Cassels

A Liability Management Prime-r

Matteo Clarkson-Maciel, Chuck Rich, Daniel P. Cipollone

January 16, 2025

Since the last financial crisis, stakeholders changed the way they approached issues with corporate liquidity. Markets in the United States and Europe are now undergoing a period of intense “liability management” activity – often referred to as “LMEs” (liability management exercises) or "LMTs" (liability management transactions). From a borrower’s or issuer’s perspective, LMEs may offer an opportunity to remedy mismatches in capital structures and provide the borrower additional liquidity in the hopes of turning its business around. For lenders, an LME re-adjusts their exposure and has the potential to provide them with access to additional collateral or improve their priority in a distribution waterfall. On the other hand, an LME also provides the potential to be left behind: for a lender to be primed by new, more senior debt, or a borrower group or collateral package materially different from when the credit was initially put in place.

While often characterized by splashy and exotic transaction structures, LMEs are – at their core – transactions designed to resolve liquidity and liability issues without the use of bankruptcy proceedings.

Have a view on whether – or how – LMEs will come to Canada? We want to hear from you.

How Did We Get Here?

Historically, during periods of market volatility, borrowers sought to optimize their capital structure by implementing cost controls, asset sales or operational changes. Meanwhile, lenders kept a close eye on the credit worthiness of borrowers through financial covenants. However, credit agreements (particularly in the US and Europe) in the years after the financial crisis have become increasingly borrower (and sponsor) friendly. Much of the credit issued in New York or London since has been ‘cov-lite,’ containing minimal financial covenants restricting borrowers or pre-empting financial distress. Many leveraged finance structures in those jurisdictions now permit leakage (assets from within a credit group being applied other than to repay the most senior tranche of outstanding debt) and priming (the introduction of a new tranche of debt ranking senior to the most senior tranche of outstanding debt).

LMEs came into vogue in the US and Europe for a variety of factors: the shift in covenant packages, the rising costs of in-court restructurings and proceedings, the desire for sponsors to maintain control, and — in the case of Europe — the risks from insolvency processes thought unfriendly to secured creditors.

Most LMEs are undertaken with a view to refinancing or restructuring a borrower’s or issuer’s outstanding debt obligations. In practice, this is meant to provide the debtor group with liquidity or extend maturities, and it may also decrease overall leverage, reduce interest expenses, capture possible accounting gains, or improve financing flexibility (possibly through covenant relief). In some (non-Canadian) deals we've worked on, the latter has been achieved through 'covenant stripping' where, on exit out of the existing credit, lenders vote to remove the covenants entirely.

Drop-downs, Uptiers and Other Structures: A Prime-r Overview

The types of LMEs attracting the most attention are *drop-down* (shifting assets outside of the credit group) and *uptier* (shifting existing debt into new, super senior tranches of debt) transactions.

Other structures have adopted similarly exotic names: *double dips* — evoking the image of a Timmy's order — entitles creditors to claim twice in a bankruptcy in respect of a single advance; *pari plus* provides a tranche of debt with participation in both the shared transaction security and third-party collateral.

Commentators in the United States have come to call many of these LME's "lender-on-lender violence." In the United States, the risk of "lender-on-lender violence" has led to a proliferation of cooperation agreements. They provide lenders with protection in numbers, allowing them to collaborate in a refinancing or restructuring discussion in the knowledge that the participating lenders will not turn against them.

Drop-downs

In most deals we have seen drop-downs take one of two forms: by 'redesignation' or by 'disposition.' In both cases, the effect of the transaction is that a borrower removes certain collateral from within the existing collateral ringfence or restricted entity group to outside the ringfence, to an entity often referred to as an "unrestricted subsidiary" or "UnSub." The unrestricted subsidiary is neither a guarantor nor loan party under the existing loan documentation and is not subject to the covenants or restrictions contained therein. The transfer is effected either through redesignating a restricted subsidiary as an unrestricted subsidiary, or through an asset sale (either of a subsidiary or individual assets). In the case of the former, the borrower can rely on restricted payment and/or investment basket capacity (to the extent available). In the latter, the borrower can find permission to sell assets either under an asset sale covenant or under the restricted payment and/or investment basket carve-outs under the asset sale covenant (to the extent available).

