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WHITE PAPER

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Extracting Value from Leveraged Businesses: The Case of McLaren and its Bondholders

In recent years, market participants have watched with interest from across the Atlantic as U.S. out-of-court liability management and restructuring transactions moved material assets out of the creditors' collateral pools, to enhance liquidity, to raise additional debt or to extend the maturity of existing debt. Many have wondered when these sort of transactions will reach European shores.

That moment has now arrived.

INTRODUCTION

In the early days of the COVID-19 crisis, the UK-headquartered McLaren Group ("McLaren" or "Group") faced a material liquidity shortfall. Having reportedly failed to obtain UK government funding, it sought to raise additional liquidity by transferring some of its real estate and classic car collection outside of its restricted group ("Proposed Transaction"). These assets previously secured McLaren's obligations under its bonds, and some bondholders strongly contested that the Proposed Transaction breached the terms of the bond indenture. McLaren sought court approval for the Proposed Transaction, but the court never decided whether the Proposed Transaction was permitted. That being said, the issues in dispute are instructive and may foreshadow future differences of view among market participants in these situations.

EXISTING FINANCIAL ARRANGEMENTS

The Group's main debt obligations prior to the Proposed Transaction were:

- A fully drawn £130 million multi-borrower revolving credit facility dated 10 July 2017 ("RCF"); and
- £370 million 5% senior secured notes and $350 million 5.75% senior secured notes, each due in 2022 and issued by McLaren Finance plc under an indenture dated 20 July 2017 ("Notes").

The obligations of the RCF borrowers and the Notes issuer were guaranteed by various Group entities and were secured by assets that included McLaren's collection of classic cars ("Heritage Cars") and real estate at the Group's Woking HQ ("Properties") (together, "Security"). The Security was held by U.S. Bank Trustees Limited as security agent for the creditors ("Security Agent") and was subject to an intercreditor agreement dated 20 July 2017 ("Intercreditor Agreement").

THE DISPUTE

McLaren's proposed solutions for its urgent cash requirements were:

1. Sale and leaseback of the Properties to a purchaser outside the Group for cash; or
2. In addition to (1) above, either (i) sale of certain Heritage Cars to a third-party purchaser or (ii) sale of certain Heritage Cars to an unrestricted subsidiary to be used as collateral for an asset-backed loan from a third-party lender ("ABL"); or
3. In addition to (2)(ii), transfer of the McLaren Technology Centre to an unrestricted subsidiary as additional collateral to upsize the ABL.

The existing creditors objected vociferously to the partial release of the Security by the Security Agent which was required to give effect to the options above. In particular, a group of ad hoc noteholders ("Ad Hoc Noteholders") warned the Security Agent that it was not permitted to release the Security. McLaren, however, believed that the release of the Security was compliant with the covenants under the Notes and the RCF.

In an attempt to resolve the issue, McLaren applied to The High Court of Justice of England and Wales ("Court") for declaratory relief against U.S. Bank Trustees Limited (in its capacity as Security Agent and trustee under the Notes). McLaren argued that the Intercreditor Agreement permitted it to enter into the Proposed Transactions and that McLaren alone was responsible for certifying that the conditions to the release of the Security had been met—the most important of which was that McLaren did not dispose of "all or substantially all" of its assets. McLaren argued that the Heritage Cars and the Properties did not reach that threshold given that they amounted only to approximately a fifth of the Group's revenues and a quarter of its assets.

In Court, McLaren stated that the Ad Hoc Noteholders had initially threatened to accelerate maturity of the Notes on the basis that the Proposed Transactions would breach the terms of the Notes. Instead, the Ad Hoc Noteholders proposed an alternative financing that did not involve the release of Security and added that rejecting the Proposed Transaction would lead to a protracted legal battle that the Group could not afford.

THE OUTCOME

Before the issues in dispute could be determined, McLaren withdrew its application to the Court on the basis that:

1. The Group had obtained a new unsecured £150 million loan facility (structured as equity) from the National Bank of Bahrain (McLaren's majority shareholder is the Bahraini sovereign wealth fund Mumtalakat, which also held a stake in McLaren's new lender).
2. The Group had completed a consent solicitation process on 9 July 2020, which amended the terms of the Notes to permit the sale and leaseback of the Properties and the sale of the Racing and Applied Technologies divisions. In exchange, the Group agreed to a more restrictive covenant package, which included:
   - **Intellectual Property**. Prohibition on the sale or other disposition of IP used or likely to be used in the business of the restricted group to anyone outside of that group.
   - **Heritage Cars**. Prohibition on the transfer of Heritage Cars if the remaining Heritage Cars owned by the obligors would have a fair market value of less than £150 million.
   - **The Properties**. Restrictions on the disposal of the Properties, such that it must be by way of sale and leaseback and for 100% cash consideration in an amount of at least £170 million. The first £85 million of disposal proceeds must be offered to repay the Notes within 10 business days of any sale.
   - **McLaren Racing Limited**. Requirement that a sale of assets/businesses in this division is for 100% cash consideration. Net cash proceeds must be applied to redeem the notes, and noteholders must have collateral over any capital stock retained by the Group in the entity that owns the racing assets. Any subsequent disposal would be subject to normal asset disposal provisions.
   - **Applied Technologies Assets**. Requirement that a sale is subject to 100% cash consideration, and net cash proceeds above a minimum liquidity threshold must be applied to redeem the notes. Noteholders must have collateral over any capital stock retained by the Group in the entity that owns the Applied Technologies assets. Any subsequent disposal would be subject to normal asset disposal provisions.
   - **Other Amendments**. Value leakage (deletion of a number of baskets for restricted payments, additional controls on restricted and permitted investments and requirement that unrestricted subsidiaries must be subsidiaries of a member of the restricted group), debt (deletion of the ratio debt and other debt incurrence permissions and baskets) and liens (general basket deleted together with other restrictions).

