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Another Page In The Issuer-Bondholder Playbook

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When a borrower or issuer finds itself in a distressed situation, management, shareholders and/or private equity sponsors will often identify specific assets that are of the greatest value and attempt to isolate those assets from the distressed company as a whole. Such assets may be specific items of intellectual property or specific lines of business. It is often in the best interests of management and the shareholders to extract as much cash or other value out of those assets as possible, either to improve the balance sheet (by reducing debt) or to take an equity distribution. However, this can often be to the detriment of a specific group of creditors.

A number of transactions of this type have been in the news recently, most notably J.Crew Group Inc.'s transfer of trademark assets out of the group liable to its term loan lenders in an effort to use those assets to refinance earlier-maturing payment-in-kind (PIK notes**)**. In that situation, the lenders attempted to prevent the transaction, and J.Crew argued that the transaction was permitted under the term loan covenants. J.Crew vigorously defended its right to consummate the transaction and proactively sought declaratory relief from the courts confirming that the transaction was permissible.

Recently, Algeco Scotsman Global SARL ("Algeco Global," and together with its subsidiaries, the "company"), a modular space business owned by the U.K.-based private equity fund TDR Capital LLP (the "sponsor"), attempted to isolate and sell its most valuable subsidiary to create value for the sponsor (and consequently remove that value from the pool of assets available to satisfy creditors). The holders of certain senior unsecured notes of a subsidiary of Algeco Global (through their trustee) filed a lawsuit to prevent the sale. Unlike in the J.Crew fact pattern, prior to even filing a response with the court, the sponsor entered into a settlement agreement with the noteholders agreeing to use a portion of the proceeds to reduce the notes. This compromise meant that, although the valuable asset would still be sold, those noteholders would share in the proceeds, which would not go exclusively to the company, the sponsor or an unrelated group of creditors.

This article focuses on the claims made in the lawsuit that the transaction would result in the company's violation of the applicable indenture covenants. These claims can be separated into three parts: (1)

violating the covenant against the sale of material assets, (2) violating the covenant against transactions with affiliates and (3) being in default by virtue of having provided notice of its intent to deny Williams Scotsman International Inc.'s liability under its note guarantee (as a result of the transaction and the related release of Williams Scotsman (the entity subject to the transfer) of its guarantee of debt of the company).

Background on the Transaction

On Aug. 21, 2017, Algeco Global entered into an agreement to sell Williams Scotsman, which was perceived to be the crown jewel of the company, to Double Eagle Acquisition Corp. (DEAC), also a TDR-controlled entity (the "transaction"). The purchase price of the transaction was $1.1 billion (half of the price the company initially paid for Williams Scotsman in October 2007), consisting of $1.025 billion in cash and $78.5 million in shares of DEAC's holding company. On the signing date of the transaction, Williams Scotsman was a guarantor of $745 million of 10.75 percent senior unsecured notes due in 2019 (the "SUNs," and the holders of the SUNs, the "SUN holders"), issued by Algeco Scotsman Global Finance PLC (the "issuer") pursuant to an indenture, dated as of Oct. 11, 2012 (the "indenture"), by and among the issuer, the guarantors named therein (including Williams Scotsman and Algeco Global) and Wells Fargo Bank National Association, as trustee.

On Nov. 15, 2017, Delaware Trust Co., as successor indenture trustee (on behalf of the SUN holders) sued the company in New York state court to enjoin the transaction. The SUN holders claimed that the closing of the transaction would both breach the indenture and constitute a fraudulent conveyance. The SUN holders argued that, as the indebtedness of the insolvent company was nearing maturity, TDR arranged the transaction to move the most valuable asset of the company outside the reach of its creditors, and that its actions in doing so breached the indenture in multiple ways.

The transaction resulted in TDR receiving at least 27 percent of the outstanding shares of DEAC (in addition to the cash consideration described above). The SUN holders contended that these shares were received at a substantial discount and that TDR received other "unjustifiable" benefits, including the nomination rights for four of the six board members of DEAC and an earnout agreement and put option possibly worth up to an additional $132.5 million combined. Furthermore, in connection with the transaction, Williams Scotsman was required to spin off or dispose of Target Logistics Management LLC, its remote accommodations business, which was facing risks relating to litigation and was rooted in the struggling commodities industry. The SUN holders claim that this disposition would result in a risky aspect of the Williams Scotsman business remaining with the company, further diminishing the potential value of the assets available to satisfy the creditors of the company, while allowing the sponsor to maintain control of an even more valuable collection of assets in the transaction.

The plaintiffs alleged that the transaction would keep the most valuable asset of the company under TDR's control and leave the company's creditors with a significantly smaller pool of assets from which to recover. Prior to announcing the transaction, neither TDR nor the company had informed the SUN holders of their intentions, nor did they give the SUN holders an opportunity to bid on or purchase Williams Scotsman. In fact, according to the SUN holders, despite the clear indications of SUN holders' willingness to bid on the Williams Scotsman assets, the company ignored their interest and refused to engage with them. While the plaintiffs did not allege that either of these facts, in and of themselves, violated the terms of the indenture, the SUN holders pointed to them as further proof of the fraudulent nature of the transaction.

Claim of Breach of Indenture — Sale of Assets and Transactions With Affiliates

Asset Sale Covenant

The indenture prohibits Algeco Global, or any of its restricted subsidiaries, from consummating an asset sale unless it "receives consideration at the time of such Asset Sale at least equal to the fair market value (as determined in good faith by [Algeco Global] at the time of contractually agreeing to enter such Asset Sale)." The SUN holders claimed that Algeco Global would be in breach of the indenture covenant by selling its equity interest in Williams Scotsman without the belief that in doing so it was receiving fair consideration for such assets. The complaint points to, among other evidence, the purchase price of $1.1 billion, which is just half of the $2.2 billion that the company initially paid for Williams Scotsman, as an indication that Algeco Global could not possibly have believed the consideration to be fair market value.

