Liability Management Exercises - Managing Litigation Risks in Financing for Distressed Borrowers

I. What Are LMEs And Why Are They Deployed?

In the world of corporate finance, it is said that markets have no memory. Not long after the 2007-2008 credit crunch and ensuing global financial crisis, borrowers regained significant bargaining power over the lending community. Apart from ultra-low interest rates, borrowers began retaining substantial flexibility in their loan agreements with fewer covenants against additional borrowing and for amending covenants that may otherwise restrict such borrowing. At the same time, as traditional money-center banks retrenched from leveraged lending, alternative providers of debt capital filled the void and created new dynamics. According to McKinsey, the size of private credit as an asset class is ten times larger than it was in 2009.[1] A new generation of direct lending institutions, with their own attitudes towards what is customary and appropriate behavior has accordingly arrived on the scene. The confluence of all these factors has created opportunities for borrowers, typically (although by no means exclusively) private-equity sponsored portfolio companies, to engage in efforts to manage liquidity ("liability management exercises" or "LMEs") by modifying their capital structure when industry or macroeconomic headwinds arise. Some have referred to such maneuvers as engendering "creditor on creditor violence," while others have observed that markets will continually change and react to new environments.

LMEs seek to take advantage of the relative lack of restrictions and flexibility in obtaining amendments found in recent vintage debt documents (as compared with loans taken when credit markets were tighter). Take a simple example: A company with a strong brand name seeks to raise additional debt capital but has already pledged substantially all of its assets to a syndicate of lenders. The debt documents, however, provide that they can be amended with consent of a majority of lenders. The company negotiates with 50.1% of the lenders and obtains their consent to release the intellectual property from the existing collateral; at the same time, these lenders agree to exchange their existing loans for new loans secured by the intellectual property along with the new additional loans the company wants. Thus, following the new loans, the majority lenders will have effectively retained their senior position with respect to the company's assets, the company will have received the additional capital, and the 49.9% of the lenders who were left behind will be left without the value intellectual property collateral. The company will assert that all creditors benefited from the additional capital, but the left-behind lenders will point out that in the event the company stumbles, they will be the ones holding the bag without the benefit of valuable collateral they originally bargained for.

The simple example above is not new. In fact, it is taken from a financing done in 2017 by the retail clothing company J. Crew Group, Inc. This transaction staved off an impending default from an upcoming loan maturity and obtained additional runway for the company although it later filed for bankruptcy in 2020. Similar financing techniques have been used by *iHeart Media*, *Revlon*, and *Neiman Marcus*, with varying degrees of success. As expected, all these transactions spawned litigation between the have-nots (the lenders who lost their collateral), the haves (the lenders who facilitated the transactions), and the company (along with its private equity sponsor, if any).

The J. Crew example is commonly known in leveraged finance as a "dropdown" or "unsub" (unrestricted subsidiary) transaction because assets owned by a borrower or guarantor are contributed to a newly formed subsidiary that is not restricted by the loan agreement. There are several variants on the theme

[1] McKinsey & Co., *The Next Era of Private Credit* (Sept. 24, 2024), available at The next era of private credit | McKinsey.

of borrowers attempting to take advantage of perceived flexibility in their credit documents. Others include "uptiers" (when the consenting lenders whose votes are provided to support a company's requested amendment exchange their old loans for new more-senior loans, ranking ahead of the lenders left behind in their tranche). Uptiers prominently featured in several litigated recapitalization transactions, including those done by *TriMark, Boardriders*, *Serta Simmons*, *TPC Group, Mitel, Envision Healthcare, Wesco Aircraft*, and *Robertshaw* (several such companies later filed for bankruptcy with differing litigation outcomes and are subject to ongoing appeals). Other recent examples of litigation arising from LMEs include *Bombardier* and *EchoStar/DISH* which are currently pending. These techniques are now ubiquitous in the United States and are also gaining traction in Europe. This note discusses the lessons learned from U.S. litigation over LMEs.

