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DROP-DOWN FINANCINGS IN TODAY'S MARKET

Over the past several years, drop-down financing transactions have become increasingly prevalent in the debt markets. Such transactions can offer distressed companies an alternative financing option and provide new money lenders with structurally senior claims on a borrower's assets. Drop-down financing structures are continually evolving, and new variations, such as the so called "pari-plus" and "double-dip" structures, have attracted attention recently. This article provides an overview of drop-down financing structures and discusses some of the common documentation terms that are often implicated by such financings.

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Out-of-court liability management transactions (or "LMTs") have recently emerged as a popular alternative to in-court restructuring processes for companies, both public and private, seeking to address liquidity shortfalls, extend maturities, and capture discount. In an effort to preserve equity value and avoid the potentially staggering cost of a proceeding under the US Bankruptcy Code or the premiums associated with a "regular-way" refinancing of their funded debt — even if the syndicated loan or capital markets are readily available for a borrower or issuer in the company's current financial position — companies have turned to adopting novel transaction structures that are disrupting credit market norms and forcing investors to reexamine how they traditionally thought about their investments.

One form of LMT is the so-called "drop-down" financing. Drop-down financings come in many varieties, but the basic principle across all types is a concept called "structural subordination." The concept is simple: Debt issued by an entity with assets (an "OpCo") is "senior" with respect to the value of such assets relative to debt issued by the parent company of that OpCo (a "HoldCo"). The reason for this is that HoldCo debt has recourse only to the residual equity value of OpCo, whereas the OpCo debt has recourse to the value of the assets of OpCo and generally recovers value on its claim before any equity value of OpCo flows to the HoldCo's creditors. Thus, the HoldCo debt, merely by virtue of the corporate structure, is "structurally subordinated" to the OpCo debt.

To structurally subordinate an existing debt financing to a new one through a drop-down financing, assets securing the existing debt are typically transferred from an existing collateral package to a new corporate entity, which is often a subsidiary outside of the reach of a company's existing creditors and covenants under its

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FORTHCOMING

- ***CORPORATE TRANSPARENCY ACT: THE EXPANSION OF BENEFICIAL OWNERSHIP REPORTING REQUIREMENTS***

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debt documents (i.e., an "unrestricted subsidiary") or other non-guarantor subsidiary of the entity that previously owned the transferred assets. Creditors that were once secured by these assets will no longer have direct recourse to their value as a result of such assets being moved to the new corporate entity. In some cases (including more recent drop-down financings), the new debt issued by a non-guarantor subsidiary that enjoys structural seniority will also benefit from a secured claim that is *pari passu* with the existing debt against the left-behind collateral package, bolstering the loan-to-value ratio of the new debt and diluting the claims under the existing debt. This structure is commonly referred to as a "pari-plus" structure.

The idea that a company might incur structurally senior debt in its capital structure is, by itself, unremarkable. Debt covenants for large and mid-cap borrowers have long afforded flexibility to incur agreed amounts of such debt in one form or another. But the scale and purpose driving more recent drop-down financings is changing the restructuring landscape. It is now accepted that credit agreements and indentures that allow companies to move material assets away from existing creditor groups effectively permit companies to resolve issues with their capital structures that they would otherwise be forced to resolve in a bankruptcy proceeding, waiver or refinancing, or to be opportunistic in capturing value or providing additional capital resources for its operations. As examples of these transactions become more common, companies have become increasingly comfortable utilizing this flexibility. Investors, cognizant of this changing landscape, are adjusting their expectations regarding how debt markets function.

In this article, we will discuss (1) recent examples of drop-down financings, (2) common provisions in credit agreements and indentures that permit companies to effectuate drop-down financings, and (3) language in documentation intended to curtail these types of transactions.

