AMERICAN BANKRUPTCY INSTITUTE

2021 Virtual Annual Spring Meeting

Current Liability Management Issues

Hosted by the Claims Trading and Financial Advisors & Investment Banking Committees

Scott L. Alberino
Akin Gump Strauss Hauer & Feld LLP

Jennifer E. Daly
King & Spalding LLP

Gregory V. Demo
Pachulski Stang Ziehl & Jones

Deborah J. Newman
Quinn Emanuel Urquhart & Sullivan, LLP

CONCURRENT SESSION

2021

April 14, 2021

American Bankruptcy Institute Annual Spring Meeting: Liability Management Transactions

Panel:

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LIABILITY MANAGEMENT TRANSACTIONS: WHAT ARE THEY?

- Liability Management Transactions generally fall into two buckets:
  - "Dropdown Transactions"
  - "Uptiering Transactions"
- Dropdown Transactions
  - Financing transactions whereby distressed borrowers attain access to new capital by moving collateral beyond the reach of existing secured creditors, and then encumbering that collateral to obtain new capital.
    - The borrower will use "Investment" or other baskets to transfer encumbered assets to new unrestricted subsidiaries. The assets are then released from the existing secured lenders' collateral package.
    - The unrestricted subsidiary then issues new debt secured by the transferred assets.
- Uptiering Transactions
  - Financing transactions whereby distressed borrowers attain access to new capital by amending their existing secured debt documents to permit new "superpriority" secured debt
    - Participation in the new money transaction is typically limited to a subset of lenders who are able to approve the amendment of existing loan documentation necessary to effectuate the priming transaction.
    - In exchange for providing new capital, participating lenders are given new "superpriority loans" in addition to the "roll-up" of some or all of their existing loans into the superpriority tranche.
    - Nonparticipating lenders find themselves subordinated not only to the new money but also to a significant portion of previously *pari passu* or junior debt.

REASONS FOR RECENT SURGE OF LIABILITY MANAGEMENT TRANSACTIONS

- Since 2010, the syndicated lending market has grown exponentially due to historically low interest rates and a surplus of cash held by institutional investors.
  - The surge in access to financing has whittled away lender protections and led to a proliferation of "covenant-lite" credit agreements.
- The COVID-19 crisis has also caused many US businesses to suffer liquidity issues, and led to some borrowers resorting to increasingly creative restructuring options, including the use of priming transactions, to obtain access to capital.
  - However, liability management transactions existed prior to the COVID-19 pandemic, and will likely continue once it has passed.

Recent Case Examples

- J.Crew
  - In 2016, J. Crew, facing the impending maturity of over $540 million in unsecured PIK notes and an ailing retail market, distributed certain J.Crew trademarks (the "IP") to an Unrestricted Subsidiary, with a license back to the operating companies.
    - First, the Company used a $150 million basket permitting "Investments" in non-guarantor restricted subsidiaries and a $100 million general Investment basket to transfer the IP to a Cayman Islands restricted subsidiary.
    - Second, the restricted subsidiary transferred the IP to an unrestricted subsidiary under another Investment basket that allowed investments of any amount by a non-guarantor restricted subsidiary into an unrestricted subsidiary if financed with the proceeds from other permitted Investments. The unrestricted J.Crew subsidiary was not bound by the terms of the credit facility and was free to incur additional indebtedness secured by a lien on the IP.
  - In response to rumors that the Company's term lenders intended to issue a notice of default alleging that the IP transfer was impermissible, J. Crew filed a lawsuit seeking a declaratory judgment that the IP transfer was expressly permitted by the terms of the credit agreement and that no default or event of default had occurred.
  - The litigation was ultimately resolved as part of a second deal J.Crew made with the term lenders whereby:
    - 99.9% of the outstanding PIK notes were exchanged for new, senior secured notes issued by Unrestricted J. Crew (secured by the newly transferred IP) and preferred and common equity.
    - The Company made a $150 million par paydown on its existing term loans (funded, in part, by the new $300 million term loan and the new notes issued by Unrestricted J. Crew), increased the applicable interest rate and amortization, and tightened certain restrictive covenants in the existing term loan facility.
  - Other companies have recently executed similar Dropdown Transactions, including Revlon, PetSmart, Neiman Marcus, and Travelport.

