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National Conference of Bankruptcy Judges: Private Credit Lenders and the Changing Dynamic of Chapter 11

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Educational Materials

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Private Credit Lenders and the Changing Dynamics of Chapter 11

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Private Credit Lenders and the Changing Dynamics of Chapter 11

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National Conference of Bankruptcy Judges
Panel: Private Credit
August 2020
Proskauer

Market Snapshot

Leveraged Loan Market

- Three subsectors:
  1. Investment grade market
  2. Leveraged loan market
  3. Middle market
- Major players in the leveraged loan market:
  1. CLOs [$620B]
  2. Banks
  3. Credit Funds
  4. Mutual Funds
  5. Pension Funds
  6. Managed Accounts
  7. Insurance Companies

Private Credit Market

- Direct lending market continues to grow and attractive asset class.
- Record sums are now managed by private credit funds exceeds $1 trillion in AUM
- Roots in the middle market and now competing for deals directly with leveraged loan market.
- Expanding up-market – $50 million to $250 million EBTIDA companies.
- Players: private debt funds, business development companies, insurance companies, finance companies, family offices. More than 150 private debt funds, including:
  - Ares
  - Blackstone
  - Goldman HPS
  - Oaktree
  - Cerberus
  - Apollo
  - TPG
  - KKR
  - OwlRock
  - BlackRock
  - Partners
  - Golub
  - Bain
  - Crescent
  - Carlye

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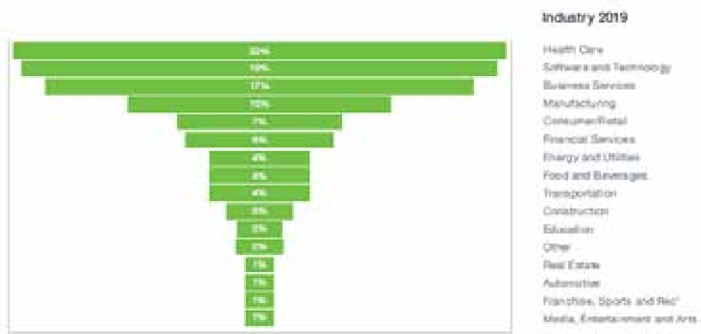
The Private Credit Market

What Proskauer is seeing in the market, based on our 2019 deal statistics:



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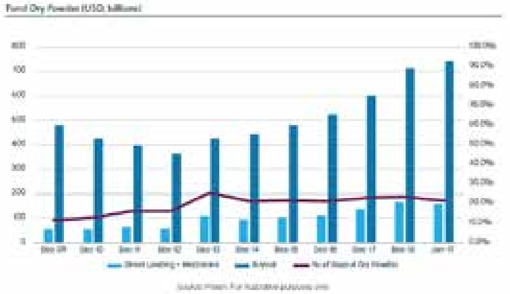
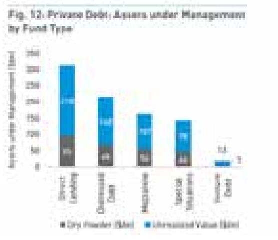
State of the Private Credit Market

- As of late last year, the total of outstanding leveraged loans was estimated to be just under $2 trillion, as of 9/19.

- Globally, private credit, which includes distressed debt and venture financing has grown form $42.4 billion in 2000 to $776.9 billion in 2018. By some estimates the total is likely to top $1 trillion in 2020.

- There was an estimated $103 billion in "dry powder" (or uninvested capital) held globally by direct lending firms and approximately $55 billion in mezzanine dry powder, bringing the combined available private credit for leveraged buyouts to about $158 billion. – Preqin Q3 2019





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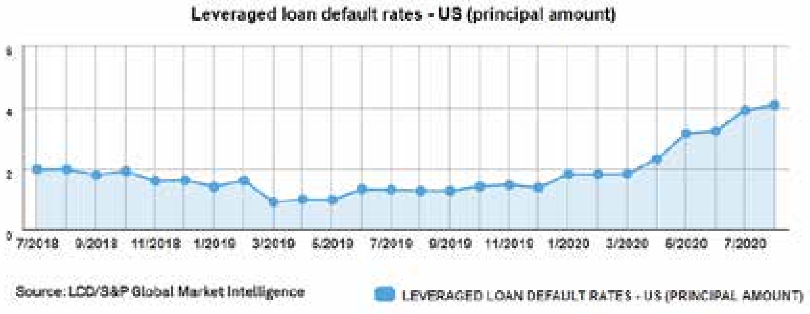
State of the Private Credit Market

- Lenders allowed $215 billion to be drawn down between March 5, 2020 and April 9, 2020, as tracked by S&P's Leveraged Commentary & Data service.
- Fitch Ratings has revised its default forecast as of March 27 for U.S. leveraged loans for 2020 to 5%-6%, up from 3 percent previously forecast. This equates to more than $80 billion, surpassing the previous high of $78 billion in 2009.
- This estimate increases to 7%-8% for lower middle market deals by the end of the year. As a point of comparison Proskauer's Private Credit Default Index which examines 546 active loans representing $101.6 billion of aggregate deals reported an 8.1% default rate in Q2 2020.



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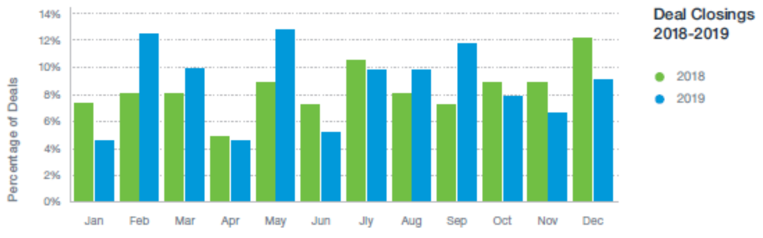
Deal Closings

- Deal activity increased year-over-year.
- We closed 231 deals with a transaction value of $57.9 billion. This represents a 23% increase in deal count and 38% increase in transaction value.



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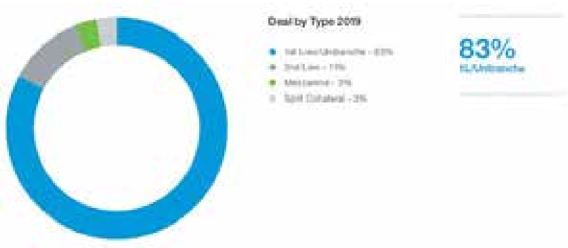
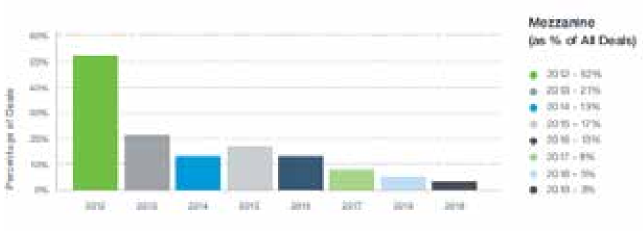
Deal Types

- 1st Lien/unitranche deals increased by 21% to account for 83% of all deals.
- The prevalence of mezzanine deals has been in near constant decline since 2012 when such deals represented 52% of transactions, falling to 3% of total deals in 2019.





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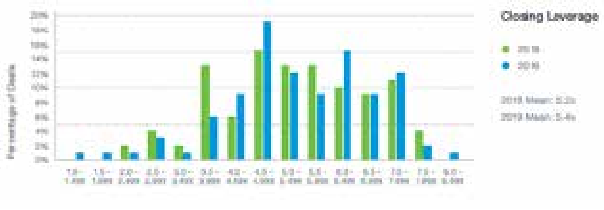
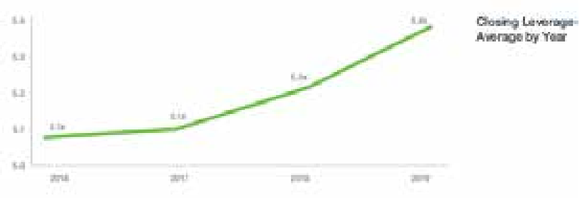
Closing Leverage

- Leverage increased in 2019 with an average of 5.4x compared to 5.2x in 2018.
- 61% of deals had closing leverage greater than 5.0x in 2019 compared to 53% in 2018.
- 42% of deals had closing leverage greater than 5.5x in 2019 compared to 41% in 2018.
- 33% of deals had closing leverage greater than 6.0x in 2019 an increase from 28% in 2018.





