Liability Management Transactions 2.0:
Win, Lose, or Subordinated

A Panel Discussion and Webinar with the LSTA and Sidley

May 9, 2023

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MARKET CONTEXT: HISTORICAL (AND FUTURE?) LOAN DEFAULT AND RECOVERY EXPERIENCE

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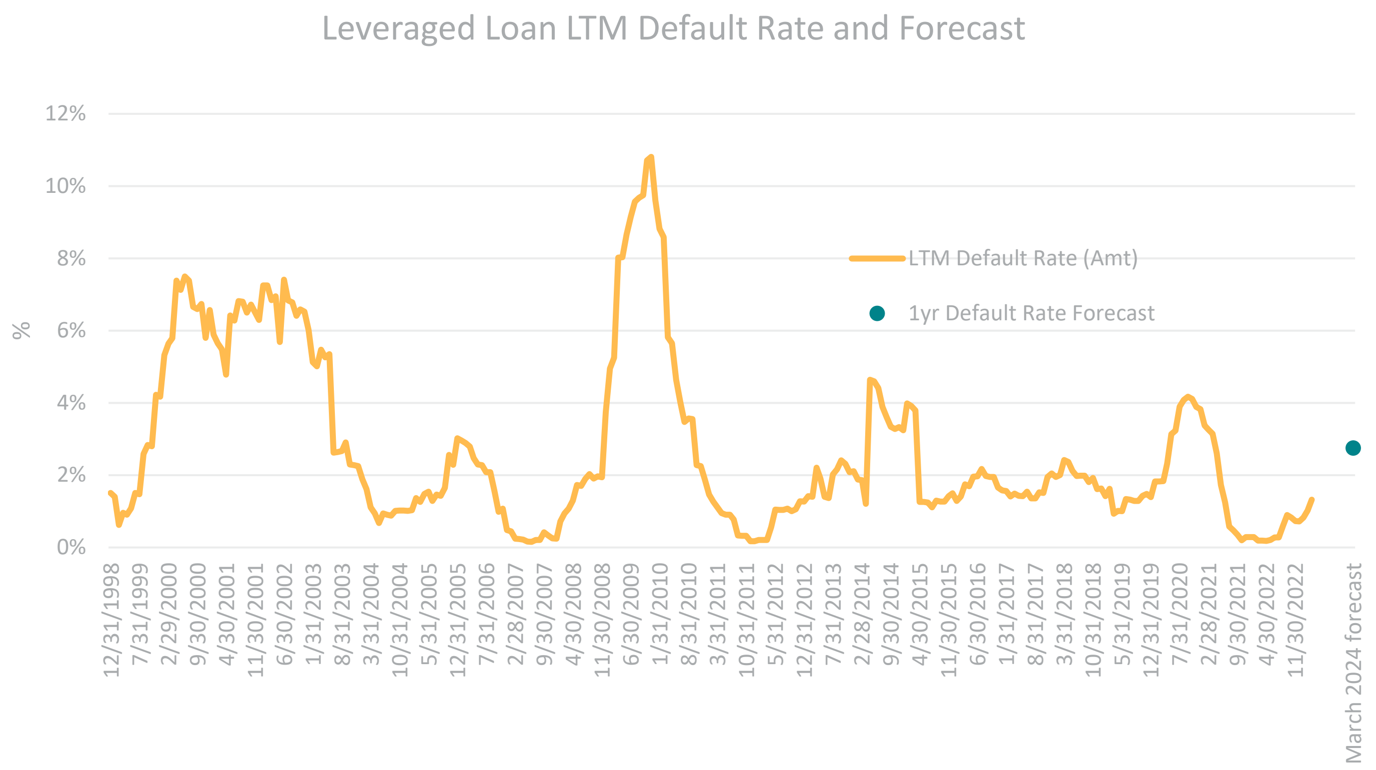
Level Setting: How Historical Default Experience Might Inform a View on Liability Management Transactions

- The historical default rate has varied with the cycle. Typically, when the default rate is higher, recovery given default is lower. Market participants expect the loan default rate to climb from today's historically low levels.
- In addition to default rates climbing, more companies have lower ratings (B-/CCC) and downgrades are outpacing upgrades. The fact that more companies may be closer to default suggests that they may be incented to engage in liability management transactions to avoid a default.
- Companies are more highly leveraged today and more of their leverage comes in the form of senior debt. Senior debt typically has a higher recovery rate because there is subordinated debt beneath the senior debt to absorb losses. However, in an uptiering transaction, formerly senior debt is, in effect, subordinated and this should reduce its recovery given default substantially.
- The historical recovery performance of second lien debt may be illustrative. According to Standard & Poor's, the historical mean recovery rate for first lien term loans is 79 cents on the dollar. The historical mean recovery rate for second lien term loans is 42 cents on the dollar. With "primed" first lien debt becoming subordinated, it is possible that the primed debt will have recovery rates more reminiscent of historical second lien levels.

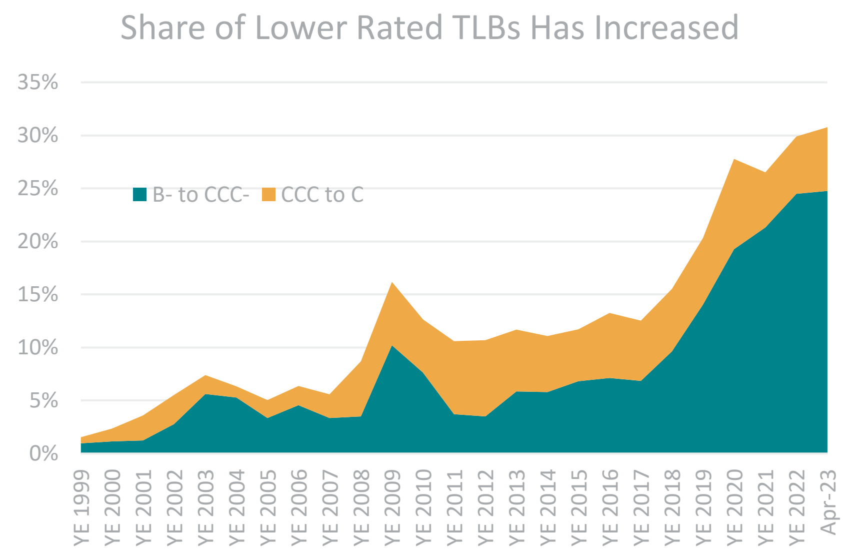
Historical Loan Default Rates & Forecast

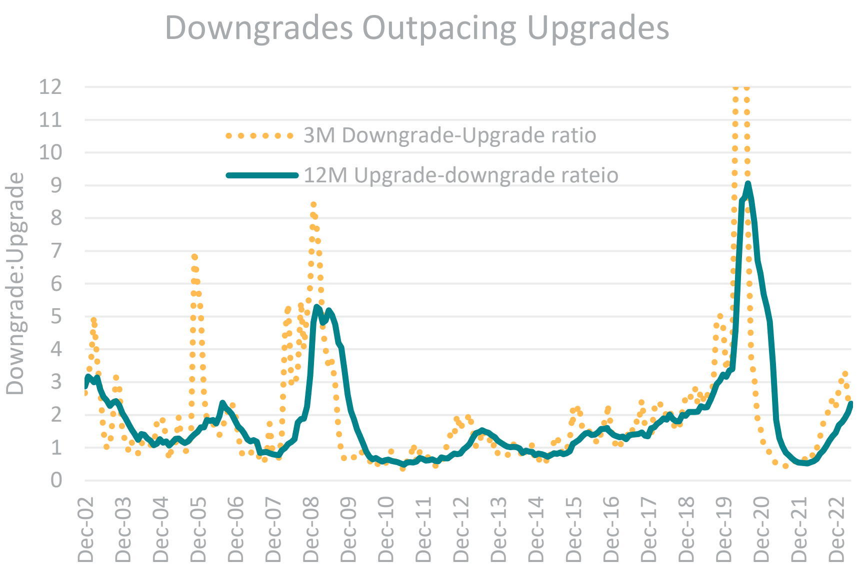


- Loan default rates vary over the cycle…but are forecast to rise significantly

Source: Pitchbook LCD

Loans may be in a More Fragile State (More Downgrades, More Lower Rated TLBs)

