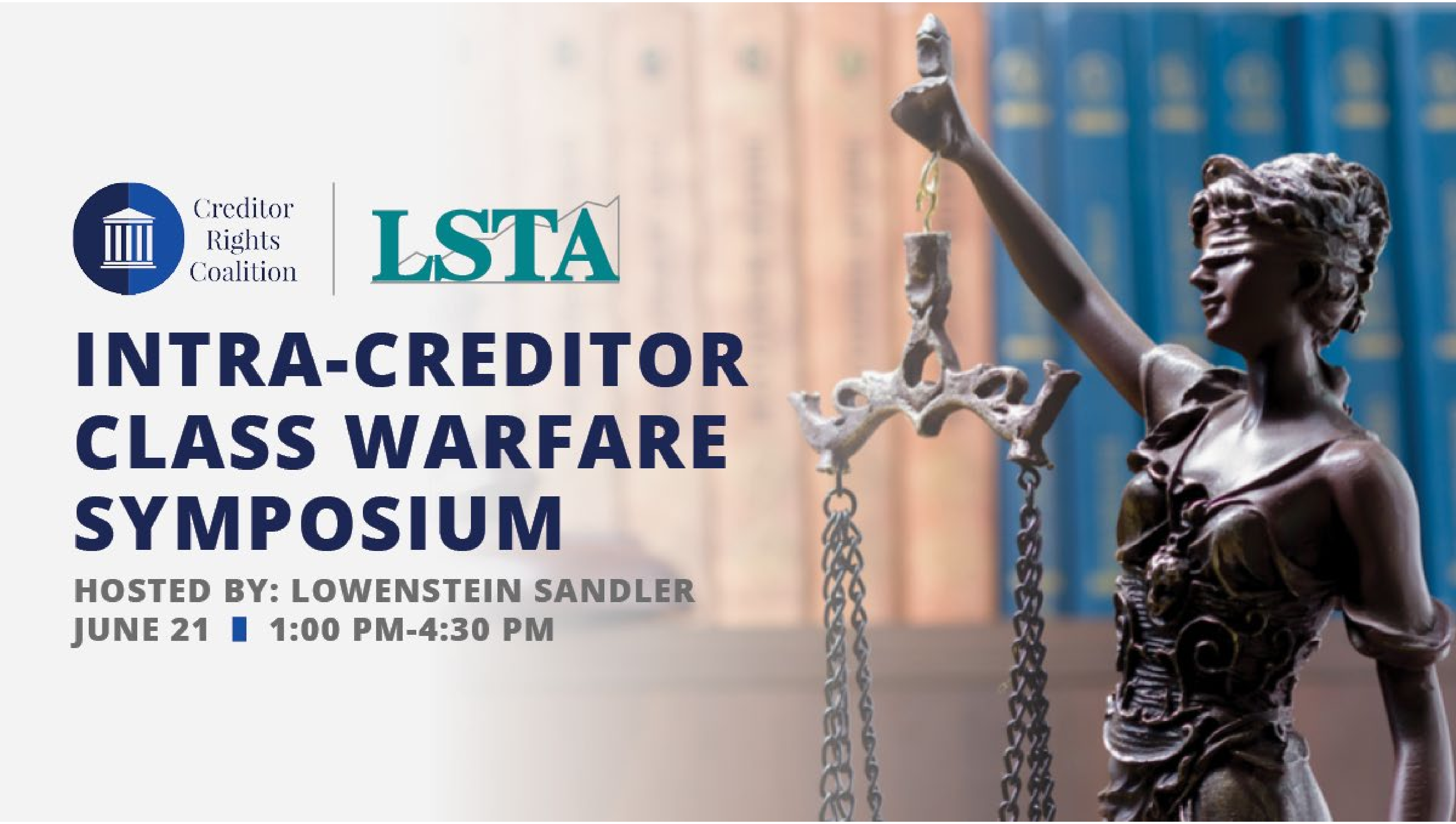
Panel 1: What is class warfare?



Intra-Creditor Class Warfare: What is it?