Recent Case Examples

- AMC Entertainment
  - On June 3, 2020, AMC Entertainment ("AMC") announced a proposed bond exchange whereby outstanding (i) unsecured subordinated notes would be exchanged at a discount for new second lien secured debt (the "Subordinated Notes Exchange") and (ii) convertible notes held by Silver Lake Group LLC ("Silver Lake") would be exchanged for new first lien debt, ultimately reducing AMC's debt by over $1.0 billion. Although the terms of the Subordinated Notes Exchange were subsequently modified, AMC argued that the original terms of the contemplated exchange transactions were fully permitted by existing debt documents.
    - Under the terms of the original proposal, existing Subordinated Notes were to be exchanged for new second lien secured notes due 2026 (the "New 2L Notes") at a discount of approximately 50 to 53 cents on the dollar. To the extent the company was to receive the consent of a majority of each tranche of such notes, AMC would be able to strip the Subordinated Notes of various protective covenants and exceed an otherwise-applicable $640 million cap for the exchange
    - Due to the more restrictive provisions around refinancing debt in Silver Lake's indenture, the Subordinated Notes Exchange would also require the consent of Silverlake, which was also an AMC board member. To secure such consent, the company offered Silver Lake an opportunity to receive (either by an amendment or an exchange) a first priority security interest in the collateral securing AMC's Credit Agreement and 1L Notes.
    - All new classes of exchanged notes could be secured because the indentures governing the existing Subordinated Notes contained a flawed concept of "refinancing debt" that does not require a refinancing of any unsecured subordinated notes to retain the same relative payment and lien ranking within AMC's capital structure.
    - While any exchange of the Subordinated Notes constituted a payment on account of "Junior Financing" under the company's existing first lien facilities (and therefore subjected the exchange to negative covenants restricting prepayments of junior debt), the first lien facilities provided extremely generous capacity to prepay such junior debt.
    - AMC was also able to incur the new $600mm Silver Lake debt as *pari passu* first lien debt because the first lien notes had a "credit facilities" basket that, based on 2019 adjusted EBITDA, allowed AMC most of the necessary capacity (~$578 million), with the potential to use a 3x leverage ratio prong and multiple other debt and lien baskets to secure the remainder.

Recent Case Examples

- NYDJ
  - In May 2017, NYDJ Apparel, LLC ("NYDJ") entered into amendments to its credit agreement with the majority consent of its lenders (the "Majority Lenders"), which purported to prime the outstanding debt of the non-consenting minority lenders (the "Minority Lenders") with a new $20 million term loan tranche and the existing debt held by the Majority Lenders. NYDJ did not ask the Minority Lenders for their consent to the amendments.
  - In November 2017 certain Minority Lenders filed suit against NYDJ and the Majority Lenders with respect to the purported priming of their loans. The Minority Lenders' claims included breach of contract, breach of the implied covenant of good faith and fair dealing, unjust enrichment and breach of the NY Debtor and Creditor Laws.
    - The Majority Lenders and NYDJ argued that they could amend the credit facility to permit the incurrence of the $20 million super-priority incremental term loan at the top of the post-default payment waterfall and elevate the seniority of the Majority Lenders' original loans with the consent of only a majority of the lenders because the credit agreement's amendment/voting provisions did not expressly include the pro rata payment and pro rata sharing provisions as "sacred rights."
  - The litigation ultimately settled. As part of the settlement, the Minority Lenders were offered the same deal that the Majority Lenders received.

