Simpson Thacher

Simpson Thacher's Liability Management *Expresso*

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Welcome to the inaugural edition of Simpson Thacher's *Liability Management Expresso*. Your quick taste of the latest trends and insights from the world of creative leveraged finance transactions. Written by our Liability Management and Special Situations team, this regular bulletin delivers a concise overview of developments that we see shaping markets in the U.S. and Europe. Whether you are staying ahead of strategic liquidity plays, tracking tactics employed across the market, or are simply curious about this continuously-evolving space, we will make sure that you are up to speed.

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U.S. Trends

LMEs: Let the good times roll or will tighter terms limit future activity?

Q: How widespread are liability management exercise transactions in the U.S.?

A: LMEs in the U.S. started as a trickle with J. Crew and Serta Simmons but have now become commonplace. LME activity surged to unprecedented levels in 2024. This activity saw borrowers implement more established types of transactions (uptiers and dropdowns) as well as more novel structures (such as double-dips and pari-plus) and transactions that combine several different LME elements.

Covenant Review tracked over 30 transactions that involved LME elements in 2024. In contrast, less than 20 comparable LMEs were tracked in 2023. The number of these transactions is even greater taking into account LMEs completed in a more traditional refinancing context.

Q: Will LME transactions continue to be commonplace?

A: There are no signs that LME activity will slow down. As long as there are viable options to extend maturities, raise capital and/or delever out-of-court, borrowers will (and should) continue to utilize LMEs. They are an effective technique to garner a high level of investor support, address near/intermediate term business concerns, potentially add liquidity and avoid a bankruptcy.

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However, post-LME documentation typically includes tighter covenants that may limit future refinancing or LME options. Certain of these restrictions are making their way in various forms into broadly syndicated loans and indentures (as well as private credit).

Q: What are examples of changes that may restrict future LMEs?

A: Building on the early-stage LME protections (such as Serta, Chewy and J. Crew blockers), the next generation LME blockers are broader and have developed in response to more novel structures. Below are some examples of next generation LME protections. Most of these protections tend to be subject to heavy negotiation.

Envision protection, investment limitations: Ensuring there is a cap on investments by credit parties in non-credit parties and/or, in certain transactions, requiring that investments in unrestricted subsidiaries be made solely pursuant to a dedicated (and capped) investments basket.

Other limitations on unrestricted subsidiaries: Varying tests designed to limit unrestricted subsidiaries or their use, *e.g.* pro forma leverage tests, capping the total value of unrestricted subsidiaries or the assets they can hold either at designation or for the life of the debt instrument, limiting the ability of unrestricted subsidiaries to provide credit support to or receive credit support from the credit group, or purpose-based clauses designed to prescribe what an unrestricted subsidiary can be used for. Or, in some cases, eliminating the concept of unrestricted subsidiaries altogether.

Enhanced sacred rights: Barring amendments to all or certain LME protections without the consent of each creditor or voting thresholds greater than a simple majority.

Double-dip and pari-plus protections: Requiring that any intercompany debt be unsecured and subject to a customary subordination agreement. Prohibiting unrestricted subsidiaries from holding debt that has recourse to the restricted group both at the time of their designation and at any point thereafter. Eliminating pari plus debt capacity whereby pari debt that is permitted under the debt document can also benefit from additional collateral and guarantees not provided to existing creditors.

Wesco/Incora protection, anti-dilution: Restricting the borrower from incurring or permitting additional debt for the primary purpose of influencing voting thresholds.

Instructing order of paydown: Directing the order in which the borrower can repay its debt, such as specifying that later-dated debt cannot be paid down before debt with an earlier maturity date.

General LME protection: Restricting the borrower from entering into certain transactions in connection with a liability management transaction, which may be a defined or undefined term.

Q: So, are documentary protections ending LMEs?

A: Not really, because strict LME protections remain relatively uncommon. The competitive landscape to provide financing for relatively healthy companies continues to lead to looser documentation terms and few, if any, LME protections.

Fulsome creditor protections generally only appear in documents after the borrower has executed an LME or emerged from Chapter 11 and, even then, only in certain situations. While loose versions of early generation LME protections have in some fashion made their way into the broader debt and loan markets, whether (and in what form) the next generation of LME protections make their way into the broader debt and loan market remains to be seen.

As the ever-evolving spectrum of LMEs prove, innovative structures will likely continue to provide for LME opportunities.

Sticks and carrots: Penalties for non-participating creditors and the cherry on top for those who structure the transaction

Q: How are non-participating creditors being incentivized to participate?

