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Liability Management Transactions With Non-Loan-Party Subsidiaries

By Evan Palenschat, Ethan Konschuh, Allison J. Satyr, Kelly M. Dybala, James A. Snyder, Kelly A. Lazaroff and James E. Croke*

In this article, the authors examine liability management transaction structures that do not require lender approvals at all.

Default rates on leveraged loans climbed to 5.3% in 2024, exceeding the pandemic-era spike of 4.5% in 2020. Early 2025 data points to further increases, pressured by higher long-term interest rates, slower projected U.S. gross domestic product growth and tariffs headwinds in certain sectors.

In these conditions, operating companies often struggle with liquidity, leverage, and near-term maturity. At times, private-equity sponsors respond by executing liability management transactions with the goal of adding liquidity, reducing leverage, or extending maturities – while protecting sponsor equity value. Because disadvantaged lenders may have little incentive to consent to transactions that may compromise their economic positions, these transactions must often be permitted without needing lender approvals under the existing credit documents or, if lender approval is required, without needing unanimous consent.

This article focuses on transaction structures that do not require lender approvals at all and does not discuss other types of liability management transactions that are typically done with required lender approvals (e.g., priming transactions). The feasibility of these transactions and the manner in which they can be structured depend on the terms of the underlying credit documentation – specifically, (i) the restrictions on transferring assets to, or providing credit support by the borrower or other loan parties to, non-loan parties, and (ii) the rules governing the designation of unrestricted subsidiaries, as transfers of assets to such entities trigger an automatic release of the security granted to the existing secured lenders in the transferred assets, which, in turn, provides flexibility for such assets to be relevered by new debt outside of the structure to which the existing lenders extended credit.

LOAN PARTIES AND NON-LOAN PARTIES

Credit documentation generally refers to loan parties as borrower-affiliated entities that are either directly obligated to repay a given loan or extension of

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credit (borrowers) or have guaranteed such obligation to repay (guarantors). In secured deals, loan parties pledge their assets as collateral to secure the underlying debt. Lenders typically negotiate for restrictions on the activities of such entities, through covenants that govern their ability to incur debt, grant liens, make investments, make certain distributions to upstream entities, repay junior or subordinated debt, and consummate transactions with affiliates. However, it is not always the case that all company entities are required to become loan parties that provide guarantees and pledge assets.

Within the non-loan-party group, there are two categories: non-loan-party restricted subsidiaries and unrestricted subsidiaries.

1. Non-Loan-Party Restricted Subsidiaries

Non-loan-party restricted subsidiaries are subsidiaries of the company group that, while not required to guaranty the debt or pledge assets to secure it, are still bound by the covenants and events of defaults that govern the permitted activities of loan parties. These entities are included for purposes of performance calculations (earnings before interest, taxes, depreciation, and amortization or EBITDA; leverage; coverage ratios; etc.) but are either not able to be guarantors (due to legal or contractual restrictions) or it would be inefficient to require them to become guarantors. A common example is a foreign subsidiary that has operations that contribute to the company's performance but cannot provide credit support without triggering liability under the United States tax regime, or, even where tax implications are less relevant, where such subsidiary operates in a jurisdiction where it is expensive to document the credit support or the subsidiary's jurisdiction of organization has an ineffective lender enforcement regime. Because senior secured lenders do not have claims against or other direct recourse to non-loan-party restricted subsidiaries, credit documentation will, among other things, limit debt (whether secured or unsecured) of, and transfers of assets to, non-loan-party subsidiaries.

2. Unrestricted Subsidiaries

Unrestricted subsidiaries, like non-loan-party restricted subsidiaries, are company entities that do not guaranty debt or pledge assets to secure it. However, in contrast to non-loan-party restricted subsidiaries, they are not bound by the restrictions under the credit documentation and are not included in the company's performance calculations. Given this, credit documentation will typically include rules around designation of, and transfers of assets to, unrestricted subsidiaries to avoid excess value leakage from the collateral and guarantee support packages that the lenders rely on.

