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Liability Management Exercises – The New Normal in Leverage Finance

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Liability management exercises (LMEs) are fundamentally altering how companies address financial distress. Recent transactions – such as Altice France, Ardagh, Intrum, and Hunkemöller – underscore the evolving nature of these strategies, showcasing both financial ingenuity and the legal complexities surrounding their implementation.

The surge in LMEs is driven by weak credit documentation, rising debt costs, looming maturities, and financial sponsors seeking to protect or unlock equity value. While there is no precise definition of an LME, these transactions typically involve non-traditional debt restructuring methods conducted outside formal bankruptcy proceedings. By leveraging LMEs, companies can extend their financial runway and delay, or even avoid, default.

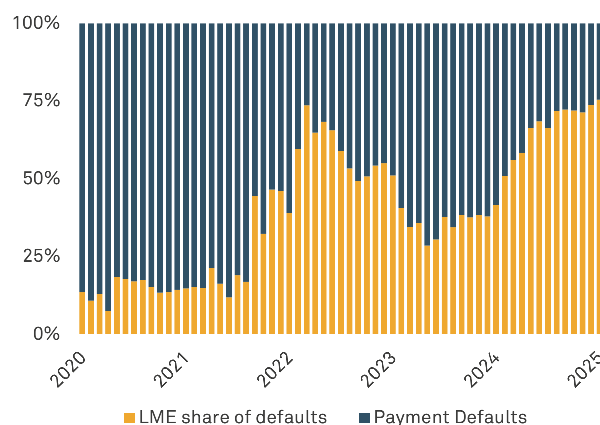
However, these maneuvers are not without risks. LMEs often create uneven outcomes among creditors – some investors benefit from new money opportunities, while others find their claims diluted or reprioritized within the capital structure. Navigating this complex landscape requires strategic foresight, legal expertise, and deep industry connections to mitigate risks and optimize returns.

Why are LMEs on the rise?

The rise in LMEs is fueled by a confluence of structural and market-driven factors, compelling companies to restructure obligations while avoiding formal insolvency.

CHART 1: LME ON THE RISE

US HY and loan bankruptcies: LMEs vs. bankruptcies split



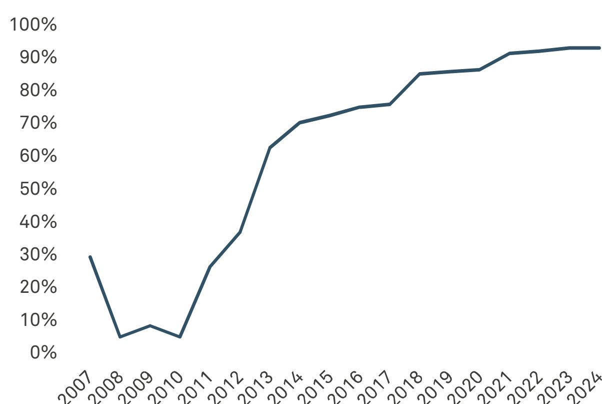
Source: BofA, XAIA Investment

The proportion of stressed U.S. companies choosing LMEs over bankruptcy has grown significantly, a trend now gaining traction in Europe. However, European adoption of aggressive LME tactics tends to lag behind the U.S., typically following precedents set in American markets.

Key factors driving LME adoption include:

Weak Credit Documentation: Loose lending standards have left creditors with minimal contractual protections, making it easier for companies to pursue aggressive restructuring strategies that dilute or subordinate existing claims.

CHART 2: WEAKER DOCS ENABLE LMES
Share of covenant lite loans in the US



Source: Pitchbook, LCD

Elevated Debt Costs: Rising interest rates have made refinancing more expensive, forcing companies to extend maturities and restructure repayment terms rather than take on new debt at higher costs.

Looming Maturities: With significant debt maturities on the horizon, many borrowers are turning to LMEs as an out-of-court solution to delay obligations and secure liquidity without triggering default.

Financial Sponsor Motivations: In-court restructurings often lead to equity losses for sponsors, as creditors convert debt into ownership. LMEs, however, allow sponsors to extend financial runway, preserve control, and manage financial distress on their own terms, often at the expense of existing creditors.