A: The suite of terms to incentivize participation is expanding. Incentives include:

Lien subordination: Non-participating creditors' liens on all collateral are stripped or subordinated by an amendment to existing debt documents, usually with the consent of a simple majority or a two-thirds supermajority.

Turnover provisions and payment subordination: Non-participating creditors must turnover collateral proceeds, guarantee or other unsecured recoveries to participating creditors until they are paid in full.

Economics: Supportive ad hoc group creditors may participate on better terms than those outside the ad hoc group through, for example, better exchange terms, cash or backstop fees.

Covenant strip: Participating creditors generally seek to execute exit consents and strip existing debt of its covenants, collateral and/or guarantees where possible, limiting or even removing many of the contractual and credit protections of the non-participants' debt documents.

Elimination of rights: Participating creditors may seek to neuter non-participating creditors' rights, such as potentially deferring interest payment defaults until maturity to effectively PIK the non-participant debt.

New debt lien/payment position: Participating creditors may get a mix of new second-out and third-out debt rather than being relegated to a third-, fourth-, or fifth-out position if they do not participate.

New money debt: Participation may provide non-ad hoc group creditors with an opportunity (but not necessarily an obligation) to contribute to new super-priority debt tranches on a proportional basis with their ownership of the original debt. These new money debt instruments generally have favorable pricing and robust prospects for recovery in a subsequent default.

Alternative transaction structure: Requiring participation in alternative transactions such that if certain levels of participation are not achieved, the alternative transaction, such as a drop down transaction, will automatically be implemented.

We employed a number of these strategies in connection with iHeartCommunications' recent LME, including an alternative transaction structure, covenant strips, guarantee releases, lien releases and lien subordination and/or recovery turnovers, to achieve over 92% aggregate participation across five debt tranches. Ultimately, an increased willingness by creditors to participate in LMEs may be driven more by the desire to avoid an outcome even worse than the LME (such as prolonged litigation, a less favorable debt instrument, reputational damage or bankruptcy) than by the terms or the fairness of the LME proposal.

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Q: How are participating creditors capturing post-LME transaction economics and optionality?

A: Ad hoc group members or key structuring participants are also leveraging their negotiation position to seek post-LME transaction benefits. These are a relatively new and expanding feature of LMEs that we expect to continue to evolve.

Ad hoc group-specific baskets: Participating debt documents may provide for an additional pari debt basket that is only available to be funded by the ad hoc group and with their consent.

Pricing MFN: Requires that the all-in yield of the closing date debt is increased to match (less a differential, *e.g.* 50 basis points) the all-in yield of any new incremental or other debt that is pari passu in payment and lien priority.

Hunter-gatherer rights: Provides participating creditors with the ability to exchange debt purchased in the open market for new senior debt at a premium to the purchase price, allowing such participating creditors to capture the discount (the amount, if any, of the economics split with the borrower is strongly negotiated).

European Trends

2024 in Europe: The Big Bang for U.S.-style priming?

Q: Did U.S.-style priming truly arrive in Europe in 2024?

A: Yes, though the answer is nuanced. Headlines from 2024, including Hunkemöller's uptier, Altice France's unsub transactions and Ardagh's pari-plus and hunter-gatherer transaction, suggest that Europe is seeing more creative priming maneuvers similar to those seen in the U.S. However, it remains to be seen whether 2024 was the Big Bang for European LME. Regardless, liability management (and the question "what can the borrower and its supportive investors do under the terms of the debt documents?") remains top of mind going into 2025.

Q: What is different about Europe compared to the U.S. when it comes to creative priming transactions?

A: Size of capital stacks, and risk/reward, matters. In Europe, large cap borrowers generally carry less debt than their U.S. counterparts, potentially reducing the perceived upside reward for investors that participate in more creative (and, some would argue, riskier) priming transactions. Supporting this thesis are the exceptions of Ardagh and Altice France, both of which have seen more creative transactions within their sizeable capital stacks of approx. $12 billion and €24 billion respectively.

Outside of these exceptions, the question remains whether there is enough upside reward in smaller capital structures to incentivize the pursuit of more creative transactions. Particularly in Europe where restructuring processes are often less expensive than Chapter 11 (and thus there is less incentive to avoid an expensive bankruptcy process). Interestingly, there have been bold moves in sub-$1bn cases like Hunkemöller (uptier), Oriflame (designating certain restricted subsidiaries as unrestricted), and (looking further back) Intralot (unsub transactions), suggesting that investor appetite may be growing.

