Lien times

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To borrow from the old phrase about the importance of location to real estate, creditors of financially troubled companies or projects understandably might say that the three most important elements in a restructuring are: collateral, collateral and collateral. As the credit quality of any company or project deteriorates, some of the first questions asked by creditors will be: (1) what collateral supports the company's obligations, (2) what are the company's other assets, and (3) what impediments exist to encumbering those assets in support of the company's obligations.

For participants in the historically stable United States domestic energy industry, the role and importance of collateral in the structure of financing transactions have become startlingly clear. In recent years, the multiple and well-publicized troubles of the industry have led to a sharp rise in the number of restructurings by energy companies striving, not always successfully, to stabilize their financial condition and better equip themselves to meet the challenges of the future.

This article examines how collateral considerations impact financial restructurings in the context of the United States domestic energy industry. In particular, this article surveys common issues and potential impediments to structuring collateral packages for these transactions, including operational issues, legal and regulatory constraints, and bankruptcy and other considerations. While some of the matters discussed in this article have specific relevance to US energy companies and their creditors, the underlying principles and issues are applicable to companies and creditors across other industries when faced with the challenging task of completing a significant financial restructuring.

Common components of collateral packages

Collateral types

While many different types of energy companies have undergone restructurings in recent years, the collateral packages provided to creditors have contained similar types of collateral. These collateral packages often include one or more of the following:

? Real and tangible personal property of the company or its subsidiaries subject to the lien of a first mortgage indenture,

? Pledges of the equity and debt interests of the company in its subsidiaries,

? Parent or affiliate guarantees from more credit-worthy entities, or

? Cash sweep or ?lock-box? arrangements.

Nature of the company's business

The nature of an energy company's participation in the market often has an important, if not determinative, effect on the structure of the collateral package available to be pledged to existing creditors or to support a new financing. For example, utilities often have significant unencumbered real and personal property which may be available to support a restructuring. Indeed, the past few years have seen a resurgence of financings based on first mortgage indentures by utilities which previously financed borrowings on an unsecured basis. In contrast, independent power companies often have few unencumbered assets to support a restructuring because they financed most of their assets on a limited recourse or project finance basis through separate special-purpose subsidiaries. Typically, in these financings, the creditors have a first lien on all or nearly all of the assets of the special-purpose subsidiary, including the assets constituting the project. In addition, independent power companies have little unencumbered collateral to support a restructuring outside of equity distributions from the special-purpose subsidiaries.

Creditor perspectives

Another dynamic affecting the nature and extent of the collateral package a company provides to its creditors in a restructuring is the initial perspectives of the creditors. These perspectives can vary significantly and are especially pronounced between a company's existing creditors and institutions seeking to provide new financing to restructure a company's existing obligations.

Once a restructuring becomes necessary, whether following a default or otherwise, existing creditors often approach the situation with little appetite either to compromise on the extent of the collateral package to be provided by the company or to limit the scope of the covenants restricting the company's activities in the future. In addition, the primary objective of the creditors often is not the long-term health of the company but rather being repaid as soon as possible. This is particularly true if a company's creditors include a large bank syndicate. Often times at least some of the members of the syndicate will have such a strong desire to be repaid that they will advocate obtaining a lien upon all unencumbered collateral and imposing stringent covenants on the activities of the company. From their perspective, the more constricting the terms of the restructuring, the more likely the company will be to arrange alternative financing and repay the restructured obligations.

Institutions seeking to provide new financing arrangements often are much more willing to consider restructurings with reduced levels of collateral supporting a company's obligations. Without the likely prior history of a default and waiver or amendment negotiations which often accompany restructurings with existing creditors, companies often find that new institutions are able to consummate transactions more easily than existing creditors without pledging all or substantially all of their unencumbered assets as long as an appropriate collateral value to loan ratio is maintained. The appropriate collateral value ratio will depend on the quality and liquidity of the collateral that is included in the collateral package and pledged to the creditors.

