

WHAT ARE LIABILITY MANAGEMENT EXERCISES?

Liability management exercises – also known as LMEs, liability management transactions (LMTs) and distressed debt exchanges – are back in the headlines. LMEs are complex strategies that companies use to restructure their debt obligations – often by exchanging, repurchasing, or renegotiating terms – to reduce financial strain, manage cash flow more effectively, and improve their overall financial health as an alternative to bankruptcy. While recent LMEs have spurred concerns across creditors, it is important to note that this strategy can also be used constructively. In such cases, LMEs commonly exhibit voluntary participation, transparent communications, and prioritize value preservation for the borrower while ensuring the same terms for all creditors. That being said, common controversial LME solutions that can also be used in some combinations (not mutually exclusive) include dropdowns, uptiers, and double-dips

- **Dropdowns:** Allows the borrower to move material assets (without creditor approval) to a subsidiary, with those assets then used as collateral to issue new, structurally senior debt. For example, in 2017, J.Crew transferred its IP to an unrestricted subsidiary that was subsequently used to secure new financing, leaving existing lenders with a lesser valued collateral. Today, many credit documentation mitigates for this risk dubbed the “J.Crew blocker”.
- **Uptiers:** Allows a majority or supermajority of existing creditors to amend their debt documents to subordinate the liens on existing collateral to a new issuance of senior debt and then exchange their subordinated debt for the new debt, at the expense of nonparticipating creditors. For example, in 2020, Serta Simmons Bedding (Serta), engaged in a deal with a majority group of lenders to exchange their existing loans for super-priority debt, subordinating lenders that did not participate in this exchange. As a result, many high-profiled lawsuits ensued and still affect how LME contracts are structured today.
- **Double-dips:** Allows distressed borrowers to raise new capital while leveraging their existing capital structure for enhanced collateral coverage. In these deals, a subsidiary incurs new debt that is secured by its assets and guaranteed by the credit group – the first dip. The borrower uses the proceeds to fund a loan to the existing group for the purpose of buying back the existing debt at a discount which creates a receivable for the borrower that is pledged to the lender as additional collateral – the second dip. For example, in 2023, At Home Group executed a double dip transaction to address

near term liquidity needs and impending debt maturities by issuing new senior secured notes through a newly established subsidiary. With no guarantor ties to the parent company's existing debt, the subsidiary lent the proceeds back to At Home Group in exchange for a secured intercompany note. As a result, both the new notes (subsidiary) and intercompany loan were guaranteed at the parent level (At Home Group), creating two separate claims against the same collateral for the creditors involved in the transaction. In response, stronger documentation languages have emerged to tighten the definitions of "Loan Parties" and "Guarantors", limiting exposures to this type of LME.

Controversial LMEs typically follow a similar playbook – raise new capital during periods of financial stress, avoid consent from all existing lenders, and skip the line (prime) for new/existing lenders to existing collateral. Notably, these types of controversial transactions have occurred mostly in the broadly syndicated loan (BSL) market, underscoring how borrowers can exploit documentation gaps and or a fractured creditor base. In contrast, private credit lenders tend to be better insulated against controversial LMEs through structural mitigations including control over debt documentation, unanimous club or sole lender consent rights for any amendments, direct management access, and collateral protections through strong covenants (often with triggers).

BACKGROUND

LMEs have been around for decades beginning in the 1980s and 1990s stemming from the savings and loan crisis, high interest rates, deregulation, and the surge in high-yield bond activity and leveraged buyouts from the creation of junk bonds. In the early days, LMEs were designed primarily to lower principal, extend maturities, or modify interest rates.

In the 2000s, LMEs became more prominent due to the burst of the dot-com bubble and the Global Financial Crisis (GFC) as borrowers struggled with unsustainable debt loads. During this period covenant-lite terms proliferated both the bond debt market and credit facilities which gave borrowers more flexibility to restructure outstanding debt obligations. LMEs were largely used to "amend and extend" which were broader refinancing initiatives to increase liquidity to extend the runway during the financial crisis and bypass bankruptcy proceedings.

The landscape for LMEs changed in the 2010s due to the extended period of low interest rates post the GFC. During this time the low-interest rate environment fueled intense competition which created unprecedented borrower-friendly debt documents with weakened protection for creditors. This gave distressed borrowers the ability to maneuver around restrictive covenants in pursuit of creative and complex capital solutions.

IMPACT ON INVESTORS

As noted above, LMEs have the potential for distressed companies to become viable as liabilities are restructured. While LMEs offer a lifeline for distressed companies, they do not necessarily have a strong success rate, as 35% of companies that conduct this type of transaction default within two years. Moreover, recovery values tend to be lower for a company that defaults after completing an LME, as opposed to just defaulting.

LME restructurings can also be beneficial to private equity owners because they bolster valuations, protect management fees charged to investors, and cut companies' costs while providing more time for the company to potentially recover.

According to S&P Global, the number of LMEs in the US in 2024 was 15 compared with 6 in 2023. In general, LMEs can be beneficial to creditors depending on whether the creditor is a majority or minority creditor. The primary concern for credit investors (mainly high-yield and leveraged loans) is LMEs can lead to lower returns, higher risk, and/or unfavorable credit terms as majority lenders can force unfavorable terms on minority lenders causing the initial seniority of claims to become subordinate which also increases risk and can lead to lower income. This is noticeable in the high-yield and leveraged loan markets where LMEs are prevalent due to a lack of covenants. However, this is less common in middle market direct lending as most lenders are the lead and/or sole lender (no competition), have restricted covenants (no loopholes to exploit), and the relationship between borrower and lender is symbiotic in nature (more favorable outcomes when restructuring occurs).

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