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# Liability management goes mainstream

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Once a last resort for companies facing a liquidity crisis or other distress, liability management transactions are increasingly viewed as legitimate long-term capital and liquidity management strategies – much like managing maturity profiles through refinancing, buybacks or amend and extend transactions.

The provisions in loan documentation that enable these strategies are viewed by borrowers as features, rather than loopholes, and a natural evolution of the loan product which increasingly allows flexibility of financing, including through non-pro rata treatment of lenders. Finally, borrowers contend, these transactions are beneficial to the overall enterprise and creditors as a whole because they give the borrower runway to 'fix' liquidity or capital structure issues.

The borrower perspective is not without its lender-side detractors. In syndicated financings, lenders object to the creditor-on-creditor violence that necessarily accompanies many of these transactions, as some creditors benefit at the expense of others (in the form of reduced recovery or frustrated priority expectations) often without being given an opportunity to participate.

Direct lending transactions typically involve a smaller, more active 'club' of lenders that is less susceptible to (though not immune from) creditor-on-creditor violence. So, in the direct lending context the objection tends to be more focused on the 'leakage' of value from the guarantor group. And of course, lenders point to the frequency with which borrowers file for bankruptcy after engaging in a liability management transaction, often soon thereafter, and question whether these transactions really have a compelling 'turnaround' rationale.

Whichever position a particular loan market participant holds, and notwithstanding developing (and at times conflicting) jurisprudence, it is clear that liability management transactions are both better understood and more prevalent than they were even a few years ago.

**Types of liability management transactions**

There is a wide range of liability management transactions, but the two basic types examined in this note are 'drop-down' financings and 'uptiering' transactions.

*Drop-down financings: structural subordination.* In a drop-down financing, a borrower identifies assets that may be readily separated from the rest of the business (such as a separate business line or intellectual property (IP)) and transfers the assets to an unrestricted subsidiary (NewCo). Upon such transfer, the lien on such transferred assets securing the existing credit facility is automatically released and such (newly) unencumbered assets are available to secure indebtedness of NewCo provided by the sponsor or existing or new creditors.

There are variations on this general theme. In some cases, transfers can be made to a non-guarantor restricted subsidiary, which has the same result except that the amount of debt that can be incurred at that subsidiary is subject to the limitations set forth in the loan documentation. In other cases, a borrower will designate an existing subsidiary as an unrestricted subsidiary in lieu of (or in addition to) transferring assets to a new entity, thereby achieving the same result. This note will focus on transfers to unrestricted subsidiaries.

Where the new financing to NewCo is provided by existing lenders, it may also be structured with a 'roll-up' feature pursuant to which the participating lenders exchange existing debt of the borrower for new debt of NewCo, thereby 'rolling up' existing (subordinated) exposures into a structurally senior position with respect to those assets, often at a discount to reflect the heightened expectations of recovery of the new loans. The amount of indebtedness that may be incurred at the unrestricted NewCo is not limited by the loan documentation.

In either case, the claims of the new creditors against this NewCo – and the transferred assets – are 'structurally senior' to the claims of the existing lenders. In some cases the providers of the new structurally senior loans may also have a pari passu or junior claim against the borrower (and existing credit parties). The quintessential drop-down financing was the 2017 J. Crew transaction, but more recent examples include *Travelport* (2020), *Cirque de Soliel* (2020), *Revlon* (2020) and *Envision* (2022).

*Uptiering transactions: contractual subordination.* In an uptiering transaction, rather than transferring assets outside of the credit group, a borrower offers a new lender a claim against the existing loan parties and collateral that is contractually senior (typically through lien priority (via a new or amended intercreditor agreement) or in the form of payment priority through a waterfall) to the claims of existing lenders.

An uptiering transaction will typically be offered to existing (majority) lenders, which will provide all or a portion of the new senior financing, and typically will be permitted to exchange (or refinance) all or a portion of their existing exposure into debt that is contractually junior to the new money, but senior to the existing debt held by non-participating lenders. Such exchanges are typically made at a discount to par and, to facilitate the transaction, the participating existing (majority) lenders will effect any necessary amendments to the existing credit facility through an 'exit consent'.

The result for the borrower is much-needed new money loans, reduced overall debt burden (on account of the discount capture in the exchange) and often additional covenant flexibility. One of the earliest examples of an uptiering transaction was the 2017 NYDJ transaction, but more recent examples include *Murray Energy* (2018), *Serta Simmons* (2020), *Boardriders* (2020) and *Trimark* (2020).

