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Best Practices in Liability Management

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Borrowers have a broad suite of liability-management options — including up-tier exchanges and asset drop downs — all of which they can use to capture discount, extend runway, and otherwise maximize enterprise value. But just as important as knowing that these strategic options exist is knowing how to implement them successfully.

Depending on where they sit in the capital structure, some lenders applaud the use of liability-management tools; others, however, view such liability-management activities as some sort of financial alchemy or tactic for preventing lender remedies. While borrowers can — and should — use the flexibility afforded them under their contractual, bargained-for financing documents as a component of their liability-management toolkit, they must also remain cognizant of the complex legal tactics and strategic considerations essential to effecting such a liability-management transaction.

The Bankruptcy Court for the Southern District of Texas's recent decision in the iHeart Chapter 11 proceedings highlights two essential components of a debtor's ability to fully utilize its credit documents in the liability-management context: strict adherence to the text of the credit documents and proper corporate governance. The court's decision demonstrates that a company's liability-management activities can withstand judicial scrutiny where the company complies with the language of the credit documents and uses best practices in corporate governance to effectuate a strategy that, in its business judgment, maximizes value for its stakeholders. In those situations, courts are likely to respect a borrower's business judgment, and not introduce extra-contractual equitable remedies to aid in the enforcement of credit documents where the contracts themselves are clear.

Liability Management Toolkit

Liability management is not a novel concept. Borrowers often manage accounts

payable and cash flows to comply with financial-performance covenants and otherwise ensure that there is sufficient cash to run their businesses. These efforts, however, usually will not improve the company's overall financial health in any meaningful way. Luckily, credit documents often contain flexibility for the company to unlock a treasure trove of value-maximizing alternatives.

Some of the more common liability-management tools include:

1. **Up-Tier Exchange Offers.** Company offers bondholders the ability to exchange unsecured bonds for secured bonds that are either pari pasu with or subordinated to the company's existing secured debt (e.g., "1.5 lien" or second lien).
2. **Asset Drop Downs.** Company places certain encumbered assets into an unrestricted subsidiary or designates a restricted subsidiary as unrestricted using an investment or unrestricted subsidiaries basket. This may be accompanied by new money debt raises or exchange offers (along with covenant strips).
3. **Debt Repurchase Transactions.** Company makes a cash tender offer for outstanding bonds at a discount to par value.

These examples of liability-management tools are not mutually exclusive. Moreover, the availability and usefulness of these tools is highly dependent upon each company's credit documents, financial and tax position, and market dynamics surrounding the company's securities.

iHeart Situation Summary

Recently, iHeart Communications, Inc. successfully defended a liability-management transaction in the Bankruptcy Court for the Southern District of Texas. iHeart had issued various tranches of unsecured notes under a common indenture (the "Legacy Notes") and, as part of a broader liability-management effort, an iHeart subsidiary purchased approximately $57 million of outstanding Legacy Notes due December 15, 2016 (the "2016 Notes") on the open market. Repayment of the 2016 Notes at maturity would bring the total value of outstanding Legacy Notes below $500 million, thus instantly triggering, under a senior credit agreement, a "springing lien" on a substantial percentage of iHeart's assets. The imposition of the springing lien would, in turn, trigger an obligation under iHeart's indenture governing the Legacy Notes to provide "equal-and-ratable" liens to the remaining Legacy Notes. Simply put, the repayment of iHeart's 2016 Notes at maturity had the potential to convert a significant amount of

iHeart's unsecured debt into secured debt and instantly encumber substantially all of iHeart's assets. As the 2016 Notes' maturity date approached, iHeart therefore knew that it had to take action or else risk a series of events that could significantly handicap its restructuring efforts. *See Op.* at 19.

iHeart's Board established and followed a careful corporate-governance procedure to determine how to best manage the situation. Recognizing that certain stakeholders would likely assert that the sponsor-affiliated directors were favoring their own interests, the Board delegated decision-making authority over certain issues to disinterested directors who did not have an interest in the outcome or affiliation with any of iHeart's existing stakeholders.