Balancing protection of collateral and required flexibility

When a restructuring becomes necessary, creditors naturally desire to restrict the activities of a company in a manner intended to both (1) preserve the collateral supporting the financing arrangements, and (2) prevent the company from engaging in activities which may result in a recurrence of financing difficulties. Still, a company must be permitted to operate its business in an efficient manner, thereby generating the necessary revenues to repay the creditors in accordance with the terms of the restructured financing arrangements. Balancing these frequently competing objectives can be one of the most difficult tasks in negotiating a restructuring.

The difficulty in achieving this balance is influenced by many factors, including the nature and complexity of the operations and financing arrangements of a company and its affiliates. Two areas in which this balancing is especially difficult relate to internal corporate reorganizations and inter-company debt.

Internal corporate reorganizations

A company with a significant number of subsidiaries may require flexibility in effectuating reorganizations of its internal corporate ownership arrangements through mergers and transfers of assets among these subsidiaries. This need is often greater with financially distressed companies attempting to raise cash and reduce debt by selling subsidiaries or assets owned by its subsidiaries.

One method of mitigating these issues is to effectuate a pre-restructuring reorganization of the company's family tree to segregate pledged from non-pledged subsidiaries. Another solution is to attempt to identify the structure of frequent or contemplated transactions in advance of the restructuring and create safe-harbor provisions in the documentation to permit the transactions. A third way to provide companies the necessary flexibility to reorganize their subsidiaries is to permit the restructuring of the company's ownership of subsidiaries ?inside the box,? that is, to permit subsidiaries under a common pledged parent to merge with or transfer their assets to other subsidiaries of the pledged parent but not to any other subsidiaries of the company.

Inter-company debt

Prior patterns of internal financing also can pose significant challenges which need to be carefully considered in a restructuring. Many companies do not have formal or documented arrangements with respect to loans between subsidiaries or the transfer of monies through various subsidiaries to effectuate financing arrangements. Due to the possibility of a large number of these inter-company loans, unwinding them prior to the restructuring can prove difficult. If the inter-company loans are part of a financing structure used in connection with transferring funds between domestic and international subsidiaries on a tax-efficient basis, these arrangements often are extremely difficult to restructure without incurring additional tax liability. In these cases, companies must scrutinize carefully all covenants relating to the making of advances, investments, or loans, the incurrence of debt, or the declaration or payment of dividends to ensure that these financing structures can continue to work as planned.

At the same time, creditors need to be careful to ensure that inter-company lending arrangements do not dilute their collateral. Creditors need to protect pledged subsidiaries from claims of other subsidiaries of the company in the event the creditors foreclose on the pledged equity interest in the subsidiaries. One method of protecting the creditors from these types of claims is to obligate the company to evidence all inter-company borrowing arrangements with subsidiaries by means of a promissory note which is then pledged to the creditors. The administrative burden associated with this approach may not be feasible for a company if it has many of these transactions. In this case, a master or ?grid? promissory note from each such subsidiary may be pledged to the lenders.

Perfection issues

Even if a company grants a lien in substantially all of its assets, creditors may be frustrated in perfecting a security interest in material portions of the company's assets. A company with transmission facilities may hold thousands of easements, rights-of-way and other similar real property interests in order to operate its facilities over the property of others. A company with wholesale energy trading activities similarly may be party to thousands of contracts. The logistical difficulties associated with identifying each of these interests, obtaining necessary consents and granting a lien in them often is administratively prohibitive without significant delay in the timing of the restructuring. As a result, creditors may be required to settle for obligating the company to contribute these types of rights to a subsidiary, the equity interest of which is pledged to the creditors. Alternatively, creditors may have to become comfortable with covenants by the company not to permit liens on these assets or other covenants, such as an obligation of the company to exercise its power of eminent domain if requested by the creditors.

Letters of credit

One issue often encountered in restructuring companies in the energy sector arises as a result of their need to issue numerous letters of credit, either in connection with their trading activities, in support of projects under development or otherwise. If, for example, a credit facility under which letters of credit were issued is being replaced in connection with a restructuring, the company may be faced with replacing dozens or even hundreds of letters of credit with new letters of credit. Timing the replacement of such letters of credit with the closing of a restructuring raises significant hurdles, particularly if the company's relationship with any of the beneficiaries is strained. Alternatively, if the company can convince existing letter of credit providers or participating lenders to accept the preference risks discussed below for a limited period, the company may be able to cash collateralize the existing letters of credit at the closing of the restructuring and replace them with new letters of credit within a short period of time thereafter.

