

Feature

KEY POINTS

- J-Crew-type financings have invariably faced intense market scrutiny, often ending up in disputes.
- Many companies with cash flows affected by the coronavirus disruptions have had to pledge some family silver to bolster their liquidity and stay afloat.
- Investors complain that they have never granted consent to substantial chunks of a debtor's asset base slipping out of their control through the doorway of unrestricted subsidiaries, which was created to launch start-up businesses.
- Using available collateral more creatively through dedicated baskets has untapped potential for both emergency financings and leveraged buyouts.

Author Francesco Lione

Creative uses of collateral: opportunities for leveraged companies

Credit to leveraged companies normally ties to the cash flow of the borrower's business. But the coronavirus pandemic has wreaked havoc on the financial standing of many borrowers, upending their ability to predict cash flows and prompting them to raise capital against hard assets' liquidation value. In the process, new transaction structures have emerged that use collateral more creatively to maximise borrowing capacity.

THE DILEMMA OF RAISING EMERGENCY FINANCE

Raising emergency finance involves balancing the interests of existing creditors and new lenders

Raising fresh capital in response to financial difficulties has always been a delicate balancing act for leveraged companies. They must convince new lenders to extend credit, which invariably involves anchoring lenders' recoveries to first-priority security over valuable assets. At the same time, leveraged companies must tactfully maintain existing creditors' strategic support. Allowing new lenders to skip the queue and take a priority claim over some family silver weakens the position of old creditors who have supported the business in the past. If antagonised, old creditors can organise and oppose the new capital raise or disengage and sell their debt, driving down its trading price. Either course of action can amplify the company's financial weakness and precipitate the very situation of distress that the emergency financing is designed to stave off.

Walking this tightrope is normally left to borrowers who have their backs against the wall: the marginal credits who struggle with making required payments on borrowed money, paying down trade credit, addressing covenant breaches or funding their operations. But the coronavirus outbreak

brought such a scale of disruption across the economy as a whole that scrambling for new capital injections to stay afloat became a fact of life for many businesses.

"J-CREW"-TYPE FINANCINGS

J-Crew-type financings have invariably faced intense market scrutiny, often ending up in disputes

When dusting off the toolbox in the spring of 2020 to make out ways of raising emergency financing, leveraged companies initially found one dominant blueprint, dubbed the "J.Crew" technique. In 2016, J.Crew Group Inc. transferred its brand and trademarks to an unrestricted subsidiary, situated beyond existing lenders' reach. That subsidiary issued secured bonds and swapped them for J.Crew's junior debt, thereby depriving existing lenders of their security over the intellectual property and repaying junior creditors ahead of them. The ensuing dispute with lenders quickly wound up in litigation, but settled before the court could render a final judgment. In the settlement, J.Crew offered lenders a suite of concessions (a partial early repayment, an accelerated amortisation schedule and tighter covenants) in exchange for their acquiescence to the unrestricted subsidiary's financing. When J.Crew ultimately collapsed in 2020, becoming one of the first major US retailers to be pushed over the edge by the pandemic, the practical

implications of that financing became clear: the old lenders languished in insolvency without recourse to J.Crew's valuable brand-name assets, which remained safely stowed away as collateral for the unrestricted subsidiary's bondholders.

Using unrestricted subsidiaries to place major assets out of existing lenders' reach has always rattled debt investors and stirred bitter legal battles, taking on a markedly negative connotation and turning into highly combustible PR material. The J.Crew saga was reminiscent of a prior fight between iHeartMedia and its creditors. In 2015, the US radio giant hived off its outdoor advertising business into an unrestricted subsidiary, provoking its bondholder group to rise up in revolt. Texas courts ruled in the company's favour, finding that the bond indentures explicitly permitted the disputed transfer. When iHeartMedia later filed for bankruptcy protection, the outdoor advertising business remained alive as a separate going concern, unaffected by the bankruptcy proceedings. Several other borrowers have followed in J.Crew's footsteps in recent years, in widely reported transactions that have proved equally effective at raising well-collateralised new debt as well as at spooking existing investors.