Recent Case Examples

- Serta Simmons
  - Serta Simmons Bedding LLC ("Serta"), a portfolio company of Advent International, entered into three credit facilities on November 8, 2016 comprised of: (i)a $1.95 billion first lien term loan agreement (the "Existing First Lien Term Loans"), (ii) a $450 million second lien term loan agreement (the "Existing Second Lien Term Loans") and (iii) a $225 million asset based revolving credit facility.
  - On June 8, 2020, Serta announced that it had entered into a transaction support agreement with a group of lenders (the "Priming Lenders") that provided for a debt recapitalization (the "Proposed Transaction") that included: (i) $200 million of newly funded super-priority "first out" debt ranking ahead of the Existing First Lien Term Loans, (ii) $875 million of super-priority "second out" debt ranking ahead of the Existing First Lien Term Loans in exchange for the exchange of certain Existing First Lien Term Loans and Existing Second Lien Term Loans held by the Priming Lenders, and (iii) an additional basket for super-priority "third out" debt that would rank ahead of the Existing First Lien Term Loans and could be used for future similar exchanges.
    - Serta used its existing accordion capacity to incur $200 million in incremental equivalent debt, which will be funded on a super-priority basis and be "first out" (i.e., ranking ahead of all existing first lien and second lien debt).
    - Serta then "incurs" additional "second out" debt that ranks behind the new $200mm "first out" credit facility, and the proceeds of which are used (essentially on paper) to repurchase existing first lien and second lien loans held by participating lenders.
    - The repurchases are effected using the "open market purchase" provisions of the existing debt documents, which effectively results in a debt-for-debt exchange on a non-pro rata basis of loans under the Existing 1L and Existing 2L into the new "second out" loans. The new loan documents also permit an unspecified amount of "third out" loan capacity that can be used to fund further exchanges in the future.
    - Participating lenders, which collectively hold a majority of outstanding loans under each of the 1L and 2L agreements prior to giving effect to the Proposed Transaction, then agree to an amendment to the existing 1L and 2L agreements that (x) permits the new credit facilities to be secured on a priming basis, and (y) directs the agents on the Existing 1L and Existing 2L to enter into an intercreditor agreement that will effectively subordinate their liens and claims to the new credit facilities.

Recent Case Examples

- Serta Simmons
  - On June 11, 2020, lenders holding approximately $600 million of the Existing First Lien Term Loans that were not included in the Priming Lender group (the "Minority Lenders") filed a lawsuit in the New York State Supreme Court challenging the Proposed Transaction for breach of contract and breach of the implied covenant of good faith and fair dealing.
    - Serta argued that the Proposed Transaction complied with the Credit Agreement because (i) the non-pro rata debt exchanges were permitted as open market purchases under Section 9.05(g) which provides: "any Lender may, at any time assign all or a portion of its rights and obligations under this Agreement in respect of its Term Loans to any Affiliated Lender on a non-pro rata basis … through open market purchases … without the consent of the Administrative Agent," and (ii) the credit agreement permitted (x) the incurrence of $200 million of incremental equivalent debt and (y) the amendments that allowed the new loans to have senior payment priority with majority lender consent.
  - On June 20, 2020, the court denied the plaintiffs' request for a preliminary injunction blocking the Proposed Transaction and the transaction subsequently closed. The court held that that the plaintiffs not only failed to establish irreparable harm, but also failed to show a likelihood of success on the merits with respect to their breach of contract and covenant of good faith and fair dealing claims. The court noted:
    - 1. Plaintiffs' argument that the transaction would impermissibly amend the waterfall provisions, altering the *pro rata* sharing requirements "fail to address" the open market purchases exception in section 9.05(g), which "seems to permit the debt-to-debt exchange on a non-pro rata basis as part of an open market transaction."
    - 2. Plaintiffs' claim for breach of the implied covenant of good faith and fair dealing "appears to be identical to [plaintiffs'] breach of contract claim, and thus, it is unlikely to survive a motion to dismiss."
  - On November 30, 2020, the court grated the plaintiffs' motion to discontinue the action without prejudice.
  - On July 2, 2020, a parallel lawsuit was brought by certain Minority Lenders in the Southern District of New York. This lawsuit was dismissed on March 21, 20201 for lack of diversity jurisdiction. The court held that because the plaintiffs' and certain of the defendants' principal place of business is New York, "there [was] not complete diversity among the parties," and the federal court therefore lacked subject matter jurisdiction over the lawsuit, which raised only state law claims.