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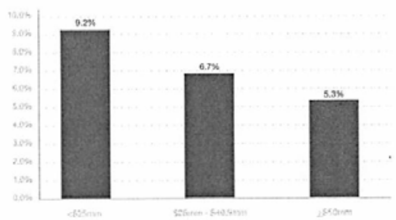
Proskauer» The Private Credit Group

Q2 2020 Default Rate

Overall default rate was 8.1%, up from 5.9% in Q1. Companies with more than $50 million of EBITDA at the time of origination had a 5.3% default rate, up from 4.4% in Q1.

Default Rate by EBITDA



Companies with $25-50 million of EBITDA had a 6.7% default rate in Q2 compared to 5.2% in Q1. As a point of comparison, Fitch Ratings recently projected a 7% to 8% lower middle market default rate by the end of the year.

Companies with less than $25 million of EBITDA had a 9.2% default rate in Q2 compared to a 7.0% default rate in Q1, with more than 46% of the defaults concentrated in companies with less than $15 million of EBITDA. The higher default rate for smaller companies likely reflects the fact that on average those companies have a greater number of financial covenants than loans to larger companies. For example more than 33% of deals with more than $50mm of EBITDA were covenant lite in 2019.

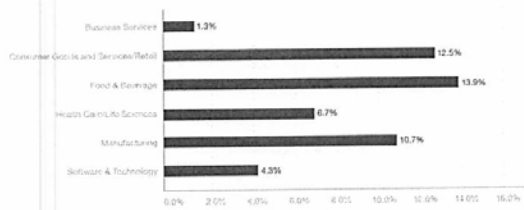
Proskauer's Private Credit Group has over 500 active private credit deals from over 75 lenders in their database.

The default rate for healthcare deals increased to 6.7% in Q2, up from 5.5% in Q1. The default rate for software/technology deals was slightly lower at 4.3% in Q2 from 4.5% in Q1. The default rate for business services deals remained consistent at 1.3% in Q2, similar to 1.4% in Q1, which is significantly lower the average for all other deals.

The Proskauer Private Credit Default Index© includes 546 active loans in the United States representing $101.6 billion in original principal amount.

The number of deals in our database for Q2 declined from 576 in Q1 to 546 due to loan payoffs, restructurings, and slower than typical deal flow related to COVID 19. The Index includes companies across all major industry groups with EBITDA (earnings) from $0 to more than $1 billion.

Default Rate by Industry: 2020 Q2



Methodology

Our index is based on U.S. dollar denominated senior secured and unitranche loans. Default rates are calculated by dividing the number of defaulted loans by the aggregate number of loans in the Index.

While there are varying conventions of what is considered a default for purposes of calculating a default rate, the Index includes loans that have a payment, financial covenant or bankruptcy default, loans that are otherwise in default if the default is expected to continue for more than 30 days (excludes immaterial defaults) and loans that were amended in anticipation of a default.

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A default is assumed to take place on the earliest of:

- The date a debt payment was missed
- The date a distressed restructuring occurs
- The date the borrower filed for, or was forced into, bankruptcy
- The date a financial covenant default occurs
- The date that a default occurs if that default is expected to continue for more than 30 days (excludes immaterial defaults)
- The date the loan is modified in anticipation of a default

For the purposes of this study if a borrower re-emerges from bankruptcy, or otherwise restructures its defaulted debt and, restablishes regular, timely payment of all its debts, we reclassify the borrower as a non-defaulted borrower, as of the date of emergence or restructure.

About Proskauer

We are 725+ lawyers serving clients from 12 offices located in the leading financial and business centers in the Americas, Europe and Asia. The world's leading organizations, companies and corporations choose us to be their representatives in their most critical situations. But more, they consider Proskauer a strategic partner to drive their business forward. We work with asset managers, major sports leagues, Fortune 500 companies, entertainment industry legends and other industry-redefining companies.

Restructuring Trend: The Ultrafast Prepack for Private Credit Deals

November 4, 2019

Our private credit clients are preparing for the next restructuring cycle and have called us about ultrafast bankruptcy cases. These chapter 11 cases have grabbed headlines because they lasted less than a day. Specifically, FullBeauty Brands and Sungard Availability Services emerged from bankruptcy in 24 hours and 19 hours, respectively. Is this a trend and which companies are best suited to zip through chapter 11?

A. Prepacks, Pre-Negotiated Cases, and Free-Falls

Technically speaking, a speedy bankruptcy case is known as a "prepackaged" bankruptcy case (or a "prepack"). A prepack is a chapter 11 case where the borrower negotiates, drafts a chapter 11 plan, and solicits acceptances for the plan before the bankruptcy case is even filed. In contrast, a pre-negotiated case is one where the chapter 11 plan is negotiated before the filing with the company's principal creditors, and the bankruptcy case is filed based upon a commitment to pursue and support confirmation of that plan (which is often attached as a term sheet to a restructuring support agreement). A filing without meaningful pre-bankruptcy preparation (including without a fully-baked plan or restructuring support agreement) is referred to as a "free-fall" or "naked filing" and is a disruptive way to start a bankruptcy case. According to an article published in the *American Bankruptcy Institute,* prepacks and pre-negotiated bankruptcy cases now represent the majority of all large chapter 11 filings, with 65% of large cases filed as prepacks or pre-negotiated ones, compared to 37% in 2010-15.[1]

A prepack offers many advantages. First, it is typically less expensive than a pre-negotiated or free-fall case, because the prepack case is shorter in duration and less contentious. Second, a prepack minimizes the bankruptcy stigma and business disruption, which minimizes the risk of losing trade credit, deterioration in vendor relationships, and employee departures. Finally, a prepack provides greater certainty to the residual stakeholders because the bankruptcy case is filed with a confirmable chapter 11 plan and, as is often the case, an unsecured creditors' committee is not formed because unsecured creditors are unimpaired.

B. When is a Prepack a Viable Strategy?

In our experience, there are five key factors that impact the determination of whether a prepack is a viable strategy: (1) type of restructuring: balance sheet versus operational; (2) degree of creditor support; (3) public debt versus private debt; (4) liquidity; and (5) forum.

1. Balance Sheet Restructuring. A prepack is best suited for an operationally sound business that needs to restructure by deleveraging its balance sheet. As a result, most prepacks involve the conversion of certain funded debt for reorganized equity while all other liabilities are left unimpaired, which means that those other creditors "ride through" a bankruptcy with their claims left unaltered. A distressed company in need of the "bankruptcy tool box" to address operational issues (*e.g.*, rejecting numerous burdensome leases or modifying legacy liabilities) is not an ideal candidate for a prepack. That being said, a prepackaged chapter 11 case can still be successful even if it incorporates the bankruptcy tool box so long as it is done in a limited way and the process remains largely consensual. For example, in *Sungard*, the debtors rejected several contracts and the rejection damages claims were paid in full.

2. Strong Creditor Support. A prepack is a viable strategy for a restructuring that has significant creditor support, which is often easiest to obtain when the debt is not widely held. Thus, a distressed borrower with funded obligations to a group of private creditor lenders in a club deal is better suited for a prepack as compared to a borrower with widely-held syndicated loans or bond debt. On a related note, prepacks are an effective strategy to bind minority holdouts to a restructuring that otherwise has strong creditor support. In a typical private credit loan, converting debt to equity is a "sacred right" that requires unanimous consent. By comparison, a consensual chapter 11 plan only requires the acceptance of each voting class, which means a majority of the voting lenders holding at least two-thirds of the debt in the class. When a borrower in the midst of an out-of-court restructuring anticipates a hold-out problem, it is not uncommon for the company to simultaneously pursue an out-of-court proposal with a back-up prepack to take advantage of the more liberal voting thresholds (a so-called "stapled prepack").

3. Private Debt. A prepack strategy works best if the debt being restructured is not public. Given the uncertainty as to whether Bankruptcy Code section 1145's exemption from the securities laws applies to a prepetition solicitation of votes for a prepack, it is advisable that any pre-bankruptcy solicitation be structured to comply with U.S. federal and state securities laws. For public debt, public disclosure requirements and the delay and expense of the SEC registration process may foreclose the prepack option for a distressed company. However, when a debtor is restructuring private debt held by a relatively small group of investors, a prepetition solicitation is typically structured to be exempt from the registration requirements pursuant to Section 3(a)(9) or Section 4(2) of the Securities Act of 1933 and can be done in a quick manner with minimal SEC filing requirements.