RECENT EXAMPLES OF DROP-DOWN FINANCINGS

Covenants in debt documents that limit a company's ability to transfer assets to its subsidiaries or third parties — whether as an investment, a distribution to equity holders, or through a sale — are not new. For an investment-grade company, these covenants may impose few practical restrictions; but for a lower-rated one, they will typically be more complex and significantly more restrictive. For much of the past decade, with the cost of capital historically cheap and investors looking to deploy capital for debt financings, the protections afforded to secured investors against the material depletion of their collateral generally eroded, as baskets and carveouts in these restrictive covenants became more favorable to borrowers.[1]

In 2016, a drop-down transaction entered into by J. Crew Group, Inc. ("*J. Crew*") exposed some of the consequences of this erosion. There, J. Crew availed itself of a basket in its term loan credit agreement to transfer an interest in material domestic trademarks (valued at approximately $250 million) to an unrestricted subsidiary. Specifically, J. Crew relied on carveouts in its investments covenant to effectuate the transfer of the trademark interest to an unrestricted subsidiary using a two-step process: (1) it utilized $250 million of investment capacity to transfer the interest to a non-guarantor foreign restricted subsidiary and (2) it utilized another carveout to the investments covenant (now sometimes referred to as the "*J. Crew* Trapdoor") that permitted investments in unrestricted subsidiaries by any non-loan party restricted subsidiary to the extent such investment is financed with the proceeds received by such restricted subsidiary from an investment previously made in such restricted subsidiary. By combining these two exceptions to the investments covenant, J. Crew was able to convert a narrow carveout — intercompany investment capacity — into a broad one. The unrestricted subsidiary then issued debt secured by the transferred interest in exchange for

[1] Sally Bakewell, *Alarm Sounded on Latest Evidence of Weakening Loan Protections*, Bloomberg (Sept. 14, 2016), https://www.bloomberg.com/news/articles/2016-09-14/alarm-sounded-on-latest-evidence-of-weakening-loan-protections; Selcuk Gokoluk & Sally Bakewell, Yield Hunt Emboldens Companies to Chip Away Loan Safeguards, Bloomberg (Aug. 22, 2016), https://www.bloomberg.com/news/articles/2016-08-22/yield-hunt-emboldens-companies-to-whittle-away-loan-safeguards.

unsecured PIK notes previously issued by a parent entity in order to avoid a default under the PIK notes.[2]

J. Crew's drop-down financing was not without controversy. In response to rumored threats by its lenders that they would declare an event of default under its credit agreement, the company initiated preemptive litigation against the administrative agent seeking a declaratory judgment confirming that the transfer of the intellectual property complied with the credit agreement.[3] While the litigation ultimately settled,[4] the *J. Crew* transaction attracted much attention and represented what many consider to be a watershed in the relationship between borrowers and their creditors; following *J. Crew*, companies became more open to the idea of utilizing covenant flexibility to implement novel transaction structures to address issues with their capital structures.

Following *J. Crew*, in 2018 PetSmart, Inc. ("*PetSmart*") consummated a similarly novel LMT in connection with the spinoff of its Chewy.com business ("*Chewy*"). Specifically, PetSmart spun off 20% of the equity interests of Chewy (which was a guarantor under PetSmart's funded debt) to its sponsor equity owner and transferred another 16.5% of Chewy's equity interests to an unrestricted subsidiary. As a result of the spin-off, Chewy became a non-wholly owned subsidiary of PetSmart. Becoming a non-wholly owned subsidiary under PetSmart's credit agreement was extremely significant. PetSmart's credit agreement — like many others — contained a provision that permitted the borrower to request the release of a guarantor from its collateral and guarantee obligations upon such guarantor ceasing to be a wholly owned subsidiary.

Immediately following the spin-off, PetSmart directed the administrative agent under its credit agreement to terminate Chewy's guarantee of existing debt and the liens on Chewy's assets granted to secure such debt. When the administrative agent refused to acknowledge the direction, the company filed a lawsuit against the administrative agent asserting breach of contract and seeking a declaratory judgment to compel the administrative agent to deliver the necessary release documentation.[5] The litigation ultimately settled, but *Chewy* was consequential because: (1) it demonstrated that the effect of a drop-down financing can be achieved even without transferring any assets (aside from equity) or utilizing certain kinds of investment capacity, (2) it revealed a new use case for a provision in a credit agreement that was commonplace and previously viewed as non-impactful — a provision that still exists in various forms today that would lead to a similar result,[6] and (3) it was yet another example of a high-profile company executing a transaction that involved the stripping of collateral value from secured creditors.