LIABILITY MANAGEMENT TRANSACTIONS USING NON-LOAN PARTIES

Two of the most common iterations of liability management transactions using non-loan parties (but by no means the only available options) are "drop-down" and "double-dip" transactions. Both are methods of raising new debt by giving certain existing and/or new lenders improved claims to the assets of the loan parties. The first widely publicized liability management transactions used unrestricted subsidiaries as the vehicle through which these transactions were consummated. These transactions led lenders in the market to negotiate for increased protections to limit transfers to unrestricted subsidiaries and overall exposure to value leakage. In the past few years, companies have begun to use non-loan-party restricted subsidiaries to accomplish similar results.

1. Drop-Downs

In a drop-down transaction, a company will typically cause loan-party assets (i.e., collateral) to be transferred to non-loan-party subsidiaries, resulting in an automatic release of existing senior secured liens. Next the non-loan-party subsidiaries incur new debt secured by those assets on a "structurally" senior basis to the existing senior secured debt.

- *J. Crew.* The flagship drop-down transaction was consummated in 2016 by J. Crew. The transaction involved the use of three transfer baskets: (1) the common intercompany basket for investments by loan parties in non-loan-party restricted subsidiaries; (2) a common general use investment basket; and (3) a basket (which came to be known as the trap door basket) permitting investments by non-loan-party restricted subsidiaries in unrestricted subsidiaries if such investment is financed with the proceeds of other permitted investments. This trap door allowed the company to convert the investment capacity under the first two baskets to be used for transferring value into an unrestricted subsidiary in the form of J.Crew's valuable intellectual property. Because unrestricted subsidiaries are not bound by the covenants in the credit documentation, there were no limits on such subsidiary incurring debt secured by such material intellectual property (IP).

In the years following this transaction, the market has largely accepted a new lender protection in credit transactions whereby material IP is not permitted to be transferred to, or exclusively licensed by, unrestricted subsidiaries. Some variations of this protection in the market are stronger than others and are negotiated on a deal-by-deal basis.

- *Envision.* The market language incorporated to curtail the "J. Crew risk" was focused on stopping drop-down transactions accomplished by transfers of IP but generally did not prevent companies from using available basket capacity to transfer other types of assets into unrestricted subsidiaries. In 2023, Envision Healthcare consummated a transaction that highlighted the possibilities afforded by "stacking" various baskets permitted to be used for investments in unrestricted subsidiaries. It is customary in credit documentation for the designation of an unrestricted subsidiary to be treated as an investment in that subsidiary for purposes of the investment covenant. Accordingly, to designate an unrestricted subsidiary, there must be sufficient capacity under the investment baskets to do so. The Envision loan party group comprised a profitable segment and a struggling segment. By "stacking" multiple baskets, the company found sufficient capacity to designate the profitable segment of the business as an unrestricted subsidiary, resulting in the release of material guarantees and collateral that had supported the existing senior debt, which were then used to secure new debt issued by the unrestricted subsidiary. Since the Envision transaction, the market has reacted by limiting the baskets that can be used to transfer property (whether as an investment, restricted payment, or otherwise) to unrestricted subsidiaries to a limited set of capped baskets (thereby restricting the "stacking" of baskets to be used for transfers of assets into unrestricted subsidiaries).

A typical current formulation for "Envision" protections in credit documentation would be that investments in unrestricted subsidiaries can be made only in reliance on a single basket (i.e., no stacking) specifically to be used for investments in unrestricted subsidiaries. A more ideal formulation for lenders (though rarely found in the sponsor-backed market) would restrict unrestricted subsidiaries from ever owning more than a de minimis percentage of total assets and a de minimis percentage of consolidated EBITDA for the consolidated company. Also, reclassification of baskets to increase investment capacity in unrestricted subsidiaries may sometimes be prohibited, and the company is restricted from "rebuilding" the applicable basket after usage.