4. Liquidity. While prepacks have a short stint in chapter 11, there is substantial work required before the bankruptcy case is filed. It takes time for a proactive borrower to engage with its lenders, negotiate and draft the plan documents, solicit acceptances, and prepare the other papers necessary to commence a chapter 11 case. Thus, a successful prepack requires a company with sufficient liquidity to fund this process and the

associated professional fee burn. Where the liquidity runway is insufficient, the existing lenders and/or sponsor may be reluctant to advance new loans outside of a DIP loan to allow for these negotiations to play out, especially when the outcome may be uncertain. The case of *Monitronics* is a good example. There, the prepackaged chapter 11 plan was confirmed 38 days after the petition date, but the restructuring was negotiated over the course of 18 months leading up to the filing.

5. Forum. The final factor for an ultrafast prepack is the jurisdiction where the chapter 11 case is filed. Typically bankruptcy courts will confirm a prepack in 30 to 60 days. But, as we saw in *FullBeauty* and *Sungard*, some jurisdictions are willing to confirm a chapter 11 plan on the day the petition is filed where the company can demonstrate compliance with all applicable notice requirements. Notably, the Bankruptcy Court for the Southern District of New York confirmed the chapter 11 plans in both *FullBeauty* and *Sungard* in less than a day notwithstanding objections from the U.S. Trustee in both cases. To counter the objections of the U.S. Trustee, the debtors explained the exigent circumstances that weighed against prolonging the chapter 11 cases. For example, in *Sungard*, the debtors' key customers indicated that they would defect to the debtors' competitors if the debtors were to remain in bankruptcy. There was also a substantial risk that the debtors' contractual counterparties in other countries would not grasp the unique protections afforded to debtors under the Bankruptcy Code. Although the court did not rely on such circumstances in its decisions, it is not clear whether other jurisdictions will similarly overrule objections filed by the U.S. Trustee or other parties in interest in the absence of any exigent circumstances.

C. What Happened in *FullBeauty* and *Sungard*?

The restructurings of *FullBeauty* and *Sungard* illustrate how these factors played out in practice. FullBeauty is a direct-to-consumer retailer in the plus-size apparel market. Its prepetition capital structure consisted of: an asset-based loan facility in the aggregate principal amount of roughly $144 million, including a first-in, last-out (FILO) tranche in the amount of $75 million; a first lien term loan in the amount of roughly $782 million; and a second lien term loan in the amount of $345 million. The first and second lienholders agreed to accept a combination of new term loans and reorganized equity in a restructuring that, among other things, resulted in a $35 million injection of new money and a reduction of existing secured debt by a total of $900 million. All other classes, including general unsecured claims, were unimpaired. The restructuring support agreement was signed by 99% of first lienholders and 95% of second lienholders. Ultimately, 100% of voting parties agreed to accept the plan.

Sungard is an information technology company that provides business continuity management software and disaster recovery services. Its prepetition capital structure consisted of: a secured revolving credit facility in the amount of $35 million; two secured term loans in the amounts of $421 million and $380 million; and unsecured notes in the amount of $425 million. Among other things, the Sungard plan converted (i) all $836 million in secured term and revolving loans into a $300 million new term loan and 89% of reorganized equity and (ii) all $425 million of notes into the remaining 11% of reorganized equity. All other claims of creditors were unimpaired, including general unsecured claims and rejection damages claims. The restructuring support agreement was executed by holders of roughly 75% of secured claims, holders of roughly 85% of unsecured notes, and the sponsors. As in *FullBeauty*, the plan was ultimately accepted by 100% of voting parties.

D. Practical Insights

We believe that the trend of chapter 11 cases filing as prepacks or pre-negotiated ones will continue in the next restructuring cycle. This is especially true in private credit deals because (a) most of the borrowers are sponsor-backed private companies, (b) funded debt is not widely held, (c) private credit lenders often have long-standing relationships with the equity sponsors across multiple credits and platforms, (d) the administrative and professional fee burn associated with a free-fall case can substantially impair recoveries, and (e) private credit lenders have the dry-powder and restructuring flexibility to convert their debt to equity and take control of an over-leveraged business, albeit often as the exit strategy of last resort. Consequently, stakeholders in distressed private credit deals may be better able to reach consensus for a commercial solution around a conference room table that maximizes value and preserves the going concern. While not every distressed situation will fit this paradigm, a "speedy" chapter 11 case may be a viable strategy for private creditors to maximize their recovery.

[1] *See* John Yozzo and Samuel Star, "For Better or Worse, Prepackaged and Prenegotiated Filings Now Account for Most Reorganizations," *ABI Journal*, November 2018, *available at* abi.org/abi-journal.

Will the Next Restructuring Cycle Be Different?

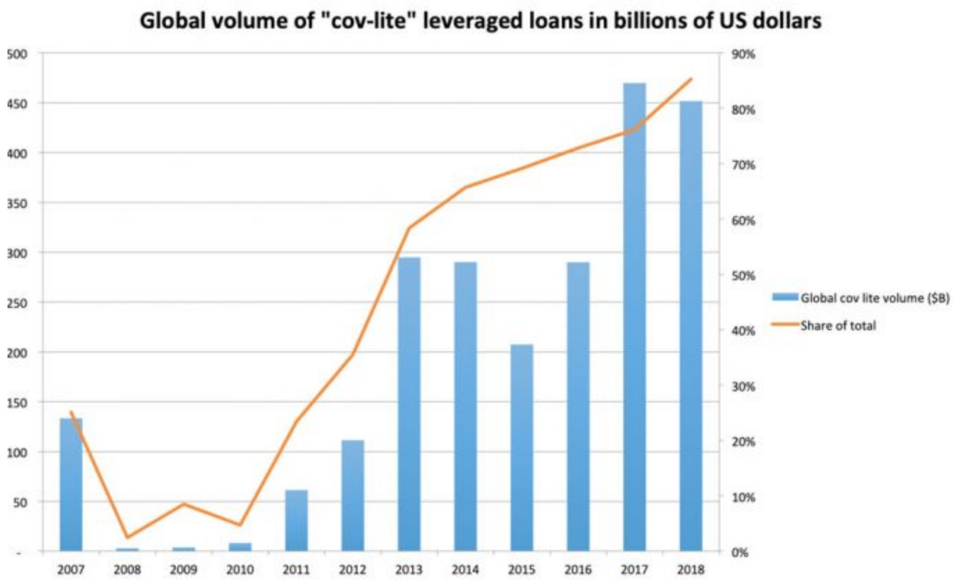
June 20, 2019

The direct lending market continues to grow at an explosive pace and the record sums now managed by private credit firms exceeds $770 billion (up from $275 billion in 2009) with $110 billion alone raised in 2018, according to a report from Preqin. Of course, no one knows how long the decade-long bull run that global markets have enjoyed will continue. But, with businesses carrying record levels of leverage and if default rates match the last recession's peak of more than 10%, there can be little doubt that private credit firms will play a significant role in the next restructuring cycle.

So will the next restructuring cycle be different? Yes, and likely in several key respects. Most notably, the next cycle will be different as a result of the proliferation of borrower friendly loan documentation that has spread from the syndicated loan market to the middle market because of intense competition for deals, the volume of "dry powder" raised by private credit funds and private equity sponsors, and the flexibility of private credit funds to support a restructuring as compared to traditional bank lenders.

"Borrower Friendly Documentation"

The sheer volume of capital vying for lending opportunities means borrower-friendly terms, with limited or significantly loosened covenants (*i.e.* "cov-loose") have become the norm as compared to the last cycle. A massive 85% of global leveraged loans are now covenant-lite, according to S&P, compared to just 23% in 2011. And an astounding total of $452 billion of new cov-lite loans were issued last year alone.



Leveraged Commentary & Data/S&P Global Market Intelligence*

Significantly, cov-lite credit agreements are no longer restricted to the syndicated loan market. Unlike the run up to the financial crisis of over a decade ago, cov-lite deals are now present in the middle market, but even more concerning is the pervasiveness of cov-loose deals. Notably, only 60 percent of deals in Proskauer's most recent Private Credit Insights report featured traditional financial covenants with the balance being either cov-lite or cov-loose.

