The ins and outs of liability management transactions

In recent years, some distressed US borrowers have taken liability management transactions to increase their liquidity or extend their debt maturities. Now, these sorts of transactions – which are often intended to favour one class of creditors over others – are increasingly occurring in European jurisdictions, including the UK. Lewis Grimm of Jones Day explains what they are and why borrowers should be aware of them.

These liability management transactions – often referred to by the names of prominent companies which have done them, such as J.Crew, Chewy, Serta and Revlon – fall into three main categories:

- **Uptiering** – improving the payment priority or security ranking of all or part of a debt class relative to any other debt classes – for example, by converting unsecured into secured debt.
- **Drop-downs** – putting a business's 'crown jewel' assets out of reach of the secured creditors. This could be either to raise new debt or to provide additional collateral for existing debt (for example, in exchange for extending the debt's maturity). For example, a drop-down could be achieved by designating a subsidiary that owns material intellectual property as an unrestricted or excluded subsidiary.
- **Phantom debt** – incurring new debt that exists only temporarily in order to reach the required consent threshold to take actions under the terms of the debt documents.

These measures can be seen as an opportunity or a threat, depending on the interests of the party concerned. In the US, many lenders have tried – with varying degrees of success – to insert blocker provisions aimed at preventing these sorts of transactions from occurring.

So can these transactions occur in Europe? So far, there have been only a few prominent European transactions. They have included dropdowns from McLaren and Intralot and an uptiering from Cineworld. However, there are a few key differences in Europe relative to the US:

- **Legal fees** – many European jurisdictions require the losing party to pay the legal costs of the winner. This can be a strong disincentive against taking aggressive manoeuvres.
- **Director liability** – some European jurisdictions impose civil or even criminal liability for trading while insolvent. This could result in directors avoiding any actions they consider too risky.
- **Legal framework** – it is important to consider the legal principles that apply in the relevant jurisdiction to protect both borrowers and lenders (including minority lenders), both in and out of bankruptcy, since they often differ in material ways. For example, English law has 'anti-abuse' restrictions limiting the majority creditors' ability to exercise power to the detriment of the minority. This could make the majority creditors more reluctant to take aggressive actions that impair the interests of the minority.
- **Market implications** – both borrowers and private equity sponsors will want to consider whether their actions could impact their ability to borrow or enter into amendments or waivers in the future, especially if they need to engage with the same counterparties.

A borrower or lender which wants to engage in – or is concerned about – a liability management transaction will need to think carefully about the above points and their legal and business implications.

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