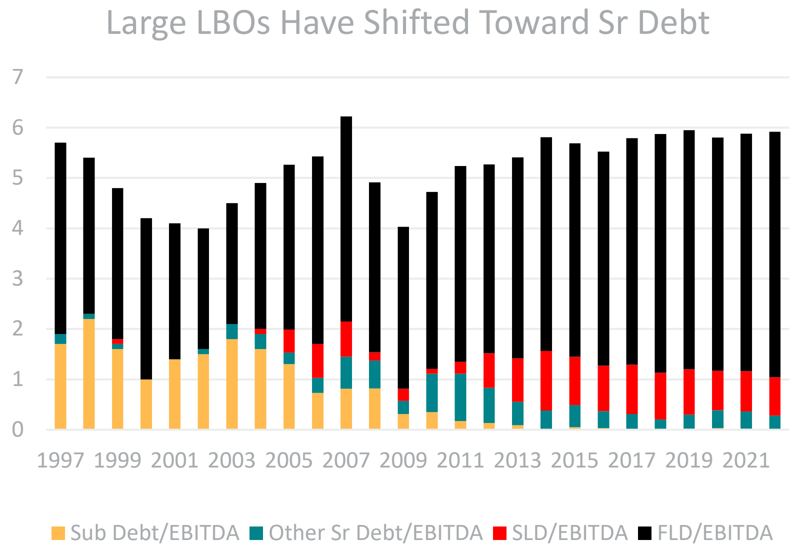


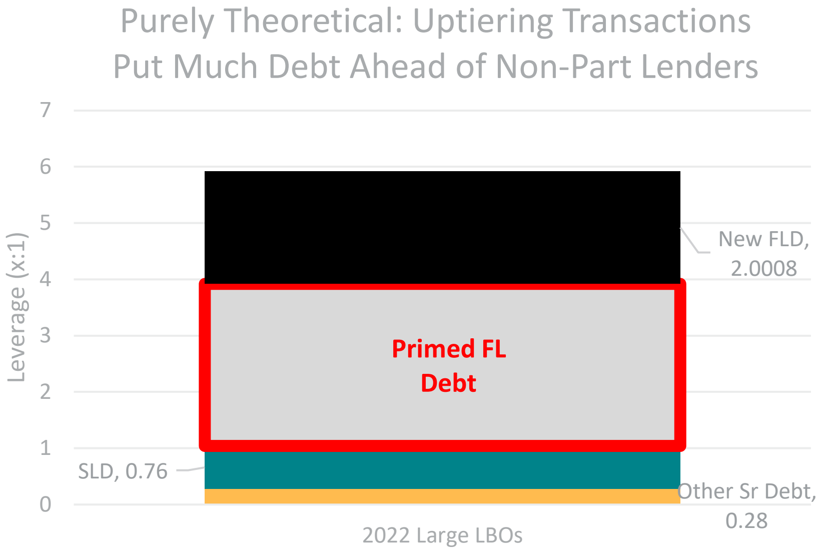


- Ratings of outstanding institutional loans have shifted down in past decade (note: some of this is due to previously unrated loans receiving B/B- ratings)
- There are more downgrades than upgrades

Source: Pitchbook LCD

There's More Senior Debt in LBO Cap Structure; Priming Pushes Non-Part Lenders Down Cap Structure

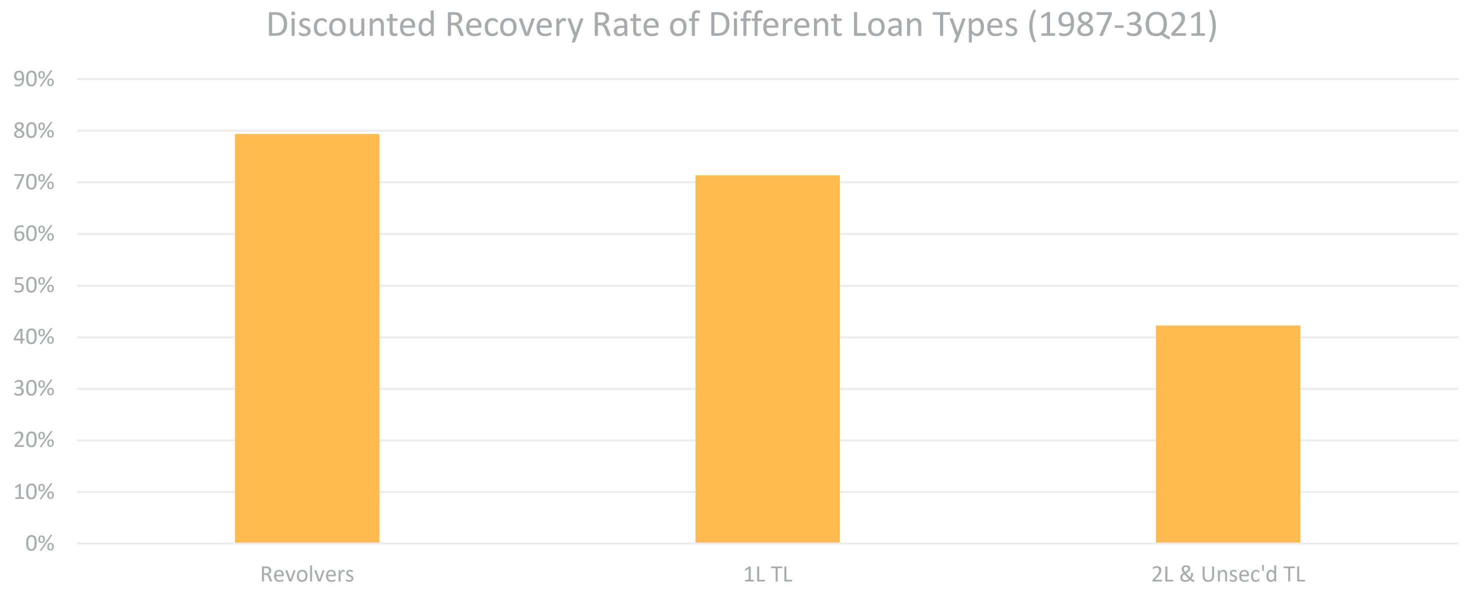




- LBO loans have ever more senior debt in cap structure
- Uptiering transactions, in effect, push non-participating lenders to subordinated positions
- **Huge Caveat: Theoretical example ignores that i) *more* debt is added to cap structure and ii) EBITDA has declined…so total leverage would be materially higher**

Source: Pitchbook LCD

Second Lien Loans Have Much Lower Recoveries



- More subordination under a loan generally means higher recovery

Source: Standard & Poor’s

LIABILITY MANAGEMENT TRANSACTIONS: WHERE ARE WE NOW?

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An Introduction to Liability Management Transactions

Liability management transactions are simply transactions undertaken by a company to restructure the liabilities on its balance sheet. Common objectives of liability management include additional liquidity, deleveraging and the extension of upcoming debt maturities.

While liability management transactions may take a variety of forms, in recent years two types have become by far the most important (and newsworthy) in the loan market: **asset dropdowns** and **"uptiering" priming transactions.** Challenging market conditions have led to the increased use of these tools, and that trend is likely to continue.

Specifically, these techniques are used by distressed borrowers to, among other things, obtain liquidity, capture discount, and/or extend maturities by offering a group of lenders the benefit of a senior claim against all of the borrower's or a specific subset of the borrower's assets. This can prove critical to a company that may otherwise be unable to incur new debt or amend and extend its existing facilities through conventional means, or may only be able to do so on unfavorable terms.

J. Crew is the best-known example of an asset dropdown, while **Serta** is now regarded as the archetypal uptiering priming transaction.

An Introduction to Liability Management Transactions (cont'd)

Whether or not a particular transaction is feasible, and how it is structured, is highly dependent on the specific terms and language in a company's debt documents. Agreements vary greatly in the amount of flexibility under negative covenants, as well as the inclusion and formulation of restrictions on designation of unrestricted subsidiaries (and transfers of material assets thereto), borrower buyback provisions and restrictions on amendments to pro rata sharing and subordination provisions (to name some of the most important).

It is also important to note that both types of transactions are adverse to lenders, either as a whole or to a specific subset (giving rise to the sometimes used moniker "creditor-on-creditor violence"). Accordingly, these transactions are often challenged by creditors. Many liability management transactions resulted in lawsuits, and there are a number of important cases and unresolved issues currently being litigated or that have been settled without a final judgment on the issue being litigated (although that has not deterred the use of these tools to date).

Overview of Asset Dropdowns

Asset dropdowns involve the transfer of assets to a non-loan party subsidiary, and the incurrence of new debt secured by those transferred assets. That new debt can then be used for purposes of additional liquidity and/or to facilitate a debt exchange.

