Strafford

Presenting a live 90-minute webinar with interactive Q&A

Liability Management Exercises: Drop-Down Financings and Uptiering Transactions, What is a Lender to Do?

THURSDAY, MAY 20, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Alison R. Manzer, Partner, **Cassels Brock & Blackwell, LLP**, Toronto

Valerie S. Mason, Member, **Otterbourg P.C.**, New York

David W. Morse, Member, **Otterbourg P.C.**, New York

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1**.

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the 'Full Screen' symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

Program Materials

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

What's a Lender to Do?

Some 2020 Cases on "Liability Management Exercises" and Covenants to Address Them

David Morse
Valerie Mason

Strafford Webinar
May 20, 2021

Otterbourg P.C.

Introduction

- 2020: What a Year!
- "Liability Management Exercises"
  - Dealing with distress
  - Use in syndicated leveraged finance transactions with sponsors, but implications for other debt
  - Shifting risk: Reducing equity risk with increase in lender risk
  - J. Crew, PetSmart, Neiman Marcus
- Two types of "exercises"
  - "Drop down financing"
  - "Uptiering transaction"

Otterbourg P.C.

The “Drop Down Financing” and “Leakage”

- 2020 cases: Progeny of J. Crew et al.
  - Travelport
  - Revlon
  - Cirque de Soleil
- Elements
  - Transfer of intellectual property, equity of subsidiaries or other assets to a newly formed non-loan party using baskets in covenants
  - Non-loan party obtains new additional financing from sponsors or subset of existing lenders
  - Existing lenders left with less value at borrower and new liabilities
  - Sponsor (and some subset of existing lenders) have first liens on valuable assets to support additional investment in distressed portfolio company
- Twist on standard loan workout playbook

Otterbourg P.C.

J. Crew Recap: The Paradigm

- Three types of parties
  - **Loan Parties**: Borrowers and guarantors with assets to secure the debt
  - **Restricted Subsidiaries**: Subsidiaries that may or may not be a borrower or guarantor, but subject to covenants in loan documents
  - **Unrestricted Subsidiaries**: Subsidiaries designated by company as such—assets do <u>not</u> secure debt and <u>not</u> subject to covenants in loan documents
- Permitted investments
  - **Restricted Subsidiary Basket**: Loan Party may make investment in a non-Loan Party Restricted Subsidiary so long as it does not exceed greater of <u>$150 million</u> or 4.0% of "total assets" plus "Available Amount"
  - **General Basket**: Loan Parties and Restricted Subsidiaries may make "other" investments so long as do not exceed greater of <u>$100 million</u> or 3.25% of "total assets" (plus if no default, "Available Amount")
  - **"Trap Door" Basket**: Investments by a Restricted Subsidiary that is not a Loan Party "to the extent such investments are financed with the proceeds received by such Restricted Subsidiary from an investment in such Restricted Subsidiary"

The J. Crew Transfers

J. Crew International
(Loan Party)

72.04% undivided interest in trademarks ($250 million of value)

J. Crew Cayman
(Non-Loan Party Restricted Subsidiary)

72.04% undivided interest in trademarks ($250 million of value)

Brand Holdings
(Unrestricted Subsidiary)

Other "Brand" Entities
(Unrestricted Subsidiaries)

License of Trademarks

J. Crew Operating Companies

Transfer 1: Loan Party to Non-Loan Party Restricted Subsidiary using Restricted Subsidiary basket and General Investment basket

Transfer 2: The "**Trap Door**" --Non-Loan Party Restricted Subsidiary to Unrestricted Subsidiary to the extent "financed" with proceeds of investment received by Restricted Subsidiary

Transfer 3: Unrestricted Subsidiary to Unrestricted Subsidiary—Basket?

Otterbourg P.C.