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The disinterested directors ultimately decided to continue paying interest on the 2016 Notes held by iHeart's subsidiary, but decided not to pay those Notes' principal. This decision split the 2016 Notes into two de facto classes: one class that would be paid and retired on maturity, and another class — the approximately $57 million of 2016 Notes purchased by iHeart's subsidiary — that would remain with the subsidiary. iHeart obtained a new CUSIP number for the second class and the remaining 2016 Notes were paid and retired. Thus, more than $500 million of Legacy Notes remained outstanding, and the springing lien was not triggered.

Representatives of parties who would have benefited from the imposition of the springing lien and the equal-and-ratable liens (the "Plaintiffs) alleged that the 2016 Notes held by iHeart's subsidiary were no longer outstanding because the subsidiary had purchased them, and, therefore, the springing lien had been triggered. *Id.* at 6–7.

To the extent the court determined that the springing lien had not been triggered under the credit documents, the Plaintiffs then argued that the court should grant equitable remedies in its favor to correct the injustice caused by iHeart's actions to avoid triggering the springing lien and equal-and-ratable liens.

The Court Holds Springing Lien Was Not Triggered, Finds iHeart's Adherence to Credit Documents' Text and Corporate Governance Record Persuasive

Following an evidentiary hearing, the court noted that the case presented a "close call," but held in iHeart's favor across the board, repeatedly returning to both the explicit text of the relevant credit documents and the "overwhelmingly credible" testimony from iHeart's directors and management regarding iHeart's sound business purpose for its actions related to the Legacy Notes. *Id.* at 18–19.

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The Text of the Credit Documents

The court began with a close reading of the credit documents, finding that under the credit documents' plain language the 2016 Notes held by iHeart's subsidiary remained outstanding and that the liens had not been triggered. Moreover, the court concluded that the credit documents — as the contracts governing the situation — precluded certain remedies such as quasi-contractual unjust enrichment. *Id.* at 29.

iHeart's Corporate Governance and Strategy

Testimony from iHeart's Treasurer and disinterested directors demonstrated that iHeart's decisions related to broader liability-management efforts and were the result of sound business judgment. As part of the evidentiary record, iHeart also demonstrated (through testimony and contemporaneous documentation) that the decisions were carefully considered by the disinterested directors after significant investigation and discussion. Moreover, the testimony evinced the fact that, because of the potentially devastating domino effect described above, the disinterested directors would *never* have allowed the springing lien to be triggered, and that iHeart would have filed for bankruptcy in 2016 if it had not developed the alternative strategy that it ultimately pursued. The court specifically found that "it [was] impossible to ignore the *volume of evidence* demonstrating that retaining the [2016 Notes] was a business decision, necessary to preserve iHeart's remaining value and negotiating position in light of an imminent bankruptcy filing," and that "the non-payment of the [2016 Notes] at maturity was undertaken as an alternative to bankruptcy." *Id.* at 19–20 (emphasis supplied). The court rejected the assertion that iHeart had acted in bad faith, concluding that "iHeart's decision . . . was a product of good faith business judgment." *Id.* at 20.

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Takeaways

Liability-management transactions are not riskless exercises for all companies. A company considering a liability-management transaction should be mindful of the following lessons learned from iHeart and other cases addressing the viability of such transactions:

1. The company should follow best practices in corporate governance, including establishing a thorough and well-documented decision-making process and considering all reasonably available information and alternatives. Additionally, early planning by company management is critical to documenting, structuring, and implementing the appropriate transaction. To the extent the transaction involves a potential conflict of interest, the company may also consider

delegating the decision-making authority over the liability-management transaction to one or more disinterested directors — i.e., directors who do not have a direct or indirect interest in the particular transaction.

2. To the extent the company seeks to rely on particular provisions in its credit documents, the company should ensure that the actions taken in connection with the liability-management transaction strictly adhere to the language of the relevant credit documents. A deep understanding of each credit document's language is integral to the success of any liability-management campaign. From the credit document's most unambiguous clauses to the implications of different jurists' interpretive methodologies, borrowers must prepare themselves for rigorous arguments over what the text — and spirit — of their credit documents does and does not permit.
3. The company should ensure that there is a legitimate, value-maximizing business purpose for engaging in a particular liability-management transaction.
4. The company should consult with professional advisors regarding all of the foregoing and analyze any other potential causes of action that may be invoked to challenge liability management transactions, including preference and fraudulent-conveyance actions.

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