



AMERICAN
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The Ramifications of Covenant-Lite Structures

Roger G. Schwartz, Moderator

Latham & Watkins LLP; New York

Sarah Robinson Borders

King & Spalding; Atlanta

Hon. Robert D. Drain

U.S. Bankruptcy Court (S.D.N.Y.); White Plains

John Greene

Bardin Hill Investment Partners LP; New York

Jack F. Williams

Baker Tilly Virchow Krause, LLP/Georgia State University; Atlanta

THE RAMIFICATIONS OF COVENANT-LITE STRUCTURES

*OR WHERE DID MY COLLATERAL GO AND
HOW DO I (CAN I) GET IT BACK?*

American Bankruptcy Institute
33rd Annual Spring Meeting 2019

Sarah Robinson Borders, King & Spalding
Hon. Robert D. Drain, U.S. Bankruptcy Court (S.D.N.Y.)
John Greene, Bardin Hill Investment Partners LP
Prof. Jack Williams, Georgia State University/Baker Tilly
Roger G. Schwartz, Latham & Watkins LLP (Moderator)

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DISCUSSION TOPICS

- Leveraged Loan Credit Agreement/High-Yield Bond Indenture Basics
 - > Capital Structure Overview
 - > Covenant Structure Overview
- History and Overview of Covenant-Lite Structures
- Recent Collateral Leakage Transactions
 - > J. Crew
 - > Chobani
 - > Petsmart/Chewy
 - > Neiman Marcus
- Litigation Responses
- Other Considerations
- What Comes Next?

LEVERAGED LOAN CREDIT AGREEMENT BASICS

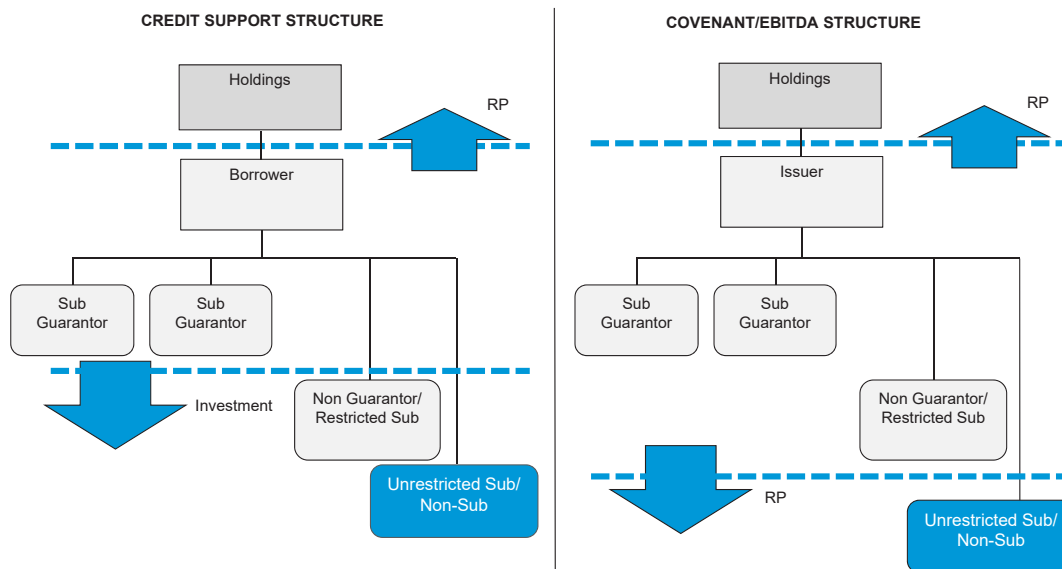
CAPITAL STRUCTURE OVERVIEW

- Credit Agreements typically have a borrower whose obligations are guaranteed by (i) the borrower's direct parent ("Holdings") and (ii) the borrower's wholly-owned domestic subsidiaries ("Subsidiary Guarantors").
- The borrower often has flexibility to designate non-guarantor subsidiaries as either "Restricted Subsidiaries" or "Unrestricted Subsidiaries."
 - > Restricted Subsidiaries are subject to Credit Agreement covenants and may or may not guaranty debt.
 - > Unrestricted Subsidiaries are not subject to Credit Agreement covenants and do not guaranty debt.
- Typically, the Credit Agreement imposes limitations on the extent to which subsidiaries can be designated as "unrestricted."
 - > May be subject to and require compliance with covenants.
- Unrestricted subsidiary becoming restricted can occur either because the subsidiary no longer meets the conditions applicable to unrestricted subsidiaries or if the borrower's board of directors chooses to designate the subsidiary as a restricted subsidiary.
- Holdings may or may not be subject to Credit Agreement covenants.

