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Private Credit and Middle Market Update 2024: Rising Returns and Increasing Risk of Default Driving Priming Liability Management Structures

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Introduction

By the end of 2023, private credit market volume soared past $1.5 trillion. The flexibility of private credit, the ability to bridge the gap between equity and debt, plus the relative quickness of credit decisions and execution has made private credit extremely attractive to borrowers.

At the same time, the slowdown of the high-yield and broadly syndicated credit markets provided more opportunities for private credit providers to enter new credit structures and build relationships with new debtors. Rising interest rates have also made it attractive for private debt investors to fill the gap in the markets. In late 2023, a first lien debt position for good credits with relatively low leveraged risk were getting all-in yields of 10–12%.

Over the last year, private credit funds have increased their investments in special situations, asset-based lending, opportunistic financing, and liability management transactions. In 2024, these trends have continued, as private credit deals are being carried out at all levels of the capital stack and various phases of business development. From growth capital and recurring revenue financing to leveraged debt and liability management, all borrowers, but in particular, cash-strapped borrowers, continue to turn to private credit for bespoke solutions to manage maturities and covenant restrictions. This has led to the continued evolution in liability management through debt exchanges, covenant stripping and, most prominently, priming structures.

Priming Structures

Priming structures have traditionally fallen into two general categories: (1) drop down financing, which involves moving assets away from an existing credit group to a non-guarantor subsidiary to create a structurally senior debt position; and (2) uptiering financing, which directly subordinates the liens of the existing credit group to a new financing tranche, usually with the assistance of a subset of lenders modifying the existing debt terms to allow the new priority debt. The year 2023 saw the rise of a third category of priming: the "double-dip" (as further explained below).

For most borrowers, the goal of priming transactions is to improve their liquidity position to stave off a freefall bankruptcy. These transactions are oftentimes the only means to get more liquidity, extend maturities, restructure covenants, or take other steps to preserve equity. For the participating lenders, the goals are to provide a fiscal solution to the borrower's liquidity problems while protecting its return on its new investment. For the existing lenders, the priming transaction may not only protect their existing positions and help increase their blended returns on their aggregate exposure to a borrower, but also provide them with the advantage of a more senior position (relative to the non-participating lenders). For the non-participating lenders, the transaction often results in their original investment being devalued as it is pushed down the capital structure. We have provided below an overview of these priming transactions with an emphasis on the "double-dip" transactions given the uptick in these type of transactions in 2023 and offer some thoughts for the year ahead.

Drop Downs and Uptiering

Overview of drop down transactions

In drop down transactions, lenders rely on existing baskets, loopholes, and trapdoors in the credit documents to transfer collateral away from existing loan parties and out of the existing lenders' collateral package to foreign subsidiaries, non-wholly owned subsidiaries, or unrestricted subsidiaries. These entities are typically not required to provide credit support for the borrower's existing debt. Companies will then use the transferred assets to back additional financing issued by those entities on a structurally senior basis.

Drop down transactions typically do not require an amendment to the existing credit agreement and as a result do not need the consent of existing lenders. Instead, lenders look to the existing (1) investment baskets, (2) restricted payment baskets, (3) guarantor release provisions, and (4) other carve-outs to the negative covenants to permit the transaction.

Borrowers in drop down transactions may also offer some or all of the existing lenders the opportunity to participate in the new debt that is now structurally senior to the existing debt to avoid future litigation from the participating lenders. Examples of transactions carried out in this manner that have been successful despite challenges from the minority group include *J.Crew*, *Travelport*, *Neiman Marcus*, and *PetSmart*.

Overview of uptiering transactions

Uptiering transactions are a tool that borrowers can use – with the blessing of the majority lenders – to create new debt senior in lien or payment priority to some or all of the borrower's existing debt facilities. The opportunity to put money in on a senior basis facilitates the infusion of new cash into the borrower. Typically, the holders of the majority of the existing debt will agree to amend the existing loan documents to allow for the new senior debt. Oftentimes, these participating lenders will then roll up or exchange their existing debt for a portion of the new senior debt.

The non-participating lenders, which are normally the minority lenders under the existing debt facilities, will effectively be left with just the payment obligation under the existing debt after giving effect to the subordination and other amendments imposed in the transaction. These left-behind lenders consist of lenders that are either limited in their investment options to agree to the new terms (as is often the case with many CLOs) or are simply left out of the process by virtue of being part of the minority lender class.

In more recent years, uptier transactions have become increasingly challenged by the minority lenders due to aggressive tactics by the majority lender classes. In *Revlon*, for example, certain lenders amended the existing credit agreement to increase their revolver commitments under the terms of the credit agreement. Labeled a "sham revolver", the participating lenders were able to get to a technical majority position with the inclusion of the increased commitments without the additional commitment being funded. In the *TriMark USA* and *Boardriders Inc.* transactions, majority lenders amended the existing credit facilities to not only permit the priming transaction, but to also strip out covenants, defaults, and other customary lender protections.

