LMA Loan Market Association

LSTA ADVANCING THE CORPORATE LOAN MARKET

UK and US Loan Markets: Trends and Deal Terms

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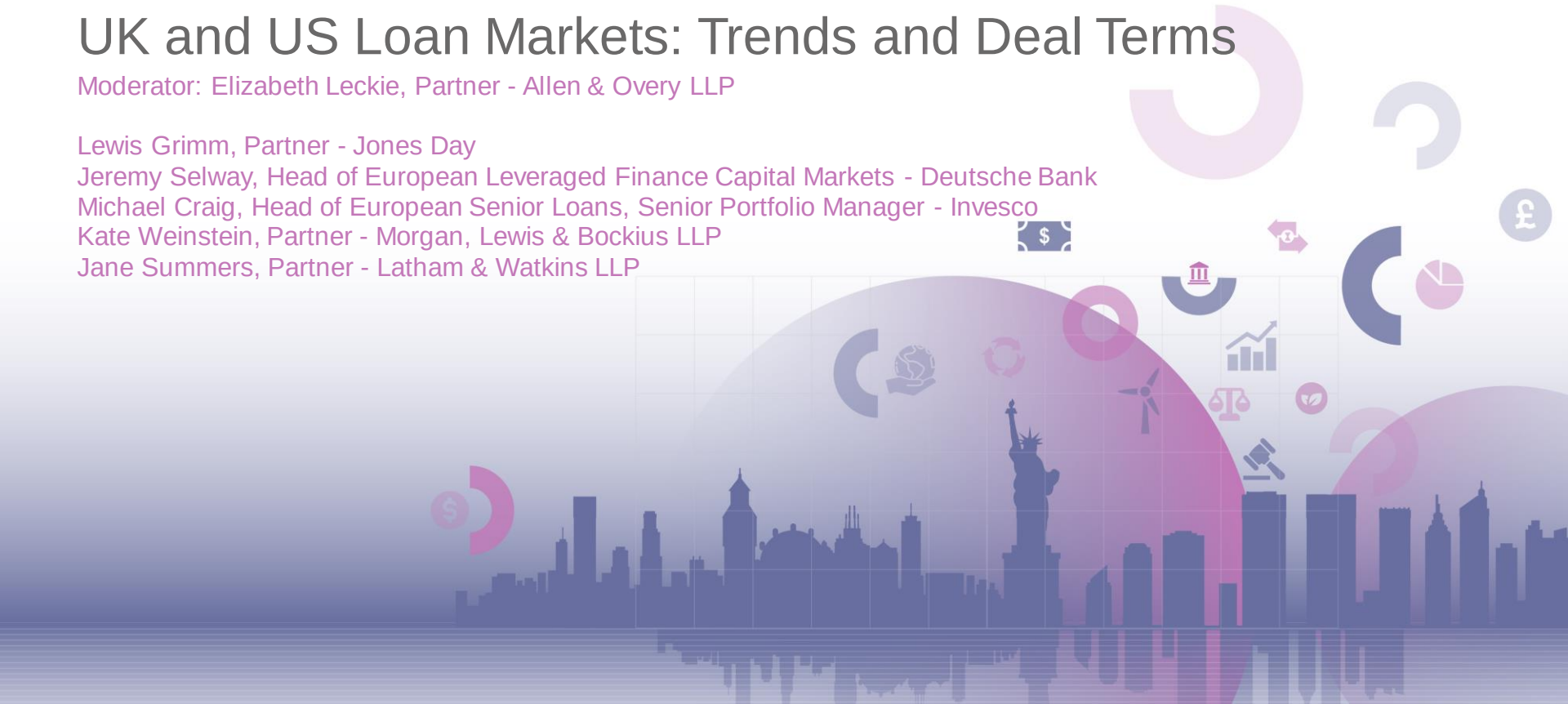

US Liability Management Transactions

- When faced with liquidity needs, Companies have in recent years turned to liability management strategies

- This presentation will focus on two types of transactions that have gotten a lot of attention:
  (1) “Drop-down” transactions (examples include J Crew and Petsmart/Chewy)
  (2) “Uptier” transactions (examples include Serta, Trimark and Boardriders)

