BANKING
LIABILITY MANAGEMENT

Lessons for the loan market from recent liability management transactions

Partners from Davis Polk in New York provide an overview of the structural elements of these transactions and examine practical changes that could be made to loan documentation

Much has been written recently about high profile liability management transactions that have benefited certain creditors at the expense of others. While, in many cases, a technical reading of the financing documentation confirms the permissibility of these transactions, many market participants have expressed concern that these transactions violate the spirit of such documentation and upend fundamental tenets of the loan market. It is far from clear that there is consensus – between or amongst arrangers, lenders, borrowers and sponsors – as to the right answer to these concerns. What is clear is that unambiguous, express contractual provisions will generally be respected by the courts. In this note, we provide an overview of the structural elements of these transactions and examine practical changes that could be made to loan documentation to address some of these concerns.

Types of Liability Management Transactions

There is a wide range of liability management transactions, the two basic types examined in this note are drop-down financings and uptiering transactions. In this note we assume the reader's familiarity with leveraged loan market conventions for distinguishing among the rights and obligations of various constituents in the borrower's corporate structure, including restricted subsidiaries, unrestricted subsidiaries and guarantors (and, relatedly, loan parties and credit parties).

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) and transfers the assets to either an unrestricted subsidiary or non-guarantor (excluded) restricted subsidiary (NewCo). Upon such transfer, the lien securing the existing credit facility is automatically

released and such (newly) unencumbered assets are available to secure indebtedness of NewCo provided by new creditors.

A drop-down financing may also be structured with a roll-up feature, pursuant to which existing lenders both (x) provide the new financing to NewCo as well as (y) exchange existing debt of the borrower for new debt of NewCo, thereby rolling up existing (subordinated) exposures into a structural senior position. The amount of indebtedness that may be incurred at NewCo may be limited by the existing credit facility covenants (in the case of non-guarantor (excluded) restricted subsidiaries) or unlimited (in the case of unrestricted subsidiaries).

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. 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) and Revlon (2020).

Uptiering Transactions: Contractual Subordination

In an uptiering transaction, rather than transferring assets outside of the credit group, a borrower offers new lenders a claim against the existing loan parties and collateral that is contractually senior (either through collateral priority 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, who 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 contractually senior debt. 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 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; litigated/decided in 2020) and Serta Simmons (2020).

Loans vs Bonds

It is worth noting that uptiering transactions and drop-down financings (and related exit consents) have been commonplace in the high yield bond market for many years. Given the convergence in investor base and documentation between the two markets over the past few years, it is not surprising that borrowers have increasingly sought to deploy these strategies in the loan market.

Many features of these strategies, however, frustrate traditional expectations of loan market participants, including pro rata treatment with respect to payments and recoveries (or at least an equal opportunity to participate) and capital structure seniority (without fear of priming). Furthermore, although the loan market is far more liquid than it was ten years ago, structural limitations such as borrower consent rights to assignments and disqualified lender lists leave lenders with less flexibility to manage risk than bondholders.

Competing Objectives

From a lender's perspective, the most troubling characteristic of liability management transactions is that existing creditors who do not participate in the financing (and who may not even be given an opportunity to participate) may find themselves structurally junior or contractually subordinated to other lenders, contrary to some of the key assumptions underlying their investment decision.

From the borrower's perspective, a key objective in negotiating loan documentation is to maximise flexibility to manage the borrower's capital structure since, in the broadly syndicated loan market, it may not be economically feasible to obtain amendments, extensions or incremental liquidity in times of distress. To increase the likelihood of financing being available in such circumstances, borrowers seek the ability to offer the carrot of priming liens or senior claims to those willing to provide additional liquidity or covenant flexibility. From the borrower's perspective, a drop-down financing or uptiering transaction can offer a route to stabilising its capital structure at a critical time.

Reconciling these competing interests and negotiating a set of contractual provisions that clearly delineate a compromise position is challenging. While market conditions will dictate a borrower's or lender's negotiating leverage, both sides will have an incentive to agree to clear, comprehensible and unambiguous loan documentation, if only to reduce the likelihood of future litigation.

Key Points of Negotiation

A Loan Documentation Checklist

Set forth below is an outline of liability management-related provisions that the parties should consider when negotiating loan documentation and in analysing the permissibility of liability management transactions.

Investments Covenant and Unrestricted/Excluded Subsidiaries: A drop-down financing depends for its execution on the availability of an unrestricted subsidiary or a non-guarantor restricted subsidiary with assets – including the ability of the credit group to invest new assets – and debt capacity sufficient to allow the new financing. Accordingly a first step for all parties is reviewing all baskets or exceptions in the investments covenant that might be used for the investment, as well as any J. Crew-driven limits on the types of assets that may be invested.

Designation of an unrestricted subsidiary will often be subject to a separate set of conditions which must also be evaluated. Finally, valuation matters: review the standard for assessing the value on the assets or assets and liabilities invested. Is it fair market value of the assets only? The value of the overall investment? Does the borrower have the right to determine value in good faith?