II. What Types Of Litigation Arise From LMEs?

Types Of Claims. Even if a company thinks it is complying with its legal and contractual obligations and follows a deliberative execution process, any liability management transaction that disadvantages lenders (or a subset of lenders) carries a risk of litigation. The types of claims arising from liability management transactions asserted against companies, participating lenders, boards of directors, and private equity sponsors commonly include:

- Breach Of Contract – The company violated one or more provisions of the relevant debt documents by engaging in the transaction. This risks the company having an immediate event of default and acceleration if the default is not cured, or potentially rescission of the LME if parties can be restored to the status quo.
- Breach Of The Implied Covenant of Good Faith and Fair Dealing – By privileging certain lenders over others, or by depriving lenders of the benefit of their bargain (*e.g.*, their recourse to collateral or their right to be treated ratably with other lenders from the same tranche), the company violated the covenant of good faith and fair dealing implied in every contract.
- Tortious Interference With Contract – The participating lenders induced the company to breach its contract with non-participating lenders and are therefore liable for the resulting harm.
- Unjust Enrichment – The participating lenders were improperly enriched at the non-participating lenders' expense.
- Intentional Fraudulent Transfer – The company diverted assets with the actual intent to hinder, delay, or defraud its creditors.
- Constructive Fraudulent Transfer – The company transferred assets or incurred obligations and (i) received less than reasonably equivalent value in exchange for the assets transferred or obligations incurred and (ii) was insolvent or undercapitalized at the time such transfers were made or obligations were incurred, or was rendered insolvent or undercapitalized as a result of such transfers or obligations.
- Breach Of Fiduciary Duty/Aiding And Abetting – The board members of other decision-makers breached their fiduciary duties to the company by authorizing the LME or by not considering other alternatives. Those who assisted the board aided and abetted the bad decision and should also be held liable.

Some of these claims (*e.g.*, breach of contract, implied covenant, and possibly tortious interference) present questions of law and therefore can be dismissed on the pleadings. Others, however, are more fact-intensive

(*e.g.*, fraudulent transfer) and, as a result, can only be adjudicated with the benefit of discovery, expert testimony, and trial.

Injunctive Relief. If news of a prospective LME leaks, excluded lenders may threaten the collateral agent not to follow any instructions of the company or directing lenders, and may even file suit seeking a temporary restraining order or preliminary injunction to prevent the company from consummating the transaction. Companies concerned about this prospect typically try to minimize the risk of this outcome by adhering to strict confidentiality protocols and creating a detailed record to demonstrate its good-faith need for the transaction. Difficulties in obtaining injunctive relief may include demonstrating that money damages are not an available remedy at law, or a court requiring that a bond be posted to compensate the company in the event the challenge fails and the company is injured by the delay.

Seeking Declaratory Relief vs. Waiting To Be Sued. To remove the cloud over a consummated transaction, some companies have employed a strategy of closing the deal (*i.e.*, obtaining the new funds, moving assets, stripping liens, etc.) and promptly bringing suit against the indenture trustee (or other applicable party) for a judicial declaration that the transaction complied with its debt documents. This approach allows the company choice of the initial venue for litigation, afford control over timing and media messaging, and accelerate possible settlement discussions all of which can be important business considerations.

III. Common Issues In LME Litigation

Prior to launching a liability management transaction companies accordingly undertake a comprehensive assessment of their debt documents and contemporaneous materials, with the aim of maximizing the perceived benefits of any transaction (typically more cash generated from new loans, reduced interest rates, greater covenant flexibility, and extended maturity or "runway") while minimizing risk. At its center, an LME often presents a breach of contract question (although fraudulent transfer issues can also loom, depending on the circumstances). Loan agreements and bond indentures are long, complex documents that courts have no power to rewrite, but rather will interpret them based on their sense of what words of provisions mean in their ordinary usage. Custom and usage evidence can be introduced, if the court finds terms ambiguous, and contemporaneous materials can also be considered by the court (such as offering materials). Many courts have refused to imply terms that are not expressly included in long-form agreements while a minority of others have been less hesitant to outright dismiss implied covenant claims if they are persuaded that an essential part of the debtor-lender relationship has been thwarted by an LME or if they believe hyper-technical readings could undermine that essential bargain even if literally correct. It bears emphasizing that with rare exception judges—even those steeped in commercial law—are not as ready to accept conventions in leveraged finance. Often times corporate finance transaction counsel will see no ambiguity in a phrase because they are accustomed to how it is used or "how it's supposed to work." Such evidence is routinely inadmissible unless the words are ambiguous and, even then, courts may resist invitations to hear from practitioners about what is customary when it comes to the use of language (what is meant by "have the effect") or undefined terms (what constitutes a "redemption" of debt). Increasingly, companies and lenders are consulting litigation counsel who are not participants in the niche leveraged loan market for an independent "plain meaning" read of how debt documents may be interpreted in light of a proposed transaction prior to pulling the trigger.

