KEY POINTS

- Intralot used standard covenants in its indentures in novel ways to restructure its debt through a US style drop-down transaction for the first time in Europe.
- Covenants can be exploited to reduce the value of assets subject to a drop-down and to generate investment capacity in unexpected ways.
- Non-consenting creditors can be bypassed by using optional redemptions followed by new notes' issuances.

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Intralot's drop-down restructuring games: priming *pari passu* noteholders, circumventing non-consenters and artificially reducing asset values

Intralot is the first European group to restructure its debt using the "J. Crew"-inspired drop-down procedure, transferring its unencumbered US business away from unsecured noteholders due to be repaid in 2024, to be used to support secured debt to refinance unsecured notes maturing earlier in 2021. The trustee for the notes due in 2024 is suing and there is a separate claim for fraudulent transfer. In this article, the authors explore:

- how unsecured *pari passu* and *pro rata* noteholders came to prime others by becoming senior secured noteholders under the drop-down procedure;
- how the drop down was achieved by a US subsidiary issuing unsecured notes due 2025, swapping them for the unsecured notes due 2021 issued by a holding company, being designated an "Unrestricted Subsidiary", with its shares and assets then being pledged as security for the notes due 2025;
- how Intralot exploited imprecise but standard drafting of the covenants to ensure the value of the US business was low enough to fit within investment basket capacity required to be used for the drop-down;
- why only 75% of the primed noteholders may have decided to stay being supported by the non-US business rather than exchange for equity in the US business;
- how the different bargaining power among creditor groups impacted the restructuring and resulted in unequal outcomes for creditors in the same class;
- how a minority of 2021 noteholders withheld consent to force repayment of 59% of their notes at *par* prior to the refinancing-by-drop-down; and
- "J. Crew" blockers as anti-drop-down provisions and their frequency in 2021.

BACKGROUND

As 2020 ended, the Greek gaming company Intralot was in financial difficulties and faced the upcoming 2021 maturity of its €250m 6.75% unsecured senior notes (2021s). Payment default thereon would default its €500m 5.25% unsecured senior notes due 2024 (2024s), and risk insolvency.

The 2021s and 2024s, both issued by Intralot Capital Luxembourg S.A., were *pari passu* with similar terms except for maturity and margin. To entice 2021 noteholders to refinance, attractive terms for the new debt were required, however the notes' indentures only permitted €100m of secured debt.

Intralot took inspiration from the infamous "J. Crew" drop-down manoeuvre, also used by Neiman Marcus, Cirque du Soleil and Travelport in the US; they all refinanced debt by (generally) transferring valuable assets from a "restricted" group to an "unrestricted" group not subject to debt document covenants, to pledge them to refinancing creditors. Intralot designated its valuable US business as "unrestricted", transferring it away from the 2024 noteholders, refinanced the 2021s with debt secured thereon, and offered 2024 noteholders equity in the US business in return for their 2024s.

2024 NOTEHOLDERS LITIGATE THE US BUSINESS DROP-DOWN

In July 2021, litigation ensued. Funds holding around 3.5% of the primed 2024s failed to block the restructuring through a temporary restraining order. Intralot's restructuring was completed on 3 August 2021. In January 2022 an expanded group of 2024 noteholders filed a substantive claim asserting, among other things, that Intralot's restructuring violated covenants in the 2024s indenture. The complaint related to breach of debt and lien incurrence covenants and the covenant prohibiting the US business from being released as a guarantor and designated "unrestricted". They also claimed there were breaches under the Uniform Voidable Transactions Act.