- While drop-down transactions may not require lender consent, uptier transactions have generally been effectuated with majority lender support (and often do not permit minority lenders to participate)

Drop-Down Transactions

- Typically involves the Borrower selling or transferring assets constituting a secured lender's collateral from loan parties to non-loan parties, and then using such assets as leverage or collateral for new debt

- **J Crew** transaction – started the trend in 2016, when J Crew used a combination of investment baskets in its term loan agreement to transfer approximately $250 million of IP assets to an unrestricted subsidiary

    - Once transferred, the IP was no longer part of collateral package for term lenders. The Company then had the unrestricted subsidiary license the IP back to the Company (thus giving the unrestricted subsidiary a revenue stream)
    - The unrestricted subsidiary used those assets and revenue stream to secured new financing, which was structurally senior to the term loan facilities

Drop-Down Transactions; J Crew

Jargon Spotlight:

- **Pulling a J Crew**: refers to a Borrower transferring material assets (the "crown jewels") to an unrestricted subsidiary
- **J Crew trapdoor**: flexibility in the documentation that permits transfers to non-guarantor restricted subs and then subsequent transfers to unrestricted subsidiaries
    - Sample language of a basket that freely permits using proceeds of investments in non-guarantor restricted subsidiaries by loan parties to transfer value to unrestricted subsidiaries: "Investments made by any Restricted Subsidiary that is not a Loan Party with proceeds received by such Restricted Subsidiary from an Investment made by any Loan Party in such Restricted Subsidiary pursuant to this Section [__]"
- **J Crew Blocker**: a provision intended to prevent a borrower from transferring material assets to an unrestricted subsidiary
- **Chobani Black Hole**: In the Chobani deal, there was an unlimited ability to transfer value to non-guarantor restricted subsidiaries. When paired with the sample language above, this creates the "black hole", effectively allowing for unlimited investments in unrestricted subsidiaries

Drop-Down Transactions; J Crew

- Mitigating the risk from J Crew:
  - Limitations on designation of unrestricted subsidiaries
    - In smaller deals, may be capped as a percentage of EBITDA or assets of Borrower and its subsidiaries
  - Limitations on investments in unrestricted subsidiaries (in order to achieve this result, documentation may include limitations on usage of JV basket, general basket, ratio basket or any other basket (other than the specific unrestricted subsidiary basket) to make investments in or otherwise transfer value to unrestricted subsidiaries
  - Expressly limiting the right of unrestricted subsidiaries to own material IP (or other material assets)
    - Some common issues:
      - Prohibits a subsidiary that owns material IP to be designated as unrestricted, but does not prohibit subsequent transfers of IP from restricted subs to unrestricted subs
      - Does not capture exclusive licenses
      - Does not address other material assets

Drop-Down Transactions; J Crew

Closing the J Crew Trap Door:

1. Prohibit use for investments in unrestricted subs and joint ventures
   - Sample Language: "Investments made by any Restricted Subsidiary that is not a Loan Party ***(excluding any Investment made in an Unrestricted Subsidiary or a joint venture)*** with proceeds received by such Restricted Subsidiary from an Investment made by any Loan Party in such Restricted Subsidiary pursuant to this Section [__];"
2. Carve out proceeds of investments using baskets intended for investments in restricted subs (e.g. intercompany investments baskets; fixed dollar basket for investments in non-guarantor restricted subs)
   - Sample Language: "Investments made by any Restricted Subsidiary that is not a Loan Party with proceeds received by such Restricted Subsidiary from an Investment made by any Loan Party in such Restricted Subsidiary pursuant to this Section [__] ***(other than pursuant to clause [ ] of Section [ ])***"
3. Replace basket with an interpretive provision allowing for "pass through" investments to be disregarded
   - Sample Language: "To the extent an Investment is made by the Borrower or any Restricted Subsidiary (the "Initial Investor") in any other Person (each such person, a "Target Person") through substantially concurrent interim transfers through any Restricted Subsidiary for the purpose of ultimately making the relevant Investment in the Target Person, each such substantially concurrent interim transfer shall be disregarded for purposes of this Section [__] (it being understood that such Investment must satisfy the requirements of, and shall count toward any thresholds or baskets in, the applicable clause under Section [__] as if such Investment was made by the Initial Investor directly in the Target Person).