Consent Thresholds. Almost inevitably, a company's ability to amend its debt documents to accomplish the desired liability management exercise will turn on whether the company had the requisite consent to amend. Loan agreements and indentures typically have either a two-tier or three-tier hierarchy of consents that are required depending on how significant a change to the debtor-lender relationship is deemed to occur. For example, the change to a lender's right to receive principal and interest at a particular rate (coupon) or by a particular time (maturity) cannot be changed without each affected lender's consent. In other words, such an amendment typically has to be unanimous. Such rights are known as "sacred rights" because they are deemed to be the essential elements of the bargain. At the other end of the spectrum, an amendment

to how much additional debt can be incurred is typically subject to receiving majority consent. Some debt documents contain an in-between category for significant changes that fall short of being "sacred" but are not considered routine either. For example, altering the priority waterfall of payment from a collateral pool shared with other creditors may require super-majority (*e.g.*, two-thirds) consent of affected lenders in order to be binding on all creditors in the tranche. Litigation has ensued in different LMEs challenging whether votes counted towards the amendment were proper, including whether the company had already agreed to purchase the debt (or exchange it for another), whether an affiliate's participation in the debt exchange was permitted, whether the company was permitted to issue more debt for the purpose of obtaining the requisite votes, and whether the offer of consideration given to lenders to agree to the amendment needed to be made ratably to all lenders.

No Action Clauses. Indentures and loan agreements typically bar individual noteholders or lenders from bringing suit for anything other than a payment default. Under the collective action provision of such documents, a minimum threshold of debt holders must first instruct the official representative (indenture trustee or agent) to bring breach of contract claims (such as improper amendments or the violation of lesser covenants than the covenant to be paid) and only if the representative fails to do so can a group of creditors bring suit in their own name. Creditors also typically will have to become "registered holders" of the debt before instructing or commencing litigation, and this can be a time-consuming process that needs to be factored into any litigation strategy. In addition, some LME transactions have themselves amended the terms of the prior no-action clause to make bringing suit even more onerous. The enforceability of such amendments is routinely the subject of the disgruntled creditors' challenge. The breadth of no-action clauses can also be relevant to whether creditors (or even the official representative) can sue for fraudulent transfer or other types of claims.

Transfers Of "All Or Substantially All" Assets. If the Company plans to use its permitted investment capacity to transfer assets, it will likely also have to ensure compliance with a covenant proscribing the sale, transfer, or disposition of "all or substantially all" assets. While these provisions paradigmatically apply to prevent a borrower from selling itself to a successor without the successor assuming the liability for the debt, they can be triggered by other types of transactions. Courts have evaluated both quantitative and qualitative factors to determine whether this provision has been breached. The quantitative analysis seeks to examine the value of the assets transferred in relation to the enterprise as a whole and what was left behind for lenders. The qualitative analysis explores the nature of the assets transferred, including whether the assets were fundamental to the company's operating activities, essential for generating revenue, or fundamental to the business, such that their sale effectively changed the nature of the borrower from the lender's perspective.

Process Integrity. When LMEs are challenged, allegations are routinely lodged about the unfairness of the transaction. The volume around those allegations can be significantly influenced by the process employed by the board of directors and the company's advisors. Factors such as the thorough consideration of all available alternatives can shape how courts evaluate the overall fairness of the transaction and that can influence how they rule even on contract interpretation issues. Some examples we have seen include whether the company fully explored the possibilities of obtaining additional equity from an equity sponsor (if any), offering all lenders the opportunity to participate in the financing on a *pro rata* basis, or competing transactions from lenders who are excluded from the LME chosen by the company. If in the course of considering options, there is a conflict of interest with an equity sponsor or even the appearance of a conflict of interest, companies consider appointing one or more independent directors and vesting such directors with the authority to approve or reject the transaction. The independence of decision-makers, and the advice they rely on, will also influence a court's view of the transaction. Depending on the circumstances, companies may consider engaging an independent third party to evaluate the impact of the transaction on any affected entities and assess whether such entities are solvent both before and after giving effect to the transaction; in the event of insolvency, the critical issue is whether the liability management exercise enhances prospects/maximizes value/minimizes cost as opposed to chapter 11 reorganization.