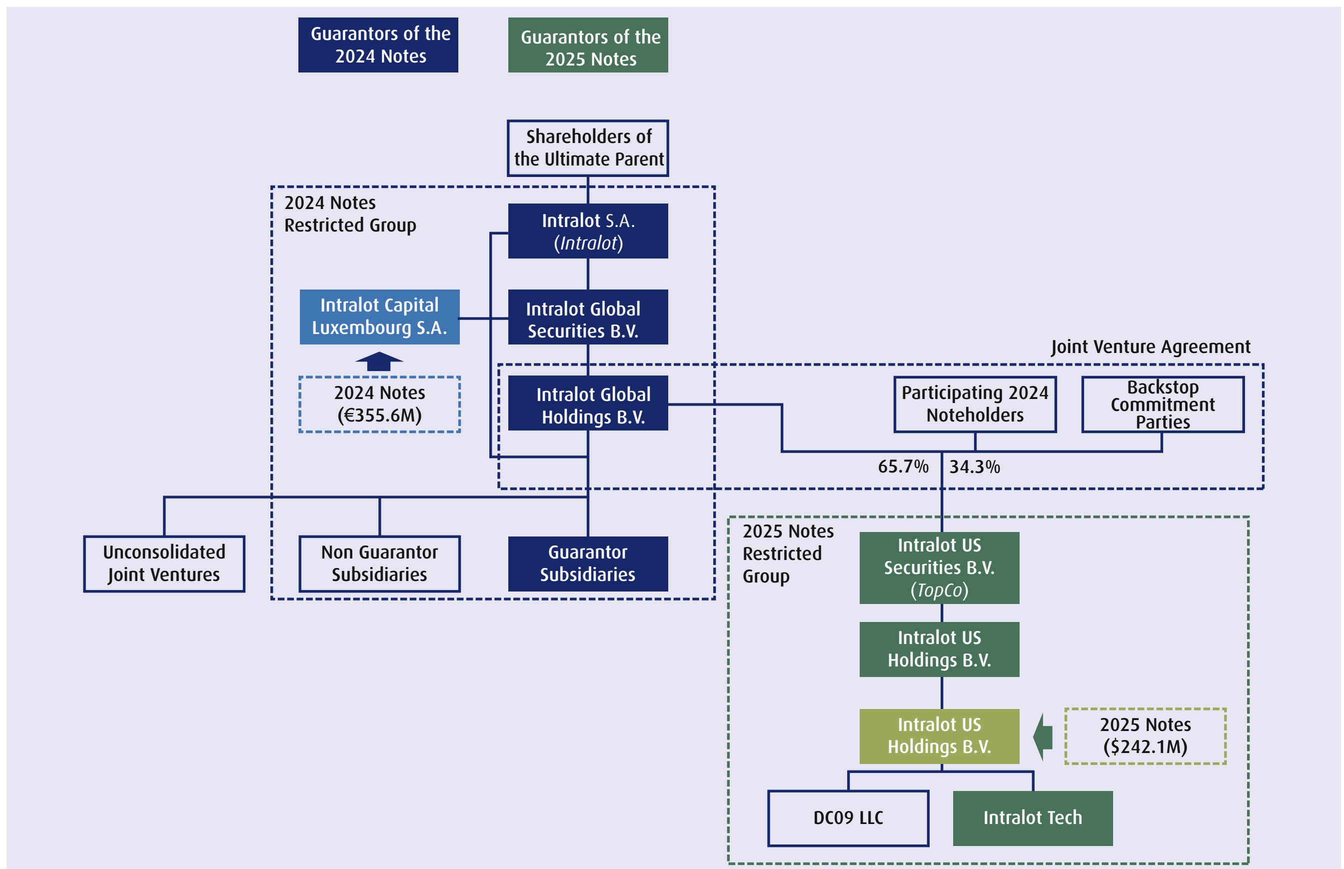
Intralot filed a motion to dismiss the Complaint on 31 March 2022. On 20 April 2022, the 2024 notes trustee (Trustee) filed a revised Complaint as regards breach of contractual terms, which superseded the January 2022 Complaint on the same points (Complaint).

Our analysis is based solely on information that is publically available, including the declaration made by Intralot's deputy CEO in July 2021 objecting to the temporary restraining order (Declaration).

