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USA: Trends and Developments

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Trends and Developments

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Davis Polk & Wardwell LLP

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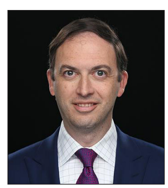

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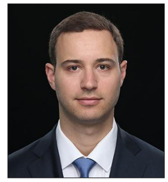

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Recent Trends in Liability Management Transactions

Since the beginning of the COVID-19 pandemic in Spring 2020, borrowers have executed more and increasingly complex liability management exercises to address their liquidity needs and obtain required covenant relief. At the same time, due to strong lender-side demand during this period, loan documentation terms have been at least as borrower-friendly as, and in certain cases more so than, those that marked the years immediately preceding the pandemic. A theme of the market over the past few years has been lenders' efforts to balance these two competing considerations: on the one hand, winning mandates and market share by providing flexibility on key economic and operational items requested by borrowers; and on the other, exercising discipline on certain structural elements of the documentation in an effort to protect against coercive and aggressive liability management exercises that have become important tools for distressed (or, in certain cases, simply opportunistic) borrowers.

During the pandemic and immediately thereafter, nearly all liability management transactions were based on one of two fundamental structures: uptiering transactions and drop-down financings. Over the past 12-18 months, however, borrowers and opportunistic lenders have innovated both new forms of liability management transactions (eg, "double-dip" and "pari-plus" facilities) as well as further refined existing structures in manners not contemplated (and, thus, not restricted) by most loan documentation, even ones specifically drafted to restrict pre-existing forms of liability management. This article traces recent trends in liability management transactions as well as the broader set of loan documentation provisions implicated by their newest and most novel forms.

Uptiering transactions

In uptiering transactions, borrowers offer new lenders a claim against an existing credit support package that is contractually senior to the claims of the existing creditors. This seniority is most typically effectuated through lien priority of a new facility on the collateral provided to the existing creditors, but, in certain cases, is addressed via payment priority in the collateral waterfall itself. The right to participate in uptiering transactions is sometimes offered to all or a subset of existing lenders who provide all or a portion of the new financing and are, typically, permitted to exchange all or a portion of their existing loans into (additional) contractually sen-

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ior debt. These "debt-for-debt" exchanges of the existing loans are usually made at a discount to par of the existing loans so exchanged and are often accompanied by an "exit" consent from the participating lenders to effect necessary (or otherwise desirable) amendments to the existing facility. The primary benefits of these transactions for borrowers are additional liquidity, reduced overall debt burden arising from the deleveraging exchange, additional financial and negative covenant flexibility and extended maturities.

Drop-down financings

Rather than reallocating the priorities within an existing guarantee and collateral package, borrowers in drop-down financings identify assets that are readily separable from their business and transfer these assets – often material intellectual property – to a subsidiary that is not required to guarantee the existing facility, most commonly an unrestricted subsidiary ("NewCo"). Upon their transfer to NewCo, the transferred assets are automatically released from the existing collateral package and fully available to secure new indebtedness of NewCo. Drop-down financings also often include a roll-up feature permitting the participating lenders to exchange a portion of their debt under the existing facility at a discount to par for the new structurally senior debt of NewCo. The quantum of financing that may be incurred by NewCo as an unrestricted subsidiary is not subject to any limitations under the existing loan documentation, and the claims of the new creditors against NewCo and the transferred assets are structurally senior to any claims of the existing lenders on such assets. In a recent innovation on this structure, borrowers have utilised a non-guarantor restricted subsidiary as the NewCo – into which material IP was transferred and by whom the new debt incurred. The decision on whether to use a non-guarantor restricted subsidiary rather than an unrestricted subsidiary will be driven by the applicable limitations on both investments and additional indebtedness in the existing loan documentation, with the first (investments) often providing fewer restrictions on transfers of assets to a non-guarantor restricted subsidiary, and the second (indebtedness) imposing limitations on the ability of a non-guarantor restricted subsidiary to incur and secure new financing.

Double-dip and pari-plus facilities

A third form of liability management transactions that has been recently utilised by borrowers is the "double-dip" facility. Under this structure, borrowers provide lenders with both (i) a direct claim against the collateral and guarantee package available to existing lenders as well as (ii) a lien on an intercompany claim that benefits from the same credit support. The typical structure for achieving this result is for third-party lenders to lend to an unrestricted subsidiary (an "SPV"), which then on-lends the funds to the borrower on a pari passu basis with the existing secured facility. These same loan parties then provide a separate and further secured guarantee of the third-party lenders' loan to the SPV, which is also secured by a pledge by the SPV of its intercompany secured loan. The direct guarantee claim and the intercompany claim represent separate sources of recovery from the obligors and collateral, so this structure is particularly powerful in a bankruptcy proceeding in which any individual claim against the debtor group is unlikely to be paid in full.

Under "double-dip" facilities, the new lender may file two independent proofs of claim with respect to its direct and (pledged) intercompany claims, thereby effecting a double claim and potentially doubling its recovery against the debtors as a result of its claims on the loan party group both through the separate guarantee and its rights to the intercompany loan. A further enhancement of the double-dip facility is sometimes referred to as the "pari plus", in which the SPV's obligations to the third-party lender are further supported by guarantees and collateral from subsidiaries – such as foreign subsidiaries – that do not guarantee the existing facility and, thus, are incremental to ("plus") the credit support for the existing facility and its lenders.