Assets/equity are typically moved to a foreign or non-wholly owned subsidiary or an “unrestricted” subsidiary. Under most syndicated credit facilities (and secured indentures), these entities are not required to provide credit support for the borrower’s debt. Accordingly, while the assets to be transferred may have secured the borrower’s existing credit facilities, those liens will typically be released once the assets are transferred to a non-loan party, **thus allowing them to be used as collateral for a new financing**. Any new lenders will have a direct claim to those assets, while the borrower’s existing lenders will only have a residual claim via the borrower’s equity in the non-loan party (referred to as “structural subordination”).

A key aspect of a dropdown is that, by virtue of being transferred in compliance with the borrower’s existing debt documents, **no consent from its creditors is required**.

A critical question for any potential dropdown is whether the borrower has sufficient capacity under its debt documents to transfer the assets to the non-loan party. Creditors may challenge a dropdown on the basis that the transfer breached the covenants to which the borrower is subject, e.g., by arguing that the value of the transferred assets exceeded available capacity.

Another frequent challenge is that the transfer constituted a fraudulent conveyance.

Each of these challenges is highly fact-specific, oftentimes relating more to valuation (or reasonably equivalent value) and less to interpretation of provisions in the credit documentation.

Overview of Asset Dropdowns (cont'd)

Asset Dropdowns: Key Takeaways	
Description	• Borrower transfers assets to a non-guarantor using available capacity under its negative covenants. Those assets can then be used to incur structurally senior debt. • Structurally senior debt may be provided by third-party financing sources or existing lenders. • Viability depends on whether assets are sufficiently valuable for market to lend against. • Transferred assets are licensed back so transaction does not impair borrower's operations.
Benefits to Company	• Structurally senior debt backed by transferred assets can be used for purposes of additional liquidity and/or to facilitate a debt exchange. • Does not require lender consent if permitted under the negative covenants. • A possible dropdown can be used as leverage in negotiations with creditors.
Key Documentation Considerations	• Permitted investment and/or disposition capacity. • Permitted debt capacity (if assets are transferred to a non-guarantor restricted subsidiary vs. an unrestricted subsidiary). • Restrictions on transferring assets material to the business to non-guarantors. • Conditions for designation of unrestricted subsidiaries. • Potentially, restrictions on affiliate transactions.
Potential for Legal Challenge	• May be challenged by lenders who are no longer secured by transferred assets (e.g., by alleging value of transferred assets exceeded available investment and/or disposition capacity and/or transaction was a fraudulent conveyance).

Typical Structure and Applicable Credit Agreement Provisions

Typical Structure	Applicable Credit Agreement Provision
Formation or identification of NewCo	• Definition of “unrestricted subsidiary” and unrestricted sub “designation” provisions • Collateral and guarantee requirements / excluded subsidiary provisions
Transfer of assets to NewCo (often accompanied by a license of the transferred asset back to borrower)	• Investments covenant • Asset sale covenant • Collateral release provisions • Sale leaseback covenant • Limitations on release of all or substantially all of the collateral (if applicable)
Incurrence of new indebtedness by NewCo (the “New Structurally Senior Debt”), which will either be: • unlimited (if NewCo is an unrestricted subsidiary); or • subject to the existing credit facility covenants (if NewCo is an excluded restricted subsidiary).	• If applicable, restrictions on unrestricted subsidiaries guaranteeing, or being guaranteed by, credit parties • If incurred at or guaranteed by an excluded restricted subsidiary, debt and lien capacity (subject to any “non-guarantor” caps or sublimits)
Where applicable, exchange or “roll-up” all or a portion of any existing loans of the new creditors for or into the New Structurally Senior Loans	• Pro rata sharing provisions • Borrower buybacks and/or Dutch auction provisions

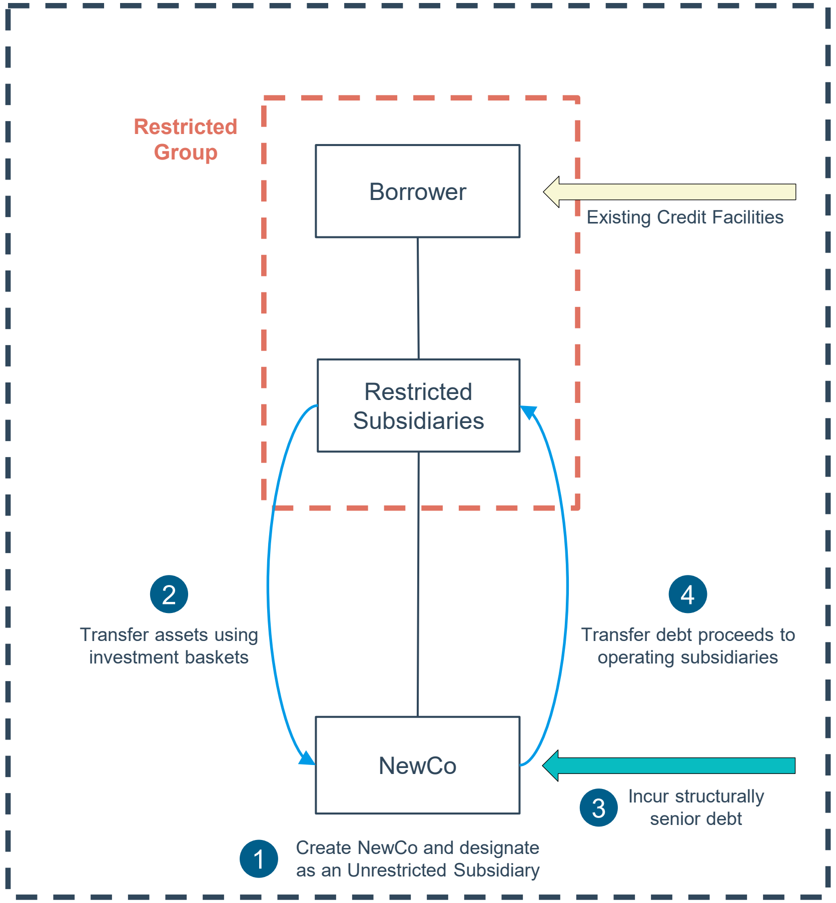
Illustrative Transaction Structure

1. Company creates "NewCo" and designates it as an Unrestricted Subsidiary:
   - Because NewCo is an Unrestricted Subsidiary, covenants in the existing credit agreement do not restrict its activities.
   - NewCo can be formed at the time of, or prior to, the transaction.
   - Designation of Unrestricted Subsidiaries may require compliance with certain conditions (such as financial ratio tests and/or default blocker).

2. Company then transfers assets to NewCo using available investment and/or disposition baskets in the credit agreement.

3. Incur structurally senior debt at NewCo from existing lenders, sponsor, or 3rd party:
   - Quantum of debt raised will be a function of value transferred and market debt.

4. Proceeds of new debt up-streamed to the borrower/operating entities to fund cash flow shortfalls and bolster liquidity (and also refreshing investment capacity as returns on investments).



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Notable Asset Dropdowns

Among the most notable asset dropdowns are:

- J. Crew (2016);
- PetSmart/Chewy (2018); and
- Neiman Marcus (2018).

More recent examples include:

- Travelport (2020);
- Cirque du Soleil (2020);
- Revlon (2020);
- Envision Healthcare (2022) and;
- Bausch Health (2022).

Overview Of “Uptiering” Priming Transactions

Priming transactions have gained prominence as a tool for borrowers to raise additional secured debt capacity in distressed situations by creating a new class (or classes) of debt that are senior in priority to the borrower’s existing secured debt.

Specifically, a borrower and at least a majority of its existing creditors will amend the borrower’s debt documents to permit the incurrence of new super-priority debt. That new debt will typically be incurred under a separate agreement, with the priority being documented under a new intercreditor agreement. The super-priority debt may be comprised of a new money tranche, and frequently the exchanged debt of creditors who consent to the transaction. This can enable a borrower to obtain liquidity, and potentially deleverage and/or extend debt maturities through the debt exchange.

If the priming transaction does involve an exchange, the opportunity to exchange into new super-priority debt is a critical enticement for creditors to consent to the transaction, as those who do not consent will be left with a subordinated claim. In some priming transactions, each creditor is given the opportunity to consent to and participate in the priming debt. However, in many instances, the opportunity to participate is only provided to a group of creditors who collectively hold enough voting power to effect the necessary amendments. Generally speaking, transactions that do not give all creditors a chance to participate have historically been more vulnerable to court intervention.

