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By Sean Scott, Adam Wolk, Meir Dominitz and Lisa Holl Chang

The Dizzying Impact of LMTs: Where We Are Now

Meir Dominitz
Mayer Brown LLP
New York

Lisa Holl Chang
Mayer Brown LLP
Chicago

Sean Scott and Lisa Holl Chang are partners in Mayer Brown LLP's Restructuring Practice in Chicago. Adam Wolk and Meir Dominitz are partners in the firm's Banking and Finance Practice in New York.

In recent years, the U.S. leveraged-loan market has received a crash course in liability-management transactions (LMTs). This article looks at the evolving mechanics of LMTs (including drop-down, uptiering and double-dip transactions), the opportunities for borrowers, the potential risks to lenders and the market's response to the growing use of LMTs. By becoming familiar with the shared tools by which LMTs are executed, borrowers and lenders can understand how the transactions can be utilized and how to mitigate any potential associated risk.

Background

LMTs have become an increasingly prevalent method for borrowers and private-equity sponsors to adjust their capital structures when facing financial headwinds, navigating uncertain market conditions or weathering financial distress. Although their specific techniques vary, LMTs rely on technical — and sometimes aggressive, depending on one's perspective — interpretations of existing credit documentation to manage existing debt and raise new capital.

As borrowers have increasingly used drop-down and uptiering transactions to move collateral out of the scope of existing lenders' security interest, many lenders have become wary of the growing use of such transactions. How did we get to where we are now? Let's start with J. Crew and drop-downs.

Asset Drop-Downs Put LMTs on the Map

LMTs shook U.S. leveraged-loan markets seven years ago when certain household names — including J. Crew, Neiman Marcus Group and PetSmart — began using drop-down transactions to move valuable collateral assets beyond the reach of existing lenders. The transactions used credit-agreement baskets that technically permitted such an action, but lenders perceived these as "loopholes," since those baskets were not intended to permit the end result. While the specifics of each drop-down transaction varied, they all had at least one thing in common: The borrower executed the LMT *without* the consent of members of the existing lender group.

How Drop-Down Transactions Work

In drop-down transactions, the borrower identifies one or more existing baskets in the negative covenants provisions of its credit documentation that permit it to transfer certain assets to an affiliated entity. The motivation behind these transactions is often to use the transferred assets as collateral to secure new debt, and the assets are transferred simultaneously with the incurrence of such new debt.

Drop-down transactions typically rely on baskets under the "permitted investments" and "restricted payments" negative covenants. Accordingly, the specificity, clarity and scope of what is permitted and restricted in these baskets define how much the lender group will be protected from the adverse consequences of drop-down transactions.

A common thread with these transactions is the use of unrestricted subsidiaries, which are entities within the corporate family that are not required to comply with the provisions of the credit agreement, including by joining the credit agreement as a guarantor or pledgor. Each of the transactions described herein used a combination of permitted investments, restricted payments and unrestricted subsidiaries provisions to move valuable collateral out of the reach of the existing lender group.

The "J. Crew Trap Door"

In 2016, J. Crew[1] executed a transaction that took the market by such surprise that it became known as the "J. Crew trap door." Because the permitted investment baskets allowed the company to make investments in entities not subject to the terms of their credit agreement or the liens of the lenders (*i.e.*, unrestricted subsidiaries), J. Crew designed certain transactions to move valuable collateral out of lenders' reach for the purpose of securing new indebtedness. Specifically, the credit agreement permitted the following: (1) up to $150 million of investments *made* to non-guarantor restricted subsidiaries; (2) up to $100 million of general investments; and (3) an unlimited amount of investments *made* by non-guarantor restricted subsidiaries, provided the investment was financed with the proceeds of previous investments permitted under the credit agreement.