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LEVERAGED LOAN CREDIT AGREEMENT BASICS (CONT.)

CAPITAL STRUCTURE OVERVIEW



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HIGH-YIELD BOND INDENTURE BASICS

CAPITAL STRUCTURE OVERVIEW

- Convergence of leveraged loans and high-yield Bond Indentures covenants.
- Many incurrence covenants that exist in Credit Agreements also exist in Bond Indentures.
- Typical covenant-lite structure lacks traditional financial maintenance covenants.
 - > Tends to have fewer and looser negative and incurrence covenants.
 - > Move to incurrence covenants promotes borrower flexibility, reduces technical default and need for waivers, and tends to delay restructuring.
 - > Lessens creditor protections, increasing rates and fees.

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HISTORY AND OVERVIEW OF COVENANT-LITE STRUCTURES

- Role of covenants: Ensuring and monitoring payment, allocating control rights between debt and equity, and limiting firm action to protect value of debt.
- Covenant packages for highly levered companies originally included full packages of maximum leverage ratio and minimum coverage ratio tests.
- Covenant-lite deals developed in the 2005-2007 bubble for certain top-tier sponsor transactions, and have since become a common feature in leveraged transactions, even in the middle market.
- As sponsor transactions became more aggressive and pushed the envelope, arrangers were compelled to underwrite transactions without financial covenants that applied to protect term loan facilities.
- Covenant-lite deals generally (i) have financial covenants that are only for the benefit of the revolving credit facility and (ii) only require testing if revolver usage is in excess of a specified threshold.

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HISTORY AND OVERVIEW OF COVENANT-LITE STRUCTURES (CONT.)

- Relevant Types of Covenants:
 - > Financial – Generally require Borrower to meet agreed-upon threshold of projections.
 - > Non-Financial – Generally require Borrower to take actions not involving financial targets/metrics, such as continued existence, compliance with laws, etc.
 - > Affirmative – Require Borrower/Issuer to take certain actions, such as payment of interest and fees, maintenance of insurance, payment of taxes, delivery of quarterly operating reports, etc.
 - > Negative – Prohibit Borrower/Issuer from engaging in specified activities, such as investments, incurring new debts or liens, selling assets or making acquisitions.
 - > Maintenance – Require Borrower to maintain a certain state of affairs, for example, to meet or exceed various financial performance measures.
 - > Incurrence – Prohibit Borrower/Issuer from certain actions except under agreed conditions or subject to specified caps.
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HISTORY AND OVERVIEW OF COVENANT-LITE STRUCTURES (CONT.)

PROS AND CONS

Lenders

- Pros:
 - > Higher yield
 - > Dealflow and fees
- Cons:
 - > Lose early warning mechanism
 - > Lose effective repricing option provided by financial covenant
 - > Lose ability to extract other concessions
 - > Lose early seat at the table to discuss restructuring plans
 - > Lose ability to control fundamental changes (e.g., investments, incurrence of additional debt)

Borrowers

- Increased business flexibility
- Lower amendment, default and repricing event risk
- Increased document and structuring flexibility
- Less likely to trip default and event of default provisions

Sponsors

- Similar to borrowers with added benefit of providing flexibility to protect and preserve ownership stake/investment
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RECENT COLLATERAL LEAKAGE TRANSACTIONS

J. CREW

- Background
 - > Clothing retailer had approximately \$2bn in debt outstanding (\$1.5bn secured term loan, \$350mm ABL revolver and \$500mm in unsecured notes at parent level).
- Initial IP Transfer
 - > In December 2016, J. Crew transferred 72% of intellectual property (valued at \$250mm) from Loan Parties to an Unrestricted Subsidiary.
 - > \$100mm permitted under its general investments basket.
 - > Remaining \$150mm permitted by two-step process utilizing two separate baskets that together constitute the so-called “trap door”:
 - Non-Loan Party Restricted Subsidiary basket allowed investments “by any Loan Party in any Non-Loan Party that is a Restricted Subsidiary . . . of \$150,000,000.”
 - Proceeds basket allowed unlimited investments made by any non-Loan Party Restricted Subsidiary to the extent such investments were financed with the proceeds received by such Restricted Subsidiary from a permitted Investment in such Restricted Subsidiary.
 - > Remaining 28% of IP subject to license agreement that limited Restricted Subsidiary use.

