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Alerts & Publications

Predatory Priming: How Can Investors Protect Their Priority?

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Introduction

Priming transactions have been increasing in frequency during the current pandemic restructuring cycle. Priming usually involves the debtor shifting collateral and assets away from their core lending group to support new tranches of debt that are structurally or directly senior to their existing lenders. Holders who are not included in the priming tranche are left with their investments further underwater and their restructuring options more limited if the priming "fix" doesn't turn the debtor's business around. Some priming transactions have recently become more aggressive and involve a subset of lenders rigging a majority to improve their positions over minority lenders. This "predatory priming" has investors rightly concerned about how to protect their collateral priority and payment position in restructurings. While tighter drafting may protect majority holders from "trapdoors," these fixes may face market resistance, and efforts to protect against majority oppression may be particularly difficult to obtain. Discussed below is a brief overview of priming mechanisms and some suggestions on how investors can better protect their positions from becoming subordinated to new debt.

Priming Mechanisms

As detailed in one of our prior client alerts (COVID-19: Prime Time for Priming), priming transactions are primarily accomplished through two different routes (or a combination of the two): (1) taking advantage of existing loopholes and "trapdoors" to shift collateral away from existing lenders to unrestricted subsidiaries or non-guarantor subsidiaries or affiliates for new money tranches and (2) having majority lenders modify the credit documents to permit the majority to exchange their debt for, or participate in, an improved priority position at the expense of minority lenders.

When priming through existing loopholes and trap doors, a company will typically utilize existing investment and restricted payment baskets and carve-outs to the negative covenants to move collateral away from existing lenders so that it can serve at the primary source of secured assets for new money and/or restructuring existing debt. Examples of priming transactions that have been successful in this manner include *J.Crew*, *Travelport*, *Neiman Marcus* and *PetSmart*. These transactions usually use third-party debt (including incremental equivalent debt) to prime all of the existing lenders and do not require lender consent.

When priming with the consent of a majority of lenders, companies will amend the credit documents to permit the priming debt. In a majority priming deal, the lenders who are left out of the new tranche of debt are usually investors who do not approve of the credit changes or, like many CLOs, are limited in their investment options to agree the new terms (as further discussed in one of our prior client alerts, CLO Issues in Workouts and Debt Restructurings). In some cases, however, the minority lenders are not even given the option to get the majority deal. By issuing additional permitted debt (through incremental equivalent debt baskets or amending the existing credit documentation to approve new third-party debt), the majority can use provisions for debtor debt buybacks and open market purchases of outstanding loans to effectively trade their existing debt for the new tranche with superior collateral and payment rights. These structures avoid having to share the improved debt position pro rata with all existing lenders.

Recently, in *Revlon*, the company proposed a priming transaction with the consent of majority lenders. The company did not have a majority on board so it utilized what some are attacking as a "sham revolver." To increase the voting power of the lenders willing to consent, the lenders driving the restructuring issued new, unfunded revolver commitments to skew the majority vote mechanic. As these new revolver commitments increased the vote of the consenting lenders, the company was able to cross the 50.0% threshold and push through the changes needed for the priming. This "sham revolver" technique has been challenged by one of the lenders and the court has yet to opine on whether this approach was permissible.

These "insider" or "club" priming transactions, what we have been calling "predatory priming," have opened new frontiers on how debt can be restructured at the expense of "outsider" minority lenders. This naturally has investors focused on how credit documents can be used against them, and how they might be modified to better protect their interests.

Possible Solutions

In response to these priming transactions, investors have attempted to protect themselves with various changes to credit documentation. Whether it be tightening specific investment or restricted payment baskets (i.e. capping the aggregate value of investments in non-guarantor subsidiaries and unrestricted subsidiaries and limiting restricted payments), attempting to close each loophole can be a cat and mouse game. As one trapdoor is closed, others will open. The market presently demands many baskets and carve-outs to negative covenants, and a borrower will likely be able to cobble together multiple baskets and exceptions as a workaround. While this leakage can be closed, experience suggests the market will not maintain that discipline for long. Further, absent revisions to amendment provisions, any closed trapdoor can still be opened by majority lenders.

Aside from the lender "sacred rights," specified modifications that require the consent of all lenders or all affected lenders, the borrower may amend the credit documents with just the consent of a majority of lenders. In most credit documents the "sacred rights" are limited to changes extending maturity, delaying scheduled payments, reducing interest margins, changing pro rata payments, releasing all or substantially all of the collateral, and changing amendment provisions related to sacred rights. In many deals, the sacred rights have exceptions for indirect modifications resulting from transactions permitted by the credit such as the incurrence of incremental tranches, open market debt purchases and borrower debt buy-backs that might otherwise appear to run afoul of pro rata provisions and other sacred rights. The trend over the years in credit deals has been to narrowly define sacred rights and generally make the amendment provisions more permissive. The net result is, in many deals, the majority lenders can make significant amendments and adjustments that can materially modify the rights and payment priority of non-consenting lenders.

There is no one magic bullet that can prevent all possible priming transactions. However, certain macro-level changes could be made to credit documentation that can provide investors some protection from being primed. Some possibilities include:

- ***Release of Collateral Sacred Right.*** Expanding the sacred right on the release of collateral to include any subordination of the underlying lien priority would address the shortcomings of the credit documentation in both *Murray Energy* and *Serta* where the terms required all affected lenders to agree to the release of all or substantially all of the collateral. In both cases, the credit documentation was amended in connection with transactions that left the minority lender groups with a subordinated lien position. In each case, the minority lender groups were unsuccessful in challenging the transactions on the rationale that the priming left their junior collateral positions with no value, effectively the same result as if the collateral had been released. The courts declined to equate subordination with release, reasoning that if the parties intended to cover subordination, they could have used different wording. Changing this sacred right to cover subordination (or require a supermajority for lien priority changes) in addition to release would help limit direct priming by majority lenders. It would also be consistent with the bond markets where first lien bond documentation usually requires all holders to approve an adverse change in lien priority. This fix, however, would not prevent priming through structural subordination such as in *J.Crew*.