A critical aspect of any potential priming transaction is determining the consent requirement for subordinating the priority of existing debt. Agreements may only require the consent of a majority of creditors, or possibly each affected creditor (or some other amount).

Overview Of “Uptiering” Priming Transactions (cont’d)

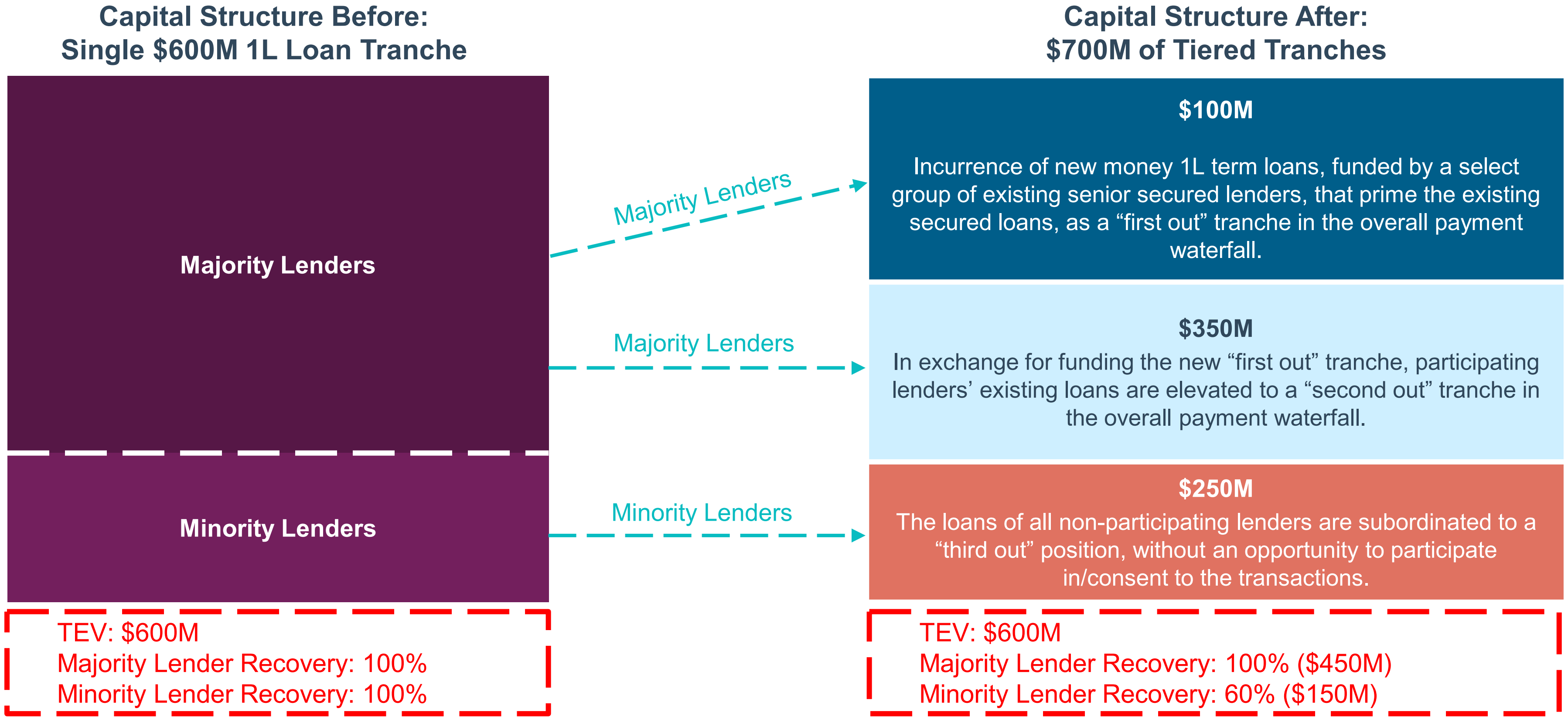
Priming Transactions: Key Takeaways	
Description	• Amend existing documents with consent of requisite creditors to permit the incurrence of super-priority debt. • Super-priority debt may consist solely of new money debt, or a combination of new money debt and the rolled-up debt of exchanging creditors consenting to the transaction. • Opportunity to participate in super-priority debt may be given to all creditors, or only a subset of creditors who possess the voting power to effectuate the transaction.
Benefits to Company	• Additional liquidity, deleveraging, and/or maturity extensions.
Key Documentation Considerations	• Consent requirements for subordination and changes to pro rata sharing. May not be possible depending on the language in credit agreement/indenture. • Restrictions on the ability of borrower and sponsor to repurchase debt. • Often in credit agreements, changes to waterfall requires all affected lender consent, which is why these are often done in separate agreements.
Potential for Legal Challenge	• May be challenged by non-participating creditors. • Case law on these transactions is evolving and currently uncertain.

Typical Structure and Applicable Credit Agreement Provisions

Typical Structure	Applicable Credit Agreement Provision
Incurrence of new debt by the borrower that is senior to existing loans.	• Debt and liens covenants • Limits on subordination of existing debt
Exchange/rollup of all or a portion of existing loans into senior debt that is pari with or junior to the New Superpriority Debt (but senior to the existing loans) ("Rolled Up Superpriority Debt").	• Pro rata sharing provisions • Borrower buybacks and/or Dutch auction provisions
The New Superpriority Debt and the Rolled Up Superpriority Debt may take the form of: • a new tranche of loans within the loan document, with priority governed by a payment "waterfall"; or • new loans under a separate credit facility, with priority governed by an intercreditor agreement.	• Pro rata sharing/waterfall provisions (including related amendment requirements) • Subordination/release of all or substantially all collateral • Intercreditor requirements

Illustrative Transaction Structure

- Company incurs new money “super-priority” loans provided by a group of existing lenders that is senior to the company’s existing debt. This is done through a new Credit Agreement, and priority is governed by a new Intercreditor Agreement.
- Participating Lenders amend existing credit docs to permit “super-priority” incurrence and direct agent to enter new intercreditor agreement.
- In exchange, existing debt of participating lenders is exchanged for or “rolled up” into (typically a lesser amount of) “second” priority loans.
- Existing loans of non-participating lenders are then effectively subordinated to a “third” priority position.
- Equity (or equity-like) instruments may be included to provide participating lenders with potential equity upside.



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Notable Priming Transactions

As mentioned above, Serta (2020) has become the most famous example of a priming transaction.

Other notable examples include:

- Murray Energy (2018; litigated in 2020);
- McDermott (2019);
- Boardriders (2020);
- TriMark (2020);
- TPC (2021);
- Incora (2022);
- Mitel (2022); and
- Rodan + Fields (2023).

CONTAINMENT STRATEGY: LITIGATION

Litigation (and Bankruptcy) Tracker

Transactions that have resulted in litigation	Transactions where company filed for bankruptcy (or foreign equivalent)
• J. Crew • PetSmart/Chewy • Neiman Marcus • Travelport • Revlon (both pre-filing and post-filing) • *Serta (both pre-filing and post-filing) • Murray Energy • *Boardriders • TriMark • TPC (post-filing) • *Incora • *Mitel • *Bausch Health *Denotes ongoing litigation	• J. Crew • Neiman Marcus • Cirque du Soleil • Revlon • Serta • Murray Energy • McDermott • TPC

Serta

Serta Simmons Bedding LLC, a portfolio company of Advent, had the below capital structure as of June 2020:

– Approximately $2 billion of first lien term loans (the "TLB") maturing November 8, 2023;

– Approximately $450 million of second lien term loans (the "2L") maturing November 8, 2024; and

– An ABL facility with approximately $225 million of revolving commitments maturing November 8, 2021.

