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What You Need to Know about "Unrestricted Subsidiaries"

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As more and more companies face liquidity issues and near-term debt maturities, they are looking closely to exceptions contained within their indenture/credit agreement covenants in order to achieve an overall or partial restructuring of their capital structure. Investments in "unrestricted subsidiaries" are an exception to investment covenants, which have been used in an attempt to provide flexibility in restructuring a company's capital structure. Two recent and well-publicized examples of moving value into an unrestricted subsidiary relate to the financing agreements of iHeartCommunications and J.Crew Group Inc. Before purchasing any debt, distressed investors need to be mindful of what unrestricted subsidiaries are and how they may impact the overall credit of a company or debt recoveries.

What is an "Unrestricted Subsidiary"?

Covenants in a financing agreement generally apply to the company and its "restricted subsidiaries." Unrestricted subsidiaries are not bound by the financing agreement's covenants and restrictions. Therefore, an unrestricted subsidiary is free to incur debt, grant liens, and make investments, restricted payments and asset sales even if the financing agreement would otherwise prohibit the company and its restricted subsidiaries from doing so. In addition, unrestricted subsidiaries do not guaranty the outstanding principal amount of the debt, they do not provide liens as part of a collateral package (in the case of secured debt) and in some cases, the parent of the unrestricted subsidiary is free to grant liens to third parties on the stock of the unrestricted subsidiary. The downside of an unrestricted subsidiary for a company is that the income of an unrestricted subsidiary is not included in the company's earnings

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before interest, tax, depreciation and amortization (EBITDA), and therefore such income cannot be used by the company when calculating financial definitions and covenants in the financing agreement.

Financing agreements will typically permit the company to designate a subsidiary as an "unrestricted subsidiary" if certain conditions are satisfied. Such conditions may include: (1) that such subsidiary at the time of determination would not hold liens on, indebtedness of, or equity interests in its parent company or a restricted subsidiary; (2) that the company is permitted by the financing agreement covenants to make an investment in the unrestricted subsidiary in an amount equal to, or greater than, the fair market value of such unrestricted subsidiary; (3) that the company and its restricted subsidiaries are not responsible for any debt incurred by such unrestricted subsidiary; and/or (4) that the debt incurrence test (contained in the restrictions on indebtedness covenant) must be satisfied at the time of, and after giving effect to, the designation of such unrestricted subsidiary.

Use of an Unrestricted Subsidiary

Companies may use unrestricted subsidiaries in order to transfer a valuable asset outside of the purview of the financing agreement's covenants and into an unrestricted subsidiary. A company can then use the unrestricted subsidiary in order to exchange near-term maturing debt that is junior in the company's capital structure for debt issued by the unrestricted subsidiary — an exchange that would otherwise not be permitted by the financing agreement's covenants. The exchanged indebtedness could then be supported by the asset that has been transferred to the unrestricted subsidiary.

Investments and Unrestricted Subsidiaries

In order to determine whether or not a company has the capacity to transfer a valuable asset to an unrestricted subsidiary, the investor needs to review both the covenant restricting "restricted payments" and the definition of a "permitted investment." A specific basket for investments in unrestricted subsidiaries is not exclusive, the company could utilize a general investment basket, a general restricted-payment basket and any available "builder" basket. When the investment in an unrestricted subsidiary is that of a noncash asset of the company, the issue becomes one of value. The company has to determine the valuation of the asset in order to fit the investment within its covenant exceptions. The investment covenant in a financing agreement typically states that the amount of the investment is the fair market value of the investment that is determined by the board of directors of the company at the time the investment is made. This can be a point of contention — the investors and the company may have two completely different determinations of the fair market value.

Transactions with Affiliates

An investment in an unrestricted subsidiary could also be covered by a financing agreement's "transactions with affiliates" covenant. A "transactions with affiliates" covenant will typically provide that any transaction with an affiliate must be on terms at least as favorable as those in a similar transaction with a nonaffiliate. By definition, an unrestricted subsidiary is an affiliate of a company and therefore, any investment in that unrestricted subsidiary should be subject to the "transactions with affiliates" covenant. "Transactions with

affiliates" covenants, however, contain an important exception: In the event that the transaction with the affiliate is a permitted restricted payment or "permitted investment," then the transaction is likely excepted from the covenant. Some financing agreements may even explicitly state that transactions with unrestricted subsidiaries are excepted from the covenant. These exceptions put further pressure on the investor to scrutinize the overall transaction with an unrestricted subsidiary in order to determine whether or not that transaction is subject to the "transactions with affiliates" covenant.

iHeart and JCrew

In the case of iHeart,[1] in December 2015, a restricted wholly owned subsidiary of iHeartCommunications Inc. (the "issuer") contributed shares of its subsidiary Clear Channel Outdoor Holdings Inc. to an unrestricted subsidiary named Broader Media LLC (the "share transfer"). The share transfer allowed Broader Media LLC to receive dividends from Clear Channel and, because Broader Media was an unrestricted subsidiary, Broader Media could freely determine how to invest such dividends. The investors sent default notices to the issuer asserting that the share transfer was not a "permitted investment" because such transaction was not even an investment in the first place. The investors argued that an "investment" is an expenditure intended to produce a profit, as the definition of the term "investment" under the Black's Law Dictionary would require. In addition, the investors argued that even if the share transfer qualified as an investment, it was not a "permitted investment" as the value of the shares contributed to Broader Media LLC was not determined in good faith by the issuer and, therefore, vastly exceed the indenture's $600 million basket. The issuer used the market price of another share class and the bondholders contended that the criteria was arbitrary and undervalued the shares transferred. In March 2016, the issuer filed a lawsuit against the investors rejecting the arguments brought by the investors in the default notices and seeking relief in the form of a temporary restraining order (TRO) and injunctions preventing the creditors from issuing additional default notices. The court granted the TRO. On July 15, 2016, Broader Media purchased approximately $383 million of iHeart's 10 percent senior debt due 2018 for $222 million.

In the case of J.Crew, on Dec. 5, 2016, J.Crew transferred certain of its intellectual property into a Cayman Islands unrestricted subsidiary. On Feb. 1, 2017, J.Crew filed a complaint of declaratory judgment against Wilmington Savings Fund Society, the new agent under its term loan agreement that seeks to prevent an ad hoc group of lenders from declaring an event of default under the term loan agreement.[2] J.Crew argues that the transfer of intellectual property was permitted under its various investment baskets. J.Crew states in the complaint that the transfer was made for "the pursuit of potential value-maximizing strategic transactions." The transfer is likely being made in an effort to exchange the $500 million 7.75 percent/8.5 percent senior payment-in-kind (PIK) toggle debt due 2019 issued by J.Crew's holding company.

Conclusion

Today, where a company's liquidity and ability to refinance existing debt is becoming more challenging, a careful and diligent review of covenants is required before a potential purchase of a company's debt. Investors must be mindful of the unrestricted subsidiary concept and the exceptions that correspond with it. Investors must also be prepared to "think outside the box" to determine if there is any way for a company to

utilize its unrestricted subsidiary covenant to transfer value to an unrestricted subsidiary. These types of reviews are necessary in order to avoid pitfalls or unexpected disputes.

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1. iHeartCommunications Inc. v. Benefit Street Partners LLC et al., No. 2016CI04006 (Bexar Cty. Tex.D.Ct. March 7, 2016).
2. J. Crew Group Inc. et al. v. Wilmington Savings Fund Society, FSB, No. 650574 (Supreme Court NY Feb. 1, 2017).

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