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Navigating Today's Environment

The Directors' and Officers' Guide to Restructuring

SECOND EDITION

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AMERICAN BANKRUPTCY INSTITUTE

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7.II AVOIDING A BANKRUPTCY FILING: CORPORATE DECISION-MAKING AND LIABILITY MANAGEMENT TRANSACTIONS

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When a corporation faces significant financial distress, its board of directors and management team must carefully consider all potential strategic alternatives that may provide relief, including whether the corporation should pursue an in-court or out-of-court process. In evaluating different alternatives in the zone of insolvency, directors and officers must be mindful of their expanded fiduciary obligations to all stakeholders. This chapter discusses corporate decision-making when a company becomes insolvent and the liability management transactions that may provide financial relief without a bankruptcy filing.

Corporate decision-making and potential challenges to transactions

Prior to evaluating strategic alternatives and liability management transactions, it is important that directors and officers be reminded of their fiduciary duties while a company is in the zone of insolvency.

Fiduciary duties

Directors and officers are fiduciaries of, and owe corresponding fiduciary duties to, their company and must make decisions consistent with their roles as such. Generally, this means that directors and officers must make decisions on behalf of the company that are in good faith and in a manner consistent with the best interest of the business.

Fiduciary duties are categorized as the duties of care and loyalty.

Duty of care

The duty of care is a fiduciary duty requiring directors and officers of a corporation to make decisions that pursue the corporation’s interests with reasonable diligence and prudence. Decisions made by disinterested directors and officers are generally protected by the “business judgment rule”; under this standard, courts will uphold actions so long as they are made in good faith with reasonable diligence and prudence.

Duty of loyalty

The duty of loyalty requires directors and officers to act in a manner that is in good faith, without personal economic conflict. They must put the interests of the corporation before any personal interests or those of another person or organization.

In normal circumstances (outside of the distressed context), these fiduciary duties flow directly to the corporation and its shareholders. However, when a corporation becomes insolvent, these fiduciary duties extend to creditors. As one court explained, "What changes upon insolvency is the constituency: the creditors are now the "risk bearers," so they now have the right, like stockholders, to bring a derivative action in the corporation's name against directors who "unduly risk" corporate assets." (*In re AWTR Liquidation, Inc.*, 548 B.R. 300, 325 [C.D. Cal. 2016.])

In distressed situations, directors and officers must balance aggressive liability management strategies, and make associated governance decisions, in light of fiduciary duties owed to all stakeholders. The failure to do so may expose such directors and officers to personal liability.

Other potential challenges to liability management transactions

In addition to potentially exposing directors and officers to suit based on alleged breaches of fiduciary duties, dissatisfied stakeholders may seek to challenge a liability management transaction on the grounds that it was not authorized by the subject debt documents, it constituted a fraudulent transfer or was otherwise improper.

Liability management transactions

A corporation working with its lenders may have a number of avenues to potentially avoid or delay a bankruptcy filing. The availability of such strategies, however, will depend on the precise terms of the corporation's debt documentation.

Covenant relief and consensual amendments to credit agreements

As a first step to any potential workout, management typically attempts to negotiate certain consensual amendments to credit agreements. Such amendments may include altering or stripping affirmative and negative covenants (and related events of default). In instances where a company has more than one lender, such amendments may require all or only certain lenders' consent.

Credit agreements often have a list of "sacred rights," which can be modified only with the consent of all lenders or all adversely affected lenders. These rights, and the concomitantly high consent-to-modify thresholds, protect the fundamental interests of minority lenders from being altered by the majority without minority lender consent. "Sacred rights" are typically limited to material covenants, such as maturity dates, scheduled payments, pro rata sharing provisions and collateral releases. Aside from modifications of "sacred rights," covenant amendments typically require only majority lender consent.

Accordingly, and as discussed below, if a matter is not expressly a "sacred right," companies may rely on the express terms (perhaps colloquially "loopholes" or "trapdoors") of credit documents, without material modification, to engage in liability management transactions.

Asset dropdowns

In asset-dropdown transactions, corporations use asset transfer flexibility in their existing credit documents to transfer ("dropdown") valuable assets and collateral (often valuable intellectual property or other intangible assets) out of the existing lender collateral package into new "unrestricted" subsidiaries. These unrestricted subsidiaries then typically raise additional debt using the newly transferred assets as collateral.

The following examples demonstrate how these transactions work.

J.Crew

J.Crew is a U.S. retailer that pledged, among other assets, its intellectual property to secure its $1.6 billion term loan facility. Given the challenges of operating in the distressed retail industry and an approaching maturity date for certain notes, the company urgently needed to find value or risked default.