Unlike traditional restructurings, LMEs do not always involve a direct value transfer from equity holders to debt holders. Instead, they often redistribute value among creditors, leading to conflicts and asymmetrical outcomes – sometimes referred to as "creditor-on-creditor violence." This occurs when certain creditors gain priority over others through restructuring maneuvers. To navigate this shifting terrain, creditors must anticipate risks, enforce contractual protections, and adapt restructuring strategies to safeguard their interests.

Key objectives of LMEs

LMEs serve as a financial lifeline for distressed companies, enabling them to restructure debt, manage creditor relationships, and maintain financial stability – often without resorting to bankruptcy. The core strategic objectives include:

Extending Maturities: When a company faces an impending debt maturity with limited refinancing options, extending maturities provides additional breathing room to stabilize operations and improve earnings. This helps prevent default while maintaining continuity in business operations.

Altering Creditor Priorities: Some LMEs restructure the debt hierarchy, allowing companies to raise new financing by granting senior priority to fresh lenders while subordinating older creditors. This tactic improves liquidity but can trigger conflicts among creditor groups, especially if existing lenders are forced into less favorable recovery positions.

Raising Liquidity via Asset Transfers: By moving key assets to unrestricted subsidiaries, companies can use them as collateral for new secured debt while shielding them from existing creditors. This enhances short-term liquidity, but often results in value dilution for legacy lenders, leading to legal disputes and creditor pushback.

Minimizing Sponsor Equity Losses: Financial sponsors often seek to retain control of distressed companies rather than cede ownership to creditors through traditional debt-for-equity swaps. LMEs help sponsors extend financial runway, negotiate selective restructurings, and facilitate distressed exchanges that preserve their investment while reducing the risk of bankruptcy.

Managing Voting Rights and Creditor Influence: Some LMEs manipulate voting structures to push through favorable amendments. Tactics such as Exit Consents and Vote Rigging allow issuers to strip creditor protections and override dissenting lenders, effectively forcing through restructuring terms that may not reflect broader creditor consensus.

Executing an LME

Once a company identifies the need for an LME, it collaborates with legal and financial advisors to determine the most effective approach, such as debt exchanges, maturity extensions, or asset transfers. Creditor engagement follows, where negotiations take place to secure approval for the restructuring plan.

LMEs can be executed out-of-court, in-court, or through a hybrid approach:

Out-of-Court Restructurings: These involve direct negotiations with creditors to amend agreements, offering a faster and more flexible resolution while avoiding the costs of formal bankruptcy.

In-Court Restructurings: Legal proceedings, such as Chapter 11 in the U.S. or U.K. schemes of arrangement, provide companies with legal protection against creditor actions but are more complex and time-consuming.

Hybrid Approaches: Some companies attempt an out-of-court restructuring but retain the option of seeking court approval if creditor consent is insufficient or legal enforcement is needed.

Depending on the chosen strategy, the execution of an LME typically involves structuring the transaction, obtaining creditor approvals, and implementing changes to debt agreements. This may require negotiating amendments, exchanging old debt for new securities, or transferring assets to different entities. Once agreements are finalized, the LME is formally executed through documentation updates, financial settlements, and legal filings as needed. Throughout the process, companies must carefully navigate creditor pushback, regulatory scrutiny, and market reactions to ensure a successful and legally enforceable restructuring.

Implication for investors

For investors, LMEs present both risks and opportunities, depending on their position within the capital structure and the restructuring strategy employed.

Senior Creditors: May benefit if an LME improves a company's liquidity and reinforces their repayment priority. However, they also face risks if new priming debt is introduced, potentially diluting their recovery prospects.

Junior Creditors & Unsecured Bondholders: Often bear the brunt of LMEs, as these transactions frequently subordinate existing claims, extend maturities, or reduce payouts, leading to value erosion.

To navigate LMEs effectively, investors must proactively assess credit documentation for weaknesses that could expose them to unfavorable outcomes. Weakened covenants, low voting thresholds, and the absence of protective provisions (e.g., J. Crew or Serta blockers) can leave creditors vulnerable to coercive restructurings and value leakage to new lenders or financial sponsors.

Additionally, market volatility and price dislocations surrounding LMEs create opportunities for distressed debt investors. Those positioned to capitalize on discounted bonds, negotiate better restructuring terms, or participate in new financing rounds may find significant upside. However, as LMEs face increasing legal scrutiny and evolving case law, investors must also weigh litigation risks and potential post-restructuring legal challenges.

As companies continue to push the boundaries of liability management, investors must remain vigilant, proactive, and legally informed to protect their claims and maximize recovery potential.

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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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