Feature

KEY POINTS

- Loan agreements typically include restrictions on the transfer of assets. Tensions may arise with creditors when assets are transferred outside the borrower group.
- If assets are transferred to an Unrestricted Subsidiary, creditors may lose direct recourse and be at risk of other claims diluting the benefit of the assets to meet their own claims. This may have implications in a distressed scenario for the underlying companies, its directors, and the various creditors.
- Determining the most appropriate value to be attributed to any asset that is transferred is key, and may limit the possibility that any such transfer is capable of being challenged going forwards.

Authors Gregory A. Campbell, Amy Kennedy and Nisha Navekar

Intra-group asset transfers: in the net, or out?

Creditors are naturally concerned to ensure that their obligors have assets available to meet their claims. Consequently, financing arrangements invariably contain restrictions on asset transfers. This article examines the ability of borrowers under the terms of financings to effect asset transfers within a corporate group from Restricted Subsidiaries to Unrestricted Subsidiaries, and what this means for directors and creditors.

Financing arrangements – whether provided under a loan agreement or bond documentation – invariably include restrictions on the behaviour of the borrower/issuer group. Whilst these restrictions may vary by number, extent and degree, their purpose is the same: to impose behavioural control on borrowers of financial indebtedness. These restrictions apply to those members of the borrower's group that are identified as "Restricted Subsidiaries" under the terms of the financing. These Restricted Subsidiaries will include those group companies which have provided guarantees (and in some cases security) in respect of the payment of amounts outstanding under the financing as well as any other members of the group which may be material or which simply have not been designated as "Unrestricted Subsidiaries" for the purposes of the financing terms. Unrestricted Subsidiaries are never guarantors of the financing arrangements and are not subjected to the restrictions contained in the negative covenants.

For the purposes of this article, we will focus on those restrictions (also known as "negative covenants") which relate to the transfer of assets between Restricted Subsidiaries (as transferor) and Unrestricted Subsidiaries (as transferee).

The negative covenant restricting the transfer of assets between borrower group companies to third parties is intended to protect the underlying creditworthiness of the borrower group. The ability of the borrower group to repay the funds advanced by creditors is conditional upon it having available funds to meet the obligation or, in an insolvency context, assets sufficient in value (once liquidated) to satisfy claims. In theory at least, any diminution in assets in a member of the borrower group therefore has a corresponding diminution in the value and the creditworthiness of the borrowing group. From the creditors' perspective, a diminution in the assets of a group company against which the creditors have a direct claim (by virtue of a guarantee or payment obligation) is of particular importance.

The recent well-publicised J. Crew transaction has identified some interesting considerations with respect to asset transfers generally under the terms of financing agreements, and in particular, with respect to transfers by Restricted Subsidiaries to Unrestricted Subsidiaries.

The J. Crew transaction involved the transfer of a portion of the group's intellectual property having a value of US$250m to an Unrestricted Subsidiary (and it was subsequently transferred to further unrestricted subsidiaries). By doing so, the intellectual property ceased to form part of the lenders' security package and became held by a company against which the creditors under J. Crew's financing had no direct right of recourse.

J. Crew have maintained that the transfer was entirely permitted under the terms of the financing. It is of course the prerogative of financial creditors (within the confines of market acceptability and the borrower's negotiating leverage) to condition the advance of funds on the agreement of terms which are satisfactory to them and which adequately protect their interests. Creditors therefore need to carefully consider the potential use to which baskets and exceptions under the finance documents could be put, and to ensure that provisions intended to facilitate the business and operations of the borrower group are not put to more sinister use. At the same time, not every outcome is foreseeable at the point at which financing terms are agreed and neither creditors nor borrower operate in a blank-page negotiating environment: in fact, the leveraged finance market, although highly innovative, operates in a highly regularised market.

Much has already been written about the perceived rights and wrongs of the J. Crew reorganisation and the proper interpretations of the J. Crew covenants. This article focuses instead on the inherent protections afforded to creditors under English law. We assume for the purposes of this article that the relevant companies are incorporated in England.

First, directors of an English company are required to act *bona fide* in the best interests of the company. While a company is solvent, this duty largely equates to

Biog box
Gregory A. Campbell and Amy Kennedy are partners and Nisha Navekar is an associate in the London office of Gibson, Dunn & Crutcher LLP. Email: gcampbell@gibsondunn.com; akennedy@gibsondunn.com and nnavekar@gibsondunn.com

acting in the best interests of the company's shareholders. In circumstances where solvency is less certain, the primary duties of the directors transfer to the protection of their creditors' interests.