Avoidable preferences

The desire of creditors to obtain collateral in a financial restructuring, whether because the creditors previously were unsecured or to supplement previously granted collateral, creates bankruptcy preference issues for these creditors. A preference is precisely what its name suggests ? an instance in which a company, on the brink of bankruptcy, prefers some of its creditors over others. Preference issues relate to the potential impact of bankruptcy laws designed to protect creditors if a company declares bankruptcy soon after transferring assets to one of its creditors.

Generally speaking, the US Bankruptcy Code is designed to facilitate the policy of equally distributing a company's assets among its creditors and protecting the company from creditors attempting to take its assets during the months and weeks prior to filing for bankruptcy protection. Section 547 of the Bankruptcy Code enables a bankruptcy trustee or a debtor-in-possession to avoid any transfer of the company's property (including grants of liens in collateral) that:

? was made to or for the benefit of a creditor,

? was made for or on account of an antecedent debt,

? was made while the debtor was insolvent,

? was made within ninety days (for non-insiders) or one year (for insiders) of the bankruptcy filing, and

? enables the creditor to receive more than if the debtor's assets were liquidated under Chapter 7 of the Bankruptcy Code.

Exceptions, however, do exist if, for instance, the transfer was made in exchange for contemporaneous new value or in the ordinary course of the debtor's business.

It is especially important for creditors and companies involved in restructurings to keep preference issues in mind for several reasons. First, companies typically enter into a restructuring because of some degree of financial distress. Consequently, a material near-term bankruptcy risk often already exists. Second, creditors arranging a restructuring often will subject the company to more demanding terms than its previous financing arrangements, including the pledge of additional collateral. This kind of transfer raises a significant preference risk. Such a risk can be reduced or shifted through various techniques. However, preference risk allocation and other structuring around bankruptcy issues requires the attention of bankruptcy counsel and deserves consideration at the onset of the structuring process and throughout subsequent negotiations.

State corporate law

One area of law not often considered when planning a restructuring is state corporation laws. Yet, some state corporate laws contain significant restrictions on common corporate functions. These restrictions, such as various limitations on the ability of a company to issue dividends, can significantly interfere with the transfer of funds between subsidiaries and with repayment of obligations to creditors. For example, California's corporations code provides that corporations must meet quantitative and qualitative tests before paying a dividend.1 New York and Delaware corporate laws also limit the ability of a corporation to declare and pay dividends in certain situations.2 The application of these provisions can result in a subsidiary corporation not being able to distribute available cash to its parent in order to service its obligations under a restructuring facility.

Ring-fencing

In recent years, many companies have attempted to insulate portions of their corporate family from the deterioration of the financial condition of other members of the corporate family. These companies have entered into ?ring-fencing? transactions intended to achieve managerial, organizational and financial separation of the ?ring-fenced? company from its affiliates, and consequentially to preserve the separate financial attributes of the ring-fenced business. These transactions often include restrictions on the transfer of assets, including pledges, without the consent of an independent director or the independent holder of a class of securities of the company. Consequently, a parent company's desire to garner the additional credit support which may result from the pledge of a more profitable affiliate in connection with restructuring may not be available. A parent company could dismantle the ?ring-fence,? but this may have other consequences, such as a potential reduction in the credit rating of the ring-fenced businesses, if used to provide credit support for the restructuring. As a result, if ring-fenced businesses exist in a company's corporate family, consideration should be given to any ring-fencing provisions and the benefits and costs of dismantling a ring-fence.

Regulatory matters

Even if the company and its creditors agree upon the structure of the collateral to support a restructuring, the consent of one or more regulatory authorities frequently must be obtained prior to the pledge of the assets.3 State regulatory authority in this area varies significantly from state to state and prior to agreeing on a collateral package, confirmation or at least assessment of the regulatory issues should be completed during the initial stages of the restructuring.

Both federal and state regulatory authorities increasingly have become more concerned with restructurings due to the unfolding of well-publicized recent events impacting the energy industry, particularly due to the financial plight of many unregulated energy companies. Specifically, regulatory authorities have become especially sensitive to pledges of jurisdictional utility assets to support indebtedness or other obligations incurred in connection with non-utility operations.