IV. The J. Crew Case Study (Dropdown)

In need of additional capital in 2017, J. Crew transferred its valuable intellectual property to a newly formed subsidiary. That subsidiary was considered "unrestricted," meaning that it was not subject to the terms of J. Crew's credit agreements. As such, J. Crew was free to incur additional indebtedness at that unrestricted subsidiary, which could grant a lien in the transferred intellectual property as security. This provided $300 million of incremental liquidity for the company.

Upon closing the transaction, the company went on the offensive, using both litigation and negotiating leverage to accomplish its business goals of (i) extending near-term maturities, (ii) raising money to pay down certain creditors, (iii) capturing the discount to par amount on the company's indebtedness observed in the trading markets, and (iii) averting the prospect of a near-term bankruptcy. To preempt litigation from lenders over the transaction, J. Crew instituted its own suit against the agent on its term loans, seeking a declaratory judgment that the IP transfer was permitted under its credit agreements and that no event of default had occurred. In this way, J. Crew ensured that litigation over the transaction would occur in the forum of its choice and that it would have the first opportunity to shape the narrative for a court reviewing the transaction. Predictably, the term loan agent filed counterclaims against the company for breach of the relevant term loan agreements and intentional fraudulent transfer.

While the litigation was pending, J. Crew commenced a private offer to exchange certain of the company's unsecured notes at a discount for new notes with a later maturity that would be secured by the transferred IP. Given existing market dynamics, lenders were strongly incentivized to participate in the exchange, and virtually all holders of the notes did so. The company also approached its term loan lenders with a deal whereby, in exchange for dismissing the litigation with prejudice, the company would pay down $150 million of its outstanding term loans at par, agree to increase the interest rate and amortization on the remaining term loans, and agree to tighten certain restrictive covenants in its term loan agreements. Holders of 88% of the outstanding term loans agreed to this deal, resulting in dismissal of the litigation and ratification of the transaction.

J. Crew's liability management transactions enabled the company to delever its balance sheet by approximately $340 million, capture a trading discount on its PIK Notes of approximately $130 million, raise incremental liquidity, and extend its runway by several years. Although J. Crew later filed for Chapter 11 in the wake of the COVID-19 pandemic, the success of its LME transactions a few years earlier provided important lessons worth noting. First, J. Crew's decision to proactively seek a declaratory judgment confirming the permissibility of the transactions created meaningful settlement leverage. By seizing the initiative to explain in plain terms why the liability management transactions complied with its credit documents, the company was able to disparage its term lenders' position as weak rather than wait to be accused of boldly trampling lender rights—something that could have damaged the company's standing in the market. This in turn facilitated a favorable settlement for the company and ratification of the transactions.

In terms of process integrity, J. Crew created a special committee of independent directors at the operating company ("OpCo") that transferred the IP. Those independent directors were given complete discretion over whether to approve the transaction and did so on the ground that the transaction would benefit the enterprise as a whole (including OpCo) by extending J. Crew's runway and raising liquidity. The special committee retained a third-party consultant to provide a solvency opinion. The special committee was then able to rely on that consultant in determining the company was solvent at the time it approved the transactions and its prospects were enhanced. As Quinn Emanuel explained in the report it provided to the independent director established to review the transactions as part of J. Crew's subsequent bankruptcy proceedings, this process integrity substantially undermined any claim that the transaction was an actual or constructive fraudulent transfer.