OVERVIEW

- Over the past several years, **"aggressive"** forms of distressed liability management transactions have caused **creditor concern** and questioned long-standing market assumptions about creditor protections
  - ***"Drop-down" financings***, in which assets (oftentimes **"crown jewel"** assets like intellectual property) are transferred outside of an existing collateral package often, though not always, using unrestricted subsidiaries, and then offered to a sub-set of creditors as structurally senior financing
    - The quintessential drop-down financing was the *J. Crew* transaction from 2016
    - More recent examples include:
      - *Travelport* (2020)
      - *Cirque du Soleil* (2020)
      - *Revlon* (2020)
      - *Envision* (2022)
  - ***"Uptiering" transactions***, in which **priming new-money and/or rolled debt** is offered to a sub-set of creditors to enhance the priority of their claims to an existing collateral and guarantee package over other existing pari-passu creditors
    - One of the earliest uptiering transactions was the NYDJ transaction from 2017
    - More recent examples include:
      - *Murray Energy* (2018; litigated in 2020)
      - *Serta Simmons* (2020)
      - *Boardriders* (2020)
      - *TriMark* (2020)
      - *Incora* (2022)

Drop-Down Financings: Why the Controversy

- Using "trap doors" and other flexibility in "covenant-lite" loans, distressed borrowers have moved collateral away from existing lenders to secure new loans, including by "dropping down" **crown-jewel assets** (e.g., intellectual property) oftentimes into an unrestricted subsidiary
  - E.g., Claire's, J. Crew, Revlon, Envision
- **Some (but not all)** existing lenders/noteholders who hold a majority of the debt may be offered the opportunity to exchange their existing debt for new debt secured by the transferred assets
- While J. Crew utilized a **"trap-door"** to access an additional $150 million of basket capacity (an unusual provision) it has come to symbolize aggressive use of liability management techniques to shift assets away from creditors
- This implicates what type of covenant flexibility is envisioned by market participants (and when the line is crossed)
- Controversy of how to value assets within the purview of the sponsor/company

Drop-Down Financings

Typical Structure	Applicable Credit Agreement Provision
Formation or identification of NewCo	• Definition of "unrestricted subsidiary" and "designation" provisions • Collateral and guarantee/excluded subsidiary provisions
Transfer of assets to NewCo (often accompanied by a license of the transferred asset back to borrower)	• Investment covenant • Asset sale covenant • Collateral release provisions • Sale leaseback covenant • Limitations on release of all or substantially all of the collateral (if applicable)
Incurrence of new debt at NewCo (the "New Structurally Senior Debt"), which is either: • unlimited (if NewCo is an unrestricted subsidiary); or • subject to the existing credit facility covenants (if NewCo is an excluded restricted subsidiary)	• If applicable, restrictions on unrestricted subsidiaries guaranteeing, or being guaranteed by, credit parties • If incurred at or guaranteed by an excluded restricted subsidiary, debt and lien capacity (typically subject to "non-guarantor" sub-limits) • Future guarantor provision
Where applicable, exchange or "roll up" all or a portion of existing loans of the new creditors into New Structurally Senior Loans	• Pro rata sharing provisions • Borrower buybacks; Dutch auction provisions; provisions allowing for non-pro rata assignments via "open market purchases" • Limits on prepayments junior debt (if applicable)