Drop-Down Transactions; Petsmart/Chewy

Chewy overview:

- In 2017, Petsmart bought the online retailer chewy.com
- The brick and mortar portion of the business had performance issues. In 2018, PetSmart disclosed that it had spun-off 20% of Chewy's equity by declaring a dividend and separately transferred 16.5% of Chewy's equity to a newly-formed unrestricted subsidiary of the Borrower
- The term loan agreement included an **automatic release provision** upon Borrower's request if any subsidiary loan party ceased to be wholly-owned as a result of a transaction that is permitted under the loan documentation
- Given that Chewy was no longer a wholly-owned subsidiary, PetSmart requested that agent under the Company's term loan credit agreement release the liens on Chewy's assets and its guarantee of the term loans

Drop-Down Transactions; Petsmart/Chewy

Jargon Spotlight:

Chewy Blocker: provisions in a credit agreement intended to prevent a subsidiary guarantor from being released from its guaranty obligations solely because it is no longer wholly-owned by the Borrower

Customary way of addressing the Chewy issue is by including good faith and fair value considerations:

- The transaction that caused the entity to be non-wholly owned must not have been consummated in contemplation of the release
- The transaction must not have involved the disposition or issuance of equity interests of such subsidiary in either case to a person that is an affiliate
- The transaction must have had a legitimate business purpose
- The disposition or issuance of equity must not have been for less than the fair market value of such shares as reasonably determined by the Borrower

Revlon and the Sham Revolver

Revlon overview:

Revlon was party to a 2016 term loan agreement with approx. $1.7 billion outstanding. In 2019, the company transferred certain IP to an unrestricted subsidiary and entered into a new term loan agreement secured by the transferred assets (which also provided a pari passu lien on all other assets). The unrestricted IP subsidiary licensed the IP back to Revlon. Then in 2020, the company transferred the majority of its IP to the same subsidiary to secure a new facility that refinanced the 2019 facility. The lenders under the 2016 agreement challenged the transfers under the 2019 and 2020 agreements.

- Like J Crew, the debt documents had significant investment capacity and no limitations on transfers of material IP. Uncapped investments in non-guarantor restricted subs were permitted so long as not cash. Once in the non-guarantor restricted subsidiary, uncapped investments in other non-guarantor subs (including unrestricted subs) were permitted.
- The IP was leased back via a sale-leaseback – 2016 lenders challenge that this transaction breached the 2016 facility documentation.
- "**Revlon Sham Revolver**" – in order to enter into the 2020 loan docs, the company needed the consent of a majority of the lenders under the 2016 term loan credit agreement. They didn't have the vote, so the Company added a new $65 million revolving commitment to the term loan credit agreement, resulting in the objecting lenders having 49.9% of the vote.

Revlon and the Sham Revolver

- Revlon filed for bankruptcy in June 2022
- Certain 2016 Lenders sued Revlon; challenges against the company include:
  - Breach of contract:
  - The 2019 and 2020 sale-leasebacks of IP weren't permitted
  - The sham revolver wasn't permitted
  - Breach of implied covenant of good faith and fair dealing
- Bankruptcy Judge dismissed lawsuit against Revlon in February 2023

Uptier Transactions - Overview

A “layering” or “uptier” transaction generally involves a majority group of existing lenders providing a new priming tranche of secured financing as consideration for rolling up all or a portion of their existing secured debt into such priming tranche or a new “sandwich” tranche that is junior to the new money and senior to existing secured debt of the lenders

Uptier transactions generally need “Required Lender” consent under the credit agreement (simple majority). The issue raised by minority lenders is whether certain aspects of the transaction require all lenders’ consent.

