

Defense Against the Dark Arts? A Guide to Liability Management Blockers in the US Loan Market.

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I. Executive Summary

In the wake of liability management exercises (“LMEs”), lenders have sought to block or restrict such transactions through “blocker” provisions (“LME Blockers”). This trend coincides with growing concerns from rating agencies and market commentators about documentation standards in leveraged loan deals.

As LME transactions have matured—and with recent high-profile LMEs serving as stark reminders of documentation vulnerabilities—sophisticated borrowers and lenders have increasingly focused on negotiating LME blockers.

This client alert examines the most common LME blocker provisions currently being negotiated in leveraged loan documentation.

II. The LME Landscape

Borrowers have used covenant flexibility in loan documentation to engage in LMEs, which may include one or more of the following transactions:

- Incurrence of new debt provided by participating lenders that primes existing debt;
- Non-pro rata exchange of existing debt held by participating lenders for new debt that primes existing debt;
- Release of collateral securing existing debt held by non-participating lenders; and
- Payment, structural or lien subordination of existing debt held by non-participating lenders.

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The original LMEs have a long history dating back to distressed exchanges of high yield bonds in the early 1990s. In more recent years, the term LMEs is associated with the drop-down, uptiers and double-dip structures that have become more prevalent in the market, particularly the secured syndicated loan market:

- **The First Wave (e.g., J.Crew) (2016):** Certain distressed borrowers “dropped down” certain collateral to unrestricted subsidiaries beyond
- the reach of their existing secured creditors and used the collateral as credit support for new debt and existing debt of participating lenders.
- **The Second Wave (e.g., Serta) (2019):** Certain distressed borrowers “uptiered” debt of favored lenders by amending their existing debt documents to permit super-priority debt and subordinate the claims of non-participating lenders
- **More Recent Developments:** LMEs have included additional variations, including further innovations on subordinating claims, launching non-pro rata exchanges and “double-dips” involving multiple independent claims against a borrower and its affiliates (e.g., “pari-plus” transactions).

III. Overview of LME Blockers

The following section describes common LME blockers below (based on the name of the related LME with which such LME Blocker is often associated).

This table presents representative categories, but it is not an exhaustive list of blockers – there are as many variations of blockers as there are LME transactions.

Name	Issue	Blocker	Usual Locations
J.Crew (2016)	Dropdown of material collateral to Unrestricted Subsidiaries (e.g., “trap door”).	Restricts ability of Unrestricted Subsidiaries to own material assets (typically, just material IP).	“Permitted Investments”; Investment Covenant; Designation of Unrestricted Subs
Envision (2022)	Dropdown of material collateral to Unrestricted Subsidiaries (i.e., enhanced J.Crew).	Limits ability to invest in and/or otherwise sell or transfer assets to Unrestricted Subsidiaries to certain investment baskets.	Designation of Unrestricted Subs; Investment Covenant
Pluralsight (2024)	Dropdown of material collateral to Non-Guarantor Subsidiaries (i.e., further enhanced J.Crew).	Restricts ability of Non-Guarantor Subsidiaries to own material assets (typically, just material IP).	“Permitted Investments”; Investment Covenant
NYDJ (2018)	Incurrence of priming debt under the same agreement (with an amendment to modify the payment waterfall to subordinate minority lenders).	Restricts ability to modify payment waterfall without consent of all (affected) lenders.	Payment Waterfall; Amendments & Waivers
Serta – Uptier (2020)	Incurrence of priming debt under a separate agreement (with an amendment to	Restricts ability to contractually subordinate the Credit Agreement payment obligations and/or the liens	Amendments & Waivers