- ***Required Lender Thresholds.*** Increasing the Required Lender voting threshold from a majority to 66-2/3% would make it more difficult to use "sham revolvers" or otherwise get a consensus on the changes needed to effect priming. Such a change, however, is completely counter to credit trends over the last several decades and likely would make normal-course administration and adjustment of a credit more difficult. Using a supermajority for specified changes (such as modifications to the incremental and key baskets) might get more traction. Still, changing thresholds for even specific issues could have unintended consequences and make it easier for a minority to have "hold-up" value over the majority for many transactions that do not involve priming. Like using a hammer instead of a scalpel, changing Required Lender thresholds is likely too heavy a tool for the job.

- ***Required Lender Voting Mechanics.*** Modifying the manner in which "Required Lenders" or "Requisite Lenders" is calculated, could help prohibit exit consents or sham revolver voting. This modification runs counter to bond markets where documents typically expressly permit exit voting and exchange offers. A key difference, however, is bond documents usually require the exchange offer to be made to all holders. Changing the majority voting mechanics to prohibit "insider" voting at the expense of an excluded minority could help close the *Revlon* approach to priming. It would not, however, address third-party priming through existing trapdoors. This is a more efficient path than just changing the Required Lender threshold as it would only come into play if a group of lenders are trying to adjust terms to benefit themselves as opposed to all lenders.

- ***Pro Rata Changes.*** The pro rata sacred rights could be expanded to include modifications that indirectly negatively impact pro rata provisions, in addition to the customary language directly cross-referencing the pro rata sharing provision. This approach could have unintended consequences including preventing otherwise legitimate transactions such as incurring additional debt under the incremental and other baskets and incurrence tests. It also would not prevent priming through existing trap doors or third-party transactions. A more helpful approach would be to strengthen the pro rata sacred right provision to pick up value capture outside of the credit documents. Most pro rata provisions pick up setoff and other self-help remedies against collateral as recoveries that are used to adjust equitable sharing in the debt waterfall. These concepts could be expanded to require pro rata sharing amongst the lenders in any transaction where existing collateral is used for any lender to take a position that is senior to other existing lenders. This pro rata provision would not apply to any priming transaction that is equally offered to all lenders. While this wouldn't stop third party priming, it would be a strong disincentive to majority priming of the minority.

- ***Additional Incurrence Tests.*** Credit documents typically require that many of the mechanisms used for priming, including baskets and the use of incremental debt, is subject to pro forma compliance with a specified leverage ratio, interest coverage ratio or fixed charge coverage ratio. While these incurrence tests can be useful restraints, none address the issue of the sufficiency of the collateral remaining after the transaction. A collateral coverage ratio would be similar to the guarantor coverage ratio which used to be more common in European transactions (where lien coverage is more difficult to obtain). The collateral coverage ratio would be an incurrence test that requires the borrower to show the value of collateral (either book value or fair market value as determined in good faith) is at a pre-agreed multiple of total debt or first lien debt at the time a basket is used or other transaction is consummated. Of course, the collateral valuations could be susceptible to inflation, but including such a test imposes an additional hurdle on the borrower and another foothold for excluded lenders to challenge the priming. The test could also be limited to include only collateral in which the remaining lenders have a first lien priority. This would make it more difficult to inflate values in a priming move or move significant assets outside the credit group to support new, structurally senior, debt. The general trend in credit documents over the last couple of decades has been to limit the use of maintenance and incurrence ratios making this a more difficult path. The change would also not protect against the use of "free and clear" and other baskets and exceptions that do not require any incurrence tests as a condition to use. Further, the incurrence test could always be waived by the majority, putting investors right back in a *Revlon* scenario.

Takeaways

Each of the changes discussed above, and others that could be considered, do not on their own address all possible priming scenarios. A combination of changes that strengthen the sacred rights, adjust voting mechanics, expand pro rata provisions to capture priming, make basket incurrence tests more collateral and guarantor value focused, etc., will increase priority protection for investors. However, we would expect any attempt to change prevailing market credit documentation to address priming to receive significant push back from borrowers and arrangers. In the event additional priming protections are incorporated into credit documents in the near term, history has shown us that while restructuring cycles can lead to some corrective measures in credit documentation, those measures disappear quickly when markets and competition return.

That said, there is much that investors can do to better protect their investments. The changes discussed above do not impair the operation of a debtor's business – they are primarily intercreditor and structural adjustments that make it more difficult for a group of lenders to hijack collateral and value from existing investors. The trick is you need to be careful on how much you adjust traditional credit documentation so that you don't complicate matters for borrowers who need to adjust terms for strategic business purposes that benefit all lenders. By applying more rigor to trapdoors and using a combination of the changes suggested above, investors can do a lot to protect against third party and predatory priming without shifting the balance of control to the minority over the majority. The intent of the changes is to level the playing field without unfairly handing hold-up value to the minority.

Even with adjustments to protect against priming, no solution is going to be perfect. The best protections for investors will continue to be thorough diligence on document terms, as well as the business supporting the credit, to place all credit risks, including the potential for priming, in proper context.