2020 Headline Case: Travelport

- Travelport uses proprietary intellectual property to connect airlines, hotels, car rental companies with travel agencies and travel management companies
- Acquired by sponsors in 2019 for $4.4 billion financed with $2.8 billion first lien term loan and $500 million second lien term loan
- Forms new subsidiaries and transfers intellectual property to subsidiary (the “IPCo”)
- Designates IPCo as an “unrestricted subsidiary”
- IPCo licenses technology back to operating company borrowers
- Sponsors provide $500 million first lien financing to unrestricted subsidiary, IPCo

Term Lenders' Argument

- Total of 6 different baskets permitted investments in unrestricted subsidiaries equal $1.27 billion
- But this amount includes $238 million basket for investment in "Similar Business"
- The IPCo was not a "Similar Business" therefore this basket was not available
- Intellectual property was valued at $1.15 billion per third party valuation
- Baskets only allowed $1.033 billion
- Value was also artificially low

Travelport: Company Response

- IPCo is a “Similar Business” which is defined as “similar, reasonably related, synergistic, incidental or ancillary”—no requirement as to timing of meeting these criteria
- If term lenders wanted to prevent this transfer should have used a J. Crew blocker
- The valuation of the intellectual property under terms of credit agreement was “as determined in good faith” by borrower (and company had third party valuation)

Travelport: Points to Note and Postscript

- Size of limit on transfers to unrestricted subsidiaries—particularly when include “general” baskets
- Absence of J. Crew blocker provisions used against the lenders
- No limitation on designation of unrestricted subsidiaries—a leverage test might stop an EBITDA negative company from having the right to designate an unrestricted subsidiary
- Postscript
  - Settlement between company and lenders resulted in a $1.6 billion super priority loan split between new money and roll-up component—<u>open to all lenders</u>
  - Sponsor financing of IPCo repaid
  - IPCo became loan party
  - Baskets revised to limit ability to issue new debt
  - Any proceeds from sale of eNett, company’s travel payment business, used to pay down super priority lenders

Revlon: The Sale-Leaseback Argument and Vote Dilution Strategy—The Prequel

- 2016:
  - Revlon buys Elizabeth Arden for $1.03 billion
  - Gets $1.8 billion secured term loan facility and $400 million asset-based facility to pay purchase price and refinance debt from 2015 acquisition of American Crew
- 2019:
  - Transfers American Crew brand to newly formed "BrandCo"
  - Operating company licenses IP back from BrandCo
  - BrandCo gets $200 million term loan from Ares secured by first lien on American Crew IP
  - Revlon does not seek consent from any term loan lenders

Revlon: The 2020 Transactions—The Main Event

- Transfers all of remaining intellectual property to series of "BrandCo entities"—non-guarantor restricted subsidiaries
- New credit facilities
  - $880 million "new money" term loan secured by first lien on IP and used to repay the 2019 $200 million Ares loan
  - $950 million term loan to be used to purchase 2016 term loans—of those lenders that consented—secured by second lien on IP and pari passu lien on assets securing the 2016 term loans
  - $100 million additional revolving facility—of which $65 million drawn (and repaid in 15 days with second draw under $880 new money loan)
- Seeks consent of majority of term lenders—but doesn't have majority with creation of new revolving tranche
- With addition of new tranche of revolving loans issued just to consenting lenders, amendments approved by 50.1% to 49.9%
- Ad hoc group of non-consenting lenders commence litigation

Revlon: Term Lenders' Argument

- 2019 transfer of American Crew intellectual property and license back breached sale-leaseback covenant
- The 2020 revolving loans were only permitted if no default—American Crew transaction was default
- 2020 transfer of intellectual property and license back breached sale-leaseback covenant
- With new tranches, any amendment that affects one tranche differently than another requires 50.1% of that tranche
- Putting almost $2 billion of debt ahead of non-consenting term lenders is effectively a release of all or substantially all of collateral requiring consent of all lenders
- Amendment approval was not effective because the revolving debt that gave sufficient majority was not permitted
- Company was insolvent at time of transfer and both constructive and intentional fraudulent transfer

Revlon: So What Happened?

- Citibank "operational error": $900 million mistakenly sent to the objecting lenders
- Term lenders receiving the payment refused to return it
- Citibank starts action against term lenders in NY District Court seeking return of funds
- Term lenders say payment "matched to the penny" amounts owing and was intended as payoff
- Meanwhile—litigation by non-consenting lenders voluntarily dismissed without prejudice

“Uptiering”—Background

- Purpose: Same as with drop down financings
- Effect: Additional financing from some lenders to detriment of existing lenders
- More “lender on lender” battle
- NYDJ—The early example
- 2020 Headline cases:
  - Serta
  - Trimark
  - Boardriders

“Uptiering” Structural Elements

- Creation of new “super priority” debt entitled to payment ahead of existing debt or with higher priority lien
- Super priority debt may be either or both:
  - new tranche within existing credit facility with a modification to the “waterfall” or
  - Separate credit agreement with an intercreditor agreement
- Select group of existing lenders exchange existing debt for super priority debt (the “priming roll up”)
- Participating lenders may:
  - accept discount on the existing debt
  - provide “new money” financing usually at a higher priority than existing debt being “rolled up”,
  - consent to amendments to allow priming transactions
  - any or all of the above
- Non-participating lenders left in subordinate position behind new debt

Serta Simmons: Who's on First?