This trend towards borrower friendly documentation will impact the next restructuring cycle in several ways. First, lenders will have far less control to insist on early remedial action when their borrowers begin a slide into distress for a simple reason: there are fewer and looser covenants to trigger the panoply of default-based rights and remedies. Financial covenants generally fall into two broad categories – maintenance and incurrence covenants. Maintenance covenants generally require the borrower to maintain compliance with certain financial metrics during the life of the loan. These covenants are intended to measure the borrower's financial health and act as an early warning sign for lenders when the borrower's business starts deteriorating. When the covenant is breached, the lender can act to protect itself and effectively force the borrower to the negotiating table. By contrast, incurrence covenants test compliance only when the borrower intends to take specified action (e.g. incur debt, sell assets, pay junior debt or declare a dividend). The proliferation of cov-lite and cov-loose loans have effectively stripped-out maintenance covenants from loan documentation and have made incurrence covenants easier to satisfy. Consequently, sponsors and borrowers can keep their lenders at bay for longer while they try to address the underlying source of distress by cutting costs, disposing of assets, acquiring businesses and/or incurring additional indebtedness to fund operations. The delay may prove costly and could impair lender recoveries if it means restructuring negotiations must happen against the backdrop of a company teetering on the brink of collapse and facing an imminent liquidity crisis. Thus, it will be important for lenders to be proactive by asking questions and actively communicating with borrowers and sponsors when trends turn negative.

Additionally, borrower-friendly definitions of EBITDA will impact the next restructuring cycle by allowing distressed companies to potentially redirect cash and assets in a manner that may impair loan recoveries. Definitions of EBITDA have shifted far away from an objective accounting standard to a negotiated concept allowing borrowers to report EBITDA with generous add-backs. These add-backs allow a borrower to include projected cost-savings and synergies (in the context of acquisition financing) that have not yet been realized and sometimes projected revenue and revenue enhancements. Many of these add-backs are uncapped and both subjective and speculative. Borrowers are therefore reporting EBITDA expectations, as opposed to historical results. This type of reporting can distort the perceived financial health of the borrower. As a result, a stressed borrower (relying on an inflated EBTIDA calculation) might be able to pass a financial covenant test, incur additional debt, make a dividend to its equity holders or take other actions that otherwise would be prohibited. Thus, the next cycle will likely feature fully leveraged balance sheets with secured lenders facing an increased risk for collateral leakage, which means little to no recovery for junior lien holders and general unsecured creditors. As a result, we are likely to see aggressive litigation tactics by out-of-the money creditors with nothing to lose and whose fees (to the extent incurred by an official creditors' committee) are paid for by the company and put additional risk on the existing lenders.

> "The sheer volume of capital vying for lendin
> opportunities means borrower-friendly terms
> with limited or significantly loosened covenan
> (i.e. "cov-loose") have become the norm as
> compared to the last cycle."

Finally, another concern in the current landscape relates to the borrower's ability to move collateral beyond the reach of existing lenders through liability management strategies, such as transfers to unrestricted subsidiaries. These provisions effectively allow collateral to leave the system, impairing the recovery of creditors. While these maneuvers have grabbed headlines in the larger syndicated market (for example, J Crew and PetSmart), the next restructuring cycle may see these tactics deployed in the middle market.

"Dry Powder"

The mountain of dry powder that is driving a proliferation of private credit loans, may also impact future restructurings. While the secondary market for middle market loans has historically been limited (at least compared to the robust liquidity enjoyed in the syndicated loan market), pressure to deploy capital may well mean that lenders may be willing to put money to work in distressed situations, creating a greater depth of liquidity for potential secondary market buyers. We also can expect to see some private credit capital redirected to fund DIP and exit loans, especially in situations where existing lenders are unwilling or unable to advance new money, creating a more robust market in that space. Furthermore, private equity sponsors also have enjoyed a decade of fundraising and are sitting on vast sums of uninvested capital themselves. Thus, it is reasonable to expect many sponsors will try to help their portfolio companies weather the storm by providing the necessary equity cures/rescue financing (perhaps in partnership with their direct lenders) to bridge a restructuring and protect their invested capital.

"**Restructuring Flexibility**"

The next restructuring cycle will also see a continuation of the trend of debt-for-equity swaps (whether out of court, through a bankruptcy sale or in a chapter 11 reorganization plan). In large part, this trend stems from the fact that private credit funds generally have the flexibility (which banks and CLOs that dominated previous restructuring cycles simply do not) to acquire ownership by converting debt to equity and have available resources to provide operational and restructuring expertise to execute a turnaround plan.

Conclusion

Without question, the meteoric rise of private credit funds has had a profound impact on loan terms. Indeed, the resulting surge in borrower friendly documentation may significantly impede recovery in any future downturn. However, as borrowers and lenders brace themselves for a pronounced shift in the economic environment, it is also clear that private credit funds will have the potential to play a meaningful and proactive role in the next restructuring cycle.

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*Source: https://www.spglobal.com/marketintelligence/en/solutions/leveraged-commentary-data

COVID-19 Crisis is Severe But Private Credit Remains Resilient

April 6, 2020

A month has passed since the outbreak of the COVID-19 pandemic in the United States. The virus has impacted almost every facet of our lives, creating chaos in the financial markets, emptying Main Streets across the nation and changing our daily routines. Unsurprisingly, private credit lenders and their borrower clients have not been left unscathed. Private credit lenders were forced to respond to urgent and rapidly changing circumstances, requests for immediate cash and other relief; encouragingly private credit lenders have thus far shown great resiliency in the face of these challenges.

1. **Pre-COVID-19**. Private credit lenders were well-served by anticipatory actions they took or were in the process of taking to prepare for an economic down turn when COVID-19 hit. Some key steps:

    a. More Conservative Investment Strategy. Many were prepared for headwinds, if not an economic downturn. They were starting to take defensive positions, being more selective in credit quality, looking for ways to tighten structures and terms. Markets were still hot for competitive, quality credits, but investment committees were already beginning to shift strategies. Default rates were extremely low.

    b. Bulked-Up Restructuring Capabilities. In late 2019 many managers began to prepare for the next restructuring cycle by hiring experienced workout and restructuring professionals, including former consultants, turnaround experts, restructuring professionals and bankruptcy attorneys. Going into March 2020, many private credit lenders had the right personnel in place to respond quickly and effectively to the rapidly changing public health and economic crisis and the increasing requests for relief and support being made by their borrower clients.

    c. Improved Internal Processes. We also counseled last year that private credit lenders should install internal procedures for tracking and evaluating credit quality so that they could better track companies, anticipate issues and proactively respond to changes in the broader economy and financial markets, many did by installing more robust credit rating systems, watch lists or other means of grading and following the credit quality of their portfolio.

2. **The Impact of COVID-19**. These proactive and prophylactic measures adopted by private credit lenders have served them well. Over the last few weeks, we have observed the following:

a. Liquidity, liquidity, liquidity! If there was one word that summed up the urgency of March it was "liquidity". Many companies were faced with unprecedented circumstances – a sudden collapse of revenue, with some having to close their operations and furlough many, if not all, employees. Many were advised to, and did, draw down on their revolvers. Virtually simultaneous draws created concerns about how private credit lenders that hold revolving commitments would respond to this flood of revolver draw requests. Were they going to fund and, perhaps more importantly, did they have the capacity to meet their funding obligations? Private credit lenders responded admirably by honoring their commitments, in nearly all cases.

b. "War Room." Speed of information and decision making was crucial. This was made even more challenging given mandated quarantine and shelter in place rules in most States. Private credit lenders were quick to establish virtual "war rooms" to be able to efficiently address problems as they arose.

c. Communication and Collaboration. Given the speed at which issues had to be addressed, it was necessary to have candid and sometimes uncomfortable conversations. Largely, sponsors, borrowers and private credit lenders successfully navigated these conversations in these early days and generally the parties constructively addressed the most immediate of issues.

d. Payment Defaults. Not only were borrowers drawing revolvers, but they were undertaking other steps to preserve liquidity. They included stretching trade payables, deferring rent payments and (not surprisingly) requesting to defer interest and/or principal payments to lenders. Towards the end of March there was frenetic activity to either amend credit agreements or enter into forbearance agreements to defer payment obligations and otherwise offer interim relief.

e. Assessing/Tightening Documents. In this environment, many of our private credit clients are requiring "red flag" reviews of the loan documents in their portfolios. It is no secret that the documentation tended to be more flexible and borrower friendly in the last several years, so while private credit lenders underwrote to those risks, they are now laser-focused on anticipating how the flexibility built into the loan documentation may come into play. Particularly as liquidity continues to be an issue, layering of debt, unencumbered collateral and use of proceeds, among other terms, are now front and center. Investment committees are requiring their portfolio managers and investment professionals to refresh on key terms of credit documentation and to tighten up in connection with any amendments, concessions or forbearances.

