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REGULATORY AND TAX UPDATE

Agenda

I. Regulatory Update – Credit Funds and Fiduciary Duties

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  - Market Overview and Update
  - General Themes for 2018-19
- Fiduciary Duties
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  - SEC Proposed Interpretations of Fiduciary Duties

II. Tax Update – Tax Reform and Restructuring

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  - Tax rate on certain partnership income
- Investing in Credit of Distressed Companies
  - Pre-Bankruptcy Considerations
  - Post-Emergence Considerations
- Tax Reform's Impact on Credit Facilities
- Other Partnership Considerations
  - Effectively connected income on sale of partnership interest

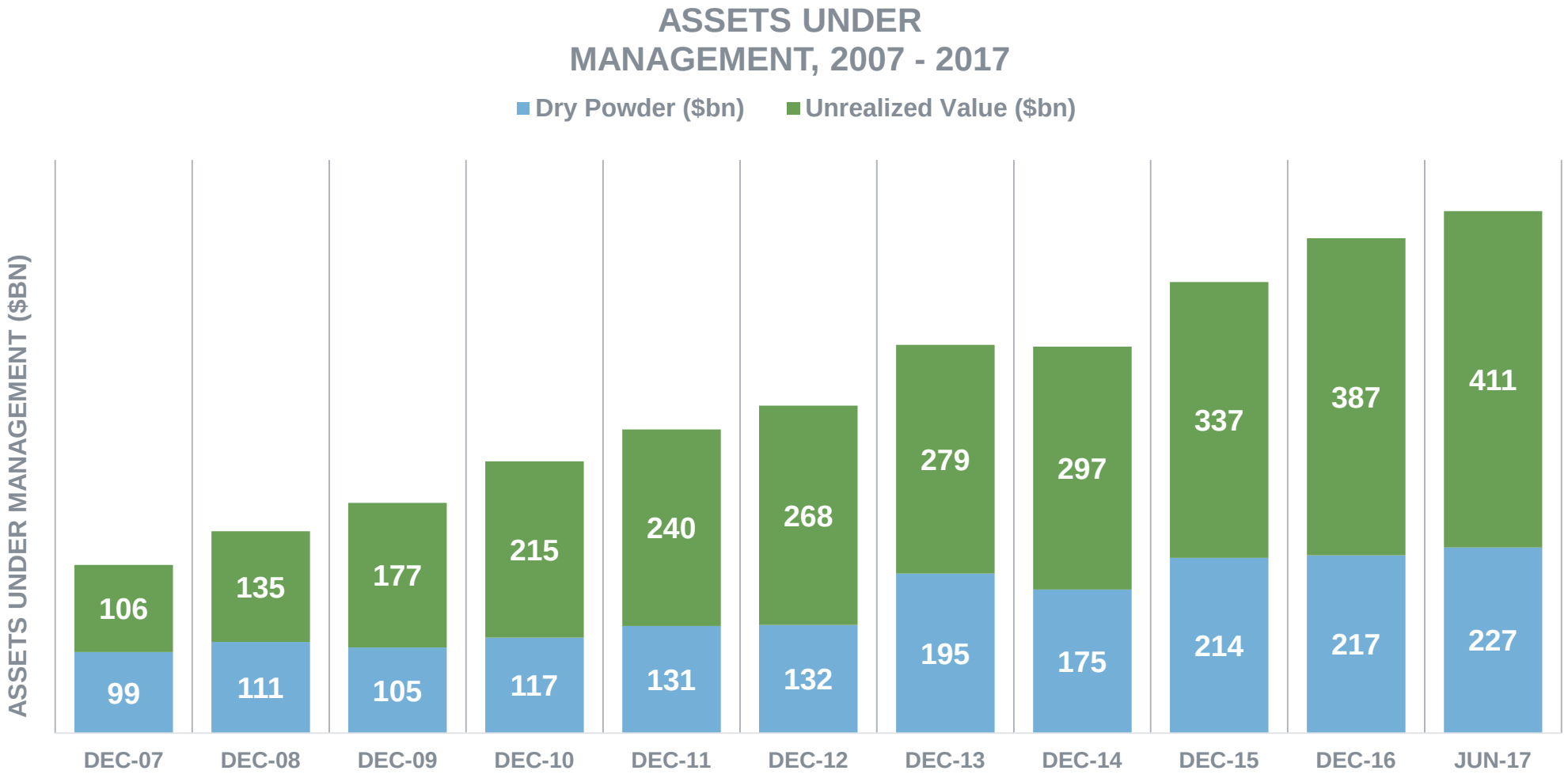
I. Regulatory Update – Credit Funds and Fiduciary Duties

Credit Funds

MARKET OVERVIEW AND UPDATE

Credit Funds

MARKET OVERVIEW AND UPDATES



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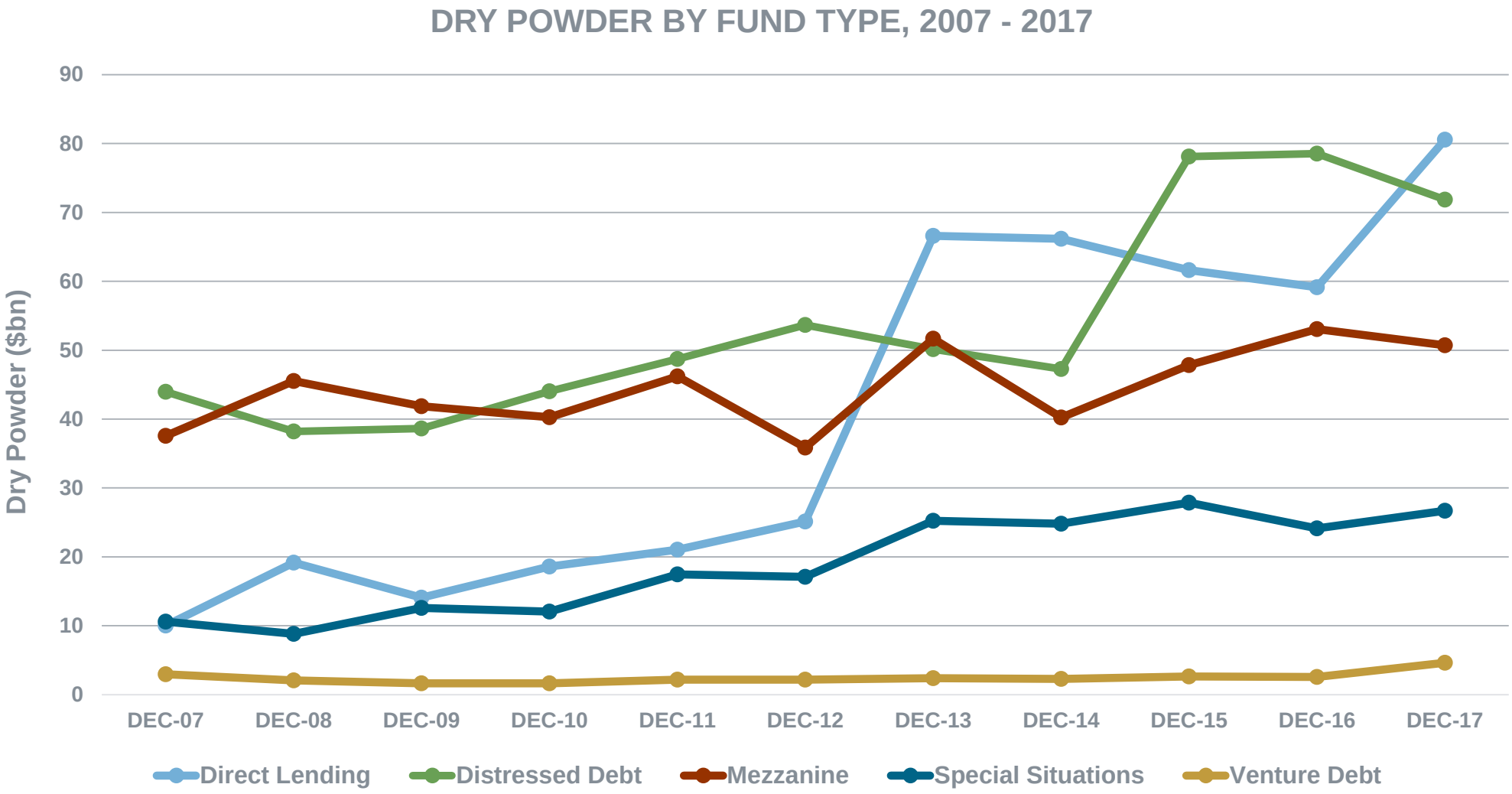
Credit Funds

MARKET OVERVIEW AND UPDATES



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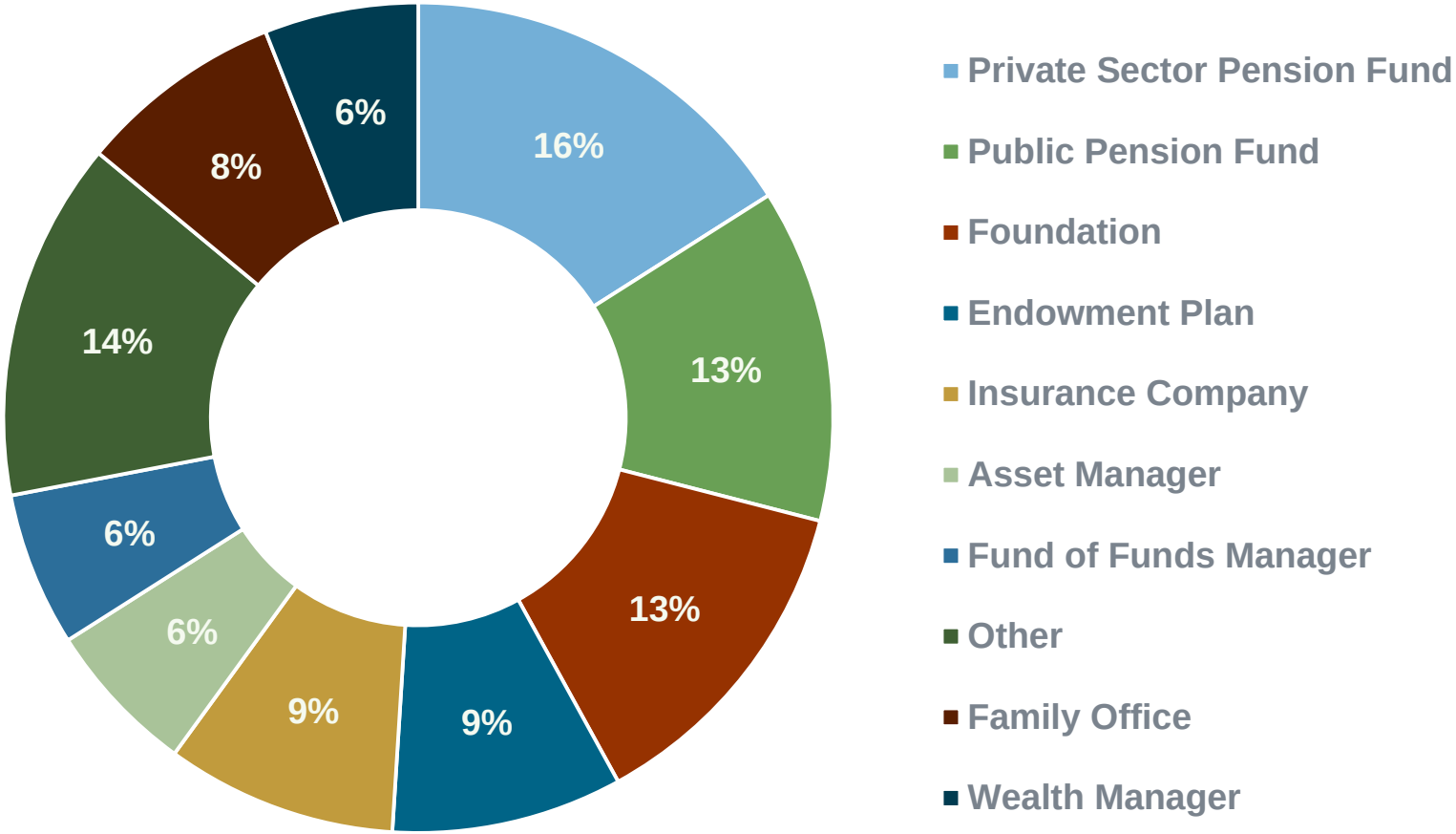
Credit Funds

MARKET OVERVIEW AND UPDATES

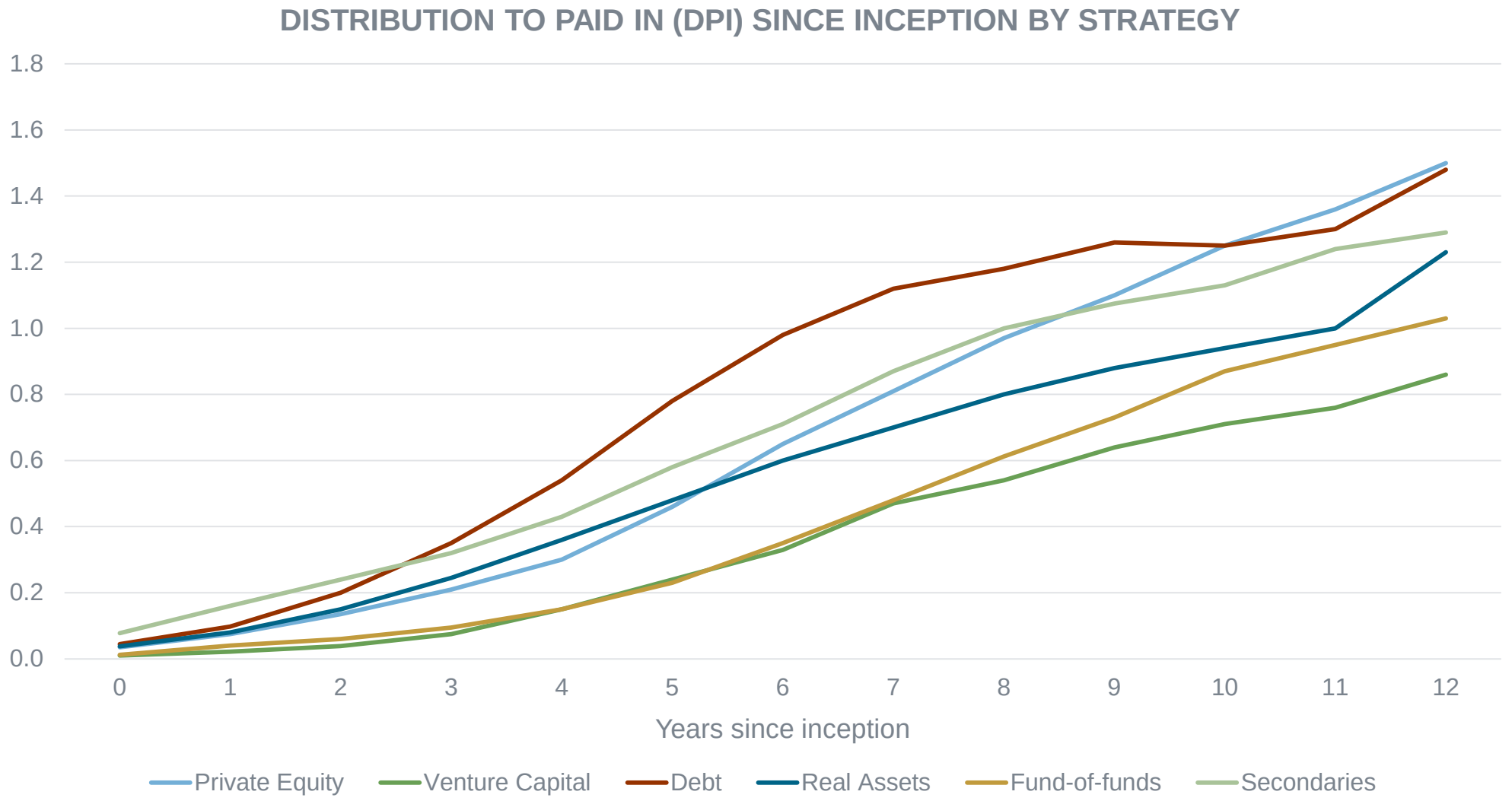
MAKE-UP OF INVESTORS BY TYPE



Source: PitchBook

Credit Funds

MARKET OVERVIEW AND UPDATES



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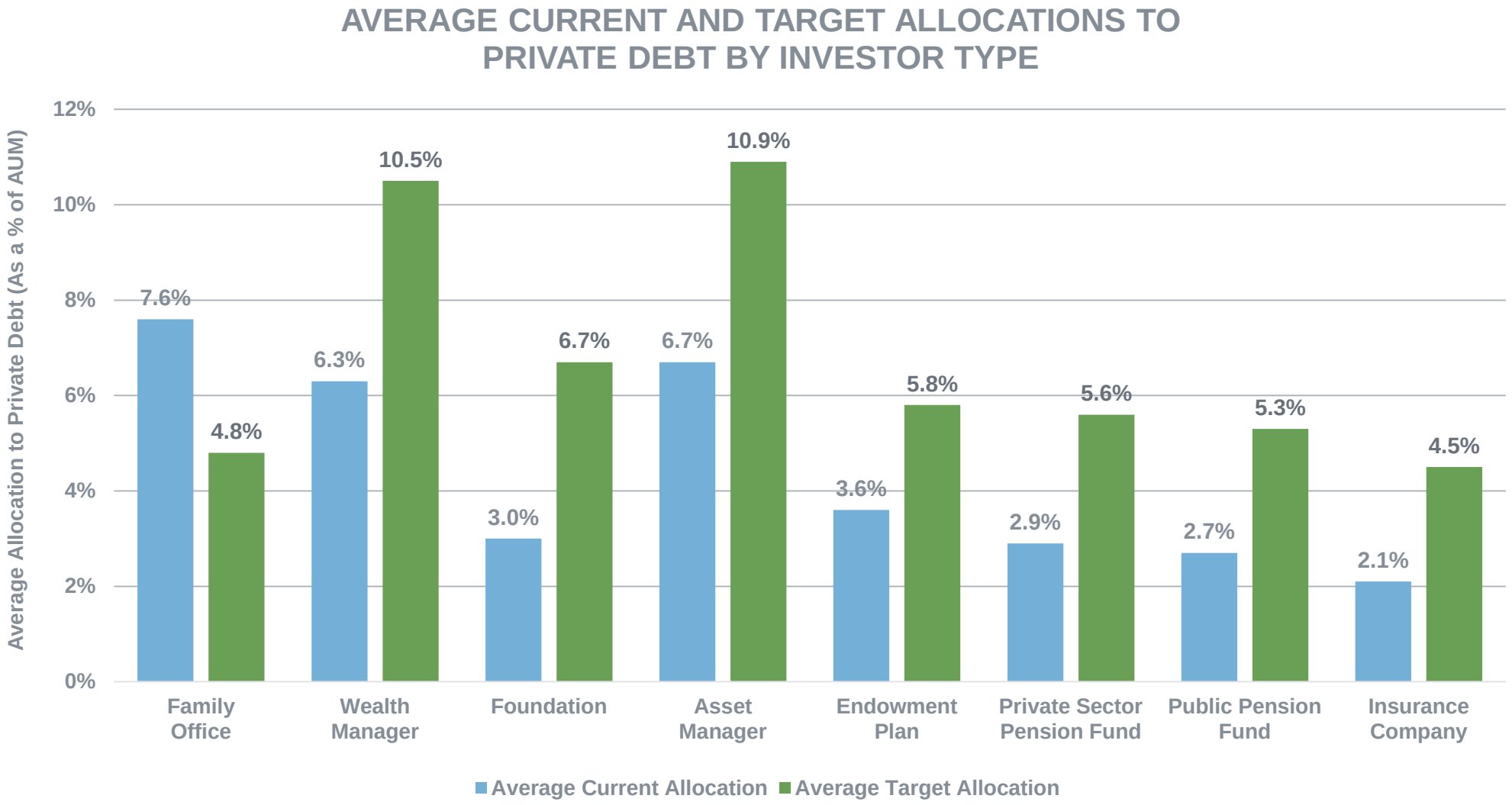
Credit Funds

MARKET OVERVIEW AND UPDATES



Source: Prequin

Credit Funds

GENERAL THEMES AND TRENDS

- Managers continue to search for growth in an extended low interest environment
- Managers seek to deliver higher returns and capture market share through diversified multi-product platforms offering a range of risk-reward profiles
- Manager views on leverage and fund structures are undergoing transition
  - Some are using leverage to generate long-term returns
  - More than half have increased their use of leverage for short-term bridging purposes
  - Some plan to use targeted derivatives with embedded leverage in response to recent U.S. tax reform
- Fund structures influenced by a desire for liquidity, as well as the maturity of investment assets, as managers seek higher after-tax returns

Source: Debtwire

Credit Funds
GENERAL THEMES AND TRENDS

Investment Strategies

- As multi-strategy platforms become the norm, managers are focusing on building out their product offerings (e.g., distressed debt, senior opportunities, direct lending)
- Most managers cite general credit opportunities or distressed/stressed debt as flagship strategy
- Most managers intend to launch a distressed/stressed debt strategy in that time period
- Most managers intend to launch a strategy focused on senior opportunities

Leverage

- Roughly half use subscription lines for short-term bridging purposes, while some also use them for longer-term investment purposes
- Many use other forms of leverage for long-term investment purposes
- Many have increased their use of leverage for short-term bridging over the past 12 to 24 months
- Many plan to use targeted derivatives with embedded leverage as a workaround for U.S. tax reform

Structuring

- Non-U.S. investors present challenges because they are often subject to U.S. taxation on income from loan origination activities conducted in the U.S., including through a partnership or agent, such as an investment adviser
- Many managers plan to use treaty fund/independent agent structures for the first time in the next 12 months—these structures generally rely on the treaties of the investors
- Some managers engage in limited direct origination, with roughly half originating less than three or four times annually

Conflicts

- Many credit fund managers operate investment platforms with multiple funds and accounts investing alongside each other
- Roughly half oversee between one to five separately managed accounts, while many run over five
- Roughly half have walls in place to address issues related to MNPI
- Many allow accounts to invest in different levels of the capital structure of a given company

Source: Debtwire

Fiduciary Duties

INCLUDING THE SEC ADVISER CONDUCT PROPOSAL

Fiduciary Duties

OVERVIEW

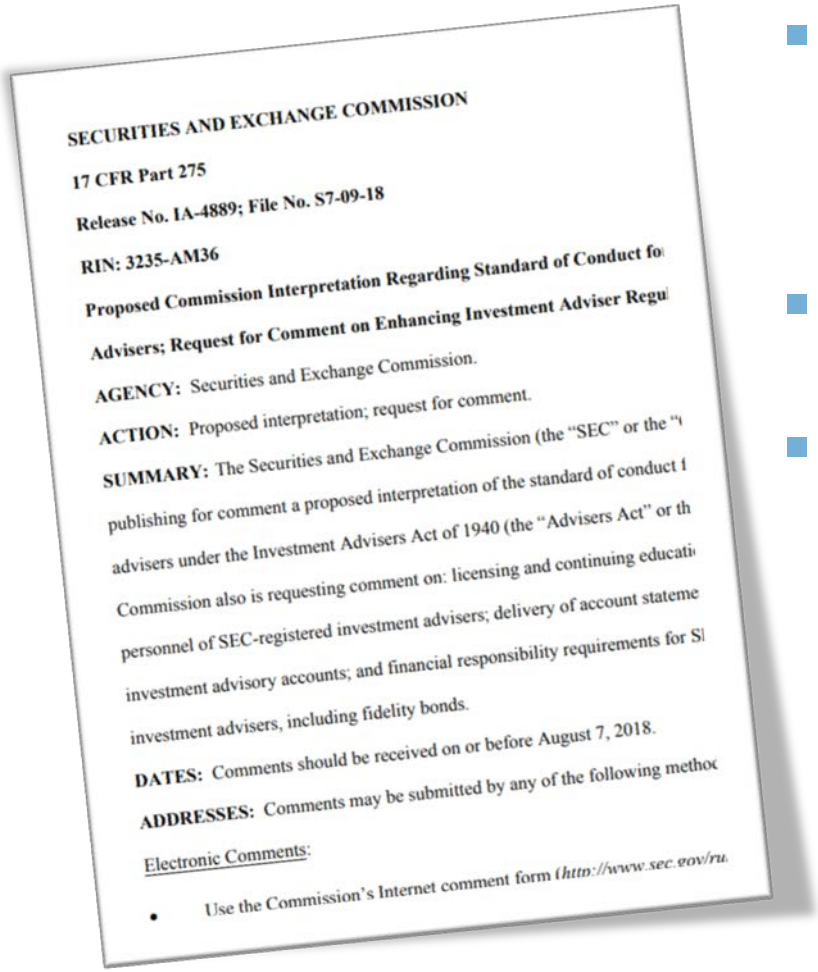
Source of Duty	Advisers Act	Delaware Law
Duty Owed by	▪ The GP (and investment adviser)	▪ The GP
Duty Owed to	▪ The client (i.e., the fund)	▪ The limited partners and the partnership
Modification of Duty	▪ Cannot be restricted or eliminated, but may be addressed through disclosure via offering documents	▪ Can be restricted or eliminated by contract (s. 17-1101(d) of DRULPA) (other than the duty of good faith and fair dealing)

Contours of Duty	▪ Duty of loyalty
	  ▪ must not favor its own interests over clients'
	  ▪ must not favor one client over another
	  ▪ full and fair disclosure of all material facts
	▪ Duty of care
	  ▪ provide advice in the client's "best interest"
	  ▪ seek best execution
	  ▪ provide advice and monitoring
		▪ Duty of loyalty
		  ▪ "best interest" of limited partners and partnership, utmost good faith and fairness
		▪ Duty of care
		  ▪ investigation; business judgment

Consequences of Breach	▪ Enforcement action (civil penalties (s.209(e)) and criminal penalties (s. 217)), but limited private right of action (not for damages)	▪ Civil action (derivative suit by partnership; direct action by limited partners)

SEC Proposed Interpretations of Fiduciary Duties

OVERVIEW



SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

Release No. IA-4889; File No. S7-09-18

RIN: 3235-AM36

Proposed Commission Interpretation Regarding Standard of Conduct fo

Advisers; Request for Comment on Enhancing Investment Adviser Regu

AGENCY: Securities and Exchange Commission.