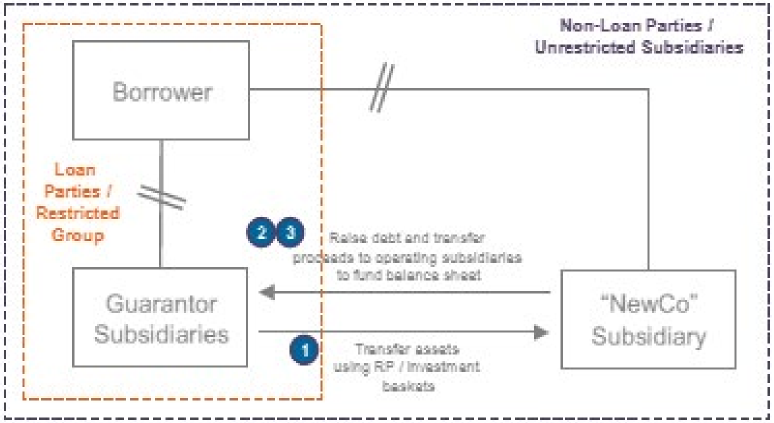
Drop-Down Financings

OVERVIEW OF TRANSACTION AND ASSUMPTIONS

1. Company creates “NewCo”; then transfers assets to NewCo or designates an existing subsidiary as unrestricted
   a) Non-Loan Party Restricted Subsidiary is bound by covenants in Credit Agreement, but does not provide a guarantee to existing indebtedness
   b) If utilizing an Unrestricted Subsidiary, covenants do not apply
2. Raise structurally senior indebtedness at NewCo from existing lenders, sponsor or 3rd party
   – Quantum of debt raised will be a function of value transferred and market for indebtedness
3. Proceeds of capital raise maybe up-streamed to the borrower / operating entities to fund cash flow shortfalls and bolster liquidity

Note: There are often limits within the document as to the amount of non-loan party debt available and the amount of assets that can be transferred outside of the credit group

ILLUSTRATIVE TRANSACTION MECHANICS



KEY CONSIDERATIONS / BENEFITS

- ✓ Provides incremental liquidity to balance sheet necessary to fund anticipated cash flow shortfall
- ✓ Generally provides for permissibility in docs
- ✓ No Sponsor capital necessarily required
- ✗ Litigation risk depending on liquidity profile and movement of assets
- ✗ Requires attractive assets for market to lend against
- ✗ Temporary fix and often still requires sustained operational improvement to address maturities

J. Crew: What happened?

Transaction: J. Crew valued its intellectual property at $347 million and then utilized two baskets to transfer a majority (~72% or $250 million) of its U.S. trademarks into a new unrestricted subsidiary ("IPCo"). Thereafter, the company entered into a series of distressed exchanges with term loan lenders and junior holdco PIK notes to move out maturities.

J.Crew "Trap Door" opened up $150 million of capacity. Section 7.02(t) permitted <u>unlimited</u> investments made by any Restricted Subsidiary that is not a Loan Party (e.g., Foreign Subsidiaries) to the extent such Investments <u>are financed with the proceeds received by such Restricted Subsidiary from an Investment in such Restricted Subsidiary made pursuant to certain sections</u>, including Permitted Investments of up to $150 million in Restricted Subsidiaries.

Why the controversy? Aggressive use of liability management through trap-door to move crown-jewel IP assets away from senior lenders to offer distressed exchange to junior holdco PIK notes created precedent for aggressive liability management.

Litigation: The company filed action against the Term Loan Agent seeking a declaratory judgment that the transaction did not violate the existing Term Loan Agreement. This action was eventually dismissed upon closing of the transaction.

Up-Tier Exchanges: Why the controversy?

- Using architecture permitting open-market purchases at a discount, sponsors/companies have engaged in "up-tier" exchange transactions with a subset of their existing lenders who hold a majority of the debt to raise additional senior priming debt
- Typical elements of an up-tier exchange transaction include:
  - Use of open-market purchase flexibility to exchange debt-for-debt (pro-rata provisions normally require 100% consent)
  - Use of Required Lender vote to effect lien subordination through amendment to permit superpriority debt and remove prohibitions on subordination of existing loans (release of collateral requires 100%)
  - Incurrence of new superpriority debt with liens having priority over existing secured debt
- Additional elements may include:
  - Roll-up of existing debt held by majority lenders (may implicate pro rata sharing provisions, waterfall provisions and/or assignment provisions)
  - Covenant strip and addition of "no-action" provision