Protecting a lender's position in the capital structure

The most challenging feature of liability management transactions for existing lenders is that their claims may become contractually or structurally subordinated to – or benefit from a "lesser" credit support package than – claims of other creditors, without, in many cases, even being offered an opportunity to participate. This outcome conflicts with long-standing assumptions in the senior secured loan market as to the general priority of such creditors in the capital structure and equal treatment across lenders in a single facility. Borrowers, in contrast, view liability management transactions as providing appropriate flexibility to manage their capital structures, especially in times of distress. Borrowers will often argue that lenders will also benefit in the long run from liability management transactions, as they permit the stabilisation of the underlying business and avoid a value-destructive bankruptcy filing.

To reconcile these competing interests, a set of provisions have become increasingly common in loan market transactions that impose limitations on borrowers' ability to subordinate existing obligations (including by modifying "pro rata" sharing provisions) and provide varying levels of protection against potential "drop-down" liability management transactions. Given the recent variations of liability management transactions, lenders and borrowers are increasingly discussing the scope of additional protections to address these developments.

As a baseline matter, it is critical to understand the specific contractual provisions implicated by liability management transactions. The loan documentation covenants, subject to the most detailed negotiation as to appropriate protections, include the following:

Investment limitations

The investments covenant is most relevant in drop-down financings under which borrowers' assets are transferred to – "invested" in – an unrestricted subsidiary or, in some more recent transactions, a non-guarantor restricted subsidiary and used as collateral to support new structurally senior debt. Lenders have long been focused on eliminating certain specific features from loan documentation, including the "trapdoor" provision, permitting a non-loan party restricted subsidiary to invest, without restriction, proceeds received as investments from a loan party. Lenders have also focused more generally on aggregate investment capacity, ensuring there is a cap on investments by loan parties in non-loan parties and/or, in certain transactions, requiring that investments in unrestricted subsidiaries be made solely pursuant to a dedicated (and capped) investments basket. More tailored provisions seek to prohibit the movement of key assets, often material intellectual property, outside the restricted party (or again, more recently, the loan party) group, whether through investments, the designation of unrestricted subsidiaries or any other disposition or transfer. To the extent any of these restrictions limit a borrower's flexibility to operate its business in the ordinary course, these tend to be subject to heavy negotiation as to scope.

Other limitations on unrestricted subsidiaries
Unrestricted subsidiaries provide borrowers with significant operating flexibility, as they are not subject to the covenants, events of default or other limitations included in loan documentation. Loan documentation, as a result, generally restricts borrowers' ability to capitalise or otherwise invest in such entities, subject to the agreed baskets referred to above. Borrowers may generally designate unrestricted subsidiaries subject solely to an event of default "blocker" and, increasingly rarely, a ratio test (though designation will typically be a deemed investment subject to available investment capacity). Focus has instead been on the amount and type of assets that can be contributed to, or owned by, an unrestricted subsidiary as noted above, and, more recently, the relationship of unrestricted subsidiaries with the restricted group. Key considerations include whether an unrestricted subsidiary should be permitted to receive a guarantee from, lien on assets of, or other direct credit support from, loan parties. If not, should such unrestricted subsidiary have the right to hold (secured) debt issued by, or otherwise benefit from indirect credit support of, the loan party group? And, where agreed, should these limitations apply solely upon the designation of the unrestricted subsidiary, or on an ongoing basis as well?

Sharing provisions and lien subordination
Most secured loan documents restrict modifications to pro rata sharing and payment waterfalls and release of all or substantially all collateral without the vote of all affected lenders. Given what some perceived as the spirit of those amendment provisions, many market participants were surprised that "uptiering transactions" resulting in new lenders having contractually senior claims against existing credit parties could be achieved with only a majority lender vote under those same typical credit agreement provisions. In response, lenders have increasingly required that any such subordination of lien priority on all or substantially all collateral require an "all-affected" lender vote, subject to, even where agreed, customary exceptions to such requirement for:

- "DIP" facilities or use of cash collateral in a bankruptcy proceeding of the borrower;
- indebtedness "otherwise permitted" by the credit agreement at closing (eg, capital leases or factoring or receivables facilities); and/or
- priming senior indebtedness, but only to the extent all existing lenders were given an opportunity to participate in that new priming indebtedness.

Release of guarantees
Under most loan agreements, subsidiaries of the borrower are released from their guarantee obligation upon ceasing to be wholly owned by the borrower. In practice, this permits borrowers to cause the release of the guarantee (and collateral obligations) of a valuable subsidiary by selling or distributing a minority interest in such subsidiary. There has been a continued focus from lenders on this release mechanism, and various forms of protection have developed, including:

(a) No such release shall occur unless the sale or distribution is for a bona fide business purpose, the primary purpose of which is not to release such guarantor, no event of default is then continuing and/or such sale or distribution is with an unaffiliated third party.
(b) Release of a subsidiary guarantor is a deemed investment and permitted solely to the extent there is investment capacity.

(c) A subsidiary guarantor is released only upon ceasing to be a subsidiary of the borrower.

Over the last several years, borrowers and lenders have continued to evaluate and implement new variations on existing themes of liability management transactions. Weighed against the competitive backdrop of preserving existing portfolio investments and existing positions in the capital structure, participants in the leveraged finance market have come to recognise that liability management exercises are no longer outliers, but a recognised tool for managing and protecting capital. As lender protections have evolved, in particular over the last 12-18 months, so too have the structures for achieving these results, in many cases frustrating many traditional and fundamental expectations of participants in the syndicated and direct secured loan markets. While, as noted above, there are potential methods for lenders to address each of the aforementioned issues – materially tightening investment capacity in unrestricted and excluded subsidiaries, requiring an "all affected" lender consent to subordinate payment or collateral rights for senior secured term loans, restricting unrestricted subsidiaries' liens on, guarantees from, and direct and indirect claims against, the loan party group – the creativity of market participants in structuring these transactions and the negotiation between borrowers and lenders on appropriate protections and flexibility is likely to continue apace.

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