ACTION: Proposed interpretation; request for comment.

SUMMARY: The Securities and Exchange Commission (the "SEC" or the "

publishing for comment a proposed interpretation of the standard of conduct f

advisers under the Investment Advisers Act of 1940 (the "Advisers Act" or th

Commission also is requesting comment on: licensing and continuing educati

personnel of SEC-registered investment advisers; delivery of account stateme

investment advisory accounts; and financial responsibility requirements for S

investment advisers, including fidelity bonds.

DATES: Comments should be received on or before August 7, 2018.

ADDRESSES: Comments may be submitted by any of the following methoc

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/ru

- On April 18, the SEC issued a release entitled "Proposed Commission Interpretations Regarding Standard of Conduct for Investment Advisers" (the "**Release**")
- The period for comment will close on **August 7, 2018**
- The Release was accompanied by two proposed rules:
  1) the proposed "Regulation Best Interest" rule under the Securities & Exchange Act of 1934 for broker dealers
  2) a proposed "Form Client Relationship Summary" for retail clients of both investment advisers and broker dealers

SEC Proposed Interpretations of Fiduciary Duties

OVERVIEW

- The Release purported to do three things:

1) "[T]o reaffirm—and in some cases clarify—certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act"

2) Not intended to create new or different obligations or requirements, but rather an attempt to gather in one place existing components of the Advisers Act fiduciary duty

3) Request for comment on a number of "enhancements" for adviser regulation

Takeaway 1:
DISCLOSURE MAY NOT BE ENOUGH TO ADDRESS A CONFLICT OF INTEREST

- Until the Release, most Advisers Act practitioners generally believed that so long as you obtained "informed consent" with respect to a conflict—that is, pre-commitment disclosure of all material facts pertaining to the conflict—that an adviser will have discharged its duty of loyalty
- Most practitioners, however, also understood that there may be rationale limits to disclosure—for instance, no client can genuinely provide "informed consent" to a fraud
- However, the Release contained a number of troubling statements:
  - "Disclosure of a conflict alone is not always sufficient to satisfy the adviser's duty of loyalty and section 206 of the Adviser"
  - "[C]onflicts may be of nature and extent that it would be difficult to provide disclosure that adequately conveys the material facts or the nature, magnitude and potential effect of the conflict necessary to obtain informed consent and satisfy an adviser's fiduciary duty"
  - "With some complex or extensive conflicts, it may be difficult to provide disclosure that is sufficiently specific, but also understandable, to the adviser's clients"
  - "In all of these case where full and fair disclosure and informed consent is insufficient, we expect an adviser to eliminate the conflict or adequately mitigate the conflict so that it can be more readily disclosed"
- The Release does not address these issues relative to the financial sophistication of the investor, implying that the level of that sophistication may be irrelevant to the question of whether disclosure is sufficient

Takeaway 2:

THE SEC IS PROPOSING FEDERAL **LICENSING** AND **CONTINUING EDUCATION** REQUIREMENTS

- The Release cites that broker-dealers must, among other things, "meet qualification requirements, which include passing a securities qualification exam and fulfilling continuing education requirements"

- The Release provides no detail on what such licensing requirements would be designed to test
  - Will such requirements replicate the content of MBAs or CFA training?
  - Will it test for knowledge of the rules under the Advisers Act (e.g., custody rule, advertising rules, etc.)?
  - Is licensing even effective? Has proven to improve the quality of service or deterred "bad actors"?

- The Release provides no detail on the subject matter of such continuing education

- The Release only refers to such requirements addressing "minimum and ongoing competency requirements" for the personnel of SEC-registered advisers

Takeaway 3:

THE SEC IS PROPOSING SO-CALLED "**FINANCIAL RESPONSIBILITY**" REQUIREMENTS

- The Release cites that broker-dealers are subject to a comprehensive financial responsibility program
- The Release, however, notes however that federal securities laws "do not impose capital requirements on investment advisers or require investment advisers to maintain a fidelity bond"
- Is this a solution in search of a problem – how often do the shortcomings of advisers result in financial loss of this type? Hence, the SEC asks:
  - Do the custody rule and other rules adequately address the potential for misappropriation?
  - Is there information or data that demonstrates fidelity bonding requirements provide defrauded clients with recovery?

II. Tax Update – Tax Reform and Restructuring

Changes to Individual and Corporate Tax Rates

- **Individuals:** highest marginal rate on ordinary income (temporarily) reduced from 39.6% to **37% (29.6%** if Pass-Through Deduction available)
  - Qualified dividends and capital gains unchanged at 20%
  - Potential “pass-through” deduction for 20% of net income from qualified businesses
- **C Corporations:** tax rate (permanently) reduced from a top marginal rate of 35% to a flat rate of **21%**
  - Dividends to U.S. individual shareholders then taxed at 20%
  - Highest combined rate on business income earned by U.S. individuals through C Corp and received as a dividend: **36.8%**

New Lower Tax Rate on Certain Partnership Income

- **Pass-through Deduction:** Individuals may deduct 20% of "qualified business income" from each "qualified trade or business," subject to cap based on share of wage expense of non-partner employees
  - "Qualified trade or business" is generally any trade or business other than a service business
    - Service business carveout not applicable if income below certain thresholds
  - "Qualified business income" is generally net income from a U.S. business other than income from certain investments, capital gain or loss, compensation for services
  - Sunsets after 2025

Investing in Credit of Distressed Companies

BASE CASE HYPOTHETICAL

- A fund with U.S. (unblocked) and non-U.S. (blocked) investors
- Considering an investment in the credit of a struggling multinational company (InvestCo)
- InvestCo is a U.S. “C corp” with domestic and foreign C corp subsidiaries

How might tax reform be relevant to the fund’s investment?

Distressed Companies—Pre-Bankruptcy

NET OPERATING LOSSES

Overview

- Under prior law, a net operating loss for a taxable year could be carried back two years and carried forward 20 years and, after application of the corporate AMT, could offset 90% of a corporation's taxable income in a given taxable year.
- Post tax reform, NOLs can no longer be carried back but can be carried forward indefinitely, and can only offset up to 80% of a corporation's taxable income in a given taxable year.
  - Affects only NOLs arising in years beginning in 2018
  - "Old" NOLs not affected, but repeal of the corporate AMT means that "old" NOLs can now offset 100% (instead of 90%) of income.

Distressed Companies—Pre-Bankruptcy

NET OPERATING LOSSES (Cont.)

Credit investment considerations

- No longer able to carry back NOLs to produce a tax refund for companies experiencing short-term or unexpected losses
- Corporations with “old” NOLs may be viewed as more valuable than corporations with post-tax reform NOLs
- Lower corporate income tax rate means that tax assets (such as NOLs) are less valuable

Distressed Companies—Pre-Bankruptcy

LIMITATION ON INTEREST DEDUCTIBILITY

Overview

- Deduction for business interest expense for any taxable year generally cannot exceed the sum of:
  - the taxpayer's business interest income; and
  - 30% of the taxpayer's "adjusted taxable income" ("ATI")
    - Through 2021, ATI is approximately equal to EBITDA (decreased by state & local taxes)
    - Beginning in 2022, ATI will be approximately equal to EBIT
- Interest not allowed as a deduction can be carried forward indefinitely
- Limit applies separately to partnerships, potentially making it disadvantageous to carry out business through a partnership

Distressed Companies—Pre-Bankruptcy

LIMITATION ON INTEREST DEDUCTIBILITY (CONT.)

Credit investment considerations

- Together with new NOL rules, may exacerbate cash flow issues for troubled companies
- Financially distressed corporations are likely to experience a decline in ATI that could result in an interest deduction limitation at a time when cash/liquidity needs arise

Distressed Companies—Emergence

Key emergence questions remain the same (answers may be different):

- Assets v. Entities
- Jurisdiction

- Assets
  - Immediate Expensing
  - GILTI benefits

- Entity
  - Value of Tax Attributes

Distressed Companies—Emergence

CHANGES TO INTERNATIONAL TAXATION

Briefly, going forward, the new international tax rules:

- Allow tax-free repatriation of certain foreign earnings through dividends
- Subject more income of “controlled foreign corporations” to current taxation under the “GILTI” regime, which imposes a minimum tax on a very broadly defined category of foreign earnings
- Implement a new alternative minimum tax on companies that “erode” the U.S. tax base by making deductible payments to foreign affiliates (“BEAT”)
- Expand the universe of entities that are treated as “controlled foreign corporations”

Distressed Companies—Emergence

CAPITAL EXPENSING

Immediate Expensing: New rules allow taxpayers an immediate deduction equal to the "applicable percentage" of the cost of "qualified property" placed in service after September 27, 2017 and through 2026

- Qualified property generally includes tangible property with recovery period of 20 years or less
  - Applies to newly purchased, used, and self-constructed property
  - Used property cannot be acquired from a related person
- "Applicable percentage" depends on when the qualified property is placed in service: 100% until 2022, 80% for 2023, 60% for 2024, 40% for 2025, and 20% for 2026
- Ability to immediately deduct all or part of purchase price provides incremental benefit to buyer in an asset sale

Distressed Companies—Emergence

STRUCTURING CONSIDERATIONS

- Asset sales (or deemed asset sales), including through credit bidding, may be appealing due to:
  - Immediate expensing (attractive to buyer)
  - Lower corporate tax rate (more palatable to seller)
  - U.S. parent groups may be relatively more attracted to offshore asset acquisitions
    - higher basis provides “cushion” against minimum tax imposed by “GILTI” regime

Distressed Companies—Emergence

STRUCTURING CONSIDERATIONS

- Continuity of the reorganized debtor may be appealing due to:
  - Continued existence of “old” NOLs and other tax attributes
  - Offshore earnings of foreign subsidiaries no longer “trapped” due to participation exemption
- However:
  - New international tax regimes haircuts the value of NOLs
    - A corporation subject to BEAT potentially loses the benefit of a portion of its NOLs
    - Use of NOLs reduce the ability to make GILTI deductions

Distressed Companies—Emergence

STRUCTURING CONSIDERATIONS

- Jurisdiction of organization
  - GILTI regime and questions regarding stability of U.S. system
  - Limitation on interest deductibility in the U.S. provides incentive to borrow outside the U.S. or to push debt down to foreign subs, including through refinancing existing debt
    - Must consider value of interest deduction in foreign jurisdictions

Tax Reform's Impact on Credit Facilities

CHANGES TO INTERNATIONAL TAXATION

- Under new "participation exemption," a U.S. corporation may receive a tax-free dividend of foreign earnings from a foreign subsidiary
- However, "deemed dividend" rules of Section 956 remain in Code
  - As a result, guarantees by a foreign subsidiary of the U.S. parent's debt, or pledges of more than 2/3 of the stock of the foreign subsidiary to secure the U.S. parent's debt, may still result in a deemed taxable dividend to the U.S. parent
- Going forward, Section 956 issues may be considered differently given the new international tax regimes
  - The one-time deemed repatriation in 2017 reduces, for the time being, the negative implications of Section 956 because pre-2018 foreign subsidiary earnings have already been taxed
  - No longer easy to achieve tax deferral through holding earnings offshore due to GILTI regime
  - Foreign sub may distribute dividends tax free under the new participation exemption
    - Foreign tax issues may limit use of this strategy
  - More entities treated as "controlled foreign corporations"

Additional Partnership Considerations

ECI ON SALE OF PARTNERSHIP INTEREST

- **U.S. Tax on Sale by Non-U.S. Persons of partnership interest**: New rules codify IRS position that gain derived by a foreign entity from the disposition of an interest in a partnership constitutes ECI to the extent the gain is attributable to assets used in a U.S. trade or business conducted by the partnership.
  - Non-U.S. person required to file U.S. federal income tax return reporting ECI and pay U.S. tax on ECI at applicable rates
  - Rules overturned holding of *Grecian Magnesite* case
- **Withholding**: New rules generally require buyer of partnership interest to withhold 10% of purchase price unless seller can establish it is a U.S. person or that no portion of the gain would be attributable to ECI-generating assets.
  - Similarities to FIRPTA withholding regime
  - If buyer fails to withhold, the partnership is liable for the withholding tax, plus interest

Presented by
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June 21, 2018

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2018 HOT TOPICS IN RESTRUCTURING

Index

A. Release of Non-Debtor Affiliates from Guaranty Claims

Release of Non-Debtor Affiliates from Guaranty Claims

BACKGROUND

- Before filing for bankruptcy relief, companies and their advisors generally undertake a comprehensive analysis of each entity in the corporate structure to evaluate its assets and liabilities (including guarantees) to determine whether such entity should file a petition for relief
- Generally, an entity must file for chapter 11 relief to benefit from the Bankruptcy Code, including the automatic stay and a discharge and release from liability, although there are exceptions where certain protections may be extended to non-debtor affiliates or other third parties
- The treatment of non-debtor affiliates has been highlighted in certain recent cases, where the U.S. Trustee and, in some cases, dueling creditors, have challenged the proposed release of non-debtor affiliates. In particular, some recent plans have released guarantee claims against the debtors' non-debtor affiliates, which, according to the objecting parties, amounts to an improper discharge of claims against non-filing entities
- Although the following cases may have little precedential value (as discussed below), they nevertheless demonstrate that courts have been receptive to debtors' creative uses of third party releases and injunctions as means to restructure debt, even where certain of the obligors did not file for bankruptcy relief

Release of Non-Debtor Affiliates from Guaranty Claims

CASE STUDY: WALTER INVESTMENT

Walter Investment

- Walter Investment Management Corp. ("WIMC" or the "Debtor") is a holding company and the direct or indirect parent of 22 non-debtor affiliates (together with WIMC, the "Company")
- Certain wholly-owned subsidiaries of WIMC (the "Non-Filing Affiliates") conduct nearly all of the Company's business, which primarily consists of originating and servicing loans for federal housing agencies: Fannie Mae, Freddie Mac and Ginnie Mae
- If the Non-Filing Affiliates were to file bankruptcy, the federal housing agencies likely could terminate the servicing rights of the Non-Filing Affiliates under a safe harbor in the Bankruptcy Code, which would preclude the Company's successful restructuring; consequently, only WIMC filed for bankruptcy
- The Company's prepetition term loan and senior notes were guaranteed by the Non-Filing Affiliates
- Term lenders holding 95% in amount of the term loan and senior noteholders holding 85% in amount of senior notes agreed to an RSA that restricted them from pursuing claims against the Non-Filing Affiliates during the case and required them to vote in favor of a prepackaged plan that released the guarantees of the Non-Filing Affiliates upon WIMC's emergence from chapter 11
- Two important issues were raised with respect to the Non-Filing Affiliates:
  - (1) the extension of the automatic stay to any guarantee claims against the Non-Filing Affiliates by lenders and noteholders who were not parties to the RSA (the "Non-RSA Parties") and
  - (2) the release, pursuant to WIMC's chapter 11 plan, of the Non-Filing Affiliates from all debt claims

Release of Non-Debtor Affiliates from Guaranty Claims

CASE STUDY: WALTER INVESTMENT (CONT.)

Extension of the Automatic Stay to Guarantee Claims against Non-Filing Affiliates

- The automatic stay ordinarily applies only to the debtor, but the bankruptcy court may extend the stay under section 105(a) of the Bankruptcy Code where (i) a "third-party action will have an adverse impact on the debtor's ability to accomplish reorganization" or (ii) "the non-debtor and debtor enjoy such an identity of interests that the suit of the non-debtor is essentially a suit against the debtor." *In re R&G Financial Corp.*, 441 B.R. 401, 409 (Bankr. D.P.R. 2010) (citing *In re Philadelphia Newspapers, LLC*, 407 B.R. 606, 616 (E.D. Pa. 2009)) (internal quotation marks omitted)
- In requesting the extension of the automatic stay to guarantee claims against the Non-Filing Affiliates, the Debtor argued that the first prong was satisfied because pursuit of such claims against the Non-RSA Parties could undermine the entire restructuring by, among other things, limiting the Company's access to financing, jeopardizing the support of other parties in interest, and significantly harming the Company's business
- The Debtor asserted that the second prong was satisfied because the Debtor would be a necessary party in any action against the Non-Filing Affiliates and because the Debtor relies on the Non-Filing Affiliates for the continued operations of the Company
- Despite an objection from the U.S. Trustee, the court extended the stay to guarantee claims by Non-RSA Parties against the Non-Filing Affiliates

Release of Non-Debtor Affiliates from Guaranty Claims

CASE STUDY: WALTER INVESTMENT (CONT.)

Plan Release of the Non-Filing Affiliates

- WIMC's prepackaged plan provided for permanent releases of claims held by holders of term loan claims and senior notes claims (unless they voted against the plan or objected to the releases) against the Non-Filing Affiliates solely with respect to the guarantees provided by the Non-Filing Affiliates under the prepetition credit agreement and senior notes indenture
- The U.S. Trustee objected to these releases on the basis that the court lacked subject matter jurisdiction to enjoin these third party non-debtor claims
- The bankruptcy court considered its subject matter jurisdiction and whether the third party releases were proper under the standard set forth in *Deutsche Bank AG v. Metromedia Fiber Network, Inc.* (416 F.3d 136, 142 (2d Cir 2005))
- A bankruptcy court has "related to" subject matter jurisdiction to approve a non-debtor release if the claims might have any conceivable effect on the bankruptcy estate.
- The court concluded that it had subject matter jurisdiction because the guarantee claims could have led to indemnification and contribution claims against the Debtor
- With respect to whether the releases were proper, the court found that the *Metromedia* standards were satisfied because (i) the enjoined claims would indirectly impact the Debtor's reorganization through claims of indemnity or contribution and (ii) the Non-Filing Affiliates made a substantial contribution to the Debtor's estate
- In reaching its decision and in response to the U.S. Trustee's concern that this may lead to other stand-alone holdco filings, the court was careful to explain that the *Walter* facts and circumstances were unique and that the court's finding had little precedential value

Release of Non-Debtor Affiliates from Guaranty Claims

CASE STUDY: CAESAR'S ENTERTAINMENT

Caesars Entertainment Operating Company

- Caesars Entertainment Operating Company, Inc. ("CEOC") and certain of its affiliates (collectively, the "Debtors") filed for chapter 11
- CEOC's parent company, Caesars Entertainment Corporation ("CEC"), and other affiliates (the Non-Filing Affiliates and, together with CEC, the "Non-Filing Parties") did not file
  - CEC did not file because it wanted to preserve the equity value of its solvent subsidiaries
- Prior to the petition date, the company engaged in a series of transactions pursuant to which various assets were transferred from CEOC to other subsidiaries of CEC, and a portion of CEC's equity interests in CEOC was sold to unaffiliated investors
- CEC took the position that, as a result of the sale of CEOC equity, its guarantees of CEOC's obligations under the first lien credit facilities and first and second lien notes had automatically terminated because such guarantees were contingent upon CEOC being a wholly-owned subsidiary of CEC
- The intercompany transfers gave rise to a series of prepetition lawsuits (the "Prepetition Actions") by various noteholders against CEOC and CEC, asserting derivative claims for fraudulent transfer and breaches of fiduciary duty, among other things. The noteholders claimed that the transactions were unlawful and/or violated certain covenants under the applicable indentures, and that the transactions were done at below-market prices as part of a scheme by CEC and the Company's sponsors to transfer valuable assets from CEOC to CEC and remove them from the reach of CEOC's creditors. The noteholders further alleged that CEOC's directors and officers violated their fiduciary duties by approving the transactions

Release of Non-Debtor Affiliates from Guaranty Claims

CASE STUDY: CAESAR'S ENTERTAINMENT (CONT.)

