Feature

KEY POINTS

- The liquidity issues suffered by US businesses as a result of COVID-19 have, in some cases, caused them to implement increasingly creative liability management techniques.
- These have typically involved either the transfer of assets outside of the value perimeter of secured creditors or the incurrence of new super-priority priming debt.
- Many of these transactions have been challenged while creditors on new transactions are seeking documentary protections to mitigate the risk of these transactions occurring in the future.

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Jumping the line: priming restructuring transactions during the COVID-19 crisis

Over the past year, the COVID-19 crisis has caused liquidity issues for many US businesses, which has forced some borrowers to resort to increasingly creative restructuring options. These have generally fallen within two categories – "dropdown" transactions and "uptiering" exchange transactions, both of which have seen borrowers take steps under their credit agreements to prioritise one set of lenders over another. This article tracks the key cases in the US market and offers a flavour of what may be arriving soon on European shores.

Under a drop-down transaction, notably deployed in the J.Crew and Neiman Marcus transactions, the borrower transfers assets into entities that are not (or designates entities holding such assets as no longer being) part of the restricted group and the secured creditors value perimeter and then uses those assets to raise indebtedness or extend maturities as part of its liability management strategy.

The second category of transactions emerging last year in Serta Simmons, Boardriders and similar cases, are "uptiering" exchange transactions where, rather than moving assets outside of the value perimeter of the secured creditors, existing term loans are exchanged for new term loans with super-priority ranked liens leapfrogging ahead of unexchanged term loans and other debt. Often lenders participating in these transactions are also given the opportunity to provide new money super-priority debt. Whilst historically this was more common in a Chapter 11 scenario with super-priority debtor-in-possession financings and related debt roll ups, uptiering exchanges now appear more regularly in pre-Chapter 11 liquidity restructurings. It is this new sub-set of transactions in particular that has captured the eyes of the European market and has raised the question as to whether similar transactions will occur in Europe.

DROPDOWN TRANSACTIONS

Unrestricted Subsidiaries and Non-Guarantor Restricted Subsidiaries

Dropdown transactions often have a single unifying feature – the creative use of unrestricted subsidiaries. Unlike restricted subsidiaries, unrestricted subsidiaries are not bound by the covenants imposed by the credit documents upon the restricted group and as such 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 borrowers' obligations. Borrowers can usually create or designate an existing restricted subsidiary as an unrestricted subsidiary fairly easily provided they have appropriate capacity under their investments covenants.

The examples below highlight the permissive exceptions available under certain US leveraged loan documentation.

J.CREW

J.Crew, the American specialty retailer, utilised a series of baskets in its credit documents to create a so-called "trap door", purportedly enabling it to move approximately $250m 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: (i) a $150m fixed-cap investment basket for investments by guarantor-restricted subsidiaries into non-guarantor restricted subsidiaries; (ii) a general basket equal to the greater of $100m and 3.25% of total assets for investments by guarantor-restricted subsidiaries into anything (including non-guarantor-restricted subsidiaries); and (iii) 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. In J.Crew, a group of ad hoc lenders brought proceedings; however, certain holdco PIK noteholders were able to buy the majority of the secured debt and approve the transactions, which rendered the litigation moot.

NEIMAN MARCUS

Neiman Marcus, an American chain of luxury department stores, was similarly able to utilise the exceptions under its covenants to spin off a division 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 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 held by an 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.

TRAVELPORT

In one of the more recent cases, Travelport, the

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UK based travel booking platform, transferred $1.15bn of intellectual property assets outside of its restricted group to unrestricted subsidiaries. Travelport had received an independent valuation on the transferred intellectual property and determined that, using multiple baskets under its credit agreement, it had available basket capacity of $1.27bn to execute the transaction.

An ad hoc group of first lien lenders challenged the transaction asserting an event of default on the basis that the valuation was flawed and unsound and that Travelport had incorrectly calculated basket capacity. Specifically, the lenders argued that the $238m "similar business" basket was not available to Travelport given the unrestricted subsidiary receiving the intellectual property assets did not have any operating business and hence was not a similar business. Travelport has since reached agreement with its creditors which included an unwind of the intellectual property transfer in question together with an out-of-court recapitalisation.

