

Client Alert

Global Finance Practice Group

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Explanation of J. Crew “back-door” provision and proposal for how lenders might address this in their documentation.

Recently, J. Crew used a “back-door” provision in its credit facility to transfer approximately \$250 million worth of intellectual property (“**IP**”) to an unrestricted subsidiary with the aim of borrowing against the transferred assets and using the proceeds to repay (or otherwise redeem or exchange) structurally subordinated debt of its parent at a discount. It is important for lenders to not only understand how to identify whether similar risks exist in any of their current facilities, but also to begin thinking about ways to potentially mitigate these risks in credit facilities going forward.

Analysis

J. Crew transferred certain of its IP assets to an unrestricted subsidiary via a two-step process. As a first step, J. Crew used a \$150 million basket permitting investments in non-guarantor restricted subsidiaries (as well as a \$100 million general investment basket) to transfer \$250 million of IP assets to a Cayman Islands restricted subsidiary (the “**Cayman Investment**”). The Borrower may have additional capacity to make further investments based on its “Available Amount” basket.¹

As is the case with many foreign subsidiaries (due to potential adverse tax consequences of a foreign entity guaranteeing domestic debt), this Cayman Islands subsidiary is not a *guarantor* of the existing debt. However, as a *restricted* subsidiary it is bound by the terms of the credit facility including the negative covenants. Just like the guarantors, it is not able to perform certain actions itself, such as incurring additional debt, without being subject to the credit facility’s debt prepayment covenant, among others.

Significantly, however, a provision in the credit facility’s investment covenant allows for investments of any amount by a non-guarantor restricted subsidiary in an unrestricted subsidiary “*to the extent financed with the proceeds received*” from certain initial investments in such subsidiary, namely the Cayman Investment.

This “back-door” provision essentially converts what was originally \$250 million of aggregate investment baskets in non-guarantor restricted subsidiaries, into a second general uncapped investment basket once such proceeds were received by a non-guarantor restricted subsidiary.

Accordingly, as a second step, J.Crew was free to transfer all \$250 million of IP from the non-guarantor restricted subsidiary to an unrestricted subsidiary. *Unrestricted* subsidiaries are not bound by the terms of the credit facility. Thus, the unrestricted subsidiary (and ultimate recipient of the \$250 million IP transfer) is permitted to incur additional indebtedness secured by a lien on the transferred IP. J. Crew’s likely strategy is to use the proceeds of such indebtedness to negotiate a restructuring of \$500 million 7.75%/8.5% senior PIK Notes issued by its holding company.

In response to rumors that J. Crew's lender group intended to issue a notice of default alleging such transfer was impermissible, J. Crew filed a lawsuit in the New York Supreme Court requesting a declaratory judgment that this intercompany IP transfer was permitted under the credit facility. Assuming the court agrees with J. Crew's analysis, it is anticipated that distressed borrowers with comparable provisions in their credit facilities may seek to employ a similar strategy. We are currently monitoring this lawsuit and anticipate that among the issues likely to be in dispute are whether the unmonetized IP assets in question constitute "proceeds" and whether the transfer of such unmonetized IP assets constitutes a "financing", as such terms are used in the back-door provision.

How Common is the "Back-Door"?

The majority of credit agreements do not include a "back-door" and instead typically permit investments in unrestricted subsidiaries by aggregating various general baskets, a dedicated restricted-payment basket and a builder basket.

Moreover, the presence of a "back-door" is not necessarily problematic in itself. The issue under the J. Crew credit facility arose because, unlike the typical "back-door" provision included in certain credit facilities, there was no provision preventing funds received by a non-guarantor restricted subsidiary from being aggregated with the general investment basket.

Conclusion and Recommendations

J. Crew serves as a dangerous example of the risks of leakage which can arise absent a thorough and diligent review of covenants in a credit agreement before investing in a company's debt. It also highlights the potential pitfalls of permitted investments in unrestricted subsidiaries and the need to be prepared for creative utilization of investment baskets generally. To be prepared and well-positioned to make informed decisions throughout the life of an existing credit facility, it might be a worthwhile exercise to have existing facility documents analyzed for potential leakage and "back-door" risks.

There are a number of ways lenders can eliminate or mitigate against this risk. In our view, the simplest approach may be to include at the end of the investment, debt and lien covenants a "catch-all" provision which sets forth that any investment, indebtedness or liens of an unrestricted subsidiary may only be incurred pursuant to the specific unrestricted subsidiary baskets. It may also be worth considering clarifying, where appropriate, that unmonetized assets will not be classified as "proceeds" and that, again, where appropriate, transfers of unmonetized assets shall not be classified as "transfers" for certain purposes under the loan documents.

We would be happy to discuss these solutions, as well as others that we have been exploring. Please do not hesitate to contact us should you have any questions or wish to discuss any of this further.

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¹ "Available Amount" means excess cash flow, declined proceeds, certain equity proceeds, certain return of investments or proceeds of investments .