Extension of the Automatic Stay to Prepetition Actions against the Non-Filing Parties

- Upon commencement of CEOC's bankruptcy case, the Prepetition Actions were stayed with respect to claims against the Debtors
- The Debtors also filed an adversary proceeding seeking to enjoin the Prepetition Actions against CEC under section 105 of the Bankruptcy Code on the grounds that the actions (i) sought to litigate claims that were property of the estate (derivative claims on behalf of CEOC), (ii) threatened the reorganization by preventing CEC from making a substantial contribution (as contemplated in the existing RSA), (iii) would deplete an insurance policy shared by CEC and CEOC, which was an important asset of the estate, (iv) create indemnification obligations for the Debtors and (v) cause an administrative burden
- The bankruptcy court ruled against the debtors, reasoning that courts can enjoin litigation against non-debtor parties under section 105 of the Bankruptcy Code, but only if the litigation arises out of the "same acts" that gave rise to disputes in the debtor's bankruptcy proceeding. The district court affirmed. On appeal, the Seventh Circuit vacated the bankruptcy court's order, finding the lower courts had erred in interpreting section 105(a) too narrowly and holding that the bankruptcy court can stay litigation pending against the debtors' non-debtor parent
- On remand, the bankruptcy court granted a temporary injunction with respect to one of the lawsuits (and continued the Debtors' request with respect to the other lawsuits), finding that (i) the debtors had a reasonable likelihood of a successful reorganization, (ii) a temporary injunction would promote an overall settlement and the debtors' reorganization and (iii) the balance of equities weighed in favor of the Debtors
  - However, the bankruptcy court denied the Debtors' request to extend the injunction through a plan confirmation decision, stating that it was no longer convinced that an injunction would enhance the Debtors' prospects for a successful restructuring

Release of Non-Debtor Affiliates from Guaranty Claims

CASE STUDY: CAESAR'S ENTERTAINMENT (CONT.)

Plan Releases of CEC Guarantees

- Notwithstanding CEC's position that the prepetition transactions had automatically terminated its guarantee obligations, CEOC's chapter 11 plan contained an express release of the CEC guarantees in addition to any claims arising from or in connection with the CEC guarantees, among other claims
  - The plan ultimately was supported by all major creditor groups
  - According to the Debtors' confirmation brief, CEC, its affiliates, the sponsors and others agreed to make contributions valued at $4.7 billion to $6.9 billion in exchange for releases of liability
- Only the U.S. Trustee objected to the plan's third party release and exculpation provisions, but the judge was disinclined to deny confirmation of a plan that was otherwise fully agreed to among the parties after many years of contentious litigation

Release of Non-Debtor Affiliates from Guaranty Claims

CASE STUDY: J.G. WENTWORTH

Orchard Acquisition Company, LLC (J.G. Wentworth)

- J.G. Wentworth Company and other holding companies in its organizational structure (collectively, the "Debtors") filed for chapter 11
- Certain affiliates of the Debtors, including the operating subsidiaries, did not file for chapter 11 (the "Non-Filing Affiliates," and together with the Debtors, the "Company")
- Certain Non-Filing Affiliates guaranteed the indebtedness of the Debtors under the prepetition credit agreement
- Holders of 87% of the claims under the prepetition credit agreement entered into an RSA with the Debtors whereby, among other things, the holders agreed to forbear from exercising any remedies under the prepetition credit agreement against the Non-Debtor Affiliates
  - Similarly, in *In re Toys "R" Us, Inc.*, prior to the bankruptcy, a forbearance was put in place that restricted creditors from pursuing remedies against certain non-debtor affiliates
- According to the Debtors, absent the forbearance agreement under the RSA, the Non-Filing Affiliates would have been required to file for chapter 11, which would likely have resulted in the default or termination of various critical financing arrangements and jeopardized important government consents and licenses relating to its retail mortgage lending business
- Pursuant to the chapter 11 plan, the guarantees of the Non-Filing Affiliates under the prepetition credit agreement were released upon emergence, in exchange for the treatment of the term loan claims under the plan
  - The Non-Filing Affiliates also received broad releases from holders of any claims that did not opt out of the releases
- The court approved the releases in their entirety, finding that they were consensual (the U.S. Trustee was the sole objector) and essential to the Debtors' reorganization

B. *Hovnanian* and CDS Risks

Basics of Credit Default Swaps

- Credit default swaps ("CDS") are derivative instruments under which one party agrees to provide credit protection to the other in the event of a third party's "credit event," such as a bankruptcy or payment default on debt. The third party is referred to as the "reference entity"
- CDS counterparties are typically two market participants (e.g., financial institutions and investment funds). The reference entity is not a party to the CDS
- While in some instances CDS function as a means to hedge an investment or insure against the reference entity's failure, CDS-based trading strategies can also be used to achieve leveraged and thus higher returns than would be available by trading only in a company's debt securities
- A CDS buyer pays both an upfront premium, which fluctuates, along with a regular coupon in exchange for the credit protection
- If a credit event occurs before the CDS matures, the CDS buyer is entitled to payment from the seller

Basics of Credit Default Swaps

CREDIT EVENT DETERMINATIONS AND "CHEAPEST-TO-DELIVER" SETTLEMENT PRICING

Credit Event Determinations

- Under a protocol set by the International Swaps and Derivatives Association ("ISDA"), an internationally recognized governing body for derivative transactions, a credit derivatives determinations committee ("DC") is convened to determine whether or not a credit event has in fact occurred and the applicable settlement price

CDS Auctions and "Cheapest-to-Deliver" Protection Payment Pricing

- To determine the cash settlement/protection payment price of a CDS, the DC supervises an auction process to approximate the post-default market price of the reference entity's debt
- The protection payment that will be owed to a CDS buyer is based on the price of the reference entity's "cheapest-to-deliver" debt instrument, as determined through the auction
  - The settlement price is calculated as the product of the notional amount of the swap and the difference between par and the auction price of the cheapest-to-deliver debt
  - Therefore, the lower the price of the reference entity's debt, the higher the settlement payment on the CDS
    - For example, if a company's bonds trade at 97 cents on-the-dollar and are delivered in the CDS auction at that price, a payout on a CDS contract for a notional amount of $1 million would be $30,000 ((100-97) x $1,000,000)
    - If the company's debt is delivered at the auction at trading prices of 50 cents on-the-dollar, then the payout on the same $1 million CDS contract would be $500,000 ((100-50) x $1,000,000)

Hovnanian – Background

- Homebuilder Hovnanian Enterprises recently entered into a refinancing transaction funded by GSO Capital Partners ("GSO")
- As part of the transaction, Hovnanian agreed not to make interest payments on certain bonds purchased by one of its affiliates, which non-payment was expected to trigger a payment default on the bonds despite the fact that Hovnanian has considerable cash on hand and is expected to make timely payments on all of its other outstanding debt
  - This payment default likely would have resulted in a credit event sufficient to trigger protection payment obligations under its CDS
- The refinancing transaction allowed Hovnanian to refinance certain of its debt with near-term maturities at below-market interest rates and retain additional liquidity on its balance sheet
- The transaction would also result in significant gains for GSO in its capacity as a net buyer of CDS on which Hovnanian is the reference entity ("Hovnanian CDS")
- One net seller, Solus Alternative Asset Management ("Solus"), sued to enjoin the transaction, alleging that it violated U.S. securities laws and reflected an improper manipulation of the CDS market because it was structured intentionally to trigger, and maximize payouts under, Hovnanian CDS

Hovnanian – Background (cont.)

- On April 24, 2018, the CFTC issued a statement regarding manufactured credit events in connection with CDS, stating that:

  > Manufactured credit events may constitute market manipulation and may severely damage the integrity of the CDS markets, including markets for CDS index products, and the financial industry's use of CDS valuations to assess the health of CDS reference entities. This would affect entities that the CFTC is responsible for overseeing, including dealers, traders, trading platforms, clearing houses, and market participants who rely on CDS to hedge risk. Market participants and their advisors are advised that in instances of manufactured credit events, the Divisions will carefully consider all available actions to help ensure market integrity and combat manipulation or fraud involving CDS, in coordination with our regulatory counterparts, when appropriate

- On May 1, 2018, Hovnanian declined to make the interest payment due on the 8% notes
- On May 30, 2018, prior to the end of the 30-day grace period for the missed interest payment, Hovnanian paid the overdue interest pursuant to the terms of a settlement between the parties. As a result of such payment, the "Default" under the indenture governing the notes has been cured. In addition, the parties signed a stipulation of dismissal with prejudice that dismissed Solus's lawsuit as to all parties. The other settlement terms have not been publicly disclosed

Hovnanian – Refinancing Transaction

STRUCTURE

- Exchange Offer. Hovnanian agreed to provide a combination of cash and new notes in exchange for between $140 and $185 million of its 8% senior notes due 2019 (the "2019 Notes")
  - In addition to offering cash, Hovnanian issued two new notes in exchange for the tendered bonds:
    - (i) a relatively short-dated, high-coupon note (13.5% due 2022) expected to trade at or above par, and
    - (ii) a long-dated, low-coupon note (5% due 2040) that is expected to trade at a steep discount (the "2040 Notes")
  - GSO agreed to tender at least $126.8 million of its existing 2019 Notes in the exchange
- Affiliate Purchase and Payment Default. Hovnanian agreed to cause its wholly-owned subsidiary to purchase $26 million of the tendered 2019 Notes (the "Purchased Notes"), and Hovnanian covenanted not to pay any interest on the Purchased Notes, with the intent of triggering a default
- New Financing. In addition to participating in the exchange, GSO agreed to provide Hovnanian with $362.5 million of new committed financing
  - The financing package includes:
    - $212.5 million in new unsecured term loans with a 5% interest rate, the proceeds of which Hovnanian has used to refinance all of its 7% notes maturing in 2019 and is also expected to use to redeem the remaining 2019 Notes not participating in the exchange
    - $150 million of additional commitments from GSO that are being used to refinance an outstanding $75 million Hovnanian term loan and provide liquidity to the company
  - According to Solus's complaint (discussed below), the financing terms offered by GSO were below-market and generally more favorable to Hovnanian than other proposals the company received from third parties that were not CDS counterparties
- Consent Solicitation. Hovnanian also commenced a consent solicitation for amendments to certain of its other outstanding notes to facilitate the refinancing of its 2019 Notes

Hovnanian – Refinancing Transaction

ANTICIPATED EFFECT

- Hovnanian declined to make the interest payment on the Purchased Notes that was due on May 1, 2018. Hovnanian's failure to make such payment within the 30-day grace period seemingly would have triggered a credit event under its CDS
  - Failure to pay interest due on the $26 million Purchased Notes would have resulted in a payment default of $1.04 million, just over the $1 million credit event threshold typically set under CDS contracts, but small enough not to trigger cross-defaults
- Precedent transactions suggest that the non-payment of interest would have been determined to be a credit event
  - ***Codere*** (2013) – Codere, a Spanish gaming company, received below-market financing in exchange for, among other things, its agreement to delay loan payments by two days in order to cause a credit event under CDS
  - ***iHeart*** (2016) – iHeart Communications intentionally defaulted on outstanding notes held by a subsidiary in order to prevent a lien from springing on other debt, and the ISDA DC found this to constitute a credit event
- A determination that a credit event occurred would have triggered payment obligations owed to purchasers of the Hovnanian CDS, including GSO
- However, absent the issuance of the new 2040 Notes, the payment obligations owed to purchasers of the Hovnanian CDS would likely be modest
  - Hovnanian's debt instruments were trading at or near par prior to the refinancing transaction. As discussed above, securities with high trading values will result in lower protection payments as determined under the "cheapest-to-deliver" pricing scheme
  - Because Hovnanian covenanted to default on only the Purchased Notes and will otherwise continue to honor its payment obligations, there is no reason to believe that the "limited" default will depress the trading prices of Hovnanian's other debt instruments
- The 2040 Notes were expected to trade well below par, thereby inflating the protection payments owed under the Hovnanian CDS upon the credit event

Hovnanian – Litigation

- On January 11, 2018, two weeks after Hovnanian announced its exchange offer and refinancing transaction, Solus commenced an action against GSO, Hovnanian and certain of Hovnanian's officers, directors and affiliates to enjoin the transaction, and for actual and punitive damages (*Solus Alternative Asset Management LP v. GSO Capital Partners, L.P.*, Case No. 18-cv-00232-LTS (S.D.N.Y. Jan. 11, 2018))
  - In its opposition, GSO asserted, among other things, that the exchange transaction was legal, the company made necessary disclosures about the transaction, and CDS market participants are sophisticated counterparties who understand that an "unconventional default" is possible
- On January 29, 2018, the district court denied Solus's request for a preliminary injunction, and Hovnanian announced consummation of the transaction on February 2, 2018
- Solus amended its complaint and alleged, among other things, a scheme to defraud in violation of federal securities laws and tortious interference with prospective economic advantage
  - Solus asserted that GSO essentially "bribed" Hovnanian to assist it in an effort to unlawfully manipulate third party CDS contracts and that, if the transaction is allowed to go forward, it would have a destabilizing effect on the broader CDS market
  - Solus further alleged that the 2040 Notes were so far off-market (relative to other high-yield issuers and Hovnanian's other notes) that the debt can be for no purpose other than CDS manipulation
- The amended complaint also sought declaratory judgment that, because Hovnanian covenanted not to pay interest on its subsidiary-held 2019 Notes: (i) the exchange transaction constituted a breach of the 2019 Notes indenture, and (ii) Hovnanian's subsidiary waived its entitlement to the interest payments and, thus, failure to pay such interest would not trigger an event of default under the 2019 Notes indenture
- GSO and certain Hovnanian-affiliated entities filed a motion to dismiss the amended complaint, asserting that the transactions were undertaken to increase profit and were not in any way deceptive
- As discussed above, Hovnanian missed the May 1 interest payment, but on May 30, 2018, the parties announced a settlement and dismissal of the litigation.

Hovnanian – Potential Implications

- Although there was precedent for an "engineered" payment default and credit event, the Hovnanian transaction was novel because of the issuance of the 2040 Notes, which were arguably designed to inflate the protection payments owed upon the manufactured credit event
- The ability to manufacture a credit event may be appealing to reference entities generally
  - Companies can (i) potentially secure new financing on below-market terms by negotiating with CDS buyers, and (ii) seek to protect themselves from aggressive acts of CDS buyers who have made a bet that the company will default (and therefore have incentives at odds with the company's)
  - Indeed, companies that are the subject of active CDS trading may have "targets on their backs," with CDS buyers otherwise incentivized to force them into default or bankruptcy
    - CDS buyers may use activist strategies to assure that a credit event occurs, and contentious creditor disputes have erupted as CDS counterparties seek to realize value on their CDS trades
  - Therefore, a manufactured credit event such as the one anticipated by Hovnanian may act as a "controlled burn" by a CDS reference entity, sufficient to trigger the swaps and clear out existing positions, but in a way that can be managed from the company's perspective to avoid cross-defaults or other negative consequences
- Despite the potential appeal of the Hovnanian transaction, it was unclear whether it would have been upheld. It is also unclear whether the ISDA will adopt any reform in response to the Hovnanian transaction

Hovnanian – Potential Implications (cont.)

- The broader implications of Hovnanian are unclear so far:
  - Will other companies be able to use the transaction as a template to engage offensively with CDS buyers, and agree to work with them in exchange for attractive financing packages?
  - Will other companies seek to use the transaction as a template to deal defensively with CDS buyers by triggering small, managed defaults to clear out CDS positions and preempt potential damage from activist campaigns?
  - Will the risk of gamesmanship chill or otherwise create long-term damage in the CDS markets?
  - Will there be court decisions or changes to ISDA rules that impede the engineering of credit events or auction outcomes going forward?

C. *Merit Management* and the Section 546(e) Safe Harbor

Merit Management and the Section 546(e) Safe Harbor

On February 27, 2018, the Supreme Court decided *Merit Management Group, LP v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018)

- In *Merit Management*, the Supreme Court issued an important decision regarding the interpretation of Section 546(e) of the Bankruptcy Code
  - Section 546(e) protects certain securities-related transactions from avoidance where the transfer was made "by or to (or for the benefit of)" a list of protected entities, including a "financial institution" or "financial participant" (each as defined in Section 101 of the Code)
- Prior to *Merit Management*, five circuit courts of appeal, including the Second Circuit, had held that Section 546(e) protected transfers made through these entities acting as intermediaries
  - Even if the funds had merely passed through a protected entity, the ultimate recipient of the transfer was protected from avoidance
- This interpretation of Section 546(e) had protected most securities transactions from avoidance, because the vast majority involve a transfer through at least one protected entity (e.g., a bank)

Merit Management and the Section 546(e) Safe Harbor (cont.)

- In *Merit Management*, the Supreme Court (unanimously) sided with two other courts of appeal and held that Section 546(e) protects securities-related transfers only if the **end-to-end** transfer is made by, to, or for the benefit of the protected entities themselves
  - In *Merit Management*, Valley View Downs (a non-protected entity) passed funds through Credit Suisse (a protected entity), to Citizens Bank (a protected entity), ultimately to Merit Management (a non-protected entity), in exchange for stock passing from Merit Management through Citizens Bank to Valley View Downs
  - The trustee sued to avoid the transfer to Merit Management, and Merit Management invoked the 546(e) defense because the funds passed through two protected entities
  - The Court disagreed, stating: "the only relevant transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid"
  - Because neither the transferor nor the transferee were protected entities (and the transfer was not made for the benefit of a protected entity), the transfer was not covered by Section 546(e), even though it had passed through protected entities
- Following *Merit Management*, a transfer that passes through a financial institution or other covered entity is no longer protected from avoidance merely because the funds passed through that entity; only transfers that are made by, to, or for the benefit of such an entity will be protected
- *Merit Management* is viewed as a significant narrowing of the scope of Section 546(e) that is likely to result in increased litigation against transferees previously thought to be immune from such suits
- Already we have seen plaintiffs in the *Tribune* and *Fairfield* fraudulent conveyance actions submit letters to the court seeking to apply *Merit Management* to defeat Section 546(e)-based defenses previously asserted by defendants in those actions

Merit Management and the Section 546(e) Safe Harbor (cont.)

Continued viability of the 546(e) safe harbor

- Even after *Merit Management*, the Section 546(e) defense remains available in a wide number of circumstances
  - All of the entities specified in Section 546(e) are still protected from an avoidance action claim with respect to securities-related transfers covered by the statute
    - These entities are: "a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency" (each as defined in Section 101 of the Code)
    - Many funds may continue to qualify for the defense as a "financial participant," which is defined as an entity that (at the relevant time) has (1) a total gross dollar value of over $1 billion in notional amount of securities, commodity, forward, repurchase, swap, or master netting contracts or (2) a gross mark-to-market value of over $100 million of the same. 11 USC 101(22A)(A).
  - In addition, the "mere conduit" defense is not impacted by the opinion; if an entity merely passed the funds to another without taking a beneficial interest, the entity can still advance a viable "mere conduit" defense to an avoidance action

Merit Management and the Section 546(e) Safe Harbor (cont.)

A Silver Lining: Footnote 2 of *Merit Management* and the "Customer" Argument

- Due to a curious footnote in the *Merit Management* opinion, the 546(e) defense may yet be available to an even greater number of defendants, including individuals who transact in securities through a commercial bank
- The defense is based on the definition of "financial institution"
  - "Financial institution" includes entities commonly understood to be "financial" such as banks, savings and loan associations, trust companies, credit unions, registered investment companies
  - "Financial institution" also includes a potentially broader category:
  - "[W]hen any such [institution] is acting as an agent or custodian for a customer (whether or not a 'customer', as defined in section 741) in connection with a securities contract (as defined in section 741) **such customer**." 11 U.S.C. § 101(22)(A)
- At oral argument in *Merit Management*, Justice Breyer pointedly asked why the defendants in that case did not claim they qualified for the Section 546(e) safe harbor as a "customer" of a financial institution
  - Counsel stated that he had "no good answer" to the question
- Hence, **footnote 2** in the *Merit Management* decision preserves the "customer" argument for future cases:
  - "The parties here do not contend that either the debtor or petitioner in this case qualified as a 'financial institution' by virtue of its status as a 'customer' under § 101(22)(A). . . . We therefore do not address what impact, if any, § 101(22)(A) would have in the application of the § 546(e) safe harbor."

Merit Management and the Section 546(e) Safe Harbor (cont.)

The "customer" argument is likely to be the subject of future litigation in major fraudulent transfer cases

- Who is a "customer" for purposes of Section 101 and Section 546(e)?
  - Not as defined in Section 741
  - No case law on the subject
  - No relevant legislative history
- The meaning of a "customer" of a financial institution may be expansive, and may include an individual who transacts in securities through a commercial bank
  - "[U]nless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning." *Sandifer v. U.S. Steel Corp.*, 134 S. Ct. 870, 876 (2014)
  - Definition of "customer" in Black's Law Dictionary: "a buyer or purchaser of goods or services"
  - Justice Breyer's questions in *Merit Management* applied ordinary meaning of "customer"
  - Other statutes pertaining to financial institutions define "customer" broadly
    - Graham-Leach-Bliley Act, 15 U.S.C. § 6827(1);
    - Right to Financial Privacy Act, 12 U.S.C. § 3401(5)

Conclusion: In *Merit Management*, the Supreme Court answered long-standing questions regarding the interpretation of Section 546(e), but others remain and will be resolved through litigation in the years to come

D. Proliferation of Professional Retentions In Recent Restructurings

Proliferation of Professional Retentions in Recent Restructurings

BACKGROUND

- Due in part to the complexity of corporate and capital structures of chapter 11 debtors, and as a consequence of earlier cases where contested intercompany claims and releases have been at the forefront, there has been a recent proliferation in the appointment of independent directors who, in turn, may require independent advisors to (i) help investigate intercompany transactions and releases in connection with a company's restructuring, or (ii) protect the independent directors' interests where potential conflicts exist among debtors or directors
- Courts have approved the new spate of additional retentions, in some cases notwithstanding objections by both secured and unsecured creditors, who have contested, among other things, substantial incremental costs

The following case studies highlight recent cases where independent directors have retained separate advisors

- These case studies suggest that, in considering requests for additional professionals for independent directors or multiple debtors, courts will continue to balance the value added to the estate by the additional professionals, including the risk of any potential intercompany conflicts, against the associated cost and risk of these fees depleting the estate
- The timing of the professionals' retention, their scope of work, and compensation structure are some of the key factors that courts have considered

Proliferation of Professional Retentions in Recent Restructurings

CASE STUDY: TOYS "R" US, INC.

Toys "R" Us, Inc.

- Each debtor silo in the chapter 11 cases—Toys Delaware and TRU Taj—appointed independent directors who sought to retain their own financial advisors. The debtors supported the additional retentions, citing the complicated corporate structure, a long list of potential matters where independent directors' interests may be at odds with the debtors' interests, and potential conflicts among the various debtors
- The U.S. Trustee, UCC, and ad hoc B-4 secured lender group, among others (collectively, the "Objecting Parties"), filed objections to certain of the retention applications for the additional financial advisors. In particular, the Objecting Parties contested:
  - The fact that no actual conflicts had arisen, and there was no active and ongoing interdebtor litigation
  - The compensation structure, consisting of fixed monthly fees and large success fees to be paid regardless of the work performed or the necessity for such work
  - The limitation of liability provision, which the U.S. Trustee argued effectively worked as a preemptive exculpation without all of the interested parties having the opportunity to give consent
- The Objecting Parties did not object to one of the additional advisors requested by Toys Delaware because its compensation was based solely on hourly fees
- The United States Bankruptcy Court for the Eastern District of Virginia approved the additional retentions, noting that it did not "relish adding to the list of professionals being compensated," but finding the disinterested directors were entitled to independent financial advice for purposes of negotiating interdebtor settlements, among other things

Proliferation of Professional Retentions in Recent Restructurings

CASE STUDY: CUMULUS MEDIA, INC.