Notwithstanding the fact that the issues in dispute were not determined by the Court, the case highlights the complexities of these situations for all stakeholders. For issuers who have negotiated flexible terms in their credit documents in order to permit them to raise additional liquidity, utilizing covenant flexibilities may in practice be difficult to achieve. Valuations remain a fertile ground for dispute, and the lack of current financial information available to creditors can make it challenging for them to appraise the legality of certain transactions entered into by an issuer.

Added to these issues, a security agent may find itself in an invidious position where it may be required to take certain steps but it receives contrary instructions and the threat of litigation if it helps consummate any proposed transaction. In European situations in particular, directors' duties also need to be carefully navigated given the additional duties (and risks) for directors in the zone of insolvency. In the context of financial distress, the urgency and complexity of these issues is typically exacerbated, resulting in a high risk of legal challenge.

LESSONS FROM THE UNITED STATES

McLaren's initial dispute and subsequent agreement with bondholders must be viewed in light of a series of restructurings in the United States where companies have sought to use covenant flexibilities and specifically unrestricted subsidiaries as a tool to transfer assets outside of the restricted group, with the intention of either raising additional liquidity and/or extending maturities as part of a liability management strategy.

Unlike restricted subsidiaries, unrestricted subsidiaries are not bound by the covenants imposed by creditors of the restricted group and can incur debt, grant liens, sell assets, pay dividends and make investments without limitation. They are also

not required to provide guarantees or collateral in respect of the issuers' obligations. Issuers can usually create or designate an existing restricted subsidiary as an unrestricted subsidiary fairly easily provided they have appropriate capacity under their investments covenants. One indirect exception is that, while unrestricted subsidiaries are not themselves expressly subject to the covenants, a "transactions with affiliates" covenant usually limits the ability of the company and its restricted subsidiaries to enter into transactions with such unrestricted subsidiaries. The protections afforded to creditors by this covenant have, however, become diluted in recent market versions.

Three examples highlight the permissive exceptions available under certain U.S. leveraged loan documentation.

J.Crew

One of the most high-profile cases in this area relates to J.Crew, the American specialty retailer. J.Crew utilized a series of baskets in its credit documents to create its so-called "trap door", purportedly enabling it to move approximately $250 million of valuable intellectual property from a guarantor-restricted subsidiary into an unrestricted subsidiary (via a non-guarantor-restricted subsidiary) and thereby outside of the creditors' collateral pool and covenant regime. The three relevant baskets used were:

1. A $150 million fixed-cap investment basket for investments by guarantor-restricted subsidiaries into non-guarantor-restricted subsidiaries;
2. A general basket equal to the greater of $100 million and 3.25% of total assets for investments by guarantor-restricted subsidiaries into anything (including non-guarantor-restricted subsidiaries); and
3. An unlimited basket for investments by non-guarantor-restricted subsidiaries, to the extent that such investment was financed with the proceeds received from a guarantor-restricted subsidiary.

Once the intellectual property was transferred to the unrestricted subsidiary through this "trap door", it was used as collateral for an exchange offer for certain holdco PIK notes in the J.Crew capital structure. More recently, documentation for certain leveraged loan and high-yield transactions have included the so-called "black hole" where the transfer at stage 1 of J.Crew (above) is uncapped, thereby allowing for a black hole of value extraction.

Notably, given the issues in *McClaren*, the term lenders in *J.Crew* commenced litigation asserting, among other things, that the IP transfer violated a covenant in the credit agreement prohibiting the disposal of all or substantially all of the company's assets. As in *McClaren*, however, the company was able to complete an alternative transaction that largely resolved the litigation.

Neiman Marcus

Neiman Marcus, an American chain of luxury department stores, was similarly able to utilize the exceptions under its covenants to spin off part of its business to shareholders through what has been coined a "two-step" dividend. As in the case of J.Crew, the valuable collateral sat with one of the guarantor-restricted subsidiaries. Using available investment capacity in the restricted group, Neiman Marcus was able to redesignate the relevant guarantor-restricted subsidiary as an unrestricted subsidiary, with such redesignation being treated as an investment equal to the fair-market value of the net assets of the newly designated unrestricted subsidiary.

