Blocking the Next "Trap Door"

Strengthening collateral protection by limiting baskets in credit agreements

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Last year, the coronavirus pandemic exacted significant damage on economies around the world, including on corporate borrowers. At the height of the pandemic, bank credit to businesses grew at an annualized rate of 80% in the U.S., Eurozone, Japan, and U.K. And with the volume of high-profile corporate bankruptcies in decline, it is apparent that companies are still seeking to amend and re-negotiate their credit agreements, or finding new sources of financing in order to bolster liquidity.

Even while, according to a recent report on credit trends by S&P Global Ratings, credit conditions remain borrower-friendly, investors may ultimately demand better yields and more security in the event that inflation materializes. One approach to that is ensuring that strong collateral protections are in place.

In secured debt financing in particular, corporate borrowers are required to pledge collateral in order to secure their, or their guarantors', obligations under the credit documents—and the collateral may comprise tangible and intangible assets of the borrower. In addition to pledging collateral, credit agreements include various covenants with which the borrower must comply.

Negative covenants set forth prohibitions on actions that the borrower may not take, like making investments, incurring new debt, transferring or granting liens on assets, or making acquisitions.

NEGATIVE COVENANT	EXAMPLE TEXT
Investments	The Borrowers will not, and will not permit any of their respective Subsidiaries to, purchase, hold or acquire (including pursuant to any merger or Division) any Investment, except . . . .
Incurring New Debt	Each of Holdings and the Company shall not, and shall not permit any of its Subsidiaries to, directly or indirectly, create, incur, assume or guaranty, or otherwise become or remain directly or indirectly liable with respect to any Indebtedness, except . . . .
Fundamental Changes And Asset Sales	Neither the Borrower, nor any other Loan Party nor any Subsidiary will merge or consolidate with or into any other Person (including, in each case, pursuant to a Delaware LLC Division, but excluding, in the case of a consolidation, any Netherlands Fiscal Unity), or liquidate, wind-up or dissolve (or suffer any liquidation or dissolution), and neither the Borrower nor any other Loan Party nor any Subsidiary shall sell, lease, convey, assign, transfer, or otherwise dispose of all or substantially all its assets to, any Person, except . . . .
Acquisitions	Such Obligor will not, and will not permit any of its Subsidiaries to . . . make any Acquisition or otherwise acquire any business or substantially all the property from, or capital stock of, or be a party to any acquisition of, any Person, except . . . .

These limitations on the borrower's operational and financial activities provide lenders with a degree of control, and are aimed at protecting lenders against possible non-repayment of the debt. To provide borrowers with limited flexibility to continue operating in the ordinary course of business, many negative covenants include a basket, or deductible—a maximum dollar amount relating to a specific exception to a negative covenant.[1]

[1] Examples include:

Other Investments in an aggregate outstanding amount of not more than $50,000,000 during the term of this Agreement.

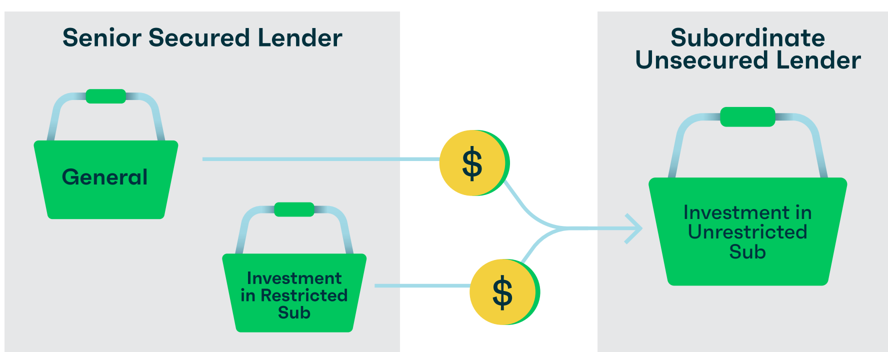
Other Indebtedness not to exceed $25,000,000 in the aggregate principal amount at any time outstanding.

Other Liens with respect to which the aggregate amount of the obligations secured thereby does not exceed $10,000,000 at any time outstanding.

