Special Situations: Addressing Post-LME Protections in 2025

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With liability management exercises (LMEs) and the requisite lender protections still a key focus for credit market participants as we enter a new year, the aftermath of a busy period of lender-on-lender violence, followed by the recent Serta decision, is driving a new conversation in relation to the documentation for post-LME credits.

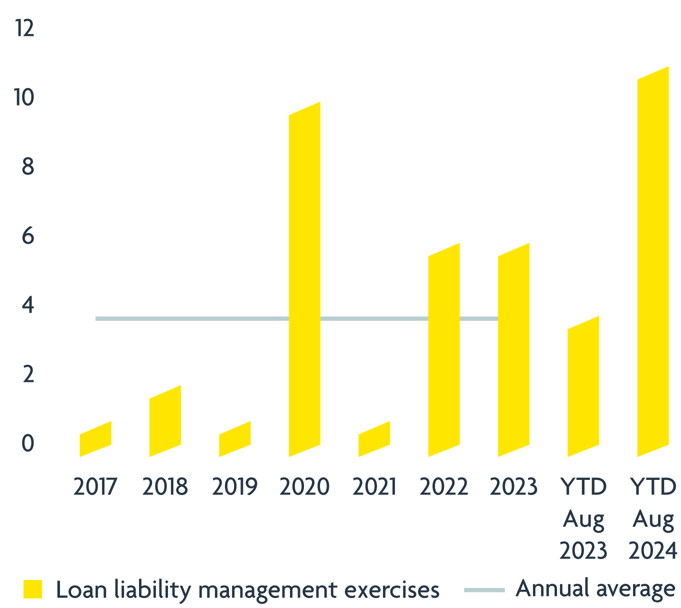
Going into 2025, we are seeing much more trading in post-LME credits than was the case five years ago, when participating lenders tended to hold on to post-LME debt. Now that these credits are trading in the market (and in fact are often viewed as more attractive since investment decisions can be made on fundamental business analysis), there is an assumption that post-LME documents are less permissive and no longer contain the pitfalls that originally permitted LMEs.

2025

Going into 2025, we are seeing much more trading of post-LME credits than was the case five years ago.

While this is generally the case, careful attention must be given in post-LME credit investment decisions to the next generation of LME threats.

Number of LMEs That Subordinate Existing Lenders



Source: S&P Global

Key Protections in Post-LME Documents

With LME protections now in the spotlight, a number of well-established clauses have become common in the broadly syndicated lending market and in private credit deals, with the most obvious being J. Crew blockers, Chewy protections and Serta protections.

With post-LME debt documents being tighter than ever (and generally tighter than broadly syndicated and private credit documents), we are seeing certain newer protections that are not yet market standard in new issuances, but can sometimes be found in post-LME documents (and, at a minimum, are typically requested by participating lenders at the outset of negotiations).

Covenant-Lite Structures in Broadly Syndicated Loans

Percentage of newly issued institutional loans

Source: S&P Global

The key protections that we expect to become the subject of increased negotiation in 2025 include:

No Unrestricted Subsidiaries

Some post-LME documents now remove the concept of unrestricted subsidiaries altogether, so that value cannot be leaked to entities that sit outside the negative covenants.

Restrictions on Debt, Liens, Investments and Restricted Payments

Because many LMEs rely on basket capacity in documents, post-LME documents will often limit baskets, restrict borrowers from taking certain actions linked to LME transactions or limit use of baskets to transactions in the ordinary course of business

Strong J. Crew/Pluralsight Blockers

In the 2024 Pluralsight "private credit LME", intellectual property (IP) was moved not to an unrestricted subsidiary but to a non-guarantor restricted subsidiary. Most recent credit agreements include J. Crew blockers that prevent the movement of material IP to unrestricted subsidiaries, but few address what happened in Pluralsight.

We are now starting to see stronger J. Crew protections and Pluralsight blockers restricting the transfers of material IP or other material assets from loan parties to non-loan parties. These protections prevent transfers to restricted subsidiaries that are non-guarantors, such as foreign and non-wholly owned subsidiaries.

72%

of industry executives expect restructuring capital structure or moving assets to be the most common liability management technique in the next 12 months to mitigate risk, according to a recent report by AlixPartners.

Anti-Chewy Protections

Anti-Chewy protections, or PetSmart protections, are now common in credit agreements and expected in post-LME documents. These provide that guarantees and collateral will not be released solely because a guarantor has become non-wholly owned, except in a transaction with a non-affiliate for a bona fide business purpose (where the purpose is not to avoid the guarantee requirements).

At Home Protections

While roughly half of broadly syndicated loan agreements have some protections preventing an unrestricted subsidiary from holding debt of the restricted group or incurring debt that is recourse to the restricted group, this language is often flawed and does not always address double-dip or pari-plus structures using non-guarantor restricted subsidiaries.

A better way to address these is with a debt covenant that includes intercompany loan protection, setting out that intercompany debt incurred under any debt basket that is owed by a loan party to a non-loan party (including both unrestricted subsidiaries and non-guarantor restricted subsidiaries) must be subordinated in right of payment.

Serta Protections

Included in almost all post-LME documents, these rule out amendments that subordinate, or have the effect of subordinating, lenders, either in right of payment or lien priority. Protections may include flat prohibitions, requirements to offer participation in priming debt to all lenders pro rata, or caps on the amount of priming debt permitted without the consent of all affected lenders.