In a two-step process, the company — relying on the $150 million and $100 million baskets — first transferred intellectual property (IP) valued at $250 million to a non-guarantor restricted subsidiary. Subsequently, that subsidiary "invested" the IP in an unrestricted subsidiary, resulting in the assets not only being removed from the collateral but also being held by an entity not subject to any of the restrictions of the credit agreement. The second transfer prompted the maneuver that became known as the "J. Crew trap door," because the collateral essentially was released from the lenders' reach through a trap door that permitted unlimited investments in unrestricted subsidiaries if financed with the proceeds of other investments permitted under the credit agreement.

Neiman Marcus's Use of Restricted Payments Basket

In September 2018, Neiman Marcus transferred its valuable myTheresa[2] business up the corporate organizational chart and beyond the reach of the lenders' security interests. When Neiman Marcus initially acquired myTheresa, the entities owning the myTheresa business were "restricted subsidiaries" but were not guarantors of the credit facility. In 2014 and 2017, Neiman Marcus designated them as "unrestricted subsidiaries" by using investment capacity under its credit agreement. Neiman Marcus then moved myTheresa outside the reach of its lenders by utilizing the restricted payments basket.

Typically, credit agreements contain negative covenants around "restricted payments" that limit, among other things, the payments the borrower can make to its shareholders. In this case, Neiman Marcus's credit agreement allowed the distribution of equity interests of any unrestricted subsidiary to the parent company. Because the entities that owned myTheresa had been designated as unrestricted subsidiaries, Neiman Marcus could distribute the equity interests to its parent company — an entity that was not subject to any of the restrictions of, or liens in favor of, the loan facility. This put the myTheresa business outside the scope of the lenders' security interests and preserved its value for the sponsors.

PetSmart's Use of Multiple Baskets

In June 2018, PetSmart[3] transferred a valuable asset — its equity interests in the online pet retailer Chewy.com — out of lenders' reach through a transaction that used permitted investments and restricted payments baskets. First, PetSmart transferred 16.5 percent of its equity interests in Chewy to a newly formed unrestricted subsidiary using capacity available under its permitted investments basket.

Second, PetSmart distributed 20 percent of Chewy's equity to its sponsor using capacity available under its restricted payments basket. As a result of these transactions, PetSmart transferred 36.5 percent of Chewy's equity to entities that were not subject to its credit agreement, resulting in Chewy no longer being a wholly owned subsidiary of PetSmart. Because the credit agreement required the release of subsidiaries not wholly owned by PetSmart, the company requested a release of Chewy's guaranty and pledged collateral, thereby limiting the collateral available to lenders.

Uptiering Transactions Usher in a New Wave

The next chapter in LMTs involved "uptiering" transactions that were part of what the loan market coined a wave of "lender-on-lender violence." Unlike drop-down transactions, in uptiering transactions the objectives of the borrower and a majority of its existing lenders were aligned, with both groups cooperating to effectuate a transaction that benefited the borrower and cooperating lender group at the expense of other lenders. In these situations, the borrower sought additional financing, and the cooperating (majority) lenders agreed to provide it, subject to an uptiering transaction pursuant to which they exchanged their existing loans for new loans with a higher collateral priority than the other (minority group of) lenders.

Made infamous by Serta Simmons, Trimark and Boardriders, these transactions and the resulting litigation brought by the nonparticipating lenders destabilized the loan market in 2020 and 2021. Unlike the drop-down transactions that were often company-specific in terms of their various permutations, uptiering transactions typically follow a formulaic series of sequential steps.

First, the borrower and a majority group of consenting lenders amend the credit agreement to permit the incurrence of a tranche of debt senior to the outstanding debt under the existing credit agreement. After adopting the amendment, the borrower incurs the newly permitted senior debt and enters into open-market purchase transactions, whereby the borrower purchases the consenting lenders' existing debt with the proceeds of the senior debt. Finally, the debt purchased by the borrower is retired and deemed satisfied.