The J. Crew "Trap Door"

Credit facility baskets came to the forefront when retailer J. Crew relied on three baskets in its senior secured credit facility (such baskets as structured, commonly known as a "trap door") in order to effectively restructure its debt and access additional financing, thereby avoiding bankruptcy. In 2016, the company transferred intellectual property (including the J. Crew trademark and related intellectual property) to a subsidiary that was not subject to the credit agreement's negative covenants. The intellectual property assets were then used to collateralize new notes in an offered exchange for unsecured pay-in-kind notes that were structurally subordinated to the senior secured credit facility. Without the brand name in its collateral package, the senior term lenders saw the recovery of the $1.57 billion term loan—representing over 90% of J. Crew's debt—sink to 41 cents on the dollar, resulting in the senior term lenders going to court in an effort to prevent the transaction from closing.

The J. Crew transaction entailed a two-step process. First, the company used the general investments basket in the credit agreement that allowed for $100 million of "other" investments by the loan parties, and a basket that permitted investments up to $150 million by loan parties in restricted subsidiaries that were not loan parties, to transfer $250 million of intellectual property assets to a restricted subsidiary. Second, J. Crew used the exceptions provided by a third basket to transfer the $250 million of intellectual property assets from the restricted subsidiary to an unrestricted subsidiary.



Collateral leakage benefits new lenders or existing subordinate lenders, to the detriment of existing senior secured lenders.

The transfer from the restricted subsidiary to an unrestricted subsidiary was permitted by the aforementioned third basket that allowed J. Crew and its restricted subsidiaries to make investments in, among other things, its unrestricted subsidiaries, financed with proceeds received from investments in such restricted subsidiaries. The unrestricted subsidiary was not bound by the terms and conditions of the credit agreement, so there were no restrictions on its ability to incur additional indebtedness that was secured by a lien on the transferred intellectual property. Further, the baskets were not limited by leverage ratios, or other financial covenants.[2]

Blocking the “Trap Door”

The “trap door” maneuver resulting in collateral leakage gained followers as the distressed environment continued to prevail. Similar transactions were effected by a number of other high-profile companies, including:

- Cirque du Soleil (transfer of intellectual property to an unrestricted subsidiary)
- Claire’s Stores (transfer of intellectual property to an unrestricted subsidiary)
- iHeart Communication (transfer of shares in its subsidiary, Clear Channel Outdoor Holdings from a restricted, guarantor subsidiary to an unrestricted, non-guarantor subsidiary)
- PetSmart (transfer of shares in its subsidiary, chewy.com, to an unrestricted subsidiary, as well as to its parent holding company, controlled by a consortium of private equity sponsors)
- Neiman Marcus (transfer of shares in its European subsidiary, MyTheresa, to an unrestricted subsidiary, followed by a subsequent transfer to the company’s parent holding company)
- Party City (designation of its balloon business as an unrestricted subsidiary)
- Revlon (transfer of intellectual property to a restricted subsidiary)
- Serta (debt-for-debt exchange pursuant to which exchanging lenders received payment priority for exchanging old debt at a discount)
- Windstream (spinoff of assets in a sale leaseback transaction)

Naturally, the highly publicized “trap door” also led to many articles advising lenders in the United States, Canada, and Europe on how they may protect themselves against such a maneuver. Lenders may take several measures to eliminate or mitigate the risk of this type of collateral leakage. Example tactics include: separate restrictions on any transfer of specifically identified or material assets, third party valuation and fairness opinion on asset transfers, limits on the assets and revenue of unrestricted subsidiaries and elimination of the category of unrestricted subsidiaries.[3] A “catch-all” provision that limits the unrestricted subsidiary to use only specific unrestricted subsidiary baskets has also been suggested.

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[2] The general investment basket was limited to the greater of $100 million or 3.25% of “total assets” plus barring an event of default, the “Available Amount” (being an amount provided for in the credit agreement that was tied to earnings). The basket that permitted investments by loan parties in restricted subsidiaries that were not loan parties was limited to the greater of $150 million or 4.0% of total assets plus the Available Amount. Additionally, the credit agreement provided that J. Crew’s ability to designate a subsidiary as “unrestricted,” meant that the company had to meet a 6.0 to 1.0 (calculated on a pro forma basis) “Total Leverage Ratio.” In the suit against J. Crew regarding this transaction, one argument against the company was miscalculation of this Total Leverage Ratio.