Cumulus Media, Inc.

- Prior to filing its chapter 11 petition in November 2017, Cumulus Media's board appointed a review committee consisting of one independent director to review and assess potential releases of interested parties in connection with a possible restructuring or reorganization transaction
- The board wanted to (i) ensure that any releases granted in connection with the restructuring were appropriate and implemented free of any allegations of undue or improper influence and (ii) give the court an appropriate record on which to grant the releases under a chapter 11 plan
- The independent director retained Young Conaway as counsel approximately one month before the November 2017 bankruptcy petition, and filed a motion to retain the firm in January 2018, disclosing a compensation structure based on hourly rates
- No party objected to the retention application and it was approved by the court
- The review committee asked Young Conaway to prepare a report of various transactions and any potential claims that might be asserted by Cumulus Media
- Based on the analysis, the review committee recommended that it was in the best interest of the company to grant the releases

Proliferation of Professional Retentions in Recent Restructurings

CASE STUDY: GENON ENERGY, INC.

GenOn Energy, Inc.

- In the wake of certain prepetition intercompany transfers between the GenOn debtors and two of their non-debtor subsidiaries (GenMA and REMA), the United States Bankruptcy Court for the Southern District of Texas encouraged the debtors at a hearing to ensure that their non-debtor entities had proper oversight
- In response to the court's request, the debtors appointed independent directors at GenMa and REMA, and had the independent directors form a governance committee to review the intercompany transfers
- The governance committee retained its own legal counsel to assist in reviewing intercompany transfers and conducting a full investigation
- Counsel for the committee also played a role in reaching a settlement regarding the questioned transfers between GenMa and GenOn, a settlement integral to GenOn's chapter 11 plan

E. Cross-Border Allocation Disputes

Cross-Border Allocation Disputes

BACKGROUND

- The complexity of corporate restructurings is magnified when transactions and recoveries cross jurisdictional boundaries. When companies are solvent, the allocation and distribution of valuable assets across international subsidiaries may not be problematic, but insolvency proceedings often shine a new light on intercompany valuation disputes that can play out across multiple jurisdictions with different restructuring schemes
- The following case studies demonstrate the complexity of cross-border allocation disputes across a corporate family and showcase the different ways that debtors and courts have sought to resolve them

Cross-Border Allocation Disputes

CASE STUDY: TAKATA CORPORATION

- Takata allegedly defectively designed and/or manufactured certain airbag inflators ("PSAN Inflators"); global recalls of these airbag inflators triggered tens of billions of dollars in indemnification and warranty claims against Takata by automakers
- Takata was also ordered by the Department of Justice to pay $850 million in restitution to automakers and personal injury victims harmed by Takata's conduct
- Faced with insolvency, Takata entered into an agreement to sell substantially all its worldwide assets unrelated to the manufacture and sale of PSAN Inflators to a third-party buyer for an aggregate purchase price of $1.588 billion
- Takata is a global enterprise with assets in over 20 countries. Thus, consummation of the sale required allocating the purchase price among 40 Takata entities located around the world (the "Seller Entities")
- To allocate the purchase price among the Seller Entities, the investment bank conducting the marketing and sale process applied a complex formula primarily linked to the net asset values of the acquired assets purchased from each of the Seller Entities (subject to certain normalizing adjustments), or to the entity's liquidation value to the extent it exceeded the entity's adjusted net asset value
  - Creditors in the U.S. and Japan were allowed to contest this allocation at separate confirmation hearings, and the U.S. and Japanese cases were not subject to an agreed-upon cross-border protocol

Cross-Border Allocation Disputes

CASE STUDY: NORTEL NETWORKS, INC.

- Ontario-based Nortel Networks was once among the biggest makers of telecommunications equipment in the world, with 93,000 employees and a market capitalization of $250 billion at the height of the 1990s technology bubble. After an accounting scandal and a series of management missteps, the company filed for bankruptcy in January 2009. Its global businesses, including its patent portfolio, were liquidated in a sale of substantially all of the company's assets, raising $7.3 billion
- For purposes of expediting the asset sale, all sides agreed to escrow the funds and for the allocation to be determined at a later date
- The contested allocation of the liquidation proceeds led to an unprecedented cross-border trial that was conducted simultaneously in the U.S. and Canada pursuant to agreed-upon cross-border protocols
  - The cross-border protocol allowed for, among other things, a telephone or video link so that each court could simultaneously hear the proceedings in the other court
  - The judges could communicate with each other (with or without counsel present) about making consistent rules and coordinating rulings

Cross-Border Allocation Disputes

CASE STUDY: NORTEL NETWORKS, INC. (CONT.)

- Ultimately, the U.S. and Canadian courts ruled that the proceeds should be divided roughly pro rata among the affiliates, with approximately 57 percent of the proceeds going to the bankruptcy estate in Canada, and about 24 percent of the proceeds going to the U.S. bankruptcy estate. The remaining proceeds were distributed among Nortel's affiliates in Africa, Europe and the Middle East
  - Canadian order: The Canadian court supported a pro rata allocation
    - The court held that Nortel was not a single corporation, and that patent registration alone was insufficient to entitle the registered owner to all proceeds from intellectual property sales
    - The court concluded that a "just" distribution should govern the allocation
  - American order: The U.S. Bankruptcy Court adopted a modified pro rata allocation model
    - The court considered Nortel as an integrated global enterprise
    - Basing the allocation on section 105(a) of the Bankruptcy Code and the court's equitable powers, the court held that this allocation was a "just" outcome
- Various parties appealed the courts' allocation decisions
  - The Canadian monitor successfully moved to bypass the U.S. district court in the allocation appeals and have the ruling certified for direct appeal to the Third Circuit, arguing that if the Third Circuit could not resolve the dispute, the litigation over sale proceeds would continue "*ad infinitum*"
    - The U.S. debtors, ad hoc bondholders, and UCC had objected to the request for certification
- After an expensive and protracted litigation over the allocation of the proceeds, lasting nearly a decade, the parties ultimately reached a global settlement

Cross-Border Allocation Disputes

CASE STUDY: TOYS "R" US, INC.

- The bankruptcy cases of the Toys "R" Us, Inc. debtors are currently being conducted pursuant to a cross-border protocol between the U.S. and Canadian courts
  - Certain entities are debtors in both the U.S. and Canadian proceedings, however, operations outside the U.S. and Canada are not included in the Chapter 11 or CCAA filings
- Toys "R" Us, Inc. is comprised of two debtor silos: Toys Delaware (North American operations) and TRU Taj (European/Asian operations)
  - Toys Delaware and TRU Taj each have their own DIP financing packages
- Certain of the U.S. debtors recently sought to assume certain IP License Agreements entered into with certain of the TRU Taj foreign affiliates
  - Geoffrey LLC ("Geoffrey"), a debtor subsidiary of Toys Delaware, existed solely to hold IP licenses for the company
  - Geoffrey entered into IP agreements to license IP rights to other Toys subsidiaries, including Toys' foreign affiliates in Asia and Europe, for royalties
  - Pursuant to both intercompany IP License Agreements, the licensees used Geoffrey's Intellectual Property in approximately 730 stores located in 17 countries, in exchange for royalty payments
    - The IP license agreements allow funds to flow between the Toys Delaware and TRU Taj silos
  - According to the assumption motion, "the Intercompany IP License Agreements are a source of value to Geoffrey because they allow Geoffrey's brand to be leveraged in international markets, generate substantial royalty payments, increase the recognition and value of Geoffrey's brand worldwide, and build equity value in the Debtors' international operations"
  - As required by the terms of the TRU Taj DIP, Geoffrey moved to assume the two intercompany IP agreements (the "Assumption Motion")

Cross-Border Allocation Disputes

CASE STUDY: TOYS “R” US, INC. (CONT.)

- The ad hoc B-4 term lenders (the U.S. secured creditors), UCC, and certain of Toys’ independent directors sought to investigate the above license agreements and a prior merger transaction, including potential causes of action for fraudulent transfer relating to the IP agreements. The B-4 Lenders also contended that the royalty rates payable under the March 2017 intercompany agreements are not reasonable or fair to Geoffrey
- Toys’ largest creditor also argued that the debtors improperly sought to retain the ability to set aside and terminate the same agreements, and asserted that the agreements require independent directors’ consent and input
- On the eve of the hearing on the Assumption Motion, the parties consensually resolved the motion, with an order that reserved the parties’ rights with respect to the assumption (including the right to seek to unassume only after the Taj notes are paid off), potential causes of action relating to the IP agreements and the prior merger transaction

F. Potential Implications of Proposed Bankruptcy Venue Reform

Potential Implications of Proposed Bankruptcy Venue Reform

BACKGROUND

- Venue in a bankruptcy case is governed by 28 U.S.C. § 1408, which provides that a debtor may file a bankruptcy petition in any district where the debtor's domicile, residence, principal place of business or principal assets have been located for the greater portion of the 180 days preceding the petition. For businesses, these can be four separate locations. The current statute also permits a debtor to file a case in a jurisdiction where an affiliate, general partner or partnership of the debtor has a pending chapter 11 case (the "Affiliate Rule")
  - 28 U.S.C. § 1412 also provides that venue may be transferred for "the convenience of the parties" or "in the interest of justice"
- The range of bankruptcy venue options has led to an increase in companies filing for bankruptcy outside of the districts in which their principal place of business (i.e., headquarters) or assets are located, with many companies opting to file instead in their state of incorporation (often New York or Delaware)
- Proponents of the current law point to the expertise of specific jurisdictions, the relative predictability that comes with filing cases in these jurisdictions, and the location of the creditors and professionals most likely to actually appear in the case
- Detractors have alleged that "forum shopping" has resulted in:
  - The concentration of many major bankruptcy cases in a few districts
  - Small businesses, employees, retirees, creditors and other important "local" stakeholders being prevented from fully participating in bankruptcy cases that may have a tremendous impact on their lives, communities and local economies
  - Courts being deprived of the opportunity to develop bankruptcy case law in their jurisdictions

Potential Implications of Proposed Bankruptcy Venue Reform

BANKRUPTCY VENUE REFORM ACT OF 2018 (THE "ACT")

- On January 8, 2018, Senators Cornyn and Warren introduced the Bankruptcy Venue Reform Act of 2018 to limit available fora in chapter 11 cases
  - No changes to 28 U.S.C. § 1410 that sets forth venue in chapter 15 cases
  - No changes to 11 U.S.C. § 109(a) that determines eligibility to become a debtor
- The Act:
  - Requires corporate debtors to file cases only where:
    - Principal assets are located; or
    - Principal place of business is located
  - Prohibits filing on the basis of state of incorporation
  - Limits the Affiliate Rule to direct or indirect parent entities; affiliates must now:
    - directly or indirectly control;
    - be a general partner; or
    - hold greater than or equal to 50% of outstanding voting securities of the filing entity
- Cash or cash equivalents are not "principal assets" for purposes of determining venue
- Under the Act, courts will be required to dismiss cases filed in the wrong district or, "if it be in the interest of justice, transfer the case" to any district in which the case could have been brought

Potential Implications of Proposed Bankruptcy Venue Reform

IMPLICATIONS FOR FOREIGN CORPORATIONS

- The proposed law, if enacted, may discourage multinational corporations with U.S. operations from filing chapter 11 cases
  - Multinational corporations whose principal U.S. assets are located in an undesirable jurisdiction may elect to file insolvency proceedings outside of the U.S.
  - Non-U.S. insolvency proceedings may be less protective of the interests or rights of certain creditors
- The Act does not provide a venue for chapter 11 cases of foreign parent corporations with only cash or cash equivalents in the United States (and no place of business or non-cash assets)
  - To establish venue under the Act, the controlling entity is required to have its principal assets or principal place of business in the United States in the district where it commences its chapter 11 case
    - Some foreign debtors have no assets (other than a bank account or attorney retainer) or place of business in the United States
    - As discussed above, cash or cash equivalents are not “principal assets” for purposes of determining venue under the proposed legislation
  - This would impact, and likely preclude, a chapter 11 filing by a foreign group of companies, even when a subsidiary has a place of business or non-cash assets in the U.S.
- The Act does not allow venue planning because it provides that no effect shall be given to a change in the ownership or control, or a transfer of the principal assets or the principal place of business, of the debtor or its affiliate within one year before the chapter 11 filing or “for the purpose of establishing venue”
- There is a conflict with existing jurisprudence regarding chapter 11 eligibility under section 109(a) of the Bankruptcy Code. Some courts have held that bank accounts and prepetition deposits of attorney retainers in the U.S. are “property in the United States” that makes a foreign debtor eligible to be a debtor under section 109(a), including a debtor under chapter 11
  - The Act provides for the mandatory dismissal or transfer of a chapter 11 case filed in the wrong district
- No impact on venue in chapter 15 cases

Appendix A - Select Additional Decisions

Select Additional Decisions

Momentive Update – Cramdown Interest Rate

- In its October 20, 2017 decision (*In re MPM Silicones, LLC*, Case No. 15-1682 (2d Cir. Oct. 20, 2017)), the Second Circuit adopted a two-part approach for choosing an interest rate in a Chapter 11 cramdown: if an efficient market exists, the market interest rate should be applied to take-back debt issued pursuant to a cramdown plan. Where an efficient market does not exist, the *Till* formula should apply
  - The *Till* formula starts with the prime rate and adjusts upward to reflect credit and collateral risk
- The Second Circuit concluded that the bankruptcy court erred in not determining whether an efficient market existed to calculate the interest rate for the replacement notes issued to Momentive's first lien and 1.5 lien noteholders, and this remains an open question on remand

Circuit Split on Make Whole Payments

- Circuit courts are currently split on the enforceability of "make whole" premiums in bankruptcy
- In *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016), the Third Circuit held that the noteholders were entitled to payment of a make whole premium under the indenture's optional redemption provision as a result of the repayment of their notes in a bankruptcy proceeding
- The Second Circuit rejected this analysis in the recent *Momentive* decision (cited above), finding that the issuance of replacement notes in bankruptcy could not be considered a prepayment of the accelerated debt because the acceleration of the debt moved the debt's maturity to the acceleration date. Thus, issuance of the replacement notes after the acceleration/maturity date did not constitute a redemption under the indenture. Furthermore, because the obligation to issue the replacement notes was triggered by operation of an automatic acceleration clause, such payment could not be considered "optional"

Select Additional Decisions (cont.)

9th Circuit Decision on the Impaired Accepting Class Requirement of 1129(a)(10)

- In *In re Transwest Report Properties Inc*., No. 16-16221, 2018 U.S. App. LEXIS 1947 (9th Cir. Jan. 25, 2018), the Ninth Circuit held that section 1129(a)(10) of the Bankruptcy Code, which requires a plan to have at least one impaired accepting class, should be interpreted to apply on a "per-plan," rather than a "per-debtor" basis. The Ninth Circuit is the first circuit court to rule on this issue
  - The decision focused on the plain language of the statute, reasoning that section 1129(a)(10) "makes no distinction concerning or reference to the creditors of different debtors under 'the plan,' nor does it distinguish between single-debtor and multi-debtor plans"
  - In a concurring opinion, one circuit judge acknowledged that the plan involved a degree of substantive consolidation that was not addressed by the bankruptcy court, and suggested that creditors who believe a plan is impermissibly substantively consolidated should object on those ground, rather than contesting the plan under section 1129(a)(10)
- The "per-plan" approach requires only one impaired accepting class among all debtors covered under a joint plan. Thus, multiple debtors with a joint plan can cram down their plan on all creditors based on a single accepting class at any one of those debtors
- The "per-debtor" approach requires acceptance of the plan by at least one impaired class for each debtor
- Lower courts remain split on this issue. The Southern District of New York previously adhered to the Ninth Circuit's "per-plan" reasoning in *In re Charter Communications*, 419 B.R. 221, 266 (Bankr. S.D.N.Y. 2009), whereas the District of Delaware required at least one impaired accepting class "per-debtor" in *In re Tribune Co*., 464 B.R. 126 (2011)

Select Additional Decisions (cont.)

U.S. Bank NA et al. v. The Village at Lakeridge LLC

- A unanimous Supreme Court held that the Ninth Circuit was correct in reviewing for clear error the bankruptcy court's determination of whether a class of creditors qualified as a non-statutory insider, rather than applying a *de novo* standard of review
- The Supreme Court reasoned that the determination of whether a class of creditors should be considered a non-statutory insider is a fact-specific inquiry and, thus, the Ninth Circuit was correct in applying a deferential standard to the findings of the bankruptcy court that oversaw the presentation of evidence

Appendix B – Potential Impact of Business Tax Reform

New U.S. Tax Law

- Makes fundamental changes to the taxation of corporations, passthrough entities and multinational groups
- Noteworthy impacts on bankruptcies and/or restructurings include:
  - Elimination of net operating loss carrybacks and limitation on income that can be offset by post-2017 NOL carryforwards
  - Limitation of interest expense deduction by reference to percentage of income
  - New tax rules applicable to private investment funds
  - Significant changes to international tax regime
- Changes also affect the consequences of transactions undertaken in connection with restructurings, in some cases requiring rethinking the “playbook” for common transactions
- For more information: https://www.taxreformandtransition.com/wp-content/uploads/sites/29/2017/12/2017-12-20-gop-tax-cuts-jobs-act-preview-new-tax-regime.pdf

Net Operating Losses

Overview

- Under prior law, a net operating loss for a taxable year could be carried back two years and carried forward 20 years and, after application of the corporate AMT, could offset 90% of a corporation's taxable income in a given taxable year.
- Post tax reform, NOLs can no longer be carried back but can be carried forward indefinitely, and can offset only up to 80% of a corporation's taxable income in a given taxable year.
  - Affects only NOLs arising in years beginning in 2018
  - "Old" NOLs not affected but repeal of the corporate AMT means that "old" NOLs can offset 100% of income.

Impact on Bankruptcies and Restructurings

- No longer able to carry back NOLs to produce a tax refund for companies experiencing short-term or unexpected losses.
- Corporations with "old" NOLs may be viewed as more valuable than corporations with post-tax reform NOLs.
- Lower corporate income tax rate means that tax assets (such as NOLs) are less valuable

Limitation of Interest Deductibility

Overview

- Deduction for business interest expense for any taxable year generally cannot exceed the sum of:
  - the taxpayer's business interest income; and
  - 30% of the taxpayer's "adjusted taxable income" ("ATI")
    - Through 2021, ATI is approximately equal to EBITDA (decreased by state & local taxes)
    - Beginning in 2022, ATI will be approximately equal to EBIT
- Because business interest expense is fully deductible against business interest income, these rules are expected to have little impact on financial or insurance companies
- Interest not allowed as a deduction can be carried forward indefinitely

Impact on Bankruptcies and Restructurings

- Together with new NOL rules, may exacerbate cash flow issues for troubled companies
- Financially distressed corporations are likely to experience a decline in ATI that could result in an interest deduction limitation at a time when cash/liquidity needs arise.

Capital Expensing

Immediate Expensing: New rules allow taxpayers an immediate deduction equal to the "applicable percentage" of the cost of "qualified property" placed in service after September 27, 2017 and before January 1, 2027.

- Qualified property generally includes tangible property with recovery period of 20 years or less
  - Applies to newly purchased, used, and self-constructed property
  - Used property cannot be acquired from a related person
- "Applicable percentage" depends on when the qualified property is placed in service: 100% until 2022, 80% for 2023, 60% for 2024, 40% for 2025, and 20% for 2026
- Ability to immediately deduct all or part of purchase price provides incremental benefit to buyer in an asset sale

International Taxation

Briefly, the new rules:

- Tax “trapped” offshore earnings of foreign subsidiaries through a one-time transition tax
- Allow tax-free repatriation of certain foreign earnings
- Expand the universe of entities that are treated as “controlled foreign corporations”
- Subject more income of “controlled foreign corporations” to current taxation under the “GILTI” regime, which imposes a minimum tax on a very broadly defined category of foreign earnings
- Allow a deduction for income earned directly by corporate U.S. taxpayers from selling property or providing services outside the United States
- Implement a new alternative minimum tax on companies that “erode” the US tax base by making deductible payments to foreign affiliates

Impact on Bankruptcies and Restructurings

EXPENSING AND INTERNATIONAL TAXATION

- Expect higher frequency of asset sales (or deemed asset sales), including through credit bidding:
  - Immediate expensing (attractive to buyer)
  - Lower corporate tax rate (more palatable to seller)
  - US parent groups may be relatively more attracted to offshore asset acquisitions, either:
    - by “controlled foreign corporations” (higher basis provides “cushion” against minimum tax imposed by “GILTI” regime)
    - directly by US parent (allows immediate expensing)
- Don’t expect increased frequency of U.S. holding companies for foreign assets.
- Offshore earnings of foreign subsidiaries no longer “trapped”

Changes that Affect Passthrough Businesses

- **U.S. Tax on Sale by Non-U.S. Persons of partnership interest:** New rules codify IRS position that gain derived by a non-U.S. person from the sale or other disposition of an interest in a partnership constitutes effectively connected income to the extent the gain is attributable to assets used in a U.S. trade or business conducted by the partnership.
  - Requires buyer of a partnership interest to withhold 10% of the gross purchase price
  - Similarities to FIRPTA withholding regime

- **Passthrough Deduction:** Individuals may deduct 20% of "qualified business income" from each "qualified trade or business," subject to cap based on share of wage expense of non-partner employees
  - "Qualified trade or business" is generally any trade or business other than a service business
  - "Qualified business income" is generally net income other than income from certain investments, capital gain or loss, compensation for services

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June 21, 2018

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OPPORTUNITIES AND RISKS FOR CREDITORS IN THE CURRENT RESTRUCTURING LANDSCAPE

Index

I. RSAs and Rights Offerings

RSAs and Rights Offerings

- Restructurings are increasingly being effectuated through pre-arranged processes pursuant to restructuring support agreements (RSAs)
- In addition, existing holders are increasingly providing exit liquidity in the form of rights offerings
- These trends can provide opportunities and also present risks to creditors
  - Use of an RSA plus consent fees and pro rata rights offerings to garner pre-filing support for chapter 11 plan and facilitate extremely quick and efficient bankruptcy proceedings
  - RSAs can be used to coerce support from lenders excluded from steering committees
  - Valuable additional investment opportunities through DIP facilities and deeply discounted equity rights offerings

RSAs and Rights Offerings

- A rights offering provides creditors or equity holders with the option (or right) to purchase new securities in a reorganized company at a set subscription price, often at a discount, during a set subscription period
- Rights offerings can benefit both debtors and creditors/equity holders
  - Debtor increases liquidity and fortifies the balance sheet
  - Reduces reorganized debtor's leverage
  - Liquidity supports plan feasibility to avoid subsequent bankruptcy filing
  - Creditor has investment opportunity usually on favorable terms
  - Enhanced recovery on claims
  - Potential to resolve valuation disputes among constituents
- Key Components of a Rights Offering:
  - Backstop: One or more parties commit to subscribe for a minimum amount, in return for a commitment/backstop fee and other consideration (e.g., break-up fee, expense reimbursement).
  - Price: Participants are offered the right to purchase securities, normally at discount to plan equity value. A larger discount increases the attractiveness, but it also increases the dilutive effect of the issuance on the parties unable or unwilling to participate.
  - Eligibility: Potential participants are typically a limited pool of creditors. Wide eligibility may increase support for the chapter 11 plan, but could also increase regulatory and administrative concerns.
  - Section 1145 Exemption: If the rights offering complies with § 1145 of the Bankruptcy Code, no SEC registration is required. Debtors may use other exemptions in conjunction with § 1145 to avoid registration.
  - Oversubscription Right: The right to subscribe for unsold rights remaining after subscription period.
  - Overallotment Right: The right to purchase an additional, predetermined amount of interests should offering be fully subscribed.
  - Transferability: Rights offerings are typically non-transferable (except together with the underlying claim) to avoid jeopardizing registration exemptions.