1. **Where Do We Go From Here**? In many ways the greatest pain is still yet to come. Borrowers and lenders are continuing to assess the short-term and long-term impact of the COVID-19 pandemic and how they can best position themselves for the days, weeks and months ahead. As this continues to unfold, difficult conversations and decisions will be unavoidable. Some key considerations will impact how private credit lenders will react, including:

a. Capital Allocation. As we enter the second quarter, private credit lenders are going to have to confront how to allocate their capital. One of the advantages of private credit lenders (as compared to banks, CLOs, mutual funds and pension funds) is that they have significant “dry powder” to invest, including for follow-on investments in existing portfolio companies. According to Prequin, private credit lenders had an aggregate of $261 billion of dry powder as of December 2019. During the last two weeks, we conducted a survey of private credit lenders. Of the over 110 private credit respondents, 97% responded that they would be willing to make additional investments in their portfolio companies. However, private credit lenders will need to determine which companies to support and how best to allocate their capital (see discussion on opportunistic financings below). Not surprisingly, sponsors will be doing the same. In this regard, valuation and cost of capital will be a significant issue.

b. Personnel Allocation. Private credit lenders will also have to decide how much human capital to allocate to any particular credit. Workouts and restructurings are time-consuming endeavors, often requiring senior resources to be fully dedicated for many months. Human capital may prove to be more scarce than investment capital, and devoting too many resources to workouts and restructurings, especially those with limited upside, may be a diversion from other, more profitable endeavors. Private credit lenders will have to determine whether the benefits of restructuring outweigh the costs on a company by company basis.

c. More Frequent Limited Partner Communication. Private credit lenders will also have to manage their limited partners. Limited partners will undoubtedly be hungry for information and may seek to make their own determinations about investment performance. The need for information at all levels will stress management of companies that are otherwise focused on survival and rehabilitation.

d. Pivot to Rescue and Opportunistic Financings. Borrowers will be focused on finding ways to bridge the next quarter or two, primarily with respect to liquidity as management looks to resuscitate operations. Many private credit lenders are well-positioned to take advantage of these opportunities. In our recent survey, almost 48% of respondents indicated that they were interested in providing special situation loans. These lenders will look for opportunities to lend against unencumbered collateral, typically on a priming basis, and other means to layer into existing capital structures.

e. New Deals Still Getting Done. Notably, while there has been a significant decline in M&A and related financings, there are new deals that have, and will, get done. More than 70% of respondents in our survey indicated that they are still looking for new acquisition financing opportunities. Recurring revenue deals, certain health care deals and financial services deals are proceeding. Moreover, it has been reported that private equity fund have over $2.5 trillion in “dry powder”. This environment may present very attractive acquisition opportunities, which will require financing.These activities will pick up as the market stabilizes and sponsors and lenders digest the immediate impact of market volatility, business and consumer demand (or lack thereof) and the impact of the federal stimulus programs.

2. **Looking Ahead**. In the current market, borrowers will continue to focus on maximizing and stretching liquidity and managing their creditors in order to best position themselves to survive the economic fallout caused by the COVID-19 pandemic. No one can predict when the economy may emerge from this pandemic or the extent of the collateral damage on the global economy. Companies that entered this cycle in a weakened state are particularly vulnerable. We predict tough and potentially prolonged negotiations among private credit lenders, sponsors and borrowers in the months ahead, and likely a spike in corporate bankruptcies, particularly in the energy, retail, hospitality and lodging, and auto supply industries. However, the best solution for many companies will be out-of-court, consensual restructurings. Private credit lenders, often as the fulcrum security, with available “dry powder” and operational resources, will be a major constituent at the negotiating table. At the same time, some private credit lenders are well-positioned to provide rescue or special situation financings as well as to take advantage of new opportunities as the M&A market regains its footing.

The “Golden Share”: All That Glitters Is Not Gold

May 18, 2020

A recent, highly anticipated ruling by a Bankruptcy Court in Delaware has reilluminated the concept of a "golden share". While an appeal of the ruling seems likely, this latest ruling by Delaware Bankruptcy Judge Mary F. Walrath suggests that as the COVID-19 outbreak continues to disrupt businesses and send shockwaves through the economy, courts may look at the specific circumstances of each case and weigh the interests of all corporate stakeholders in determining whether to enforce a "bankruptcy blocker".

What is a "Golden Share"?

A "golden share" refers to an equity interest in a company that affords the owner a number of consent rights. A key right is the right to block a company from filing for bankruptcy. Private credit lenders may rely upon a "golden share" structure when making preferred equity investments or in connection with a loan restructuring.

The Checkered History of the Enforceability of the "Golden Share" in Delaware

The first Delaware case to address the enforceability of the "golden share" was *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016). In that case, as a condition to waiving all of the company's existing events of default, a secured creditor required a borrower to amend its corporate charter to include a "golden share" provision, which required the unanimous consent of the company's common unitholders to file for bankruptcy. The company was also required to issue one common unit to the secured creditor. In response to a subsequent Chapter 11 filing by the company, the secured creditor filed a motion to dismiss, insisting that the key protection it had contracted for be enforced. Because the company had not obtained the unanimous consent of its unitholders, the secured creditor argued that the bankruptcy filing was unauthorized. Finding that the secured creditor was only a nominal unitholder and was primarily a creditor which, unlike a director, does not owe any fiduciary duties to the company, the court held that allowing the parties to contract around the constitutional right to seek bankruptcy relief would be contrary to federal public policy, and therefore, the "golden share" was unenforceable.

The Fifth Circuit Court of Appeals, however, interpreting Delaware law, came to a different conclusion when the "golden share" was held by a preferred shareholder. In *In re Franchise Services of North America, Inc.*, 891 F.3d 198 (5th Cir. 2018), a preferred shareholder agreed to make a $15 million investment in a company so long as the company reincorporated in Delaware and amended its corporate charter to include a "golden share" provision. When the company filed a Chapter 11 petition, the preferred shareholder sought to dismiss the case, arguing that the petition could not be authorized without a shareholder vote. The company responded by asserting that the shareholder's argument was a pretense for its true motivation—to secure undue leverage for repayment of its $3 million claim for unpaid consulting fees. In dismissing the bankruptcy case, the Fifth Circuit Court of Appeals agreed with the preferred shareholder and upheld the right of a bona fide preferred shareholder to exercise its "golden share".

Recently, the efficacy of the "golden share" was tested again in a bankruptcy filing by Pace Industries (*In re: Pace Industries, LLC*, Case No. 20-10927-MFW (Bankr. D. Del.)). In connection with its $37.15 million preferred equity investment, the preferred shareholder obtained various rights and protections, including an amendment and restatement of the company's corporate charter to include a "golden share" provision. In the wake of the COVID-19 pandemic, Pace Industries found itself in dire financial straits, unable to pay hundreds of millions of dollars of debt, closing many of its manufacturing facilities, and laying off the majority of its employees. However, the company successfully negotiated a restructuring and filed a Chapter 11 petition to implement the restructuring, which was supported by the company's secured creditors and which proposed to pay unsecured creditors in full. The preferred shareholder did not consent to the petition and moved to dismiss the case.

In denying the motion to dismiss, Judge Walrath was keenly focused on the harsh reality facing Pace Industries. The court was persuaded by the fact that the COVID-19 outbreak had forced the company to shut down most of its operations and that the proposed debtor-in-possession financing was the company's only source of liquidity in the midst of the global pandemic. Furthermore, Judge Walrath observed that the preferred shareholder had not offered any viable alternatives. As a result, the court concluded that permitting the bankruptcy filing would likely benefit the greatest number of stakeholders, while dismissing the bankruptcy case would violate federal public policy by taking away a debtor's constitutional right to bankruptcy relief. In declining to follow the Fifth Circuit's interpretation of Delaware state law, Judge Walrath went so far as to conclude that a blocking right might create a fiduciary duty on the part of a minority shareholder.

Key Takeaway

Unlike Franchise Services*, the bankruptcy court's ruling in* Pace Industries *echoes the sentiment expressed in* Intervention Energy *and at a minimum calls into question the enforceability of the "golden share". As Judge Walrath noted, "a minority shareholder has [no] more right to block a bankruptcy . . . than a creditor does." While the Judge Walrath's comment that the "golden share" may create a fiduciary duty may be a bridge too far, the case is a reminder that in these extraordinary times, bankruptcy courts will look skeptically on the enforceability of so-called bankruptcy blockers.*

The Private Credit Group and The Private Credit Restructuring Group at Proskauer are closely monitoring the impact that COVID-19 will have on judicial decisions that may affect private credit lenders.