When McLaren, the UK sports car manufacturer and leading F1 team, announced a plan to navigate the pandemic's challenges by resorting to the J.Crew technique, its bondholders unsurprisingly responded with fierce resistance. McLaren was animated by a legitimate desire to solve the severe liquidity squeeze brought on by COVID-19 lockdowns, which had forced it to shut down its only manufacturing facility and close its global dealership network, as sales plunged to less than half their normal levels. The company's

plan was to drop its headquarters in Woking and its iconic collection of heritage cars into an unrestricted subsidiary and borrow against the value of those assets. But the incensed bondholders pushed back, claiming that the carmaker had already pledged the same assets to them and that the proposed recourse to a J.Crew structure rested upon an abusive reading of the bond indenture. McLaren applied to the English High Court, seeking confirmation that the planned transaction was legal, but then backed off. It chose instead to enter into an accommodation with its bondholders, under which it would support liquidity with a sale and leaseback of the headquarters in exchange for a host of additional bondholder protections, including stringent restrictions on its intellectual property and collection of heritage cars. The McLaren case stood out as a sobering warning for borrowers reeling from plummeting revenues and rushing to shore up their balance sheets during the pandemic. It suggested that, in the future, companies might have to raise emergency funding in less confrontational ways than deploying the J.Crew armoury if they to preserve the broader investor base's enduring allegiance.

THE SHIFT TOWARD ASSET-BACKED LENDING DURING THE PANDEMIC

Many companies with cash flows affected by the coronavirus disruptions have had to pledge some family silver to bolster their liquidity and stay afloat

A new approach started to emerge in the wake of the stimulus measures announced by governments and monetary authorities around the world in March 2020, which buoyed the global leveraged finance markets and restored a measure of investor confidence. For businesses that had seen their revenues collapse and had little insight into when they would go back to normal levels, meeting the customary parameters of “cash flow lending” had quickly become impossible. In cash flow lending, an investor's decision to extend credit primarily ties to the prospects of servicing and repayment (at least in part) from the borrower's predictable cash flows over the term of the debt. It is the borrower's job to substantiate those

cash flows, either by sharing forward-looking projections with investors or by giving them information concerning current operating trends that would enable them to model out the future. But what assurances could borrowers give investors at a time when the borrowers' cash generation had ground to a halt and they had no idea how long the lockdowns would last or when things would get back to normal? In the teeth of the pandemic, leveraged companies intuited that, to entice investors back to the market, they had to anchor their expectations of repayment to a different and more certain metric. They then started to raise capital not against uncertain projections of cash flows, but against the liquidation value of saleable collateral. Cash flow lending was out and asset-backed lending was in.

A few pathfinding deals highlighted the new trend. Before the COVID-19 crisis, Carnival Corporation & Plc, a global cruise line business with shares listed on both the New York Stock Exchange and the London Stock Exchange, had an investment grade rating and financed its operations with *unsecured* debt, comprising short-term commercial paper, long-term bonds and revolving bank loans. In March 2020, the company had to abruptly suspend all its cruise operations, ceasing to earn any revenue and beginning a fight to stay afloat. Rating agencies quickly downgraded its credit ratings to sub-investment grade status, as the management team started rolling out a series of actions designed to stem the bleeding of cash: reducing capital expenditures, suspending dividend payments, trimming the fleet and drawing down on the revolving lines in full. To further bolster liquidity, in April 2020, the company went back to the bond market to raise \$4bn. As a “fallen angel” with uncertain prospects for long-term survival, Carnival had to grant bondholders security over 86 of its idle vessels and its material intellectual property, introduce a 25% loan-to-value (LTV) financial test and accept a steep coupon of 11.5% per year. Yet, in a surprising development, the deal closed successfully and became a harbinger of the times, demonstrating that, with a high interest rate and a low LTV ratio, even a company leaking \$1bn of cash per month could access the financing market. The value of Carnival's pledged collateral was less than certain at the time of

