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Liability Management Transactions (Part II): Drop-down Transactions

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As we discussed on Part I of this series, liability management transactions have become commonplace in the restructuring arena.[1] Both "uptier" and "drop-down" transactions are often viewed as viable options for distressed borrowers. Here in Part II, we address drop-down transactions and some representative cases where a borrower's ability to implement a drop-down has been tested.

Drop-down Transactions

In a drop-down transaction, a borrower utilizes basket capacity under existing investment and restricted payment covenants to transfer collateral away from the restricted entities to an "unrestricted subsidiary." Being unrestricted, the subsidiary is typically not required to be a guarantor (and, accordingly, does not pledge its assets as collateral), nor is it subject to the covenants in the financing agreements. Thus, the unrestricted subsidiary is often free to issue new debt, which is then secured by the newly transferred assets.

Unlike uptier transactions, drop-down liability management transactions do not necessarily require the consent of the majority creditors, although subsequent ratification of the transaction is often sought and obtained from participating majority creditors to avoid litigation. Recent drop-down transactions highlight how many borrowers and sponsors perceive financing agreements to be extremely flexible, providing ample room to undertake these transactions.[2]

The chart below explains how drop-down transactions are typically structured:

Facility:	Borrower is party to a financing agreement, which includes capacity to invest in unrestricted subsidiaries.
Transfers:	Borrower identifies investment/restricted payment basket capacity, and assets that are severable from the restricted asset group (e.g., intellectual property) and transfers such assets to an unrestricted subsidiary in reliance on the relevant baskets.
Unrestricted Subsidiary:	Once the assets are transferred to the unrestricted subsidiary, the borrower has flexibility on what to do with the transferred assets. Commonly, the unrestricted subsidiary is not a guarantor under the financing agreement, and it may incur new structurally senior debt secured by the recently transferred assets to fund the borrower's continued operations. The

[1] In Part I of this series, we discussed uptier liability management transactions and recent rulings in the NYDJ, TriMark, Serta and Boardriders cases. Available at: https://www.dechert.com/knowledge/onpoint/2022/11/liability-management-transactions-part-1.html

[2] A recent study that examined more than 600 syndicated term loans has concluded that contractual "blockers" to limit a borrowers' ability to implement drop-down transactions have not been generally adapted by the market. "Contracts could adjust to prevent dropdowns but did not." Buccola, Vincent S.J. and Nini, Gregory, *The Loan Market Response to Dropdown and Uptier Transactions* (June 22, 2022) at 41-42. Available at SSRN: https://ssrn.com/abstract=4143928 or http://dx.doi.org/10.2139/ssrn.4143928

	new structurally senior debt is often provided by existing creditors, the sponsor or third parties. Alternatively, the unrestricted subsidiary could dividend the assets to the sponsor.
New Senior Debt:	Borrower may offer some or all of the existing lenders (often just the majority lenders) the ability to exchange existing debt for new debt of the unrestricted subsidiary, which is now structurally senior to the existing debt and the only debt secured by the assets of the unrestricted subsidiary.
Aftermath	Borrower often uses the transaction to obtain an infusion of liquidity and extend its runway. Majority creditors may use the transaction to reduce the number of creditors who will have recourse to the assets dropped down, thus eliminating the dilutive impact the minority creditors would have on their recoveries.

Representative Drop-Down Transactions and Related Litigation

As with uptier transactions, these types of out-of-court transactions often lead to litigation by creditors left behind at entities with a diminished collateral package. These creditors may claim that the transfer of assets from a restricted subsidiary to an unrestricted subsidiary is an actual or constructive fraudulent transfer, a breach of the financing agreement, or a violation of the implied covenant of good faith and fair dealing. In addition, these litigations often involve disputes on whether the investment baskets were appropriately utilized, and whether the value of the assets transferred fall within such baskets. To date, only a handful of court decisions have addressed the issues involved in drop-down transactions, and we have summarized a few of them below.