The success of the *Chewy* transaction after *J. Crew* further encouraged the frequency and variety of drop-down financings, including by companies like *Travelport*, *Cirque du Soleil,* and *Revlon*, among others. In 2020, Revlon Consumer Products Corporation ("*Revlon*") utilized drop-down capacity under its debt documents to refinance different tranches of term loans that were then trading at a discount to par. As part of the refinancing, *Revlon* contributed valuable intellectual property to newly formed non-guarantor restricted subsidiaries,[7] and offered existing lenders the opportunity to refinance their loans into new term loan facilities consisting of three tranches of longer-dated debt. The main feature of the *Revlon* transaction was

[2] The company also provided a license of the trademarks back to the restricted group for continued use in J. Crew's business operations.

[3] Summons & Complaint for Declaratory Judgment, J. Crew Group, Inc. v. Wilmington Savings Fund Society, FSB, No. 650574/2017 (Sup. Ct, N.Y. Cnty. Feb. 1, 2017), ECF No. 1.

[4] In connection with the settlement, the company launched an exchange transaction with the term loan lenders that included a par paydown, revised economics, and lender-favorable amendments to the term loan credit agreement. Kenneth Ayotte & Christina Scully, J. Crew, Nine West, and the Complexities of Financial Distress, Yale L.J. (Nov. 10, 2021), https://www.yalelawjournal.org/forum/j-crew-nine-west-and-the-complexities-of-financial-distress.

[5] Complaint at 20-21, Argos Holdings Inc. & Petsmart, Inc. v. Citibank, N.A., Case No. 18-cv-5773 (S.D.N.Y. June 26, 2018), ECF No. 1.

[6] The concept that guarantors and the liens on their assets will be automatically released upon the occurrence of certain events, including a disposition permitted under the governing debt document, is commonplace in credit agreements and indentures. But credit agreements (and even indentures) often include automatic releases upon a guarantor becoming an "Excluded Subsidiary" — i.e., a subsidiary that no longer is required to comply with the collateral and guarantee requirements. The definition of "Excluded Subsidiary" commonly includes any subsidiary that is not a wholly owned subsidiary without any other limitations, often making a *Chewy*-type transaction possible.

[7] As described more fully below, these subsidiaries were not obligors under the company's existing debt but were still restricted by the covenants in the company's debt documents.

that the new term loan facilities benefitted not only from exclusive secured guarantees provided by the new entities holding the transferred intellectual property, but also from *pari passu* secured claims against the existing loan party group. This structure enhanced the recovery of the new term loan lenders in a potential liquidation because it provided such lenders with additional value in the form of collateral at the legacy *Revlon* entities (even if diluted by the claims of the non-participating lenders).

A *Revlon*-like structure — a drop-down financing that contains both structurally senior and *pari passu* claims — was adopted by Envision Healthcare Corporation ("*Envision*") in 2022 when it designated entities holding 83% of its ambulatory surgery business as unrestricted subsidiaries. The unrestricted subsidiaries then incurred $2.4 billion of first-lien and second-lien term loans and used the proceeds of the second-lien term loan to fund a secured intercompany loan back to the existing loan party group. The secured intercompany loan created a receivable owned by the unrestricted subsidiaries that secured the new first-lien and second-lien term loans and indirectly provided the new money lenders with recourse against the assets of the existing loan parties.

The *Envision* and *Revlon* transactions created what many refer to as a "pari-plus" structure where lenders participating in the drop-down financing maintain an independent direct or indirect *pari passu* secured claim against the assets of the existing loan party group, while having additional recourse against the assets of entities outside of the loan party group. The use of the secured intercompany loan in the *Envision* transaction was also particularly notable because of the way in which it created the *pari passu* secured claim — many credit agreements and indentures prohibit an unrestricted subsidiary from incurring debt with recourse to both the unrestricted subsidiary and the restricted group. The secured intercompany loan funded by the unrestricted subsidiary arguably bypassed this restriction because the unrestricted subsidiary is itself the lender of the loan to the restricted group, using proceeds that were in turn funded to it by the third-party lenders.

