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RECENT DEVELOPMENTS IN DISTRESSED LENDER-SIDE REPRESENTATIONS

RIGHTS, REMEDIES AND RISKS

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1. DROP DOWN TRANSACTIONS – OVERVIEW

- **Due to the covenant lite nature of many credit agreements, drop down/IPCo transactions have become more frequent in the market, resulting in a direct impact on the rights, remedies and risks to debt investors**
  - Borrowers typically employ drop down transactions to exchange existing debt in the capital structure or obtain additional liquidity
  - Serves as a method to increase runway or otherwise address unsustainable capital structures
  - Often results in the removal, or dilution, of collateral from the existing collateral package
  - Without general catalysts or triggers under the credit documents, a general event of default is often not available for the lenders to use to stop a drop down transaction
  - Debt holders often must look outside the credit documents for rights and remedies to prevent a transaction, such as fraudulent transfer, illegal dividend and breach of fiduciary duty claims

1. DROP DOWN TRANSACTIONS – OVERVIEW (CONT'D)

- There are several key components and factors that may influence the ability to consummate a drop down transaction
  - Designation of unrestricted subsidiaries
  - Permitted investment and restricted payment basket capacity
  - Agent authority to release liens on the collateral
  - Ability of the lender group to engage the administrative agent early in the process to prevent the release of liens on the collateral
  - Ability of the lender group to maintain majority control of the debt facility
  - Evaluation and impact of potential claims outside the credit documents, such as fraudulent transfer, illegal dividend and breach of fiduciary duty claims

1. DROP DOWN TRANSACTIONS – TYPICAL STEPS

1. Formation of an unrestricted subsidiary
2. Transfer of valuable assets from a loan party to an unrestricted subsidiary using investment and/or restricted payment capacity, often for no meaningful consideration
3. With the assets removed from the collateral and the activities of the unrestricted subsidiary unregulated by the credit documents, assets can now be used by the unrestricted subsidiary for a distressed exchange, a transfer of the assets to the sponsor, or an independent basis for a new financing
4. Alternatively, the borrower may seek to transfer assets to a non-loan party restricted subsidiary; although such restricted subsidiary would remain subject to the covenant restrictions under the credit documents, with the collateral removed, the borrower could use the assets as collateral to incur debt not otherwise prohibited under the credit documents

- After consideration of the relative maturities of the capital structure, the borrower/sponsor may be more incentivized to use a drop down transaction to transfer assets for the benefit of the sponsor or generate additional liquidity, as opposed to elevating a junior security in a distressed exchange
- A key risk to the viability of an exchange or drop down transaction designed to incur additional indebtedness at an unrestricted subsidiary is whether and how much financing a third party would provide based on the assets involved

1. DROP DOWN TRANSACTIONS – DESIGNATION OF UNRESTRICTED SUBSIDIARIES

- Under the typical TLB structure, the subsidiaries under a credit facility are generally classified as restricted subsidiaries and unrestricted subsidiaries
  - Restricted subsidiaries are further separated into loan parties and non-loan parties
  - Restricted subsidiaries are generally subject to the covenant limitations
  - Unrestricted subsidiaries are outside of the credit group and are not subject to the credit documents, including the covenant restrictions therein
- By designating an unrestricted subsidiary as part of a drop down transaction, the borrower is seeking to remove that subsidiary from the scope of the credit documents
  - The requirements for the designation of an unrestricted subsidiary are often minimal
    - On the most permissive end of the spectrum, designation may only be subject to no event of default
    - On the more restrictive end of the spectrum, designation may be subject to compliance with an incurrence financial covenant, such as a leverage ratio
- Under most TLB scenarios, it is likely that the borrower can designate unrestricted subsidiaries

1. DROP DOWN TRANSACTIONS – PERMITTED INVESTMENT AND RESTRICTED PAYMENT CAPACITY

- Once the borrower designates an unrestricted subsidiary, it will likely need to rely on a combination of permitted investment capacity and restricted payment capacity to effect the transfer of assets to the unrestricted subsidiary
- Due to the cov-lite nature of many TLB structures, the credit documents are often very permissive with respect to permitted investment capacity and restricted payment capacity
- Basket capacity typically consists of a set amount but often includes additional builder capacity of an additional "starter amount" plus a percentage of consolidated net income or excess cash flow plus equity contributions since the closing date (*i.e.*, "Available Amount", "Available Equity Amount", "Cumulative Credit", etc.)
- Permitted investment and restricted payment covenants may also include additional baskets subject to incurrence ratio tests, and may be specific to investments in unrestricted subsidiaries and/or restricted subsidiaries

