LIABILITY MANAGEMENT EXERCISES: A New Strategy For Borrowers And Investors

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LMEs

Liability management exercises (LMEs) are facing increased legal scrutiny, with recent judicial decisions from both state and federal courts shaping the landscape of permissible transaction structures. By way of background, LMEs tend to fall into one of two key categories:

Dropdowns. Dropdown transactions involve a borrower transferring certain collateral, often intellectual property, from restricted subsidiaries (*i.e.*, entities that are subject to the loan agreement) into an unrestricted subsidiary (*i.e.*, an entity that is not considered part of the borrower-lender relationship), rendering the collateral unencumbered. The unrestricted subsidiary can then pledge this liberated collateral in support of new debt. The preexisting debt is no longer secured by the dropped down collateral, and the issuer gets the benefit of additional capital without having to provide new or additional assets as security. Rather than involving a transfer of assets, the economic equivalent of dropdowns may sometimes be obtained by simply re-designating a restricted subsidiary as an unrestricted one, provided that the designation complies with rules set forth in the loan agreement.

Uptiers. Unlike dropdowns, uptier transactions do not require transferring collateral. Instead, the issuer typically acquires the necessary consents from participating lenders in order to amend the governing loan documents to permit the issuance of new notes with a superior claim on the collateral. Creditors who provide the fresh capital are also invited to exchange their existing debt for more of the new preferred debt, rendering the non-participating holders of preexisting debt subordinated and providing the issuer with the needed capital at the lowest possible cost.

Together, they serve four key purposes: (i) preserve pro rata treatment by protecting non-participating lenders from being subordinated through priming or uptier exchanges; (ii) protect credit support and collateral value by limiting transfers of valuable

assets to unrestricted subsidiaries; (iii) maintain voting integrity by limiting certain debt issuances and/or adding rights of participation in new debt issuances; and (iv) close documentary loopholes that permitted selective lenders or sponsors to extract value from others within the same capital structure.

Back in 2017, J. Crew engaged in an LME designed as a dropdown transaction with the hope of avoiding Chapter 11. In that transaction, the issuer moved its valuable intellectual property assets to an unrestricted subsidiary in order to issue additional debt backed by that IP. Following the transaction, the company commenced a declaratory judgment action defending the propriety of the transaction. Ultimately, however, the dropdown was never tested in the courts, as the company successfully incentivized noteholders to accept a deal. Several years later, when J. Crew filed for Chapter 11, an independent director with independent counsel conducted an investigation and determined the dropdown did not constitute a fraudulent transfer.

In the Serta transaction, this LME initially represented a successful transaction after holding up against litigation in the lower court, but the Fifth Circuit's reversal upended the lower court's decision and ruled in favor of the aggrieved (excluded) lenders. After a first-of-its-kind test of an uptier transaction at trial, the Southern District of Texas Bankruptcy Court had held in favor of Serta and its participating lenders that the transaction did not violate the company's credit agreement because the company used "open market purchases" (an undefined term) to facilitate non pro-rata debt exchanges. The bankruptcy court also rejected the excluded lenders' argument that the transaction violated the implied covenant of good faith and fair dealing, noting that lenders were aware of the flexibility that the credit agreement granted Serta.

However, on appeal, the Fifth Circuit reversed the bankruptcy court's decision, finding that the 2016 uptier transaction was not an "open market purchase" in light of the plain meaning of "market" and the context of the agreement, and thus Serta and participating lenders could not take advantage of that exception to end-run the agreement's provisions which otherwise required pro-rata sharing and unanimous consent among lenders. Rather than decide the breach of contract questions, the appellate court remanded the case, but observed that the excluded lenders had a compelling argument that there was a contractual breach.

The TriMark restructuring in 2020 is a more recent example of an uptiering transaction. In TriMark, the borrower and its sponsors collaborated with a majority group of existing lenders to amend the credit agreement in order to permit the borrower to incur incremental super-priority debt. The lenders in the majority group funded a new tranche of first-out super-priority debt and then exchanged their existing senior notes for a new

tranche of second-out super-priority debt. The remaining minority lenders (who were not afforded the opportunity to participate in the new money financing or the exchange) found themselves effectively subordinated to these two new super-priority tranches. By way of exit consents, the majority lenders also effected other amendments to the existing credit agreement, including stripping out affirmative and negative covenants, amending the definition of "open market purchase" to permit the borrower to repurchase existing loans by way of a debt exchange on a non-pro rata basis, and introducing certain procedural changes to hinder the remaining lenders' ability to challenge the transaction. The TriMark matter remains the subject of litigation.

Cooperation Agreements

As borrowers have used covenant flexibility in loan documentation to engage in LMEs, ad hoc groups of creditors have increasingly responded by entering into cooperation agreements. Such agreements require participating lenders to cooperate with each other in trying to reach agreements with the borrower on the terms of a restructuring. Cooperation agreements allow lenders to protect themselves against aggressive actions by a borrower and ensure fair participation in a potential LME or restructuring. They also benefit borrowers by reducing transaction costs compared to individual lender negotiations and protecting against divergent creditor factions in distressed situations.

Borrowers, however, have complained that cooperation agreements afford lenders too much leverage in negotiations, making it difficult to pursue a divide and conquer strategy against creditor factions. Recently, Optimum Communications, Inc. (f/k/a Altice USA, Inc.) filed a lawsuit in state court challenging a cooperative agreement on antitrust grounds, arguing that lender parties to such an agreement had formed an illegal cartel to lock Optimum out of the credit markets and prevent it from negotiating with individual lenders. The matter is in the early stages of litigation, and we continue to monitor it for developments as they relate to LMEs and lender cooperation agreements.

Takeaways

LMEs will continue to develop and adapt to market conditions, as well as the results of pending litigation. It is, however, fairly clear that borrowers will need to consider these solutions — or even more creative ones — when facing distressed conditions. We anticipate that we will continue to see LMEs - both with existing creditors - but also leveraging off of the potential for a deal with lenders that are not currently in the capital stack. The market continues to evolve as new LME techniques test the limits of existing loan documentation. The most effective protections are structural rather than

reactive, including a back to basics approach with more limitations on fundamental deal terms such as leverage and leakage from the outset. Smaller baskets, reduced debt capacity and tighter control over unrestricted subsidiaries (to name a few) all help to prevent majority lenders from removing essential safeguards. Increasing consent majorities to capture amendments that impact creditor rights may also mitigate risk profile. These measures tend to provide a strong defense against dilution in the capital structure. At the same time, continued creativity in document drafting will most assuredly seek to close loopholes in recent transactions.

Much has been written about the upcoming “maturity wall”, and while it is likely to be a factor in the near term, one should expect that operational restructurings will also take center stage. Instead of focusing primarily on short-term liquidity management, transactions will place heightened emphasis on capital structure optimization. As companies move beyond short-term balance sheet fixes, LMEs are likely to be paired with deeper operational initiatives aimed at improving profitability and long-term sustainability. Put another way, LMEs may increasingly function as a bridge to broader restructuring outcomes, rather than as standalone solutions, with stakeholders placing greater weight on governance and business performance.