- 2016: Three credit facilities:
  - $1.95 billion first lien term loan
  - $450 million second lien term loan
  - $225 million asset-based credit facility
- 2020: Serta receives competing proposals
  - Minority lenders (30%) propose drop-down financing
  - Majority lenders (50.1%) propose uptiering transaction
- June 8, 2020, Serta announces transaction support agreement with majority first lien/second lien lenders
- June 11, 2020, minority lenders (plaintiff lenders) start litigation for a preliminary injunction against company and majority lenders (defendant lenders)

Majority Lender Transaction

- **New Money Tranche**: $200 million of newly funded super-priority "first out" debt ranking ahead of Existing First Lien Term Loans
- **Exchange Tranche**: $875 million of super-priority "second out" debt ranking ahead of Existing First Lien Term Loans in exchange for certain Existing First Lien Term Loans and Existing Second Lien Term Loans
  - Exchange ratio of $74 of new super-priority "second out" debt in exchange for each $100 of Existing First Lien Term Loans
  - Exchange ratio of $39 million of new super-priority "second out" debt in exchange for each $100 of Existing Second Lien Term Loans.
- **Additional Third Debt**: Additional basket for super-priority "third out" debt to rank ahead of the Existing First Lien Term Loans that could be used for future exchanges of Existing First Lien Term Loans and Existing Second Lien Term Loans.
- **Covenant Flexibility**: The use of certain assets for future liquidity enhancing and/or liability management transactions.

Minority (Plaintiff) Lender Arguments

- Pro rata sharing
  - Proposed transaction requires amendment to pro rata sharing provisions of credit agreement
  - Amendment to pro rata sharing provisions requires consent of each Lender directly and adversely affected thereby
- Release of collateral and guarantees
  - Putting priority debt ahead of minority lenders' debt effectively constitute a release of the value of collateral and guarantees
  - A release of all or substantially all of collateral or value of guarantees requires each Lender consent
- Breach of implied covenant of good faith and fair dealing

Serta: Company and Majority Lender Arguments

- No amendments to pro rata sharing provisions required
  - $200 million of “incremental equivalent debt” with separate credit agreement was permitted
  - Priority of loans would be in a separate intercreditor agreement
- Exchange debt was permitted to be non-pro rata under Section 9.05(g) which allowed open market purchases of the term loan debt on a non-pro rata basis,
- Amendments to allow the new debt to have priority based on Required Lender approval and to authorize the agent to enter into a separate intercreditor agreement
- Absence of “anti-subordination” provision means it is permitted

Serta: Court’s Decision

- Court denied motion for preliminary injunction on basis that not a reasonable likelihood of success or irreparable harm
- Court relied on Section 9.05(g) as basis for consents of each lender being unnecessary
- Breach of implied covenant of good faith and fair dealing was on the same facts as the breach of contract claim
- What the opinion didn’t address

Trimark: Serta…and Beyond

- Distributor of food service equipment and supplies to restaurants owned by sponsors
- Existing debt:
  - $585 million first lien term loan
  - $235 million second lien term loan
- On September 14, 2020, Trimark announced a debt restructuring consisting of:
  - New $120 million first out, super-priority, non-pro rata term loan limited to select existing lenders secured by the same collateral as the existing first lien term loan
  - New $307.5 million second-out, super-priority loan from same lenders in dollar-for-dollar exchange of existing $307.5 million of first lien debt held by them
- Key Fact: First lien debt trading at 78 cents on dollar—Immediate $67.65 million return

TriMark: Before…and After

BEFORE

First Lien Loans
($569 million)

Defendant Lenders, Plaintiffs & Other Lenders

AFTER

First Out Super Senior Loans
($120 million)
The Defendant Lenders

Second Out Super Senior Loans
($307.5 million)
The Defendant Lenders

First Lien Loans
($261.5 million)
Plaintiffs & Other Lenders

Otterbourg P.C.

