponsor Guaranties/Capital Call Agreements

If a sponsor and lenders are aligned that the sponsor's capital can come in at a future point in time (instead of immediately), then this takes the shape of a sponsor guaranty or capital call agreement (which are substantively similar). Here are key negotiating points in sponsor guaranties and capital call agreements:

1. **Cap:** While we don't need to do a deep dive into dollar amount since that varies deal by deal, we would be remiss to not mention that a sponsor's commitment in a sponsor guaranty or capital call agreement is always capped. However, lenders often require that the amount of the lenders' enforcement expenses (*i.e.*, legal costs incurred by the lenders to enforce the sponsor's obligations if there is a breach by the sponsor) isn't subject to a cap.

2. **Trigger:** What are the trigger events for the potential capital infusion? Sponsors will typically look to limit the triggers to specific and serious financial covenant issues. Often, those triggers are a leverage covenant trip for particular testing periods and/or a minimum liquidity breach during a particular period of time. Both types of triggers lend themselves to easily calculable sponsor payments: in the case of a leverage covenant trip, a payment in the amount of the excess debt or the deficient EBITDA; and in the case of a minimum liquidity breach, a payment in the amount of the liquidity shortage. While lenders would want those types of financial covenant breaches to be triggers, they usually don't want those to be the only triggers. Instead, lenders frequently look to include other material events as triggers, such as borrower bankruptcy/insolvency, payment default, financial reporting default, financial misrepresentation, guarantor default (*e.g.*, a breach of the capital commitment provisions described below) and/or acceleration. Those additional triggers could speed up the sponsor's funding and require payment of the full amount of the undrawn cap.

3. **Capital Commitments:** While lenders may be pleased with a sponsor standing behind its borrower, a lender concern is whether the sponsor still has enough dry powder in its fund to actually fulfill its payment obligation. As such, lenders will usually want to see a sponsor agree that its fund will at all times have outstanding capital commitments from its investors of at least the amount of the undrawn cap. Lenders may also require delivery of a quarterly officer's certificate confirming same.

4. **Termination:** When does the sponsor's commitment terminate? Lenders would like the commitment to be indefinite—falling away only if the cap is fully satisfied or the credit facility is fully paid off. Sponsors, however, typically ask for an earlier expiration. An example: the sponsor's funding obligation terminates if the borrower is in compliance with certain financial covenants over two or more consecutive testing periods.

5. **Structure/Usage:** Usage of the proceeds and structure of the capital are also important negotiating points in a sponsor guaranty or capital call agreement. As to usage, the considerations mentioned above remain the same. As to structure, sponsors generally want to receive something in return for both the commitment (*e.g.*, a deferred guaranty fee) and the cash outlay (*e.g.*, equity or debt in exchange for any money that is paid). Preferred equity or unsecured subordinated debt tend to be the most frequent structural options in sponsor guaranties and capital call agreements. Having said that, lenders are keenly focused on the structure (1) not causing any sort of obstacle if a borrower bankruptcy occurs, and (2) not causing any sort of delay if a triggering event comes to pass. For example, if a borrower bankruptcy prevents a borrower from issuing equity or debt to the sponsor without bankruptcy court approval, then lenders will still require that the sponsor make any necessary payment, but will require the payment to be made directly to the lenders as a pay-down of the debt instead of as a loan or capital contribution to the borrower. This type of payment would be outside of the bankruptcy court's purview. Also, if the sponsor's new capital will be in the form of unsecured subordinated debt, then lenders usually insist that the form of the subordinated note and the subordination agreement are mutually agreed in advance. This would avoid any hold-up in negotiating those documents once the commitment actually comes due.

In summary, although a sponsor and lenders may be in agreement that a certain amount of additional capital is needed to be funded by the sponsor to a distressed borrower, that's only the first step in the negotiation process. There are a host of other negotiating points. As with many things, the devil is in the details.

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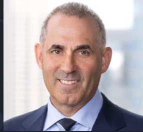

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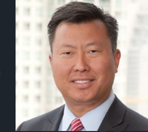

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