the deal: resale prices of ships were suffering while they remained out of service; the market for used cruise ships was small and illiquid; and Carnival's ships were flagged in jurisdictions, such as Bermuda, Panama and Curacao, where foreclosure procedures are less tested than in the US or the UK. Yet investors piled in, attracted by the high yield and reassured by the \$27bn in net book value that the vessels securing Carnival's bonds carried. Variations on the theme soon followed, with dozens of companies rushing to the capital markets to pad their balance sheets with debt offerings secured against an ever-widening universe of collateral, spanning from landing slots (Delta Air Lines) to movie theatres (AMC Entertainment), spare aircraft parts (United Airlines), tropical islands (Norwegian Cruise Lines) and mileage programs (American Airlines). Ailing companies in industries most affected by the pandemic reached for liquidity lifelines by making more creative use of their strategic assets as collateral and tapping into the renewed investor enthusiasm for yield sparked by the supportive fiscal and monetary policies announced in all major economies around the globe.

Instead of resorting to the controversial J.Crew technique, this new breed of asset-backed financings relied on concepts of “permitted lien”, “permitted security”, “exempt security interests”, or similar terms that appear universally in credit agreements and bond indentures. Under these concepts, borrowers may not typically incur liens that are not shared with existing creditors, unless those liens fall within the well-defined boundaries of permitted exceptions. By invoking these explicit exceptions, in 2020, leveraged companies started using their assets as collateral more strategically to secure emergency capital infusions.

DIVERGING MARKET REACTIONS TO RESCUE FINANCINGS

Investors have pushed back against J.Crew-style transactions but have acquiesced to other types of rescue financings that have dominated recent headlines, despite the similarity in “priming” outcomes

Existing creditors' acceptance and the market's enthusiastic reception of these

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new financings stood in sharp contrast to the vociferous opposition that the J.Crew progeny of deals elicited. Why would existing creditors acquiesce to being primed by new secured financings based on notions of “permitted security” and cry foul when the use of an “unrestricted subsidiary” achieves a similar priming outcome? The practical effect of either type of financing is the same: they both give new lenders superior ranking over important assets of leveraged companies and put them lenders ahead of existing creditors in expected recoveries from the sale of those assets.

The enigma of why certain emergency financings, like Carnival’s, maintained existing creditors’ allegiance, while others, like J.Crew’s and McLaren’s, were denied it, is one for which no definitive solution may be found. We are dealing here with a complex kind of problem that involves numerous factors working in changing combinations. It is hard to put forward a hypothesis that fully accounts for the inevitable differences in the drafting of various credit agreements and bond indentures, the uniqueness of each borrower’s business circumstances and the volatile swings in market behaviour from one moment in time to another. Any hypothesis must therefore rely on an impressionistic examination of the record and is necessarily personal. The method of inquiry here is to seek out factors of emergency financings that are both significant and different, factors that set the J.Crew structure apart from notions of “permitted security”. From this point of view, differences in the genesis of the two legal constructs appear most salient.

In the case of “permitted security”, the market has always viewed the enumerated exceptions to the negative pledge covenant as an explicit blessing to take unencumbered assets, which are not already pledged to existing creditors, and use them as collateral to secure new funding. Credit agreements and bond indentures unquestionably include these exceptions to allow borrowers to raise secured finance with first priority ranking over previously unencumbered assets. Borrowers can affirmatively rely on them as part of the original bargain with creditors to secure liquidity lines on a rainy day. Their unassailable legitimacy seems to have put them, so far, beyond the slashing

criticism and the flood of legal challenges directed at the J.Crew technique.