Release of all or Substantially All Collateral: Most credit agreements require the consent of 100% of lenders to release all or substantially all of the collateral, subject to an exception for transactions otherwise permitted by the loan documentation. While the transfer of material assets to an unrestricted/excluded subsidiary in drop-down financings (and consequent release from the liens) may reduce the existing collateral package, if it is permitted by the investments covenant a 100% vote should not be required.

In challenges to uptiering transactions, however, aggrieved creditors have argued that a subordination of the existing loans to one or more new classes of super-priority loans or a new super-priority credit facility – which may materially impair expected recoveries on the existing debt through that collateral — constitutes, in effect, a release requiring the 100% vote. The courts in Murray Energy and, implicitly, Serta, appear to have rejected this argument, distinguishing release of a lien from subordination.

Indeed, a primary element of the lenders' defense in Serta was that requiring a 100% vote for subordination would have been simple to draft for, so it would be inappropriate for courts to read those words into the documentation where they are not otherwise included.

Pro-Rata Sharing: At the heart of most liability management transactions is the ability to offer certain groups of lenders more favorable treatment than others by exchanging or rolling up existing exposures into more senior loans. The ability to do so 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 consideration in the form of senior loans by these lenders is 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) has therefore been a key factor in recent liability management transactions. In addition, even where changes to pro rata sharing provisions are 100% (or all affected) lender votes, as they were in Serta, this requirement applied solely to amendments that by their terms impact pro rata sharing provisions. It is an open question whether the court would have come to a different conclusion if the consent requirement applied more broadly to amendments that had the effect of modifying pro rata sharing provisions.

The Fine Print: Aggressive loan documentation often includes broad flexibility to refinance debt with more senior debt, without having to comply with limitations on junior debt prepayments or fitting the senior debt into any existing debt basket. Loan documentation also increasingly permits agents and borrowers to enter into intercreditor agreements satisfactory to them, without clarifying that such intercreditor agreement may only provide for *pari* or junior liens.

Finally, there is a recent trend towards limiting the remedies of individual lenders, or requiring that all claims must be brought by the agent at the direction of the majority lenders. Such language, developed as a reaction to the rise in debt activism over the last few years, may have the effect of depriving a minority lender group subordinated in a liability management transaction of standing to prosecute its claim that the transaction was not permitted.

Time to Rethink Loan Documentation?

It may be possible to rethink certain provisions entirely and introduce new technology (or borrow existing technology from other markets) to address the tensions between borrowers and lenders described in this note.

Exit Consents: 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 who immediately thereafter is rolled into the structurally or contractually senior loans. Exit consents, long a feature of the bond market, have become more common in loan market in recent years and have so far withstood judicial scrutiny.

However, many indentures include language that requires any consideration for an exit consent be offered to all bondholders. Including corresponding language in loan documentation would constrain a borrower's ability to offer preferential treatment to only a subgroup of lenders where an amendment is needed to permit the transaction.

Open Market Purchases: As noted above, another key to many liability management transactions is the ability to rollup or exchange existing loans of only the participating lenders into more senior loans on a non-pro rata basis. Very often the mechanism for achieving this exchange is a borrower buyback of which there are traditionally two types. Dutch auctions typically require all lenders (or all lenders of a particular class) to be offered the opportunity to participate in the buyback. Open market purchases, on the other hand, contain no such requirement, and have been interpreted by many to permit privately negotiated buyback transactions by the borrower and selling lenders with few restrictions.

Were buybacks only permitted to proceed through Dutch auctions (or another mechanism that required an offer to all lenders) – and if amendments to such requirements were permitted only with a 100% vote – then the unfairness of such transactions lamented by those lenders that are excluded from the opportunity to participate would be eliminated, while the Borrower would maintain the flexibility to opportunistically delever.

Guarantor Coverage Tests: By borrowing a concept from the European leveraged loan markets, it may be possible to limit "J. Crew" style dilutive transactions, while continuing to offer borrowers the flexibility to operate their business and engage in accretive strategic transactions. A guarantor coverage test requires that the borrower and the other loan parties maintain at all times a minimum percentage of the assets and EBITDA of the consolidated company. This requirement would reduce the need to impose specific limits on investments by credit parties in non-credit parties, and is now feasible for more borrowers in light of new tax rules which in many circumstances are more accommodating of guarantees by foreign subsidiaries.

Under this regime, if the borrower seeks to invest in a foreign subsidiary, it would be free to do so as long as that subsidiary is added as a guarantor to the extent necessary to satisfy the guarantor coverage requirement. This approach has its limitations, as there is an additional expense associated with non-US guarantees and non-US guarantees and collateral are often subject to regulatory limits that are not applicable in the US guarantor coverage requirements also tend to be subject to significant exceptions which can undermine their effectiveness.

No "One Size Fits All"

Certain of the potential changes to loan documentation highlighted above, such as requiring a higher voting threshold for lien subordination or adjustments to pro rata sharing requirements, will likely remain a focus for investors in light of recent liability management transactions. But in a market characterised by fidelity to precedent, there is no one-size-fits-all solution. Parties will need to continue to engage in a thoughtful analysis of loan documentation and agree to targeted adjustments that take into account both borrowers' need for flexibility to manage its capital structure and lenders' desire for certainty in its credit position.

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