1. DROP DOWN TRANSACTIONS –“TRAP DOOR” PROVISIONS

- In addition to the potential direct capacity to invest in unrestricted subsidiaries, a number of TLB credit documents contain so-called “Trap Door” provisions which effectively permit additional investment capacity in unrestricted subsidiaries through investments by restricted subsidiaries.
- Trap Door provisions generally permit investments in unrestricted subsidiaries by restricted subsidiaries to the extent such investments are financed with proceeds received from an initial permitted investment in such restricted subsidiary
- So long as the initial investment in the restricted subsidiary was permitted under the credit documents, the proceeds of that initial investment can be used by that restricted subsidiary to make further investments in an unrestricted subsidiary thereby increasing the general investment capacity under the credit documents
- **Case Example**: *J.Crew* used the Trap Door provision in its credit agreement to effectively turn $150mm of investment capacity in non-loan party restricted subsidiaries into an additional $150mm of investment capacity in unrestricted subsidiaries

1. DROP DOWN TRANSACTIONS – "J.CREW BLOCKER" PROVISIONS

- Following the J.Crew drop down transaction, lenders have attempted to negotiate provisions into credit documents restricting the ability to transfer material assets to unrestricted subsidiaries (so-called "J.Crew Blocker" provisions)
  - These provisions have not yet gained widespread traction
  - J.Crew blocker provisions have primarily focused on IP but could include any core assets
  - J.Crew blocker provisions take a variety of forms:
    - No designation of unrestricted subsidiaries without required lender consent
    - Limitations on designation of a restricted subsidiary that owns a core asset (*i.e.*, material IP)
    - The above designation restriction coupled with a limitation on making any investment in the form of a core asset
    - Restrictions on transfers to unrestricted subsidiaries in the form of a core asset
    - Restrictions on the ability of an unrestricted subsidiary to prepay any indebtedness not otherwise permitted to be paid by the borrower
    - Restrictions on the ability to transfer core assets as an investment to unrestricted subsidiaries and non-loan party restricted subsidiaries
    - Expansive definitions of the relevant core assets, including any such asset if transferred could reasonably be expected to result in a material adverse effect
  - J.Crew blocker provisions should also be considered in the context of any amend and extend transaction through which the investment and restricted payment covenants are being tightened

2. PRO RATA SHARING / WATERFALL PROVISIONS

- **Pro Rata Sharing/Waterfall**
- Typically, money paid by the borrower is shared *pro rata* among lenders
- Amendments to pro rata sharing and payment waterfall provisions originally required 100% consent; many now are simple majority although some require majority consent of each adversely affected class
- In NYDJ Apparel, LLC, simple majority consent resulted in minority non-consenting lenders being subordinated in priority due to new senior loans offered solely to majority consenting lenders
  - A minority non-consenting lender, successfully challenged the amendments in court proceedings and reached a settlement with NYDJ and the majority lenders
  - The credit agreement was amended again to give all of the lenders an opportunity to participate in the new loans
- Many pro rata sharing clauses start with "unless otherwise provided" or similar language - this may allow for indirect amendments to pro rata sharing requirements even with a 100% amendment requirement

2. PRO RATA SHARING / WATERFALL PROVISIONS (CONT'D)

- As a result of J.Crew and NYDJ, both of which had simple majority, we are seeing greater lender focus in new and amended facilities and a 100% consent requirement
- More recent amendments that we have seen go further than NYDJ:
  - Subordinated tranche – lower cash pay interest; miss out on material consent fee
  - All voluntary and mandatory prepayments applied first to consenting tranche
  - Non-consenting tranche do not get the benefits of any reps and warranties or most covenants and events of default, including no bankruptcy EOD
  - No expense reimbursement, indemnities or set off rights for non-consenting tranche
  - Consenting lenders pre-agree to waive any EOD in connection with failure to pay non-consenting tranche at maturity
  - Borrower releasing consenting lenders only from all claims relating to amendment
  - Automatic reclassification of subordinated loans to senior tranche if assigned to consenting lender or sponsor affiliates
- In addition, pro rata sharing / waterfall protections often do not include subordination or priming protection which can allow for a priming facility with approval from only required lenders

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