iHeart

In 2015, iHeart noticed that its public debt was trading at a significant discount and sought to implement a repurchase strategy. iHeart had approximately US$6 billion in debt under five indentures which limited its ability to directly repurchase its debt. In December 2015, iHeart directed one of its restricted subsidiaries to transfer shares of another subsidiary (worth approximately US$516 million) to Broader Media, an unrestricted subsidiary, which would then use this capital contribution to fund the debt repurchase. The stock transfer was characterized as an "investment" made in reliance on the "Permitted Investment" basket under iHeart's indentures and based on Broader Media's ability, as an unrestricted subsidiary, to freely use the capital to repurchase iHeart's debt.

In March 2016, holders of certain of the iHeart's priority guarantee notes issued notices of default alleging that the stock transfer to an unrestricted subsidiary was not a "Permitted Investment" under the indentures. In response, iHeart brought suit in Texas state court seeking a declaratory judgment that the stock transfer did not violate the indentures. The Texas state court ruled in favor of iHeart, holding that the transfer qualified as a "Permitted Investment" under the indenture. The noteholders appealed, and the Texas appellate court affirmed.[3] The appellate court ruling turned on whether a profit motive was required to utilize an investment basket under the indenture. After analyzing a number of dictionary definitions for the term "investment," the court found that the term does not necessarily require a profit motive, and resolved the case in iHeart's favor.

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3 *Franklin Advisers, Inc. v. iHeart Commc'ns Inc.*, No. 04-16-00532-CV, 2017 WL 4518297 (Tex. App. Oct. 11, 2017).

J. Crew

While J. Crew was not the first company to implement a drop-down transaction, it is likely the most renowned, even to the point the verb "J-Crewed" has been used to refer to lenders being subordinated by their borrowers.

In late 2016, in reliance on certain investment baskets, J. Crew transferred 72% of certain intellectual property ("IP") assets (a significant source of value that previously served as collateral for the term loan) to an unrestricted subsidiary. The unrestricted subsidiary then guaranteed and pledged its assets to secure the issuance of new secured notes. J. Crew valued the transferred IP at US$250 million, an amount far less than the amount alleged by the lenders but nearly identical to J. Crew's investment capacity under the "Permitted Investment" baskets.

J. Crew then executed a debt-for-debt exchange in which its existing unsecured notes were exchanged for both new senior secured notes (i.e., existing unsecured notes were effectively refinanced using collateral previously securing the term loan), and preferred and common equity.

Ahead of the issuance of notices of default by the term loan lenders, J. Crew filed a complaint against the lenders' administrative and collateral agent in New York state court, seeking a declaration that the transfer of the IP assets was permitted by the term loan agreement and that no default or event of default had occurred as a result of the transaction. The agent asserted counterclaims challenging the validity of the transactions. To settle the litigation, J. Crew agreed to pay-down a portion of the term loan. Following settlement discussions, 88% of the term loan lenders agreed to formally consent to the transaction (ratifying the transfer); however, certain minority lenders objected and sued in New York state court.[4]

The New York court dismissed most of the minority lenders' claims given the consent provided by the majority. Significantly, a claim that the IP transfer was, in fact, a transfer of "substantially all" of the collateral requiring unanimous lender consent, survived. Ultimately, however, this litigation was resolved as part of J. Crew's chapter 11 case, albeit without of any incremental recovery to the objecting minority lenders.

Neiman Marcus

In March 2017, Neiman Marcus disclosed that it had changed the designation of certain subsidiaries holding the valuable MyTheresa assets and certain real estate, from non-guarantor "restricted subsidiaries," subject to the restrictive covenants contained in the various funded debt agreements, to non-guarantor "unrestricted subsidiaries," which were not. For eighteen months, Neiman did nothing and the newly created unrestricted subsidiaries continued to indirectly provide credit support to the company's funded debt obligations. That changed, however, in September 2018 when Neiman Marcus disclosed that the MyTheresa subsidiaries had been conveyed through a series of distributions to an intermediate holdco wholly-owned by the sponsor, which was not, itself, an obligor on the funded debt.