Conversely, the construct of “unrestricted subsidiary” came into existence for reasons that have nothing to do with emergency funding. Borrowers were initially given the option to treat a subsidiary as unrestricted in view of the possibility that they may create new ventures that would incur losses and require sizeable financings in the early start-up phase. If included within the scope of “restricted” entities and subject to the incurrence covenants, those new ventures might adversely affect borrowers’ calculations of net income for dividend-paying purposes, of EBITDA for debt-incurrence purposes and of several other covenant metrics. Freed from the covenants’ governance and with an ability to incur substantial amounts of debt to finance their growth, those new ventures might succeed; whereas their forced compliance with incurrence restrictions might stifle their potential in the cradle. In order to give borrowers the operational autonomy to run new ventures, while preventing such ventures’ investment needs from burdening the ring-fenced resources of the credit group, the market hatched the carefully balanced concept of “unrestricted subsidiary”. On the one hand, the debtor is permitted to house the new venture in an entity that will not be governed by the restrictive covenants of the credit agreement or the bond indenture and that will be off-limits for existing creditors: an *unrestricted* entity, as the label aptly suggests. On the other hand, any use of the debtor’s financial resources for the unrestricted entity’s benefit is treated in the same way as other instances of value leakage and faces the same constraints that limit restricted investments. Once the unrestricted entity is up and running, any transactions that the unrestricted subsidiary enters into with the debtor’s ring-fenced credit group must be on arm’s-length terms and comply with affiliate transactions covenants.

Over time, not much has changed in how borrowers have leaned on notions of “permitted security”. Marketing materials used in the 1980s as well as today disclose the risk of *effective* subordination that the exceptions to the negative pledge covenant

carry: if new creditors take security over certain debtor assets to support their loan, while the debtor’s existing creditors do not, the existing creditors’ claims will be *effectively* subordinated to the new loan, to the extent of those assets’ value. Investors have always clearly understood and consented to the implications of permitted security, and the only thing that has fluctuated over time is just how keenly leveraged companies have felt the need to raise new capital under the umbrella of this contractual permission. By contrast, creative dealmakers have gradually adapted and modified the use of unrestricted subsidiaries beyond the scope of what they were initially intended for, stretching the concept to the extreme of the J.Crew-type financings. In these hotly contested financings, borrowers place existing valuable assets into an unrestricted vehicle not to fund a new venture, but to raise capital in ways that the incurrence covenants would otherwise prohibit. In some cases, those assets are not unencumbered property of a debtor, but part of the security pledged to existing creditors, which see their credit support package eroded when the debtor siphons off the same assets into an unrestricted vehicle. Despite the fact that this use of unrestricted subsidiaries often sits within the four corners of the literal text of credit agreements and bond indentures, investors have risen up in arms against the J.Crew technique because they view it as a breach of the intended bargain. They complain that they have never granted consent to substantial chunks of a debtor’s asset base slipping out of their control through the doorway of unrestricted subsidiaries, which was only ever meant to be traversed to launch start-up businesses.

Long-standing market expectations may not be dispositive in court, but they are good predictors of investors’ behaviour when issuers wish to source rescue capital without making waves with existing creditors

LEGALITY AND LEGITIMACY IN DEBT FINANCINGS

The campaigns that investors have waged against J.Crew-style capital raisings seem to go

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Francesco Lione is a partner in the leveraged finance practice of Latham & Watkins, based in London. Email: francesco.lione@lw.com

beyond the mere issue of contractual legality. Borrowers attempting these transactions may have succeeded, and may yet succeed, in pulling them off by demonstrating their compliance with the financing contracts' formal prescriptions. But experience gathered in 2020 shows that the market may nonetheless perceive those transactions as lacking commercial legitimacy. There are no indications that the regularity and earnestness with which investors have protested against the use of unrestricted subsidiaries for priming liquidity injections are set to abate anytime soon.