On June 8, 2020, Serta announced that it had entered into a transaction support agreement with a majority of lenders in respect of a recapitalization transaction, which provided for the following priming debt (documented outside the existing credit agreements):

– $200 million of newly funded super-priority, first-out debt ranking ahead of the TLB and 2L;

– $875 million of super-priority, second-out debt issued in exchange for existing TLB and 2L loans held by the consenting majority lenders, ranking ahead of the remaining TLB and 2L; and

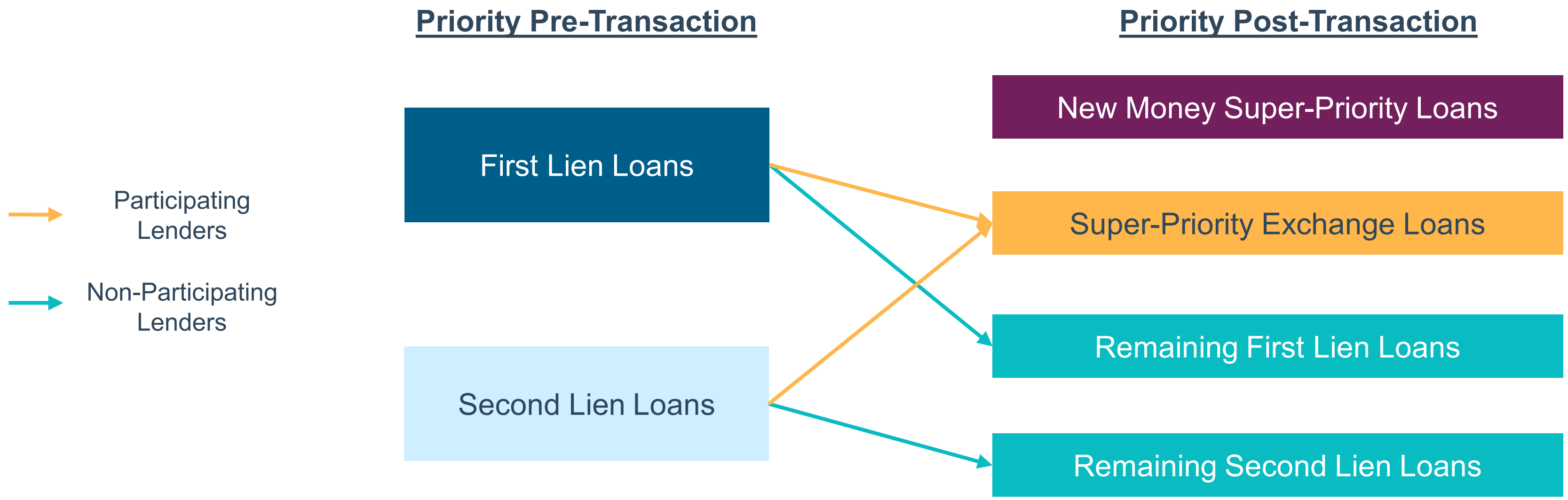
– Capacity to incur future super-priority, third-out debt, ranking ahead of the remaining TLB and 2L.

Serta (cont'd)

As a result, approximately $814 million of left-behind "first lien" loans became third/fourth lien loans and approximately $211 million of left-behind "second lien" loans became fourth/fifth lien loans.

Minority first and second lien creditors were not given an opportunity to participate in the new super-priority credit facilities (and did not learn of the transaction until it was publicly announced).

Of critical importance, the existing credit agreements did not expressly require the consent of each (or each affected) lender to subordinate the liens securing their loans.



Serta (cont'd)

On June 11, 2020, certain lenders filed suit seeking a preliminary injunction that would have blocked Serta from implementing this transaction (as illustrated above) on the basis that the transaction violated the pro rata sharing and collateral release provisions (each of which required unanimous consent to amend). That injunction was denied by the court, and the transaction was allowed to proceed.

However, a separate group of lenders filed suit. In March 2022, the court issued an order denying Serta's motion to dismiss the case, thereby allowing those claims to proceed. The key issues raised in that litigation are as follows:

- Whether the exchange of the existing loans into new priming debt was an appropriate use of the "open market purchase" provisions in the existing credit agreement; and
- Whether the transaction, *even if expressly permitted,* breached the implied covenant of good faith and fair dealing.
- From the order on the motion to dismiss: "Plaintiffs further allege that notwithstanding their contractual entitlement to be treated on a pro rata basis with other first-lien lenders, Defendant engaged in furtive negotiations with a select few creditors, manipulated the Agreement to subordinate Plaintiffs' debt without their knowledge, and struck a deal at Plaintiffs' expense."

Serta (cont'd)

Certain of the lenders who unsuccessfully challenged the transaction in 2020 then refiled their lawsuit in New York state court. Unsurprisingly, the plaintiffs echoed similar arguments raised in those other cases, contending (among other things) that:

- The pro rata sharing provisions in the credit agreement enshrine "a bedrock principle ... that the First Lien Lenders share ratably in all payments of principal or interest on their First Lien Term Loans;" and
- The exchange "was not an open market purchase" but rather "a wholly private, exclusionary transaction – an exchange, at a substantial premium to market prices, in which Serta handpicked a group of its lenders (excluding the remainder)."

Serta (cont’d)

While these cases were ongoing, Serta filed for Chapter 11 on January 23, 2023 in the Southern District of Texas. The debtors and the priming lenders then filed motions for summary judgment seeking validation of the uptier transaction.

On March 28, 2023, the bankruptcy court ruled that Serta’s uptier exchange transaction was a valid “open market purchase” under the existing credit agreement, finding in particular that “in looking at what occurred, it’s very clear to me this is what was intended by the agreement” and “it’s what’s intended by the concept of an open market purchase.” The court’s decision was a notable development in the evolving case law regarding these transactions, as it was the first definitive ruling by a judge as to whether a non-pro rata uptier exchange constituted an open market purchase.

The question of whether the transaction violated the implied covenant of good faith and fair dealing is still unresolved in the bankruptcy litigation (with a trial being set to begin May 15, 2023). However, on May 4, 2023, Judge Jones of the bankruptcy court made a discovery ruling reflecting his view that non-priming lenders’ participation in other liability management transactions could be important to the outcome of the good faith and fair dealing claim.

The minority lenders have appealed the bankruptcy court’s ruling to the Fifth Circuit, and the court has agreed to review the decision (although it also denied a motion to expedite the appeal in order to obtain a decision prior to a May 15 confirmation hearing).

Regardless of the outcome in the Serta bankruptcy, state and federal courts in New York have already considered the open market purchase exception to be ambiguous and thus able to survive a motion to dismiss, and those courts are not bound by the bankruptcy court’s (or the Fifth Circuit’s) ruling.

CONTAINMENT STRATEGY: DOCUMENTATION RESPONSES

Overview of Documentation Changes

In response to high-profile asset dropdown and priming transactions, lenders have sought documentation changes that attempt to prevent these maneuvers in the future. The market has coalesced around three types of such provisions:

- J. Crew blockers,
- Chewy blockers, and
- Serta protection.

We discuss these provisions in the following slides. However, there are several common themes to be aware of:

- The market has settled on these specific provisions instead of (or without modifying) other provisions necessary to effectuate a liability management transaction.
- These provisions are far from universally adopted. Whether or not a particular agreement includes some or all of these protections is negotiated and will likely reflect broader market dynamics at the time of incurrence.
- These provisions can take a variety of forms. Consequently, there is a spectrum of how protective these actually are to a lender (or permissive to a borrower).

As a result, there is a large degree of variation in the market as to whether individual agreements include flexibility for a potential dropdown or priming transaction.

J. Crew Blockers

These provisions seek to prevent material intellectual property from being transferred to a non-guarantor subsidiary. In most cases, the blocker will only restrict transfers to unrestricted subsidiaries, as opposed to any non-guarantor (more on that below).

In its most conventional formulation, a J. Crew blocker will provide that: “The Borrower shall not, and shall not permit any of its Restricted Subsidiaries to, sell, convey, transfer or otherwise dispose of or exclusively license any Material Intellectual Property to any Unrestricted Subsidiary.”

However, there are many variations on the J. Crew blocker. Two of the most notable are the following:

- **Variation 1:** In order for a subsidiary to be “unrestricted,” credit agreements require the borrower to affirmatively designate a restricted subsidiary as such. Some agreements do not actually restrict the *transfer* of material IP to unrestricted subsidiaries, but instead provide only that a restricted subsidiary that owns material IP may not be designated as unrestricted. While this may sound effective, a borrower could simply designate a subsidiary as unrestricted, and then transfer material IP to it some time later.

- Note that Variation 1 and the conventional formulation can both be included in the same agreement (and frequently are).

J. Crew Blockers (cont'd)

– **Variation 2:** Some J. Crew blockers prohibit the transfer of material IP owned by a borrower or guarantor to any non-guarantor. This is more expansive than the conventional formulation, because in addition to prohibiting transfers to unrestricted subsidiaries, it also prohibits transfers to non-guarantor restricted subsidiaries (most likely foreign or non-wholly-owned subsidiaries, which could otherwise use the transferred assets as security for new debt).

– Note that Variation 2 can be less meaningful given non-guarantor subsidiaries that are restricted subsidiaries (unlike unrestricted subsidiaries) typically have limited debt and lien capacity to leverage the transferred assets.

