LMEs: The New Trend for Financial Restructuring Outside of Court

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Abstract

A major trend in credit markets has emerged in the past few years: liability management exercises ("LMEs"). It's the latest action to avoid the expensive Chapter 11 bankruptcy process by extending debt maturities to allow more time for companies to execute an operational turnaround or conversely to kick the can further down the road to an eventual default.

While there have always been efforts to restructure liabilities outside of the court to stave off distress ahead of bankruptcies, the recent surge in LMEs is the result of opportunistic lending funds rapidly increasing over the last decade. The abundance of covenant-lite debt in sub-investment grade credit issued in the years leading up to 2022 has also made it easier to flex debt maturities.

What are the Components of an LME?

LMEs are used by the borrower to raise new debt that is either senior to the existing debt or backed by collateral that had previously been pledged to the existing debt.

Typically, there are three types of LMEs, each with its own characteristics:

1) **Drop-down financing:** This debt management operation has been used most notably by PetSmart, Neiman Marcus and J Crew. In this scenario, the company transfers assets — often collateral — to a subsidiary outside of the credit group. Then new lenders or a subset of existing lenders provide structurally senior financing, or in some cases, exchange existing loans for structurally senior debt to capture the discount to the subsidiary secured by the transferred assets. These transactions often, but not always, utilize unrestricted subsidiaries, which are outside the covenants or restrictions of a loan agreement and are not necessary for the repayment of the loan.

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