V. The Incora Case Study (Uptier)

Faced with the possibility of a going concern qualification in the first part of 2022, Wesco Aircraft (nka Incora) sought to raise $250 million in new senior secured notes. Incora was constrained by debt covenants in both its existing secured notes and its unsecured notes. Holders of a majority of bonds in each tranche agreed with the company to amend the existing indentures and facilitate the new borrowing as part of an out-of-court restructuring and recapitalization. The various steps of the transaction involved amending the indentures to permit the issuance of $250 million in pari passu (same rank as the existing secured notes), issuing those notes to holders of the existing majority, and obtaining the consent of those holders (who now held a two-thirds super-majority) to authorize another amendment, this time to release liens and authorize two new tranches of secured debt. To incentivize the super-majority of secured noteholders to provide the capital, they were offered the right to exchange the new capital and their existing bonds into the new super-senior tranche of bonds. To incentivize the requisite majority of unsecured noteholders to agree to the issuance of more secured debt, they were offered the right to exchange into new secured notes, too, junior only to the debt held by the providers of new capital. The equity sponsor was also permitted to participate its unsecured bonds in the exchange, although its vote was not needed and would not count under the terms of the indenture in any event.

Several months after the announcement of the transaction, the minority noteholders who were previously secured noteholders sued and asserted a panoply of claims. While that case was pending, Incora found itself continuing to struggle and filed for Chapter 11 reorganization. The litigation then was renewed before the bankruptcy court.[2] After a long evidentiary trial that concluded in the summer of 2024, the bankruptcy court announced that it is ruling the transaction violated the terms of both of the original indentures. According to the court, the amendment permitting an additional $250 million in pari passu notes could not have been authorized by a simple majority, and instead required two-thirds super-majority, because that amendment "had the effect" of (*i.e.*, caused) the subsequent release of liens. Although the release of liens was covered by a separate indenture amendment, supported by the now-issued $250 million in additional notes, the court found that the way the transaction was orchestrated and consummated required a finding that the consent for the first amendment (authorizing additional notes) was inextricably connected to the second (releasing liens) and therefore it too should have been supported by two-thirds because it "had the effect" of releasing liens.

After finding there was a breach of contract, the court considered the appropriate remedy. The court rejected arguments that the breach resulted in an unsecured claim as an inadequate remedy. While not reaching the issue of fraudulent transfer, the court invalidated the amendments and deemed them not have any effect. The court later elaborated that this meant the additional $250 million of notes would not be considered valid debt for distribution purposes other than potentially on an unsecured unjust enrichment theory. The company has announced it is in the process of formulating a consensual plan to emerge from Chapter 11 with both sides' appellate rights to be reserved.

VI. Emerging Issues

The issue of what remedy is appropriate in the face of a consummated LME that is subsequently held to have breached the lenders' rights will be closely monitored in the aftermath of the lower court's ruling in Incora. A contrary ruling was reached in the *Robertshaw* case from the same judicial district,[3] and yet another (*Serta*) is awaiting decision on appeal.[4]

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[2] *See generally In re Wesco Aircraft Holdings, Inc.*, No. 23-9061 (MI) (Bankr. S.D. Tex.).

[3] *See In re Robertshaw US Holding Corp.*, 662 B.R. 300 (Bankr. S.D. Tex. 2024).

[4] *See In re Serta Simmons Bedding, LLC*, 2023 WL 3855820 (Bankr. S.D. Tex. June 6, 2023).

Meanwhile, in response to the ubiquity of borrowers' use of LMEs, an emerging countermeasure has been used by lenders with increased frequency: so-called cooperation agreements. Cooperation or "co-op" agreements are contracts signed by holders of a company's debt whose consent will be needed by the company to facilitate a liability management transaction. The co-op's terms typically prohibit each co-op member from negotiating directly with a borrower in connection with any potential transaction unless a majority of co-op members do so collectively. It also typically prohibits members from selling any of its debt unless the buyer agrees to be bound by the co-op. While many co-op's have a medium-term duration (*e.g.*, three months) others have been extended for much longer periods, limiting the company's options while also constraining the lender-parties' liquidity (ability to exit their position). The use of co-ops is defended by lenders as merely protecting them against a "divide and conquer" strategy or what they believe would be unlawful behavior by their borrowers. Their efficacy has not squarely been tested by courts, however, including whether they are enforceable or may give rise to claims by the borrower. These issues, too, will be closely monitored as the jurisprudence in this area continues to develop.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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