Apart from the formulation, another issue is the definition of "Material IP" to which the blocker applies. Consider the following definitions: "IP material to the business or operations of the Borrower or its Restricted Subsidiaries" vs. "IP that, if disposed, would reasonably be expected to result in a Material Adverse Effect." The first definition is more lender-friendly, as it restricts the transfer of any IP which is material in a more conventional sense. The second is more borrower-friendly, because it only restricts the transfer of IP that is so important that it would rise to the level of a Material Adverse Effect (which is a higher standard).

Finally, note that there is an important limitation on J. Crew blockers, regardless of what form they take: they almost always only apply to IP assets. Accordingly, they do not restrict a borrower from engaging in a dropdown of non-IP assets (such as equity interests in a subsidiary); although there are formulations that include equity in entities that own IP assets. Moreover, amendments to these provisions are usually not a sacred right and thus protections can be removed or modified in a transaction where the majority lenders/holders are supportive.

LSTA Drop-Down Financing Rider

Notwithstanding anything herein to the contrary, in no event shall [(i) any Loan Party contribute, or otherwise invest, any [Material Asset] in, or Dispose of any [Material Asset] to, any Subsidiary that is not a Loan Party,][1] (ii) any Restricted Subsidiary contribute, or otherwise invest, any [Material Asset] in, or Dispose of any [Material Asset] to, any Unrestricted Subsidiary or (iii) any Subsidiary be designated as an Unrestricted Subsidiary if such subsidiary owns any [Material Asset].

"Material Asset" means any [asset] owned by any Loan Party that is, [in the reasonable determination of the Borrower], material to the operation of the business of the Borrower and its Restricted Subsidiaries, taken as a whole.[2]

[1]Borrowers will often seek to limit the restrictions on investments in or dispositions to unrestricted subsidiaries (vs. any non-credit party) covered by (ii).

[2]The scope of these assets is often limited to "Material Intellectual Property".

Chewy Blockers

Chewy blockers are provisions designed to prevent a subsidiary guarantor from being released from its obligations on the grounds that it is no longer wholly-owned, as happened in PetSmart/Chewy. Under many syndicated credit facilities and secured indentures, non-wholly-owned subsidiaries are not required to provide credit support for the borrower's debt and a guarantor is automatically released from its guaranty (and the lien on its assets automatically released) upon becoming an Excluded Subsidiary (i.e., a subsidiary not required to provide a guaranty). Accordingly, absent such a provision, a subsidiary guarantor could be automatically released from its guarantee (as will any liens on its assets) if it ceases to be wholly-owned.

Chewy blockers work by requiring that, before a subsidiary guarantor is automatically released from its obligations, the relevant transaction must satisfy one or more of the following specified conditions. While those conditions vary considerably, a Chewy blocker will often include some combination of the following:

- The transaction is made for a bona fide business purpose;
- Any remaining investment in (and debt and liens of) such subsidiary permitted as if invested (or incurred) at the time it became non-wholly-owned;
- The disposition is not entered into primarily for the purpose of releasing the subsidiary from its guarantee;
- The party to whom the shares are transferred is not affiliated with the borrower; and/or
- The disposition of the shares is made for fair market value.

Because there is a variety in the conditions required, there is also a variety in the effectiveness of Chewy blockers. Accordingly, whether a Chewy blocker actually prevents a subsidiary guarantor from being automatically released in a particular circumstance depends on how the blocker is drafted.

Serta Protection

Serta protection, as its name suggests, was developed following Serta to prevent the type of uptier priming maneuver that occurred in that transaction. It works by requiring the consent of each (or each adversely affected) lender to subordinate the loans, effectively giving minority lenders a veto right over potential subordination.

More specifically, Serta protection applies to the subordination of the liens on the collateral, and often subordination of the payment priority of the loans as well.

One of the most common variations is providing that the heightened consent requirement will not apply if the opportunity to participate in new priming debt is offered to each affected lender on a pro rata basis. In so doing, it takes a more nuanced approach: it allows for priming by the majority as long as the minority lenders are not excluded from the transactions, as happened in cases such as Serta, Boardriders, and TriMark. In this way, it addresses what is considered by many to be the most concerning aspect of these transactions (from a lender's perspective).

LSTA Uptiering Transaction Rider

[No amendment, waiver or consent shall] without the prior written consent of each Lender directly affected thereby, (i) subordinate, or have the effect of subordinating, the Obligations hereunder to any other Indebtedness, (ii) subordinate, or have the effect of subordinating, the Liens securing the Obligations to Liens securing any other Indebtedness, or (iii) modify Section *[include pro rata sharing, pro rata treatment, post default waterfall and borrower/affiliate buyback mechanics if appropriate]* or any other provision hereof in a manner that would have the effect of altering the ratable reduction of Commitments or the pro rata sharing of payments otherwise required hereunder.

LSTA Liability Management Checklist

1. *Investment Covenant*
   - ✓ What is the aggregate capacity for a drop-down financings? For this analysis, it is critical to take into account all relevant baskets as a whole, including ratio-based baskets, cumulative credit (including capacity that may have been built by earlier capital contributions) and other baskets that can be reallocated from the restricted payments or other covenant.
   - ✓ Is there a cap on [non ordinary course] investments by credit parties in non-credit party restricted subsidiaries? Would such a cap be appropriate given the operations of this borrower?
   - ✓ Does the document contain the "J. Crew" provision?[4]
   - ✓ Are there limitations on moving certain categories of assets outside the credit group (e.g. intellectual property or distinct lines of business)?
   - ✓ Are there specific provisions permitting the movement of intellectual property within the corporate group that would permit a drop-down financing (this has become more common in recent transactions)?
   - ✓ Consider requiring a leveraged-based or interest coverage ratio test on the use of cumulative credit for investments.
   - ✓ When investing assets, how is the value of the assets to be determined? By the borrower in good faith? Subject to a third-party verification if over a threshold (this would be unusual in loan agreements)?

2. *Unrestricted Subsidiaries*
   - ✓ Are there any unrestricted subsidiaries at closing that may be used to consummate a drop-down financing in future without complying with the applicable "designation" requirements?
   - ✓ Is there a leveraged-based or interest coverage ratio test that must be satisfied as a condition to designating unrestricted subsidiaries?
   - ✓ What limits, if any, exist on unrestricted subsidiaries guaranteeing obligations of, or being guaranteed by, credit parties?
   - ✓ Are there any significant – and meaningful – exclusions from the requirements that the borrower and its subsidiaries provide guarantees and collateral?
   - ✓ Is the exclusion of foreign subsidiaries appropriate given the transaction structure and tax regulations?

[4] If there is no cap on investments by credit parties in non-credit party restricted subsidiaries, the "J. Crew" provision creates unlimited capacity to invest in unrestricted subsidiaries.

LSTA Liability Management Checklist (cont'd)

3. *Release of all or Substantially All Collateral; Subordination.*
   - ✓ Does the credit agreement require a 100% lender vote for a subordination of existing loans?
   - ✓ Do amendments to "pro rata" sharing provisions apply broadly to amendments that "by their terms" or "have the effect" of impacting "pro rata" sharing?

4. *Pro rata sharing and Buybacks*
   - ✓ Are "pro rata" sharing provisions subject to 100% or all affected lender vote?
   - ✓ Which specific "pro rata" provisions are referenced? Pro rata sharing generally? Pro rata treatment of payments? Default waterfall?[5]
   - ✓ What are the exceptions to the pro rata provisions?[6]
   - ✓ Do the pro rata sharing provisions protect all lenders or only lenders within a class (so that the borrower may create a new class and then offer that new class non-pro rata treatment)?
   - ✓ Does the credit agreement permit "open market" repurchases and, if so, how is that defined (if at all)? Will there be a market test or opportunity for all lenders to participate? Is there an aggregate cap?
   - ✓ Does the credit agreement permit "Dutch auctions" and how is that defined? Is there an aggregate cap?
   - ✓ What vote is required to modify the open market repurchase or Dutch auction exceptions to the pro rata sharing?[7]

5. *Other Protections*
   - ✓ Consider imposing caps on non-credit party debt incurrence in light of potential future liability management transactions.
   - ✓ Do refinancing provisions (and related definitions) permit "uptiering" of lien or payment priority?
   - ✓ Review remedy limitation provisions to determine individual or minority lender rights to bring independent causes of action.
   - ✓ Review provisions referencing intercreditor arrangements (including defined terms and provisions authorizing agents to enter into intercreditor agreements consented to by majority lenders).