Up-Tiering Transactions

Typical Structure	Applicable Credit Agreement Provision
Incurrence of new debt by the borrower that is senior to existing loans	• Debt and lien covenants • Limits on subordination of existing debts
Exchange/rollup of all or a portion of existing loans into senior debt that is pari with or junior to the New Superpriority Loans (but senior to the existing loans) ("Rolled Up Superpriority Debt")	• Pro rata sharing provisions • Buybacks or Dutch auction provisions or ability to do non-pro rata open market purchases • Limits on prepayment of junior debt (if applicable)
The New Superpriority Debt and the Rolled Up Superpriority Debt may take the form of: • a new tranche of loans within the loan document, with priority governed by a waterfall; or • debt under a separate credit facility, with priority governed by an intercreditor agreement	• Pro rata sharing/waterfall provisions (including related amendment requirements) • Subordination/release of all or substantially all collateral • Intercreditor restrictions
"Covenant stripping" and Exit Consent	• Gives "pro forma" effect to new indebtedness in determining Required Lenders • Limits on exit consents

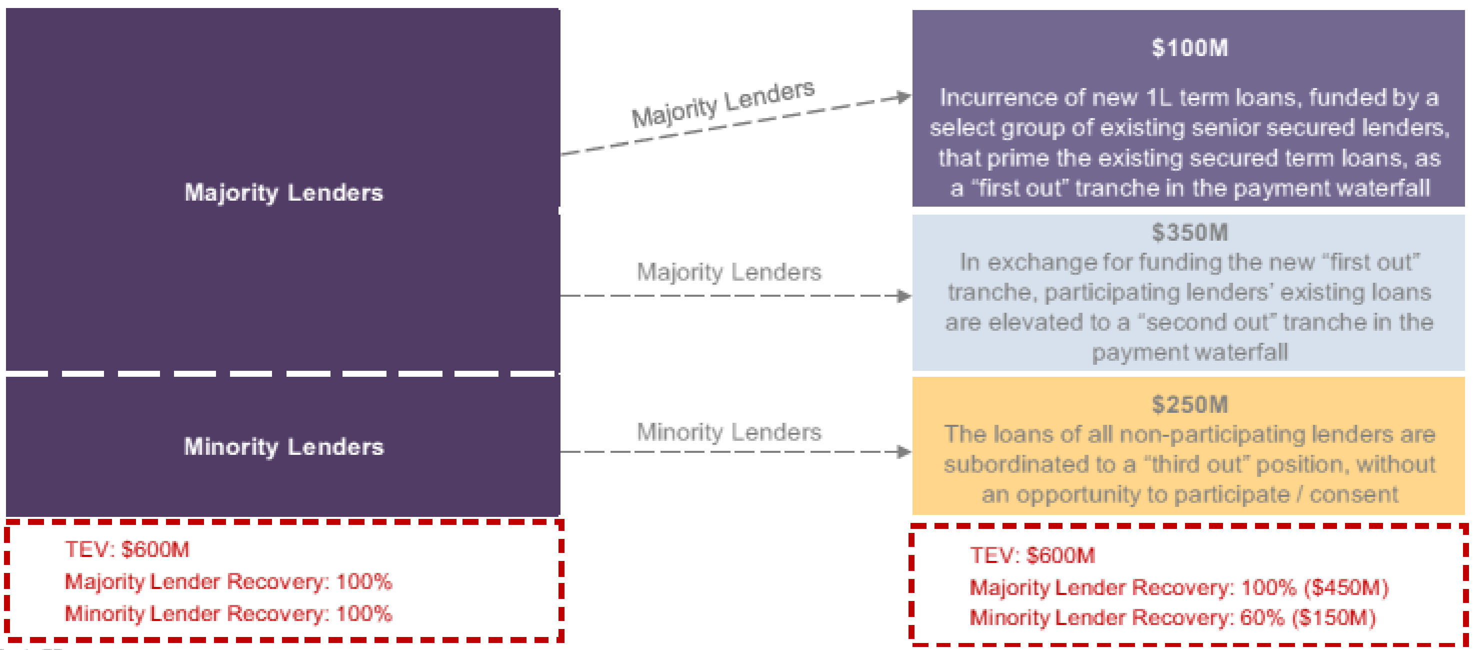
Up-Tiering Transactions

ILLUSTRATIVE TRANSACTION STRUCTURE

- Company incurs new money "super-priority" loans provided by a group of existing lenders that are structurally senior to existing debt
- In exchange, existing debt (whether senior, junior or subordinated) of participating lenders is exchanged for or "rolled up" into (typically, a lesse amount of) pari passu "super-priority" or "second" priority loans
- Existing loans of non-participating lenders are, effectively, subordinated to "third" priority
- Equity (or equity-like) instruments may be included to provide participating lenders with potential equity upside

Capital Structure Before:
Single $600M 1L Loan Tranche

Capital Structure After:
$700M of Tiered Tranches



Serta Simmons & TriMark: What happened?

