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Liability Management Exercises: A Transatlantic Perspective

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Over recent years, a prolonged period of low interest rates, together with a competitive financing market, has resulted in greater leverage and control for private companies (and their sponsors) when it comes to negotiating terms with current and potential creditors. There has also been, as a consequence of this dynamic and the general availability of capital, an expansion in debt document flexibility over the course of the last decade. The expansion of the use of the technology in such debt documents, and the existence of relatively benign economic conditions, have enabled private companies and their sponsors to consider whether to engage in certain liability management exercises (or LMEs) when facing liquidity issues or financial distress.

In this article, we will reflect on those exercises, their general use and how they may interact with (or be impactful in advance of) broader restructuring processes. We also trace the rise in their popularity in the U.S. and reflect on why these transactions are not yet market standard in Europe and so far, this has been limited to matters such as Olympic Entertainment and Intralot. As we note, legal and cultural reasons, together with the availability of relatively light-touch European restructuring processes, contribute to the limited practical application of LME transactions in Europe when compared to the U.S., and it remains to be seen whether their future use here may be on a more "exceptional" than "market standard" basis.

What Are Liability Management Exercises?

Historically, LMEs in all markets, but in particular the US, have been used by companies ahead of forthcoming maturities to reduce or manage their overall debt burden by way of tender offers (or debt buybacks) and exchange offers, allowing creditors to exchange their existing instruments for instruments with longer dated maturities and/or with other amended terms. While these techniques can be used as part of a holistic restructuring they are often used in a variety of distressed and non-distressed situations and form part of a standard tool-kit of options that companies have at their disposal when maturities are looming.

If you have questions about this article, please contact any Akin lawyer or advisor below:

Sam Brodie
sam.brodie@akingump.com
+44 20.7661.5363

Vance Chapman
vance.chapman@akingump.com
+44 20.7661.5333

Clare Cottle
clare.cottle@akingump.com
+44 20.7661.5398

Amy Kennedy
amy.kennedy@akingump.com
+44 20.7012.9868

Liz Osborne
liz.osborne@akingump.com
+44 20.7661.5347

Emma Simmonds
emma.simmonds@akingump.com
+44 20.7661.5420

Lauren Pflueger
lauren.pflueger@akingump.com
+1 310.229.1092

Patrick Mackenzie
patrick.mackenzie@akingump.com
+44 20.7661.5484

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In recent years, the term "LME" has been used by some market participants to cover two particular exercises:

a) **Drop-down and unrestricted subsidiary ("unsub") financings or spin-off**, where unencumbered assets are transferred to non-guarantor restricted subsidiaries or unrestricted subsidiaries with existing valuable assets, which are used to raise and secure additional liquidity.

b) **Senior debt incurrence and up-tiering**, which involves the insertion of priority tranche(s) of debt and/or the up-tiering of selected existing debt.

Both types of transactions are tried and tested in the U.S., but so far have not been widely seen in Europe.

Uses and Increasing Popularity

Drop-down/unsub financings and up-tiering transactions have generally been used in the US to raise additional liquidity to fund business operations or to facilitate deleveraging and capture a discount on existing debt where the company may not be able to access the traditional debt markets.

While liquidity issues, along with other potential causes of distress (such as near-term maturities or interest expense) can be addressed through a balance sheet exercise (whether that be effected consensually or through a court-sanctioned U.S. chapter 11 plan, an English scheme or restructuring plan or equivalent process), undertaking a LME with existing creditors or with third party creditors competing to offer liquidity on competitive terms can avoid the incremental time and significant cost requirements to which these US statutory processes may be subject. As discussed further below, given the amount of capital currently available in the financial markets, these types of capital structure solutions can be more attractive to sponsors and companies than seeking to implement a more comprehensive restructuring.

In the U.S., LMEs have become increasingly popular over the last decade. Availability of capital, combined with the rapid growth of the private credit market creating a larger investor community, document flexibility which have less stringent frameworks to adjust the priority of creditor claims on collateral, has meant the U.S. has been fertile ground in which drop-down/unsub financings and up-tiering transactions could evolve, particularly in the context of leveraged or high yield debt instruments.

The increased focus on the possibility of companies undertaking drop-down/unsub financings and up-tierings has been bolstered in Europe by an unusual set of economic shocks, such as high levels of inflation, the economic impact of the Russian invasion of Ukraine and the various consequences of the COVID-19 pandemic for businesses which, coupled with the withdrawal of government-backed support, have led companies to seek alternative solutions to address issues in their capital structures rather than (at least in the short term) undergoing a full-blown restructuring. When combined with financing markets which have been driven by sponsors and ever-increasing flexibility in debt documentation, it is a prime moment for sponsors, companies and opportunistic financing providers to reflect on the potential future use of these innovative structures.