While the transfer of the MyTheresa subsidiaries to the sponsor's wholly-owned subsidiary gave rise to a fraudulent transfer claim, as Neiman Marcus was likely insolvent and did not receive any consideration for the distribution, Neiman Marcus insisted that the financing agreements expressly permitted it to designate entities as unrestricted subsidiaries as well as to distribute interests in unrestricted subsidiaries. After numerous rounds of settlement discussions (both prior to and during the subsequent bankruptcy case), the sponsor, Neiman Marcus and the various

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[4] *J. Crew Group, Inc., et al. v. Wilmington Savings Fund Society,* Index No. 650574/2017 (N.Y. Sup. Ct.) (2017).

stakeholders settled the fraudulent transfer and other claims; however, the vast majority of the MyTheresa value was ultimately stripped away from the creditors for the benefit of the sponsor.

Revlon

In 2016, Revlon entered into a US$1.8 billion term loan facility that allowed for the issuance of revolving loans. In 2020, Revlon sought the support of the majority term loan lenders under the 2016 facility to support an amendment that would allow the transfer of certain collateral, including valuable IP, to an unrestricted subsidiary. Several of the term loan lenders supported the transfer, but the majority did not and signed a cooperation agreement binding the majority lenders to oppose the amendment. However, Revlon issued US$65 million of new revolving loans to the supporting lenders, which purportedly enabled them to become majority. This was because the newly issued revolving loan voted in the same class as the term loans.

Upon obtaining the support of the alleged new majority lenders, Revlon transferred the IP to an unrestricted subsidiary and entered into new credit facilities secured by, among other things, the valuable IP. In addition to exchanging the supporting lenders' loans into the new credit facilities, proceeds from the new term loan were quickly used to fully repay the revolver. Thereafter, Revlon filed for bankruptcy in June 2022.

The non-supporting lenders characterized the revolver as a "sham," as it was used solely to obtain consent to the amendments, and, thus, did not serve a legitimate business purpose. These lenders have recently filed an adversary complaint in Revlon's bankruptcy case against Revlon and the supporting lenders, which seeks to void both the 2020 amendment and the liens that were placed on the IP under the new credit facilities. On December 5, 2022, Revlon and the other defendants filed motions to dismiss the adversary complaint asserting, among other things, that the transaction was explicitly permitted by Revlon's financing agreements and that the plaintiffs lack standing to prosecute these causes of action in bankruptcy. The outcome of this dispute remains unsettled, and any future ruling/settlement will likely impact the use of revolvers to manufacture majority consent.

Conclusion

In some instances, the loan market has reacted to the use of drop-down transactions, by limiting a borrower's ability to transfer certain types of assets (e.g., IP) into unrestricted subsidiaries, or blocking the ability to create or designate unrestricted subsidiaries at all. However, most current loan documents still afford a great deal of flexibility that allow for drop-down liability management transactions.

It is imperative that lenders and bondholders understand these transactions and the risks they face when entering into financing transactions. A proper covenant analysis and in-depth review of baskets and flexibility provided by financing agreements is key to any debt transaction. Questions as to whether these transactions are truly contractual violations, breaches of the implied covenant of good faith and fair dealing or fraudulent transfers remain unsettled. However, liability management transactions that combine an opportunistic creditor with a distressed borrower focused on extending its runway are not going away anytime soon.

Please do not hesitate to contact any of the authors or your regular Dechert contact if you have questions.

Dechert takes no position on whether investment or restricted payment baskets are proper to structure drop-down liability management transactions. The information contained herein is intended only as a summary of the issues and cases identified and does not include all legal or factual arguments that may be asserted in connection with a given position.

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