INTRALOT'S RESTRUCTURING AND THE PRIMING OF THE 2024s

Overview of the restructuring

Initially, Intralot worked with an *ad hoc* group holding over 75% of the 2021s to agree the refinancing terms set out in a lock-up



agreement. The 75% threshold would allow Intralot access to a scheme of arrangement for implementation of its restructuring, but presumably this was not pursued as there was a risk this could cause a cross-default in the 2024s.

Intralot S.A. (*Intralot*) completed the following cross-conditional exchange offers with the holders of the 2021s and 2024s on 3 August 2021:

- With a 90% minimum exchange condition, Intralot exchanged €247.5m of its 2021s for $242.1m of new senior secured PIK toggle notes due 2025 issued by Intralot Inc. (New Notes) (initially unsecured but secured after the designation of the US business as "unrestricted" – see below); and
- With a minimum acceptance condition of €68.2m and a maximum acceptance amount of €169.1m, Intralot exchanged €118.24m of its 2024s for shares of Intralot US Securities B.V. (TopCo), representing 34.3% of Topco's shares, with the remaining 65.7% of shares being owned by Intralot Global Holdings B.V. (IGH), a restricted subsidiary and a guarantor of the 2024s. Holders of the remaining €355.6m of 2024s decided not to exchange (€25.2m had been previously redeemed).

As part of the restructuring, Topco and its subsidiaries, being Intralot's US business (*US Group*) were designated as "Unrestricted Subsidiaries" under the 2024s indenture on 4 August 2021 and as a result, Intralot Inc.'s guarantee of the 2024s was also released. TopCo and its shareholders entered into a joint venture (JV) agreement under which Intralot would manage the US Group.

Priming of the 2024s

Under the restructuring, the 2021 noteholders received the New Notes secured by the US Group's assets, which are substantial, generating about 50% of Intralot's projected financial year 2021 consolidated group EBITDA or 63% excluding partnerships (56% and 71% respectively projected for 2023) according to Intralot's 14 January 2021 announcement. The Complaint states the US business is Intralot's "crown jewel" and generates more than 70% of Intralot's EBITDA and earnings.

The New Notes prime the 2024s in being guaranteed and secured by the valuable US Group, where previously both the 2021 noteholders and 2024 noteholders had *pari passu* and *pro rata* unsecured claims against the entire Intralot group.

2024 noteholders could not exchange into the New Notes; they could either exchange for a minority stake in TopCo's equity, or remain holders of the unsecured 2024s with recourse to Intralot's non-US business.

Unequal treatment of the 2024 noteholders

Ahead of the general launch of the debt exchanges, a group of 2021 noteholders that cross-held 13% of the 2024s backstopped the exchange of €68.176m of 2024s for Topco

equity, satisfying the minimum acceptance condition of the 2024 notes exchange. They were paid a fee and (as stated in the Complaint) the right to appoint directors of certain US entities. The Complaint states the backstop arrangement and fees were not offered to all 2024 noteholders.

Cross-conditionality

Even though it was in Intralot's interest to reduce its debt whether or not 2021 or 2024 noteholders exchanged or not, there could be a number of reasons why the notes exchanges were cross-conditional; one reason may be because both exchanges were required to reduce the valuation of the US Group to ensure it fitted within basket capacity required for the drop-down (more on this below).

Did up-side 2021 noteholders play a coercion game?

Crucially, the 2021 notes exchange required 2021 noteholders holding at least 90% of principal to agree, however only 82% had by the initial deadline. There was no obvious reason for 18% to refuse, given the likely principal repayment default and the offer of the US Group as security. Perhaps they wanted better terms, particularly if they also held 2024s and knew the backstop parties had been offered a fee to exchange their 2024s. If they were a single noteholder or acted together, they may have rejected to exchange their 2021s in anticipation of Intralot's next move.