* * *

Proskauer's cross-disciplinary, cross-jurisdictional Coronavirus Response Team is focused on supporting and addressing client concerns. We will continue to evaluate the CARES Act, related regulations and any subsequent legislation to provide our clients guidance in real time. Please visit our Coronavirus Resource

Center for guidance on risk management measures, practical steps businesses can take, and resources to help manage ongoing operations.

Feast or Famine: Private Credit Restructuring Year in Review

February 18, 2020

With the explosion of private credit over the last decade, it felt almost inevitable that this past year, one marked by prolonged anticipation of a global economic slowdown, would experience its share of restructuring activity. As we look back on 2019, private credit lenders faced a defining moment: feast or famine. Indeed, if they could not find a seat at the table, private credit lenders likely found themselves on the menu. The notable developments below highlight the risks to minority lenders, just as much as they reveal the opportunities available to asset managers with size and capital in an environment where debt documents have become less potent for creditors to rely upon in a restructuring.

Whether opposition from borrowers and sponsors armed with cov-lite or cov-loose flexibility, or intra-creditor warfare spawned by non-pro rata transactions, 2019 served as a powerful reminder of the importance for private credit lenders to understand their rights in a downside scenario and to mobilize quickly and meaningfully the moment they sense credit deterioration.

With all the unpredictability around the world in the last few weeks alone, one thing is certain: private credit restructuring will continue to grow in 2020, and the fault lines that private credit lenders navigated in 2019 will deepen.

Direct Lenders Beware: The Threat of Surcharge in the Sears Bankruptcy Case

The Sears bankruptcy case encapsulated the risks to secured lenders if they fail to obtain a section 506(c) waiver when they have the opportunity to do so. While expenses associated with a bankruptcy case do not get paid from collateral proceeds absent an express agreement to the contrary, if the debtor uses unencumbered cash to maintain or sell encumbered assets, it can seek to "surcharge" the secured creditor under section 506(c) of the Bankruptcy Code. To avoid this outcome, at the outset of a bankruptcy case, a secured creditor should demand that a debtor waive the estate's right to seek a surcharge under section 506(c) in exchange for its agreement to allow the debtor to use cash collateral and/or provide DIP financing. Although a secured creditor typically obtains a 506(c) waiver in a cash collateral and/or DIP financing order, lenders of all types, including bulge-bracket commercial and investment banks, private credit lenders, BDCs, hedge funds and CLOs, should understand the potential for litigation if they proceed without one. In Sears, the debtors attempted to surcharge second lien lenders with more than $1.4 billion of administrative expenses. After the second lien lenders asserted a roughly $200 million superpriority claim for alleged diminution in the value of their collateral pursuant to section 507(b) of the Bankruptcy Code, Sears countered with its $1.4 billion surcharge under 506(c) to establish that the second lien lenders were not entitled to anything. Judge Drain ultimately denied the surcharge, but the decision still serves as a reminder to secured creditors of the importance of a 506(c) waiver, and the lengths debtors or their creditors' committees will go to exert negotiating leverage on secured creditors.

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Direct Lenders Beware: How Your World Can Turn Upside Down in Chapter 11

Deluxe Entertainment and CLOs: A New Frontier for Distressed Investors

The chapter 11 filing of *Deluxe Entertainment* had the distressed investing community talking about collateralized loan obligations, or CLOs. A CLO is often held by a fund that raises debt and equity capital from investors, the proceeds of which are principally used to acquire a portfolio of senior secured loans issued to below investment grade borrowers. The principal and interest payments on the underlying loans held by the fund are used to pay the CLO fund investors. The capital raised is divided into separate tranches, each of which has a different risk/return profile based upon its priority claim to the cash flows produced by the underlying loan portfolio. Importantly, CLO fund documents often include a variety of restrictions intended to help protect CLO investors from loss, including limitations on the fund's exposure to second lien or unsecured loans and the amount of CCC-rated debt that can be held in the portfolio. In addition, some CLO funds are not permitted by their origination documents to invest in equity securities. Given these restrictions, in *Deluxe Entertainment*, certain CLO fund lenders that had previously expressed willingness to finance the company's stapled prepackaged chapter 11 plan were no longer able to do so after Standard & Poor's downgraded the credit rating of the borrower's term loan to CCC (presumably because, as is the case with many CLO funds, they could not hold more than 7.5% of CCC-rated debt in their respective portfolios). This forced the company to pivot towards a longer prepackaged chapter 11 case, instead of the originally-intended out-of-court exchange or “24-hour” prepack.

As the *Deluxe Entertainment* case illustrates, the proliferation of CLOs will increasingly shape restructuring outcomes. For example, an interesting dynamic may form among lenders in an ad hoc group if some lenders are CLO funds while others are more flexible investment funds – the more flexible investment funds may be negotiating for the class of creditors to receive reorganized equity while the CLO funds could be bargaining for the class to receive take-back paper (given certain CLO fund documents do not permit CLOs to hold equity). Another problematic scenario exists when a distressed company has a loan held by both CLO and non-CLO funds. In such a situation, assuming the CLO fund lenders do not hold a blocking position in the class, the non-CLO fund lenders may propose a restructuring predicated on the infusion of new capital on a dilutive basis (*e.g.*, through a rights offering) made available to all lenders in the class. If successful, the non-CLO fund lenders could obtain an outsized share of the reorganized company compared to what they would have received had there been no participating CLO fund lenders. Additionally, many CLO funds may decline to participate in rescue financing to a troubled company because they want to minimize their exposure to CCC-rated debt, especially if CLO fund managers wish to preserve capacity for their 7.5% buckets in anticipation of a market downturn. Ultimately, any distressed investor will need to understand how CLO fund constraints affect the dynamics of corporation reorganizations.

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CLOs: A New Frontier for Distressed Investors

A Need for Speed: The Ultrafast Prepack for Private Credit Restructurings

As 2019 witnessed a number of “24-hour” prepackaged bankruptcy cases, private credit lenders should expect to see a need for speed to drive the next wave of restructurings. A “prepack” is a chapter 11 case where the borrower negotiates, drafts a chapter 11 plan, and solicits acceptances for the plan before the bankruptcy case is even filed. The advantages of a prepack include, among other benefits, the cost savings associated with a protracted bankruptcy case, as well as the certainty of outcome presented by the filing of a confirmable plan on the first day of the case. Notably, the need for speed sometimes requires paying in full the trade vendors and other creditors who would otherwise be entitled to the protection provided by a statutory creditors’ committee, whose appointment and work stand in the way of speed.

Private credit deals are natural candidates for the ultrafast prepack because (a) most of the borrowers are sponsor-backed private companies, (b) funded debt is not widely held, (c) private credit lenders often have long-standing relationships with the equity sponsors across multiple credits and platforms, (d) the administrative and professional fee burn associated with a free-fall case can substantially impair recoveries, and (e) private credit lenders have the dry-powder and restructuring flexibility to convert their debt to equity and take control of an over-leveraged business, albeit often as the exit strategy of last resort. For these reasons, stakeholders in distressed private credit deals may be better able to reach consensus for a commercial solution around a conference room table that maximizes value and preserves the going concern.

The ultrafast prepack garnered the most attention in the 2019 chapter 11 cases of *FullBeauty* and *Sungard*, which emerged from bankruptcy in 24 hours and 19 hours, respectively. FullBeauty is a direct-to-consumer retailer in the plus-size apparel market. Its prepetition capital structure consisted of: an asset-based loan facility in the aggregate principal amount of roughly $144 million, including a first-in, last-out (FILO) tranche in the amount of $75 million; a first lien term loan in the amount of roughly $782 million; and a second lien term loan in the amount of $345 million. The first and second lienholders agreed to accept a combination of new term loans and reorganized equity in a restructuring that, among other things, resulted in a $35 million injection of new money and a reduction of existing secured debt by a total of $900 million. All other classes, including general unsecured claims, were unimpaired (paid in full). The restructuring support agreement was signed by 99% of first lienholders and 95% of second lienholders. Ultimately, 100% of voting parties agreed to accept the plan.