Serta Background: Financial sponsor/company solicited refinancing alternatives from lenders; competing groups formed to gain an advantage over the other

Serta Transaction (June 2020): Serta exchanged a majority of first lien and second lien debt at a discount into new money "first out" and "second out" debt using "open market purchases" priming existing debt which became "third out" debt

- This borrowed a page from the J. Crew playbook, where only consenting lenders were offered a partial non-pro rata repayment

TriMark Background (September 2020): Financial sponsors and subset of lenders designed transactions

TriMark Transaction: TriMark exchanged a majority of first lien debt at a discount into new money "first-out" debt and "second-out" debt using "open market purchases," priming existing first lien debt which became "third out" debt

- Also amended the provision governing "open market purchases" to expressly include non-pro rata exchanges of new debt, stripped certain covenants from old debt, and added an enhanced "no-action" provision
- New superpriority intercreditor agreement subordinated existing 1L debt to the new debt

Serta Simmons & TriMark Play out in the Courts

NY State Court (Serta/June 2020): Court denied preliminary injunction against transaction, rejecting argument that transaction ***effectively*** amended pro rata sharing provision and released collateral without required consent of the minority lenders finding that

- Credit agreement "seems to permit the debt-for-debt exchange on a non-pro rata basis as part of an open market transaction"
- Transaction did not release collateral or affect plaintiffs' sacred rights

NY State Court (TriMark August 2021): Court rejected motion to dismiss breach of contract claim finding agreement subject to competing interpretations with respect to authority of majority lenders to amend certain provisions without minority lenders' consent

- <u>No-action provisions</u>. Amending the no-action provisions to prevent sub-set from bringing claims did not bar lenders from bringing litigation
- <u>Change of waterfall</u>. Change of definition of "Intercreditor Agreement" could be seen as effectively modifying application of proceeds and subordination of loans

Serta Simmons & TriMark Play out in the Courts (cont.)

SDNY (Serta/March 2022): Court denied Company's motion to dismiss complaint brought by subset of lenders:

- Claim for breach of Credit Agreement as it relates to open-market purchase survived because of reasonable alternative interpretations of the term "open market purchase" (e.g., does the term apply to privately negotiated transactions not available to all lenders?)
- If the transaction did not qualify as an open-market purchase, Company needed to secure the consent of all lenders to engage in this deal that involved paying some first-lien lenders, but not others
- The court found that the plaintiff lenders plausibly alleged that they were damaged by the subordination of their debt because they alleged that the value of their loans and rights materially declined
- The court also allowed plaintiffs' claim for breach of the implied covenant of good faith and fair dealing to survive, reasoning that lenders expressly bargained for "first-lien, priority, *pro rata* rights" (emphasis in original). Court was influenced by fact that transaction was negotiated in secret with a select group of lenders

Boardriders: the next shoe to drop?

Background: Recapitalization transaction by company, alleged to favor its financial sponsor and certain first lien lenders "handpicked" by sponsor