Taking stock of these trends, issuers who wish to raise new debt in the face of financial difficulties, without arousing discontent from existing creditors, may wish to look beyond the operative meaning of financing contracts and deploy deal structures that can be subsumed within the original bargain with investors. Similar to political theories that adduce a primeval "social contract" as the basis of legitimate governmental authority, postulating an "original bargain" with investors may at first sound more like fiction than reality. The investor base, transaction models and the wording of financial contracts evolve over time, while US and English courts have often stressed the imperative need to consistently interpret contracts that govern long-term debt based on their literal meaning, showing little regard for extratextual circumstances that evidence subjective intent. Nonetheless, uniform market reactions and long-standing transactional customs evince a more abiding conformity of understanding among market participants than the transient and unique history of any individual financing contract. These market norms may not carry the day in court, but conforming to them may turn out to be decisive when it comes to smoothing over controversies with investors swiftly and amicably.

In this light, raising new secured debt that primes existing creditors by being classified under the negative pledge covenant's permitted exceptions has proved a durable strategy endowed with a manifest seal of legitimacy. The J.Crew technique has not, but that need not be the end of the matter. Borrowers may yet be able to impart

legitimacy upon the J.Crew technique if they clearly stipulate in their contracts that they *may* use unrestricted subsidiaries to raise secured finance against assets that initially belonged to restricted entities. Efforts in that direction would almost certainly generate a response from underwriters and lenders; and might touch off a negotiating process that will over time settle the point in new, creative ways that are as yet unknown in current market practice.

IMPLICATIONS FOR LEVERAGED BUYOUTS

The recent ASDA deal shows that creative variations on the theme of asset-backed lending have untapped potential for LBO financings

The global shift towards asset-backed lending has had repercussions beyond the rambunctious province of rescue financings: it has affected the slick world of leveraged buyouts, too. Witness the financing of the Issa brothers' and TDR Capital's takeover of UK supermarket chain ASDA in February 2021.

The deal combined traditional cash flow lending and the recently rediscovered flair for asset-backed finance. The dealmakers structured the core financing package much in the customary way, encompassing *pari passu* revolving lines, term loans and senior secured bonds, with a layer of unsecured notes at the bottom of the pecking order. Yet, carefully grafted onto that stock were additional tranches of bespoke financing, each with repayment prospects specifically anchored to the monetisation of a distinct group of assets. In the olden days, the borrowers would have raised the additional funding that these bespoke tranches provided simply by expanding the size of the core financing package and raising headline leverage, perhaps in the expectation that they may sell off some assets in the near term. But during the pandemic, market appetite for high leverage had tailed off and the extent to which borrowers could stretch standard cash flow lending had clearly shown its limits. The buyers of ASDA, therefore, had to cut the capital structure a bit differently to obtain the

intended size of financing commitments.

The buyers identified certain noncore assets of ASDA, consisting of forecourts and distribution centres, that they could keep separate from the base security package offered to main creditors and subsequently sold off. They then parlayed those forecourts and distribution centres into stand-alone collateral to raise additional strips of bridge financing, which carried short-term maturities and was required to be repaid with the sales proceeds of those assets. With this innovative approach to leveraged buyout finance, the Issa brothers and TDR Capital partitioned the rich asset base of ASDA into different portfolios, each dedicated to the financial security of a different class of creditors on satisfactory terms. The investors thus succeeded in the delicate balancing act of increasing the overall amount of debt the target company carried beyond what would be typical within the boundaries of traditional leveraged lending without spooking mainstream debt investors. The £2.75bn bond sale supporting the deal drew more than £8bn of orders and priced around the tightest levels ever seen for comparable credits in the leveraged finance space, conveying a manifest endorsement by investors of the financing proposition that the ASDA owners had ventured to bring to market.

The ASDA financing template may be hard to export to asset-light companies, but parties can adapt and replicate it in future similar transactions with a bit of legwork involving accurate asset reports, in-depth structuring papers and valuation studies that credibly spell out the monetisation potential of the assets earmarked for a quick sale. ■

Further Reading:

- First among equals: priming debt in leveraged capital structures (2021) 3 JIBFL 176.
- The negative pledge and disposal restrictions: carve-outs and remedies for breach (2017) 8 JIBFL 510.
- LexisPSL: Banking & Finance: Practice Note: Covenants in debt capital markets transactions.