Tricks & Traps in Leveraged Finance

Leveraged Finance

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Meet the Faculty

Panelists

Andrew Hutchinson - Much Shelist, P.C.

Joe Patterson - Sidley Austin LLP

Moderator

Krista Mancini - Jones Day

About This Webinar

Tricks and Traps in Leveraged Finance

Leveraged finance terms have evolved in recent years to give borrowers significantly more flexibility than even before the financial crisis. In recent restructuring and workout situations, borrowers have tried to use that flexibility to improve their position relative to the existing lender group. This webinar discusses some of those recent cases and how borrowers were able to exploit weaknesses in their debt documents, as well as other trends in liability management transactions.

Learning Objectives:

- Identify common pitfalls in leveraged finance deals, including overly permissive covenants and hidden borrower flexibility.
- Learn how to spot "trap doors" in credit agreements, such as:
  - ➢ Incremental debt capacity
  - ➢ "J. Crew" and "Chewy" provisions allowing asset transfers and leakage
  - ➢ EBITDA add-backs and adjustments
- Understand risks associated with collateral leakage and unrestricted subsidiaries.
- Learn to analyze cash flow assumptions and the potential for over-leveraging.
- Explore strategies to mitigate risks for lenders and creditors while understanding borrower tactics.
- Gain practical tools to evaluate leveraged finance structures for potential "tricks" that could shift risk in unanticipated ways.

About This Series

Leveraged Finance 2025

Debt has always been an important part of the capital structure of many corporations and private equity portfolio companies. At some point, most companies will need to decide whether and how to incur debt, either in the ordinary course of business or to fund acquisitions or other transformative transactions.

This webinar series focuses on the leveraged finance market in particular, meaning borrowings by companies whose credit rating is (or would be if rated) below investment grade (that is, a rating below BBB- by S&P / Baa3 by Moody’s).

Over time, the leveraged finance market has developed its own set of market conventions and terms that may be unfamiliar to traditional lenders.

Episodes In This Series

#1: Navigating Credit Agreements

Premiere date: 6/25/25

#2: Tricks & Traps in Leveraged Finance

Premiere date: 8/27/25

#3: Current Trends in Leveraged Finance

Premiere date: 9/24/25

Episode #2

Tricks & Traps in Leveraged Finance

Each Financial Poise Webinar is delivered in Plain English, understandable to investors, business owners, & executives without much background in these areas, yet is of primary value to attorneys, accountants, & other seasoned professionals. Each episode brings you into engaging, sometimes humorous, conversations designed to entertain as it teaches. Each episode in the series is designed to be viewed independently of the other episodes so that participants will enhance their knowledge of this area whether they attend one, some, or all episodes.

Spotlight on Credit Document Provisions

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Given all of the recent focus on liability management transactions and creditors' fears of loopholes within credit documents, are there certain provisions in credit documents that receive increased attention from creditors (perhaps provisions that weren't previously a focus point)?

- Incremental DDTL
- Unrestricted Subsidiaries
- Scope of sacred rights

Key Considerations for Lenders

What about a creditor buying into an existing credit agreement or acting as a lender in a syndicate without much control over the negotiation of the credit documents. What are some key provisions or mechanics in the credit documents that a lender in this situation should focus on to assess potential leakage or layering risk?

- Debt and lien baskets
- Restricted payments capacity
- Intercreditor agreement protections
- Amendment provisions/voting thresholds
- Commercial assessment of the value of unencumbered collateral, certain business lines/subsidiaries ripe for disposal

J-Crew Trapdoor & Black Holes Explained

Sometimes people refer to concepts of the J-Crew trapdoor and of restricted payment black holes. What do these two concepts mean?

- Ability for Loan Parties to invest in non-Guarantor Restricted Subsidiaries
- Ability of non-Guarantor Restricted Subsidiaries to invest using the proceeds of a contribution by a Loan Party
- If unlimited ability to invest in non-Guarantor Restricted Subsidiaries, sometimes referred to as a black hole

Case Study: J.Crew Transaction

So J-Crew is a big focus when it comes to flexibility of debt terms.
What happened in that case?