The result is an exchange of the consenting lenders' loans that were previously secured on a *pari passu* basis, with all loans for new debt secured on a senior basis to the original loans. Therefore, the consenting lenders have effec-

1 The details of the J. Crew transaction were extensively reported at the time, and the debt documents are available on the Securities and Exchange Commission's Edgar database under "J. Crew Group Inc." *See also* Complaint, *J. Crew Grp. Inc. v. Wilmington Savings Fund Society FSB*, Case No. 650574/2017 (N.Y. Sup. Ct. Feb. 1, 2017), ECF No. 1.

2 The transfer of the MyTheresa business was initially report by Nieman Marcus in a Form 10-K filed on Sept. 18, 2018, *available at* sec.gov/Archives/edgar/data/1358651/000135865118000013/a2018072810-k.htm (unless otherwise specified, all links in this article were last visited on Dec. 5, 2023).

3 Complaint, *Argos Holdings Inc. v. Citibank NA*, Case No. 18-cv-5773 (S.D.N.Y. June 26, 2018), ECF No. 1.

tively primed the other syndicate members and obtained a senior position. On its face, these exchanges would seem to violate *pro rata* sharing provisions, which are a hallmark of multi-lender financings. Credit agreements typically treat the *pro rata* allocation of principal and interest payments among all lenders as a "sacred right" that may not be amended without the consent of each affected lender.

Litigation has focused on the *pro rata* sharing requirement and any built-in exceptions to it.[4] In a number of these transactions, borrowers, lenders and other participants have argued that they were acting within the parameters of the credit agreement's "open-market purchase" provisions, which permit a borrower to purchase a portion of outstanding loans on a non-*pro rata* basis.

In addition, litigants have argued that a debt exchange offered privately to a select group of lenders is permitted. Whether uptiering transactions constitute permissible "open-market purchases" or violate a core tenet of credit agreements remains a hotly contested issue in ongoing litigation, and the issue is currently on appeal to the Fifth Circuit Court of Appeals following a ruling in *Serta*'s chapter 11 case that the uptiering transaction was permitted.[5]

The New Frontier: The Emergence of Double-Dip Transactions

More recently, "double-dip" transactions have grabbed lenders' attention. Double-dip transactions, like drop-down transactions, take advantage of existing flexibility regarding permitted liens, investments and unrestricted subsidiaries, meaning that they can be carried out by borrowers without the consent of existing lenders. However, the hallmark feature of double-dip transactions is not stripping existing lenders of collateral; instead, it is providing new lenders with two means of potential recourse (a.k.a. "dips") against the borrower and collateral.

In a double-dip transaction, an existing or newly created subsidiary with few assets issues new debt to the lenders that participate in the transaction. The proceeds of the new debt are loaned to the borrower in exchange for an intercompany note, which is then pledged as security for the lenders of the new debt. This intercompany note (and pledge to the lenders) creates the first "dip" against the borrower and the existing loans' security.

The new debt is then guaranteed by the borrower, another member of the restricted credit group or a subsidiary outside the restricted credit group. This guaranty creates the second "dip" against the borrower and creates additional credit support for the new debt. If the guaranty comes from an existing credit party, the existing lenders' collateral may be further diluted. If not, the new lenders receive a credit enhancement not otherwise available to the existing lender group.

In September 2023, Trinseo executed a $1 billion refinancing of existing term loans and unsecured notes with pending maturities through a double-dip structure that also featured an asset drop-down.[6] The new money lenders loaned to a newly created, unrestricted subsidiary that then loaned most of the proceeds via an intercompany note to the restricted credit group. The remainder was used as an indirect equity contribution. The intercompany note (*i.e.*, the "first dip") was structured as an incremental and refinancing loan under the existing credit agreement, making it *pari passu* with the existing debt.

The "second dip" came via various guarantees, including guarantees from the new money borrowers' parents and limited guarantees from members of the restricted credit group. It is likely the guarantees were limited so as to not violate the credit agreement's permitted debt and lien baskets. The drop-down portion involved transferring a subsidiary, American Styrenics, to an unrestricted subsidiary that was also a co-borrower for the new money loans. This drop-down may have been affected using both pre-existing investments capacity and additional capacity created by the equity investment made with the new money loans' proceeds.

