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Liability Management Tools

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The debtor creditor relationship can be simple or complicated, friendly or adversarial, profitable or costly, all depending on the circumstances. The debtor wants to obtain financing on economical terms while being able to have the flexibility to operate its business and deal with changing environments without having to go back to its creditors to ask for permission to execute on business decisions. The creditor wants to clip its coupon, eventually be repaid its full principal and, in the interim, ensure that the debtor will not take steps to make full payment less likely.

Creditors have traditionally used negative covenants as a means of ensuring that the debtor would not take any actions which would negatively impact the creditors' ability to fully recover on their investment. Historically, debtors were comfortable, to varying degrees, agreeing to live with broad restrictions. Relationships were the key to that comfort. So long as the debtor believed its creditors were partners who would consent to actions which made commercial sense for their business and would not impose their own judgment over those of management or extract costly fees debtors were willing to live without covenant exceptions for every possible eventuality. The evolution of the credit market from one of relationships to a liquid market where a debtor's debt is freely transferred across a broad creditor syndicate has changed that dynamic. A debtor can no longer easily obtain permission from its creditors without cost. As a result, debtors, particularly those backed by private equity firms, became highly focused on legislating out broad covenant exceptions to allow them to operate and implement strategic plans, whether contemplated in advance or not, without needing permission from their creditors. Recent years have shown that certain covenant exceptions can provide useful new tools for debtors to execute on liability management transactions even absent lender cooperation.

There is no one size fits all solution for liability management, as each debtor's circumstances and needs are unique. The tools range from a basic "kick the can down the road" approach, to shifting the nature of the capital structure, to the secretion of assets out of the credit group entirely in order to achieve a variety of outcomes.

In a transaction to "kick the can down the road," the debtor will either approach its existing creditors asking them to agree to extend their maturities and/or seek out a new group of creditors to provide it with longer-dated debt to repay the existing debt. Depending on the debtor's financial performance, it can often find that such a transaction saddles it with a higher cost of capital. Additionally, the debtor will need unanimous (or, in some limited cases, near unanimous) support from its existing creditors in order to push out the maturity, providing potential holdouts with significant leverage if the debtor does not have an alternative path.

This paradigm of a leverage imbalace drives debtors and their advisors to seek out alternative paths to provide them with optionality and leverage in managing their balance sheets, taking advantage of often significant covenant flexibility in today's market. The breadth of optionality in an out of court transaction will be dictated by what is permitted by the particular existing debt agreements which a debtor may be looking to structure the transaction around. As we have seen in numerous recent examples such as PetSmart, Neiman Marcus and iHeart, even if the transaction appears to comply with the debt agreements, creditors will seek to find a path to block any transaction which they perceive as impairing their potential recovery. So debtors and their advisors should ensure that all conditions to a transaction have been complied with.

A tightening of liquidity may also drive a debtor to execute a liability management transaction. In such a situation, a creditor providing new liquidity will look to put itself in the best position for recovery if a debtor's financial condition continues to deteriorate. Both for liquidity, as well as to find leverage in an extension negotiation, there are a variety of tools that may be available if the covenants permit.

(1) Receivables Financing – Many financing agreements include exceptions allowing for receivables financing, whether off balance sheet or on balance sheet. This allows a liquidity provider to be secured on a senior basis by the most liquid assets of the debtor. Creative debtors might also consider utilizing these exceptions for term debt as part of an extension transaction.

(2) Priming Transaction – The debtor offers unencumbered assets as collateral to secure a liquidity facility or an extension facility. These can be assets of the credit group which can be removed from the group or could be assets of a non-guarantor subsidiary. This may now become particularly useful with the proposed rule changes for Section 956 of the Tax Code which had previously proved an impediment to foreign credit support for U.S. debtors.

(3) Unrestricted Subsidiaries – In this variation of a priming transaction a debtor moves assets into an unrestricted subsidiary and then raises debt at that level for liquidity or to retire junior debt. This can provide a workaround for debt, liens and restricted payments limitations. The downside of this for a debtor would be the need to operate at an arm's-length basis with the unrestricted subsidiary. The J. Crew IP transfer is an example of such a transaction.

    Another use of unrestricted subsidiaries is to pre-position or hive off certain assets from the collateral package. There may be no immediate

liability management transaction but a debtor might strategically pre-position value while a ratio or other test can be satisfied to preserve future optionality. An example of this appears to be a transaction by PetSmart, where they transferred ~36.5% of the equity of their online unit Chewey.com, in part to a parent company and in part to an unrestricted subsidiary, resulting in Chewey.com being removed from the credit group. That transaction is currently the subject of litigation over whether relevant ratio test was satisfied given how tight it was.

These unrestricted subsidiary transactions draw the most ire from creditors and are often litigated.

(4) Up-Tiering – The debtor offers existing creditors the option to exchange their existing debt for debt that has a more senior position in the capital structure, usually by providing a security to creditors who did not previously have security or more senior security to investors who already had some security. Such a transaction can incentivize creditors to participate to avoid being left behind with priming debt. If the transaction results in a creditor constituency being leap frogged or diluted that constituency might seek to challenge the transaction, as the lenders did in Cummulus. In such a transaction, a debtor might also seek to reduce its debt load in exchange for granting creditors a more senior position by having such creditors exchange for a lower principal amount than they currently hold.

(5) Debt Repurchases – Another tool, which is employed more opportunistically by debtors, is to repurchase debt in the open market when it is trading at a discount to par. This can help reduce the debt load and cash interest expense, and in certain circumstances may provide other utility. For example, iHeart used its holding of its debt to avoid a springing lien which would have been triggered if the aggregate principal amount of its outstanding bonds fell below a trigger amount. Avoiding the springing lien provided iHeart with additional tools for its negotiations with its creditors.

Since many of these tools offer the possibility of disadvantaging one constituency to the benefit of another and in light of the trend for creditors to litigate debtors should not be surprised if aggrieved constituencies seek to litigate. To protect themselves, debtors should ensure that their transactions strictly comply with the relevant terms of the debt agreements, including in the case of financial calculations possibly obtaining the view of an independent financial advisor and/or directors. A proper, and properly documented, board process is also of high importance.

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