Intralot's next move was for the 2021s issuer to borrow €147.6m from the *ad hoc* group to redeem 59% of the 2021s *pro rata* at *par* under optional redemption provisions. The *ad hoc* group, solely, then received €147.6m of new 2021s in repayment, which carried votes consenting to the 2021 notes exchange under the lock-up agreement. Intralot replaced just enough of the non-consenting 2021 noteholders with consenting ones to achieve the 90% threshold. The cost to Intralot was having to redeem around €26.6m (11% of principal) of non-consenting 2021s at *par*, ie non-consenting 2021 noteholders managed to get 59% of their notes redeemed at *par* as well as have their remaining €18.45m of 2021s exchanged for priming senior secured New Notes. It might not have been possible for Intralot to initially agree to a refinancing with 90% of 2021 noteholders; it needed something up its sleeve to ensure the 2021 notes exchange occurred.

This gameplay highlights:

- how creditors in the more favourable priming position, but omitted from an inner circle of creditors in initial restructuring agreements, might have a hand to play in initially withholding consent; and
- how borrowers can manipulate votes to get what they want.

WHAT'S TO TAKE OR KEEP FOR 2024 NOTEHOLDERS?

The Trustee has argued the 2024 noteholders faced a Hobson's choice – take it or be left with precious little – but it was more a "rock and hard place" predicament:

- to exchange and be demoted lower down the capital structure to be a shareholder, and a minority shareholder at that, but in relation to the higher-quality US business. This would also provide the potential to receive a return higher than an interest rate and possibly a quicker return than the 2024s debt repayment; or
- to not exchange and play a potentially longer game in remaining with recourse to the non-US businesses, relying on them being profitable enough to support the 2024s. If the US Group were profitable enough, it might also assist with 2024-related repayments (subject to the terms of the New Notes indenture); IGH, a guarantor of the 2024s, would own 65.7% of shares in the JV holding the US Group, and so its share of any returns from the JV would be governed by the 2024s indenture.

The particular circumstance of each drop-down case determines the level of coercion down-side creditors face. It may be litigation over the drop-down itself, whatever it merits, that proves to be a trump card. In the PetSmart/Chewy case, PetSmart had to settle litigation by offering better economic and other terms to creditors challenging its drop-down of Chewy equity, before it could realise its value in Chewy by way of an IPO. In Travelport, the sponsors had a stronger position: they dropped-down over $1bn of intellectual property, stating to current lenders it would reverse this if they provided new money and discounted existing lending. When negotiations broke down, the sponsors provided funding themselves, secured on the intellectual property, which helped persuade lenders to provide new money and the discount – the drop-down was reversed.

INCURRING NEW NOTES: CIRCUMVENTING THE LIENS COVENANT

The only substantial debt outstanding was the 2021s and 2024s, so under the notes' indentures there was €265m of capacity under the "Credit Facilities" basket for Topco to issue the Notes for the 2021 notes exchange ("Credit Facilities" is defined to include notes). However, only €100m in total of debt under these baskets could be secured without also securing the assets for the 2024s.

To get around this, Topco issued the New Notes as unsecured, and after the US Group's designation as "unrestricted" it could then, and did, secure the New Notes as the notes' liens covenant in the 2024s indenture would then not apply to their actions.

MAKING THE HAND FIT THE GLOVE: INTRALOT'S CREATIVITY WITH DESIGNATION PROVISIONS

Unrestricted Subsidiary designation provisions

The crux of the designation of the US Group as "Unrestricted Subsidiaries" revolves around the amount, and the timing, of their valuation.

Under the 2024s indenture, for Intralot to designate a restricted subsidiary as an "Unrestricted Subsidiary", "the Fair Market Value of the Company's interest in the Subsidiary … will be … an Investment made as of the time of the Designation".

The definition of the term "Investments" states:

"Except as otherwise provided … the amount … to the extent applicable … shall be determined based on the equity value of such Investment."

The investment must be made using either restricted payments or investment baskets. The fair market value had to be determined by Intralot in good faith.

Lowering the value of the US Group before designation

The timing of the valuation was important. We will discuss this aspect first, and then turn to the amount.