- J.Crew used the Trap Door provision in its credit agreement to effectively turn $150mm of investment capacity in non-loan party restricted subsidiaries into an additional $150mm of investment capacity in unrestricted subsidiaries
- J.Crew transferred IP assets to an unrestricted subsidiary by engaging in a two-step intercompany transaction:
  - ➢ **Step 1:** J.Crew used a $150mm investment basket earmarked for investments in non-guarantor restricted subsidiaries, in addition to the general $100mm investment basket, to contribute $250mm of IP assets to a foreign non-guarantor restricted subsidiary in the Cayman Islands
  - ➢ **Step 2:** The foreign non-guarantor restricted subsidiary made a $250mm contribution of IP assets to an unrestricted subsidiary
- The purpose of the transfer was to enable the unrestricted subsidiary to use these new assets as collateral to issue new debt in exchange for the PIK notes maturing in 2019
- Eventually the majority term lenders approved the transaction by amending the term loan terms via a debt buyback and consent solicitation.

Challenges to the J.Crew Transfer

What were the arguments used by the agent for the lenders to try to stop the transaction from taking place and what lessons can we learn?

- IP transfer exceeded permitted investment and disposition baskets (the IP license arguably gave the IPCo the ability to control all of the IP, so the contribution should be valued at 100% of the IP's value and not merely at the 72% portion that was contributed)
- Violated lien covenant (by giving IPCo the right to terminate the operating company's IP use rights if the license fee was not timely paid)
- Violated security agreement provisions precluding IP collateral from being terminated, invalid or unenforceable
- Violated covenant prohibiting the transfer of all assets by Loan Parties

Market Response to J.Crew

What has been the market response to J-Crew?

- Shock. Trying to prevent investors from being “J-Crewed”
- Introduction of J-Crew “blockers”
- Not all blockers work
- May need to broaden scope of blockers to cover other assets that are important to the business (e.g., FCC licenses, major contracts, etc.)

Case Study: PetSmart/Chewy Transaction

The PetSmart/Chewy case is another example of a company using its basket flexibility to the detriment of the lenders. What happened there?

- PetSmart acquires Chewy in April 2017 for $3 billion and entered into financings to help fund that acquisition
- PetSmart transferred 16.5% of Chewy to an unrestricted subsidiary and dividends 20% of the stock of Chewy to its parent, Argos Holdings
- Since Chewy was no longer a wholly owned subsidiary of PetSmart, Chewy was released from its guarantees of term loans and senior notes
- PetSmart noted that the transfer to the unrestricted subsidiary was made using the general investment basket and the dividend to Argos was using restricted payment capacity

Disclosure Risks in Offering Memoranda

No doubt, the transfer or release of the main assets of a note issuer is pretty scary for an investor. Are these risks typically disclosed in offering memoranda and lender presentations? Do the underwriters or arrangers have a duty to disclose these types of things?

- Buyer Beware: Do not count on flexibility being highlighted in the Offering Memorandum / Lender Presentation
- A basic premise of disclosure is that sophisticated investors do not need risk factors regarding the terms of the loans or securities they are buying
- Investors now relying more on third party services such as Covenant Review

Lender Options to Challenge Collateral Leakage

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Assuming that the covenants arguably permit a transaction that allows for collateral leakage, is there anything that can be done by the lender group to stop the transaction?

- Fraudulent transfer claims
- Illegal dividend claims
- Breach of fiduciary claims
- Other options – TROs/injunctions, UFTA remedies

Strategies for Lenders & Investors

What strategies would you recommend to lenders / investors facing these types of situations?

- Organize early
- Act collectively
- Try to maintain required lender/noteholder group
- Consider timing of perfection analysis / valuations
- Other

Uptiering Transactions: What Are They?

