Davis Polk + BARCLAYS

# Deterioration and Restructuring: Lessons Learned

**Presented at the IACPM Fall Conference**
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# What are LMTs?

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# What are liability management transactions (“LMTs”)?

LMTs are **proactive** actions that a company can take to manage—either opportunistically or in response to distress—its debt capital structure, typically to achieve one or more of the following goals:

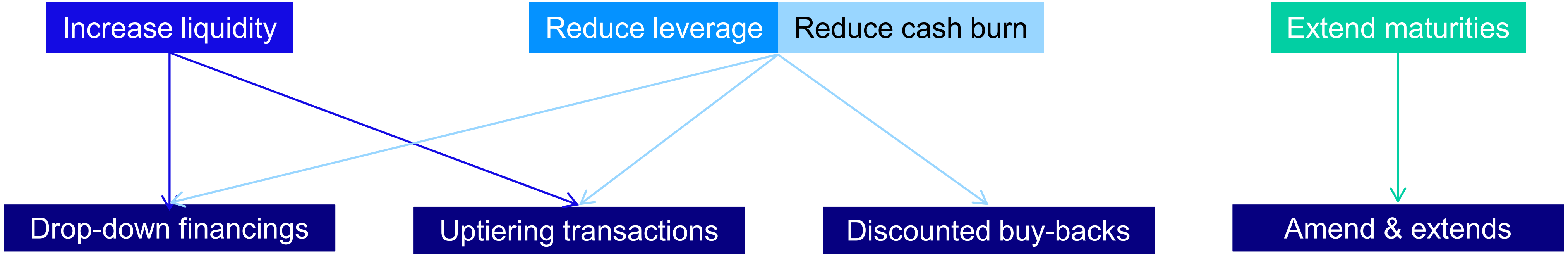
- Increase liquidity
- Reduce leverage
- Reduce cash burn
- Extend maturities

How are LMTs typically implemented?

- Drop-down financings
- Uptiering transactions (with or without new money)
- Discounted debt buy-backs
- Amend & extends

What should be considered when evaluating a potential LMT?

- Debt documentation
- Litigation risk
- Tax impact
- Ratings impact
- Stakeholder relationships



# Types of liability management transactions

- ***"Drop-down" financings***, in which lenders provide structurally senior financing secured by assets outside of an existing collateral package often, though not always, using unrestricted subsidiaries
  - The quintessential drop-down financing was the *J.Crew* transaction from 2016
  - More recent examples include:
    - *Travelport* (2020)
    - *Cirque du Soleil* (2020)
    - *Revlon* (2020-2023)
    - *Envision* (2022)

- ***"Uptiering" transactions***, in which lenders enhance the priority of their claims to an existing collateral and guarantee package, typically in connection with and consideration for providing priming new-money debt
  - One of the earliest uptiering transactions in the loan market was the *NYDJ* transaction from 2017
  - More recent examples include:
    - *Murray Energy* (2018)
    - *Serta Simmons* (2020-2021)
    - *Boardriders* (2020-2021)
    - *TriMark* (2020-2021)
    - *TPC Group* (2022)
    - *Incora* (2022)
    - *Mitel* (2022)

The details and permissibility of these transactions are heavily dependent on the credit agreement/indenture provisions pursuant to which they are undertaken

# Recent structural developments

**Some of the more recent LMTs have included one or more of the following mechanisms:**

- ***"Double dip" transactions*** – effectively giving participating creditors two claims against the same collateral securing the company's first lien debt through the use of an intercompany claim (e.g., *At Home*, *Wheel Pros*)
- ***"Pari plus" transactions*** – creditors benefit from a pari claim against the existing loan parties—which may be indirect, through an intercompany loan—plus a new-money guarantee claim against assets outside of the existing credit group (e.g., *Sabre*, *Trinseo*)
- ***Grace period extensions*** – extending the grace period for interest payment defaults without the consent of each affected bondholder or lender
- ***Entrance consents*** – issuing additional debt to consenting creditors in order to obtain the requisite vote

The details and permissibility of these transactions are heavily dependent on the credit agreement/indenture provisions pursuant to which they are undertaken

# Uptiering refresher and key takeaways

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# Uptiering transactions

Serta Simmons case study

### Original term loan capital structure

**$1.884 billion of first lien term loans (“existing first lien term loans”), all with equal payment priority as required under the credit agreement**

