Columbia and TMA-Brazil Restructuring Conference

Fall 2025

Panelists

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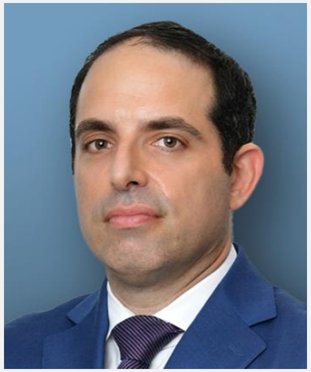

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Background

Some Key Concepts & Terminology – Beware

- **Assets – Liabilities = Equity**
- **Debt vs. Equity**
- **Liabilities vs. Debt**
- **Debt terms: principal, coupon, maturity etc.**
- **Par, Face**
- TVM
- Market price of debt, equity
- **Capital Structure**: composition of a company's debt and equity
  - **Secured vs. Unsecured Debt**
  - Collateral; Liens/Security Interest
  - Loans vs Bonds
  - Loans: TL, ABL, RBL, R/C, L/C, 1L/2L, Unitranche/FILO, etc.
  - 1st lien vs. 2nd lien
  - Bonds (notes, debentures, etc.)
  - General Unsecured Claims ("GUCs"); Trade Claims
  - Senior vs. Junior
  - Subordinated vs. Unsubordinated
  - Common vs. preferred equity

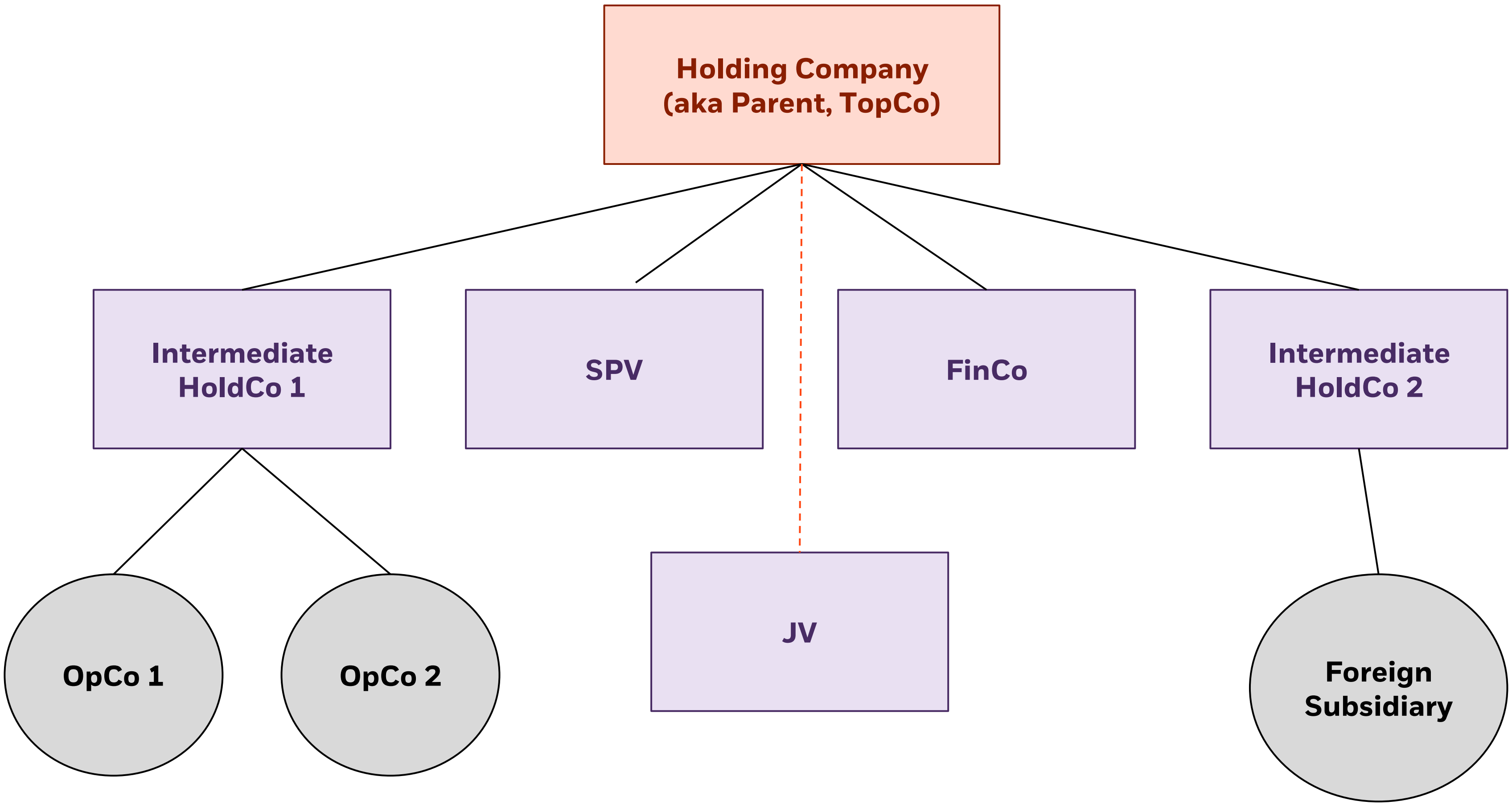
- Valuation Methods (e.g. EBITDA multiple, DCF, comp transaction, sum of parties, etc.)
- Going Concern vs. Liquidation
- **EV vs. TEV v. Firm Value vs. Reorganization Value**
- Credit Analysis; Credit Risk
- **Assets, Value, Distributable Value**
- Revenue, EBITDA
- Solvent vs. Insolvent
- **Priority, Seniority**
- Leverage
- **Recovery**
- **Waterfall recoveries**
- Business Entities: Corp., LLC, LP
- **Corporate structure**
  - Parent/Holding Company
  - Subsidiary/Operating Company
  - Affiliates
  - Corporate Governance; Board of Directors, Officers