TriMark: The Amendments

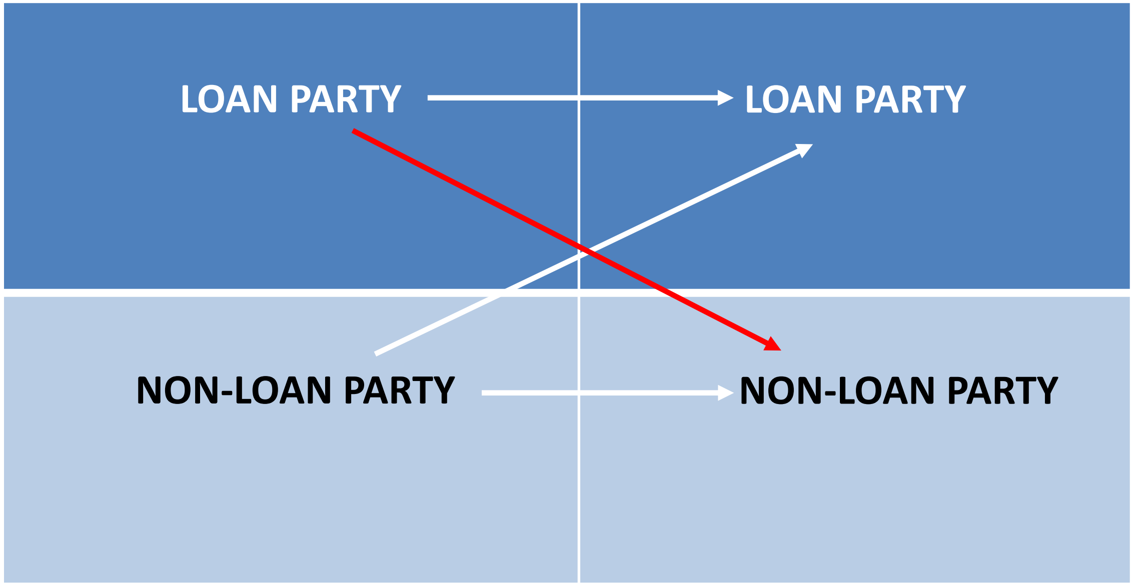
- Stripping covenants under the first lien term loan agreement, including all negative covenants
- Amending the definition of "open market purchases" to allow transactions "below or above par for cash, securities, or any other consideration with one or more Lenders that are <u>not made available for participation to all Lenders</u>."
- Changing the indemnification provisions so that instead of indemnifying all lenders, the company only indemnified the administrative agent, the collateral agent and their related parties
- Adding that no first lien lender could institute any actions for a right or remedy against not only TriMark but also any of the defendant lenders. Such suits could only be brought through the agent.
- Changing the definition of "Intercreditor Agreements". Credit agreement permitted lenders to enter into "Intercreditor Agreements. The amendment expanded the definition to include the new "Super-Priority Intercreditor Agreement"

TriMark: The Minority Lenders' Arguments

- Defendant lenders did not count as "Required Lenders"—definition excluded loans being assigned as part of open market purchase under Section 9.04(b)
- All lender consent needed to
  - reduce the principal amount of any loan or
  - affect the distribution priority of collateral proceeds
- Exception to rule requiring pro rata payments for open market purchases not applicable—"debt exchange" is not an "open market purchase"
- Putting $427.5 million of debt secured by liens ahead of remaining terms loans was effectively releasing the collateral and therefore required each lender consent