Uptier Transactions/Pro Rata Sharing Clauses

Minority lenders have argued that uptier transactions violate the pro rata sharing provisions of the credit agreement

- Fundamental rule of debt agreements is that payments in respect of outstanding obligations be shared ratably among applicable debtholders
  - Typically any modification of such rule would require the consent of a lender who would not be receiving its pro rata share
- Evolution in credit agreement / indenture technology has opened avenues for non-pro rata pay-downs
  1) Side car debt facilities, incrementals and refinancing facilities
     - All typically require that any "new" debt be *pari passu* or junior in right of payment and security and that all mandatory payments are shared at least ratably
  2) **Debt buybacks** – Borrower repurchases its loan from a holder typically at a discount (and loan is immediately and automatically cancelled)
     - **Dutch auctions** – Require auction process which typically requires ratable offer to all applicable debt holders (and that all holders which wish to participate may do so on a ratable basis)
     - **Open market purchases** – Transaction where borrower repurchases its debt from one or more individual debt holders on the "open market" (not a defined term)
     - Debt buybacks are typically subject to very few conditions (e.g., no default or Event of Default and may not use RCF) and those conditions can be modified by required lenders

Uptier Transactions/Pro Rata Sharing Clauses and Open Market Purchases

Open market purchases offer a key avenue to achieving a non-pro rata payment to a friendly lender

- Borrower may use proceeds from a “new” facility in order to buy back loans of a friendly lender (and such payment is only required to be made to that friendly lender)

In structuring an uptier transaction, Borrower could work with consenting lenders to:

- Amend loan documentation to permit incurrence of additional debt and/or liens provided by friendly lenders
- Incur new debt and concurrently use proceeds to buy back debt of friendly lenders thereby exchanging such lenders’ existing debt for new debt on better terms

Once the debt is repurchased, friendly lenders no longer have a vote under “existing” credit agreement and so they may elect to remove lender protections that could bring the borrower back to the table with lenders left behind

Uptier transactions - Serta

Serta overview (Part I):

- In June 2020, Serta entered into amendments to its existing credit facilities and also into a new credit facility using existing "incremental equivalent debt" capacity
- The incremental equivalent debt was issued in exchange for certain existing first lien and second lien loans and a subordination agreement was entered into contractually subordinating the existing first lien and second lien loans to such incremental equivalent debt (and some potential other debt)
- The opportunity to participate in the new facility was limited to certain lenders constituting Required Lenders.
- Minority lenders filed suit and requested injunctive relief, claiming, among other things:
  - Subordinating the existing term loans was effectively "a release of all or substantially all" of the value of the collateral as it was rendered worthless
  - Allowing certain lenders to participate in this transaction but not others violated the pro rata sharing provisions of the credit agreement
  - the transaction violates the implied covenant of good faith and fair dealing
- After initially being granted a TRO, in June 2020 the trial court denied the minority lenders' request for a preliminary injunction, finding that the minority lenders had failed to establish a likelihood of success on the merits and failed to establish irreparable harm as money damages are available

Uptier Transactions - Trimark

Trimark overview

- In September 2020, TriMark consummated a similar non-pro rata recapitalization executed with a majority of first lien term lenders but not offered to other lenders
- The transaction amended a number of provisions in the existing loan documents to permit:
  - a $120 million new-money superpriority “first out” term credit facility that ranked ahead of the existing first lien term loan, and
  - $307 million superpriority “second out” term notes that ranked ahead of the existing first lien term loan but behind the aforementioned “first out” loan
- Both “super senior” tranches were secured by the same collateral that secured the existing first lien debt
- Company and participating lenders effectuated the roll-up via the open market purchases provision

Uptier Transactions - Trimark

- The result of these transactions was to effectively subordinate the previously first lien debt of the non-participating lenders to the new priming facility and $307 million of previously first lien debt held by the participating lenders
- Company and participating lenders also stripped out all covenants from the existing credit facility, including information rights, and strengthened the collective action provision
- In August 2021, the **NY Supreme Court allowed the plaintiffs breach of contract claims to proceed** but dismissed the implied covenant of good faith claims
- In January 2022, the parties settled the matter, publicly noting that the settlement includes "an exchange of all outstanding First Lien Term Debt on a dollar-for-dollar basis for Tranche B Loans pursuant to the company's Super Senior Credit Agreement. Tranche A Loans outstanding under the Company's Super Senior Credit Agreement will retain their position in the Company's capital structure, senior to the Tranche B Loans."