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 automatically 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. While PetSmart did not use unrestricted subsidiaries to effect this transaction, the impact of the guarantee and collateral release was still strongly felt by the existing creditor group.

Blockers and related issues

Following widespread coverage of these cases, in recent times, creditors both in the US and Europe have focused closely on "blocker" provisions, specifically to counteract: (i) transfers of key assets to unrestricted subsidiaries (J.Crew); (ii) dividends and distributions of non-cash assets (Neiman Marcus); (iii) release of guarantees if equity is transferred to an affiliate (PetSmart/Chewy); and (iv) the subordination of liens and obligations under the credit agreement and open market debt buybacks using debt or other non-cash consideration (Serta Simmons).

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 (and sometimes non-guarantor restricted subsidiaries).

Whilst blockers can be helpful in seeking to minimise the risk of well-known liability management techniques, blockers do not (and likely cannot) cover all possible ways that assets 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 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.

UPTIERING TRANSACTIONS

Serta Simmons

The most recent evolution of priming debt restructurings through uptiering transactions began with Serta Simmons Bedding, LLC (Serta), a private equity backed US mattress manufacturer. The liquidity position of Serta was severely impacted by the COVID-19 pandemic and it entered into discussions with certain senior secured lenders to discuss its financing options. Serta had an existing capital structure comprised of a $225m asset-based loan due November 2021, a $1.95bn first lien term loan due November 2023 and a $450m second lien term loan due November 2024.

In June 2020, Serta negotiated a transaction support agreement with a group representing a majority of its existing term lenders that permitted it to incur: (i) $200m of super-priority first-out debt (new money); (ii) $875m of super-priority second-out debt, which was issued in exchange for a portion of outstanding first lien and second lien term loans at a discount; and (iii) additional amounts of super-priority third-out debt that could be used for future debt exchanges.

Importantly, the proposed indebtedness referred to above was all to rank ahead of Serta's existing facilities. As such, certain minority existing lenders that were not offered the opportunity to participate in the debt for debt exchange found themselves subordinated to new super-priority facilities and quickly filed for injunctive relief in the New York state court. After the New York state court declined to grant injunctive relief, a separate proceeding was commenced by a separate minority lender in the Federal District Court for the Southern District of New York. A number of key issues were explored in the course of the litigation which are discussed below.

LIEN SUBORDINATION

The plaintiffs in the litigation argued that the modification of the ranking of the term loans had the effect of releasing substantially all of the collateral and the value of the guarantees thereby rendering the term loans unsecured, an action which would otherwise require the prior written consent of each lender.

Serta asserted that the credit agreement could have included sacred rights (requiring unanimous lender consent) in respect of the subordination of collateral or debt obligations (as is the case in some market documents) but no such anti-subordination provision was included. As such the state court found that, although Serta's amendments had the economic effect of a release, the lack of an anti-subordination provision meant that the transaction was not prohibited.

OPEN MARKET PURCHASE EXCEPTION TO PRO RATA REQUIREMENTS

The plaintiffs in Serta also argued that the incurrence of the super-priority term loans violated the pro rata sharing provisions of the credit agreement and any amendment to the pro-rata sharing provisions required the consent of all lenders.

Typically, US credit agreements provide that mandatory and voluntary prepayments together with repayments from the proceeds of enforcement of collateral are paid to lenders on

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a pro rata basis. An exception to this rule is a repayment via an open market purchase (buying back debt on the open market) which is usually permitted (as was permitted in the Serta credit agreement) to be made on a non pro rata basis. Credit agreements that have this feature include little to no detail as to how the open market purchase is intended to work in practice.

Although the state court found that the credit agreement "seems to permit the debt-to-debt exchange on a non pro rata basis as part of an open market transaction", the plaintiffs in the federal action argued that the transaction executed by Serta was not an "open market purchase" at all because it was not offered to all lenders, and was a cashless roll-up that did not reflect the prevailing trading value of the debt. However, Serta argued that the term "open market purchase" was not defined in the credit agreement and there was no other requirement in the credit agreement for the purchase to be offered to all lenders or cash paid, nor any guidance as to pricing benchmarks.