Earlier this year, the Federal Energy Regulatory Commission (Ferc) announced a new set of conditions applicable to all public utilities seeking approval to issue secured or unsecured debt.4 In order to prevent public utilities from borrowing money to finance affiliated, non-utility operations, Ferc stated it would require that utilities use the proceeds of debt backed by utility assets only for utility purposes. If any utility assets used to secure that debt are spun off or divested, the debt must follow those assets and also be spun off. For unsecured debt, if the assets (utility or non-utility) financed by the debt are divested or spun off, the debt associated with those assets must also follow those assets. Although Ferc only has jurisdiction over securities issuances not otherwise regulated by a state commission, this ruling evidences Ferc's desire to limit the use of utility assets as collateral to support non-utility obligations.

From the perspective of the state capitols, a few recent proceedings highlight the concern of state regulators about the potential impacts a restructuring may have upon jurisdictional assets and ratepayers, and at the same time, the extent of the state's jurisdictional reach over regulated entities. In Kansas, the Kansas Corporation Commission (KCC) continues to be thoroughly involved with the restructuring by Westar Energy, Inc. (Westar), a top-level holding company for utility and non-utility assets.5 The KCC initially rejected the company's restructuring plan and directed Westar to revise its accounting practices, its treatment of utility vs. non-utility assets, and allocation of debt within the corporate family. The KCC also has mandated the maximum debt to be carried by the public utility, and has ordered a reduction of any excessive amounts of debt, by whatever means are necessary, including the sale of non-utility assets, reduction of dividends, or issuance of new stock. The Westar proceeding demonstrates the involved approach many state regulators are now taking in restructurings.

In Montana, a state public utility commission (PUC) expressed similar concerns when authorizing the issuance of bonds to Northwestern Corporation, a Montana public utility.6 The PUC noted the performance of non-utility affiliates had contributed to the utility's deteriorating financial condition, and required the utility to adopt more transparent accounting standards in order to clearly identify the financial results for each segment of the company. Although the PUC did not require a firewall between the utility and non-utility assets, the issuance provided an opportunity for the regulators to carefully scrutinize the actions affecting the utility assets.

These recent federal and state regulatory proceedings suggest that regulators will carefully review and scrutinize a proposed restructuring and the possible impacts on ratepayer and consumer interests. Any restructuring should be implemented in a way that minimizes the potential for highlighting the concerns of regulators during the regulatory approval process.

Conclusion

The numerous issues discussed in this article reflect a sample of the array of issues that likely will be encountered in connection with a complex financial restructuring. Assembling the appropriate collateral to support a restructuring requires analysis of the company's unencumbered assets, the needs of the company and its creditors, bankruptcy preference issues, state corporation laws, regulatory hurdles and other company-specific factors. Early and careful analysis of these matters is a major factor in achieving a successful restructuring. n

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Footnotes

1 Cal. Corp. Code § 500 (2003).

2 N.Y. Bus. Corp. § 510 (2003); Del. Code Ann. tit. 8 § 170 (2003).

3 As a separate matter, regulatory consent frequently must be obtained for the issuance of any debt securities or various other transactions, such as mergers, sometimes entered into in connection with a restructuring.

4 Westar Energy, Inc., Order Conditionally Granting Authorization to Issue Long-term Unsecured Debt and Announcing New Policy on Conditioning Securities Authorizations, 102 FERC ¶ 61,186 (2/21/03) (Docket No. ES02-51), and Order On Rehearing, 104 FERC ¶ 61,018 (7/2/03).

5 In the Matter of the Investigation of Actions of Western Resources, Inc. to Separate its Jurisdictional Electric Utility Business From its Unregulated Businesses (Docket No. O1-WSRE-949-GIE), Order issued 11/8/02 (Opinion No. 51), and 12/23/02 (Opinion No. 55).

6 Northwestern Corporation, For Authority to Consummate a Credit Agreement and Issue $390 Million in Principal Amount of Secured Long-term Notes in the Form of First Mortgage Bonds, Order No. 6474a, Docket No. D2002.12.159 (1/24/03). 2003 Mont. PUC Lexis 4.