Uptier Transactions – Serta revisited

Serta – Following consummation of the uptier transaction, plaintiff minority lenders sued in May 2021.

- Certain minority lenders sued Serta in SDNY. In March 2022, **the court denied Serta's motion to dismiss**
- The court rejected Serta's argument that the uptier exchange was clearly permitted as an "open market purchase" finding the term to be sufficiently ambiguous for the contract claim to survive dismissal
- The court also allowed the implied covenant of good faith and fair dealing claims to proceed, noting that while the law precludes a party from simultaneously recovering for both a breach of the implied covenant good faith and for a breach of contract, in this matter the plaintiffs asserted its theory of the breach of good faith in the alternative, which was permissible

Uptier Transactions - Boardriders

Boardriders overview.

- In April 2018, Boardriders borrowed $450 million of term loans, with $440 million outstanding as of August 2020
- In August 2020 Boardriders secretly entered into a non-pro rata recapitalization transaction with a simple majority of lenders providing $135 million of new money alongside a “rollup” of $332 million of existing debt with a newly appointed administrative agent
  - The transaction also amended the Credit Agreement to (1) allow for issuance of new superpriority debt and (2) eliminate most of the affirmative and negative covenants
- The rollup was in reality a new senior loan, the proceeds of which were used to buy back existing first lien debt via “open market” purchases on a non pro rata basis (and exchanging the new debt obligations for the old ones)
- Notably, this transaction was not offered to all lenders

Uptier Transactions - Boardriders

- Minority lenders sued in October 2020 arguing, among other things:
  - The debt-for-debt exchange did not constitute an “open market purchase”
    - No established market made by one or more third-party broker dealers
    - No competition among the market participants (i.e., the lenders) determines price
    - Company did not retire purchased debt
    - Par purchase price far exceeded market price of 50-60% trading value
    - Purchase was not standalone transaction but part of integrated restructuring
  - Exchange was voluntary prepayment that violated the credit agreement’s pro rata sharing provisions
- In November 2022, the court **denied the motion to dismiss**:
  - The court rejected a narrow reading of the sacred rights provisions (notwithstanding that the absence of an express “no subordination” sacred right) as it would “essentially vitiate the equal repayment provisions” of the Credit Agreement and be “contrary to the court’s obligation to consider the context of the entire contract and not in insolation [sic] of particular words – or in this case, the absence of particular words”. As a result, the court viewed the uptier transaction, in the context of the entirety of the Credit Agreement, as potentially violating the intent of the parties.
  - The court also found that the term “open market purchase”, undefined in the Credit Agreement, was susceptible to more than one meaning and therefore ambiguous.

Uptier Transactions – Serta Revisited

Serta (Again)

Non-participating lenders re-file their litigation claims against Serta and the participating lenders in NY court. This is the same set of lenders who did not win a preliminary injunction in 2020 (but a different set from those who filed in SDNY and survived a motion to dismiss in 2022).

- Same judge as preliminary injunction; also same judge as Boardriders decision

Serta filed for bankruptcy January 2023 in Texas

- In February 2023, the bankruptcy judge asked Serta to submit a request for a stay, saying he was considering a temporary 60-day stay to allow all the parties to brief him on the lender disputes.

Uptier Transactions – Mitigating Serta

1. **Add Subordination as Sacred Right**
   - Sample Language: "(i) subordinate any Obligations to any other Indebtedness or (ii) subordinate any liens securing any Obligations to any liens securing any other Indebtedness, in each case, without the consent of each Lender adversely affected thereby"
   - Negotiated exceptions and/or limitations:
     - Excludes DIP financings
     - Excludes debt permitted to be senior under the loan documents as in effect on the closing date
     - Excludes any transaction for which each lender is offered an opportunity to participate pro rata
   - Note that this would not prevent a transaction resulting in structural subordination (e.g. drop-down transaction contributing assets to a non-guarantor for purposes of obtaining new debt)

2. **Eliminate open market purchases**: Limit borrower buybacks to Dutch auctions only and add this limitation as a sacred right
   - This has been rare, and generally in the direct lending space

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Questions?