

WHAT CAN I DO?

Exercising Proxy Rights in a Distressed Company

Summary

Pledge agreements in secured financings will commonly include both an equity pledge and a contractual proxy that allows a secured party to exercise voting rights of the applicable pledgor upon and during an event of default. This proxy can be used, for instance, to replace a board that is not acting in the best interest of all of its stakeholders. In the right context, exercising proxy rights can be a valuable tool for secured creditors in the event that either (i) the creditor and borrower have reached an impasse over how to address an event of default, or (ii) the creditor is restricted (whether on a fund-level or otherwise) from formally taking ownership of pledged equity to effectuate a sale process or other restructuring.

Key Issues / Considerations

When evaluating a potential exercise of proxy rights, secured parties should consider the following risks:

- **Limitations on Exercise.** Exercising proxy rights is distinct from foreclosing on the equity and does not give the lender ownership in the equity or a right to share in upside recoveries, so it is best used to effectuate a broader process. In addition, any independent director appointed through a proxy exercise will still owe a fiduciary duty to all existing stakeholders (not just the lender) – including to any sponsor or existing equity holders.
- **Advanced Notice Required?** Confirm whether the loan documents require simultaneous or advance notice of the proxy exercise. A trend in more sponsor-friendly loan documentation requires advance notice which significantly limits the utility of the proxy right given that the issuer may defensively file for bankruptcy during the intervening notice period.

Exercising Proxy Rights in a Distressed Company (cont'd)

Key Issues / Considerations (cont'd)

- **Where Does the Pledge Sit?** Understand the existing capital structure so that the exercise of the pledge occurs at the right level (i.e., a single point of enforcement that includes all of the operating entities). Equity of certain immaterial or restricted subsidiaries may be carved out of the collateral package, impairing the ability to exercise at those levels down the chain.
- **Impact on Other Debt Instruments?** Determine whether an exercise of proxy may trigger certain “change of control” or other defaults in the loan documents governing other material debt or contracts of the borrower. Consider if there is any risk in providing notice to other lenders, and whether the transaction can be consummated without such lender’s consent or if the exercise is limited by applicable intercreditor agreements (or agreements among lenders).
- **Litigation Risk?** While a creditor’s ability to exercise properly documented proxy rights is well-accepted, a sponsor or borrower may nevertheless challenge the exercise through litigation, at least as a potential delay tactic. Consider risks and costs associated with defending a litigation (both economic and reputational).

Practice Pointers

- **Notice Provisions.** When negotiating original pledge documentation, push back against requirements to provide prior notice of proxy exercise or commit only to “contemporaneous notice”.
- **Target Capital Structure.** Push for a structure that will allow for a future exercise of the proxy to result in full control of the enterprise at a single point of entry (e.g., through creation of an intermediate holdco structure).
- **Replacement Board & PR Preparation.** To minimize overall business disruption, have the new directors ready to go on “day 1” and be prepared with a PR/marketing strategy for any communications to employees or vendors. Also important to understand the D&O policies and plan for how D&O coverage will be in place for the new directors and how indemnification obligations will be handled post-exercise.
- **Litigation Planning.** In the event there is concern that a sponsor may be litigious, consider engaging litigators to proactively commence litigation (e.g., a TRO) to enjoin the sponsor from interfering with the proxy.
- **Intercreditor Coordination.** The extent possible, coordinate the exercise with other holders of material indebtedness of the borrower (e.g., revolving/ABL lenders) to ensure the exercise does not trigger a cross-default and/or precipitate a liquidity crisis.

While ultimately only a means to effectuate a broader workout strategy, under the right circumstances an exercise of proxy rights can be a useful tool to bring sponsors/borrowers to the table or otherwise drive process in a default scenario.