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In workout situations, people sometimes talk about uptiering transactions. What are they and can you provide examples of these?

- Uptiering transactions are transactions that improve the credit position of one class of creditors relative to other classes.
- Examples include:
  - ➢ subordinated debt to unsecured debt (or subordinating non-consenting creditors)
  - ➢ unsecured debt to secured debt (or stripping collateral from non-consenting creditors)
  - ➢ junior lien to higher-ranking secured debt (e.g., pari passu first lien (usually via accordion), last out first lien, 1.5 (or even 1.25) lien or superpriority lien debt
  - ➢ collateral or guarantees that only benefit one creditor class (e.g, via secured guarantee of unrestricted subsidiary or other non-loan party, or pledging excluded collateral)
  - ➢ structurally senior debt (i.e., closer to the valuable assets of the group, usually at a foreign subsidiary level)

Case Study: Serta Uptiering Transaction

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When discussing uptiering transaction, we often hear Serta raised as a case study. What happened in that case?

- Serta effected a recapitalization of its debt structure by exchanging a majority of first lien and second lien debt into new money "first out" and "second out" tranches using non-pro rata open market purchases of the 1L and 2L credit agreements, which primed existing debt that became "third out" tranche
- Offer to fund the new money and roll up tranches was only made to some (but not all) of the 1L and 2L lenders
- existing credit agreements did not expressly require unanimous lender consent (nor consent of all affected lenders) to subordinate the liens
- Recent "Serta" updates:
  - ➢ Transaction fit within bounds of "open market" purchase provisions in credit agreement
  - ➢ "open market" exception not ambiguous on its face

Defending Against Uptiering Risks

What can lenders/noteholders do to prevent themselves from being uptiered?

- Clear drafting
- Anti-layering covenants
- Limit ability in debt documents to conduct dropdown transactions
- Tight debt baskets
- If holdco debt, ensure that debt documents require that the opco remain a direct subsidiary of the holdco
- Maintain required lender/noteholder group to push back on any changes (including by signing a lock up agreement, if necessary)

Questions or Comments?

If you have any questions about this webinar that you did not get to ask during the live premiere, or if you are watching this webinar On Demand, please do not hesitate to email us at info@financialpoise.com with any questions or comments you may have. Please include the name of the webinar in your email & we will do our best to provide a timely response.

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Meet The Faculty

Andrew Hutchinson - AHutchinson@muchlaw.com

Andy is a debt finance attorney who focuses on commercial lending transactions. Over the past 20 years, he has represented direct lenders, banks, private equity sponsors, and corporate borrowers in acquisition finance and corporate finance transactions.

Andy has structured, negotiated, and documented debt financing transactions of various types, including domestic and cross-border acquisition financings, general corporate lending transactions, recurring revenue facilities, syndicated facilities, asset-based loans, debtor-in-possession facilities, workouts, and restructurings.

Prior to joining Much, Andy was a partner in the finance department of a large Chicago-based law firm. Earlier in his career, he spent many years as in-house counsel, first with a New York-based hedge fund and, more recently, with a large direct lender. Andy's significant in-house experience has informed and shaped his practical approach to the transactions he handles on behalf of his clients.

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Krista Mancini - kmancini@jonesday.com

Krista Mancini represents financial institutions, public and private borrowers, private equity sponsors, project sponsors, and distressed debt investors in a variety of financing transactions. Her experience includes secured and unsecured credit facilities, acquisition financings, project financings, syndicated facilities, and debtor-in-possession financings that encompass a broad spectrum of industries and business sectors.

Joseph Patterson - jpatterson@sidley.com

Joe Patterson is a senior managing associate in the Global Finance group at Sidley Austin LLP. Joe focuses his practice on acquisition and other leveraged financing deals, including senior secured and unsecured credit facilities, mezzanine financings, asset-based transactions, advising both borrowers and lenders in syndicated, club, and bilateral transactions.

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