Trinseo and other double-dip transactions create a way for lenders to have two different claims against a borrower and its assets. Although double claims *do not* create double recoveries, they create the potential for greater recovery in a downside scenario, such as a bankruptcy proceeding, in which lenders' direct claims against specific obligors are not entitled to full repayment. Although the transactions might not be viewed as "violent," *vis-à-vis* existing lenders, as the drop-down or uptiering transactions, they have the potential to dilute existing lenders' collateral.

For borrowers, they are a valuable liability-management tool. By offering greater downside protection, borrowers can obtain new financing or a refinancing in a challenging credit environment.

Market Response: How Lenders Can Mitigate the Risks of LMTs

Initially, many LMTs surprised market participants because they were inconsistent with expectations and market norms. Several of these transactions have been challenged by the impacted lenders to varying degrees of success. As a result, certain lenders have responded by attempting to insert certain new provisions into credit agreements to prevent each of these types of transactions.

For example, in 2021, the syndicated loan market prioritized seeking "Serta blocker" language in credit agreements to mitigate the risk of uptiering transactions.[7] These provisions explicitly state that the *pari passu* status of lenders is a sacred right, and that the subordination of any or all of the loans requires the consent of each affected lender.

Although this type of provision is straightforward and effective, it has not been uniformly adopted throughout the loan market. Some versions of this provision do not require an affected lender's consent if that lender has been offered (and declined) an opportunity to participate in the uptiered

4 *LCM XXII Ltd. v. Serta Simmons Bedding LLC*, Case No. 21-cv-3987, 2022 WL 953109 (S.D.N.Y. March 29, 2022).

5 *See* Notice of Appeal, *Excluded Lenders v. Serta Simmons Bedding LLC (In re Serta Simmons Bedding LLC)*, Case No. 23-cv-20181 (5th Cir. April 26, 2023), ECF No. 1.

6 Trinseo announced the transaction via a public filing on Form 8-K on Sept. 8, 2023, *available at* sec.gov/ix?doc=/Archives/edgar/data/1519061/000110465923099167/tm2325668d1_8k.htm.

7 *See, e.g.*, Julian Bulaon, "Covenant Trends: Expanded Sacred Rights Provisions in Recent Credit Agreements Provide Varying, Sometimes Circumventable Protections Against Lien Subordination Amendments," Reorg Research (Feb. 25, 2022), *available at* reorg.com/covenant-trends-expanded-sacred-rights-provisions.

tranche. Under the shadow of litigation in recent years, borrowers and lenders interested in uptiering transactions have weighed the likelihood of facing a lawsuit by nonconsenting lenders and are considering using strategies to minimize this risk, such as opening the exchange to all lenders.

The market response to drop-down transactions (and likely to double-dips as well) has been more nuanced. The provisions at play — permitted debt and lien baskets, permitted investments, restricted payments, etc. — are key provisions that enable borrowers to pursue their business objectives. For lenders, it can be difficult to justify restrictive covenants at deal origination when the company (and financing) look promising.

Although certain blockers (such as prohibiting transfers of the company's material IP to unrestricted subsidiaries) may prevent more egregious LMTs, there is no easy fix to avoid the potential for these transactions entirely. A prohibition on the transfer of IP would not help if a company has another valuable asset that it transfers to an unrestricted subsidiary.

Key Takeaways for Lenders

Taking center stage in just a few years, LMTs have sparked various reactions in the loan market, from surprise to fearful skepticism to proactive risk-mitigation. While the loan market is far from settled, borrowers and lenders should focus on the permitted investments, restricted payments, unrestricted subsidiary and sacred rights provisions in their credit agreements. After all, the specificity, clarity and scope of these provisions can make or break whether participants realize the benefit of their bargain, or face unintended and adverse consequences. abi

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