With the value now transferred to the unrestricted subsidiary, Neiman Marcus was able to make use of a permission under its restricted payment regime which allowed for the distribution as a dividend of the capital stock of an unrestricted subsidiary.

PetSmart/Chewy

In *PetSmart*, the company was able to transfer 36.5% of its equity in its recently acquired subsidiary, Chewy, to its private equity sponsor (20%) and to an unrestricted subsidiary (16.5%). It was able to do this using two relatively standard baskets under its restricted payments and permitted investments covenants. PetSmart's credit documentation further stated that to the extent any subsidiary of PetSmart ceased to be a wholly owned subsidiary, any collateral or guarantees in respect of that subsidiary would be released. While it is usual to exclude non-wholly owned subsidiaries from the guarantee and collateral pool, the creditors had not contemplated this result, and litigation quickly ensued.

SPECIFIC TRANSACTION BLOCKERS AND RELATED ISSUES

Following widespread coverage of these cases in particular, creditors have sought to negotiate "blocker" provisions into loan and bond documentation to restrict: (i) transfers of key assets to unrestricted subsidiaries (J.Crew); (ii) dividends and distributions of non-cash assets (Neiman Marcus) and (iii) release of guarantees if equity is transferred to an affiliate (PetSmart/Chewy). There are a variety of versions of J.Crew blockers, most of which have included provisions that restrict the designation of a restricted subsidiary into an unrestricted subsidiary where it owns a core asset and restrict the transfer (whether by investment, asset sale or otherwise) of core assets to unrestricted subsidiaries.

None of these blockers has yet gained widespread traction in the European leveraged finance and high-yield market, although this may change as issuers seek to implement more creative liability management strategies and additional examples of collateral leakage occur in Europe. However, whilst blockers can be helpful in seeking to minimize the risk of well-known liability management techniques, blockers do not (and likely cannot) cover all possible ways that assets/value can be transferred out of the restricted group, nor do they prevent similar transactions being implemented without the use of unrestricted subsidiaries. In addition, given the nature of the these kinds of covenants, the market and what is often at stake in these transactions for companies and their creditors, one might expect that there will likely be an increase in controversy regarding these types of transactions. This is regardless of the seeming flexibility that covenant exceptions offer companies based on a cold reading of the document. If there is material value leakage, one might expect that the legal framework may be challenged.

Given developments in the U.S. market, the nature of covenants in bank loans and bonds and the ongoing economic and financial market impact of the COVID-19 pandemic, one may expect additional controversy about transactions related to those contemplated by this *White Paper*, including the following:

- The meaning and scope of covenants that limit the transfer of "all or substantially all" assets, which may vary depending on which jurisdiction's law governs the documents;
- The degree to which creditors can assert claims for fraudulent transfer, or claims for breach of fiduciary duty against the company's directors;
- The soundness of asset valuations in light of thresholds in covenants regarding asset values, especially in an uncertain market;
- The validity of transactions in which a group consisting of fewer than all existing creditors in a given facility or class primes other lenders in the same facility or class on a non-pro rata basis;
- The meaning of the term "similar business" in the context of covenants allowing for the transfer of assets to a "similar business", including whether such covenants can be used to transfer assets to a newly created unrestricted subsidiary;
- To the extent bonds are held in the United States, the use of exit consents in connection with privately negotiated purchases of debt, rather than with a tender or exchange offer; and the potential applicability of the Creeping Tender Doctrine of the U.S. Securities and Exchange Commission, which generally limits such purchases compared to broadly offered tender and exchange offers; and
- Whether trustees under indentures are willing to take certain actions, at the request of the company and possible counter-direction by bondholder groups.

CONCLUSION

McLaren is one of the first reported examples in which value extraction techniques, now relatively commonplace in the United States, have been proposed and challenged in the European high-yield and institutional-term loan markets. Regardless of whether one is a company, creditor or trustee, there are often significant issues to consider in these transactions.

While McLaren ultimately discontinued proceedings and reached an accord with its bondholders through a consent solicitation, the increased liquidity needs of companies around the world means that *McLaren* will unlikely be the last example of issuers in the European leveraged finance market seeking to use exceptions and flexibilities in their debt covenants and using creative restructuring strategies for liquidity enhancing and other value preservation reasons.

LAWYER CONTACTS

Lee Federman
London
+44.20.7039.5928
lfederman@jonesday.com

Alexander A. Gendzier
New York
+1.212.326.7821
agendzier@jonesday.com

Kay V. Morley
London
+44.20.7039.5156
kmorley@jonesday.com

I. Lewis H. Grimm
New York
+1.212.326.3492
lgrimm@jonesday.com

Ewen J. Scott
London
+44.20.7039.5501
escott@jonesday.com

Michael C. Schneidereit
New York
+1.212.326.3482
mschneidereit@jonesday.com

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