[3] Examples of actual drafted J. Crew “blockers,” with commentary, may be found here.

Credit Agreement Analysis

Many debtors, in need of financing to increase liquidity, appear willing to seek ways to free collateral from existing credit facilities to pledge for new money or refinance near term looming existing debt. Given the multiple examples of debtors who have followed J. Crew's lead, as discussed above, there is no better time for lenders to analyze their existing and proposed credit facilities for the risk of collateral leakage. Additionally, as certain debtors seek relief from current covenants and amendment of existing facilities, lenders have the opportunity to tighten up any potential weaknesses in these renegotiated agreements.

Lenders and their advisors need a plan to accomplish such a review and analysis. This is where AI software could be implemented for big wins as part of this plan of review, allowing greater review with less resources, more accurately and faster. Time is of the essence, as we have seen more of these maneuvers recently, including the case of Travelport Limited.

Travelport and Unqualified Baskets

As discussed above, J. Crew used a combination of baskets and subsidiaries to create its "trap door." Many credit agreements will limit the borrower's ability to utilize certain baskets to negative covenants by requiring pro forma compliance with a leverage ratio or other financial covenants. But this type of qualification does not always exist. As has been recently publicized, UK-based Travelport Limited is another example of a debtor using its covenant structure to move $1.15 billion of collateral from existing secured credit arrangements. Travelport's credit agreement is not publicly available, but it has been reported that the company took advantage of certain baskets not qualified by a leverage ratio or other financial covenants.

Financial covenants serve as important safeguards for lenders in both maintenance and incurrence based covenants. Without these safeguards in place, lenders will not be able to assert that Travelport incorrectly calculated the financial covenants that may have restricted the company's ability to use the baskets. Travelport's action in relation to its credit agreement may raise concerns for lenders and their advisors as to whether their credit agreements also contain similar weaknesses.

Analysis of 2020 Credit Agreements, January 1 through July 31

Taking inspiration from Travelport, we decided to study how many contracts we analyzed contained a general basket for the investment restriction negative covenant that were not qualified by a financial covenant.[4] A general basket is a basket that is not tied to a specific use, and general baskets appear in many other negative covenants in addition to the investment restriction. For this study, we decided to focus only on the general basket contained in the investment restriction negative covenant as it played a prominent role in the J. Crew maneuver.

Our data set consisted of 156 credit agreements filed on EDGAR between January 1 and July 31, 2020, with deal values between $25 million and $500 million. We did not set other parameters as we wanted to mimic a broad analysis of various credit agreements. We imported these agreements into Kira and analyzed the results.

Using Kira's smart fields and Answers & Insights capability, we created a series of questions to obtain a granular analysis of these agreements. After an initial filter of the agreements using a Kira built in smart field, we used Kira to accurately answer the questions we created while also providing evidence from the agreements to support the answer Kira provided, even though there was considerable variation in the agreement drafting. We also used Kira's workflow tools to filter out agreements not meeting our requirements for the study.

To quickly filter the documents, we first applied Kira's "Investments and Acquisitions Covenant" smart field to determine if the agreement contained an investment restriction negative covenant. We used Kira's workflow features to quickly separate the documents with such a covenant from the general population of all documents. From our 156 credit agreements, 100 of those agreements, or 64%, contained such a negative covenant.

