The J.Crew "trap door" and its implications for the future of leveraged finance

AUTHORS

 Darien G. Leung

 Amanda C. Balasubramanian

In 2017, J.Crew made headlines for its creative—and aggressive—approach to the refinancing of its US$500 million unsecured senior pay-in-kind (PIK) toggle notes, using intellectual property assets pledged to the lenders under the Company's US$1.567 billion term loan facility.

Clare's Stores, iHeart Communication and Revlon, among others, followed suit, and so after a collective jaw drop, lenders (and their lawyers) began to take a hard look at the covenant structures in their credit facilities.

Faced with the impending maturity of their notes, an oversized debt structure and poor results in an ailing retail market, J.Crew desperately needed to find value in the company. The negative covenant limiting investments in subsidiaries was not unusual or particularly borrower-friendly. There is a general prohibition on investments by loan parties in restricted subsidiaries; restricted subsidiaries are subject to the covenants of the loan agreement, whereas unrestricted subsidiaries are not. J.Crew included three frequently used carve-outs to this.

1. Investments by loan parties in restricted subsidiaries up to the greater of US$150 million and 4% of total assets plus an additional amount based on earnings.

2. Investments by restricted subsidiaries in unrestricted subsidiaries up to the greater of US$100 million or 3.25% of total assets plus an additional amount based on earnings if no event of default has occurred and is continuing.

3. Investments by restricted subsidiaries in unrestricted subsidiaries financed with proceeds received from an investment in such restricted subsidiary.

Taking advantage of the first two baskets, J.Crew transferred a 72.04% interest (worth US$250 million) in its trademarks to a Restricted Subsidiary named J.Crew Cayman. Then, taking advantage of the third basket, J.Crew Cayman transferred the interest to J.Crew Brand Holdings, LLC, an unrestricted subsidiary. Although not litigated, there is question as to whether the intellectual property transferred was the proceeds of a financing. The intellectual property, now held by an unrestricted subsidiary and no longer subject to the security interest of the lenders under the credit agreement, was then licensed back to the J.Crew companies so they could continue to use the trademarks in operations. J.Crew then used the trademarks to collateralize new notes offered in exchange for the unsecured PIK notes.

What happened to J.Crew and its lenders is indicative of a mounting pressure on lenders, which has become particularly acute in light of a looming economic downturn.

The ramifications of this US$250 million transfer were lenders losing their pledge of the trademarks at the core value of J.Crew, and any secured party to which those trademarks were pledged having tremendous leverage over the lender group under the credit facility. Adding insult to injury, the borrowers would now have to pay a fee to use the trademarks it formerly owned. Lastly, in a bankruptcy, the license for the trademarks could be subject to rejection by the licensor, giving the licensor additional leverage over J.Crew and its other creditors.

Hindsight is 20/20 and lending lawyers now pay close attention to investment covenant baskets for this particular issue, consider carving out core assets such as intellectual property and ensuring any “financing with proceeds” is clearly cash proceeds from third parties.

What happened to J.Crew and its lenders is indicative of a mounting pressure on lenders, which has become particularly acute in light of the economic downturn that seems inevitable these days. We have seen many years of sponsor-led loan documentation with increasingly aggressive EBITDA carve-outs and add-backs, together with multiple, overlapping negative covenant baskets and cure rights. Economic conditions are still relatively good, and as long as the M&A market remains strong, sponsors will have the advantage. When that downturn does happen, lenders will be looking at revenues and balance sheets in a very different way, as they wonder where their value went.

On the north side of the border, while we have not seen an aggressive use by a Canadian borrower of its analogous covenants in Canadian credit agreements, this case should be still taken as a precautionary tale about how baskets and leakage exceptions can be used creatively for unintended results. As always, we encourage our clients on both sides of the border to properly understand how all the baskets and exceptions can be used individually and together. The J.Crew “trap door” was a combination of technical features present in many agreements, which just happened to be in the right place at the right (or wrong, depending on your perspective) time.