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CLOs: Adding Flexibility to Engage in Liability Management Transactions

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When the supply of capital outweighs demand, as has occurred recently, borrowers have leverage to help them set favourable debt terms. Additionally, fewer arrangers hold loans for their own account than in the past, and therefore they have less of a direct interest in credit document negotiations. As a result, credit terms have loosened over time, allowing distressed borrowers to raise capital on company-friendly terms.

These transactions, commonly referred to as liability management transactions, have often taken the form of “uptiering” financings and “drop down” financings. Although borrowers have engaged in these types of transactions for some time, they have occurred with greater frequency in recent years. This trend may accelerate as economies cool in the face of higher interest rates, inflationary pressures and other headwinds.

CLOs typically require flexibility to participate in (or challenge) liability management and other restructuring transactions to maximize recoveries and preserve the value of their loan positions. This *Alert* describes these transactions, recent challenges and how CLOs have added flexibility in their terms to allow for participation in liability management transactions.

Uptiering Financings

In an “uptiering” transaction, certain existing lenders to the borrower provide the same borrower with a new senior facility which ranks senior to the existing facility. The new facility frequently consists of an exchange of at least a portion of the debt under the existing facility for debt under the new facility, with an additional loan of new money.

Parties often accomplish these transactions through amendments to the applicable debt and lien baskets under the existing credit documentation with the support of majority lenders only, and without any notice to the minority lenders or any ability for them to participate. Due to the nature of these deals, uptiering transactions have resulted in a wave of litigation from excluded minority lenders.

Minority lenders challenging uptiering transactions have argued primarily that the transaction violates their "sacred rights" under the applicable credit agreement as a form of non-*pro rata* sharing and an effective waterfall amendment and collateral release (being amendments that would typically require the consent of all lenders). Minority lenders have also argued that these transactions breach the implied covenant of good faith and fair dealing and results from tortious interference with the existing facility.

In response, borrowers and majority lenders have argued that a strict read of the applicable credit documents permits these transactions. Borrowers and majority lenders have often relied on a common exception to most *pro rata* sharing provisions that accommodates Dutch auctions and "open market" purchases.

Borrowers and majority lenders have also drawn a distinction between lien release (which generally requires consent of all lenders for substantially all the collateral) and lien subordination (which may have the effect of lien release but may not technically require a 100 percent vote under the credit agreement). They have further commonly structured uptiering transactions such that the subordination of the existing facility is accomplished pursuant to an intercreditor agreement (which generally does not require a 100 percent vote) as opposed to amendments to the application of proceeds section in the existing credit agreement (which generally requires the consent of all lenders).

Of five recent (and more robust) opinions issued on this topic, three (*Murray Energy, Serta* and *TPC*) have more strictly interpreted the terms of the applicable loan documents, distinguishing between lien subordination on the one hand and collateral release and/or waterfall amendments on the other. The remaining two (*Trimark* and *Boardriders*) have allowed the plaintiffs' claims to proceed. In contrast, courts have generally allowed claims that uptiering transactions do not fall within Dutch auction and open market purchase *pro rata* sharing exceptions contained in credit agreements to proceed to trial (*Murray Energy, Serta*, *Trimark* and *Boardriders*). Two of those cases, however, have since settled (*Murray Energy* and *Trimark*).

Although court decisions on uptiering transactions have varied, there are a few key takeaways:

- To date there has been little guidance on the applicability of the "open market purchase" exception to *pro rata* sharing protections. The exception is a relatively common one and as such the issue is likely to be the subject of further litigation.

- Lenders should keep in mind that judicial guidance has not been uniform regarding the scope of waterfall rights and protections; as a result, it is unclear whether any given court will adhere strictly to the agreement's language or take a more holistic approach. Consequently, when reviewing or negotiating credit agreements, prospective lenders should focus on the level of voting that is needed to subordinate liens, amend waterfall and pro rata sharing provisions, and whether the credit agreement provides for "open market purchase" and other exceptions to *pro rat*a sharing.

- Credit agreements that expressly require affected lender consent (including for entry into any new intercreditor agreement) to subordinate liens and rights to receive payment and do not contain or limit "open market purchase" provisions likely best protect minority lender rights.

Drop Down Financings

Drop-down transactions involve the transfer of assets from inside to outside an existing security package to collateralize new structurally senior financing. Borrowers can combine drop-downs with a non-*pro rata* partial roll up of existing loans relying on the open market purchase exceptions discussed above to maximize liquidity. Notable drop down transactions include *J.Crew, PetSmart, Neiman Marcus, Travelport* and *Envision Health*.

In a typical drop down transaction, the borrower will first form or designate an unrestricted subsidiary. Next it will stack covenant baskets to sell, contribute or transfer assets to the unrestricted subsidiary causing a release of the liens of the existing lenders on the assets. Then, the unrestricted subsidiary will incur new financing that is secured by a first priority lien on the transferred assets such that it is structurally senior to the existing debt. Litigation may then ensue typically focused on the value of the assets transferred and whether there was sufficient basket capacity under the existing credit agreement to accomplish the transfers.

To reduce the possibility of drop-down transactions, lenders should take a close look at and try to limit provisions that permit leakage, such as investment baskets that allow loan obligors to invest in non-loan party restricted subsidiaries and "trap doors" that then permit those non-loan party restricted subsidiaries to invest in unrestricted subsidiaries, essentially converting investment capacity into restricted payment capacity. Recently some counter-provisions have emerged, such as increasing restrictions on the transfer of specified material assets (often Intellectual Property), closing investment loopholes and providing greater limitations on the actions of, and transactions with, unrestricted subsidiaries and other non-loan parties.

CLOs' Treatment of Uptiering and Drop Down Transactions

These issues affect CLOs that are members of loan syndicates in two ways: First, can CLOs invest in uptiering and/or drop-down transactions or subsequent restructuring paper; and second, can CLOs bring a claim if they are part of a minority group of lenders that suffer from subordination and a reduction in value. The terms of the CLO documentation are crucial to any investment, as the terms will have to allow for sufficient flexibility to participate. If a CLO proposes to challenge a liability management transaction, then the terms of the underlying collateral loan documentation and the applicability of the court decisions discussed above will be most pertinent.

Relatively recent additions to CLO documentation have addressed liability management transactions in various ways, including by adding Collateral Enhancement Obligations, Bankruptcy Exchanges, Corporate Rescue Loans, Restructured Obligations and Loss Mitigation Obligations.

More recently, CLO documents have addressed uptiering transactions. Typically, if a borrower takes out new money financing which is senior to the original debt, or current creditors of the borrower have the option to exchange their existing debt for new senior debt, then the CLO should be able to participate in this new financing or exchange. The CLO will treat the new asset as a performing asset if it satisfies the eligibility criteria, subject to certain carveouts -- for example for rating and maturity date requirements, and concentration limits. This "Uptier Priming Debt" concept overlaps somewhat with other distressed debt concepts used in CLOs. Therefore, CLOs should take care as to the treatment and demarcation of this debt within the CLO documentation as it potentially falls within more than one definition with different resulting consequences.

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