The equity value of the US Group held by Intralot after the notes' exchanges would be much lower than its value before the exchanges because it would be reduced by:

- the amount of the New Noteholders' claims on its assets, which dilute the claims of shareholders (assuming there was no impact on the group's cash position or other assets); and
- the amount of the US Group's equity value given away in the 2024s exchange; 34.3% of Topco equity was given away for €118.24m of 2024s.

So, it was in Intralot's interest to reduce the equity value before the designation to ensure the equity in the US Group – the "Unrestricted Subsidiaries" – fitted within investment basket capacity under the 2024s indenture. Intralot played timings to their advantage to ensure debt was added, and its equity holding reduced, to achieve a lower valuation: the New Notes were issued prior to or on 3 August 2021, the exchanges settled on 3 August 2021, and the "unrestricted" designation happened on 4 August.

The Trustee is challenging the "day later" designation as an "improper fiction", stating the New Notes issuance, notes exchanges, and designation are one integrated transaction with interdependent elements, and they effectively occurred, or should have, on the same date. As a result, the US Group was worth more and there was insufficient basket capacity under the 2024s indenture for the designation.

NO STANDARD TEST FOR THE VALUATION

Except for the "fair market value" condition, there is no required procedure or guidance on how to value investments for the purpose of designating a restricted subsidiary as unrestricted.

We have estimated that based on the €118.24m 2024s exchange into 34.3% of Topco equity, the implied enterprise value of the US Group would be €550m with an equity value of €345m (€118.24m *pro-rated* for 100%), *pro forma* for the notes exchanges based on *par* value of the 2024s being exchanged into equity (with €205m of the enterprise value being represented by the New Notes). Based on the maximum acceptance amount of €169.1m of 2024s for 49% of shares, the implied equity value was €345.1m. If the market value of the 2024s is used – trading at 62 on 30 July 2021 – the implied equity value would be lower and the implied enterprise value would be around €419m.

An estimate of the value of Intralot's equity interest in the US Group – 65.7% of Topco's shares that Intralot invested in the JV – would be 65.7% of €345m, being €226.7m, or calculating the value based on the 2024s trading at 62, €140.6m.

The Declaration states an independent valuation of the US Group determined its enterprise value to be €386m and that the 2024 notes exchange was at less than the fair market value of 34.3% Topco's equity. Assuming the €386m includes the €205m of debt to be incurred under the New Notes, this gives a €181m value for Topco's equity, with 34.3% being €62m; this would mean Intralot's 65% equity investment would be €118m, well within basket investment capacity (see below).

To summarise, the value of the 34.3% stake, based on Intralot's commissioned independent valuation, was €62m – significantly lower than our calculated value implied by the transaction of €118.2m *par* value of 2024s being exchanged, or €73.3m based on their trading price at the time. However, Intralot announced on 26 April 2022 that its board has resolved for Intralot to purchase 33.2% in Topco for €121.3m conditional upon the completion of a share capital raise before 10 August 2022. 34.3% of Topco equity was valued at €62m, and 1.1% of equity less than that has been valued at €59.3m higher about a year later.

Giving away 34.4% of Topco equity to 2024 noteholders whilst the US Group were still restricted subsidiaries under the 2024s indenture could have been done by using the carve out in the asset sales covenant for any "disposition … made in connection with the establishment of a joint venture which is a Permitted Investment".

BASKETS USED FOR THE "UNRESTRICTED SUBSIDIARIES" DESIGNATION

Intralot could have used the following baskets for designating the subsidiaries in the US Group as "Unrestricted Subsidiaries":

- the 50% CNI restricted payment build-up basket, that began to accrue from 1 September 2017, as increased by build-up components such as post-issue date equity contributions, subject to a *pro forma* 2x fixed charge coverage ratio (*FCCR*) test;
- the general restricted payment basket of €40m, use of which reduces capacity under the build-up basket;
- the general permitted investments basket of the greater of €60m and 6% of total assets. As at 30 June 2021, the restricted group's total assets were €574.7m, making the "6% of total assets" amount €34.5m; and/or
- the joint venture investment basket of €125m or a *pro forma* 2x FCCR test.