Recent Case Examples

- Boardriders
  - On 31 August 2020, Boardriders announced a priming transaction that involved $110 million of new money super-priority loans together with a $332 million roll up.
    - The company used the "open market purchase" exception to the pro rata payments protection in its credit agreement to facilitate the transaction. That exception states that "[Borrower] may from time to time purchase Loans on the open market (each, an 'Open Market Purchase Offer')" and states that "purchases of Loans made ... pursuant to ... Section 2.15 ... shall not constitute voluntary or mandatory payments or prepayments under Section 4.01 or Section 4.02 [the pro rata sharing provisions]."
    - As a result, the transaction subordinated a group of minority existing lenders who did not participate in the exchange.
  - This transaction also amended the credit agreement to remove most of the lender-protective covenants.
  - Certain minority lenders filed suit in the New York State Supreme Court to void the transaction and the amendments, asserting breach of contract and voidable transfer. A motion to dismiss the lawsuit is currently pending.
    - The plaintiffs argued that the transaction and roll up violated their pro rata payment rights and unlawfully subordinated their first-lien priority. They argue the pro rata payment rights prohibit, except in very limited circumstances, the company from selectively paying down the loans of a particular lender or select group of lenders and cannot be amended without the consent of all affected lenders.
    - They also argued that the transaction was not an "'open market' transaction" as required under the credit agreement, because the Sponsor "handpicked" a preferred group of lenders to primarily exchange their old debt at par value rather than sell at the "considerably lower" market value.

How Lenders Can Protect Themselves Moving Forward: Drafting Tips

- Mitigate Against Dropdown "Trapdoors"
  - Lenders could include EBITDA or Consolidated Total Assets tests for designation/creation of unrestricted subsidiaries.
  - Lenders could include restrictions on transfer of IP (or other "crown jewel" assets) to unrestricted subsidiaries.
  - Lenders could impose caps on the borrower's ability to invest in non-loan parties, remove automatic lien release mechanisms where collateral is transferred to affiliates, and specify that general baskets may not be used to incur debt that is secured by collateral held by an unrestricted subsidiary.
- Pro Rata Protections & Equal Participation Opportunities
  - Lenders could ensure that indirect amendments to pro rata sharing provisions are prohibited.
  - Lenders could consider including a provision that requires the participation of all lenders in an priming transaction.
  - Lenders could ensure that the sacred rights in the amendment/voting section include amendments to the pro rata payment, pro rata sharing and the waterfall of payments.
- Protect Against Subordination
  - Consider making lien subordination a sacred right (*i.e.*, by requiring the consent of all lenders to enter into subordination or intercreditor agreement).

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How Lenders Can Protect Themselves Moving Forward: Drafting Tips

- "Open Market Transaction" Definition
  - Lenders could narrow the open market transaction exception:
    - Restrict to market price (as opposed to par)
    - Non-collusion provision
    - Restrict to cash consideration only
- Protections Against Junior Debt
  - Ensure that any concept of refinancing debt requires that the refinancing debt maintain the same payment and lien ranking (*i.e.*, whether first lien, second lien, unsecured, subordinated) as the debt that it is refinancing.
  - Add tighter dollar baskets and smaller grower baskets paying particular attention to the amount of additional debt permitted on an aggregated basis.
  - Ensure that the credit documentation restricts prepayment of all junior debt. Ensure that junior debt is not issued with tighter covenants than the senior secured debt.

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SPECIFIC CONSIDERATIONS FOR SPONSORS, BORROWERS, AND PARTICIPATING LENDERS

- **Allegations Against Sponsors**. Sponsor-backed transactions may give rise to additional claims of liability.
  - Claims of tortious interference, breach of fiduciary duties, self-dealing, conflicts of interest and bad faith by sponsors for allegedly using their controlling power to induce a borrower to execute a priming exchange with the sponsor's choice of lenders.
- **Alternatives for Borrowers**. To avoid the litigation risk associated with a priming transaction, borrowers could first consider issuing *pari passu* debt if they have capacity under their existing loan documentation or obtaining majority consent to increase the size of its *pari passu* debt basket.
  - Use other tools to obtain consent to extend *pari passu* loans (interest rates, fees, other protections)
  - CLO lenders likely to consent to preserve credit rating
- **Mitigating Litigation Risk for Participating Lenders**. Consider forgoing roll up and/or providing opportunity to participate to all lenders, as these are the most controversial aspects of the recent priming transactions.