- **Credit Documents**: indentures, credit agreements, security agreements, collateral agreements, amendments, supplements, OMs, prospectuses, etc.
- **Borrower/Issuer**: "Primary obligor", direct recipient of the loan/bond proceeds
- **Obligor(s):** collective reference to borrower/issuer and the guarantors
- **Guarantor:** agrees to be co-obligated to repay debt in the event of a default (typically affiliate entities in the same corporate group)
- **Debtor(s)**
- **Creditor(s)**, Claims
- **Default, Event of Default, Acceleration, Remedies**
- **Covenants**
- **Default**
- **Distress**
- **Insolvency**
- **Workout**
- **Restructuring, LME, LMT, DDE**
- **Bankruptcy**
- **Liquidation**

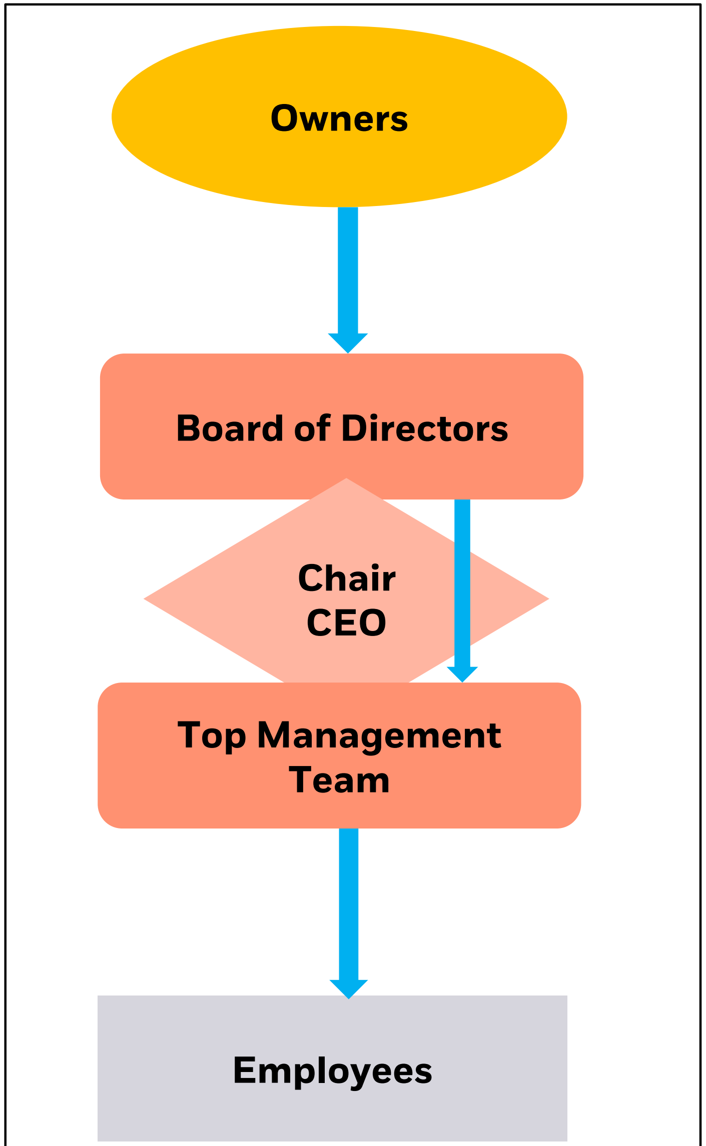
Buzzwords and Definitions

- **Workout:** An arrangement, outside of bankruptcy, by a debtor and its creditors for payment or re-scheduling of payments of the debtor's obligations. a debtor and creditors with the aim of easing the debtor's debt servicing burden so that it can maintain its business activities. Workout involves taking a non-performing loan, for example, and working to an agreed upon solution or exit strategy. It can involve a negotiated modification of debt terms or a private negotiated adjustment of creditor-debtor relations. Often it involves amendments to the debt documents, waivers of breaches covenants/defaults, amendments and resetting of covenants, temporary change from cash interest to PIK, etc. in exchange for certain payments or incremental protections for the lender. It's usually a solution that does not involve a reduction in overall leverage.
- **[Financial] Restructuring:** A general term usually applied to an out-of-court deal between a debtor and certain creditors to address a debtor's excessive leverage and/or potential insolvency. A financial restructuring typically involves "adjustment" of a debtor's liabilities to make the debtor more capable of meeting its obligations.. This can involve debt for debt or debt for equity exchange (or a combo of both) or it can involve material changes to existing debt (e.g., extension of maturity, etc.). Generally synonymous with "LME" or "LMT"
- **Bankruptcy:** "A legal procedure for dealing with debt problems of individuals and businesses; specifically, a case filed under one of the chapters of title 11 of the United States Code (the Bankruptcy Code)"
- Over time, bankruptcy has come to include nearly any reasonably comprehensive framework for adjusting a debtor's obligations, devoting some or all of a debtor's available assets (if any) to repayment of creditors, and giving the debtor a discharge (release) from its debts
  - Bankruptcy is likely to result in total shift in ownership from holders of equity to certain classes of creditors
- "**Claim**" means (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured. Section 101(5).
- "**Creditor**" "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor. . . ." Section 101(10).
- "**Debtor**": "person or municipality concerning which a case under this title has been commenced." Section 101(13).

