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In Desperate Times . . . Travelport Puts \$1.15 Billion in Collateral Value Beyond the Reach of Its Creditors

*By David L. Ruediger, George Ticknor, Jason Ulezalka, Jonathan W. Young, and Stephen J. Humeniuk**

The authors of this article discuss how certain borrowers experiencing adverse economic conditions have taken advantage of flexible terms in their credit agreements to transfer valuable collateral beyond the reach of their senior secured creditors.

Certain borrowers in industries experiencing particularly adverse economic conditions have taken advantage of flexible terms in their credit agreements to transfer valuable collateral beyond the reach of their senior secured creditors. In many of these situations, the borrowers utilized unrestricted subsidiaries to accomplish the transfers. An unrestricted subsidiary is not bound by the restrictive covenants in a credit agreement that, among other things, impose limitations on the incurrence of debt, the granting of liens, the making of investments and the declaration of dividends and other distributions to equityholders. Assets owned by unrestricted subsidiaries can generally be sold, encumbered or otherwise transferred without restriction.

J. CREW

Several years ago, J. Crew transferred its brand to an unrestricted subsidiary using what is now generally referred to in the market as a “J. Crew trap door” provision. J. Crew effectuated this transfer via a two-step process. First, the brand was transferred to a restricted subsidiary (which was not a loan party) using one of the investment baskets contained in the credit agreement. Second, the restricted subsidiary transferred the brand to an unrestricted subsidiary using a separate investment basket that permitted investments by a restricted subsidiary in an unrestricted subsidiary—to the extent financed with proceeds received from an investment in such restricted subsidiary. Taking the position that the second transfer was “financed with the proceeds” of the first transfer, J. Crew was able to convey a material portion of the collateral securing its senior debt to an unrestricted subsidiary without the consent of its secured lenders.

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PETSMART

PetSmart represents another example of a borrower using baskets in its credit agreement to transfer assets outside the reach of its secured lenders. PetSmart first transferred a portion of its equity interest in a valuable subsidiary that owned its Chewy.com platform to a holding company outside the loan party structure, and then transferred an additional portion of its equity interest in the Chewy entity to an unrestricted subsidiary. These transfers did not rely on a “trap door” but instead were accomplished through a combination of investment and restricted payment baskets in the credit agreement. Once PetSmart completed the equity transfers, the Chewy entity was no longer a “wholly-owned” subsidiary and, accordingly, not required to guaranty the PetSmart debt.

OTHERS

In addition to J. Crew and PetSmart, similar transfers were effectuated by Neiman Marcus and Windstream Services, LLC, with the latter involving a creative interpretation of a sale-leaseback covenant. In each instance, the company utilized an aggressive interpretation of the provisions in its credit agreement to access additional liquidity by moving valuable assets out of the secured lenders' collateral package.

It has been publicly reported that UK-based Travelport Limited is the latest borrower to avail itself of a weak covenant structure in its credit documents to transfer assets beyond the reach of its secured creditors. Travelport, a portfolio company of private equity sponsors Elliott Management and Siris Capital Group, agreed to sell two valuable subsidiaries to a prospective buyer in January of this year. Following the impact of the COVID-19 pandemic, a dispute arose between the parties as to whether the terms of the purchase agreement required them to proceed with the sale.

The day after the buyer announced its intention not to proceed with the acquisition, Travelport notified the lenders under its \$2.8 billion first lien term loan credit agreement that Travelport had elected to designate two of its subsidiaries as “unrestricted subsidiaries” and to transfer certain intellectual property assets including travel registration systems and patents valued at \$1.15 billion to the newly designated unrestricted subsidiaries.¹

¹ <https://www.bloomberg.com/news/articles/2020-05-22/elliott-backed-travelport-faces-lender-furor-after-moving-assets>.

ANALYSIS

In many credit agreements, a borrower's ability to designate unrestricted subsidiaries and to consummate certain investment/distribution transactions are subject to the condition that the borrower demonstrate *pro forma* compliance with a leverage ratio or other financial covenant. In both J. Crew and PetSmart, litigation was commenced by lenders challenging the questionable transfers. Among other arguments, the lenders disputed the leverage ratio calculations asserted by the borrowers, arguing that such calculations were based upon artificially inflated EBITDA calculations.

The Travelport first lien credit agreement is not publicly available and we cannot comment on the specific terms of the negative covenant and unrestricted subsidiary provisions contained in that agreement. However, it has been reported that Travelport utilized baskets under its credit agreement not qualified by any leverage ratio or other financial covenant. If that is the case, then it stands to reason that Travelport's secured lenders will not be able to challenge these transactions based on improper financial calculations.

When covenant non-compliance or other breach of contract cannot be proven, disappointed lenders are left to fall back upon fraudulent transfer arguments, which are fact specific and challenging to litigate. In J. Crew and PetSmart, a number of affected lenders ultimately chose to settle and accept early payment rather than continuing to litigate. In J. Crew, those lenders that did not agree to settle have been engaged in years of litigation, with no clear resolution in sight. These lenders sued on a variety of breach of contract, fraud, and fraudulent transfer claims, but the case was substantially narrowed in April of 2018. At that time, the Supreme Court of New York for New York County dismissed the fraudulent conveyance, fraud, and declaratory judgment claims, as well as claims against J. Crew affiliates and the administrative agent. In its ruling, the court found the claims were barred by a "no-action" clause contained in one of the agreements. Breach of contract claims remained pending based on alleged covenant non-compliance and lack of appropriate consent and ratification until the lawsuit was dismissed in July 2020. In addition, the Unsecured Creditors Committee in J. Crew's bankruptcy case is seeking to raise challenges to the underlying transactions.

CONCLUSION

The ultimate outcome of the litigation and contested matters remains uncertain. We note that litigation challenging transfers of valuable collateral is a poor substitute for the collateral itself, among other reasons because such litigation may take years to resolve. The J. Crew, PetSmart, and Travelport cases

are timely reminders to secured lenders to consider the interplay of the baskets in their credit agreements, as well as the cumulative availability to borrowers under these baskets. Such review is particularly warranted for credit agreements that—in line with recent trends—provide multiple baskets for dispositions, restricted payments, and other transactions, and then permit those baskets to be used both individually and in the aggregate.

That flexibility appears to have enabled Travelport to move critical assets beyond the reach of its senior secured lenders, and without the need to show covenant compliance on a *pro forma* basis. As shown by prior cases, secured lenders will have their work cut out for them to the extent they challenge transfers and dispositions that are authorized by the plain language of the credit documents.