RSAs and Rights Offerings

- RSAs are typically coupled with a backstop agreement
  - This locks in the creditors providing the backstop to vote in favor of the plan
  - Provides the debtors with certainty that the plan and restructuring transactions will have necessary support to be consummated or expedited through a prepackaged filing
- Backstop agreements are routinely used in rights offerings to ensure that the Debtor benefits from the full amount of the investment regardless of subscription
- Typically, when Section 4(a)(2) is used or some purchasers will become affiliates, the purchasers will require registration rights pursuant to a registration rights agreement
- Backstop agreements (also known as equity commitment agreements) typically include:
  - Commitment fee
    - Frequently 2-7% of total commitment amount, but varies
    - May be payable even if rights offering and plan are not consummated
    - Frequently payable in equity but can be structured as a cash fee (e.g., if the plan is not consummated)
  - Sometimes a separate break-up fee in the event of an alternative transaction
  - Expense reimbursement
  - Termination rights

RSAs and Rights Offerings

The following levers are frequently utilized to generate value for participating investors:

Discounted Equity Purchase

- Rights to purchase equity are granted at a discount to transaction value (or the transaction value can be set at a discount to market value)
- Allows participants in an RO to obtain a disproportionate share of ownership in exchange for their willingness to invest new capital

Backstop Fee

- Fee paid to certain specified investors (the "Backstop Parties") who agree to fund any shortfall due to other parties' failing to exercise their rights
- Backstop Parties are paid a fee in exchange for their commitment, which can be in the form of cash, equity or note

Allocation / Holdback

- Can be allocated entirely to one tranche of stakeholders or multiple tranches
- Certain investors in the rights offering are guaranteed a specific allocation of the new money investment, regardless of their pre-transaction positions

Backstop Waterfall Structure

- Structure in which Backstop Parties agree to the order in which they will fulfill their backstop commitments, such that certain investors are more likely to fund a shortfall than others
- Can be combined with a tiered backstop fee in which certain Backstop Parties get paid a larger fee in exchange for a greater probability of funding

II. Risks & Hidden Flexibilities in Loan Documentation

Hidden Flexibilities

INTRODUCTION

- As the supply/demand imbalance has continued to spur more aggressive terms, it is worthwhile identifying certain of the aggressive provisions that have made their way into loan facilities over the past few years, analyzing the ways in which such provisions have provided sponsors and aggressive borrowers with greater flexibility and suggesting potential mitigants and solutions for these provisions.
- Several themes explored in this section are:
  - ***Hidden Flexibility with Ring-fencing*** – a variety of techniques borrowers have sought to use to maximize flexibility to move assets around a corporate group into entities against which lenders do not have claims, thereby creating alternative financing options and maximizing dividends/distributions and the ability to make acquisitions and take other corporate actions.
  - ***Hidden Flexibility with Priority*** – ways in which borrowers seek to preserve flexibility in adjusting their capital structure, with sometimes surprising results.
  - ***Hidden Flexibility with Leverage*** – ways in which borrowers seek to maximize the incremental leverage they may incur, which may not be always fully understood by the market.

Hidden Flexibilities

INTRODUCTION (CONT.)

A careful review of all applicable debt documents is necessary to fully assess the risks associated with participation in a liability management transaction

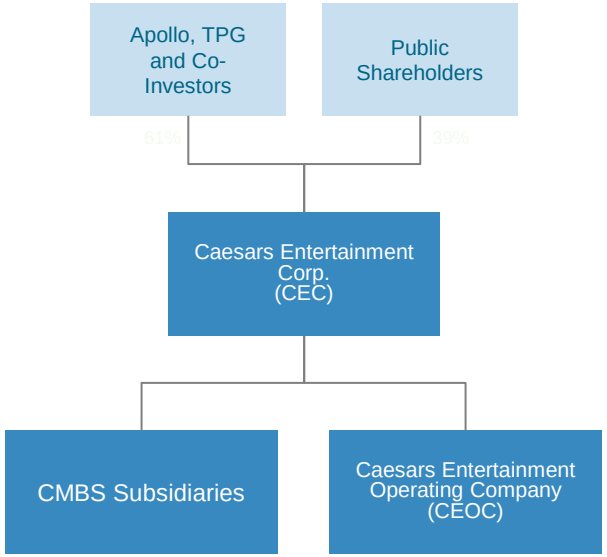
- Key provisions to review and evaluate include:
  - Investments covenant baskets
  - Debt and lien covenant baskets
  - Collateral exclusions
  - Guarantor definition
  - Asset sales provisions
  - If applicable, sponsor-related provisions
  - Amendments and voting provisions
  - Pro rata sharing and waterfall provisions
- Also important to review: Collateral agreements, such as a security or pledge agreement, collateral trust agreement and mortgages, and intercreditor agreement
  - These documents may contain additional restrictions on the ability of secured creditors to engage in certain transactions
- A collateral analysis may also be necessary to evaluate lien perfection
  - A fulsome collateral analysis requires third-party lien searches, an inventory of possessory collateral, title searches and other steps that may be costly and take significant time to complete

Hidden Flexibility with Ring-Fencing

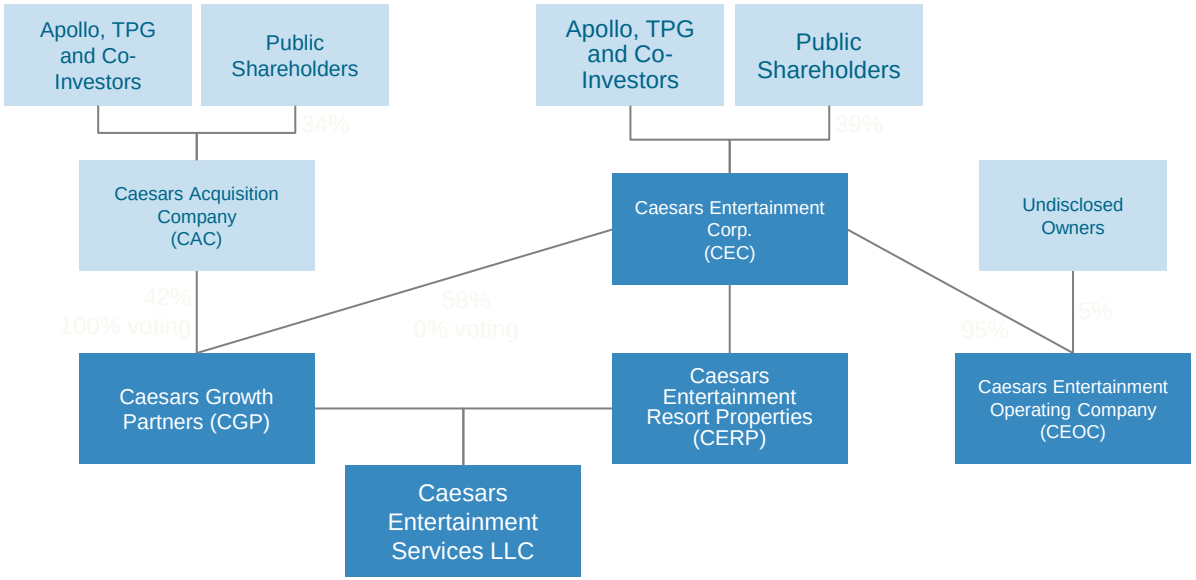
INTERCOMPANY TRANSFERS – CASE STUDY: CAESARS

- Before a series of contested intercompany transactions, Caesars' organizational structure was simple, with most operating assets concentrated in CEOC. Caesars then completed a series of restructuring transactions through which various assets were assigned from CEOC to other silos under CEC

Before:



After:



Hidden Flexibility with Ring-Fencing

INTERCOMPANY TRANSFERS – CASE STUDY: CAESARS (CONT.)

Through a series of transfers, both before and after the creation of CGP and CAC, substantial assets are transferred out of CEOC's direct or indirect ownership and to CGP and other CEC subsidiaries

- August 2010: Certain property-specific trademarks are assigned to the CMBS issuers, which were not liable for CEOC's debt
- Between April 4 and Nov. 2011: 96.4% interest in Caesars Interactive Entertainment, Inc. ("CIE") transferred from a CEOC subsidiary to a CEC subsidiary
- Aug-Sep 2013: Las Vegas properties Project Linq and Octavius Tower transferred from a CEOC subsidiary to Caesars Entertainment Resort Properties, LLC ("CERP") through a series of intercompany transfers
- October 2013: CEOC transferred its equity interest in Planet Hollywood Resort & Casino Las Vegas and its JV interests in Horseshoe Baltimore Casino, together with 50% of management fees, to CGP
- March 2014: CEOC transferred four casino properties, The Cromwell, The Quad, Bally's Las Vegas, and Harrah's New Orleans, together with 50% of the management fees payable to CEOC from those four properties, to CGP
- March 1, 2014, CEC caused CEOC to enter into an agreement under which CEOC and other licensor entities will grant Caesars Enterprise Services, LLC, a new JV of CEOC, CERP, and CGP, a non-exclusive, irrevocable, worldwide, royalty-free license to all IP owned or used by the licensors

Hidden Flexibility with Ring-Fencing

INTERCOMPANY TRANSFERS – CASE STUDY: CAESARS (CONT.)

- These intercompany transfers resulted in significant assets leaving the credit group and were made possible by limited asset sale transfer protections, including the customary general unlimited basket, subject to FMV consideration and receipt of at least 75% cash consideration.
- Caesars has also taken the view that many of the relevant transactions could have qualified as "Permitted Investments", which are carved out of "Asset Sales" (Caesars' first and second lien indentures had large general investment baskets with no conditions to use).
- At issuance of the notes, CEC (issuer's parent company) guaranteed CEOC's first lien and second lien notes. However, the relevant indentures included guarantee release language and CEC took the position that it had terminated its guarantees:
  - One release provision provided that the Parent Guarantee shall terminate upon:

    (i) the Issuer ceasing to be a Wholly Owned Subsidiary of Caesars Entertainment [*After giving effect to certain asset sales, CEC's ownership interest in CEOC was approximately 89%*];

    (ii) the Issuer's transfer of all or substantially all of its assets to, or merger with, an entity that is not a Wholly Owned Subsidiary of Caesars Entertainment in accordance with Section 5.01 and such transferee entity assumes the Issuer's obligations under this Indenture; **and**

    (iii) the Issuer's exercise of its legal defeasance option or covenant defeasance option under Article VIII or if the Issuer's obligations under this Indenture are discharged in accordance with the terms of this Indenture
  - Another release provision provided that the Parent Guarantee shall terminate **upon the election of the Issuer and Notice to the Trustee** if the guarantee by Caesars Entertainment of the Credit Agreement, the Existing Notes **or any Indebtedness** which resulted in the obligation to guarantee the Notes has been released or discharged.
    - Caesars issued a "belt and suspenders" announcement that CEOC had elected to effect the automatic release of CEC's guarantee of each series of notes for the additional reason that CEC's guarantee of other notes specified in the applicable indentures had been released

Hidden Flexibility with Ring-Fencing

INTERCOMPANY TRANSFERS

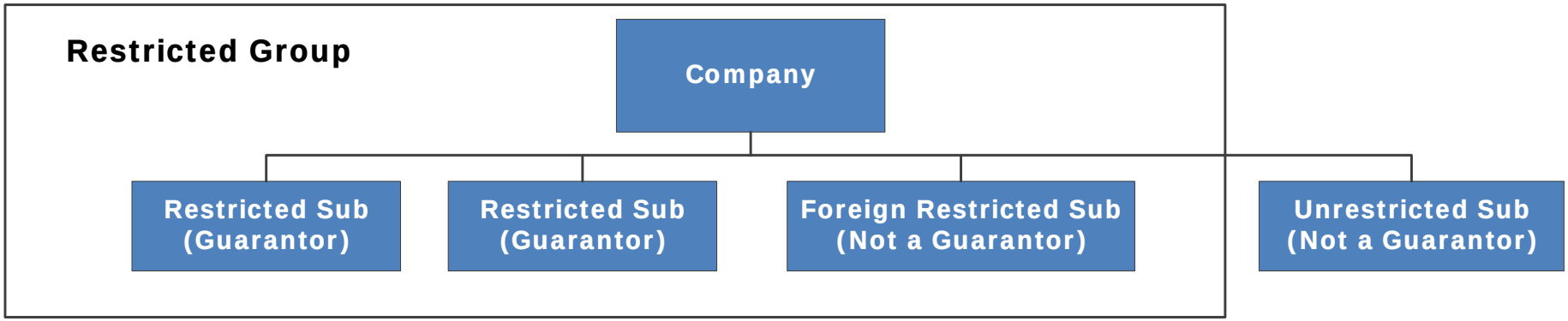
- **Mitigants/Solutions**
  - If a parent company guarantee is contingent upon the borrower/issuer being a wholly-owned subsidiary of the parent, ensure that the borrower/issuer remains a wholly-owned subsidiary (or that any successor parent assumes guarantee obligations).
    - Relatedly, if any subsidiary will be released from its guarantee upon becoming a non-wholly-owned subsidiary, ensure there are appropriate parameters around the sale of any stock of such subsidiary to prevent the release of such subsidiary's guarantee (along with its assets pledged as collateral).
  - If "Permitted Investments" don't constitute Asset Sales governed by the asset sale covenant, appropriately size any general investment baskets to avoid significant collateral leakage from the credit group.

Hidden Flexibility with Ring-Fencing

TRANSFERS TO UNRESTRICTED SUBSIDIARIES

Only the Issuer/Borrower and its Restricted Subsidiaries are subject to the representations, covenants and events of default in debt documents

- Even Restricted Subsidiaries that are not guarantors must comply with such provisions in debt documents



Unrestricted Subsidiaries are not subject to the covenants

- Issuers/Borrowers may attempt to move assets to unrestricted subsidiaries to take actions from which they are otherwise prohibited
- Depending on how large an Issuer/Borrower's restricted payments/investment baskets are, creatively using unrestricted subsidiaries could divert material value away from creditors
- Designating a subsidiary as an unrestricted subsidiary is itself typically considered an investment
- As seen in the recent *iHeart* litigation, creditors may attempt to stop value leakage to unrestricted subsidiaries by arguing that investment baskets do not apply to certain intercompany transactions

Hidden Flexibility with Ring-Fencing

TRANSFERS TO UNRESTRICTED SUBSIDIARIES (CONT.)

- **Issue:** Historically, unrestricted subsidiary capacity was intended to allow borrowers to carve out from the covenant and collateral package certain subsidiaries and business that were not considered part of the core credit. For example, unrestricted subsidiary capacity is useful in separating out project or receivables financings and in temporarily housing the financing for an acquisition prior to consummation (e.g., in an escrow closing structure).
  - Designating a subsidiary as unrestricted was traditionally subject to pro forma compliance with a ratio test and absence of default (and may also be subject to additional fixed dollar caps). As these provisions have evolved, however, restrictions have loosened, so that the typical formulation today often does not include a ratio test as a condition to designation, so long as the deemed investment in such unrestricted subsidiary would be permitted by the investment covenant.
- Over the past few years, unrestricted subsidiaries have been utilized in sometimes unexpected ways, including recently by retailers seeking out-of-court liability management solutions
  - The ability to “invest” in unrestricted subsidiaries is often broader than many realize, as most investment baskets (including the ratio investments basket) are generally available for this purpose.
  - Furthermore, certain credit facilities allow unrestricted subsidiaries or proceeds of the sale of assets of unrestricted subsidiaries to be distributed to shareholders, not subject to any conditions.
  - Dividends paid by an unrestricted subsidiary may also be distributed, either directly or via building the available amount/cumulative credit basket.
  - Taken together, the current unrestricted subsidiary structure may be – and has been – used to allow a borrower to achieve an outcome that it might not otherwise be able to accomplish.

Hidden Flexibility with Ring-Fencing

TRANSFERS TO UNRESTRICTED SUBSIDIARIES (CONT.)

- **Mitigant:**
  - The chief mitigant for these fact patterns cited by borrowers is that none of the above should be a surprise; as long as the investment of assets in an unrestricted subsidiary is permitted by the credit facility, subject to the agreed limits, the borrower should have the free ability to deal with such assets thereafter.
    - The counterpoint from lenders is that the unrestricted subsidiary concept was always intended to serve a legitimate business purpose, not to accomplish indirectly what borrowers cannot accomplished directly.

- **Solution:**
  - Were borrowers able to invest cash in unrestricted subsidiaries and then simply distribute the assets of or equity in unrestricted subsidiaries to its shareholders, it would effectively convert all investments baskets into RP capacity, in clear violation of the spirit of the credit facility. One way to reduce this risk is to permit the distribution from an unrestricted subsidiary solely to the extent the assets of such unrestricted subsidiary are not primarily cash. This, however, is far from a perfect answer and would still leave the possibility of the borrower's spinning out an entire business.
  - Another possibility is to more tightly control investments in unrestricted subsidiaries (e.g., exclude the use of the ratio investment basket for such purpose, limit investments to the specific unrestricted subsidiary basket and prohibit the investment of IP (as we have seen in a few recent deals)).
  - Perhaps a more fruitful approach would be to add a ratio test on the designation of unrestricted subsidiaries that mirrored the RP ratio condition for use of the available amount basket (or at least pro forma financial covenant compliance).
    - Note the ratio should ideally be tested at the time the investment is made rather than the time of designation (though this is not the way the market approaches it).
  - It is also important to closely analyze the circumstances in which distributions from an unrestricted subsidiary build available amount capacity or increase EBITDA for financial covenant calculations. In certain formulations, distributions from an unrestricted subsidiary build EBITDA even if such distribution was not attributable to the CNI of such unrestricted sub (e.g., a debt-funded dividend).

Hidden Flexibility with Ring-Fencing

TRANSFERS TO UNRESTRICTED SUBSIDIARIES – CASE STUDY: iHEART

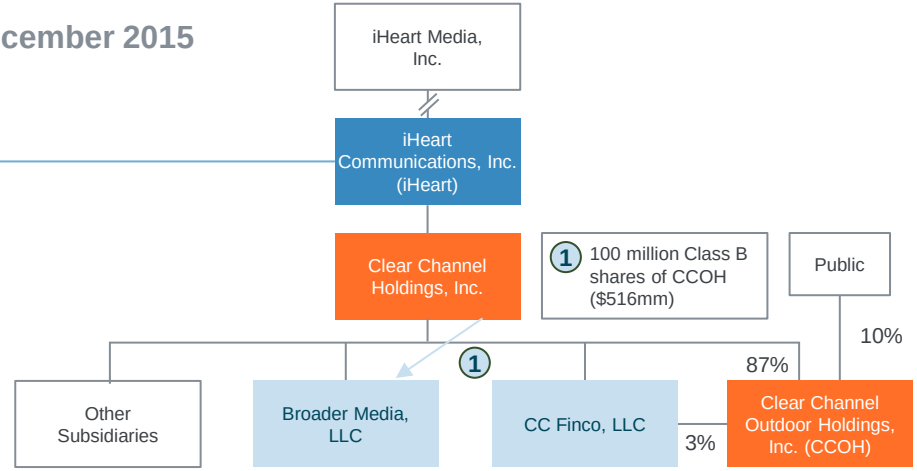
iHeart

- iHeart's capital structure includes multiple series of priority guarantee notes, or "PGNs." The PGNs have substantially similar covenant packages
- An iHeart subsidiary, Clear Channel Holdings (CCH) (a restricted subsidiary under the PGNs), transferred 100 million shares of stock in Clear Channel Outdoor Holdings to Broader Media (an unrestricted subsidiary under the PGNs)
  - The purpose of the transfer was to facilitate repurchases by Broader Media of debt issued by iHeart, which was trading at a discount. Broader Media ultimately used the value of the shares transferred from CCH to repurchase the debt
- iHeart characterized the transfer as an "Investment," and relied on its general and certain other investment baskets to make the transfer
- A group of noteholders argued that the transfer was not permitted under the PGNs—i.e., it was not in fact an investment—and sent notices of default
- In response to the notices of default, iHeart filed for declaratory judgment, seeking a finding that no default occurred because the transfer was an "Investment" under the PGNs
- iHeart prevailed at trial and on appeal
- The Texas Court of Appeals concluded that "only iHeart's interpretation of the pertinent language is reasonable" and, despite the noteholders' assertion, the indenture "[did] not require the existence of a 'profit motive'" for a transfer to constitute an Investment

Hidden Flexibility with Ring-Fencing

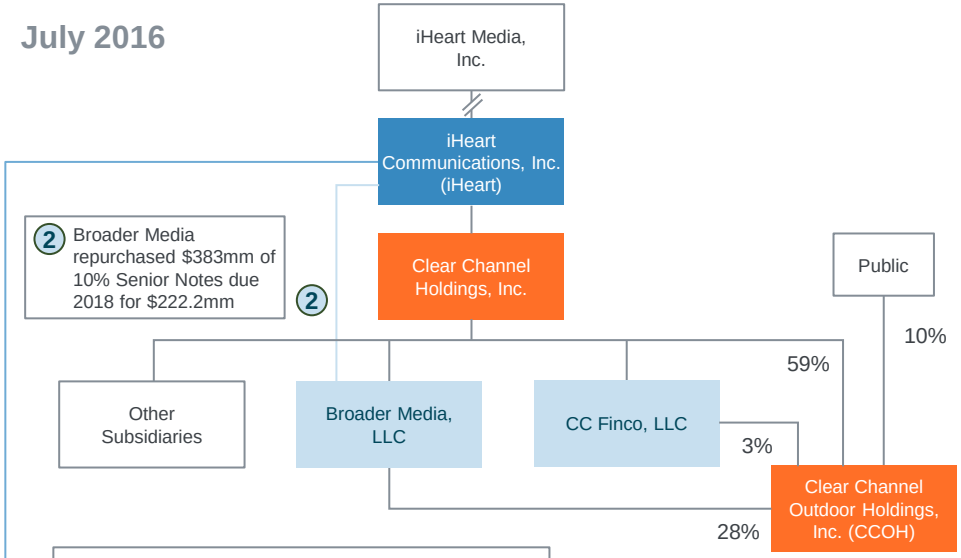
TRANSFERS TO UNRESTRICTED SUBSIDIARIES – CASE STUDY: iHEART (CONT.)