J.Crew's debt documents contained common (and non-borrower friendly) negative covenants restricting investments in certain subsidiaries. These negative covenants included typical carve-outs: (i) a carve-out equal to the greater of $150 million or 4 percent of total assets for investments into non-guarantor *restricted* subsidiaries and (ii) a general carve-out equal to the greater of $100 million or 3.25 percent of total assets for investments into non-restricted subsidiaries. Relying on these two carve-outs, J.Crew transferred more than 70 percent of its interest in intellectual property, equaling to the cumulative $250 million permitted by these carve-outs, to a restricted subsidiary, J.Crew Cayman.

Relying on a third carve-out (permitting investments by restricted subsidiaries in unrestricted subsidiaries financed with proceeds received from an investment in such restricted subsidiary), J.Crew Cayman transferred the intellectual property it received to an unrestricted subsidiary, J.Crew Brand Holdings, LLC. Once the intellectual property interest was transferred to the unrestricted subsidiary, it was used as collateral for an exchange offer for the near-maturity notes. Litigation commenced by certain term loan lenders with respect to these transactions was ultimately resolved as noteholders purchased the majority of the senior debt.

PetSmart, Inc.

Using restricted payment and investment carve-outs, PetSmart was able to achieve a similar result by transferring 36.5 percent of its equity in its recently acquired subsidiary, Chewy.com, to its private equity sponsor and to an unrestricted subsidiary. It was also able to obtain releases of liens and a guarantee granted by Chewy with respect to the 63.5 percent equity that was not transferred.

In 2017, PetSmart acquired Chewy for $3 billion, funded through a combination of $1 billion in private equity contributions and $2 billion in financing. In 2018, relying on a generous investment carve-out under its existing debt documentation, PetSmart "invested" 16.5 percent of Chewy equity to a newly formed, unrestricted subsidiary. Separately, relying on a restricted payment basket, PetSmart transferred 20 percent of equity in Chewy as a dividend to its private equity sponsor. To make this restricted payment transfer, PetSmart's management determined that it could dividend, under an "available amount" basket, value in Chewy up to the original $1 billion investment received from the sponsor.

Following the restricted payment and investment transactions, Chewy was no longer a wholly owned subsidiary of PetSmart. Under common credit agreement provisions, the administrative agent was required to release any collateral or guarantees with respect to a subsidiary that was no longer wholly owned. When PetSmart demanded that the administrative agent release any liens on Chewy's assets and Chewy's guarantee under the existing debt documents, the agent countersued. Additionally, an ad hoc group of lenders sued PetSmart, challenging these transactions based on various covenant interpretations. Following various amendments to the credit documents, PetSmart obtained lender consent and the lawsuits settled, confirming Chewy's guarantee and lien release. Notably, while much of the equity in Chewy had been transferred away, the majority remained in a restricted subsidiary of PetSmart. However, because the agent had released its liens and Chewy was no longer a guarantor, the subject lenders' interests were structurally subordinate to Chewy's debts.

Cirque du Soleil

Relying on a similar strategy to J.Crew, Cirque transferred certain intellectual property, other than U.S. and Australian intellectual property, to a holding company controlled by its private equity sponsor. Facing the pandemic-induced shuttering of all in-person performances, Cirque required additional liquidity to offset a reduction in revenues. Cirque's credit documentation was structured more like a high-yield bond indenture than a typical credit agreement; it included a single restrictive payment covenant with respect to both dividends and investments and generous carve-outs. With this flexible document formulation, Cirque was able to transfer its intellectual property beyond the reach of its then-current creditors. It used the transferred

intellectual property as collateral for a new loan of $50 million. Shortly after completing this transaction, Cirque restructured in-court in Canada and obtained recognition under Chapter 15 in the United States.

Current asset dropdown status

Using similar covenant exceptions and interpretations, numerous borrowers have successfully engaged in similar asset dropdown transactions. More recent credit agreements have attempted to preempt these types of transactions (absent consent) through various limitations, such as restrictions on material intellectual property transfers and investments by non-loan party restricted subsidiaries into restricted subsidiaries. Corporations should carefully analyze their debt documentation to determine whether an asset dropdown may be permitted to access otherwise encumbered assets.

Uptier exchanges

In uptier exchanges, borrowers typically offer certain existing senior creditors the opportunity to exchange a portion of their debt for new, structurally senior debt. In an uptier transaction, the borrower amends its existing loan documents to permit the incurrence of superpriority debt and to remove any provisions prohibiting or limiting the subordination of existing loans. Additionally, the relevant parties typically enter into a new intercreditor agreement that governs the relative priorities of the post-transaction tranches of debt. With the exception of "sacred rights," discussed previously, the corporation typically only needs the consent of "required lenders" (usually a majority) for such amendments.

The following recent examples demonstrate how uptier transactions work and identify potential pitfalls.