- *Pluralsight.* In 2024 Pluralsight consummated a drop-down using investment capacity in non-loan-party restricted subsidiaries. Taking a page out of the J. Crew playbook, the company transferred material IP to a non-loan-party restricted subsidiary, which also resulted in a release of the liens in favor of the existing senior secured lenders. However, since non-loan-party restricted subsidiaries are still bound by the covenants in credit documentation, the amount of liens and debt permitted to be incurred by those subsidiaries under the Pluralsight Credit Agreement was limited.

As a result, although Pluralsight was able to move some assets out of the reach of its existing lenders and use those assets to raise debt at a non-loan-party restricted subsidiary, it was limited by the amounts permitted under its covenant baskets; ultimately the new money injected was not enough to satisfy the company's liquidity needs, and the company was subsequently turned over to the lenders in an out-of-court restructuring. In the wake of Pluralsight, lenders have sought to place aggregate caps on the amount of debt that can be incurred at non-loan-party restricted subsidiaries under general use baskets as well as to limit the amount of assets that can be transferred by loan parties to these entities (including, in some cases, restrictions on transfers of material IP).

A typical current formulation for "Pluralsight" protection in some deals would be provisions restricting any affiliate of the company that is not a loan party from owning, holding, or exclusively licensing any material IP and/or imposing aggregate caps on non-loan-party investment and debt basket capacity. A more ideal formulation for lenders (again, rarely found in the sponsor-backed market) would be a restriction on any affiliate of the company that is not a loan party from ever owning, holding, or exclusively licensing any asset (including IP) that is material to the business of the company. Some formulations are stronger than others and may not be feasible in certain structures, so lenders and borrowers should consider the relevant factors on a deal-by-deal basis and tailor Pluralsight protections accordingly.

2. Double-Dip

Double-dip transactions involve structures resulting in certain lenders having multiple claims against assets that are generated from the same extension of credit.

- *At-Home.* In May 2023, a non-loan-party restricted subsidiary of At Home Group Inc. organized in the Cayman Islands issued a tranche of senior secured notes. The newly issued notes were guaranteed on a senior basis by the company and certain restricted subsidiaries, and the issuer lent the proceeds of the notes to the company in exchange for an intercompany note guaranteed by the same parties that guaranteed the notes directly. As a result, the holders of the notes had two separate paths to recovery: (x) a direct secured claim against the Cayman subsidiary, the company, and the restricted subsidiary guarantors via the guarantee of the notes, and (y) an indirect secured claim via the Cayman subsidiary's interest in, and pledge of, the intercompany note.

Since this transaction, the market approach to preventing double-dip transactions has been to (1) not allow unrestricted subsidiaries to hold debt in, liens on, or equity of the borrower or any of its restricted subsidiaries at any time (instead of only limiting this conduct at the time the subsidiary is designated as unrestricted), and (2) in some deals, to expressly restrict a double-dip transaction with detailed language or restricting any non-loan-party affiliate from owning any debt in a loan party unless it is unsecured and subordinated to the senior obligations.

While liability management transactions are an important option for companies facing capitalization difficulties, certain iterations – including drop-downs and double-dips – often result in existing creditors being disadvantaged. The market has evolved to include language that provides protection to creditors against these transactions, but which protections are appropriate and how restrictive they are is determined on a case-by-case basis. Both lenders and borrowers need to consider the salient aspects of the borrower's business and its corporate structure and weigh the legitimate needs for the ability to transfer assets to non-loan parties against the need for lenders to be confident that they have access to the assets they are lending against. However, note that even in deals where the lenders are able to negotiate to include any of the protections described in this article, such protections can still be overridden with a vote of a majority of the senior lenders, as the provisions implementing the same are rarely included as a sacred right that would need the approval of all lenders adversely affected thereby, rendering the negotiated protections only as strong as the relationships among the parties.