64% Included Investment Restriction Negative Covenant

Source Data: 156 credit agreements filed on EDGAR between January 1 and July 31, 2020, with deal values between $25 million and $500 million

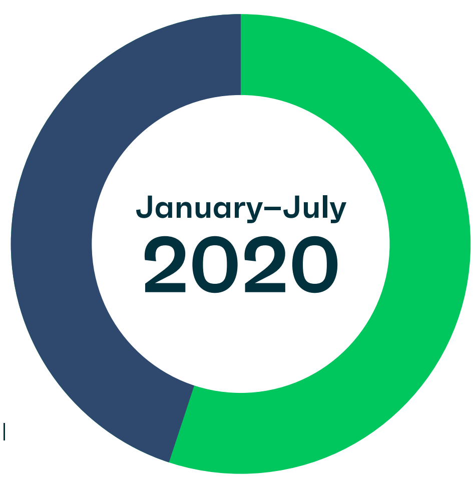
[4] For the purposes of this study, we considered any general basket that either was completely dependent on a financial covenant or financial calculation for its existence or was tied to a financial covenant or financial calculation to be qualified.

We then used Answers & Insights to identify whether the investment restriction negative covenant contained a general basket. From the 100 agreements with the covenant, 71 of those agreements, or 71%, contained a general basket.

— **71%** Included General Basket

Source Data: 100 credit agreements filed on EDGAR between January 1 and July 31, 2020 with deal values between $25 million and $500 million that included an investment restriction negative covenant

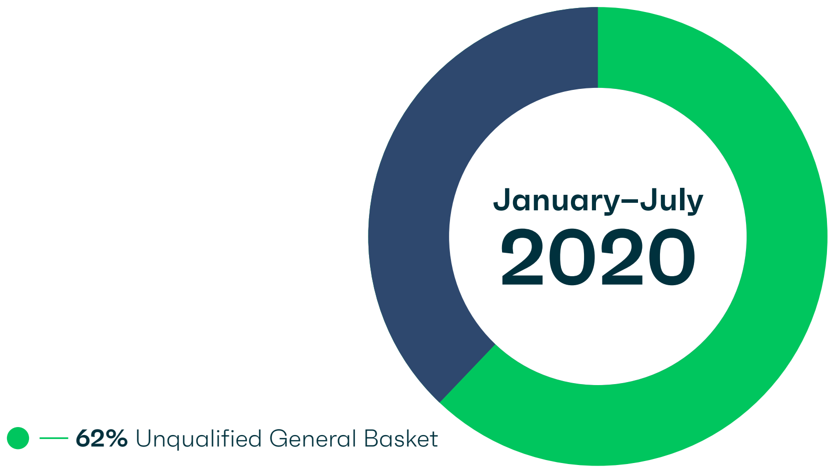
We then used Answers & Insights to analyze if such general baskets were tied to a financial covenant. From the 71 agreements with the general basket, 39 of those agreements, or 55%, were **not** tied to a financial covenant.



— **55%** General Basket Not Tied to Financial Covenant

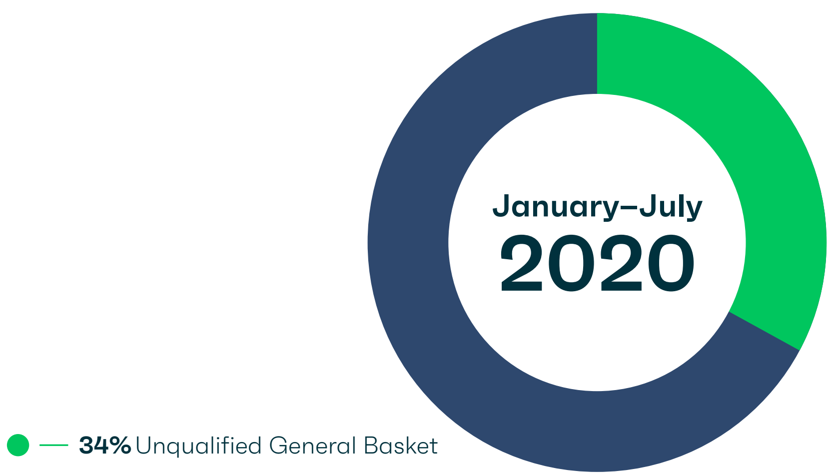
Source Data: 71 credit agreements filed on EDGAR between January 1 and July 31, 2020 with deal values between $25 million and $500 million that included a general basket for an investment restriction negative covenant

Finally, certain baskets are qualified by a reference to “no event of default” occurring or would occur if the basket were used. Many credit agreements will then contain financial covenants that must be met to avoid an event of default. We also wanted to exclude any general baskets that may be qualified by this event of default language in credit agreements that also contain financial covenants. To that end, we used Answers & Insights to determine if any of the remaining agreements contained financial covenants and if the general baskets were qualified by event of default language. From the 39 remaining agreements, 24 of those agreements, or 62%, did **not** contain this qualification.