December 2015



$6.5bn Senior Secured Credit Facilities
$2.0bn 9% PGNs due 2019
$1.75bn 9% PGNs due 2021
$575mm 11.25% PGNs due 2021
$1bn 9% PGNs due 2022
$950mm 10.625% PGNs due 2023
$1.7bn 14% Senior Notes due 2021
$730mm 10% Senior Notes due 2018
$193mm 5.5% Senior Legacy Notes due 2016
$175mm 6.875% Senior Legacy Notes due 2018
$300mm 7.25% Senior Legacy Notes due 2027

July 2016



$6.6bn Senior Secured Credit Facilities
$2.0bn 9% PGNs due 2019
$1.75bn 9% PGNs due 2021
$575mm 11.25% PGNs due 2021
$1bn 9% PGNs due 2022
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$1.7bn 14% Senior Notes due 2021
$347mm 10% Senior Notes due 2018
$193mm 5.5% Senior Legacy Notes due 2016
$175mm 6.875% Senior Legacy Notes due 2018
$300mm 7.25% Senior Legacy Notes due 2027

Issuer
Restricted Subsidiary
Unrestricted Subsidiary

Hidden Flexibility with Ring-Fencing

TRANSFERS TO UNRESTRICTED SUBSIDIARIES – CASE STUDY: J.CREW

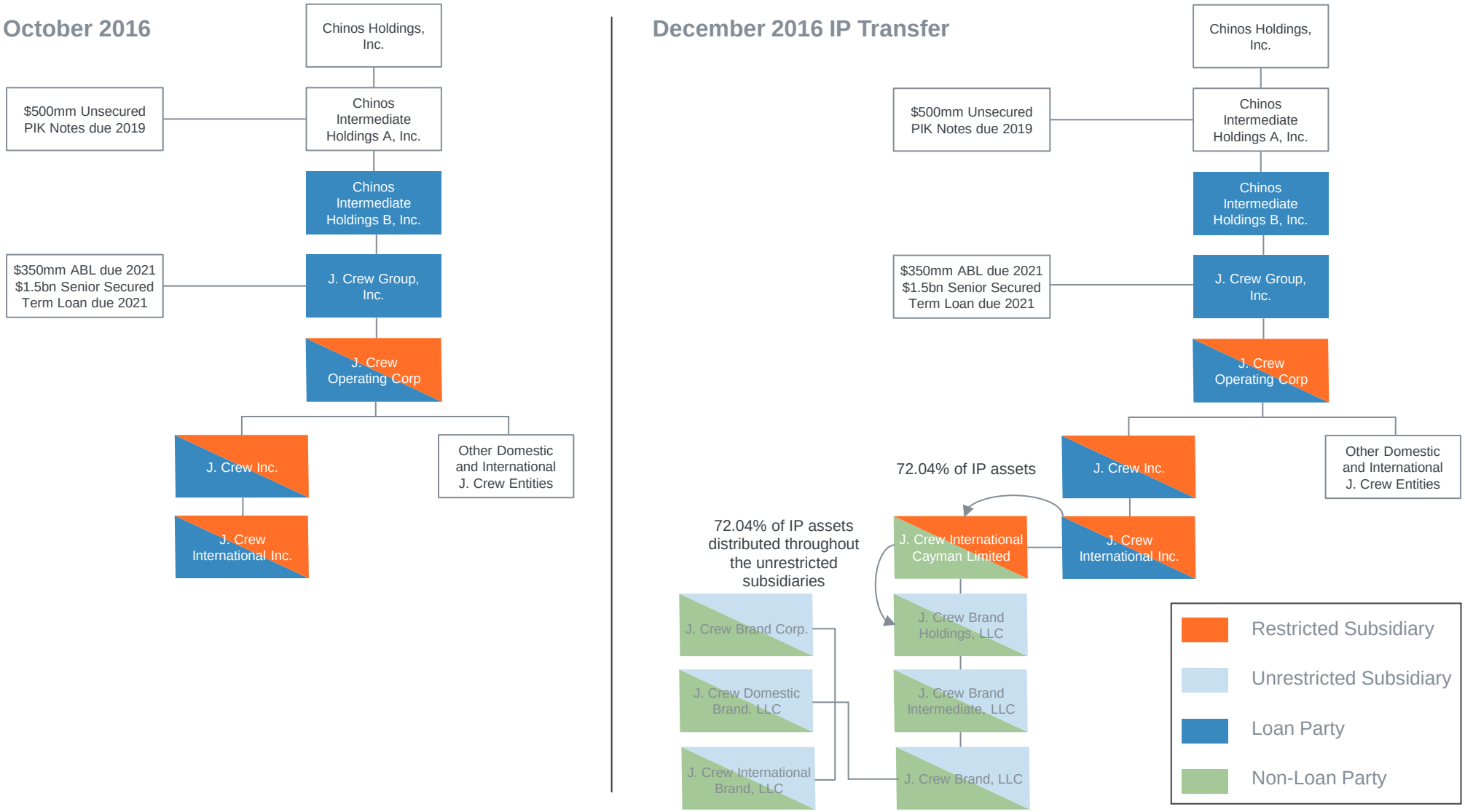
J.Crew

December 2016 Initial IP Transfer and Related Litigation

- In December 2016, J.Crew International contributed a portion of its valuable intellectual property to a newly created unrestricted subsidiary, via a foreign restricted subsidiary (J.Crew Cayman). The IP assets had been collateral securing the company's $1.5 billion term loan, but were released as a result of the December transaction
- On February 1, 2017, J.Crew Group, Inc. and certain of its affiliates filed a complaint against Wilmington Savings Fund Society (WSFS), the term loan administrative agent, seeking a declaratory judgment that the transfer of IP assets was expressly permitted by and complied with the terms of the credit agreement and that no default or event of default occurred or was continuing as a result of the transfer
- WSFS filed an answer to the complaint and asserted counterclaims seeking declaratory and other relief, including claims that the December transaction violated the term loan credit agreement and was an intentional fraudulent transfer
- The parties disputed, among other things:
  - The interpretation of the credit agreement's Investment baskets, including whether the transfer of the IP assets constituted a permissible "Investment" and whether the IP assets transferred to the new unrestricted subsidiary qualified as "proceeds" of the Investment from J.Crew International into J.Crew Cayman;
  - Whether the company was able to designate an Unrestricted Subsidiary (which required that the pro forma Consolidated Leverage Ratio not exceed 6.0x); and
  - Whether the affiliate transaction was on terms as favorable to the Borrower and its Restricted Subsidiaries as would be obtainable in an arm's-length third-party transaction, because, as part of the IP transfer, the company and its newly created entities also entered into an exclusive, non-transferable license agreement pursuant to which J.Crew International was able to continue using the IP assets in the operation of J.Crew's business in exchange for license payments to the unrestricted subsidiary

Hidden Flexibility with Ring-Fencing

TRANSFERS TO UNRESTRICTED SUBSIDIARIES – CASE STUDY: J.CREW (CONT.)



Hidden Flexibility with Ring-Fencing

TRANSFERS TO UNRESTRICTED SUBSIDIARIES – CASE STUDY: J.CREW (CONT.)

J.Crew (cont.)

June 2017 Exchange Transaction and Consent Solicitation and Related Litigation

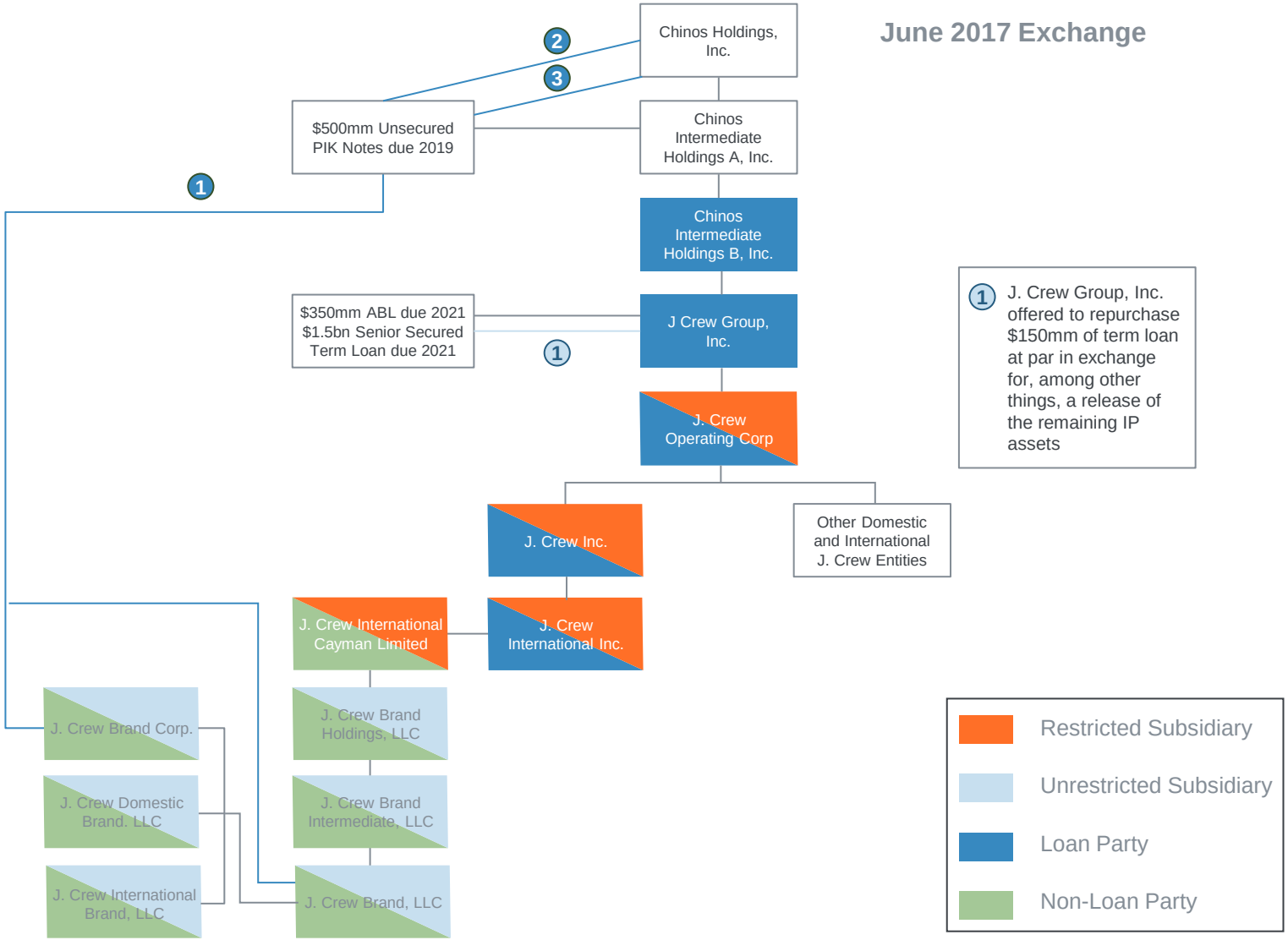
- Following negotiations between J.Crew and certain holders of its unsecured PIK notes, in June 2017, the newly created unrestricted subsidiary commenced a private offer to exchange J.Crew's unsecured PIK notes for new senior secured notes secured by, among other things, the IP assets that were transferred in December 2016. 99.85% of PIK notes participated in the exchange
- The company also solicited consents from the term loan lenders for a series of transactions and amendments to the credit agreement that would transfer the remaining IP assets to the new entities and settle and dismiss the February 2017 litigation between the company and WSFS. The company received consents from 88% of principal amount of term loans
- After a court denied their efforts to enjoin the June 2017 transactions, certain minority term loan lenders who did not consent to the June 2017 transactions filed a lawsuit seeking to restore the transferred IP collateral or for its equivalent value as damages. The objecting lenders also seek a declaration that the transactions constitute a fraudulent conveyance made with actual intent to defraud, and reiterate many of the counterclaims asserted by the administrative agent in the February 2017 litigation
- The parties dispute, and the court has requested discovery concerning, whether the IP transactions involved a transfer of "all or substantially all" of the collateral securing J.Crew's term loan obligations (and thus whether the transfers required the consent of each Lender under the terms of the credit agreement)
- The court recently granted the defendants' motion to dismiss the minority lenders' remaining claims, finding that the plaintiffs lack standing and their claims are precluded by the collective action provisions and no action clause in the credit agreement. If the plaintiffs prevail on their argument that "all or substantially all" of the collateral was transferred, the court will conduct a second round of discovery on the merits of the plaintiffs' claims for breach of sections 7.04 and 7.05 of the credit agreement, which prohibit disposition of the collateral

Hidden Flexibility with Ring-Fencing

TRANSFERS TO UNRESTRICTED SUBSIDIARIES – CASE STUDY: J.CREW (CONT.)

Unsecured PIK Notes due 2019 exchanged for:

1. $250mm of 13% senior secured notes issued by J. Crew Brand LLC & J. Crew Brand Corp. and secured by, among other things, the IP assets
2. $190 mm of 7% preferred stock of Chino Holdings, Inc.
3. 15% of the equity of Chino Holdings, Inc.



Hidden Flexibility with Ring-Fencing

TRANSFERS TO UNRESTRICTED SUBSIDIARIES – CASE STUDY: J.CREW (CONT.)

J.Crew (cont.)

IP-Specific Arguments

- The parties dispute the value of the IP collateral that was transferred to the unrestricted subsidiaries
  - Relevant for determining (i) compliance with the permitted investments basket in the term loan credit agreement, and (ii) whether the transfer of the IP assets to the unrestricted subsidiaries constituted a transfer of "all or substantially all" of the collateral securing the term loan (thus requiring consent of each term loan lender, as opposed to majority lender consent)
- The plaintiffs assert that the transfer of a percentage of an "undivided interest" in the IP assets is indistinguishable from exclusive license to the assets in their entirety, and that the value of intellectual property arises from the ability to control use of the brand for commercial gain, which requires use and control of the whole
  - Therefore, the plaintiffs assert that the transfer of a portion of the IP assets to the unrestricted subsidiaries, even if it was only a 72% "undivided interest," carried with it the right to control the J.Crew brand and the right to convey a full, 100% license, and this devalued the IP assets that remained with the restricted subsidiaries

Hidden Flexibility with Ring-Fencing

TRANSFERS TO UNRESTRICTED SUBSIDIARIES – CASE STUDY: PetSmart

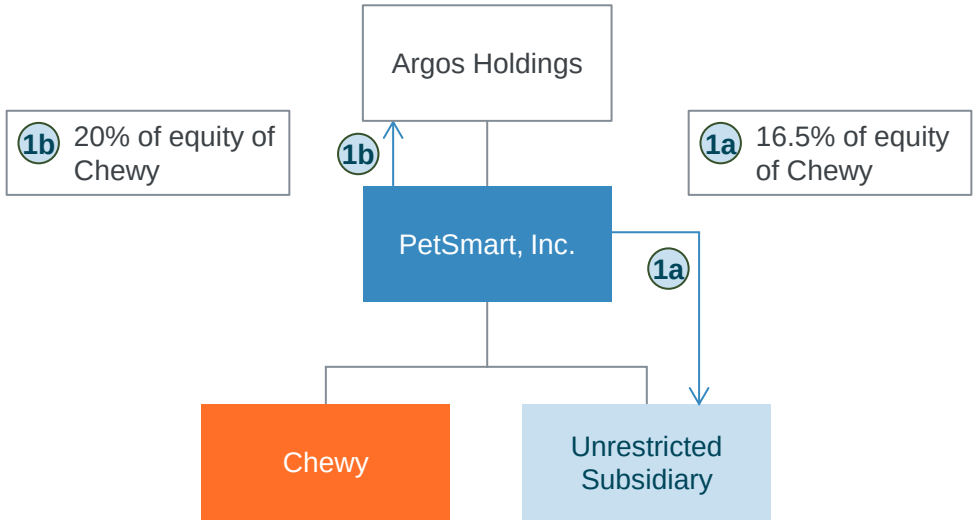
PetSmart

- PetSmart recently spun out a 16.5% stake in Chewy to a wholly-owned unrestricted subsidiary of PetSmart. The company also declared a June 1 dividend to its parent company, Argos Holdings, in the form of 20% of the outstanding stock in Chewy
- As a result of the Chewy transactions, Chewy is no longer a wholly-owned subsidiary of PetSmart, and the unit's term loan guarantees have been released, resulting in the release of the guarantee under PetSmart's senior notes as well
- PetSmart has claimed to have no less than $1.2 billion of investment capacity and $1.2 billion of restricted payments capacity under its credit agreement
- PetSmart indicated that the equity transferred to the unrestricted subsidiary was made pursuant to the general investment basket and the equity transferred to parent company Argos Holdings was made using restricted payments capacity
- PetSmart valued Chewy at $4.54 billion. Therefore, the implied value of the unrestricted subsidiary transfer is approximately $750 million and the implied value of the transfer to Argos Holdings is approximately $908 million
- PetSmart also disclosed that it will continue to evaluate its capital structure and pursue additional transactions
- PetSmart acquired Chewy.com, an online pet supply retailer, in April 2017 for $3 billion dollars

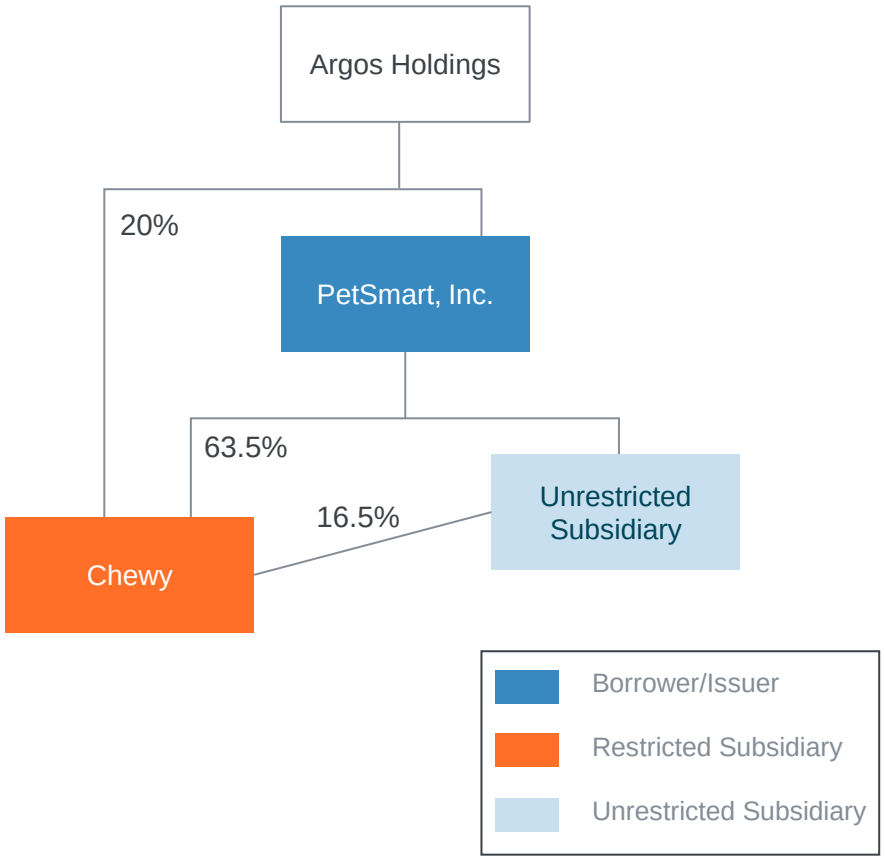
Hidden Flexibility with Ring-Fencing

TRANSFERS TO UNRESTRICTED SUBSIDIARIES – CASE STUDY: PetSmart

Before



After



Hidden Flexibility with Priority

NON-PRO RATA APPLICATION OF PREPAYMENTS

Issue: Contrary to the traditional expectation that the free cash flow of borrowers is to be applied pro rata among the senior lenders:

- The ability to do non-pro rata on-market buybacks and to give dollar-for-dollar credit for the amount spent to acquire such debt against the (pro rata) ECF sweep permits the borrower to favor selling lenders.
  - **Mitigant:** Most borrower buybacks tend to happen through Dutch auctions (though rarely mandated), in which case each lender will have an opportunity to bid for its pro rata share. Also, as these repurchases tend to happen at a discount to par, there is a deleveraging event, which arguably benefits the credit as a whole.
- Prepayments of junior lien debt are deducted from ECF (that is otherwise swept to the senior lenders) on a dollar-for-dollar basis permits the borrower to favor junior lenders.
  - **Mitigant:** The prepayment of junior debt should be (though is not always) subject to a cap or other parameters and would result in a deleveraging.
- The ability to deduct from ECF on a dollar-for-dollar basis prepayment of senior lien debt (and/or to share ECF on a ratable basis with other pari secured debt) permits the borrower to favor (or at least provide equal benefit to) *pari passu* lenders.
  - **Mitigant:** As above, this too represents a deleveraging event.

Solution: These provisions appear to be fairly well accepted, though they should be considered in each transaction as they push against the fundamental assumption of pro rata treatment.

Hidden Flexibility with Priority

AMENDMENTS TO PRO RATA SHARING AND WATERFALL PROVISIONS

- Waterfall provisions typically address application of payments from proceeds of collateral following an event of default and acceleration and provide for all lenders to receive their principal and interest on a pro rata basis
- Amendment provisions in credit agreements sometimes require the consent of all lenders or each affected lender to amend a waterfall provision
  - However, many credit agreements have no such “all lender” or “affected lender” amendment requirement, meaning that the waterfall provision can be amended by the required lenders – typically a bare majority
- If lenders holding a majority of the loans can amend the waterfall provision, they may be able to split the loans under the credit agreement into multiple tranches, with loans in one tranche receiving priority and loans in another tranche becoming effectively subordinated
  - Modifications to the waterfall provision could be used to coerce participation in an amendment or other transaction (e.g., consenting lenders receive priority over non-consenting lenders)
  - Alternatively, a majority could theoretically amend the waterfall provision to elevate the priority of their own loans over the other loans
  - Subordination pursuant to a modified credit agreement waterfall provision would not necessarily be enforceable in bankruptcy
  - It is not entirely clear that a waterfall provision amended without the consent of the subordinated creditors would be enforced as a “subordination agreement” under section 510(a) of the Bankruptcy Code

Hidden Flexibility with Priority

AMENDMENTS TO PRO RATA SHARING AND WATERFALL PROVISIONS (CONT.)

- Example of amendment provision with "all lender" consent requirement for amendments to the waterfall:
  - Secured Credit Agreement of C&J Energy Services Ltd., dated March 24, 2015, as amended by the Third Amendment (Refinancing Amendment) to Credit Agreement, dated September 29, 2015 – Section 10.01(f)(i):

    "no . . . amendment, waiver or consent shall . . . (f) change (i) Section 8.03 [*waterfall provision*] in a manner that would alter the pro rata sharing of payments required thereby without the written consent of each Lender"

- Variation – provision permitting amendment to waterfall provision with the consent of the majority of an affected "Class" (typically defined as all lenders (or loans) under a particular series of revolving loans, term loans, etc.)
  - This formulation prevents one "Class" from discriminating against/subordinating another (e.g., term lenders modifying the waterfall to subordinate the revolving lenders)
  - However, this formulation does not necessarily protect against subordination within a class (e.g., term lenders that support an amendment subordinating the term lenders that do not consent)
    - The act of subordination would likely make the consenting term lenders a different class from the non-consenting term lenders. However, at the time the amendment is entered into, the lenders would still be in the same class
  - Example – First Lien Credit Agreement of RCS Capital Corporation, dated April 29, 2014 – excerpt from Section 9.08(b):

    "no [amendment or modification] agreement shall . . . (vi) change the relative priorities of the Obligations secured by the Collateral without the prior written consent of Lenders holding a majority in interest of the outstanding Loans and unused Commitments of each adversely affected Class"

Hidden Flexibility with Priority

AMENDMENTS TO PRO RATA SHARING AND WATERFALL PROVISIONS (CONT.)