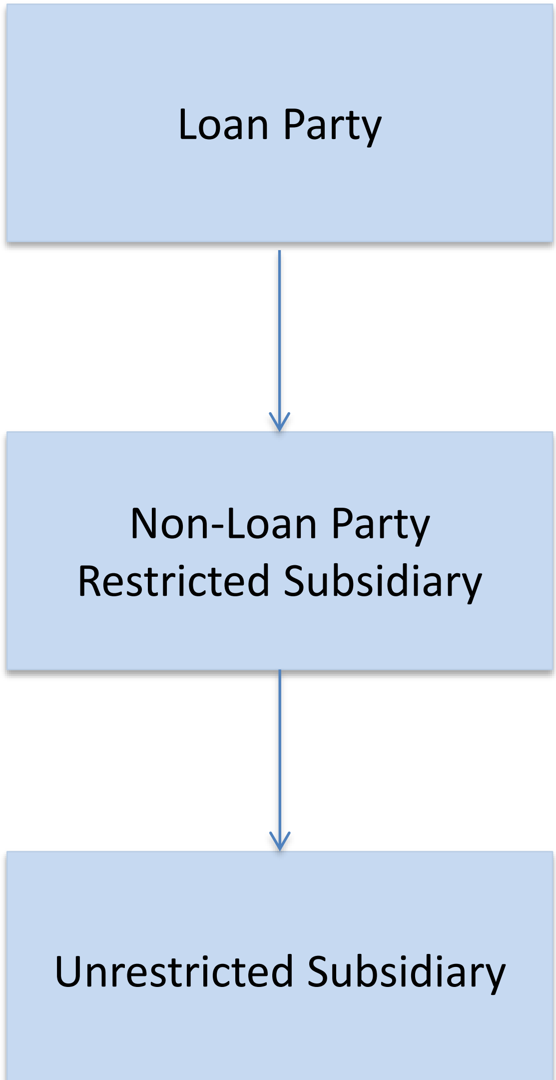
Otterbourg P.C.

Covenant Implications: Leakage and the Matrix



Loan Party to Loan Party = No problem
Loan Party to non-Loan Party = Watch out
Non-Loan Party to Loan Party = No problem
Non-Loan Party to non-Loan Party = No problem

Covenant Implications: “Black Holes” and “Trap Doors”



The “black hole” results when a credit agreement which permits **unlimited investments in non-guarantor restricted subsidiaries** also has a “trap door”.

The “trap door” permits non-guarantor restricted subsidiaries to **invest in unrestricted subsidiaries with the proceeds of any investment** made in them.

Otterbourg P.C.

Covenant Implications: Cap on Investment in Non-Loan Parties

- Structure investments using the “Matrix”
- Think about investments in non-Loan Party Restricted Subsidiaries like investments in third parties
- Limitations
  - Payment conditions
  - Dollar cap plus percentage of LTM EBITDA
- Potential Traps
  - Use of proceeds of equity contributions etc.
  - Basket: “any Investment in the Borrower or any Restricted Subsidiary”

Covenant Implications

- Watch out for multiple baskets: "Stacking"
  - Baskets may not refer specifically to "Unrestricted Subsidiary"
  - Consider overriding cap applying to all baskets:

  "Notwithstanding anything to the contrary herein, in no event shall any Loan Party make investments in, dispose of assets to, Subsidiaries that are not Loan Parties in an aggregate amount exceeding the greater of $_______ or ___% of LTM EBITDA."

- Character of assets permitted to be transferred
  - Categories of assets: intellectual property, equity interests, other?
  - Defining "Material Assets" or "Material Intellectual Property"
  - Lender's expectation: Cash or cash equivalents

Transfers of Intellectual Property: The "J. Crew Blocker"

- Definition of "Material Intellectual Property"
  - General definition
  - ABL narrow definition
- Points to consider
  - Loss of value attributable to transferred intellectual property
  - The role of the intellectual property in the operations of the business
  - The cash flow impact of the license fees and royalties
  - Control of the intellectual property by other secured lender—the IPCo issue
  - Allocation of proceeds in a "mixed sale"

J. Crew Blocker Analysis

Blocker	Issue
No Restricted Subsidiary that owns Material IP may be designated as an Unrestricted Subsidiary.	Does not stop the transfer of the IP to an Unrestricted Subsidiary.
No Loan Party shall be permitted to make any new Investment in any Unrestricted Subsidiary in the form of Material IP.	Stops a Loan Party from transferring IP to an Unrestricted Subsidiary—but does not stop a Restricted Subsidiary from doing so; Allows transfer from Restricted Sub to Unrestricted Sub.
No Intellectual Property that is material to the business shall be permitted to be transferred to an Unrestricted Subsidiary.	This seems to work the best, except may not stop a Subsidiary from being designated as an Unrestricted Subsidiary.
No Material Intellectual Property may be contributed as an Investment by any Loan Party to any non-Loan Party.	Does not stop a transfer in the form of a dividend or as a permitted asset transfer.