Based on our analysis, accrued CNI was negative and there were no equity contributions increasing the build-up basket. The investment baskets aggregate to €185m which were fully available except for €7m (as stated in the Declaration), leaving €178m of investment basket capacity (ignoring the 2x FCCR basket). With the general restricted payments basket, there would be €218m of capacity. This is substantially below Intralot's remaining interest in the US Group of €226.7m based on *par* value and why it is in Intralot's interest to argue the market (and

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not *par*) value of the 2024s applies to the valuation.

The Trustee claims that the "either" restricted payments "or" investment basket wording in the designation provisions means that both types cannot both be aggregated. The 2024s indenture expressly allows debt baskets to be aggregated, but there is no such allowance for restricted payments and investment baskets. Typically, in current note indentures, restricted payments and investment basket aggregation is expressly permitted for an "unrestricted subsidiary" designation.

It is significant that the investment is a JV because this allows Intralot to use the substantial JV investment basket. The Declaration does not state the *pro forma* 2x FCCR JV investment basket was relied upon, possibly because it would not be satisfied upon the designation. However, it might be a potential ace card for Intralot, as its availability would render the issues of valuation and inadequate investment capacity through other baskets irrelevant. Intralot has not disclosed the *pro forma* FCCR and there isn't enough publicly available information to accurately calculate it.

In the context of unrestricted subsidiaries even if majority held by the restricted group, a 2x FCCR investment basket offers inappropriate creditor protection because it does not constrain value leaving the restricted group by directly referencing the EBITDA generated by assets or the assets' value, but how well the restricted group can pay its post-investment fixed charges. The basket is rare to see, except in US oil and gas deals. Reorg's databases show a coverage ratio-based investment basket was in Arcaplanet's senior secured notes due 2028 issued in 2021, but last seen before these in European high-yield notes in 2012, and present in one European leveraged loan (February 2022). In 2021, investors successfully deleted during the marketing phase a 2x FCCR investment basket in Arxada's senior secured notes due 2028 and Advanz Pharma's senior secured notes due 2028.

Another issue is the use of a JV investment basket to make investments into a subsidiary. "Joint venture" is typically not defined in documentation and has no specific legal meaning; legally, there are no JV-specific characteristics required of it, such as an equal 50:50 shareholding. Creditors should consider JV investment baskets as being available for investments in majority-held unrestricted subsidiaries.

A "J. CREW" BLOCKER MAY PREVENT A DROP-DOWN OF ASSETS

Anti-drop-down provisions are far from common or standardised and are usually only found in relation to intellectual property, the most common being a "J. Crew" blocker. A "J. Crew" blocker prevents intellectual property from being transferred to unrestricted subsidiaries. The strength of protection provided varies and creditors should scrutinise each blocker for loopholes. In 2021, 8% of European high-yield notes and 15% of European leveraged loans included a "J. Crew" blocker.

CONCLUSION

Many drop-down cases have been possible not because the covenants reflect a bad bargain, but because the terms of their "market standard" bargain have been exploited by borrowers to get them out of a tight corner. Bespoke tailoring of certain provisions has also been important in determining the power buy-side and sell-side have in the debt restructuring negotiations of these cases.

The motion states that since the exchanges, the market value of the 2024s "has increased to around 85% of par", whereas the exchange ratio of 2021s into the New Notes was 82% (although fees may also have been paid). This suggests that 2024 noteholders have suffered less damage than alleged. However, if they can establish the 2024s indenture has been breached, they could claim damages or request that the refinancing be unwound. A remedy would not necessarily focus on market price. ■

Further Reading:

- Jumping the line: priming restructuring transactions during the COVID-19 crisis (2021) 2 JIBFL 100.
- First among equals: priming debt in leveraged capital structures (2021) 3 JIBFL 176.
- LexisPSL: Banking & Finance: Article: Creative uses of collateral: opportunities for leveraged companies.

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