WATERFALL PROVISIONS

The next issue was whether the transactions violated the waterfall and pro rata sharing provisions of the credit agreement on the basis that the super-priority debt was only offered to certain lenders.

The plaintiffs relied on the provision that stated that any amendment that "by its terms alters the pro rata sharing of payments" requires unanimous lender consent. The plaintiffs argued that the transaction violated their sacred rights under the pro rata sharing and amendment provisions because it had the effect of amending the waterfall provision in a way that altered the pro rata sharing of payments, because the existing term loan lenders would get paid only after the new super-priority debt.

However, the state court held that, because the transaction did not actually amend any part of the pro rata sharing provisions themselves and the new super-priority debt was to be incurred in a separately documented transaction, no sacred right had been violated.

IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

Finally, the plaintiffs further alleged that the transaction violated the implied covenant of good faith and fair dealing which all US states imply into their respective contract laws to ensure that parties to a contract do not act to destroy the other party's rights to receive the benefits of the relevant contract.

In rejecting the plaintiff's injunction motion, the state court found that the plaintiffs could not establish a likelihood of success on their claim for breach of the implied covenant because: (i) the covenant cannot nullify express terms of a contract or create independent contractual rights; and (ii) a good faith claim cannot arise from the same facts and seek the same damages as a breach of contract claim.

BOARDRIDERS

On 31 August 2020, Boardriders, the California-based surfing and skateboarding apparel company, announced a restructuring transaction which bore many of the features of Serta. The restructuring involved $110m of new money super-priority loans together with a $332m uptiering debt exchange using the same "open market purchase" exception to the pro rata payments regime in its credit agreement. Both of these debt issuances effectively subordinated a group of minority existing lenders who were not given an opportunity to participate in the exchange.

This transaction also involved the amendment to the existing credit agreement to remove substantially all affirmative and negative covenants by the use of exit consents notwithstanding that almost all of these were included in the new credit agreement governing the super-priority debt. This was a fairly novel step in the US leveraged loan market notwithstanding the prevalence of covenant stripping in the high yield bond world.

The minority lenders filed suit in the New York state court to void the transaction and the accompanying credit agreement amendments, as well as seek damages for breach of contract and voidable transfer on similar grounds to Serta, namely: (i) the violation of the pro rata sacred rights provision; (ii) the inapplicability of the "open market" purchase provisions; and (iii) a breach of the implied duty of good faith particularly with regard to the punitive covenant stripping. A motion to dismiss has been filed, and the litigation remains pending.

THE EUROPEAN PERSPECTIVE

Given the attention that this most recent round of uptiering cases has received, lenders have focused more on the risks involved and are fighting back. Although it is not obvious that these cases are moving the market on new money transactions, lenders would be well advised to take steps at the outset of deals to mitigate the risk of future uptiering exchange transactions. Simple changes such as the inclusion of appropriate blockers or anti-subordination provisions, will go a long way to achieving this.

As the carnage piles up in the US, European lenders are becoming more wary of these scenarios playing out in the European market outside of any formal restructuring implemented by way of an English scheme or pursuant to the new restructuring plan.

European leveraged loan transactions on the whole provide stronger protections for the pro rata treatment of lenders in debt repurchase transactions. These will typically require, in the first instance, a solicitation process whereby the borrower invites every lender to participate in the debt repurchase. The repurchase process outlined in the credit agreement will also likely include restrictions on the sources of funding any buybacks, which may not allow for a debt for debt exchange.

Unlike Serta and Boardriders, European credit agreements also usually include very prescriptive ranking provisions and any purported cramdown of existing debt to permit the incurrence of super-priority debt would likely require an amendment to the intercreditor agreement, which typically requires more than a mere majority lender consent. In addition, there may be possibilities for minority creditors who are not invited to participate in any uptiering to challenge the transaction under English law on the basis that there has been an improper exercise of voting power against the minority.

This is of course not to say that European borrowers will not still be seeking to find ways, whether through the structural adjustment or permitted refinancing debt provisions in credit agreements or hollow tranches in intercreditor agreements to incur new super-priority debt. We haven't seen examples of this yet but as the COVID-19 fallout continues, we expect borrowers to continue to consider their options, keeping a close eye on developments and innovations across the pond. ■