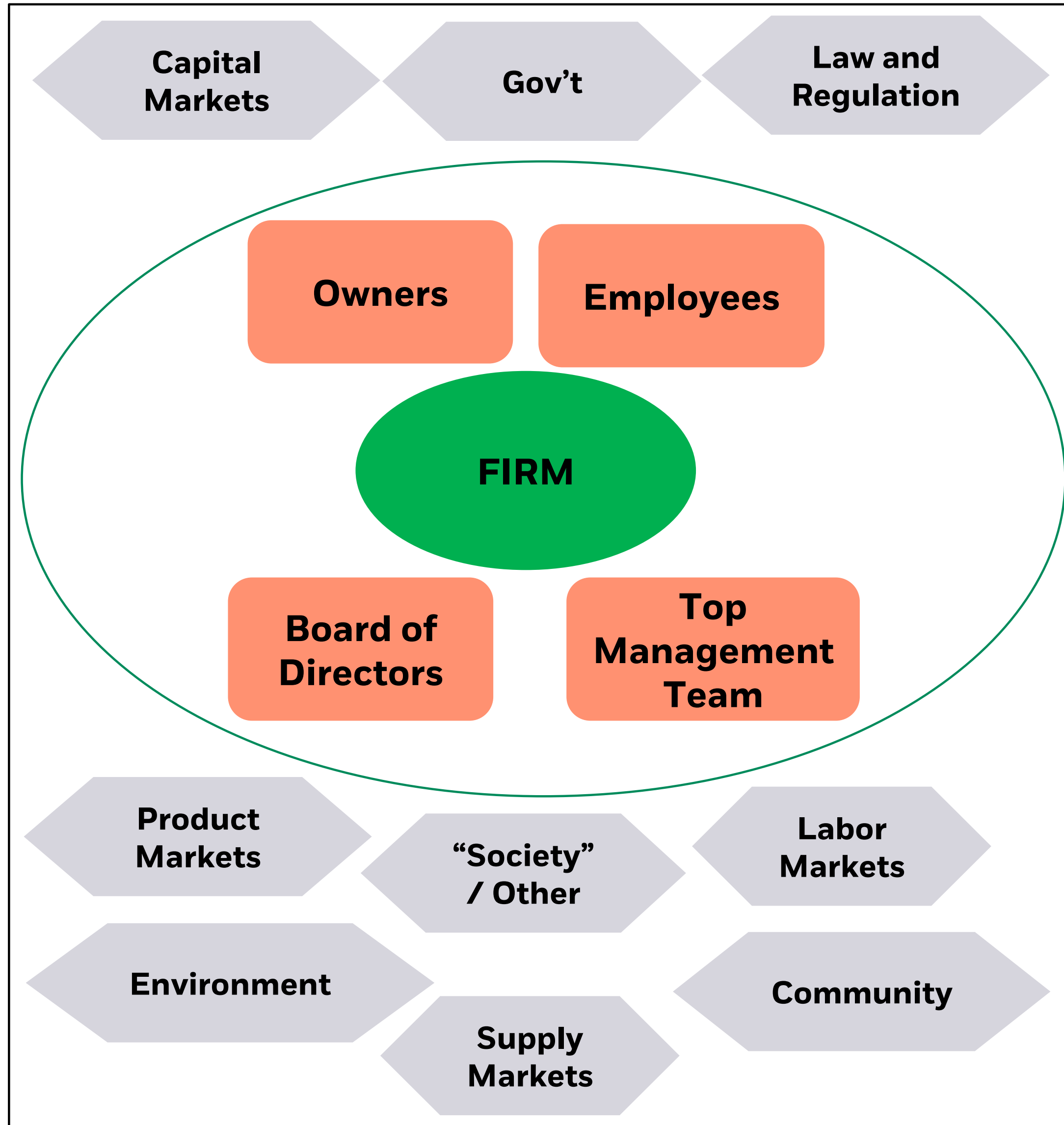
Example of Simplified Corporate Structure



Shareholder View



Stakeholder View



Distress & Insolvency

Setting the Stage

- The continuous entrance and exit of productive entities are natural components of any economic system is an "an essential fact about capitalism." Schumpeter, *Capitalism, Socialism, and Democracy* (1942)
- Because the costs of failure of business enterprise, laws and procedures have been established to, (1) protect contractual rights of interested parties, (2) to orderly liquidate unproductive assets, and (3) when deemed desirable, provide for a moratorium on certain claims to give debtor time to become rehabilitated and emerge from the process as a continuing entity
- Restructuring is about fixing "failing" firms. The goal is to restructure the left side of the balance sheet (asset or operational restructuring), or the right hand of the balance sheet (financial restructuring).
- The goal of **asset restructuring** is to improve operations and thus cash flows and redeploy underperforming or unexploited assets to more efficient users.
- Motivation for **financial restructuring** is to make firms cost of capital cheaper. Firms with expensive capital need financial restructuring to deleverage the firm to a level that is sustainable in the long term.