[5] There is considerable variation in the market as to which pro rata provisions require 100% lender consent.
[6] As a baseline matter, these provisions will expressly cross reference borrower buybacks.
[7] This is typically not a 100% vote requirement, which could undermine 100% voting protection for pro rata provisions.

DO LIABILITY MANAGEMENT TRANSACTIONS WORK?

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Why Do Companies Engage in Liability Management Transactions?

What are the considerations in pursuing them?

- Nature of the company’s challenges
- Fiduciary duties

What are the stated objectives?

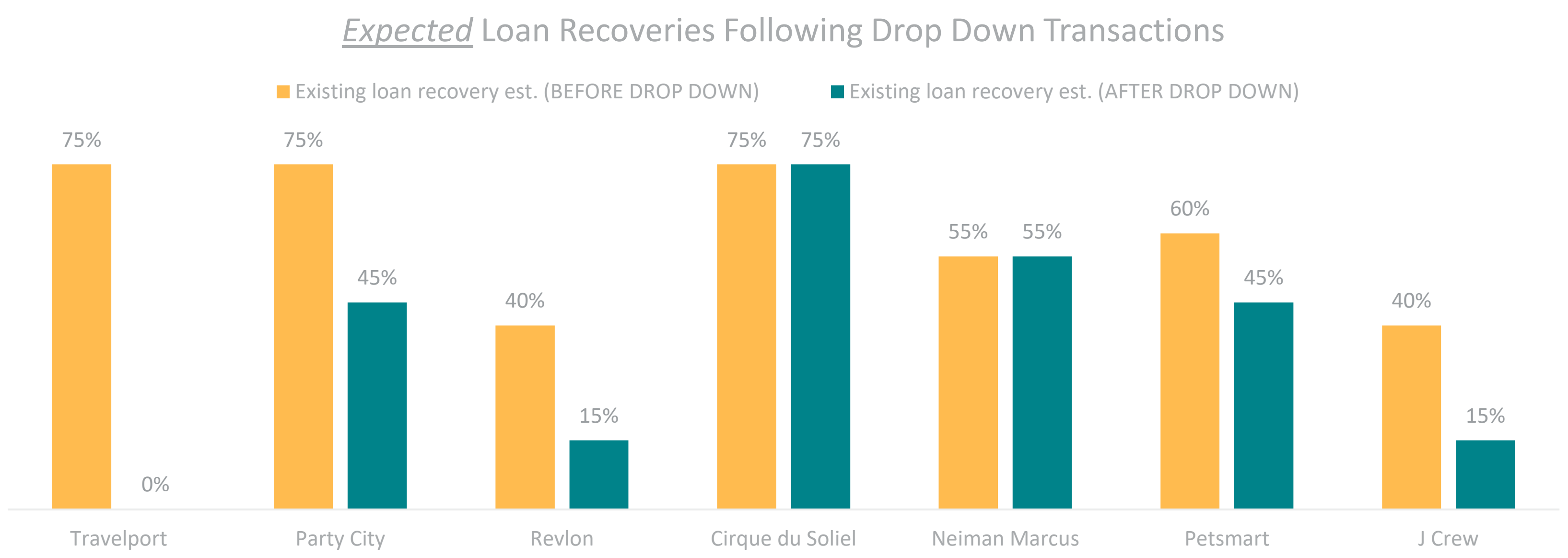
- Increased liquidity, deleveraging, extended debt maturities
- More time/runway to improve performance and avoid bankruptcy
- Potential to achieve a better outcome for all constituents

BUT…

Are those objectives being achieved, and at whose expense?

How do you measure success?

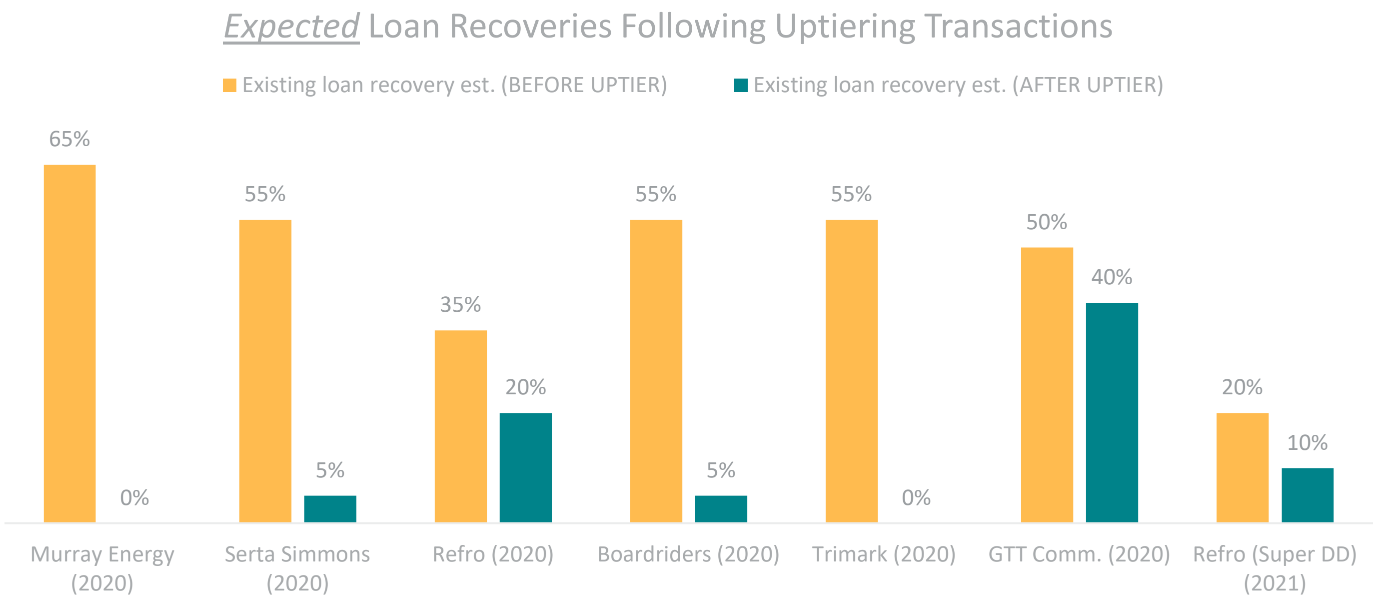
LMTs & Impact on Expected Recoveries



- Note that – generally – drop down transactions impaired recoveries less than uptiering transactions

Source: Standard & Poor's

LMTs & Impact on Expected Recoveries



- Uptiering transactions substantially impact recovery expectations for non-participating lenders

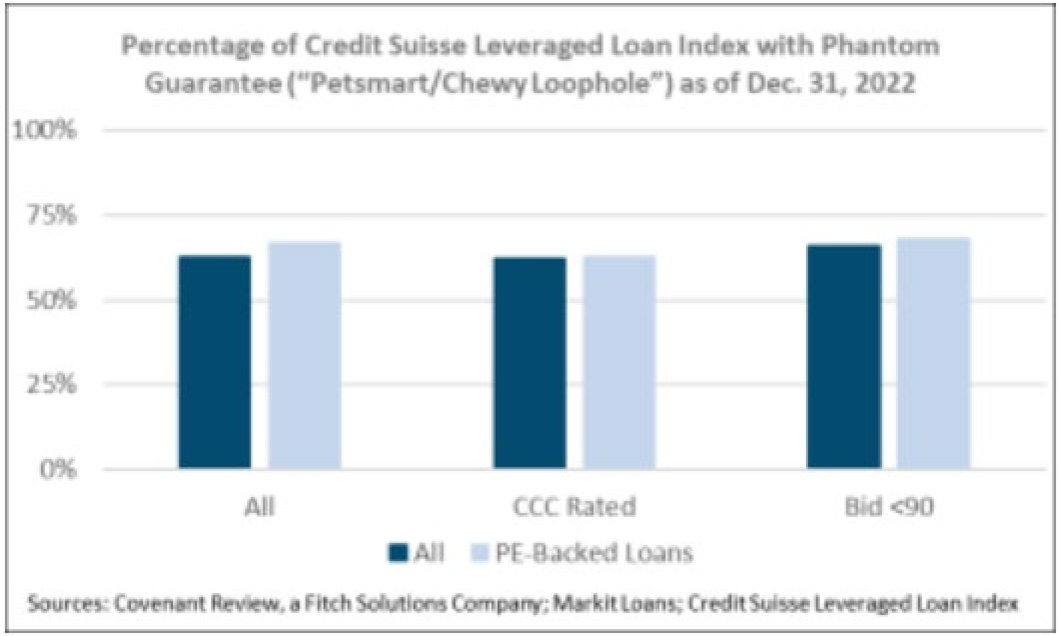
Source: Standard & Poor's

Bankruptcy (and Litigation) Tracker

Transactions that have resulted in litigation	Transactions where company filed for bankruptcy (or foreign equivalent)
• J. Crew • PetSmart/Chewy • Neiman Marcus • Travelport • Revlon (both pre-filing and post-filing) • *Serta (both pre-filing and post-filing) • Murray Energy • *Boardriders • TriMark • TPC (post-filing) • *Incora • *Mitel • *Bausch Health *Denotes ongoing litigation	• J. Crew • Neiman Marcus • Cirque du Soleil • Revlon • Serta • Murray Energy • McDermott • TPC