Transactions With Affiliates Covenant

The indenture also prohibits Algeco Global, or any of its restricted subsidiaries, from "mak[ing] any payment to, or sell[ing], leas[ing], transfer[ing] or otherwise dispos[ing] of any of its properties or assets to ... or enter[ing] into or mak[ing] or amend[ing] any transaction, contract, agreement, understanding, loan, advance or guarantee with, or for the benefit of, any Affiliate of [Algeco Global] ... involving aggregate payments or consideration in excess of €15,000,000." However, such activities are permitted by the indenture when they are "on terms that are not materially less favorable to" Algeco Global than what would have been "obtained in a comparable transaction … with an unrelated Person on an arm's-length basis." Additionally, there is an exception to the prohibition if Algeco Global, or any of its restricted subsidiaries, "delivers to the Trustee a letter from an Independent Financial Advisor stating that such transaction is fair … from a financial point of view or stating the terms are not less favorable in any material respect … than those that would have been obtained in a comparable transaction … with an unrelated person on an arm's-length basis." The SUN holders argued, in a similar vein to the argument set forth above, that Algeco Global violated this covenant, as the terms of the transaction with DEAC (an affiliate of Algeco Global, since both are under the common control of TDR) "were materially less favorable to the Sellers than would have been obtained in a comparable transaction with an unrelated person on an arm's-length basis."

The Fairness Opinion

The company delivered to the trustee a fairness opinion prepared by Duff & Phelps. The SUN holders were not provided a copy of that opinion. As such, their argument was that, given the purported insolvency of the company and the agreed purchase price, the fairness opinion "cannot comply with the requirements of the Indenture." The SUN holders further pointed to peer companies of Williams Scotsman that are being purchased for or trading at multiples of 12 times its estimated earnings before interest, taxes, depreciation and amortization, or EBITDA, while the proposed purchase price for Williams Scotsman in the transaction was only nine times its EBITDA, despite additional factors involved in the transaction that would ordinarily increase the sale price, including a control premium. They argued that this shows both the lack of fair value (required by both the asset sale covenant and the transactions with affiliates covenant) and the failure to receive equivalent consideration to what would have been received from an unaffiliated third party in an arm's-length transaction.

Claim of Breach of Indenture — Denial of Guarantee Liability

Under the indenture, it is an event of default if an officer of Algeco Global or another guarantor wrongfully denies that it has further liability under its guarantee. The indenture provides that upon a permitted sale of a guarantor, any guarantee provided by that entity is automatically released. The SUN holders alleged that by executing an amendment to the company's revolving credit facility releasing Williams Scotsman from its obligations under the credit facility, notice was given of intent to deny any further liability under the Williams Scotsman note guarantee with respect to the SUNs. Furthermore, the stock purchase agreement contained a condition that the sellers do everything in their power to obtain the release of Williams Scotsman from its obligations under the indenture, including guarantees. The SUN holders argued that because the transaction was prohibited due to the violations of both the asset sale and transactions with affiliates covenants (as detailed above), the sale could not be said to have been "made in compliance with th[e] Indenture," and thus the execution of the stock purchase agreement constituted notice of denial of further liability under the guarantee and resulted in an immediate event of default under the indenture.

The Settlement

On Nov. 20, 2017 — five days after the SUN holders commenced their lawsuit — the company announced that the sponsor entered into an agreement with certain of the SUN holders to, among other things, purchase $125 million aggregate principal amount of the SUNs at a purchase price of $950 per $1,000 principal amount, plus accrued and unpaid interest on such amount. In connection with such agreement, the SUN holders instructed the successor trustee to withdraw the lawsuit. Additionally, the issuer agreed to execute a supplemental indenture providing for certain additional covenants.

Lessons To Be Learned

There are important takeaways from the Algeco Global/SUN dispute and settlement from the perspective of both the issuer and the bondholders. At inception and time of issuance, issuers should and must be careful when negotiating covenants in their debt documents (whether in credit agreements or bond indentures) to ensure and to understand what flexibility they may (or may not) have to operate their business and maximize value for shareholders.

Similarly, bondholders (or lenders) should understand and know well prior to investing in such securities (or loans) where there are restrictions and consequential risks in the covenant packages, especially carveouts and baskets in covenants that could result in significant assets no longer being available for utilization in the business and in connection with increasing liquidity.

Finally, there are salutary lessons that can be gleaned from the timeline under which the above described Algeco events occurred.

The agreement to dispose of Williams Scotsman was entered into in August 2017. No immediate action was undertaken and pursued by the SUN holders. Algeco Scotsman then launched a new financing transaction by its Williams Scotsman subsidiary on Nov. 14, the purpose of which was to finance the transaction. Immediately thereafter, on Nov. 15, the SUN holders filed their action. As noted above, five days later, on Nov. 20, the settlement and withdrawal of the lawsuit was announced, and two days later, on Nov. 22, 2017, Williams Scotsman priced the new notes. The sale of the Williams Scotsman subsidiary to DEAC was then completed (with the proceeds of the new notes) on Nov. 27, 2017.

The duration of time, from signing to launch of the new notes offering, was a 10-week period. In contrast, the duration of time, from the launch and pricing of the new notes, the filing of the lawsuit and then settlement and withdrawal, was merely nine days (from Nov. 14 through Nov. 22).

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