In some instances, debt documents prohibit unrestricted subsidiaries from owning debt of the restricted group at any time, which would have prohibited the unrestricted subsidiary in *Envision* from owning the intercompany loan receivable. But in 2023, a drop-down financing effectuated by Trinseo PLC ("*Trinseo*") revealed that even this restriction can be overcome with novel transaction structuring. In *Trinseo*, the lenders funded a new $1.077 billion term loan (the "*New Money Loan*") through a subsidiary of a parent entity that was outside of the restricted group. This entity was neither a "restricted" nor an "unrestricted" subsidiary under the company's debt documents; rather, it was a sister affiliate to the restricted group. The sister affiliate then loaned the proceeds of the New Money Loan to the loan party group through a secured intercompany loan and used such proceeds to refinance a tranche of debt with a near-term maturity. In addition, the company (1) transferred valuable assets to an unrestricted subsidiary and made the unrestricted subsidiary an obligor and pledgor under the New Money Loan and (2) utilized available secured debt capacity under its covenants to provide secured guarantees of the New Money Loan by certain of the company's non-loan party restricted subsidiaries.

By funding the New Money Loan through the sister affiliate and on-lending the proceeds to the existing loan party group, the company was able to recreate the *Envision* intercompany loan structure without violating the limitation in one of its indentures that prohibited unrestricted subsidiaries from owning debt of the restricted group.[8] Moreover, the unrestricted subsidiary's credit support for the New Money Loan permitted the circumvention of the restriction on lenders from having recourse to both unrestricted subsidiaries and the restricted group.[9]

An additional form of drop-down financing is commonly referred to as the "double dip." In a classic double-dip transaction, the new money lenders will benefit from two *pari passu* secured claims against the same entities, theoretically increasing a lender's recovery against such entities in a chapter 11 bankruptcy proceeding. This structure was effectuated by At Home Group ("*At Home*") in 2023. In *At Home*, the company established a new Cayman entity that was a restricted

[8] 5.125% Notes Indenture among Trinseo Materials Operating S.C.A., Trinseo Materials Fin., Inc. & Bank of N.Y. Mellon (Mar. 24, 2021).

[9] A variation of the structure used in *Trinseo* entails utilizing a joint venture or special-purpose entity that is not a "subsidiary" at all. A company, with the support of third-party investors, could consider establishing a joint venture or even an unaffiliated entity to which the debt documents' covenants do not apply because it is not majority-owned or controlled by the company (and therefore not a "subsidiary" of the company). By using a joint venture entity, the company could rely on its asset sale or investment flexibility to transfer assets to the joint venture entity as part of the transaction. With a non-controlled entity, the parties could avoid some of the restrictions that apply to the company's subsidiaries (but would still need to consider whether any covenants governing transactions with affiliates are implicated).

subsidiary under its debt documents but excluded from the collateral and guarantee obligations because it was a foreign subsidiary. The Cayman entity then issued $200 million of new secured notes and lent the proceeds to the existing loan party group through a *pari passu* secured intercompany loan. The key feature in *At Home* was that the new secured notes were guaranteed on a *pari passu* secured basis by the existing loan party group and had the indirect benefit of a lien on the receivable created by the secured intercompany loan. It is through this structure that the holders of the new secured notes doubled their *pari passu* secured claim against the existing loan party group — one claim via the secured guarantees and one claim via the secured intercompany note.

DOCUMENTATION TECHNOLOGY

Different provisions in a company's debt documents are typically implicated when a company structures a drop-down financing. This section highlights several such provisions, particularly those that companies and sponsors will commonly use and/or consider when seeking to implement a drop-down financing.