Source Data: 39 credit agreements filed on EDGAR between January 1 and July 31, 2020 with deal values between $25 million and $500 million that included a general basket for an investment restriction negative covenant not tied to a financial covenant

Thus, we determined that a total of 24 agreements out of the 71 agreements with general basket contained in the investment restriction negative covenant, or 34%, analyzed using Kira, were **not** qualified by financial covenants.



Source Data: 71 credit agreements filed on EDGAR between January 1 and July 31 2020 with deal values between $25 million and $500 million that included a general basket for an investment restriction negative covenant

Accordingly, over a third of the relevant credit agreements we analyzed appeared to be at an enhanced risk of collateral leakage through a "trap door" type transaction or similar aggressive use of covenant weaknesses due to the presence of an unqualified general basket in a negative covenant. Note that for this study we focused on the investment restriction negative covenant; however, general baskets occur frequently in many other types of negative covenants and all general baskets should also be analyzed in a comprehensive review of credit agreements.

Given the frequency with which general baskets are included in investment restriction negative covenants (as mentioned above, due to borrowers' need for some operational flexibility), the significant portion of those agreements in which the general basket for the investment restriction negative covenant is neither tied to financial covenants nor otherwise qualified by "no event of default" language, should serve as a caveat emptor for lenders. Careful analysis of the effects of baskets on restrictive covenants, as well as consideration of the aggregate amount available under such baskets, will be essential to lenders as they develop strategies to protect their investments and to mitigate the risk of collateral leakage or transfer of collateral.

For borrowers, the lack of both financial covenants and "no event of default" language in connection with the general basket for the investment restriction negative covenant means that covenant weaknesses may still facilitate creative transactions that provide borrowers with additional liquidity. This study focuses on one aspect of the overall analysis that both lenders and borrowers should undertake in evaluating exposure (or availability, depending on the perspective) to potential transfer of collateral. By using other smart fields and Answers & Insights, loan parties can quickly gain a complete understanding of that exposure.

Conclusion

It is likely that financial covenants will see a corresponding increase in pressure as borrowers seek new financing, or amendments and waivers to their credit facilities in order to preserve liquidity, avoid defaulting, and remain afloat as global economies begin to recover. These amendments and waivers may include temporary softening or suspension of financial covenants, as well as waivers of potential or actual breaches. Also, companies may opt to take aggressive stances in the interpretation of their credit agreements. Companies may have significant needs for financing that can only be secured by valuable assets, which some lenders believe are already securing existing facilities. Conversely, if credit markets become less accessible to borrowers due to inflation, for example, weaker companies may not be in a position to negotiate for “trapdoor”-like provisions, and lenders may be more vigilant about basket restrictions and collateral leakage.

As part of more overarching plans for reviewing large volumes of credit documents and developing strategies to withstand a likely uneven economic recovery, Kira can help accelerate the timeline on which accurately identifying important provisions can be completed, along with recommendations shared in our webinar on rapid response loan review and the changing regulatory environment. This study in particular illustrates the criticality of accurately identifying potential weaknesses in covenants and evaluating collateral related provisions for the risk of collateral leakage.

To mitigate the risk of collateral leakage, lenders should proactively seek to include “blocker” language and basket restrictions to limit borrowers’ actions with respect to unrestricted subsidiaries. As to existing agreements, in the past few years, the debt market has accepted increasingly more borrower-friendly terms and conditions, including more generous baskets and aggressive methods for calculating financial covenant components. Lenders need a thorough understanding of risks contained in their contracts to create a plan to handle those risks. On the other hand, as lenders become wary of weaknesses in covenants and transactions intentionally structured to take advantage of them, borrowers should similarly review covenant language carefully, so that subsequent transactions do not pose the risk of breaching their obligations under pre-existing credit facilities.

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