Possible Reasons for Distress and Need for Restructuring

- The reasons companies need to restructure are complex and vary significantly from case to case. But these can generally be classified into (at least) four categories:
  1. Overleverage associated with financing of buyouts, expansions, or acquisitions combined with poor operating performance
  2. Mismanagement that is exposed by secular or cyclical volatility or competitive pressure
  3. Liquidity and funding shocks; adverse capital markets, including credit tightening or commodity price dislocation
  4. Litigation, tort claims, accounting issues, unexpected liabilities, fraud, regulatory or legal changes, etc.
- Financial results can decline for numerous reasons:
  - Dramatic shift in cost and expenses (e.g., spike in commodity price)
  - Change in competitive landscape (e.g., price cutting from competitor)
  - Secular change in industry (e.g., print to digital)
  - Change in government policy (e.g., healthcare payment changes)
  - Bad (or conflicted) strategic choices by board/management

Sources: Altman, et al., *Corporate Financial Distress, Restructuring and Bankruptcy* (2019)

Perspective: What Leads to Distress?

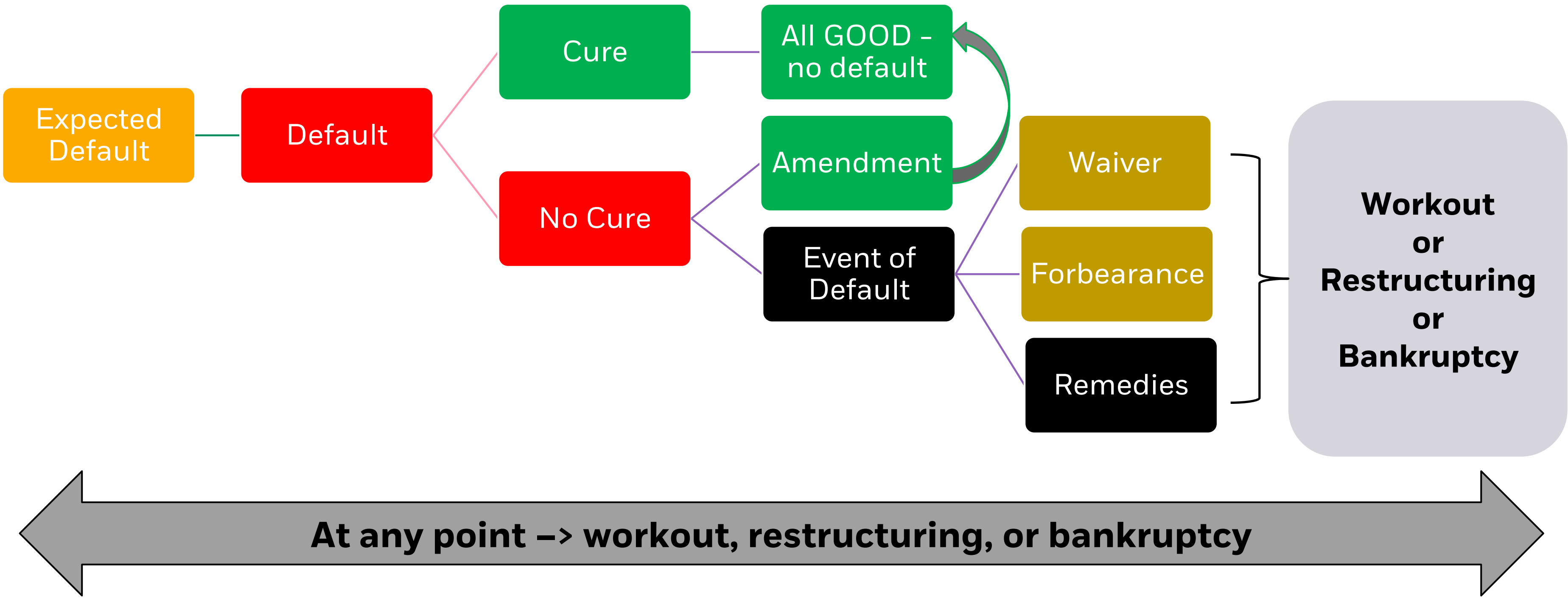
- **Causes vs. Symptoms vs. Triggers**
- **Don’t confuse correlation with causation**
- **Companies get into financial difficulty for a large variety of reasons. Examples:**
  - Continued losses from operations
  - Overextended credit to customers
  - Poor management of working capital
  - Failure to react to changes in economic conditions
  - Changes in an industry (secular or cyclical changes, competition, cost increases, etc.)
  - Operational problems
  - Loss of demand, customer churn, etc.
  - Labor problems
  - Litigation
  - Political or regulatory changes
  - Operational misstep combined with too much leverage
  - Too much debt or inadequate financing
  - Exogenous events and shocks (war, terrorism, natural disaster, pandemics, etc.)