The Unrestricted Subsidiary

A critical component to structuring a drop-down financing is establishing where in the corporate organizational structure the financing will take place. As noted above, the borrower and its subsidiaries (and sometimes the borrower's parent entities) will generally be subject to covenants in a credit agreement or indenture that limit the incurrence of debt and liens, investments, distributions to equity holders, and sales of assets. The entities subject to these covenants are often referred to as the restricted group. In many cases, the company's debt documents will allow it to designate subsidiaries as being unrestricted (these are the "unrestricted subsidiaries" discussed in Section I above). If a subsidiary is an unrestricted subsidiary, it is not bound by the limitations in the covenants or events of default, allowing the company to implement a transaction using an unrestricted subsidiary that it would otherwise be prohibited from doing within the restricted group.

Designating a subsidiary as an unrestricted subsidiary has tradeoffs. For example, the unrestricted subsidiary is treated as a third party vis-à-vis the borrower and the other subsidiaries in the restricted group. Typically, the company will not be permitted to include the unrestricted subsidiary's net income or EBITDA for purposes of calculating financial ratios that are used in financial maintenance covenants and incurrence-based tests, except to the extent of cash actually distributed by the unrestricted subsidiary to a member of the restricted group. The company will also be limited in its ability to transfer assets to the unrestricted subsidiary and must typically comply with a covenant that restricts the company's ability to enter into transactions with affiliates that are not in the restricted group.[10] But these tradeoffs may be of little concern to companies if (1) there are no financial maintenance covenants that require compliance on an ongoing basis, (2) the company has significant drop-down capacity under its negative covenants, and (3) the company is otherwise comfortable making the case that the ultimate transaction is an arm's length transaction (a determination that can be difficult for investors to disprove, and in any event is often subject to an exception for investments otherwise permitted by the investment covenant).

The requirements for designating an unrestricted subsidiary under the debt documents are also important. These requirements are often found in the definition of "Unrestricted Subsidiary" itself or in the covenants. Typically, a designation will be deemed to be an investment in the designated entity equal to the fair market value of the assets (or in many cases "net assets") of such entity. Other requirements may include the absence of a default or event of default, board approval, and possibly pro forma satisfaction of a financial ratio. Credit agreements and indentures may also include additional requirements (as discussed above) that the designated entity not own debt or equity of the restricted group (which may be limited to the time of designation) or not have lenders with recourse to assets of the restricted group. These last two factors may present obstacles to a structure where investors require credit support from both the unrestricted subsidiary and the restricted group as they did in *Envision* and *Trinseo*.

Assuming there are no major roadblocks in the designation requirements, another critical component to the permissibility of a drop-down financing is the amount of value that a company can transfer to an unrestricted subsidiary (or in the case of an existing

[10] The affiliate transactions covenant typically requires that any transaction with an affiliate (other than an entity within the restricted group) must either be (x) an arm's length transaction on terms that are no less favorable to the company than those that could be obtained in a transaction with a non-affiliate or (y) a transaction that fits within another carve-out (such as ordinary course compensation with management and directors or the obtainment of a fairness opinion from an independent third party).

subsidiary, the value it can hold at the time of designation). The investment covenant will generally restrict a company's ability to acquire interests in or make capital contributions to its subsidiaries. One common carveout to such restriction is a general dollar basket for investments that can be used for any purpose. Other carveouts commonly found in credit agreements and indentures include a dedicated basket for investments in unrestricted subsidiaries, a dedicated basket for investments in similar businesses, and a dedicated basket for investments in joint ventures.[11] Furthermore, credit agreements and indentures commonly contain a "builder basket" that can be used for investments, dividends, and distributions to equity holders and prepayments of restricted debt. This basket often contains a dollar starter amount and grows by, among other things, a percentage of the company's excess cash flow, net income, or EBITDA since the date of closing.[12] This basket may also grow by the amount of dividends and distributions received from an unrestricted subsidiary without limitation, which may create an opportunity for sponsors and companies to potentially try to grow their drop-down capacity by distributing the proceeds of a new money financing received by the unrestricted subsidiary to the restricted group (in lieu of loaning it back to the restricted group in the form of an intercompany loan).[13]