But what drove the interest? The European market closely follows developments in the U.S. market, so inevitably developments in the latter will affect the evolution of the former. Document flexibility has also been a critical factor. Several years ago, loan covenants in the European leveraged finance market almost entirely converged around incurrence based covenants giving greater flexibility to debtors regardless of the type of leveraged instrument they chose to issue. Baskets have also generally become more generous and more highly structured (e.g. grower components, the ability to reclassify utilisation of baskets, freebie elements, high-watermarking and multiple permissions for similar concepts). It is now common for companies to have the ability to incur both pari passu and super senior financing as well as structurally senior financing through drop-down/unsub financings when the loan and/or bonds are first put in place, while the only financial covenant will typically be a springing

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net leverage covenant under an RCF (for the benefit of the RCF lenders only). In that context, the ability of investors to stop a company from pursuing a LME will in many cases be limited or non-existent.

While these transactions are common place in the U.S. market, they remain controversial and frequently lead to litigation as to the permissibility of the transactions: (i) under the terms of the debt documents; and (ii) more generally as a matter of law. However, to date, the U.S. courts at multiple levels have upheld a number of these transactions. Most recently in Serta Simmons, the U.S. bankruptcy court confirmed the debtor's interpretation of the term "open market purchases". In that case, Serta and certain lenders entered into an uptier transaction, with those lenders providing first out superpriority debt and exchanging their existing first and second lien debt for second out superpriority debt. Excluded lenders – with their prior first lien debt now subordinated – challenged the transaction, including on the basis that it was not an "open market purchase" under the credit agreement. In the recent decision, the judge held that the steps taken fell within the definition of "open market purchase" and so did not require Serta to extend the exchange of first and second lien debt to all (rather than some) lenders. This decision – the first on the use of "open market purchase" provisions to effect uptier transactions – will likely be a key reference point for future consideration of these types of transactions.

LMEs vs Restructurings

With such tools at their disposal, we have seen US companies and their sponsors seek to implement a LME in the first instance, rather than launch a restructuring process. Costs may be one driving factor towards the focus on a LME: effecting a solution under the terms of existing documentation, without (seemingly) needing to navigate competing stakeholder demands and/or a protracted, court-connected process, would necessarily seem to come with a lower spend. However, U.S. experience indicates that, notwithstanding the efforts to avoid a restructuring by undertaking the original LME, a number of US companies have subsequently entered a formal bankruptcy process. Therefore, while LMEs serve a useful purpose and have been effectively used to address immediate or near term issues for a company, they are no guarantee of avoiding a wider restructuring, as shown by the Serta Simmons, Neiman Marcus, Revlon and Envision Healthcare restructurings.

Creditors looking to participate in a LME should therefore carefully assess the potential for (a) future litigation in respect of the transaction, and (b) a future restructuring of the subject company as part of their diligence exercise so that they have a clear understanding of the potential risks or the potential benefits of the LME in a subsequent restructuring. Generally, the presence of an additional creditor, or group of creditors, in the capital structure with claims of differing structural seniority than the principal creditors will significantly heighten litigation risk and complicate any future restructuring process, from negotiating a deal to implementation considerations. This is likely to mean that restructurings post-LME will require more time to agree and place a greater strain on the implementation mechanism when compared to restructurings of unmodified capital structures.

We Know About the U.S. What About Europe?

As we've noted, the European market for drop-downs/unsubs and up-tiers is, at this stage, less developed than the U.S. market. This can be attributed to:

a) **Directors' duties regimes** – in the U.S., directors are generally protected by the "business judgment rule". While this varies between states, broadly speaking, the rule will mean that the courts will defer to board decisions and be reluctant to substitute their business judgment for that of the directors or to question business decisions, unless the decision of the board cannot be attributed to any rational business purpose. Therefore, the decision to elect to pursue a LME will not be subject to material court scrutiny. Directors' duties regimes in Europe are different, and can see directors personally liable (including on a criminal basis) for transactions while an entity is in the zone of insolvency. Given the lack of significant LME precedent in

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Europe, directors here feel more cautious than their U.S. counterparts when considering the implementation of a LME. That said, directors are likely to consider the duties they owe to the company require them to consider all available options to address the issues of the debtor which (given flexibility in financing documents) is likely to include LMEs and they will take comfort from any legal advice provided with respect to the permissibility of those transactions.