1. Liquidity
2. Litigation
3. Default -> Event of Default

The Context

- A loan agreement (or bond indenture) typically includes an **events of default** section, which specifies certain events, circumstances or conditions that are considered breaches or violations of the loan agreement and the rights and remedies of the lenders if an event of default occurs. Generally, the lenders can exercise their contractual remedies under the loan documents, seek a court-ordered resolution or proceed under Article 9 of the **Uniform Commercial Code** (UCC).
- However, declaring an event of default and pursuing contractual and legal remedies is not the only option available to lenders faced with a defaulting or troubled borrower. Instead, the parties may negotiate:
  - A **waiver**, in which the lenders agree to waive the breach or event giving rise to the event of default
  - A **forbearance agreement**, in which the lenders agree not to declare an event of default with respect to the particular default or to exercise any remedies they may have under the loan agreement for a certain period of time subject to certain conditions (for example, no other events of default occurring)
  - An **amendment** to the loan agreement, in which the lenders and borrower agree to revise a provision that may no longer be appropriate or accurate because of changing conditions (whether affecting the borrower specifically and/or the market generally) or to prevent the borrower from repeatedly breaching the same provision
  - An out-of-court restructuring of the defaulted loan, in which the borrower and the lenders typically renegotiate the loan agreement to restructure the terms of the borrower's debt

Illustrative paths in life of defaulting loan/bond



<u>Options and possibilities at any point throughout this process</u>:

- The parties may mutually agree to resolve the problem by a "workout" or "restructuring"
- The company may preemptively commence a bankruptcy proceeding
- Company may commence the bankruptcy if the parties cannot agree to a workout/restructuring solution
- Company may have continuing problems even after a workout/restructuring/bankruptcy and start the process all over.

What is "Insolvency"?

- Two key definitions: "balance sheet insolvency" and "equitable insolvency"
  - **Balance sheet insolvency** is "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof." Put another way, under the Bankruptcy Code, the term "insolvent" means a "financial condition such that the sum of such entity's debts* is greater than all of such entity's property, at a fair valuation," exclusive of fraudulent transfers and exempt property. 11 U.S.C. Section 101(32).
    - **Balance Sheet Test**: If **Liabilities > Assets (fmv)**, then Insolvent
    - Note that insolvency is comparing the amount of liabilities of a corporate entity to the value of its liabilities.
    - *Liabilities* includes more than what is on a balance sheet under GAAP requirements.
    - *Liabilities* includes more than just financial debt obligations (e.g. loans, bonds, etc.)
    - *Liabilities* here refers to the broad umbrella category that also includes, for example, non-financial obligations such as accounts payable, pension liabilities, lease obligations, contractual obligations, contingent and non-contingent liabilities, matured and unmatured liabilities, etc.
  - **Equitable insolvency** is "an inability to meet maturing obligations as they fall due in the ordinary course of business." This definition of insolvency ignores the balance sheet and instead focuses on the corporation's ability to pay its current debts.
    - **Cash Flow Test**: put simply, will future assets, including future cash flows to the subject, allow the company to satisfy any cash flows out.

Questions:

1. What are some examples or situations where a debtor is equitably insolvent but balance sheet solvent?

2. Can a company have a large equity market cap but still insolvent?

*NOTE: The Bankruptcy Code defines debt broadly.