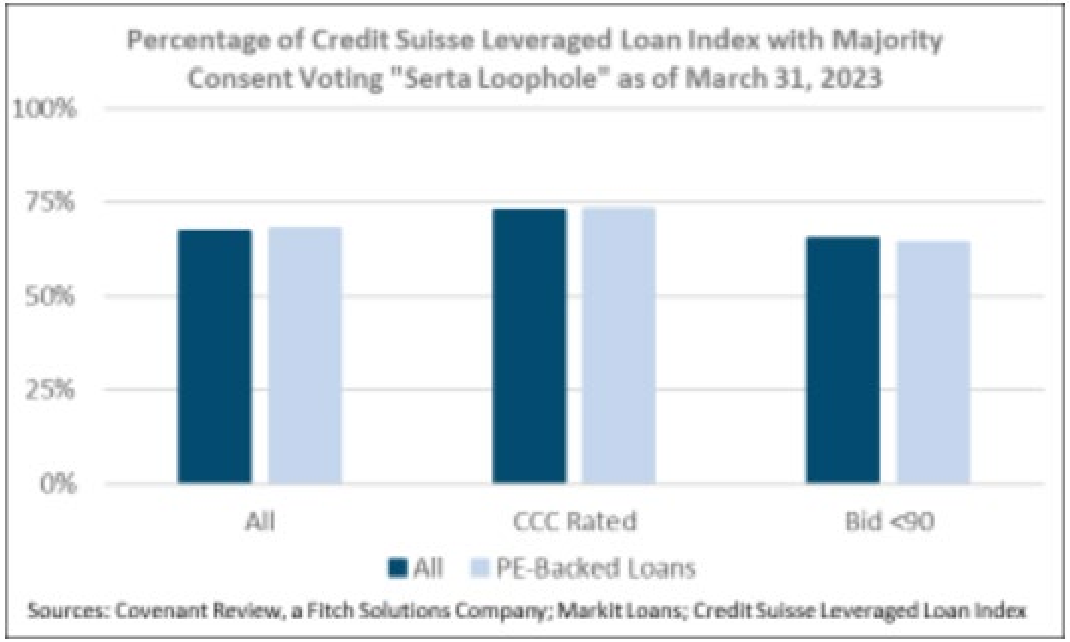
Chewy Blocker Usage

The following chart shows, as of December 31, 2022, the percentage of loans in the Credit Suisse Leveraged Loan Index that provides for the automatic release of guarantees provided by entities that become excluded subsidiaries by virtue of ceasing to be wholly-owned (or in other words, loans that do not include any form of Chewy blocker). The data is broken down by all loans vs. PE-backed loans, and all loans vs. CCC rated loans and those bid less than 90.



Serta Protection Usage

The following chart shows, as of March 31, 2023, the percentage of loans in the Credit Suisse Leveraged Loan Index that only require majority lender consent for subordination (i.e., those that do not include Serta protection). The data is broken down by all loans vs. PE-backed loans, and all loans vs. CCC rated loans and those bid less than 90.



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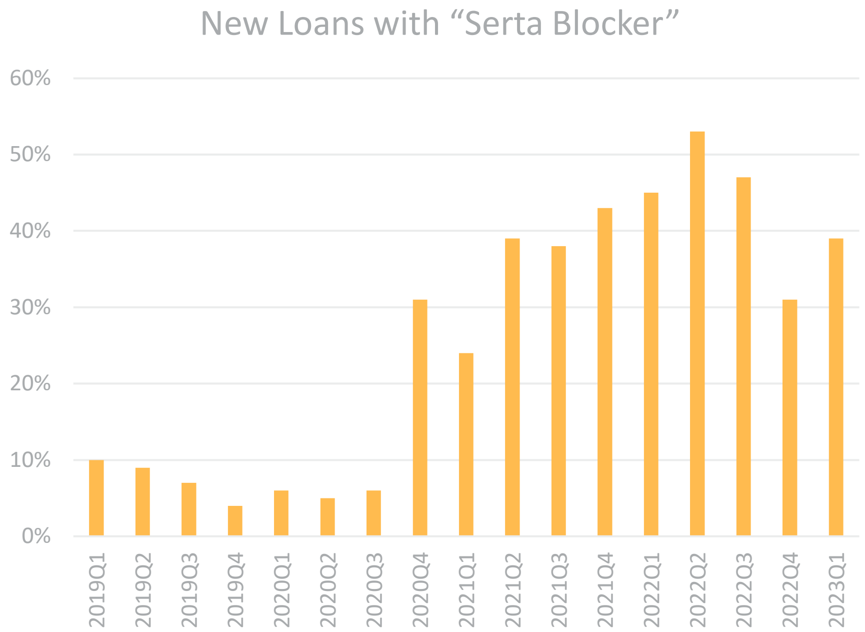
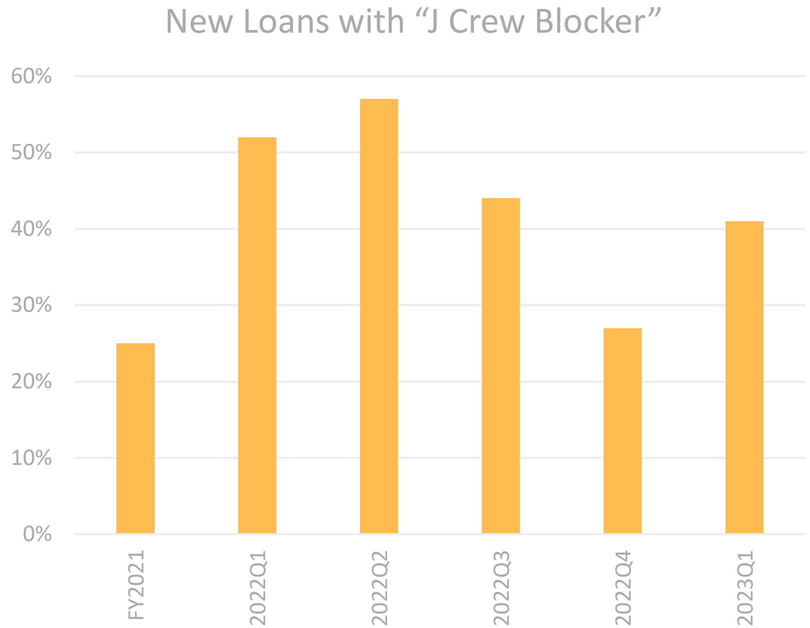
Use of Blockers Increased, Then Declined





- LSTA published its LMT advisory in March 2021 which was followed by a surge in use of blockers
- But … use of blockers has since declined

Source: Covenant Review, a Fitch Solutions Company

WHAT COMES NEXT?

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What Do These Transactions Mean for Loan Market and Participants?

- Loans' attractions are due in part to being senior secured and having a high recovery given default.
- Can document holes be fixed before there are higher defaults and low and bifurcated recoveries? If not…
  - What happens when recoveries are *generally lower*? Do investors leave?
  - What happens when recoveries are *bifurcated?* Do investors leave? How will rating agencies rate to bifurcated recoveries?
  - How will investors think about loans when loan recovery is so *idiosyncratic?*

Speakers

Meredith Coffey, Executive Vice President of Research and Co-Head - Public Policy, Loan Syndications & Trading Association

Tess Virmani, General Counsel & Executive Vice President - Public Policy, Head of ESG, Loan Syndications & Trading Association

Susan Atkins, Managing Director, Investment Bank Special Credits Group, J.P. Morgan

Andrew Thau, Senior Legal Analyst, Whitebox Advisors LLC

Stephen Hessler, Partner and Global Practice Leader, Restructuring, Sidley Austin LLP

Kelly Lazaroff, Partner, Global Finance, Sidley Austin LLP

Allison Satyr, Partner, Global Finance, Sidley Austin LLP