Upon completion of the drop-down, the liens of the existing lenders on the transferred assets are released. The unrestricted subsidiary can then incur new senior debt secured by the assets transferred from within the ring fence under the existing loan documentation. Typically, the new senior debt lenders are many of the existing lenders under the old loan; but not always. The effect of a drop-down is that the new lenders are now closer to the transferred assets. For the existing lenders, the scope of their collateral has shrunk. From a borrower perspective, the value of a drop-down is additional liquidity that need not be used to repay lenders. In some deals, documentation has allowed borrowers to repurchase debt asymmetrically (as opposed to pro rata) and at deep discounts. Documentation also affords borrowers with considerable flexibility in valuing assets. As a result of US drop-downs occurring with *J.Crew* and *Chewy*, more recent loan agreements include restrictions designed to constrain drop-downs. In both cases, litigation ensued.

Uptiers

By contrast, an uptier involves the borrower incurring debt in a new senior tranche that 'primes' the existing debt. Uptiers may occur by way of new money or an exchange of existing debt junior to the new tranche on a non-pro rata basis. The borrower is able to obtain an injection of additional capital (often at a discount) that can improve its overall capital structure and reduce some of its financing costs. Under the existing loan documentation, a borrower may be permitted to raise new debt through its debt baskets. The debt baskets will permit the borrower to incur new debt either on the existing collateral (a 'permitted collateral lien') or on new, unencumbered collateral (a 'permitted lien'). Permitted collateral liens will typically dilute existing lenders' collateral coverage and will sit *pari passu* with the existing debt. It is therefore not uncommon for some baskets to include a leverage test requirement. Debt incurred on permitted liens will rank senior to the exiting lender's claims and while the size of those baskets are often *de minimis*, can — when used in combination with other baskets — have a substantive aggregate effect negatively impacting existing lenders. In most cases, the debt basket will provide for super senior debt incurrence capacity under a "revolving credit facility" basket. These are typically drafted broadly to allow for any type of debt to be incurred.

Where a borrower wishes to raise more super senior debt than permitted under its existing baskets, a borrower may structure an uptier to seek the consent of its lenders to at least (1) expand its existing debt baskets; or (2) grant new liens. A borrower often only needs to find a group of lenders holding as little as 50% of the existing debt to do this. From there, the borrower and its majority lenders will amend their existing loan documentation to permit the borrower to incur new senior indebtedness. The new senior indebtedness will provide the participating lenders claims against the existing loan parties and collateral that ranks in priority to the existing lenders, which is typically done by way of contractual subordination. In some cases, the new senior indebtedness will be provided by the borrower's existing majority lenders who will exchange their existing debt for the new contractually senior debt leaving the remaining existing lenders with subordinated debt/claims against the loan parties and their collateral. In exchange for these senior claims, the participating lenders in the new senior debt will typically offer such debt at a discount to par. It should be noted, however, that it is not uncommon for minority or non-participating lenders to challenge uptier transactions or bring claims against majority creditors for such actions and there are various cases and examples in the United States where minority creditors have brought such claims. Most recently, the Sera Simmons LME was successfully challenged on its non-pro rata participation and contractual indemnity.

Cassels: Advising on the Canadian Perspective

The use of liability management transactions by borrowers and, where applicable, majority lenders, represents a relatively novel approach to managing capital and financial risks, maintaining creditworthiness and improving a borrower's overall financial health and stability. LMEs are quickly moving mainstream. They clearly present possibly significant opportunities and risks to lenders and minority creditors and it is critical that lenders are aware of such transactions and the risks and opportunities they pose when reviewing and entering into loan documentation. Liability management seen in the United States and Europe is beginning to creep into Canada, too. Indeed, they have already come to Canadian borrowers raising debt in the US: Cirque du Soleil is one of the earliest examples of an LME. More recently, a CBCA plan was preceded by an intellectual property drop-down reminiscent of the J.Crew "trap door."

Our team has extensive experience advising borrowers and lenders on a broad variety of liability management transactions in other jurisdictions and is well placed to advise on how to consider and act on the risks and opportunities liability management exercises pose in Canada, both as Canadian and lead counsel.

In Part 2 of this Article, we will consider the structural and market reasons why LMEs in Canada may differ.

For the latest drafting and precedents in liability management and other capital solution tools, please contact Matteo Clarkson-Maciel[1], Chuck Rich, or Daniel Cipollone.

---

[1] Admitted as a solicitor in England & Wales.