b) **Intercreditor agreements** – the English law model for intercreditor agreements (starting with the LMA) also presents a challenge for LMEs which include an uptiering or other modification to ranking with respect to the collateral not envisaged at original closing. Unanimous lender consent would typically be required to effect those modifications, meaning that an English scheme or restructuring plan would be needed if unanimity cannot be achieved – which negates the perceived simplicity of the types of transactions that we have been considering. Given these structural features are in place from the outset, structuring around such intercreditors to implement a LME can be impractical.

c) **The creditor / sponsor community in Europe** – it has been frequently noted that the creditor community in Europe is generally smaller and more collaborative than in the U.S., which may mean that there is less inclination for creditors and sponsors to pursue LMEs of the nature that we have described. European creditors may therefore be more likely to remain aligned. It will remain to be seen if that united approach continues or, when presented with a suitable opportunity (or opportunities), there is a shift to a more divided approach. This may be particularly true where investors have large quantities of undeployed capital (due to the current nature of capital markets) and are seeking innovative ways to deploy that capital while achieving suitable returns.

d) **Case law considerations** – exit consents are commonly used in connection with exchange offers in the U.S., which will strip the covenants (and other key provisions) of a debt instrument for non-consenting creditors. However, where the debt is English law governed debt, case law may limit the scope of exit consents the debtor wishes to employ. Since the 2012 *Assénagon* decision[1], market participants have expressed doubt over the extent of coercion that can be included in a consent solicitation. As a result, to date, a generally cautious approach has been taken to offers that include exit consents. Relatedly, in England, a majority vote must be exercised bona fide for the purposes of benefitting the class of stakeholders as a whole (*Redwood*, 2006[2]). This legal landscape, which is significantly different to the U.S. (as is exemplified by *Marblegate*, 2017[3]), provides an additional complexity to work through when preparing to implement the kind of transactions on which we have been reflecting.

e) **Differences in restructuring processes** – in Europe, in-court restructuring processes (such as the English scheme of arrangement and restructuring plan) provide a flexible framework within which debtors can seek to restructure specific tranches of debt, often resulting in these processes being more time (and cost) limited. These processes also typically give directors a good deal of comfort as they offer a court-approved transaction and usually provide for directors to be released from liability in relation to their involvement in the restructuring (and its preparation). Furthermore, the scheme of arrangement is a corporate law process and so does not have the attendant risks which can accompany commencing insolvency proceedings. In Europe, these factors may make a more formal in-court process more appealing than a LME transaction, with its attendant litigation risk. The dynamic is different in the US – where the alternative to a LME transaction is an often lengthy and costly chapter 11 process – and may be another reason why LME transactions have been more prevalent there than here.

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So What Is To Come In Europe?

LMEs of the kind that we have described are well-established processes (including before the courts) in the U.S. While there have been far fewer examples of these transactions in Europe to date, in the current market, it is inevitable that European companies (and their sponsors) are looking and will look at all options, even if they are discounted or simply used as leverage in negotiations. The technology exists in European documentation to execute these LME style transactions and, while the extra-contractual aspects that we have noted will need to be navigated, it may only be a matter of time before we see increased levels of activity in this area. What is clear, however, is that these types of transactions will form an important part of any strategic options analysis for European debtors for the foreseeable future, although the likelihood of such transactions being implemented (as opposed to acting as a coercion tactic when negotiating with creditors) will remain highly fact-dependent.

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[1] Assénagon (*Assénagon Aasset Management SA v Irish Bank Resolution Corp Ltd (formerly Anglo Irish Bank Corp Ltd) [2012] EWHC 2090 (Ch)*): Invitation by Anglo Irish Bank for noteholders to exchange existing notes for new ones. Exchanging bondholders required to commit to vote in favour of a resolution which would entitle the bank to redeem the notes of non-exchanging holders for 0.00001 per cent of their face value. The resolution passed, and minority bondholders challenged the resolution as an abuse of power by the majority bondholders, who unfairly oppressed the minority (non-accepting) bondholders.

[2] *Redwood Master Fund Ltd. V TD Bank Europe Ltd [2002] EWHC 2703 (Ch)*

[3] *Marblegate Asset Management, LLC v Educ. Mgmt. Fin.Corp., 846 F.3d1 (2d Cir. 2017)*, the effect of this decision was to narrow the grounds of challenge for dissenting bondholders in coercive exchange offers (where the core payment terms of the indenture are not amended). Albeit, this decision was limited to SEC-registered securities that are subject to the Trust Indenture Act.

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