**Recent developments in liability management transactions**

*Investments and unrestricted/excluded subsidiaries.* A 'J. Crew' style drop-down transaction is perhaps the better understood and, at least in its execution, less controversial form of liability management transaction. A drop-down financing depends on the availability of an unrestricted subsidiary with assets – including the ability of the credit group to invest new assets. Accordingly, the first step for all parties is reviewing all baskets or exceptions in the investments covenant that might be used for an investment of such assets.

Recently, lenders have requested a so-called 'Envision' blocker, which limits investments in unrestricted subsidiaries to just the unrestricted subsidiary basket (rather than the standard formulation that allows most investment capacity to be used for investment in unrestricted subsidiaries), and may even prevent that basket from being replenished from returns on that initial investment. A second step is to carefully examine any *J. Crew*-driven limits on the types of assets that may be invested. Such limits, if they exist at all, vary widely in scope. The narrowest formulations only limit the investment of material IP (as determined by the borrower) in an unrestricted subsidiary and only if coupled with a leaseback of that IP to the credit group. The broadest formulations would prohibit any key asset from leaving the guarantor group.

*Non-pro rata payment.* The ability to 'roll up' participating lenders and not others, which is central to many liability management transactions, depends on finding exceptions to the general rule that all lenders should receive their pro rata share of payments and recoveries, since receipt of new senior loans by these lenders is typically treated as a receipt of payment by those lenders (and only those lenders).

The erosion over the past decade of 'pro rata' protections, either directly (so that those protections can be modified by majority vote) or indirectly (through permissive debt buyback provisions that are stated to be exempt from the pro rata sharing provisions) has therefore been a key factor in recent liability management transactions. Very often the mechanism for achieving a rollup is an 'open market repurchase' of loans in exchange for more senior loans. Open market purchases are typically not required to be offered to all existing lenders and have been understood by some market participants, with the endorsement of some courts, to include privately negotiated exchanges with individual lenders. In new transactions, borrowers often seek to make this understanding explicit.

*Voting.* Most credit agreements require the consent of 100 percent of lenders to release all or substantially all of the collateral, subject to an exception for transactions otherwise permitted by the loan documentation. While a permitted transfer of material assets to an unrestricted subsidiary in drop-down financings (and consequent release from the liens) may reduce the existing collateral package, this transfer does not itself typically require an amendment, and in any event, a 100 percent vote will generally not be required. In the context of uptiering transactions, the courts in *Murray Energy* and, implicitly, *Serta*, have concluded that 'subordination' is not the same as a release, so will also not attract a 100 percent vote requirement.

Accordingly, lenders negotiating loan documents will often seek 'Serta' protection, which prohibits 'subordination' of the subject loans, including lien subordination, to other debt without approval of the adversely affected lenders. The strength of those protections varies widely. Exceptions can include debtor-in-possession financings, transactions in which all lenders are offered the opportunity to participate (ratably and, except for fees paid to the creditor group proposing the senior financing, on the same terms) and other exceptions contemplated by the loan documentation.

Entry and exit consents are another key flashpoint in liability management transactions. One of the primary tools distressed borrowers use to encourage lenders to approve amendments necessary to consummate liability management transactions is the 'exit consent' – a consent granted by a lender whose loans are immediately thereafter exchanged into the structurally or contractually senior loans. Exit consents, long a feature of the bond market, have become more common in the loan market in recent years and have so far withstood judicial scrutiny. In a relatively new development, there are some high-profile instances where new financing was provided by an existing creditor group, and counting that new financing helped achieve the requisite vote necessary to implement the liability management transaction. Increasingly lenders in new transactions are seeking to limit the operation of these entry consents, particularly with respect to unfunded incremental commitments.

**Conclusion**

'Mainstream' does not mean 'uncontroversial'. Borrowers continue to test the boundaries of loan documentation in executing liability management transactions, and non-participating, aggrieved lenders increasingly take their objections to court (e.g., *Incora/Wesco, Mitel* and *Revlon*). Lenders in distressed situations may seek to control the process for (or forestall) potential liability management transactions by entering into 'cooperation agreements' which bind them to act together in restructuring negotiations.

However, only clear and unambiguous contractual provisions can protect creditors and ensure that the parties strike the agreed balance between lenders' priority and recovery expectations, and borrowers' desire to retain flexibility to proactively manage their capital structure and address liquidity needs. ■

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