In order for an uptiering transaction to be executed successfully, the existing debt documents must either expressly allow for the uptiering transaction or authorize the majority lenders to amend the documents to allow for the transaction. Typically, proponents of the transaction will look to (1) the existing debt and lien covenants to ensure it allows for the incurrence of the new senior debt and the ability to maintain any other unexchanged or unmodified debt in the capital structure, (2) the *pro rata* sharing provisions and buyback or Dutch auction provisions to confirm it permits the company to engage in non-pro rata open market purchases of its debt, and (3) the amendment and consent provisions to confirm the participating lenders meet or exceed the voting thresholds needed to amend the debt documents in the manner necessary to undergo the transaction.

Double-dip Structures

While not new to the world of bankruptcy and distressed debt investing, double-dip financings were, nonetheless, the latest 2023 tactic lenders have employed to maximize recovery by establishing multiple independent claims against a borrower's organizational and capital structure.

Double-dipping is fundamentally a hybrid priming structure as it can combine elements of drop down and uptiering to execute the new financing. These transactions can be structured in a variety of ways, but generally require the following steps:

- **Step 1 – empty shell subsidiary:** The parent creates or identifies an empty shell subsidiary that is not a guarantor of any existing credit facilities of the parent's existing debt. Whether or not this new subsidiary is a non-guarantor restricted subsidiary (as with *At Home* and *Wheel Pros*) or an unrestricted subsidiary (as with *Sabre* and *Trinseo*) can have implications on the new money loan outlined in step 2 below. Typically, the formation of an unrestricted subsidiary should not require use of an investment basket because the subsidiary will hold no assets with actual value (i.e., even when the intercompany loan is funded, it is offset by the corresponding debt claim of the participating creditors).
- **Step 2 – new money loan:** The double-dip lender advances new money debt to the empty shell subsidiary. If this new subsidiary is a non-guarantor restricted subsidiary, this will require the existing credit documents to have the necessary debt and lien capacity to permit it (e.g., a general debt basket, foreign subsidiary debt basket, a dedicated non-guarantor debt basket, or sometimes a ratio debt basket). If it is an unrestricted subsidiary, it will not be subject to the negative covenants in the existing credit agreement.
- **Step 3 – new money loan guarantee:** The newly advanced debt is then guaranteed by the parent or other members of the existing debt's restricted group or secured by collateral of the existing restricted group. The guarantee gives the new lenders the first claim or "dip" against the existing credit group. The guarantee by the existing restricted group will generally require compliance with the existing credit agreement's debt, lien, and investment covenants (e.g., look to the general-purpose debt and lien baskets as well as the corresponding investment basket permitting investments consisting of debt or liens permitted under the liens and debt covenants). If the new money borrower is a non-guarantor restricted subsidiary, there may also be a basket that allows restricted subsidiaries to guarantee debt of other restricted subsidiaries under certain conditions that can be used. One "gotcha" that should be confirmed when reviewing the existing credit documentation is whether the unrestricted subsidiary designation provision requires the subsidiary to not have any debt with recourse to the assets of the restricted group. If that is the case, the guarantee by the restricted group is prohibited and the provision would need to be amended to allow the transaction to move forward.
- **Step 4 – intercompany loan:** The new debt subsidiary then loans the proceeds of the new money facility to its parent or other members of the existing credit group on a secured basis with the new debt subsidiary remaining with no assets other than the intercompany receivable. The secured intercompany loan is then pledged to the new lenders as additional collateral, providing them with their second claim or "double-dip" against the existing credit group. In traditional double-dip loans, the amount of the intercompany loan will mirror the amount of the double-dip loans, but that is not always the case, as with the *Rayonier* transaction (further described below). This component will require appropriate baskets under the debt and lien covenants in the existing credit agreement (e.g., using the general purpose debt and lien baskets, the ratio-based baskets, and if the proceeds are being used to refinance the existing debt – as was the case in *Sabre* – the baskets for permitted refinancings).

Unlike the drop down financing structure, it is not necessary to shift assets (*J Crew* style) to the borrower subsidiary. Of course, if it is possible to move assets with material value (such as intellectual property), that will enhance the credit support for the new lenders.

To carry out a double-dip, the terms of the existing credit need to be flexible enough to permit it. As noted in the uptiering discussion above, if the double-dip is being carried out by a subset of existing lenders who have, or can manufacture, a majority of the existing loans, then the existing credit agreement can be amended to permit the new transaction. In *Trineo*, for example, the existing credit agreement was amended to permit the intercompany loan, but otherwise the covenants and other terms of the existing credit agreement remain unchanged. On the other hand, in *Sabre*, the intercompany loan was used to repay a portion of the company outstanding notes and therefore, was likely incurred under the baskets for refinancing existing debt.