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RECENT COLLATERAL LEAKAGE TRANSACTIONS (CONT.)

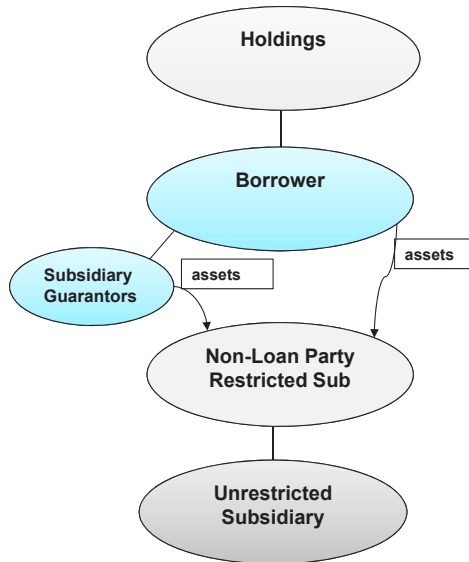
J. CREW

- After the initial IP transfer, J. Crew launched offer to exchange existing unsecured PIK notes for new notes secured by transferred IP.
- J. Crew also solicited term lenders for partial term loan repurchase at par in exchange for consent to (i) lien release on remaining IP, (ii) licensing fee arrangement, and (iii) dismissal of term lender litigation claims.
 - > Transaction originally was viewed as “required lender” issue.
 - > J. Crew initially obtained 88% term lender consent and by the time of closing received 99% term lender participation in exchange.
- End Result
 - > J. Crew’s most valuable asset – the brand – was removed from the initial lenders’ collateral package and covenants and used to repay structurally subordinated claims of the parent.
 - > J. Crew leveraged term lenders to dismiss litigation (holdout lenders now claim that IP transfer was for all or substantially all of the assets (i.e., “all lender” issue)).

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RECENT COLLATERAL LEAKAGE TRANSACTIONS (CONT.)

J. CREW



Steps

- Create an Unrestricted Subsidiary and Non-Loan Party Restricted Subsidiary
- Transfer assets into the newly created non-Loan Party Restricted Subsidiary
- Transfer assets into Unrestricted Subsidiary
- Incur debt at Unrestricted Subsidiary supported by transferred assets
- Obtain impaired lender consent for transaction by offering consenting lenders only a portion of value moved out of Loan Parties

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RECENT COLLATERAL LEAKAGE TRANSACTIONS (CONT.)

CHOBANI

- J. Crew involved a traditional Credit Agreement – it had a cap on investments in Unrestricted Subsidiaries, but the cap was large enough to permit the transfer when coupled with the proceeds basket.
- Chobani was a worst-case scenario for lenders – called a “black hole” – where any and all assets could be removed from the Loan Parties.
- Chobani contained both a traditional bond-style investments covenant and a bank-style proceeds basket.
 - > Unlimited investments in Restricted Subs (with no cap on investments in non-Loan Parties); AND
 - > Unlimited investments by non-Loan Parties with the proceeds from investments by Loan Parties.
- These Chobani-style deals are in the market (although not common), but generally the market will accept J. Crew-type restrictions.

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RECENT COLLATERAL LEAKAGE TRANSACTIONS (CONT.)

PETSMART/CHEWY

- Background
 - > Petsmart acquired Chewy.com in May, 2017 for \$3.23bn, \$1bn of which was funded through an equity contribution by BC Partners.
 - > Petsmart credit facility included a secured guaranty from Chewy.
- Restructuring Transaction – Partial Spin-off of Chewy
 - > 20% of common stock distributed to Argos Holdings (sponsor SPE), then to the parent's parent, Argos Intermediate Holdings (unrestricted), and then to subsidiary, Buddy Holdings (unrestricted) via dividend under the restricted payment basket.
 - > 16.5% of common stock contributed to Unrestricted Sub of Petsmart (Buddy Chester) under the investment basket.
 - > 63.5% of common stock retained by Petsmart.
 - > Chewy remained a Restricted Subsidiary of Petsmart (63.5% stock remained pledged).