Name	Issue	Blocker	Usual Locations
	subordinate existing debt) and rollup of debt of majority lenders.	securing the Credit Agreement obligations without consent of all (affected) lenders.	
Serta – Non-Pro Rata Exchange (2020)	Non-pro rata buyback and exchanges of existing debt in open market purchase or otherwise (often for priming debt in connection with a dropdown or uptier).	Restricts ability of Borrower or its affiliates to buyback debt on a non-pro rata basis (e.g., open market purchases). Typically relevant if pro rata sharing provisions are treated as a “sacred right” (requiring affected lender consent for amendments).	Pro Rata Sharing; Prepayments; Assignments
Chewy (2018)	Release of guarantor after disposition of minority interest.	Restricts ability to transfer minority equity interests of a guarantor resulting in the automatic release of the entity from its guaranty obligations.	Release of Guarantees
Incora / Wesco (2022)	Incurrence of incremental commitments by lenders whose votes will tip the balance to obtain majority lender consent.	Restricts ability to vote undrawn incremental commitments.	Voting / Amendments
At Home (2023)	Creation of two separate claims for the same underlying debt obligation. “Double Dip” meaning (1) new debt incurred by a non-guarantor, (2) that lends the proceeds thereof to the existing borrower and (3) the new debt and the intercompany loan receive the benefit of guarantees and collateral from the existing borrower group. “Pari Plus” meaning the new debt also receives the benefit of additional guarantees and collateral that the lenders to the existing borrower do not receive.	Restricts ability to layer intercompany claims and/or structure “double dip” or “pari plus” transactions.	Unrestricted Subsidiaries; Debt Covenant; Lien Covenant

Each of these blockers must be read together with the amendment provisions, specifically the “sacred rights” (i.e., provisions that require consent from all lenders or all affected lenders to be amended). If a LME blocker is not a “sacred right”, then the borrower could obtain consent from participating lenders that constitute the majority required lenders and waive the LME protections - in that situation, the LME blockers may only be effective against LMEs with third parties (e.g., a deal-away).

IV. Drop-Down Blockers

These blockers restrict the ability of borrowers to move material assets outside of the collateral package.

- **J.Crew Blocker (2016)**
 - **Restrictions**
 - No unrestricted subsidiary may own or exclusively license Material Assets at any time.
 - No restricted subsidiary that owns or exclusively licenses Material Assets may be designated as an unrestricted subsidiary.
 - **Common Points of Negotiation**
 - Limiting Material Assets to just Material Intellectual Property.
 - Limiting only transfers (or even just investments) of Material Assets (rather than applying to ownership).
 - Exception for arms-length transactions that do not materially interfere with ordinary course of business.
 - Limiting to transfers for the purpose of raising additional debt secured by the transferred assets.
- **Envision Blocker (2022)**
 - **Restrictions**
 - Transfers in any form (including designations) to unrestricted subsidiaries may be made solely pursuant to a dedicated unrestricted subsidiary investment basket.
 - No reclassifications / reallocations between the dedicated unrestricted subsidiary investment basket and other baskets.
 - No rebuilding of the dedicated unrestricted subsidiary investment basket from returns on investments or otherwise.
 - **Common Points of Negotiation**
 - Including additional baskets (e.g., general investment basket, builder basket, etc.) to the list of permitted baskets.
 - Limiting only investments in unrestricted subsidiaries (or even only designation of unrestricted subsidiaries).
- **Pluralsight Blocker (2024)**
 - **Restrictions**
 - Non-guarantors may not own or exclusively license Material Assets at any time.
 - Often written as an extension of a J.Crew blocker.
 - **Common Points of Negotiation**
 - Limiting Material Assets to just Material Intellectual Property.
 - Limiting transfers (or even just investments) of Material Assets.
 - Exceptions for arms-length transactions that do not materially interfere with ordinary course of business.

- Exceptions for transfer pricing / cost-sharing.
- Exceptions for tax savings strategies or tax planning.
- Limiting to transfers for the purpose of raising additional debt secured by the transferred assets.

V. Uptier Blockers

These blockers restrict the ability of borrower to “uptier” debt (i.e., incur or convert existing debt into new debt that primes existing debt).

- **NYDJ Blocker (2018)**
 - **Restrictions**
 - All lender consent for modifications to the payment waterfall and pro rata sharing provisions.
 - **Common Points of Negotiation**
 - Excluding certain provisions from the payment waterfall and pro rata provisions.
 - Whether consent of all lenders or only affected classes are required.
- **Serta Uptier Blocker (2020)**
 - **Restrictions**
 - All lender consent required for subordination of the liens/payment obligations.
 - All lender consent required for adverse amendments to “pro rata” sharing provisions and payment waterfalls, including amendments that have the effect of the same.
 - **Common Points of Negotiation**
 - Requiring consent of all affected lenders.
 - Applying only to “debt for borrowed money” (and, more aggressively, just new money).
 - Applying only to subordination of all or substantially all collateral.
 - Excluding DIP facilities or use of cash collateral in a bankruptcy proceeding of the borrower.
 - Excluding indebtedness “otherwise permitted” by the credit agreement or the intercreditor agreement on the closing date (or more aggressively, as approved by the administrative agent).
 - Permitting subordination if affected lenders received a pro rata offer to participate on the same terms as other similarly situated lenders (other than backstop, arrangement or structuring fees).