Were a Restricted Subsidiary to transfer material and valuable assets to an Unrestricted Subsidiary, we would contend that its directors would first need to consider whether the transfer would be in the best interests of the company. This general question has a number of very specific components. First among these components is whether the directors' powers in authorising the transaction are being used for a proper purpose. In the context of the transfer of valuable assets away from the Restricted Subsidiary group, the focus will be on whether the purpose is a legitimate business purpose to promote the company's success or benefit its stakeholders or rather, an improper purpose, such as putting assets beyond the reach and recourse of its creditors.

A second and related component is value. If the asset is being transferred for good consideration that is fully equivalent to the value of that asset, it is difficult to see how the transaction would impact the company's stakeholders. An asset has simply been exchanged for something of equivalent value. This is a key protection for creditors, although determinations of value and equivalence can be highly subjective. The valuation question becomes especially pertinent in situations where the consideration for the transfer is the cancellation or transfer of intercompany receivables or equity capitalisations or when the transfer value is derived entirely from the company's books.

In assessing whether a transaction is in the best interests of the company, a relevant consideration is the importance of the asset sought to be transferred away from the transferor-company's business. In the J. Crew case, the ability to use intellectual property is a key operational requirement having regard to the retail nature of the business and the importance of brand recognition and differentiation. In J. Crew, a licence was granted back to the Restricted Subsidiary group as a condition of transfer in return for which the Restricted Subsidiary group was required to pay a periodic fee. Given the Unrestricted Subsidiary transferee would, post-transfer, be permitted to use the acquired intellectual property credit support for a potentially new secured financing, a relevant consideration for the directors of the transferor would be an assessment of the risk that the licence is terminated or the right of the Restricted Group to enjoy the rights granted thereunder are challenged in connection with an insolvency of its owner or as part of a security enforcement by the new creditors. The value question is potentially wider than a purely monetary valuation assessment at the time of transfer.

In addition, a transfer of a valuable asset for less than its real value by an English company to a related company (a shareholder, or a subsidiary of a shareholder) may, under the *Aveling Barford* line of cases, be re-characterised under English law as a dividend, and therefore unlawful if the company has insufficient distributable reserves at the time the transfer was effected. In either case, the directors of the Restricted Subsidiary transferor could face potential scrutiny and personal liability for misfeasance and breach of duty.

English insolvency law also offers a means by which transfers may be revisited. The two specific basis for revisiting transfers are where the transfer constitutes a transaction at an undervalue or is a preference (a transaction where the transferor was influenced by a desire to prefer one creditor over others). A transaction that constitutes a preference may additionally constitute a transaction at an undervalue. An English liquidator is empowered to act in the name of the company to pursue directors for misfeasance (including breach of duty) in much the same way that a shareholder might do under a derivative action (but without the administrative burdens that apply to derivative actions more generally).

Each of these remedies predicate the failure and insolvency of the transferor, and are unlikely to be of much practical use to creditors unless and until such an eventuality has occurred.

In conclusion, the terms agreed between creditors and borrower remain of the utmost importance. The flexibilities afforded to the borrower under the financing covenant package (especially in terms of structure and maintenance of key assets) must be fully understood in all its potentiality by the creditor prior to entering into the transaction. Participants in the international debt markets are frequently highly innovative and sophisticated, and the market continues to evolve – in part, as a result of fact scenarios such as those presented by the J. Crew matter. Financing terms will no doubt evolve in tandem – perhaps to include protections which may be perceived as lacking or by means of engendering a clearer understanding of the parameters of the drafting. In any case, financing agreements and the market they represent do not operate in a vacuum: every director of every borrower is subject to company law and fiduciary constraints of one sort or another. These should, if observed, operate to some degree to ensure fair play in situations where the finance documents may appear to have opened a "trap door" in the credit structure. Rumours of the death of the Unrestricted Subsidiary concept have (with apologies to Mr Twain) been greatly exaggerated. ■

Further Reading:

- Intra-group transfers at "market value": good intentions count (2011) 7 JIBFL 416.
- Cross-border intra-group asset transfers: too big to ignore? (2010) 5 JIBFL 300.
- LexisPSL: Restructuring & Insolvency Practice note: Common issues in an intra-group reorganisation.