

CLIENT ALERT

# The Xerox “Non-Subsidiary Drop-Down Financing”: A New Frontier in Leakage and Subordination?

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Last month, Xerox Corporation (Xerox) completed a \$450 million intellectual property-backed financing through a newly formed joint venture with third-party private equity investors. The transaction has drawn considerable attention among leveraged finance participants and practitioners as it exposes a potential structural gap found in many of today’s credit documents.

Unlike other liability-management drop-down financings involving unrestricted subsidiaries or non-guarantor restricted subsidiaries, the Xerox transaction was specifically structured to circumvent market lender-protective provisions by transferring intellectual property to an entity that would not qualify as a “subsidiary.” Consequently, the relevant intellectual property was transferred from the existing credit group to the joint venture and subsequently leveraged to finance proceeds distributed to Xerox without triggering any of the customary covenant protections creditors rely on today. The transaction may represent the emergence of a new liability-management strategy—the “non-subsidiary drop-down.”

## TRANSACTION OVERVIEW

Based on Xerox’s public filings, the Xerox drop-down financing appears to have involved a multi-step structure designed to move intellectual property outside the credit group while maintaining operational control over those assets. First, Xerox formed a joint venture (IPCo) with third-party investors in which, it is reported, Xerox does not hold a majority of voting control. Second, Xerox contributed certain core intellectual property to IPCo, including trademarks related to the Xerox brand. Third, IPCo raised approximately \$450 million of capital secured by such intellectual property assets (through a combination of \$405 million in debt and \$45 million in equity). Finally, the proceeds raised by IPCo were distributed to Xerox, and Xerox entered into a license agreement allowing it to continue to use the transferred intellectual property.

## KEY COVENANT GAPS HIGHLIGHTED BY THE TRANSACTION

The Xerox transaction illustrates how several now-customary provisions in financing documentation may include limitations that provide yet another opportunity for collateral leakage from, and structural subordination of, existing creditors.

Perhaps the most important provision involves the definition of a “subsidiary.” In most credit agreements and bond indentures (including those of Xerox), a subsidiary means any person or entity of which at least 50% of voting stock is owned or controlled by the borrower. As reported, the Xerox transaction exploited this concept by structuring the joint venture in such a manner that Xerox did not have a majority of the ownership or control. Without the requisite 50.1% voting power, IPCo was not considered a subsidiary under Xerox’s existing credit documents. Unless otherwise designated by a borrower, any subsidiary is deemed to be a restricted subsidiary (and is therefore subject to the terms, provisions and covenants in such credit documentation). However, because IPCo was not actually a subsidiary (but a minority-owned joint venture), IPCo was not (i) a restricted subsidiary, (ii) required to guarantee Xerox’s existing debt obligations, (iii) required to pledge its assets as collateral for such obligations and (iv) subject to the terms, provisions and covenants in Xerox’s credit documents.

Furthermore, the Xerox structure avoided certain intellectual property transfer restrictions that today’s credit documents protect against. For example, after J. Crew’s drop-down financing in 2017, many credit documents include provisions prohibiting the transfer of intellectual property (or, in some cases, other material assets) to unrestricted subsidiaries and/or non-guarantor restricted subsidiaries. As noted above, because Xerox’s intellectual property was transferred to a non-subsidiary joint venture, any J. Crew (or other “crown jewel”) protections did not apply. Furthermore, while certain of the Pluralsight set of drop-down limitations and anti-priming protections applicable to unrestricted subsidiaries are common in many credit documents, any such limitations and protections would not have defended against Xerox’s non-subsidiary, joint venture investment structure.

The Xerox transaction also relied on available capacity under Xerox’s investment covenants. Credit agreements and bond indentures such as Xerox’s often allow borrowers to make certain investments in joint ventures and other affiliates using negative covenant baskets (including a designated joint venture investments basket, a general investments basket and certain other baskets, including, for example, a builder basket). Intellectual property often has a relatively modest book value compared to its strategic importance, which makes it a class of assets borrowers may focus on in similar joint venture transactions, given the ability to contribute such assets using relatively minor investment capacity.

Finally, the Xerox financing illustrates how debt incurrence restrictions do not apply to entities outside the credit group. Most credit documents, including Xerox’s, limit the ability of a borrower and its subsidiaries to incur additional indebtedness, using either fixed dollar or leverage-based debt baskets. Entities that are not subsidiaries, and therefore not within the borrower’s consolidated group, are not subject to such limitations.

## **IMPLICATIONS FOR FUTURE CREDIT AGREEMENT DRAFTING**

This transaction will likely cause market participants and practitioners to reconsider several aspects of credit documentation in order to prevent structures similar to the Xerox non-subsidiary drop-down financing in the future.

One such proposed change involves expanding the definition of “subsidiary.” Rather than relying solely on majority voting ownership or control, lenders may instead seek to define “subsidiary” based on economic interests and/or contractual control rights.

Another potential drafting response involves broadening restrictions on transfers of intellectual property (or other material assets) by limiting transfers to affiliates (in addition to unrestricted subsidiaries and non-guarantor restricted subsidiaries).

Lenders may also consider imposing tighter limitations on investments in joint ventures that hold material assets. For example, these limitations could include limiting investments in such joint ventures to just one fixed-dollar basket or requiring that lenders consent to any contribution of assets to any joint venture structure.

## **CONCLUSION**

The February Xerox financing highlights how documentation gaps in traditional covenant frameworks can allow valuable assets to move outside creditors’ collateral packages, even in credit documents that include protection against contemporary liability-management techniques. By transferring intellectual property to a joint venture that was

not a subsidiary, Xerox appears to have avoided many of the lender-protective provisions developed in response to prior drop-down transactions.

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