- Majority lenders
- Minority lenders

**$424 million of second lien term loans (“existing second lien term loans”)**

- Majority lenders
- Minority lenders

Majority lenders

Majority lenders

Minority lenders

Minority lenders

### Term loan capital structure Following transaction with majority lenders

**$200 million of new superpriority “first out” term loans provided by the majority lenders**

**$875 million of new superpriority “second out” term loans issued in exchange for certain existing first lien term loans and existing second lien term loans**

**$TBD of new super-priority “third out” term loans available for future exchanges**

**Up to $814 million of first lien term loans ranking behind all of the tranches described above and held by lenders who were excluded from the exchange transactions**

**Up to $211 million of second lien term loans ranking behind all of the tranches described above and held by lenders who were excluded from the exchange transactions**

To permit the proposed transaction, the existing credit agreements would be amended by majority lenders to, among other things, permit (i) the incurrence of $200 million super priority loans, (ii) the roll up of $875 million of second-out loans and (iii) a future tranche of third-out superpriority debt in an undetermined amount

# Key takeaways from recent cases

- **Opportunity to participate:** courts continue to have differing views; unclear whether courts would be similarly skeptical in the indenture context where the indentures permit non-pro rata purchases and privately negotiated transactions
- **Subordination is not release:** while courts have regularly held that subordination is not lien release and does not require consent of all existing lenders, lenders have argued that subordination is contrary to the pro rata sharing right. Multiple courts that recently considered this argument have sustained complaints at the motion to dismiss stage.
- **Open market purchases:** plaintiffs in several cases have argued that the exchange into the new financing was not a valid "open market purchase"; courts seem split
- **Exit consents:** *TriMark* confirmed that, absent clear contractual language to the contrary, exit consents will be enforceable
- **Lender action provisions:** Borrowers and sponsors have attempted to preclude <u>any</u> lender taking <u>any</u> action against the borrower, except through the administrative agent and with a required lender vote. Where such provisions were added in the context of a workout, courts have taken a skeptical view of their enforceability; it is unclear whether such clauses would be enforceable against non-participating lenders in the chapter 11 context
- **Good faith and fair dealing:** While courts have historically construed the implied covenant of good faith and fair dealing narrowly, recent cases in the loan context have sustained implied covenant claims at the motion to dismiss stage
- **Fraudulent transfer and estate claims:** Plaintiffs in liability management transaction cases also typically seek equitable relief that would unwind the transaction and return the parties to the status quo ex ante. No state court has weighed in on the permissibility of this remedy, but there is authority that such remedies should not be permitted as a matter of law

# Liability management 2.0: “Double dip” and “pari plus” transactions

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# “Double dip” financing overview