- Sharing provisions typically provide for pro rata sharing among the lenders in a given class of all payments received in respect of the loans. If a lender receives consideration disproportionate with or not provided to the other lenders in the class, that lender is generally required to turn over the excess amount received to be distributed ratably by the agent among the rest of the class
- Credit agreements often (but do not always) require "all lender" or "affected lender" consent within the class to modify the sharing provision
- If a sharing provision can be amended by a bare majority, then the majority could potentially modify the sharing provision to provide for selective payments
  - For example, the majority lenders could "roll up" the priority of their debt, by (A) amending the credit agreement to permit a new super-senior loan, (B) funding that super-senior loan and (C) using the proceeds of that super-senior loan to repay just their own loans under the existing credit facility
    - A pro rata sharing provision normally prevents this, but could be amended to permit it
  - A sharing provision could also be amended to permit a partial paydown of consenting lenders' loans that is not made available to non-consenting lenders
- Example of amendment provision with all lender consent requirement for amendments to the sharing provision:
  - C&J Energy Services Ltd., Section 10.01(f)(iv):

"no . . . amendment, waiver or consent shall . . . (f) change . . . (iv) modify the sharing provisions of Section 2.13 [pro rata sharing] without the written consent of each Lender directly affected thereby"

Hidden Flexibility with Leverage

"STACKING"

Issue:

- High-yield bond documentation historically permitted issuers to (x) incur indebtedness up to a 2x fixed charge coverage ratio (subject to a non-guarantor cap) and (y) secure such indebtedness up to a maximum secured leverage ratio.
- In recent years, this concept has migrated into loan documentation, often with a revised formulation permitting incremental indebtedness subject to three independent tests, depending on the priority of the debt being incurred:
  - A maximum first-lien secured leverage ratio governs if first-lien debt is being incurred;
  - A maximum total secured leverage ratio governs if second-lien debt is being incurred; and
  - A maximum total leverage ratio (or minimum fixed charge coverage ratio) governs if unsecured debt is being incurred.
- Taken together, a borrower may first incur unsecured indebtedness up to the maximum total leverage ratio (or minimum fixed charge coverage ratio); second incur second-lien indebtedness up to the maximum total secured leverage ratio, and finally, incur first-lien indebtedness up to the maximum first-lien leverage ratio. In contrast to a high-yield bond, the aggregate incremental indebtedness may, in the aggregate, exceed the maximum total leverage or minimum fixed charge coverage ratio.

Hidden Flexibility with Leverage

"STACKING" (CONT.)

- **Mitigant:** Exploiting this flexibility would require finding lenders willing to lend in excess of the applicable maximum total leverage ratio (or minimum fixed charge coverage ratio) and there do not appear to be many instances, in practice, in which a borrower has successfully utilized this loophole
- **Solution:** Require that all incurrence of "ratio-debt" comply with both a maximum total leverage ratio (or minimum fixed charge coverage ratio) governor as well as the relevant maximum first lien/secured ratio test (consistent with the high-yield bond paradigm)
- **Variant:** A variation of this "wedding cake" approach is for incremental indebtedness (and "incremental equivalent" debt) to be tested against a single maximum first lien leverage ratio.
  - In such cases, it is imperative that any junior lien or unsecured incremental indebtedness permitted to be incurred in reliance on such ratio be deemed to be "first-lien debt" both for purposes of such ratio as well as all future debt and lien incurrence ratios test. If this were not the case, the borrower would have an unlimited debt basket (either immediately or for future debt incurrence) to the extent of junior lien or unsecured debt incurred.

Hidden Flexibility with Leverage

LAYERING

Issue:

- When putting in place a capital structure consisting of multiple layers of lien priorities (e.g., a first-lien/second-lien financing), it is important to understand whether there are restrictions on the borrower incurring "1.5 lien" debt (i.e., debt that is junior in lien priority to the first-lien, but senior to the second lien debt). If the flexibility to incur such "layering" debt exists, the following considerations arise:
  - ***"MFN" Protection*:** "Most favored nation" pricing provisions are intended to protect existing lenders from more favorable pricing of future *pari passu* debt. As 1.5 lien debt is *pari passu* with neither the first-lien nor second-lien debt, it may be exempt from such protections at both levels.
  - ***Capital Structure*:** While second-lien lenders expressly agree to the quantum of debt that may be senior to them, they may not anticipate that such priority debt would include an entirely new class of debt, which may lead to a more complicated capital structure, especially in connection with a restructuring.
  - ***Leverage Ratio Calculations*:** In certain deals, 1.5 lien debt is not included in the first-lien debt ratios/caps as calculated under the second-lien credit facility (as such debt is subordinated to the first-lien debt), creating a loophole to incur unlimited priority (but not true first-lien) debt.
- **Mitigant:** Properly drafted credit facilities expressly address the MFN protection end-run and the leverage calculation exclusion (by treating all priority debt (including 1.5 debt) as first-lien for both purposes), which significantly mitigates the risks of such layering.
- **Solution:** The second-lien credit agreement should provide that any debt incurred on a junior lien basis to the first-lien loans be secured on either a *pari passu* or junior lien basis to the second-lien loans.

Hidden Flexibility with Leverage

"INDEBTEDNESS" AND CASH NETTING

Issue:

- ***"Indebtedness"*:** The definitions in certain agreements limit the scope of indebtedness included in financial covenant/ratio calculations to "debt for borrowed money," which excludes capital leases and purchase money debt as well as other material categories of debt (e.g., hedges and drawn letters of credit).
- ***"Secured Indebtedness*:** The definition of first lien/secured in certain deals is limited to indebtedness secured by the collateral. As above, such a narrow formulation would exclude capital leases and purchase money debt as well as debt incurred by foreign subsidiaries secured by assets of such subsidiaries (which are generally excluded from the collateral package). Where such a limited definition exists, a borrower may incur unlimited secured "ratio debt" at foreign subsidiaries, since the maximum first lien/secured leverage ratio condition would not include the incurrence of such debt.
  - **Mitigant:** with respect to the incurrence of "ratio debt" by non-loan parties, most credit agreements will include a non-guarantor debt sublimit to "ratio debt" baskets.
- ***Cash Netting*:** Credit agreements often permit borrowers to "net" some or all of their unrestricted cash against the principal amount of outstanding indebtedness for leverage ratio calculation purposes. In certain agreements, the proceeds of the debt being incurred may also be netted against that incurred debt in determining whether such debt is permitted, which fully offsets the effect of such incurrence on such leverage ratio.
  - **Mitigant:** Even in credit agreements that do not expressly exclude the proceeds of the incurred debt from permitted cash netting, such leverage ratio determination is often made giving pro forma effect to the use of such proceeds. As such, unless such proceeds are intended to be held on the balance sheet, it would be very difficult to argue that such proceeds should be netted.

Hidden Flexibility with Leverage

"INDEBTEDNESS" AND CASH NETTING (CONT.)

Solution:

- When defining "Secured Indebtedness," include (x) **all** debt of the borrower and restricted subsidiaries other than unsecured debt or (y) all debt secured by **any** asset of the borrower and its restricted subsidiaries.
- When defining "First Lien Indebtedness," include all debt secured by **any** asset of borrower or restricted subsidiaries other than pursuant to liens that are subordinated or junior to other liens (note, however, that lenders are generally willing to limit "First Lien Indebtedness" to debt that is secured *pari passu* with the first-lien credit facilities).
- Expressly provide in all cases that the proceeds of the indebtedness being incurred be excluded from any permitted netting in the applicable leverage ratio, even if intended to be held on balance sheet.

Hidden Flexibility with Leverage

RECLASSIFICATION

- **Issue:** The ability to reclassify debt among the various debt baskets, subject to certain parameters, is very common in high-yield bonds and has become more common in loan financings. If agreed upon, reclassification may create a number of loopholes, including allowing closing date debt to be reclassified as ratio debt, thereby creating a new and very large debt basket. In addition, borrowers have pushed to permit reclassification between the "freebie" and ratio baskets with respect to incremental indebtedness, thereby permanently reloading the freebie basket capacity.
  - **Mitigant:** Reclassification of incremental indebtedness is not, substantively, different from the more common reclassification among fixed-dollar baskets and a ratio basket in the debt covenant. However, it is contrary to the way that many lenders (and regulators) traditionally think about the incremental freebie basket.
- **Solution:** With respect to the debt covenant, expressly carve out any closing date debt basket from borrower's ability to reclassify. For incremental facilities, if such right is agreed upon, require that the borrower deliver written notice of such reclassification at the time of such reclassification to ensure that the lenders are able to track the freebie basket capacity Lenders should carefully consider (and do typically resist) expanding this right to permit reclassification of investments, restricted payments and similar baskets.
- **Variant:** A related provision is the right of borrowers to ignore the incurrence of debt under the "freebie" incremental basket for a concurrent incurrence of debt under the ratio incurrence test. This provision has been relatively uncontroversial so long as the two incurrences are contemporaneous. More controversial variations are the right of borrowers to ignore a concurrent utilization of the revolving credit facility and, more egregiously, to ignore any utilization of a "freebie" basket under any negative covenant (e.g., debt) when utilizing any ratio incurrence under any negative covenant (e.g., restricted payments).

Hidden Flexibility with Leverage

USING REFINANCING BUILDER TO CREATE UNLIMITED INCREMENTAL CAPACITY

Issue:

- Incremental facilities often contain the ability to build incremental "freebie" capacity by voluntarily prepaying loans under the credit agreement (or even other *pari passu* debt), the rationale being that the company has de-levered so incurring incremental debt in such amount should be a leverage-neutral event.
- One issue arises where the debt that is repaid – and increases "freebie" capacity – was originally incurred under the leverage-based prong of the incremental – by paying down such debt, the company would be preserving the ability to re-incur that "ratio debt" even at a time when it is not in compliance with the applicable ratio.
  - **Mitigant:** Many transactions allow this issue on the basis that at least the debt was permitted to be incurred under the applicable ratio at the time of incurrence and by definition there was deleveraging upon its prepayment.
- Another issue arises when such prepayment is made via a refinancing with the proceeds of other debt. In such a case, the borrower would remain levered at the same level, yet be able to incur additional debt in the future as a "freebie" (not subject to the leverage governor) under the incremental.
  - **Mitigant:** Properly drafted credit facilities will always exclude debt-financed prepayments (although in many cases this is limited to long-term debt, which creates the possibility of a revolver-financed basket build).
- A final issue is that if the incremental facility allows junior lien or unsecured debt, then the voluntary prepayment limb can result in building first-lien capacity using the repayment of junior lien or unsecured debt, without ever testing compliance with the first-lien leverage ratio.

Hidden Flexibility with Leverage

USING REFINANCING BUILDER TO CREATE UNLIMITED INCREMENTAL CAPACITY (CONT.)

- **Solution:** In addition to the mitigants noted above, push to exclude from the voluntary prepayments prong prepayments of the debt incurred under the ratio prong. And, at a minimum consider only permitting prepayments of senior secured debt to build the freebie.
- **Variant:** Some credit facilities have a separate exception from the debt covenant for refinancing of debt incurred under any other debt basket. Unless carefully drafted to ensure that any such refinancing continues to be utilization of the original basket, this could be used to perpetually refresh dollar baskets through refinancings. This could then be considered unintended “reclassification” flexibility.

Appendix A – Select Case Studies

Case Study: Denbury Resources Inc.

Denbury Resources Inc.

KEY TAKEAWAYS AND LESSONS LEARNED

Denbury

- **It is important to remain cohesive and unified**
  - Company-side advisors attempted to negotiate confidentially with individual large holders in the group in an attempt to create a “prisoner’s dilemma” and obtain the most favorable terms for the Company
- **A critical mass of holdings can minimize the ability of the Company to successfully negotiate around the group**
  - The ability to amass a significant block of subordinated noteholders (holding over $500 million in notes) increased the Ad Hoc Group’s leverage and weakened the ability of the company to negotiate with (or threaten to negotiate with) a competing group of holders
- **A deep understanding of the relevant credit documents (e.g., indentures, credit agreement, intercreditor agreement and security documents) helps frame negotiations**
  - Presenting a willingness to be flexible and come up with creative solutions for the Company that are actionable and permitted under the Company’s existing agreements can build confidence in ability of the group to follow through and close

Denbury Resources Inc.

BACKGROUND

- Denbury Resources Inc. (NYSE: DNR) ("Denbury") is an independent oil and natural gas company with operations focused in the Gulf Coast and Rocky Mountains
- **December 2015**: Denbury announces commencement of discounted private offers to exchange existing unsecured 6.375% senior subordinated notes due 2021, 5.5% senior subordinated notes due 2022 and 4.625% senior subordinated notes due 2023 into new unsecured 7.5% senior subordinated notes due 2024
- **January 2016**: Denbury terminates previously announced private exchange offers
- **May 2016**: Denbury privately exchanges $1,057.8 million in aggregate principal amount of outstanding senior subordinated notes for $614.9 million in aggregate principal amount of new 9% senior secured second lien notes due 2021 and 40.7 million shares of common stock.

Denbury Resources Inc.

BACKGROUND

Denbury

- **September 30, 2017**: Long-term debt as set forth on 10-Q for Q3 2017

Note 3. Long-Term Debt

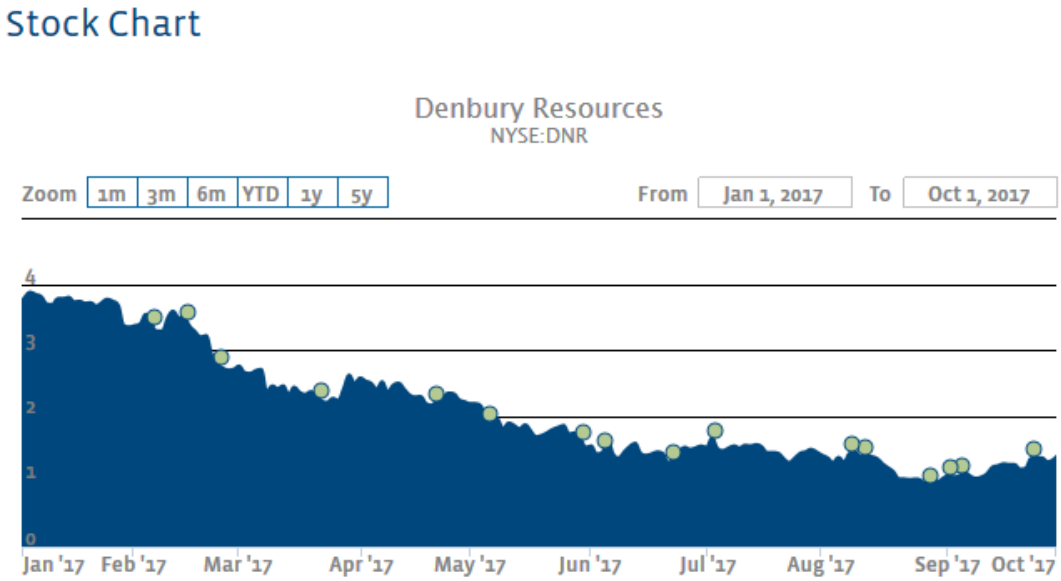
The following long-term debt and capital lease obligations were outstanding as of the dates indicated:

In thousands	September 30, 2017	December 31, 2016
Senior Secured Bank Credit Agreement	$ 495,000	$ 301,000
9% Senior Secured Second Lien Notes due 2021	614,919	614,919
6⅜% Senior Subordinated Notes due 2021	215,144	215,144
5½% Senior Subordinated Notes due 2022	772,912	772,912
4⅝% Senior Subordinated Notes due 2023	622,297	622,297
Other Subordinated Notes, including premium of $1 and $3, respectively	2,251	2,253
Pipeline financings	195,258	202,671
Capital lease obligations	34,542	48,718
Total debt principal balance	2,952,323	2,779,914
Future interest payable on 9% Senior Secured Second Lien Notes due 2021 (1)	203,686	228,825
Issuance costs on senior secured second lien and senior subordinated notes	(13,568)	(15,641)
Total debt, net of debt issuance costs	3,142,441	2,993,098
Less: current maturities of long-term debt (1)	(85,002)	(83,366)
Long-term debt and capital lease obligations	$ 3,057,439	$ 2,909,732

Denbury Resources Inc.

BACKGROUND

- **January 1, 2017 – October 1, 2017**: Denbury's stock price declines by approximately 65% from $3.80/share to $1.42/share



- Similarly, in early October 2017, Denbury's senior subordinated unsecured notes were trading at distressed prices
  - 6 3/8% senior subordinated notes due 2021 traded at a high of 59.000 as of October 4, 2017
  - 5 1/2% senior subordinated notes due 2022 trade at a high of 57.000 as of October 2, 2017
  - 4 5/8% senior subordinated notes due 2023 trade at a high of 52.125 as of October 2, 2017

Denbury Resources Inc.

AD HOC GROUP ORGANIZES

Denbury

- **October 2017**: Ad hoc group of holders (the "Ad Hoc Group") of approximately 35% of Denbury's senior subordinated notes, advised by Davis Polk, organizes and communicates to Denbury its willingness to engage in preliminary discussions regarding the terms of a potential transaction
  - Ad Hoc Group was sensitive to Denbury's failed exchange in early 2016 and made an effort to show that it had the wherewithal to close a transaction rapidly
- Davis Polk commenced a top-to-bottom review of first lien credit agreement, second lien notes indenture, subordinated notes' indentures and other relevant credit documents to determine the art of the possible
  - Anti-Layering Provision, together with Payment for Consent provision, in the second lien notes indenture presented an obstacle to exchanging into 1.5 lien debt

Section 4.04 Incurrence of Layered Indebtedness. The Company shall not, and the Company shall not permit any Restricted Subsidiary to, directly or indirectly, Incur any Indebtedness that is or purports to be by its terms (or by the terms of any agreement governing such Indebtedness) subordinated in right of payment to any other Senior Indebtedness of the Company or of such Restricted Subsidiary, as the case may be, unless such Indebtedness is also by its terms (or by the terms of any agreement governing such Indebtedness) made expressly subordinated in right of payment to the Securities or the Subsidiary Guarantee of such Restricted Subsidiary, to the same extent and in the same manner as such Indebtedness is subordinated in right of payment to such other Senior Indebtedness of the Company or such Restricted Subsidiary, as the case may be. The Company shall not, and shall not permit any Restricted Subsidiary to, directly or indirectly, create, Incur, assume or suffer to exist any Lien on Collateral securing any Indebtedness if such Lien would (a) have or purport to have priority over the Parity Liens on such Collateral and (b) be contractually subordinated to any Priority Liens on such Collateral.

Section 9.07 Payment for Consent. Neither the Company nor any Affiliate of the Company shall, directly or indirectly, pay or cause to be paid any consideration, whether by way of interest, fee or otherwise, to any Holder for or as an inducement to any consent, waiver or amendment of any of the terms or provisions of this Indenture or the Securities unless such consideration is offered to be paid or agreed to be paid to all Holders that so consent, waive or agree to amend in the time frame set forth in solicitation documents relating to such consent, waiver or agreement.

Denbury Resources Inc.

TRANSACTION CHRONOLOGY

Denbury

- Indebtedness and restricted payment provisions in the second lien notes indenture imposed limitations on the ability of Denbury to exchange subordinated notes into additional second lien notes
  - Second lien and junior lien debt capped at the greater of (i) $1 billion and (ii) 65% of Modified ACNTA (determined at the date of incurrence), less the aggregate amount of second lien notes outstanding (§ 4.03(b)(3))
    - Denbury's calculation of Modified ACNTA was not publicly available, making it difficult to ascertain the exact amount of secured debt available to be incurred under this basket
  - Restricted payment basket for "purchases, repurchases, redemptions, defeasances or other acquisitions or retirements for value of" the existing subordinated notes capped at $1 billion, less the principal amount of the original second lien notes issued, plus an additional $200 million, which implied capacity of $585 million (§ 4.05(b)(8))
- In November 2017, negotiation between Denbury's advisors and Davis Polk began in earnest around a potential exchange transaction
  - A subset of the Ad Hoc Group consisting of three members (the "Subcommittee") entered into a short-term NDA with the company to negotiate on behalf of the Ad Hoc Group
  - On November 24, 2017, the Subcommittee reached an agreement with the company on the principal terms of an exchange transaction
  - On November 28, 2017, members of the Ad Hoc Group agreed to become restricted for a period of 24 hours to review the agreed-upon exchange term sheet
  - All members of the Ad Hoc Group agree to the terms of the exchange transaction
  - On November 30, 2017, exchange agreements between Ad Hoc Group members and the company are executed, and the company publicly announces the private exchange

Denbury Resources Inc.

SUMMARY OF KEY TRANSACTION TERMS

Denbury

- Exchange Terms:

Subordinated Notes Series	New Second Lien Notes (per $100 in principal amount tendered)	New Convertible Notes (per $100 in principal amount tendered)
6.375% Notes due 2021	--	--
5.500% Notes due 2022	$64.00	$13.50
4.625% Notes due 2023	$60.50	$14.50

- Key Terms of New Second Lien Notes
  - Issuer: Denbury Resources Inc.
  - Issue: Senior Secured Second Lien Notes
  - Guarantors: Same as 9.00% Second Lien Notes due 2021
  - Security: Same as 9.00% Second Lien Notes due 2021
  - Coupon: 9.25%
  - Maturity: 3/31/2022
  - Equity Clawback: Prior to 3/31/19, up to 35% of the notes at 109.250% with equity proceeds
  - Optional Redemption: NC until 3/31/19, then 109.250%/104.625%/100.00%, payable upon any acceleration
  - Change of Control: 101% put
  - Covenants: Same as the Existing Second Lien Notes

Denbury Resources Inc.

SUMMARY OF KEY TRANSACTION TERMS

Denbury

- Key Terms of New Convertible Notes
  - Issuer: Denbury Resources Inc.
  - Issue: Convertible Notes
  - Guarantors: Same as 9.00% Second Lien Notes due 2021
  - Security: None
  - Coupon: 3.50%
  - Maturity: 3/31/2024
  - Optional Redemption: None
  - Optional Conversion: Optionally convertible into 444.44 common shares per $1,000 principal amount at any time, plus (i) 15.56 additional shares per $1,000 principal amount for optional conversions within 60 days of the issue date or (ii) 11.11 additional shares per $1,000 principal amount for optional conversions thereafter but within 120 days of the original issue date
  - Mandatory Conversion: Mandatorily convertible at stock price at or above $2.65/share based on VWAP for 10 out of 15 consecutive trading days
  - Change of Control: 101% put
  - Covenants: Same as the Existing Second Lien Notes
- "Most Favored Nation" Language Negotiated
  - MFN language in exchange agreements gave exchanging holders the right to participate in a subsequent transaction 180 days after the closing if any of the following four criteria met:
    - (1) exchange consideration for 2022 subordinated notes exceeds $775/$1000 principal amount, or exchange consideration for 2023 subordinated notes exceeds $750/$1000 principal amount,
    - (2) new second lien notes exchanged for 2022 subordinate notes in an amount that exceeds $640/$1000 principal amount or for 2023 subordinated notes in an amount that exceeds $605/$1000 principal amount,
    - (3) new second lien notes issued with coupon greater than 9.25% per annum, or
    - (4) fair market value of consideration greater than fair market value of second lien notes

Denbury Resources Inc.