The following are summaries of the more notable "double-dip" transactions of 2023.

The At Home Group double-dip transaction

In May 2023, At Home Group created a new Cayman subsidiary as a restricted party and as issuer of $200 million 11.5% secured notes due 2028. The secured notes were guaranteed by the existing parent (the first "dip") and the proceeds of the notes were advanced back to the parent through an intercompany loan (the second "dip"). Both the guarantee of the notes and the intercompany loans were secured on a *pari passu* basis and for the same amount, suggesting that this was purposefully designed to provide credit support to the lenders.

The Sabre double-dip transaction

In June 2023, Sabre GLBL, the operating subsidiary of Sabre Corp., formed two new wholly owned bankruptcy remote unrestricted subsidiaries, one of which was a direct parent (the "SPV Holdings") of the other (the "SPV Borrower"). A group of lenders of Sabre GLBL then provided an upsize of a $700 million term loan to the SPV Borrower, and SPV Borrower concurrently funded an intercompany loan back to Sabre GLBL. The new upsizing term loan is guaranteed by SPV Holdings as well as certain of Sabre GLBL's foreign subsidiaries capped at $400 million. Here, the first "dip" is the guarantee of the upsizing term loan by certain of Sabre GLBL's foreign subsidiaries and the second "dip" is the intercompany loan claim. According to reports, this transaction could potentially provide Sabre's lenders under the upsizing term loan with at least $1.1 billion's worth of claims (the $700 million of the upsizing term loan plus the $400 million in guarantees) despite only putting in the initial $700 million for the upsizing term loan.

The Rayonier "1.6 Dip" transaction

In July 2023, Oaktree funded a $250 million unsecured term loan to a newly created special purpose entity of Rayonier Advanced Materials ("RYAM") called RYAM Lux Sarl. The new term loan has a secured guarantee from the RYAM credit group (the first "dip"). The new subsidiary used $150 million from the new term loan to advance a secured intercompany loan to RYAM (the second but partial "dip"). This could provide Oaktree with credit support of up to $350 million ($250 million term loan guarantee plus the $150 million intercompany loan), but given the imbalance between the amount of the term loan and the intercompany loan, reports describe this as a "1.6 dip" instead of a "double-dip" transaction.

The Wheel Pros double-dip transaction

In September 2023, lenders funded $235 million in new money with a first-in-last-out facility to Wheel Pro Inc., and certain participating lenders funded new first and second lien loans to a newly formed non-guarantor restricted subsidiary of Wheel Pro Inc. At the same time, the new subsidiary funded an approximately $1.3 billion intercompany loan to Wheel Pro Inc., the proceeds of which were used to execute open-market repurchases of the same lender's existing debt.

Distinct from other double-dip transactions, the $235 million in new money does not directly benefit from the double-dip structure, and instead, the lenders benefit from an enhanced collateral position by exchanging their existing unsecured first lien positions into the new first lien and second lien loans to the non-guarantor restricted subsidiary with secured parent guarantees (first "dip") as well as getting the benefit of the intercompany loan claim (the second "dip").

The Trinseo double-dip transaction

To round out 2023, in September 2023, Trinseo PLC, a plastic and latex binders manufacturer, entered into a new approximately $1.1 billion term loan agreement with borrower entities not restricted by the existing credit facility. The proceeds of the new facility were used to fund an intercompany loan to the existing credit agreement borrowers *pari passu* with loans under the credit agreement (the first "dip"). The new lenders also received guarantees from the parent entity of each new borrower as well as a limited guarantee from certain affiliates of the new borrowers (the second "dip"). Reports suggest that these guarantees could be as much as $352 million of the debt on a secured basis.

Conclusion

From one perspective, priming is a way to provide emergency liquidity for entities facing a severe cash crunch. A more cynical view is they just "kick the can down the road" and buy time for a borrower's business to recover and work out more permanent solutions for capital later.

As we detailed in our chapter for the 2023 edition of *ICLG – Lending & Secured Finance* (Private Credit and Middle Market Update), lenders have reacted to the "lender on lender violence" by either limiting a borrower's ability to transfer certain assets into foreign subsidiaries, unrestricted subsidiaries and other affiliates or blocking the ability to create these types of entities through the insertion of "anti-Serta provisions" and "PetSmart/Chewy blockers". However, the continued use of liability management transactions, with ever increasing complexity, strongly suggests these transactions are here to stay.

Before entering into financing transactions, lenders and bondholders need to understand these transactions and, importantly, the risks associated with them – all of which can be done through proper covenant analysis and an in-depth review of baskets and flexibility provided by the loan agreements, as well as being aware of what modifications are permitted by majority lenders as opposed to the "sacred rights" that require all lender approval.

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