TriMark

In August 2017, through a leveraged buyout, private equity firms acquired a majority stake in TMK Hawk Parent, Corp. (DBA "TriMark"), a food-service equipment distributor. Roughly two-thirds of the purchase price was financed through an $820 million syndicated loan. In early 2020, because of pandemic-related restrictions on indoor dining, the company faced significant financial distress.

In an effort to resolve financial constraints, lenders holding a majority of the syndicated debt collaborated with TriMark and its sponsors to execute an uptier exchange comprised of three primary components. First, TriMark entered into a Super Senior Credit Agreement where the company issued new First-Out Super Senior Debt (Tranche A Loans) to the collaborating lenders. TriMark did not offer to issue this new debt to the remaining lenders in the syndicate. This is a hallmark of an uptier exchange. Second, TriMark issued new Second-Out Super Senior Debt (Tranche B Loans) to the collaborating lenders in a dollar-for-dollar exchange of the debt they originally held in the original loan. Third, TriMark and the participating lenders amended the original credit agreement, stripping covenants that might have prohibited the first two transactions and adding provisions intended to impede the remaining lenders from successfully filing suit against the borrower and the collaborating lenders.

The non-collaborating lenders sued, and the collaborating lenders and TriMark moved to dismiss. The New York Supreme Court issued an opinion, *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp.*, No. 565123/2020 (N.Y. Sup. Ct. Aug. 16, 2021), granting in part and denying in part the defendants' motions to dismiss. In denying in part the motions to dismiss, the Court found that the original credit agreement could be reasonably read to require the non-collaborating lenders' consent for the challenged amendments.

On January 7, 2022, TriMark issued a press release announcing that it reached a consensual resolution of the dispute with the non-collaborating lenders. Under the settlement, TriMark will exchange all outstanding original debt for Tranche B Loans, and the Tranche A Loans will remain senior to the Tranche B Loans.

Serta Simmons Bedding, LLC

In a June 8, 2020 press release, Serta announced an agreement with a majority of its first and second lien term lenders to repurchase hundreds of millions of dollars of term loans in exchange for

new superpriority loans (senior to the then-existing first and second lien debt), effected through, among other transactions, various amendments to the existing loan documents. Non-participating lenders immediately challenged the transaction in New York State Court and requested a preliminary injunction to block the transaction. They argued, in part, that any change in the pro rata distribution provisions of the subject credit agreement required approval of all affected lenders.

The State Court denied the motion for a preliminary injunction, holding that the credit agreement "seem[ed] to permit[] the debt-to-debt exchange on a non-*pro rata* basis as part of an open market transaction." (*North Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC*, No. 652243/2020 [N.Y. Sup. Ct. June 20, 2020.]) The Court concluded that "[s]ince the amendments do not affect plaintiff[s'] so-called 'sacred rights'[] under the Credit Agreement, plaintiffs' consent does not appear to be required."

Other lenders challenged the transaction in the U.S. District Court for the Southern District of New York. The District Court dismissed the case on jurisdictional grounds and did not address the substance of the transaction.

Chesapeake Energy Corp.

In December 2019, Chesapeake Energy engaged in an uptier exchange of $3.2 billion in then-existing unsecured notes for $2.2 billion in second lien notes, reducing the company's pro forma debt obligations and extending maturity dates. Additional second lien notes were issued pursuant to a private offering. Unlike in the transactions discussed previously, Chesapeake Energy and certain affiliates filed for Chapter 11 bankruptcy shortly after closing on the uptier transaction. During the Chapter 11 cases, the official committee of unsecured creditors sought standing to challenge the uptier transaction, alleging that only certain preferred creditors "could reap the benefits," as they had exchanged unsecured debt for secured debt. Specifically, the committee sought standing to challenge the liens granted pursuant to the uptier transaction as both constructively and actually fraudulent transfers.

In a brief oral ruling denying the committee's standing motion and confirming Chesapeake Energy's Chapter 11 plan, the Bankruptcy Court found that settlements embodied in the plan, including those that settled claims related to the uptier exchange, were appropriate and comprised a "prudent exercise of business judgment" by Chesapeake Energy's management. The plan and associated settlements went effective shortly thereafter.

Recent uptier exchange status

Recent uptier exchanges provide a clear model for reducing pro forma liabilities in exchange for senior debt. Although such exchanges may be the subject of litigation, borrowers have been successful in defending against such suits and closing on uptier transactions.

Conclusion

Directors and officers of distressed companies have a number of tools available to them short of a bankruptcy filing to manage liability. Good faith, along with well-informed and prudent tactical decisions, can both satisfy fiduciary obligations and lead to improved financial standing.

Consensual covenant relief and amendments are often appropriate first steps in any workout. Asset dropdowns and uptier exchanges, where permissible or possible under existing debt documentation, are valuable alternatives as well. With appropriate advisors, management of a distressed company should analyze its credit agreements and other debt instruments to determine whether any of these, or any other liability management transactions, may be possible.

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