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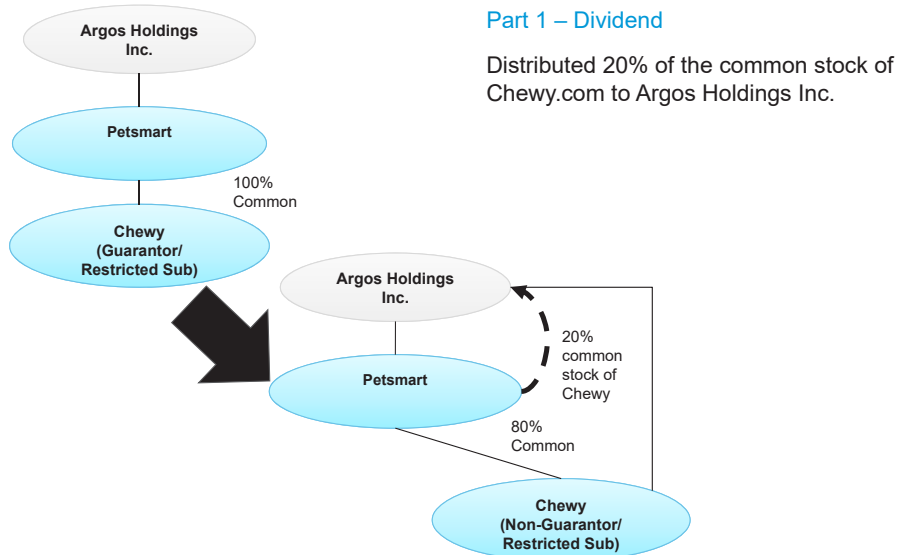
RECENT COLLATERAL LEAKAGE TRANSACTIONS (CONT.)

PETSMART/CHEWY

- Petsmart demanded that agent (Citi) release liens on 36.5% stock transferred based on common Credit Agreement provision requiring release of guarantees and liens of non-wholly-owned subsidiaries.
 - > Citi resigned upon receiving required lender direction not to sign release. Wilmington substituted as agent.
- Petsmart and its immediate parent (Argos Holdings) brought declaratory judgment action in federal district court against the agent for PetSmart's term loan credit facility over the agent's failure to execute documentation confirming the termination and release of guarantees and liens resulting from the Chewy share transfers.
- **Restricted payment basket.** While the Credit Agreement limits PetSmart's ability to make restricted payments (such as the 20% of Chewy's equity as a dividend), it does not prohibit them outright.
- **Investment basket.** The transfer of 16.5% of Chewy's equity to an unrestricted subsidiary was through the "investments" basket.

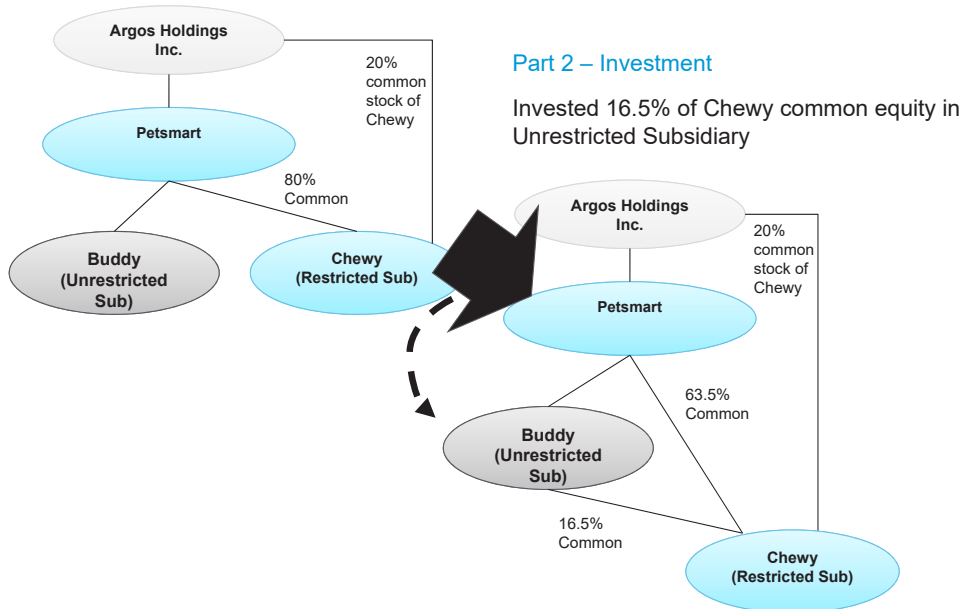
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RECENT COLLATERAL LEAKAGE TRANSACTIONS (CONT.)
PETSMART/CHEWY



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RECENT COLLATERAL LEAKAGE TRANSACTIONS (CONT.)
PETSMART/CHEWY



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RECENT COLLATERAL LEAKAGE TRANSACTIONS (CONT.)