Faculty

Scott L. Alberino is a partner with Akin Gump Strauss Hauer & Feld LLP in Washington, D.C., where he focuses on corporate restructuring matters and distressed transactions. He guides companies and creditors through evaluating, structuring and implementing in-court and of out-of-court restructuring strategies, and his experience spans a variety of industries and jurisdictions and includes cross-border reorganizations. Mr. Alberino represents debtors, official creditor committees, informal creditor groups, equityholders and other stakeholders in all aspects of corporate liability management, restructuring, bankruptcy and insolvency proceedings. He regularly advises boards of directors of public and private companies on issues facing financially distressed companies, including fiduciary duties, corporate governance and executive compensation. He also regularly represents private-equity funds, hedge funds and other financial institutions that are acquiring control positions in financially distressed companies and in structuring debtor-in-possession (DIP) and exit financing. Mr. Alberino has represented public and private distressed companies, informal creditor groups, official creditor committees, providers of DIP and exit financing, acquirers of distressed assets and significant stakeholders. He is a member of ABI and the Turnaround Management Association. Mr. Alberino received his B.A. in 1997 and his J.D. in 2000 from Emory University School of Law.

Jennifer E. Daly is a partner with King & Spalding in New York in its Leveraged Finance practice group, and specializes in private credit and special-situations investing. Having previously held senior roles in the financial services and investment management sectors at Bank of America Merrill Lynch and distressed credit fund Avenue Capital, she most recently was the COO and Chief Compliance Officer of hedge fund Hunter Peak Investments before rejoining the firm. Ms. Daly is lead counsel for private credit funds, special situation and opportunistic funds, business development companies (BDCs), hedge funds and other investment advisors, leading financial institutions and borrowers in LBOs, leveraged finance, unitranche, first lien/second lien, mezzanine, debtor-in-possession financings, rescues, exits, liability management transactions, and other secured and unsecured lending transactions, with a focus on both performing credit and the finance elements of in and out of court workouts and restructurings. Some of her significant representations include Antares, Apollo, Blue Torch Capital, CVC, GSO, KKR, Owl Rock, MSD Capital, Park Square Capital and New Mountain Capital. Ms. Daly received her B.A. from Georgetown University and her J.D. from Fordham University.

Gregory V. Demo is an attorney with Pachulski Stang Ziehl & Jones in New York and regularly represents hedge funds and other significant holders of securities in connection with complex chapter 11 reorganizations. In addition, he is part of the firm's team handling insolvency-related sales and acquisitions. Mr. Demo is adept at creating litigation strategies for investments in state, federal and bankruptcy court, and overseeing all aspects of the implementation of such strategies. He is admitted to practice in New York and Illinois. Mr. Demo received his B.A. *magna cum laude* in 2003 from Marquette University and his J.D. in 2008 from the College of William & Mary School of Law, where he was elected to the Order of the Coif, served on the *William & Mary Law Review* and graduated second in his class.

Deborah J. Newman is a partner with Quinn Emanuel Urquhart & Sullivan, LLP in New York, where her practice focuses on bankruptcy-related litigation and complex commercial litigation. She represents creditors, bondholders, indenture trustees, hedge funds, institutional investors, creditor committees and debtors in the full range of complex litigation matters arising in the course of chapter 11 restructurings, cross-border insolvencies and other bankruptcy contexts, as well as other complex commercial litigations occurring in state and federal courts. Ms. Newman has litigated some of the most cutting-edge issues in bankruptcy litigation, including the treatment of original-issue discounts under the Bankruptcy Code, the appropriate cramdown interest rate for a secured creditor, the applicability of § 546(e) of the Bankruptcy Code to constructive fraudulent conveyance claims, and individual creditors' ability to pursue fraudulent conveyance actions following a debtor's bankruptcy filing. Ms. Newman also has wide-ranging experience in complex commercial litigation occurring outside of the bankruptcy courts, including by recently obtaining a ruling from the First Department of the Appellate Division of New York reversing a lower court decision and dismissing with prejudice an action seeking more than $90 million. She was selected as a 2016 "Rising Star" in bankruptcy litigation by *Law360*. Ms. Newman received her undergraduate degree from the University of Michigan with honors in 1997 and her J.D. from Columbia University School of Law in 2002.