TRANSACTION OUTCOME

Denbury

- **December 6, 2017**: Transaction closes
  - Approximately $610 million aggregate principal amount of senior subordinated notes due 2022 and 2023 exchanged into approximately $382 million aggregate principal amount of new 9.25% second lien notes due 2022 and $85 million aggregate principal amount of 3.5% convertible senior notes due 2024
  - The exchange was a win-win for all participants, with Denbury reducing the principal amount of its debt by $144 million
- **December 7, 2017**: Denbury announced follow-on private offers to exchange subordinated notes for up to $182 million of 9.25% second lien notes due 2022 and up to $147 million of new 5% convertible senior notes due December 15, 2023.

Denbury Resources Inc.

TRANSACTION OUTCOME

Denbury

- Terms of the follow-on exchange skewed more heavily toward the new convertible notes portion of the exchange rather than the second lien note portion

Series of Old Notes	CUSIP Number	Principal Amount Outstanding[1]	Acceptance Priority Level[2]	Exchange Consideration[3][4]	Early Participation Premium	Total Exchange Consideration[3][5]
6⅜% Senior Subordinated Notes due 2021	247916AC3	$215,144,000	1	$410.00 principal amount of New Second Lien Notes and $340.00 principal amount of New Convertible Senior Notes	$50.00 principal amount of New Second Lien Notes	$460.00 principal amount of New Second Lien Notes and $340.00 principal amount of New Convertible Senior Notes
5½% Senior Subordinated Notes due 2022	247916AD1	$408,882,000	2	$382.50 principal amount of New Second Lien Notes and $342.50 principal amount of New Convertible Senior Notes	$50.00 principal amount of New Second Lien Notes	$432.50 principal amount of New Second Lien Notes and $342.50 principal amount of New Convertible Senior Notes
4⅝% Senior Subordinated Notes due 2023	24823UAH1	$376,501,000	3	$360.00 principal amount of New Second Lien Notes and $340.00 principal amount of New Convertible Senior Notes	$50.00 principal amount of New Second Lien Notes	$410.00 principal amount of New Second Lien Notes and $340.00 principal amount of New Convertible Senior Notes

Case Study: Synchronoss Technologies, Inc.

Synchronoss Technologies, Inc.

KEY TAKEAWAYS AND LESSONS LEARNED

- **The occurrence of an Event of Default, or an imminent Event of Default, may allow opportunistic and organized lenders to re-negotiate key terms of a Credit Agreement, even if the Borrower is ostensibly not in distress**
  - Sophisticated lenders may insist upon, in addition to a consent fee, amendments to a credit agreement in exchange for a waiver that would increase restrictions on the company and could potentially increase the price at which the paper trades
  - Here, credit agreement closed in January and re-negotiation occurred in July, only six months later
- **Two-step process of (i) short-term limited waiver followed by (ii) amendment and longer-term waiver gives lenders time to consider range of potential asks and negotiate with the Company with the overhang of a looming Event of Default still in effect**
  - Two-step process can be alternative to a forbearance agreement or simple waiver-for-fee
- **Clarity around which private-side lenders willing to go restricted and participate in negotiations may increase efficiency in fast-moving deals**
  - The appointment of a small steering committee – comprised of a diverse set of large holders – assisted advisors in understanding non-negotiable terms and potential areas of compromise

Synchronoss Technologies, Inc.

BACKGROUND

- Synchronoss Technologies, Inc. (NASDAQ: SNCR) ("Synchronoss") is a software company that provides mobile cloud services for mobile carriers, enterprises and retailers
- **January 19, 2017**: Synchronoss enters into first lien credit agreement (the "Credit Agreement") to finance its acquisition of Intralinks Holdings, Inc.
  - Term loan lenders extend initial term loans in an aggregate principal amount of $900 million
  - Revolving credit lenders extend revolving credit loans in an aggregate principal amount of $200 million
- **May 15, 2017**: Synchronoss issues press release stating that CEO and CFO require "additional time to comply with the Company's internal controls and procedures and to review certain aspects of the Company's financial statements"
  - Synchronoss's independent auditor, Ernst & Young LLP, suggested "additional reviews"
- The failure to timely deliver quarterly financial statements to the Administrative Agent would trigger an event of default under the Credit Agreement
- At the end of June 2017, lenders holding approximately $700 million in aggregate principal amount of the term loans organize (the "Lender Group") and are advised by Davis Polk and Houlihan Lokey
- **June 30, 2017**: The Lender Group executes a temporary, 14-day waiver through July 13, 2017
  - **15 bps consent fee for temporary waiver payable to all consenting lenders**
- During 14-day period, advisors to and private-side members of the Lender Group engaged in an intense series of negotiations regarding a complex, comprehensive amendment to the Credit Agreement to substantially improve its economic and legal terms

Synchronoss Technologies, Inc.

BACKGROUND

synchronoss

General Terms of Amendment	
Temporary Waiver	▪ 90 days, subject to extension for an additional 30 days for a 25 bps fee
Consent Fee	▪ 100 bps (reduced by 15 bps paid in connection with June 30 waiver)

Interest Rate	▪ Increased from L+275 to L+450 through the initial 150-day period following the amendment effective date (period subject to adjustment)
	  ▪ After initial 150-day period, 100 bps step-up in margin if secured debt to EBITDA ratio greater than 5.0x
	  ▪ LIBOR floor of 100 bps

Call Protection	▪ 101 soft call protection through the 150-day initial period ▪ 102 hard call protection for 1-year period after the 150-day initial period ▪ 101 hard call protection for 1-year thereafter
Revolver	▪ Immediate permanent commitment reduction from $200 million to $100 million ▪ Revolver availability limited to $50 million during 90-day waiver period

Synchronoss Technologies, Inc.

BACKGROUND

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Summary of Terms Related to Financial Reporting and Internal Controls	

Audited Restated Financials	▪ Audited restated financial statement for FY 2015 and 2016, and potential 2014, which must show:
	  ▪ No change in ending cash balance for each fiscal year in excess of $1 million
	  ▪ Net revenue variance of less than 15% in any given year; if variance greater than 15%, interest rate spread over LIBOR increases by 25 bps

Internal Control Certification	▪ Management required to disclose the following:
	  ▪ Any material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial information
	  ▪ A specific plan to address any remedy any such material weaknesses
	  ▪ Timetable to correct any such material weakness

FY 2017 Quarterly Reports	▪ Quarterly financials for the 3-month periods ending March 31, 2017 and June 30, 2017 must conform to requirements set forth in the Credit Agreement

Reporting	▪ Lenders and their professionals have access to management during 90-day waiver period
	  ▪ Professionals receive ending cash balance on a monthly basis
	  ▪ Professionals have diligence calls with Company's auditors on a bi-weekly basis
	▪ Company to provide:
	  ▪ Quarterly lender calls to discuss performance
	  ▪ Private-side lender calls to discuss financial forecast
	  ▪ Responses to lender inquiries
	  ▪ Disclosure to private-side lenders of ending cash balance and outstanding revolver balance on a monthly basis
	  ▪ Support for calculation of covenant EBITDA upon request from private-side lenders, including breakdown of (i) EBITDA prior to add-backs, (ii) add-backs on a line-item basis, and (iii) exclusion of any revenue shifted into later periods due to any financial restatements
	▪ Counsel to collateral agent to perform collateral review and lien perfection analysis

Synchronoss Technologies, Inc.

BACKGROUND

Summary of Terms Related to Financial Covenants	
Maintenance Covenants	▪ Existing covenants for the benefit of revolving lenders to be applied to the term loans ▪ Minimum Interest Coverage Ratio floor decreased from 3.50x to 2.00x ▪ Total Gross Leverage Ratio cap adjusted
Covenant EBITDA	▪ Add-back for non-recurring items, non-cash expenses or losses, restructuring charges, certain pro forma adjustments related to various transactions and “run-rate” cost savings, operating expense reductions and synergies required to be (i) realized in the next 12 months for future actions and (ii) capped at 5% of LTM unadjusted EBITDA in Q3 2017, 15% of LTM unadjusted EBITDA in Q4 2017 and 25% of LTM unadjusted EBITDA thereafter

Synchronoss Technologies, Inc.

BACKGROUND

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Summary of Amendments to Baskets

	Restricted Payments	
	Pre-Amendment	**Post-Amendment**
General Basket	$100 million	$10 million
Available Amount Starter	$100 million (no grower; cumulative with investments and debt prepayments)	Removed
Existing Share Repurchase Program	$70 million (no grower)	$70 million subject to 3.5x total leverage test
Repurchases from Employees	$10 million per annum	During 90-day waiver period, up to no more than $300,000 per employee; thereafter, $5 million per annum
Distribution of Equity Interests of Unrestricted Subsidiary	Unlimited	Removed
	Debt Prepayments	
	Pre-Amendment	**Post-Amendment**
Scope	Subordinated debt only	Subordinated, unsecured and junior lien debt (but carve-out for capitalized lease obligations)
Available Amount Starter	$100 million (no grower; cumulative with investments and debt prepayments)	$10 million

Synchronoss Technologies, Inc.

BACKGROUND

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Summary of Amendments to Baskets

	Investments	
	Pre-Amendment	**Post-Amendment**
Non-Guarantor Restricted Subsidiary	$50 million	$10 million for non-subsidiary JVs (carve-out for significant JV); $25 million (shared with Asset Sales basket)
Permitted Acquisition	Unlimited, no cap on non-Guarantors	Subject to total leverage < 3.50x and pro forma financial covenant compliance; cap on non-guarantor acquisitions
Similar Business	$50 million	Removed
General	$100 million	$25 million if total leverage > 3.50x $100 million if total leverage < 3.50x
Advances/Guarantees to Employees	$10 million	$5 million
Available Amount Starter	100 million (no grower; cumulative with investments and debt prepayments)	Removed

Synchronoss Technologies, Inc.

BACKGROUND

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Summary of Amendments to Baskets

Asset Sales		
	Pre-Amendment	**Post-Amendment**
De Minimis Threshold Not Considered Asset Sale	$10 million per sale	$1 million per sale, $5 million aggregate
Intercompany	No limit on transfers to non-guarantors	Shares basket with investments in non-guarantors
Exchange of Like Prior in a 1031 Exchange	Unlimited	Removed
Permitted Asset Swap (for Assets Useful in Business)	Unlimited	Removed
Disposition of Equity in Unrestricted Subsidiary	Unlimited	Removed
Sale Leasebacks	Unlimited for property acquired after the closing date	Immediate sweep of proceeds
General Basket	$20 million	$10 million
Designated Non-Cash Consideration	$50 million	Removed
Threshold for Asset Sales to be Subject to Tests	$20 million	$5 million

Synchronoss Technologies, Inc.

BACKGROUND

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Summary of Amendments to Baskets

Debt		
	Pre-Amendment	**Post-Amendment**
Permitted Refinancings	Must mature outside debt being refinanced	Must mature 181 days outside of Term Loans Debt cannot be refinanced with more senior debt (e.g., unsecured into secured)
General Basket	$100 million	$50 million
Acquisition Debt (Unsecured or Junior Lien)	FCCR of 2.0x or no worse than prior, or Total Leverage of 4.50x or no worse than prior	Total Leverage of 4.50x, “no worse than prior” prong removed
Acquisition Debt (Pari Passu)	First Lien Leverage of 3.00x or no worse than prior	Removed
Incremental Facilities	$300 million starter, plus all voluntary prepayments, plus unlimited subject to 3.00x First Lien Leverage; may be inside maturity	Starter removed; all MFN exceptions removed; ability to do inside maturity removed
Liens		
	Pre-Amendment	**Post-Amendment**
General	$85 million	$25 million
Additional General	Liens securing general debt basket	Removed
Liens on Non-Collateral	Permitted if loans secured equally and ratably	Removed

Synchronoss Technologies, Inc.

BACKGROUND

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Summary of Amendments to Baskets

Mandatory Prepayments		
	Pre-Amendment	**Post-Amendment**
Asset Sales	Amounts above $5 million, within 12 months + 180 days	Amounts above $5 million, within 12 months + 120 days Proceeds from payoff of seller paper triggers immediate paydown
Equity Sweep	None	25% of net cash proceeds until Total Leverage < 3.50x
ECF Percentage and Stepdowns	50% 25% below 2.75x First Lien Leverage 0% below 2.25x First Lien Leverage	75% 50% below 3.50x First Lien Leverage 25% below 2.75x First Lien Leverage 0% below 2.25x First Lien Leverage
ECF Threshold	$5 million	Removed
ECF Deductions	Future planned expenditures Restricted Payments	Planned capital expenditures capped at $25 million
Declined Proceeds	Builds Available Amount	Must be offered to accepting lenders pro rata; if declined, can build Available Amount
Other		
	Pre-Amendment	**Post-Amendment**
Debt Buybacks/Exchanges	Permitted open market, Dutch auction and Permitted Debt Exchanges	Removed
Reclassification	Permitted across all baskets and transactions	Removed
LCT Election	Permitted for acquisitions and investments	Removed

Case Study: Expro International Group Holdings, Ltd.

Expro International Group Holdings, Ltd.

- **Case Overview**
  - $1.4 billion restructuring through the prepackaged chapter 11 bankruptcy of Expro International Group Holdings Limited, a provider of oilfield exploration and optimization and enhancement services around the world. Expro and certain of its affiliates filed for chapter 11 protection in the Southern District of Texas on December 18, 2017 and emerged from bankruptcy less than two months later, on February 5, 2018
  - Prepackaged plan of reorganization provided for (i) a full equitization of the Expro's prepetition credit facility and (ii) a new investment through a $200 million rights offering backstopped by the ad hoc lender group
  - Lenders received all of the equity in the reorganized company, subject to dilution by a management incentive plan and the issuance to junior stakeholders of warrants for up to 7% of the new equity

Pre-Bankruptcy Capital Structure	Post-Emergence Capital Structure

• $1.417 billion secured credit facility consisting of:
  • $175 mm revolver due 2021 ($125 mm drawn as of the petition date)
  • $1.267 billion term loan due 2021
	• $200 mm new equity capital raised through backstopped rights offering

Expro International Group Holdings Ltd. (cont.)

- **Rights Offering Terms**
  - $200 million equity rights offering backstopped by members of the ad hoc lender group
  - Backstop parties received (i) exclusive allocation of 25% of rights (i.e., $50 million of investment opportunity) and (ii) a 5% backstop fee payable in equity
  - Opportunity to participate and subscribe for remaining 75% of rights was available to backstop parties and lenders signing the restructuring support agreement within 5 business days of its execution by the backstop parties and announcement to other lenders. Rights were offered on pro rata based on amount of participating lenders' claims as reported under the RSA
  - Rights offering equity was offered at $12.50 (a 36% discount based on the midpoint of the debtors' valuation analysis)

Expro International Group Holdings Ltd. (cont.)

- **Key Advantages of Rights Offering and Structure**
  - Allowed debtors to raise working capital and emerge with substantially no leverage
  - Discounted price of rights offering shares and risk of dilution incentivized broad participation
  - Tying rights offering participation to RSA and providing only a 5 business-day sign-up period incentivized participation (and, accordingly, locked in support for the plan) providing path for speedy prepackaged process with minimal controversy
  - 25% exclusive equity allocation and equity backstop fee provided mechanism for backstop parties to receive enhanced economics relative to claim size

- **Process Issues and Challenges**
  - Benefits to backstop parties (fee and exclusive allocation) at high end of market and short sign-up period created risk of pushback from non-backstop lenders (though lenders ultimately gave overwhelming support)
  - Some legal risk associated with tying rights offering to RSA and not making rights available to all members of the class
  - Because rights offering was not tied to the plan, shares were not subject to registration exemption under section 1145 and were instead exempt from registration under Section 4(a)(2) of the Securities Act

Case Study: C&J Energy Services Ltd.

C&J Energy Services Ltd.

C&J ENERGY SERVICES

- **Case Overview**
  - $1.75 billion restructuring through the pre-arranged chapter 11 bankruptcy of C&J Energy Services, a leading provider of oilfield services to North American E&P companies. C&J and certain of its affiliates filed for chapter 11 protection in the Southern District of Texas on July 20, 2016 and emerged from bankruptcy on January 6, 2017
  - The restructuring resulted in the almost complete deleveraging of C&J's capital structure through the conversion of C&J's secured debt to equity and provided additional new liquidity to the company through a $200 million equity rights offering backstopped by the steering committee and a new $100 million ABL facility
  - Plan was initially subject to significant objection by junior stakeholders, but objections ultimately settled
  - Unsecured creditors received a mix of cash and warrants, and shareholders also received a warrant distribution

Pre-Bankruptcy Capital Structure	Post-Emergence Capital Structure
$1.35 billion secured credit facility consisting of: $300 mm revolver due 2020 $569 mm term loan due 2020 $480 mm term loan due 2022	$100 mm ABL facility due 2022 $200 mm new equity capital raised through backstopped rights offering

C&J Energy Services Ltd. (cont.)

C&J ENERGY SERVICES

- **Rights Offering Terms**
  - $200 million equity rights offering backstopped by members of lender steering committee and certain others
  - Backstop parties received 5% fee, payable in equity at rights offering price
  - Rights offered to all members of secured lender class as part of plan treatment
  - Rights offering shares priced at a 20% discount to expected plan value (a 33% discount to plan value presented at confirmation)

C&J Energy Services Ltd. (cont.)

C&J ENERGY SERVICES

- **Key Advantages of Rights Offering and Structure**
  - Allowed debtors to raise working capital with little leverage and brought capital structure in line with market expectations and peer companies also restructuring
  - Discounted share price and risk of dilution incentivized broad participation
  - Rights offering was open to entire class and occurred entirely within the scope of the plan process, minimizing controversy among prepetition lenders

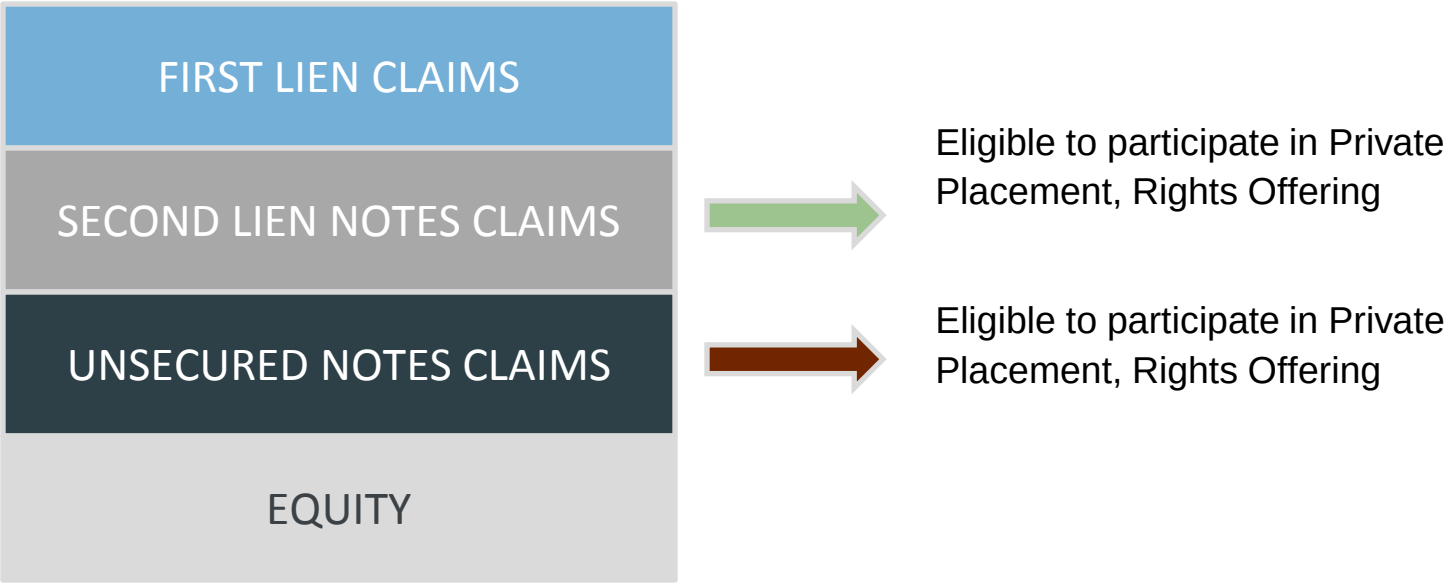
- **Process Issues and Challenges**
  - Rights offering became central target for attacks by junior stakeholders even though it only caused dilution of equity already allocated to secured lenders
    - Shareholder objections called the rights offering "extraordinarily onerous," "coercive" and "a sweetheart deal for the Lenders, to the detriment of . . . [prepetition] equityholders"
    - Majority shareholder made several attempts prior to the bankruptcy to make a new-money investment in the post-emergence company in exchange for a significant portion of equity; lenders chose instead to make their own investment through the rights offering process
  - Debtors' enterprise valuation increased by 20% between disclosure statement filing and confirmation but rights offering share price stayed the same, resulting in discount at high end of market and potential for further controversy (junior stakeholder objections settled before valuation was fully litigated)

Case Study: Peabody Energy Corporation

Peabody Energy Corporation

- **$1.5 billion equity capital raise:**
  - $750 million Rights Offering, participants receive common equity
  - $750 million Private Placement, participants receive convertible preferred equity

- **Relevant classes of prepetition capital structure (simplified):**



Peabody Energy Corporation

RIGHTS OFFERING

- ***Rights distributed:***
  - Reorganized PEC Common Stock
  - Rights Offering Penny Warrants, exercisable for 2.5% of fully diluted Reorganized PEC Common Stock
- ***Purchase price: 55% of Plan Equity Value***
- ***Eligible participants***:
  - Allowed Second Lien Notes Claims
  - Allowed Unsecured Notes Claims
- ***Backstop*: Parties to Rights Offering Backstop Commitment Agreement ("BCA")**
- ***Allocation*: Rights distributed *pro rata* on account of claims in the above classes**
- **Req*uirements for participation*: none*; rights distributed on account of claims**

*Participation subject to certain securities law qualifications

Peabody Energy Corporation

PRIVATE PLACEMENT

- ***Rights distributed*:**
  - Convertible preferred equity of Reorganized PEC (convertible to Reorganized PEC Common Stock) (the "Preferred Equity")
- **Purchase price: 65% of Plan Equity Value**
- ***Eligible participants*:**
  - Allowed Second Lien Notes Claims
  - Allowed Unsecured Notes Claims
- ***Allocation*: Determined by Private Placement Agreement ("PPA")**
- **Requirements for participation: All participants* must become parties to each of:**
  - the PPA,
  - the BCA, and
  - the Plan Support Agreement ("PSA")

*Participation subject to certain securities law qualifications