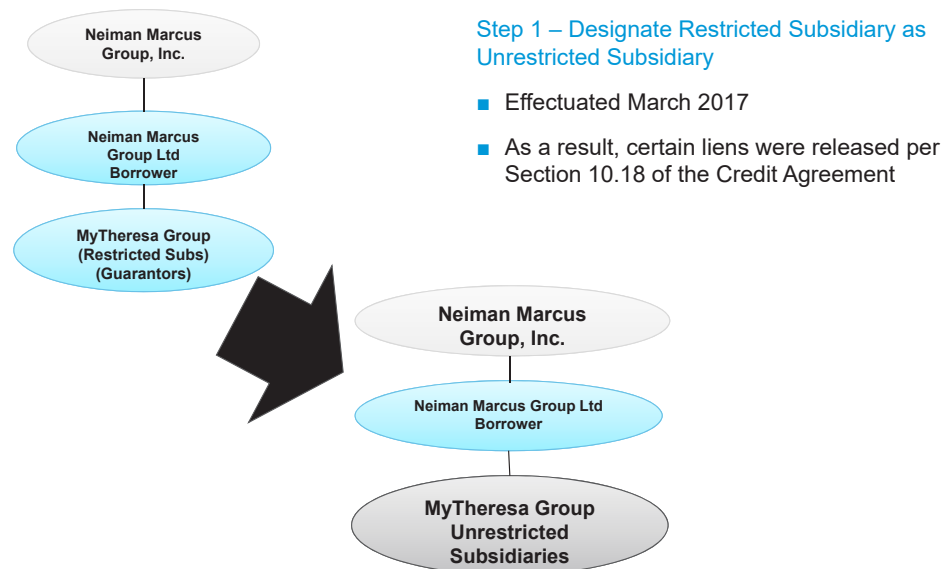
NEIMAN MARCUS

- Background
 - > Neiman acquired MyTheresa eCommerce site in 2014 for \$238mm (now estimated to be worth over \$500mm).
 - > MyTheresa originally was a Restricted Subsidiary.
- Restructuring Transaction
 - > In March, 2017, Neiman designated MyTheresa as an Unrestricted Subsidiary, triggering release of guarantees and liens in favor of existing lenders.
 - > In September, 2018, Neiman announced spin-off of 100% of MyTheresa stock to ultimate Neiman parent controlled by the sponsors (not a Loan Party).
- Neiman commenced restructuring negotiations with its term lenders and bondholders.
- On November 30, Neiman announced talks with creditors stalled.
- Lender Marble Ridge filed lawsuit against Neiman entities on December 10.

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RECENT COLLATERAL LEAKAGE TRANSACTIONS (CONT.)