VI. Non-Pro Rata Exchange Blockers

These blockers restrict the ability to buyback or exchange existing debt on a non-pro rata basis (i.e., often priming debt resulting from an uptier or a dropdown).

- **Serta Non-Pro Rata Exchange Blocker (2020)**
 - **Restrictions**

- Any purchases of debt by the borrower and its affiliates must be open to all lenders on a pro rata basis cash consideration.
- No amendment of pro rata provisions or the assignment provisions without affected / all lender consent.
- **Common Points of Negotiation**
 - In the wake of the Fifth Circuit Serta decision in December 2024, whether to permit privately negotiated offers on a non-pro rata basis (e.g., subject to a cap or on an unlimited basis).

VII. Other Blockers

These blockers restrict a variety of other LME transactions, such as collateral stripping, voting gerrymandering and double dips.

- **Chewy Blocker (2018)**
 - **Restrictions**
 - No release of non-wholly owned guarantors.
 - Transaction deemed to be an investment in such non-wholly owned subsidiary at fair market value.
 - **Common Points of Negotiation**
 - Excluding transactions where the primary purpose is not to release the guaranty/collateral.
 - Excluding transactions for a bona fide business purpose.
 - Excluding transactions with non-affiliated third parties.
 - Permitting any deemed investment in the resulting non-wholly owned entity.
- **Incora Blockers (2022)**
 - **Restrictions**
 - No voting rights given to incremental debt incurred for the purposes of influencing a vote.
 - No voting rights given to incremental undrawn commitments until actually drawn.
 - **Common Points of Negotiation**
 - Permitting voting rights as soon as conditions to draw are satisfied.
- **At Home Blocker (2023)**
 - **Restrictions**
 - Non-guarantors cannot hold liens on assets or equity of the borrower or any restricted subsidiary.
 - Non-guarantors cannot hold debt of the borrower or any restricted subsidiary.
 - Unrestricted subsidiaries cannot be obligors of any debt of which the borrower or any restricted subsidiary is also an obligor.

- Any pari passu secured debt may not benefit from (i) liens on any assets that do not constitute collateral or (ii) guarantees from any non-guarantor.
- **Common Points of Negotiation**
 - Limiting blocker to unrestricted subsidiaries (rather than all non-guarantors) - permitting intercompany debt owed to non-guarantor restricted subsidiaries if unsecured and/or subordinated in right of payment.
 - Permitting credit support from unrestricted subsidiaries to specified permitted debt of borrower and its restricted subsidiaries.

VIII. A Note on “Omni-Blockers”

Omni-blockers refer to recent provisions that seek to define “liability management transactions” and broadly restrict all such transactions. Rather than targeting specific methods of implementing LMEs (e.g., drop-downs, uptiers, etc.), the provision targets the outcome of LMEs (e.g., any transaction that effectively replaces existing debt with senior debt, whether by structural subordination, lien subordination, removal of collateral, modification of payment rights or maturity).

The aim is to block all LMEs and prevent any structuring around typical LME blockers, but they have not yet been tested in the courts. The challenge in drafting an “Omni-blocker” is the need to avoid being so vague as to be overly broad or effectively unenforceable. There are many variations on the concept (e.g., whether the defined term is limited to priming debt transactions or any transaction that favors a creditor group and whether there are any carveouts for pro rata offers or bona fide business rationales).

At the present time, these blockers are relatively rare and typically only included in post-LME credit documents or for borrowers in severe distress.

IX. Key Takeaways

First, not all LME blockers are created equal. Precise drafting is particularly critical here. LMEs take a variety of forms, which means that effective protection may combine multiple blockers. By the same token, LME blockers may be drafted so broadly so as to impede legitimate business purposes. Borrowers and lenders will need to negotiate and determine the proper balance of protection for each specific deal.

Second, the landscape for LMEs is constantly shifting – LMEs and new LME blockers are in a perpetual state of invention. Market participants need to stay on top of recent developments and determine what really matters in their deals.

For more information on LME blockers and their implementation in your credit facilities, our team here at Cleary Gottlieb is available to consult.

This alert is for informational purposes only and does not constitute legal advice.

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