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From Structure to Substance: Understanding Value Transfers in LMEs

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In our March edition, we discussed how Liability Management Exercises (LMEs) have become a dominant strategy for distressed companies navigating tight liquidity and looming maturities. We explored why LMEs are on the rise and how they challenge traditional notions of restructuring.

This month, we focus on a core element behind many of these strategies: value transfer – how companies shift value within their capital structure, often disadvantaging certain groups of creditors.

Why Value Transfer Matters

At the heart of many LMEs lies a simple but powerful objective: reallocate economic value within the capital structure without triggering formal insolvency. This may involve transferring value from subordinated to senior creditors, or more controversially, from existing creditors to new ones (often backed by sponsors).

The implications of such value transfers are enormous:

> Creditors with previously equal ranking can see their recovery expectations altered overnight.

> Legal disputes often arise as some lenders challenge restructurings that bypass traditional protections.

> For investors, failing to identify a potential value transfer mechanism can mean significant losses.

How Value Transfer Is Made Possible: Covenant Flexibility

These redistributions are possible because of weak or flexible credit documentation – particularly in covenant-lite loan and bond structures. The growing dominance of covenant-lite debt in both the U.S. and Europe has weakened traditional creditor protections, allowing issuers to:

> Amend core terms with minimal lender consent.

> Carve-out asset movement and lien loopholes.

> Re-designate subsidiaries and reclassify debt.

In this environment, LMEs can be executed through clever legal structuring, often in ways that were not envisioned when the debt was originally issued.

Loan vs. Bond Covenant Frameworks

To understand how value transfer works, it is helpful to look at the legal tools companies use.

In loan agreements, these tools are called Investment Covenants. They limit how borrowers can use their capital – for example, by restricting investments in subsidiaries, asset transfers, or the designation of certain subsidiaries as "unrestricted", meaning outside of creditor protections.

In bond documents, the main control is the Restricted Payments Covenant. This restricts e.g. the company from paying dividends, buying back shares or debt, or

transferring assets to affiliates or unrestricted subsidiaries.

In both cases, borrowers can work around these rules by using carve-outs, exceptions, and baskets – built-in allowances that give them room to maneuver.

Carve-outs are specific exclusions built directly into the covenants. They permit defined activities that would otherwise be prohibited. For instance, a covenant may generally restrict asset transfers to subsidiaries, but a carve-out might allow such transfers up to a fixed amount (e.g., €25 million annually). Carve-outs provide narrow, rule-based allowances.

Exceptions override a restriction altogether, but only if certain conditions are met. For example, a company might be prohibited from making dividends, except if its leverage ratio falls below a pre-agreed threshold. These are typically linked to financial tests and offer broader flexibility conditional on company performance.

Baskets are quantitative permissions within covenants that allow borrowers to make certain payments or investments up to a predefined monetary limit. These may be cumulative (building over time), general (for any use), or specific (e.g., for acquisitions or restricted payments). They serve as controlled zones of flexibility within otherwise restrictive agreements.

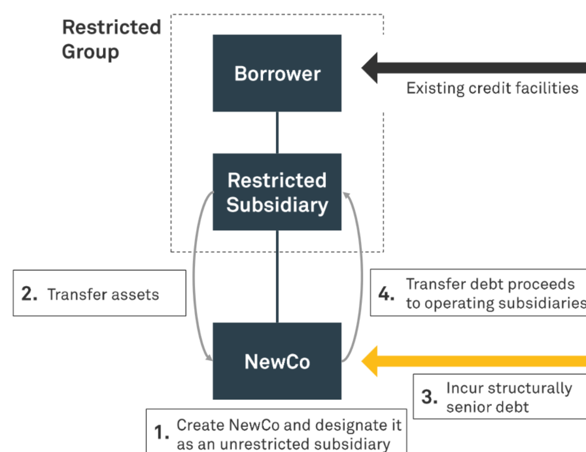
These mechanisms, especially when layered or used in combination, allow issuers to navigate around protections embedded in credit documentation. While legitimate in design, they can be leveraged to facilitate material value transfers that significantly alter creditor expectations and undermine the original structure of a transaction.

Drop-Down Transactions: A Playbook for Value Transfer

A textbook example of how value transfer is executed is the drop-down transaction. Here's how it typically works:

1. **Create NewCo and designate an Unrestricted Subsidiary:** The issuer uses carve-outs to designate a subsidiary as "unrestricted," freeing it from most covenant protections.
2. **Transfer Assets:** Valuable assets (e.g., intellectual property, real estate) are moved from the restricted group to the newly unrestricted entity.
3. **Incur structurally senior debt:** The unrestricted subsidiary raises new debt, secured by the transferred assets.
4. **Transfer debt proceeds to operating subsidiaries:** Proceeds from the new financing may be used to pay down old debt, support operations, or even make distributions. The existing lenders, now without access to key assets, find themselves in a structurally subordinated position.

ILLUSTRATION 1: DROP-DOWN TRANSACTION



Source: XAIA Investment

Case in Point: J.Crew

The most prominent and formative example of a drop-down liability management exercise is J.Crew's 2017 restructuring, which reshaped the playbook for sponsor-backed transactions in distressed debt. Facing mounting financial pressure, the U.S.-based apparel retailer took advantage of bond indenture flexibility to implement a highly controversial value transfer.

At the heart of the transaction was J.Crew's decision to designate one of its subsidiaries as "unrestricted", thereby removing it from the protective covenants of the company's existing bond agreements. Using carefully structured carve-outs in its restricted payments and investment covenants, J.Crew transferred its most valuable asset – its brand intellectual property (IP) – to this unrestricted entity. Since the entity was no longer subject to the original debt covenants, the transferred assets could now be used as collateral for fresh financing.

J.Crew proceeded to raise $300 million in new debt secured by the IP held by the unrestricted subsidiary. Existing bondholders, who once relied on the brand IP as core collateral, suddenly found themselves with inferior claims. Though the move was technically permissible under the bond covenants, it had the effect of significantly reducing recovery expectations for legacy creditors while preserving liquidity and equity value for sponsors.

The maneuver sparked widespread criticism and litigation, but it survived legal challenge due to the precision with which it was executed. As a result, the market quickly responded by adopting "J.Crew Blockers" – explicit provisions in bond documents designed to prevent similar value-stripping transactions in the future. These clauses have since become a critical focus for debt investors during documentation review and negotiations.

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Philipp Graxenberger and Josef Pschorn oversee Alternative Credit Strategies at XAIA Investment, specializing in identifying inefficiencies in the credit market, particularly within complex capital structures and special situations. Their expertise spans credit arbitrage, relative value, special situations, and restructurings.

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