Until the recent Serta decision, whether post-LME documents allowed for "open market purchases" (undefined) or non-pro rata purchases, or explicitly allowed for privately negotiated debt exchanges, was not a point of focus. In light of the recent decision, if participants want to allow for future uptier debt exchanges if offered to all lenders, the assignment section should make clear that such exchanges are permitted (given the scrutiny on the ambiguous “open market purchase” language). Alternatively, if participants do not want to allow for future uptier exchanges, the post-LME document should specify that any purchases by the Borrower or its affiliates must be in cash (other than proceeds of any indebtedness).

RR Donnelley Protections

Language preventing exchange transactions into contractually or structurally senior debt (the so-called “LME blocker”), unless offered to all lenders on a pro rata basis, has appeared in some recent 2024 documents but is not yet common.

Lender Gerrymandering Protections

A borrower and a subset of lenders may attempt to “gerrymander” the required lender threshold, as we saw in Revlon, when undrawn commitments were issued using the incremental loan capacity to a sub-group of lenders. Gerrymandering can also be done by issuing new incremental debt solely to give a lender group the required lender threshold to release collateral or subordinate liens to uptier exchange debt, with the new debt then immediately exchanged for super-senior debt.

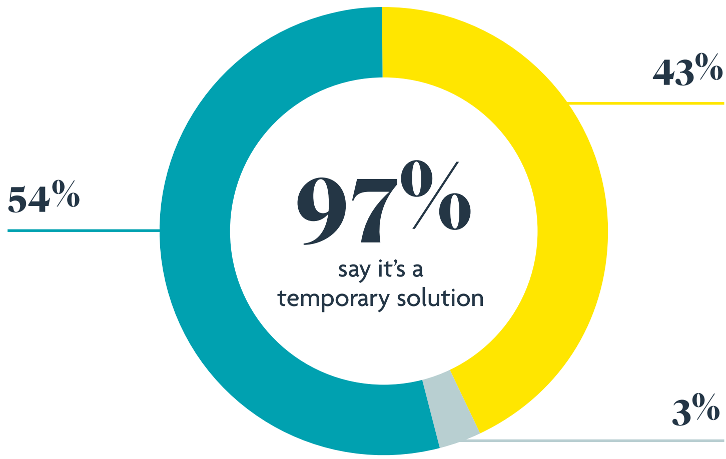
Protections can be used to restrict new issuances from being included in the calculation of the required lender threshold, but the vast majority of credit agreements have yet to include them.

Envision Blockers

Many agreements have a specific investment basket for investments in unrestricted subsidiaries. However, there are often several other baskets available for investments, and access to those allows borrowers to combine the baskets and use the aggregate for transfers to unrestricted subsidiaries. The Envision blocker provides that only the specific basket for investments in unrestricted subsidiaries can be used for transfers to, or designations to, unrestricted subsidiaries. (Note that terminology is evolving in real time, and there is some discrepancy in what is meant by terms such as the “Envision blocker.” Be sure to clarify intent when using newer terms!)

How Successful Have LMEs Been?

In your experience, how successful have amend & extends or liability management efforts been in the past 12 months?



- A temporary solution that doesn't ultimately resolve the fundamental issues
- A temporary solution granting time to turnaround or improve operations
- A permanent fix that enables the company to rebuild enterprise value

Note: Respondents are industry executives spanning the Americas, EMEA, and Asia

Source: AlixPartners

The Latest Potential Pitfalls

Sacred Rights

While post-LME credits will continue to feature a new generation of protections, an emerging issue is whether those protections are sacred rights that cannot be amended without the consent of each lender. If not, lenders may be protected against third-party transactions but not from a subsequent LME led by a majority lender group that may waive or amend the protections.

From a minority lender's perspective, all document protections should be taken with a grain of salt unless they are incorporated into the sacred rights. Otherwise, 51% of lenders can team up with the borrower to remove those protections as part of a negotiated transaction. As a result, we do see post-LME documents starting to incorporate a broader range of protections into sacred rights.

Intercreditor Issues

Post-LME credit agreements are typically structured as multiple tranches of debt in one bespoke document with, for example, first out new money, second out loans exchanged for pre-LME first lien debt and third out loans exchanged for pre-LME second lien debt.

The classification and voting rights of these tranches are being increasingly scrutinized as trading results in more constituents owning different tranches, giving rise to more intercreditor issues. We are seeing questions arise on a wide range of issues, such as who controls a debtor-in-possession financing process and whether first out creditors have special voting rights.

Europe/U.S. Credits

While the reality is there have been fewer LME transactions in Europe—given differences in directors' duties regimes, intercreditor agreement terms, restructuring processes and market culture—the issues and considerations are very similar on both sides of the Atlantic.

For New York law governed credits that have both a U.S. tranche and a European tranche, we have found that both tranches are aggregated for voting purposes. In the past year, there have been certain instances where the lenders in the U.S. tranche have organized first, and lenders in the Euro tranche have been left out of the ad hoc group. Post-LME, this dynamic often continues in which the U.S. tranche and Euro tranches do not have separate voting rights.

This evolving array of protections and potential pitfalls should be carefully considered in the negotiation of post-LME documents, but should also inform the future drafting of new issuance documents, as well as the evaluation of existing loan documents.

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