Proskauer

The Latest Liability Management Technology: Structurally Senior Minority-Owned Joint Venture Financings

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Last month, a publicly traded company (the "Company") announced the formation and capitalization of a new joint venture (the "JV") in a deal-away transaction (i.e., not with the Company's existing lender group). The JV raised new capital – comprised of senior secured term loans and preferred equity – from a lender group unaffiliated with the Company's existing lenders. The net proceeds were distributed to the Company.

This structure combines, among other complexities, (i) a drop-down of material intellectual property to a non-subsidiary joint venture, resulting in structural priming of existing secured creditors; and (ii) the reported use of so-called "rinse-and-repeat" investment capacity to maximize negative covenant basket capacity. We will discuss these and an oft-overlooked interpretive provision impacting transactions such as this, and close with a few thoughts about liability management in debt markets today.

The Joint Venture Drop-Down

The Company moved valuable assets – including material trademarks – into the newly formed JV. As a result of the transfer, these assets, which were previously collateral for the Company's existing senior secured loans, were released from their existing liens. The JV then raised structurally senior debt and preferred equity supported by this property. The legacy lenders to the Company retain their claims, which are supported by liens on other collateral, but they do not have any direct claim against the JV or its assets.

This drop-down was consummated despite the existing credit documents including a typical *J. Crew* blocker that restricts transfers of material IP to unrestricted subsidiaries. In fact, even a customary *Pluralsight* blocker – which goes farther and additionally restricts transfers of material IP to non-guarantor restricted subsidiaries – would not have prohibited the drop-down in this instance. This is because the JV is neither an unrestricted subsidiary nor a restricted subsidiary: as a minority-owned joint venture, it is not a "Subsidiary" at all under this or the vast majority of credit documents in the market today.

Minority-owned joint ventures and other non-subsidiaries are generally not subject to the various covenants in credit documents, including, crucially, restrictions on incurrence of debt and liens, making dividends, and, in most cases, liability management provisions such as the so-called *J. Crew* (transfer of material intellectual property) and *Envision* (investments in unrestricted subsidiaries) provisions. In other words, they enjoy the same freedom from restrictions as unrestricted subsidiaries, but, typically, with fewer constraints on their formation and capitalization.

We have early indications that at least some lenders will seek a new blocker to address this type of maneuver, though it remains to be seen to what extent such term will be accepted by the broadly syndicated or private credit markets (though we would be surprised if there were not some divergence between the two). Such a blocker is not complicated to draft. Rather than merely prohibiting transfers of Material IP to unrestricted subsidiaries and/or non-guarantor restricted subsidiaries, the provision might either prohibit such transfers to anyone, or otherwise prohibit them to any entity in which the Loan Parties, directly or indirectly, retain any ownership interest.

"Rinse-and-Repeat" Investment Capacity

When the Company contributed IP assets down to the JV, it consumed investment capacity under the Company's existing credit documents. Market reporting indicates that the distribution of the JV financing proceeds back to the Company may have rebuilt such investment capacity. That is because, under many credit documents, such a distribution is characterized as a "return on investment," which is netted from the outstanding amount of an investment for determining the amount of basket capacity that has been used under negative covenants.

As a simple, fictitious example, imagine a borrower that wants to incur $300 of structurally senior debt, but only has capacity to invest $200 in a non-obligor (which may be an unrestricted subsidiary, non-guarantor restricted subsidiary, or minority-owned joint venture). Obviously, no third-party lender will provide a $300 loan against $200 of collateral. So, the borrower may set up a series of substantially concurrent transactions in which (i) the borrower invests $200 of assets into the non-obligor, using all of its basket capacity, (ii) the borrower incurs $200 of debt at the non-obligor (at an unsustainable loan-to-value ratio of 100%), (iii) the non-obligor distributes all $200 of proceeds to the borrower, which reloads its investment basket capacity from $0 to $200, (iv) the borrower contributes an additional $200 of collateral to the non-obligor, and (v) the non-obligor incurs an additional $100 of debt. The end state is $400 of invested assets that support a $300 loan, with $200 distributed to the borrower. There are a nearly endless number of permutations of this illustrative transaction, including ones whereby the borrower uses a portion of the $200 distributed to it to retire the legacy debt of certain lenders (who also provide the non-obligor financing) on a non-pro rata basis (effectively exchanging such lenders into the structurally senior position).

While this “rinse-and-repeat” capacity is common, it is not universal, and it has been on our watch list for some time. Many private credit documents include blockers to this strategy, such as by limiting the “return on investments” provision to only the proceeds of internally generated cash of the non-obligor (and excluding proceeds of financing activities).

Integrated Transactions

To determine whether strategies such as those discussed above are permitted by applicable credit documents, one must also consider the threshold question of whether they are correctly treated as a series of independent transactions, or a single, integrated transaction completed in multiple steps. The difference between those – as you may intuit from the “return on investment” analysis above – could lead to opposite conclusions. For example, this issue is at the heart of another well-known liability management dispute, where collapsing the various steps into a single transaction would more likely result in a breach of the documents, while respecting their separateness would decrease the likelihood of a breach.

Generally, credit documents are ambiguous as to whether related transactions should be treated as a series of independent actions, or a single integrated transaction. Many borrowers, though, wish to resolve this ambiguity in the manner most favorable to them, and seek the inclusion of either a provision stating that all actions will be treated separately (even if concurrent, related, mutually dependent and undertaken by the same or related parties), or, even more favorably, a provision that allows the borrower to make an election on a case-by-case basis as to whether its actions should be treated independently or collapsed. Of course, the opposite provisions are possible in theory – either specifying that all sufficiently related transactions should be collapsed, or that the agent or lenders should make the election as to their treatment – but given market dynamics, we do not expect those to take hold any time soon.

Takeaways

Sophisticated and creative principals, advisors, and lawyers continue to innovate and iterate liability management structures to meet their objectives without clearly breaching the express terms of their credit documents. Individual "blocker" provisions – designed to prevent a single type of past transaction (and often named after the specific example that first gained notoriety) – may be insufficient to prevent aggressive parties from executing similar strategies, even if those provisions are carefully drafted (not all are) and continually updated for newly consummated transactions.

A holistic approach to creditor protections, offering layers of defense across multiple provisions, is more effective – though, obviously, more difficult for lenders to require in a competitive market environment. Private credit has an advantage over the syndicated market in this respect; all else equal, direct lending covenants (both directly and indirectly related to liability management) tend to be tighter, with smaller baskets, broader covenant protections, and more narrowly tailored permissions.

"Omni LME blockers" – broad prohibitions on priming capital and/or non-pro rata exchanges into superior capital positions – are a solution for creditors weary of slogging through an ever-expanding list of protections on their liability management checklist. These provisions have seen some uptake in the middle market, but remain difficult to obtain in negotiations and are uncommon in competitive situations.

We also acknowledge that while borrowers and issuers resist fulsome liability management protections partly to maintain flexibility in case of future restructuring needs, they also do so because broader restrictions intended to limit liability management may restrict unrelated bona fide business transactions.

There continues to be no single or simple answer to addressing liability management risks. At Proskauer, we closely monitor developments across the private credit, leveraged finance, and capital markets and advise both lenders and issuers on emerging structures, appropriate credit terms, and workout strategies using our broad and deep experience and a fully integrated team of finance and restructuring professionals.

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