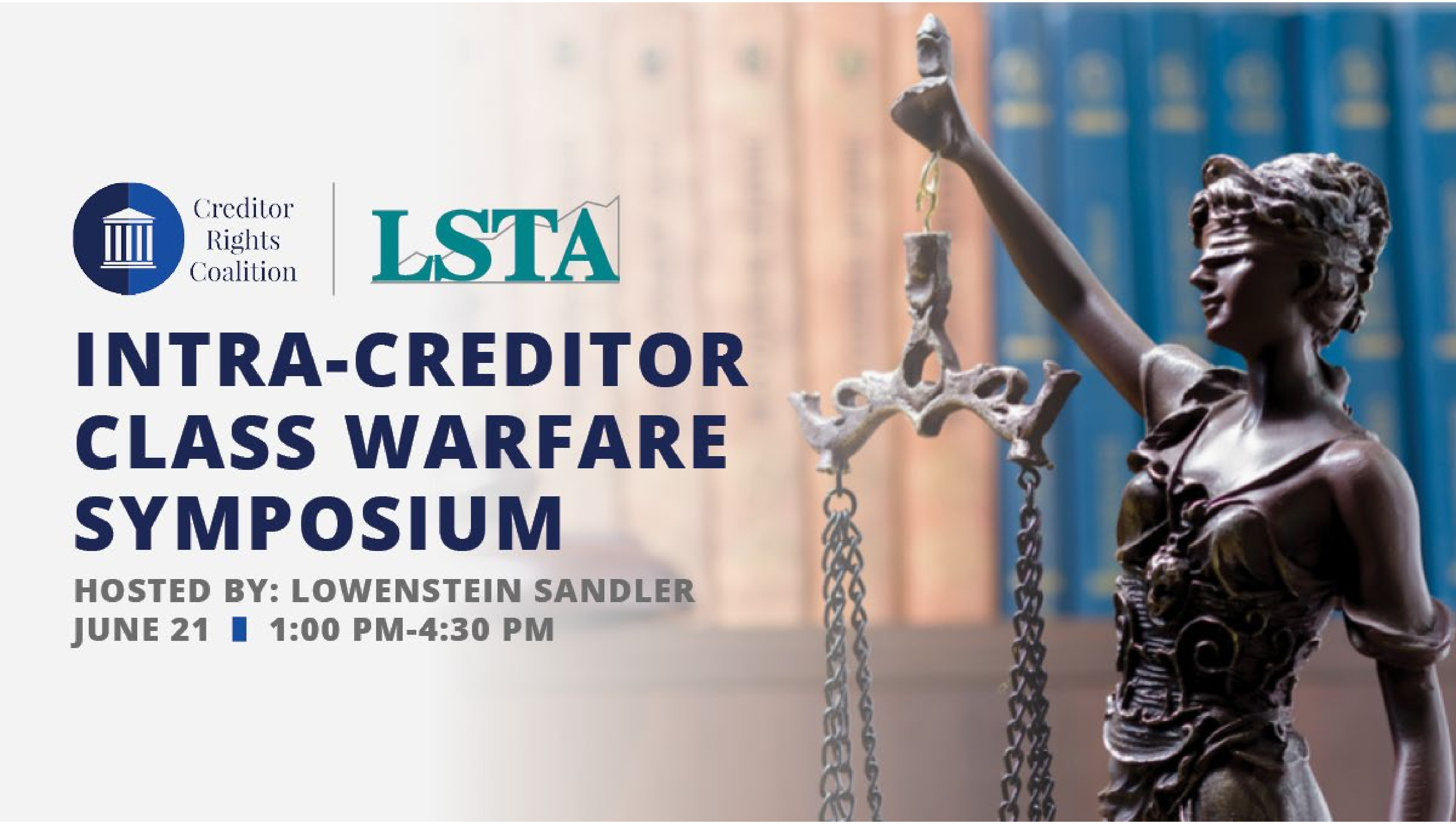
Transaction: Boardriders exchanged a majority of its outstanding first lien debt into two tranches of new money debt and one tranche of existing term loan exchanged into new third out debt at par via "open market purchases"

- Intercreditor agreement subordinating the remaining existing term loans to the new money and rolled-up debt
- Also stripped covenants and added a "no-action" provision

Litigation: Minority lenders sued Boardriders, its sponsor and majority lenders in New York state court

Status: Majority lenders, Boardriders and sponsor filed motions to dismiss, which are pending decision by the court, arguing

- Plaintiffs lacked standing because they failed to comply with the no-action provision in the amended credit agreement
- Credit agreement explicitly permitted the amendments and related transactions through "open market purchases" without limitations on how those purchases are conducted


Creditor Rights Coalition
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