Liability Management Transactions:

A Balanced Approach to "Blockers"

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In the past several years companies have been utilizing liability management exercises (or LME for short) and strategic capital solutions in order to address upcoming debt maturities, litigation risk, business performance challenges and other pressing financial needs. In a world where debt documentation, for the most part, is borrower/company-friendly, companies look to unlock value by analyzing existing documentation to implement innovative, tailored solutions that provide cost-efficient alternatives to traditional restructuring, whether by way of a "drop down," "up-tier", "double dip", "pari plus", some combination thereof, or a whole new strategy altogether. As result of the continued use and evolution of LME, lenders have been successful in constructing and implementing accompanying "blockers" (i.e. "J.Crew blockers", "Serta blockers", "Envision blockers", etc.) to restrict or limit borrowers from undertaking similar transactions. These blocker provisions are negotiated in connection with new financings as early as the term sheet stage and/or in connection with amendments to existing documents and continue to evolve to keep up with more intricate liability management solutions developed by counsel and advisors. Whenever a debt document is opened in connection with an amendment in the current market, lenders see an opportunity to institute these restrictions, whether relevant to the underlying transaction or not.

LMEs generally involve bespoke strategies tailored to a specific business, which has resulted in many of these transaction structures being identified by reference to the initial business that utilized a particular set of structuring tools. As LME has become a mainstream mechanism for addressing capital structure and operational challenges for companies, it is not surprising that a new lexicon has developed around it. A standard approach to the initial review and engagement both by borrowers and financial investors on LME matters has developed and usually includes an analysis on the feasibility to consummate a transaction that looks similar to previous ones or a combination of the same. Notable examples include:

- <u>"J.Crew" or "Drop Down" Transactions</u> – Rely on investment capacity to move assets such as entire business units, monetizable intellectual property or real property outside of the existing lender group's collateral package and to unrestricted subsidiaries and/or non-guarantor subsidiaries in order to separately finance such assets and create additional liquidity. The initial J.Crew transaction also included a license to J.Crew of the intellectual property that was "dropped down" to permit the existing business to continue to benefit.

- <u>"Chewy" Transactions</u> – Create financeable assets by placing them in a subsidiary guarantor entity, the equity of which is then partially sold to an affiliate or third party. Formulations of release provisions in certain debt documents require an automatic release of the guarantor and all of its assets once the entity is no longer wholly-owned.

- <u>"Serta" or "Uptier" Transactions</u> – Consist of two customary pieces (i) entering into new debt documents (whether in the same facility or in a "side car") which are then able to "prime" the existing debt documents with the consent of the applicable threshold of lenders (typically 50.1%) and (ii) having the lenders who provide such new debt agree to exchange their existing debt for the new "priming" debt with new terms in reliance on the "open market" buy back provisions of a credit agreement (NB: following the Fifth Circuit ruling in Serta, we have seen alternative structuring in deals where there is only an "open market" exception). This may be accompanied by actions to strip out the covenants or other protections of the original debt that is subordinated (i.e. the "stub" tranche of debt which is not exchanged).

- <u>"At Home" or "Double Dip" Transactions</u> – In connection with a "Drop Down" transaction, the proceeds of any financing raised at the newly capitalized entity are lent by that entity back to the restricted group via an intercompany loan which is guaranteed and supported by assets of the restricted group, therefore allowing the lenders to the new entity to be secured by (i) the assets of the new entity, (ii) a pledge of the secured intercompany loan (benefiting from support from the restricted group) and (iii) the guarantee and credit support provided by the obligors of the existing debt with respect to new debt. The items in clauses (ii) and (iii) are the first "dip" and the second "dip" – creating two claims against the original obligors.

- "Pari Plus" Transactions – A variation on a Double Dip transaction where the loan provided to the newly capitalized entity also obtains the benefit of collateral and guarantees by members of the restricted group who are not otherwise guarantors of the existing debt on an exclusive basis – such that the new lenders have a pari claim against the original obligors (by virtue of one or both "dips") and a sole claim against the exclusive guarantors / collateral (the "plus").

These blocker provisions, while customary, can create unintended risks and consequences for shareholders and companies. For example, a customary "Drop Down" blocker limits the ability of a company to invest or contribute material intellectual property to an unrestricted subsidiary. These provisions are sometimes drafted in an overbroad manner that may inhibit the ability of a company to transfer any assets to non-loan party subsidiaries, whether in connection with normal operations, permitted securitizations or other contemplated sale transactions. Additionally, a poorly drafted blocker may limit such subsidiaries from developing their own valuable intellectual property or receiving purported "material" intellectual property from the company that is only useful in connection with the other assets being contributed. The potential overreach here can be avoided by ensuring restrictions are narrowly tailored to material intellectual property and limited only to intellectual property material to the restricted group (i.e. the remaining business unit after the relevant contribution).

In response to the initial set of "Uptier" transactions, lender voting provisions have been updated to require a one hundred percent vote to amend a debt agreement in a manner that subordinates the rights or claims of the lenders to new senior priority debt. Similar to the "Drop Down" blockers, these subordination restrictions can result in unintended effects and restrictions on what would normally be considered ordinary course. For example, these subordination provisions often contain exceptions for debt offered to all lenders on a pro rata basis, customary debtor in possession credit facilities, capital leases and other items that typically "prime" credit agreements with respect to certain types of collateral. A provision without the proper exceptions could limit a company's ability to (i) incur necessary debtor in possession financing in connection with an in-court restructuring, (ii) increase capital lease capacity or (iii) to the extent required by an insurance company, provide appropriate liens related to the financing of insurance premiums. While many of these items are not controversial if raised and discussed with financing sources prior to execution of the transaction documents, they often cannot be fixed without an accompanying enhanced threshold for voting at a later date.

Additional blockers include restrictions on the investment capacity and restricted payment or dividend capacity that can be utilized to contribute assets to unrestricted subsidiaries, limitations on the ability of unrestricted subsidiaries to provide debt to the restricted group (and therefore on-lend the proceeds of a Drop Down transaction to consummate a Double DIP, Pari Plus or other transaction), and limitations on the ability to release a subsidiary from its guarantee and collateral requirements in connection with a partial transfer. A more recent development has come in the form of an "Omni-Blocker" which purports to restrict a company's ability to enter into any transaction that is not offered to all of the lenders on a pro rata basis. Omni-Blockers are in their infancy and have not gained traction as a holistic solution to all potential liability management risk. They also run the risk of being overbearing, overbroad and imposing restrictions on a company that would prohibit the ability to the company to operate in the ordinary course or similar manner without consistent engagement with the lender group. For these reasons, the so called Omni-Blockers have not been adopted other than a limited universe of credit facilities which are "locked down" following an LME transaction.

As strategic LME and related blocker provisions continue to evolve, companies and their advisors should ensure they do not unintentionally restrict the ability of a company to be nimble. Blockers should be properly tailored to balance risk for lenders and other investors, while also ensuring companies are able to take reasonable action in response to external factors and otherwise engage in transactions necessary to continue operations with minimal disruptions. Improperly drafted blockers can add time, expense (in the form of legal costs or related consent fees), and unnecessary headaches to transactions otherwise permitted by the debt documentation that would typically be seen as customary but for these new lender protections. The best way to be protected is to continue to push back on aggressive asks on “blockers” and ensure documents are properly drafted to reflect both the most recent market trends and the particular needs of an operating company. To the extent a company is heading down a path that may lead to an LME transaction, it is also important to understand the flexibility the debt documentation provides before engaging with lenders as they will require these blockers in connection with any waiver or consent at the first sign of distress.

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