Q: What other factors may limit creative priming activity in Europe?

A: Institutional relationships have a role to play. Markets are a people business. As the investor pool is smaller in Europe (when compared to the U.S.), a desire to maintain relationships may discourage maneuvers that might be seen as overly aggressive by other institutions and individuals in the European market. By contrast, family- or closely-owned companies (like Altice France, Ardagh and Intralot) may be more willing to consider creative priming transactions if they feel less restricted by the weight of cross-investment and cross-institutional relationships.

Q: Are there legal or structural hurdles to priming in Europe?

A: Three hurdles often come up.

First, European financing agreements may carry higher consent requirements than their U.S. counterparts for transactions that subordinate excluded creditors, particularly in loan agreements and accompanying intercreditor agreements. However this varies depending on a variety of factors, including the

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sponsor's leverage, the size of the deal and the nature of the debt instrument. The key question is what do the particular debt documents say? The smallest variation in drafting debt documents can have a big impact on borrower flexibility.

Second, priming transactions that rely on documentary interpretation (and ambiguity) inherently carry greater risk—brought into focus by the trend of excluded creditors fighting back. Any perceived increase in the likelihood of litigation post-transaction may influence behavior in Europe and lessen investor appetite for exclusionary transactions (particularly in jurisdictions where the loser typically pays both sides' costs, such as in England). The litigious environment can be seen on transactions such as Hunkemöller, the Dutch debtor-borrower that now finds itself in the New York state courts defending a challenge to its uptier transaction. Serta recently saw a U.S. appellate court decide that its 2020 uptier breached its credit agreement and excised the borrower's indemnity protection for its supportive creditors (see *below* for further detail).

Third, directors' duties across Europe are a patchwork of different regimes. Often, those regimes place stricter fiduciary responsibilities upon directors than those seen in the U.S. This makes it harder to justify moves that could put certain creditors at a disadvantage, particularly the closer the borrower gets to being at risk of insolvency.

Q: What is the outlook for liability management in Europe?

A: We have seen a real uptick in interest in liability management from European borrowers, and their sponsors and creditors. However, this interest does not necessarily equate to an interest in creative priming transactions alone. Their interest also extends to sensible portfolio management, transactions that capture the discount and that help to improve a cap stack or manage liquidity (in both the ordinary course and during times of temporary difficulty). More vanilla transactions align with principles of good governance and compliance with duties owed to investors.

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At the more creative end of priming transactions, the outlook in Europe remains situation-specific. Whether these transactions are capable of implementation will depend on the legal and relationship dynamics at play. Each borrower's situation is nuanced, turning on the jurisdictions involved, documentary constraints, the nature and wider context of the liquidity need, and the attitudes of the borrower, its sponsor/shareholder(s), its existing creditors and any potential liquidity providers.

Creditors are increasingly asking “what can we do” as opposed to “what can be done to us?” as European creditors and borrowers become more attuned to their rights and vulnerabilities. This knowledge might be best used as a stick to influence behaviors and encourage inclusive soft amendments and extensions (A&Es) or pro-rata transactions.

European co-ops: With friends like these, who needs LMEs?

Q: What is driving the rise of co-op agreements?

A: A trend from the U.S., co-ops are an attempt to shield against priming by forming a club of existing creditors that agree to a set of rules or parameters in respect of a borrower and a potential transaction. The shield may be effective, provided the co-op group holds a sufficient majority of the debt to be able to block transactions that require creditor consent. However, co-ops are far from a perfect defense and they are not appropriate in every situation.

Q: What are the limitations of co-op agreements?

A: Co-ops are most effective against actions that explicitly require creditor consent under the debt documents. However, they can be less effective (or worse, ineffective) in scenarios where borrowers have sufficient flexibility under their documents to execute a transaction without creditor consent or if the co-op group does not hold a blocking stake where majority consent is required (a co-op will likely not become effective until this threshold has been achieved).

Co-ops also frequently restrict debt trading while the co-op is in place, limiting market liquidity.

We have also seen the beginnings of borrower pushback against co-ops. Borrowers may use NDAs to create information imbalances and restrict communication between their creditors, undermining the ability of creditor groups to communicate and work together. Some borrowers are even seeking to include contractual terms in new deals that restrict creditors from talking to each other during the term of the debt, effectively using contractual covenants to block the formation of any co-op group further down the road (though this has yet to clear the market). There is also a growing question as to whether co-ops might be anticompetitive in some contexts, although this remains to be tested.