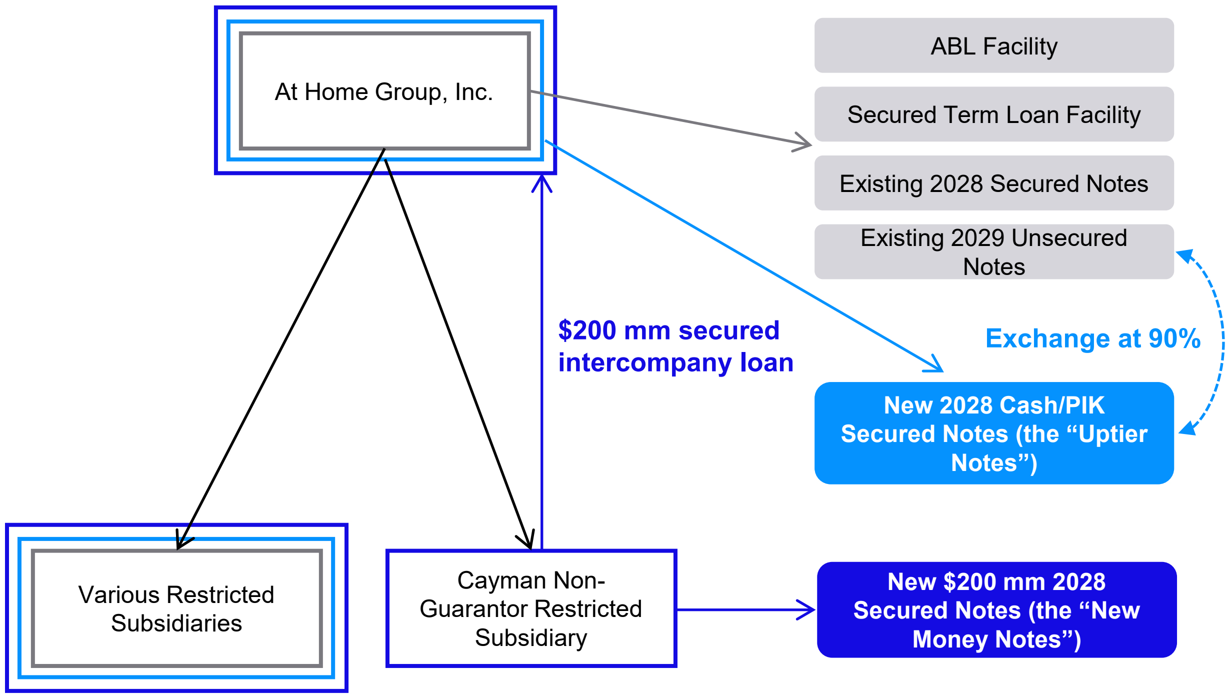




**What is a “double dip”?**

– The concept of a “double dip” describes a structure where a creditor has the benefit of a guarantee for a primary obligation from a debtor entity, and the primary obligor – against which the creditor also has a claim – has its own intercompany claim against the guarantor debtor as well
  - The direct guarantee claim and intercompany claim each represent an independent source of potential recovery
– Double dip claims arise organically under certain financing structures, such as bonds issued by special purpose “FinCos”, with the bondholder having a claim against the FinCo and a guarantee claim against the operating entity
– In bankruptcy, creditors and distressed investors sometimes identify these structures as potential opportunities for “double dip” recoveries if the debt in question is in a class of claims likely to be paid less than in full
  - Partial payment through (a) the direct guarantee claim against the debtor and (b) the primary obligor’s assertion of its intercompany claim can create an enhanced overall recovery relative to other members of the class

# “Double dip” transactions – *At Home* case study




**Legend:**

**Guarantors / Obligors of Existing Debt**

**Guarantors / Obligors of Uptier Notes**

**Guarantors / Obligors of New Money Notes and Intercompany Loan**

## *At Home* pro forma capitalization

**Pro Forma Capitalization**

| *($ in millions)* | FY Q4'22 | Adj. | PF Q4'22 |
|---|---|---|---|
| ***NEW*** Private Placement | - | 200 | 200 |
| **Total Subsidiary Secured Debt** | **$0** | **$200** | **$200** |
| ABL Revolver | 338 | - | 338 |
| Term Loan B due 2028 | 600 | - | 600 |
| 4.875% Senior Secured Notes due 2028 | 300 | - | 300 |
| ***NEW*** Exchange Sr. Secured Notes due 2028 | - | 412 | 412 |
| **Total First Lien Debt** | **$1,238** | **$612** | **$1,850** |
| 7.125% Senior Unsecured Notes due 2029 | 500 | (447) | 53 |
| **Total Debt** | **$1,738** | **$165** | **$1,903** |
| **Total First Lien Claims** | **$1,238** | **$812** | **$2,050** |

*Source: Reorg Research*

# “Pari plus” structure in a new financing

- Similar to a double-dip financing, a pari plus transaction typically involves a new third-party secured loan to an entity (the “New Borrower”) that is an affiliate of the existing credit group, but is not, itself, a loan party under any existing debt
  - **Pari**: The New Borrower then on-lends the proceeds of the third-party loan to the existing credit group, and the existing loan parties provide guarantees and collateral to the New Borrower to secure its intercompany loan on a *pari passu* basis with existing secured debt
  - **Plus**: In addition, the New Borrower and/or subsidiaries of the New Borrower provide additional liens and guarantees to the new lenders that are not shared ratably with the existing credit group

# “Pari plus” transactions – *Sabre* case study

### First Loan (external)

- Third party lender lends money to an UnSub of Sabre
  - Foreign subsidiaries provide secured guarantee of obligations of the UnSub, subject to a cap
  - The domestic obligors (borrower/guarantors) under Sabre’s existing debt do not guarantee this loan

### Second Loan (intercompany loan)

- UnSub (borrower under first loan) lends external loan proceeds to existing Sabre borrower (no 3rd party lender)
  - Existing domestic guarantors provide secured guarantee to existing Sabre borrower’s obligations
  - The foreign subsidiaries do not guarantee this Loan