Aside from the investment covenant, there are other means of transferring asset value to unrestricted subsidiaries. If investment capacity is insufficient, companies might consider transferring assets in the form of a disposition that utilizes the company's asset sales baskets. Most credit agreements and indentures will contain a general dollar basket for asset sales as well as a basket that permits unlimited dispositions at fair market value subject to (1) receiving not less than 75% cash consideration and (2) prepayment of the term loans or notes at par with the net cash proceeds, subject to reinvestment rights. Common exceptions to the 75% cash consideration requirement include a basket to designate non-cash consideration as cash and an exception for the assumption of liabilities by the transferee. To that end, it's conceivable that an unrestricted subsidiary could purchase a portion of the assets of the restricted group in a drop-down financing without using any cash (and more importantly, without having to use the proceeds of any new money financing to pay down existing debt at par) by designating the value of the equity interests in the unrestricted subsidiary as "deemed cash" consideration under its designated non-cash consideration basket.[14] Companies might also consider structuring the transaction so that the unrestricted subsidiary assumes any new money debt initially incurred by the restricted group to receive additional credit against the 75% cash consideration requirement.

The company may also have the capacity to distribute assets to a parent entity in the form of a restricted payment[15] and then transfer the assets to the unrestricted subsidiary in a multi-step transaction. There is often a general dollar basket for dividends and distributions that the company may utilize in addition to its capacity under the "builder basket." In addition, credit agreements and indentures often permit the company to utilize restricted payment capacity for investments, allowing the company to pull in additional capacity to transfer assets directly to an unrestricted subsidiary (as opposed to distributing them first to a parent entity).

Finally, another key component to drop-down financing is enhancing collateral coverage by establishing recourse to the assets that are left behind in the loan party group, which was accomplished by the "pari-plus" structures implemented in *Envision* and *Trinseo*. As discussed above, if the unrestricted subsidiary is not prohibited from holding debt of the

[11] Many debt documents do not define what it means to be a "joint venture," such that a sponsor or even participating investors may seek to acquire a partial interest in the unrestricted subsidiary to further increase investment capacity.

[12] The builder basket is sometimes subject to pro forma compliance with a financial ratio, but many credit agreements and indentures do not have this requirement.

[13] Credit agreements and indentures also typically contain a carveout for unlimited investments subject to compliance with a leverage ratio. However, companies seeking to implement a drop-down financing are often in distress and are unable to satisfy such ratio either at the time of or on a pro form basis after, giving effect to the transaction.

[14] Note that a common carveout in the investment covenant permits investments in assets received as consideration in connection with a permitted asset sales. The presence of this carveout is critical to utilizing the designated non-cash consideration strategy because it allows the company to retain the equity interests of the unrestricted subsidiary without having to use up other dollar investment capacity.

[15] It's common for indentures to define a "restricted payment" as an investment, dividend, or distribution in respect of equity interests and a prepayment of restricted debt. But credit agreements will often address these three items in separate covenants, and a "restricted payment" will be defined solely as a dividend or distribution in respect of the company's equity interests.

restricted group, companies can and have taken advantage of this flexibility by loaning the proceeds of the new money financing to the restricted group in the form of a secured intercompany loan that is *pari passu* in right of security with the liens securing the company's existing debt, so long as sufficient *pari passu* debt capacity exists. Other potential options to enhanced collateral coverage include utilizing secured debt capacity at non-loan party restricted subsidiaries to guarantee the debt incurred by the unrestricted subsidiary or simply creating another secured intercompany loan to the non-loan party restricted subsidiaries. If unrestricted subsidiaries are limited in their ability to hold debt of the restricted group, companies and sponsors might seek to "outflank" the covenants in the company's debt documents by forming a sister affiliate and funding new money through that entity.

Other Forms of Drop-Down Transactions

While a drop-down transaction involving unrestricted subsidiaries has proved to be an attractive option in many cases, if the company does not have the flexibility to utilize an unrestricted subsidiary under its debt documents, one alternative is to utilize a restricted subsidiary within the restricted corporate group. Credit agreements and indentures often permit unlimited transfers of assets — whether as an investment or a disposition — to subsidiaries within the restricted group, even if the transferee subsidiary is not a guarantor of the existing debt. And even if the debt documents restrict transfers from loan parties to non-loan party subsidiaries, many of the same baskets available to make investments in unrestricted subsidiaries will also be available for investments in non-loan party subsidiaries.[16] Moreover, it is common for credit agreements and indentures to exclude from the collateral and guarantee requirements any subsidiary that is not a wholly owned subsidiary, and as described above with respect to *Chewy*, it is typically permitted, subject to satisfaction of any applicable requirements, to convert a loan party into a non-loan party by simply distributing a portion of its equity to an affiliate or other third party.