Sungard is an information technology company that provides business continuity management software and disaster recovery services. Its prepetition capital structure consisted of: a secured revolving credit facility in the amount of $35 million; two secured term loans in the amounts of $421 million and $380 million; and unsecured notes in the amount of $425 million. Among other things, the Sungard plan converted (i) all $836 million in secured term and revolving loans into a $300 million new term loan and 89% of reorganized equity and (ii) all $425 million of notes into the remaining 11% of reorganized equity. All other claims of creditors were unimpaired, including general unsecured claims and rejection damages claims. The restructuring support agreement was executed by holders of roughly 75% of secured claims, holders of roughly 85% of unsecured notes, and the sponsors. As in *FullBeauty*, the plan was ultimately accepted by 100% of voting parties.

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Restructuring Trend: The Ultrafast Prepack for Private Credit Deals

On the Eve of Filing: The Rise of the Non-DIP, DIP

As an alternative to traditional debtor-in-possession financing, two notable borrowers in 2019 took advantage of the flexibility in their credit documents and issued secured debt against unencumbered assets on the eve of their planned chapter 11 filings. Thus, overnight, both PHI, Inc. and Bristow Group became synonymous in the private credit market with a phenomenon now known as the "non-DIP, DIP" and brought into focus the importance of understanding the existing collateral package long before distress appears on the horizon.

In these cases, the debtors obtained the liquidity they needed to fund an in-court restructuring without bankruptcy court approval or junior creditor consent. Unlike the "non-DIP, DIP," routine postpetition debtor-in-possession loans often invite scrutiny from unsecured creditors and statutory creditors' committees, as their approval can vest DIP lenders with case control and enhanced collateral. A mechanism that allows a borrower to procure a bankruptcy loan without such obstacles, therefore, is highly attractive. While PHI and Bristow demonstrate the ultimate success of "non-DIP, DIP" loans, lenders extending financing on this basis must ensure that they have a high degree of confidence in the perfection of their liens (which they may have been forced to diligence on an expedited timeline) without the protections of a bankruptcy court order, and understand the potential for the cramdown or reinstatement at exit. Will non-DIP, DIPs continue to have a resurgence in 2020? Private credit lenders should pay close attention and also understand the risks. Any prepetition secured or unsecured loan can be restructured in chapter 11 and is subject to cramdown. Prepetition loans do not qualify as administrative expenses. The debtor is not necessarily required to pay postpetition interest prior to plan confirmation. The loan itself is a financial accommodation which the debt may not assume or assign. Thus, while the lender may consent and even urge its assumption, parties in interest may challenge the debtor's use of it unless the loan amount was fully drawn prepetition. Parties in interest may also challenge any fees associated with the loans as fraudulent transfers if they were not 'market.' This is not for beginners!

Know Thy Pledge: The Limitations of a Voting Proxy in the MTE Bankruptcy

Private credit lenders often require a borrower to pledge its equity in operating subsidiaries as collateral to secure repayment of a loan. Thus, upon a default, among other remedies, the lenders can exercise the borrower's voting rights through the equity pledge and reconstitute the subsidiary's board of directors with a new slate unencumbered by any allegiances to the sponsor. In the chapter 11 case of MTE Energy, an LLC, the borrower filed for bankruptcy after the lenders directed the agent to exercise their proxy rights, appoint a chief restructuring officer, and a new five-member board. MTE did not recognize the agent's enforcement actions on the basis that its exercise of the proxy was not valid because it did not take the steps required under the collateral agreement and the Delaware LLC Act. After a contested trial, the bankruptcy court ruled the agent did not properly exercise the proxy. Here, the collateral agreement provided that the pledged shares ***first*** had to be registered in the name of the lender, which the agent failed to do. To register the shares, the LLC agreement provided the lender had to obtain a transfer of the membership interests and a certificate evincing the lender's ownership interests. To ensure they preserve all the rights and remedies they have bargained for and do not unnecessarily cede any leverage to the borrower or sponsor, private credit lenders must take care to ensure their security documents do not present any obstacles to the exercise of an important lender remedy, and if they determine to exercise their proxy rights, they must do it ***precisely*** as prescribed.

Corporate Governance Considerations: Nonvoting Board Observers in Tibet Pharmaceuticals

As private credit lenders engage with borrowers in distress, they may seek to enhance visibility through corporate governance; namely, the right to hold one or more board seats or, alternatively, to appoint a nonvoting board observer with information rights. In *Obasi Investment Ltd. v. Tibet Pharmaceuticals Inc.,* the Third Circuit rejected the theory that nonvoting board observers were similar to directors for the purposes of imposing liability for securities law violations. Here, Tibet Pharmaceuticals filed a registration statement in connection with Tibet's initial public offering, which listed the defendants, an early investor and financial professional affiliated with the placement agent, as nonvoting board observers. The registration statement failed to disclose material negative information, which led to the eventual crash of Tibet stock. Certain equity investors in Tibet sued the Observers, among others, alleging violations of section 11 of the Securities Act of 1933, which prohibits untruths and omissions made in registration statements. Section 11 liability attaches to "every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner." Plaintiffs alleged the Observers fit this category and should be held liable.

The court disagreed finding the nonvoting board observers were ***not*** a person who, is or is "about to become a director [] [or] person performing similar functions …" for purposes of section 11 of the Securities Act. The court determined that directors are "defined by their formal power to direct and manage a corporation, and the responsibilities and duties that accompany those powers." By contrast, the Observers were not directors nor performing "similar functions" because (1) the Observers could not vote for board actions, (2) the Observers loyalties were aligned with the placement agent, not the company and its shareholders and (3) the Observers could not be voted out because their tenures had an automatic end date.

While the court's decision is limited to determining who can be held liable under section 11 of the Securities Act, it offers some helpful guidance to private credit lenders on the distinction between nonvoting board observers and formal corporate directors, and highlights the significant differences between the two. For example, directors have voting – and sometimes veto – rights, but also owe certain fiduciary duties to the company and its shareholders and must be careful not to engage in activities that could be viewed as self-interested or not in the best interest of the company and its shareholders. That would breach their duty of loyalty. In addition, a member of the private fund advisor who also sits on the company's board of directors must navigate potential conflicts of interest between their duties to the company and the private fund. Board observers, on the other hand, have access to important and timely information, and while they do not have voting rights, board observers, unlike directors, do not owe fiduciary duties. The Third Circuit's decision – distinguishing board observers from directors for purposes of liability in at least some contexts – is another data point for private credit lenders to consider when weighing the pros and cons of appointing a director or a nonvoting board observer. For whether non-voting observers will be charged with other duties, such as confidentiality and noncompetition, stay tuned.

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Private Credit Prepares for the Next Cycle

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Will the Next Restructuring Cycle Be Different?

Minority Lenders Strike Back: The Empire Generating Bankruptcy Case and Lessons from the Alta Mesa Decision

In *Empire Generating,* the bankruptcy court approved both a credit bid and chapter 11 plan negotiated by the majority secured lenders over vigorous objections from minority secured lenders.

Debtor TTK Empire, LLC owned 100% of the equity of debtor Empire Gen Holdings, LLC and had pledged its equity interests in Holdings under the prepetition credit documents. The debtors sought authority for a simultaneous (a) sale of the equity interests in Holdings and (b) chapter 11 plan for creditors of Holdings and the other debtors. To effectuate the sale, the majority lenders (who held 55% of the debt) directed the agent under the credit facility to credit bid all outstanding obligations under the prepetition credit documents (including the objecting minority lenders' 45% of the debt) in exchange for the equity interests in Holdings. Contemporaneously, the debtors filed a plan under which the debtors' remaining creditors would be paid in full. The debtors and majority lenders argued that claims under the credit facility were not subject to classification or treatment (or entitled to vote) under the plan because the credit bid had exhausted their claims in the credit-purchase of their collateral.

The minority lenders asserted, among other things, that the credit bid violated the collateral agent's duties under the intercreditor agreement to act for the benefit of all secured lenders - not just for the majority lenders. The minority lenders also objected to the sale's discharge of their liens and claims that had extinguished their right to vote under the plan without any actual determination of whether the minority lenders were impaired. The minority lenders were specifically concerned because the sale and plan provided the majority lenders with the ability to control the governance structure of the reorganized debtors and could avoid providing any meaningful protections for the minority lenders' interests in the reorganized debtors. The majority lender responded that the intercreditor agreement vested the collateral agent (at the direction of a majority of lenders) with sole discretion over enforcement rights including the right to credit bid for the underlying collateral, and that any claims based on corporate governance concerns should be prosecuted in state court.