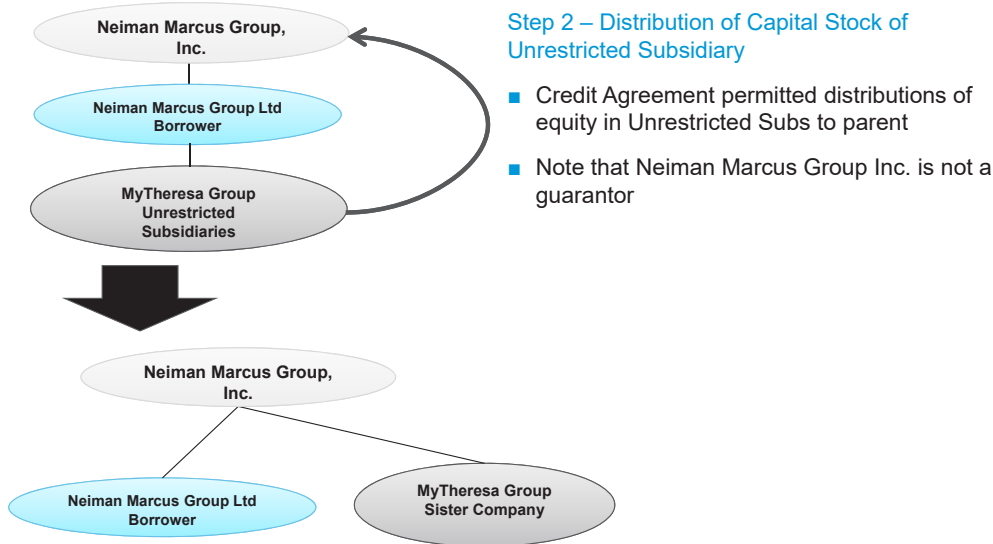
NEIMAN MARCUS



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RECENT COLLATERAL LEAKAGE TRANSACTIONS (CONT.)

NEIMAN MARCUS



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RECENT COLLATERAL LEAKAGE TRANSACTIONS (CONT.)

HOW PREVALENT IS THIS LEAKAGE RISK

- J. Crew-type basket for unlimited investments in non-Loan Party Restricted Subsidiaries is increasingly common.
- J. Crew-type “Trap Door” proceeds basket is somewhat common.
- Chobani-type “Black Hole” (unlimited investments in Restricted Subsidiaries plus unlimited proceeds basket) uncommon.
- Petsmart-type lien release provisions for non-wholly-owned subsidiaries are very common.
- Neiman-type Unrestricted Subsidiary dividend provisions are fairly common.

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LITIGATION RESPONSES

- Litigations around transactions are still in the early stages, but claims face significant hurdles and a number of defenses. Common litigation claims include:
 - > Actual fraudulent conveyance (i.e. transfer with actual intent to hinder/delay/defraud creditors)
 - It may be difficult to prove actual fraudulent conveyance if the credit documents permit the challenged transaction.
 - > Constructive fraudulent conveyance (i.e. the debtor was insolvent or rendered insolvent by the transaction and no “reasonably equivalent value” or fair consideration was exchanged)
 - It may be hard to establish lack of “reasonably equivalent value” in a permitted transaction.
 - Solvency is a complete defense to constructive fraudulent conveyance.
 - Estoppel and waiver under UFTA section 10, UFTA section 11, and UVTA section 12.

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LITIGATION RESPONSES (CONT.)

- > Breach of contract; illegal dividend
 - The challenged transaction may be permitted under the express terms of the credit document.
 - Solvency is a key defense to illegal dividend.
- > Breach of fiduciary duty; fraud
 - It may be difficult to establish that a particular transaction constitutes a breach of fiduciary duty/self-dealing where the transaction is contractually permitted and/or justified as necessary to enhance company value or survival.

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OTHER CONSIDERATIONS

- Sophistication of Parties
 - > Are these transactions bargained-for rights?
 - > Why shouldn't parties be bound by the expectations of their agreements?
- Majority Rules
 - > Transactions may require ratification and/or the support of required lenders and/or required holders.
 - > What significance does required lender/required holder approval have?
- Procedural Issues
 - > How to weigh the role of "independent" board members and advisors in connection with approving such transactions?
- Fiduciary Duties
 - > Does the board have a fiduciary duty to effectuate these transactions for the benefit of the stakeholders?
 - > What is the role of the business judgment rule? How much deference should be given to decisions made by the company, management and the board?

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OTHER CONSIDERATIONS (CONT.)

- Judicial Perspective
 - > How should courts evaluate collateral leakage transactions?
 - > Should courts develop rules of engagement for evaluating covenant-lite structures?
- Bankruptcy Perspective
 - > Do prepetition changes to a debtor's capital structure impact the debtor's bankruptcy proceedings?
 - > Do covenant lite structures raise issues at confirmation such as cram down under section 1129(b) of the Bankruptcy Code and impairment under section 1124 of the Bankruptcy Code?

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WHAT COMES NEXT

- Expect an increasing number of creative liability management transactions . . . and an increasing amount of litigation around such transactions.
- Short and long term document fixes:
 - > In the short term, lenders and holders will scrub documents to tighten and close holes while companies and sponsors will scrub documents to create leverage and structure liquidity-enhancing transactions.
 - > Longer lasting changes may depend on the market's reaction or counter-reaction to these structures.