Utilizing a non-loan party restricted subsidiary to effectuate a drop-down financing has its limitations. The restricted subsidiary will still be subject to the covenants in the debt documents, most notably the debt and lien covenants. In that regard, while there may be sufficient capacity to move the assets to a non-loan party restricted subsidiary, the debt and lien covenants will restrict the ability of non-loan party restricted subsidiaries to incur and guarantee debt (whether secured or unsecured). The company's material debt baskets may be off-limits to a non-loan party restricted subsidiary, which could thwart a company's ability to implement a material drop-down transaction at a restricted subsidiary.

Lender Participations in Drop-Down Financings

The threat of a drop-down financing that removes significant value from the existing collateral package can provide sponsors and companies with a great deal of leverage in distressed situations. Where sponsors and companies entertain proposals for a drop-down financing from third-party sources, the company's existing creditors may seek to take action to protect their collateral by submitting a competitive financing or transaction proposal of their own.

Many of these self-help proposals may involve exchanging existing debt for newly issued debt by the drop-down entity, whether it be an unrestricted subsidiary or a sister affiliate. When determining whether such exchange is permitted under the existing debt documents, one area of focus — particularly in credit agreements — is whether the company has the ability to exchange its existing debt for new debt on a non-pro rata basis.

A common feature in the leveraged loan market and written into the vast majority of credit agreements, is that a borrower must pay principal and interest to each lender holding loans in a particular class on a pro rata basis. In other words, the company cannot choose to pay one lender and not another similarly situated one. One common exception to the pro rata sharing requirement is that the borrower may purchase term loans in the open market or pursuant to a privately negotiated exchange on a non-pro rata basis. The intent of this exception is to provide the borrower with the ability to capture this discount by buying back the loans and cancelling them in the event such loans are trading at a discount. Discounted buy-backs, at least in this form, in theory benefit all parties: the company de-leverages and captures debt savings, the credit profile of the company is enhanced (thereby benefitting other lenders), and the selling lender is able to freely trade out of its loan position should it choose to do so.

Lastly, if the drop-down financing involves exchanging junior debt in the existing capital structure, the restrictions on the company's ability to prepay junior debt in its debt documents might apply. Such

[16] There is often a dedicated basket for investments in non-loan party subsidiaries that may also provide additional flexibility.

restrictions may prohibit prepayments (including redemptions and purchases) of debt subordinated in right of payment. However, it is not uncommon for such restriction to extend to debt secured by a junior lien or even unsecured debt.

RESTRICTIONS LIMITING DROP-DOWN TRANSACTIONS

The flexibility afforded to companies in their debt documents is the product of negotiation between the initial investors, on the one hand, and the sponsors and companies, on the other. In much of the past decade, the frothiness of the credit markets created a borrower-friendly environment that caused a fundamental shift to "covenant-lite" loan documentation.[17] Bucking this trend can prove challenging, even during pockets of market volatility. As a result, the market's response to the emergence of drop-down financings has been targeted, often focused on preventing the recurrence of a particular construct and fact set, rather than sweeping. Protections in debt documents have appeared that are designed to prevent the implementation of transaction structures and tactics used in *J. Crew* and *Chewy*, but such protections can vary from deal to deal.

The two most prominent protections to appear in debt documentation are commonly referred to as the "*J. Crew* blocker" and the "*Chewy* protection." Both were developed in response to the transactions that bear their name. The *J. Crew* blocker often appears at the end of the investment or dispositions covenant and, in its most basic form, prohibits a company from transferring material intellectual property to an unrestricted subsidiary – whether as an investment or a disposition.[18] Variations of the *J. Crew* blocker may include prohibition on (1) transfers to both unrestricted subsidiaries and non-loan party restricted subsidiaries, (2) transfers of any material property (not just material intellectual property), and (3) unrestricted subsidiaries from owning material property at the time of designation.