Notwithstanding the foregoing, in no event shall any Loan Party (a) Dispose of any Material Intellectual Property to any Subsidiary that is not a Loan Party, (b) contribute or otherwise invest any Material Intellectual Property to or in any subsidiary that is not a Loan Party or (c) designate any subsidiary as an Unrestricted Subsidiary if such subsidiary owns any Material Intellectual Property.

Otterbourg P.C.

Covenant Implications

- The many ways to transfer assets
  - Permitted investments
  - Restricted payments
  - Asset transfers
- Unrestricted Subsidiaries
  - Do you have to have them?
  - Conditions for designation
    - Non-borrowers
    - No default
    - EBITDA threshold
    - No ownership of equity of a Loan Party
    - Treatment under other material debt
  - Prohibition on ownership of Material Intellectual Property or Material Assets by an Unrestricted Subsidiary

Covenant Implications—Uptiering: "Anti-Subordination" Provisions

No amendment, waiver or consent shall…, <u>except as expressly permitted herein</u> or in any other Loan Document, subordinate the Obligations or the Liens granted under the Security Documents to any other Indebtedness or Lien, as the case may be, <u>without the written consent of each Lender</u>;

- Make sure voting covers both debt and liens
- Consider adding "or has the effect of subordinating"
- Address changes to debt and lien baskets so that the subordination does **<u>not</u>** become "expressly permitted herein"
- Review debt and lien baskets for issues on priority
- Check definition of "Refinancing Indebtedness"
- Address ability to enter into intercreditor agreements
- Limit right to amend provision governing right to enter into intercreditor agreement

Otterbourg P.C.

Covenant Implications—Uptiering: Waterfall and Pro Rata Sharing Provisions

(e) (i) change Section [waterfall] or Section [pro rata sharing of payments] in a manner that would alter the pro rata sharing of payments or order of application required thereby or (ii) change Section [waterfall] or any other applicable provision of this Agreement in a manner that would alter the distribution to each Lender of payments from or on behalf of the Borrowers for the account of such Lender received by Administrative Agent, in each case without the written consent of each Lender directly and adversely affected thereby;

- Use of "Incremental Facility"
- Address the priority of application of payments to all "Secured Obligations"
- Clarify that pro rata sharing and waterfall apply to all debt subject to credit agreement, not each "class"
- Any exceptions for "open market purchases"—clarify that not intended to allow new categories of debt with a higher priority in right of payment as part of exchange or refinancing
- Consider expanding "payments" to cover other forms of consideration

Choosing the Right Liability Management Tool

Restructure, Retire, Risk Management, Reduce Costs

1. Redemptions
2. Repurchases
3. Tender Offer
4. Private Exchange Offer
5. Exchange Offer
6. Debt for Equity Exchange
7. Equity for Equity Exchange
8. Consent Solicitation
9. Plan of Arrangement

Liability Management Documentation

Goal Less Time – Less Documents

From Least to Most Time Documentation are Lock Step

1. Redemptions and Repurchases
2. Tenders
3. Exchange Offers
   a) Private
   b) 3(a) 9
   c) Registered
4. Swaps (not the derivative kind)
   Debt for Equity
   Equity for Equity

The Practice Tips to Consider

1. **Consider the reason**

   Distressed

   Opportunistic
2. **Consider the objectives**

   accounting

   regulatory

   tax

   financial
3. Understand the starting point – the contracts
4. Regulatory concerns – tender offer
5. Financial circumstances – is there cash
6. Large or small holder group
7. Is there a Trust Indenture Act problem

Best Approach Considers

1. Legal
2. Accounting
3. Ratings
4. Regulatory
5. Tax
6. Cash Availability
7. Holders
8. Nature of Debt – Hybrid Issues
9. Securities
10. Governance

Loan Documentation – The Relevant Clauses

1. Restriction on Investments
2. Subsidiaries – Excluded
3. Collated Release
4. Sharing – Can You Prefer
5. Permitted Debt
6. Redemption, Repurchase

Contact Information

Alison R. Manzer, Partner
Cassels Brock & Blackwell, LLP
amanzer@casselsbrock.com

Valerie S. Mason, Member
Otterbourg P.C.
vmason@otterbourg.com

David W. Morse, Member
Otterbourg P.C.
dmorse@otterbourg.com