The bankruptcy court ultimately approved the sale and confirmed the plan over the minority lenders' objection finding the credit bid was proper and that the Plan's treatment of claims complied with the Bankruptcy Code. The minority lenders' appeal of the bankruptcy court's sale and confirmation orders are currently pending with the district court. Lesson: Beware of the terms of security agreements and rights of collateral agents.

The outcome of this dispute, which remains ongoing, will be important for both majority and minority lenders, as well as crafting new documentation, going forward.

Indeed, just last month, a Houston bankruptcy judge in the Alta Mesa chapter 11 case held minority lenders lacked standing to object to free and clear sales of the lenders' collateral where the majority lenders had directed the agent to consent to the sale. The court found that under the credit agreements, the lenders had irrevocably granted the agent the exclusive authority to approve the sale transaction and release liens on the collateral, and, thus, the minority lenders had consented to the sale. The court also found that while lenders might have standing to raise objections that did not deal with collateral, exercising such standing would violate their contractual agreement not to take actions inconsistent with the agent's actions. Recognizing the impact of the decision, the court pushed back the sale closing to allow parties to appeal the decision to the District Court.

The battle of minority lenders to have their voices heard in private credit restructurings will continue in 2020.

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Proskauer Sees Dry Powder Helping Restructurings: Q&A

Healthcare Restructuring Challenges: The State of Medicare Provider Agreements in the Wake of the Verity Health and Philadelphia Hospital Cases

Since 2016, more than one in five private credit transactions handled by the Proskauer Private Credit Group involved healthcare borrowers. While default rates on these loans have remained low, private credit lenders must be sensitive to the unique characteristics of healthcare loans and how those qualities manifest themselves when a borrower experiences financial or operational stress. One of the most common obstacles faced in healthcare loan restructurings stems from theborrower's inability to transfer or monetize its relationship with Medicare, particularly when the borrower has exposure for Medicare overpayments or other liabilities arising from non-compliance with applicable healthcare laws. In an out-of-court setting, CMS aggressively enforces its rights, in particular the right to recoup overpayments or suspend Medicare reimbursements where False Claims Act and other violations of law are suspected. By aggressively, we mean aggressively. CMS does not hesitate to charge fraud and ask the FBI to raid the debtor's offices. In bankruptcy, CMS is equally aggressive, insisting that borrowers may only "assume and assign" rights to participate in Medicare – frequently referred to as a "Medicare provider agreement" – under Bankruptcy Code provisions governing executory contracts. To do so, a borrower or a purchaser of its business must cure all existing defaults and assume full responsibility for all known ***and*** unknown liabilities, including liabilities for False Claims Act, Stark, and Anti-Kickback violations. Faced with this "all or nothing" dilemma, private credit lenders will have no interest in acquiring the borrower's business and, therefore, the strategic options available may be limited to a fire sale of the borrower's assets to a strategic purchaser. Two recent bankruptcy court decisions, however, may have dramatically changed the landscape.

In separate decisions handed down in September 2019, in the *Verity Health* and *Philadelphia Hospital* bankruptcy cases, respectively, bankruptcy judges in California and Delaware rejected these conventional notions about Medicare participation, concluding that a debtor's "participation agreement" is not an executory contract. Rather, both courts held that Medicare participation is a statutory entitlement that a debtor/borrower may sell free and clear of pre-existing liabilities, including claims of overpayment by CMS. While the precise contours of these rulings remain to be developed in future cases, if upheld on appeal, lenders may have a powerful new tool to work with that was previously unavailable to them in a healthcare setting – a credit bid in bankruptcy.

The ability to deploy new capital to fund a corporate turnaround as a means of maximizing existing loan recoveries is one of several attributes that sets a private credit provider apart from a traditional lender. In the healthcare context, if a borrower's right to participate in the Medicare system is an asset that can be encumbered and sold like other assets, ***free and clear*** of preexisting liabilities, then direct lenders will no longer be relegated to accepting the net proceeds from fire sales to a strategic bidder in a hastily organized sale process. On the contrary, lenders may now be able to avoid the triple threat posed by (i) the right of CMS to suspend, withhold or recoup Medicare payments, (ii) the inability of a borrower to discharge False Claims Act liability under a chapter 11 plan, and (iii) the ability of CMS to impose "successor liability" as a condition of any sale by a troubled healthcare company.

In a world where Medicare provider entitlements may be encumbered and sold free and clear of pre-existing debts, private credit lenders can structure and finance a sale process that will be open to financial purchasers and where a reserve price is effectively set. Absent purchase offers at price levels the lender believes are achievable immediately or in the future following a turnaround effort by the borrower, the lender can credit bid its debt, acquire the borrower's business and implement a turnaround plan as the owner of a company with a restructured balance sheet. Although this strategy is routinely pursued in other industries, it has previously been unavailable to health care lenders.

The Year Ahead: Private Credit Restructuring in 2020

As predictions for the timing of the next cycle abound, private credit restructuring already has witnessed continued activity in the new year. With the growing sophistication and resiliency of sponsors, private credit lenders must refine the lessons they learned in 2019 as they script the 2020 restructuring playbook. In a world of feast or famine, the stakes for private credit lenders have never been higher.

Faculty

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David M. Hillman is a partner with Proskauer Rose LLP in New York, co-head of its Private Credit Restructuring Group and a member of its Business Solutions, Governance, Restructuring & Bankruptcy Group. He has spent nearly 25 years of experience with an emphasis on representing private credit lenders, private funds, sovereign wealth funds and other alternative lenders and distressed investors in special situations and restructurings both in and out of court, whether the lender is secured or unsecured, unitranche or structured preferred. Mr. Hillman has experience in every phase of restructuring and distressed investing, including credit bidding sales under § 363, debt-for-equity swaps, chapter 11 plans, out-of-court restructurings and foreclosures, and navigating intercreditor issues involving the relative rights of majority and minority lenders. He also litigates the issues facing private credit lenders, including issues involving plan confirmation, solvency, valuation, intercreditor disputes, financing and cash-collateral disputes, fraudulent transfers, equitable subordination, recharacterization, breach of fiduciary duty and similar disputes. Mr. Hillman was listed as a "leading individual" in bankruptcy/restructuring by *Chambers USA* and as a leader in his field by *New York Super Lawyers* as well. A member of ABI, he speaks frequently on bankruptcy-related topics, including recent decisions affecting secured creditor rights and preparing creditors for bankruptcy risks. Mr. Hillman received his B.A. *cum laude* from the State University of New York at Oneonta and his J.D. *cum laude* from Albany Law School, where he was associate editor of the *Albany Law Review*.

Hon. James M. Peck (ret.) is global co-chair of Morrison & Foerster LLP's Business Restructuring & Insolvency group in New York. Previously, he served as a U.S. Bankruptcy Judge for the Southern District of New York in New York, appointed on Jan. 10, 2006, and presided over the chapter 11 and SIPA cases of *Lehman Brothers* and served as mediator in a number of major cases including *American Airlines*, *MF Global*, *Residential Capital* and *General Motors*. Prior to his appointment, he was in private practice in Philadelphia and New York City for 35 years, concentrating in insolvency law and creditors' rights. Judge Peck was a partner at the law firm of Duane Morris LLP for 10 years and moved to New York in 1990 to join Schulte Roth & Zabel LLP as co-head of its Business Reorganization department. He has written and lectured extensively on business bankruptcy topics and has frequently served as both moderator and panelist at regional, national and international conferences. Judge Peck is a member of INSOL International's College of Mediators and is on its Prime Finance Panel of Experts. He also co-chaired the International Insolvency Institute's 16th Annual Conference in Tokyo. Judge Peck is a member of The World Bank's Task Force on Creditor/Debtor Regimes and the advisory board of ABI's and Georgetown University Law School's Views from the Bench program. He is also an adjunct professor of finance at New York University's Stern School of Business. Judge Peck received his B.A. from Dartmouth College and his J.D. from New York University School of Law.

Hon. Scott H. Yun is a U.S. Bankruptcy Judge for the Central District of California in Riverside, sworn in on June 23, 2014. Prior to his appointment to the bench, he was a shareholder of Stutman, Treister & Glatt in Los Angeles, where he specialized in representing debtors, committees and other constituents in chapter 11 bankruptcy cases. Before entering private practice, he clerked for Hon. Ernest M. Robles, U.S. Bankruptcy Judge for the Central District of California. Judge Yun received his B.A. *cum laude* from University of California, Los Angeles in 1993 and his J.D. from the University of Southern California in 1996, during which time he was an extern for Hon. Barry Russell, U.S. Bankruptcy Judge for the Central District of California.