The *Chewy* protection provides that any release of a guarantor as a result of such entity becoming a non-wholly owned subsidiary (and therefore an "Excluded Subsidiary" not required to guarantee the particular financing) will occur solely in connection with a transaction that serves a legitimate independent business purpose and if the transferee of equity triggering the release is a non-affiliate.[19] Other iterations may include (1) prohibiting the release of a subsidiary guarantor unless the transaction results in such entity no longer being a "Subsidiary" (not just an "Excluded Subsidiary"), (2) deeming any such release as a new investment that must comply with the investment covenant (and therefore use available baskets), and (3) removing non-wholly owned subsidiaries altogether from the list of subsidiaries that are excluded from the collateral and guarantee requirements.

Other measures beyond the two identified above could limit a company's ability to effectuate drop-down financings. Eliminating the concept of unrestricted subsidiaries altogether is an obvious measure — effective but blunt and challenging for a lender to achieve in a competitive environment. Other measures may include (1) limiting investments in unrestricted and/or non-loan party subsidiaries to a single basket or an overriding cap (a so-called "*Envision* blocker"), (2) capping the value of assets that non-guarantor restricted subsidiaries and unrestricted subsidiaries may hold at any one time, (3) requiring all intercompany loans to be unsecured and subordinated in right of payment to the existing secured debt, regardless of the carveouts used to create such intercompany loan, and (4) capping the amount of consideration paid in non-ordinary course transactions with affiliates. Whether such measures are incorporated into debt documents depends in large part on the facts and circumstances surrounding each issuance.[20]

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[17] Brian Chappatta, *The 'Cov-Lite' Fight in Leveraged Loans Is Lost*, Bloomberg (February 18, 2020), https://www.bloomberg.com/opinion/articles/2020-02-18/the-cov-lite-fight-in-leveraged-loans-is-lost.

[18] One example of such J.Crew blocker is as follows: "Notwithstanding anything to the contrary herein, in no event shall the Borrower or any Restricted Subsidiary sell, convey, transfer or otherwise dispose of (including as an Investment, Restricted Payment, or otherwise), or exclusively license, any material intellectual property to any Unrestricted Subsidiary."

[19] One example of such Chewy blocker is as follows: ". . . in no event shall any Guarantor cease to constitute a Guarantor solely as a result of such Guarantor ceasing to constitute a Wholly Owned Subsidiary after the Closing Date (unless either (I) pursuant to a disposition permitted hereunder for a bona fide business purpose to an unaffiliated Person or (II) such Person otherwise constitutes an Excluded Subsidiary (other than solely on account of constituting a non-Wholly Owned Subsidiary)".

[20] Drop-down financings, particularly those involving the company's existing investors, will often result in a new set of debt documents that seek to limit the company's ability to do that type of transaction again. The covenants in debtor-in-possession financings for companies in a chapter 11 bankruptcy

DROP-DOWN FINANCINGS — THE NEW NORM

The proliferation of drop-down financings has transformed norms and expectations in the leveraged loan market. A substantial portion of the deals originated in the U.S. leverage loan market in the late 2010s and early 2020s are covenant-lite,[21] and as those credits approach maturity (particularly in a high interest rate environment), drop-down financings are a known tool that sponsors and companies could explore using to manage their capital structures. The periodic softening of credit markets in recent years has not appeared to discourage companies and their advisors — or competing ad hoc groups of a company's creditors — from this mindset or contemplating this paradigm. As such, credit investors and companies have become more engaged in understanding their applicable debt documents early in the credit and investing cycle so that they can be in a position to move quickly, either as reactor or first-mover, should financing or liability management needs arise. ■

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proceeding will also be stripped down to those that only permit the company to operate in the ordinary course of business.

[21] Abby Latour, Covenant-lite deals exceed 90% of leveraged loan issuance, setting new high, S&P Global Market Intelligence, Oct. 8, 2021.

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