Q: How should creditors approach co-op agreements?

A: Creditors should critically assess whether the co-op is appropriate for the specific situation. Test the thesis behind the co-op. Speak to fellow creditors and your trusted advisers. Be aware of the latest trends, including the recent rise of two-tier co-ops where certain co-op group members receive different consent rights and/or economics under the co-op agreement.

Court Activity

NYE LME: Serta Simmons and Mitel Networks

On New Year's Eve, two different U.S. courts gave decisions on two headline non-pro rata uptier LMEs. Both Serta Simmons and Mitel Networks had relied on loan buyback provisions to exchange participating creditors' existing debt for new super-priority debt. Non-participating creditors were subordinated.

In *Serta*, the Fifth Circuit ruled the exchange was not an open market purchase (and breached the credit agreement's pro rata sharing provisions). In *Mitel*, the New York State Supreme Court found the exchange fell within a permitted purchase of existing debt (and did not breach the pro rata sharing provisions). For more detail on the *Serta* and *Mitel* decisions and the potential implications for the LME market, please see our memorandum and our observations for European LME.

Can you trust your appointed trustee (or your votes for amendments, etc.)?

Q: What has happened for securityholders?

A: A recent federal court decision, *UMB Bank v. Bristol-Myers Squibb* (BMS), serves as a cautionary tale for securityholders who replace their trustee without going through The Depository Trust Company (DTC).

Q: Why did the holders seek to remove and replace the trustee?

A: The holders of BMS' Contingent Value Rights (CVRs) were entitled to over $6 billion in payments if the FDA approved marketing applications for three of BMS' products by specified milestone dates. The CVR required BMS to use diligent efforts achieve the milestone dates. BMS failed to meet the milestone dates. Only the trustee could bring suit against BMS and certain holders thought that a trustee appointed by them would be better suited to take actions against BMS under the CVR.

Q: So, how was the trustee replaced?

A: Under the CVR Agreement, the trustee could be removed by at least a majority of the Holders of the CVRs, meaning the registered holders (*i.e.* DTC, acting through its nominee, Cede & Co.). However, an instrument of removal executed by a majority of the beneficial owners, but not DTC, was delivered to the then-acting trustee, Equiniti, purporting to replace it with a new trustee, UMB Bank. Equiniti issued a notice, executed by BMS, confirming that UMB Bank was the new trustee.

Q: How did things play out in court?

A: The CVR beneficial holders instructed UMB Bank to sue BMS for breach of the CVR for failing to use diligent efforts to meet the milestone dates, which it did. Two years after the case was filed, and after BMS' initial motion to dismiss was denied, BMS filed a motion to dismiss for lack of standing because Equiniti was never properly removed as trustee. UMB argued that Equiniti had authority to determine whether its removal was properly effectuated. The court granted the motion to dismiss: because DTC's nominee, Cede & Co. was the true "Holder" of the CVRs and had not appointed UMB Bank as the new trustee, UMB Bank did not have standing to sue BMS. So, the "new" trustee was not the trustee at all.

Q: What does this mean for securityholders?

A: Holders seeking to remove and replace a trustee or seeking to direct trustees for amendments or other actions under indentures or other instruments with trustees should be aware that instructions given by beneficial holders are subject to challenge and invalidation. Holders should instead seek the consent or proxy of DTC acting through Cede & Co. This "Demand and Dissent" process can take time and holders are cautioned to ensure timetables take this into account. Failing to do so can be incurable.

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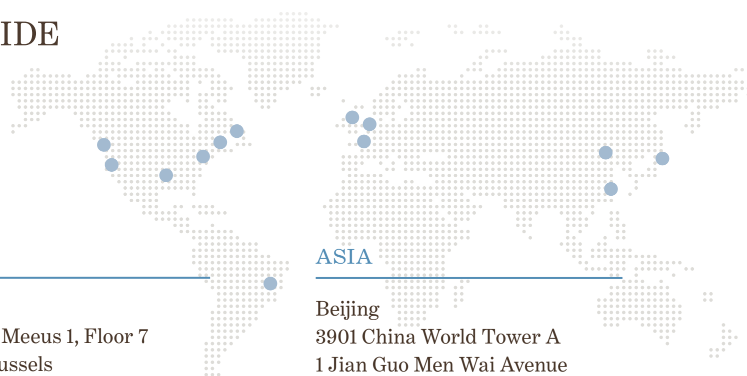

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**In November 2024, Simpson Thacher announced that it will open an office in Luxembourg.*