- Bankruptcy Code Section 101(12) defines **debt** as meaning "liability on a claim."
- Section 101(5) defines **claim** as (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

Insolvency brings out conflicts and divergence in interests

<u>IMPORTANT POINT</u>:

- During insolvency, there is the potential for a significant divergence (conflict) in interests among various stakeholders, especially between creditors (debt) vs. equity
- Why?
- "Debt" vs. Equity
- Other stakeholders?

Debt	Equity
• Contractual • Fixed upside (generally) • Downside protection comes from rank, collateral, priority and other legal rights • Reward: timely payment of interest and principal producing excess "yield" relative to risk (and on occasion further upside depending on debt terms, premiums earned, equity kickers, etc.)	• Residual ownership • Unlimited upside • No downside protection; rights are, in many respects, more limited than those of creditors • Reward: capital appreciation and dividends

Restructurings

Workouts

1. "Pay me later" workouts
    - Forbearance agreement: refraining from enforcing a right, obligation or debt
    - Moratorium style extensions: authorized postponement in deadline for paying/performing
    - Standstill agreement: agreement to refrain from taking action for a period of time
2. "Pay me less or differently" workouts
    - Composition: pro rata cash settlement. Accept less than full payment
    - Combination: most common. A blend of multiple types

Restructurings

1. Operational Restructuring
2. Financial Restructuring
    - Efforts taken to "address" challenges *financial* liabilities (i.e. leverage, liquidity, maturities, etc.)
    - Two approaches for a financial restructuring:
        - <u>Out-of-court</u> restructuring is a voluntary agreement between the company and its creditors (can be all or some)
        - <u>In-court</u> restructuring refers to a formal court supervised process that binds creditors (a chapter 11 bankruptcy process, is an example)

The <u>**trigger event**</u> (as opposed to underlying cause) for workout or restructuring negotiations is typically an ***actual or expected*** (i) financial "**covenant breach**" under credit agreement or indenture, (ii) **payment default** (i.e. company does not have cash to make principal or interest payment on its debt), or (iii) **liquidity** challenges.

Examples of Out of Court Measures

Out-of-Court Remedies	
Debt Refinancing	The refinancing of debt is an ideal option, as it involves revisions to the interest rates, repayment schedules, and pricing terms of an existing agreement. The concern is whether lender(s) would want to refinance the debt of a borrower at risk of default – hence, there may be unfavorable terms if approved.
Debt-for-Equity Swap	In a debt-for-equity swap, an existing debt is exchanged for a pre-determined amount of equity in the debtor. The exchange often coincides with lender not wanting to force debtor into bankruptcy – or the belief that the equity can hold value someday.
Debt-for-Debt Swap	In a debt-for-debt exchange, the existing debt is exchanged for a new issuance with a longer tenor, and other terms of the debt are changed to favor the lender – all while reducing the near-term obligations. Or, the borrower can propose to unsecured debt holders an exchange of their debt with secured debt with a lien for a lower principal amount (i.e., certain debt holders move up the priority waterfall in return for a reduction in principal and interest).
Cash Interest to Payment-in-Kind (PIK)	To provide the debtor with more short-term liquidity, a creditor can agree to convert some (or all) of the cash interest terms to PIK, which causes the interest to accrue to the principal as opposed to requiring cash payments upfront. While the near-term cash outlay is reduced, the accruing interest expense increases the principal amount due at maturity.
Equity Interests	Debt-for-equity swaps would fall into this category, however, there are also other types of equity interests that can be given to lenders in return for renegotiated terms. E.g., Warrants, Conversion Feature, Option to Co-Invest
Debt Issuance	The debtor can participate in new round of debt financing to implement growth initiatives, but terms are unlikely to be in their favor – and there is a low chance of much investor interest with the requisite risk appetite. The existing senior creditors likely push back against putting another lien on the company, or a covenant breach may occur from raising more debt.
Equity Injection	Equity issuances would likely receive less scrutiny from lenders (although there is a dilutive impact created for existing shareholders, the new capital may be in their interest as their chance of recovery is low). But again, considering the risk of equity being at the bottom of the capital stack, it may be challenging to raise new equity.
Distressed M&A	Selling non-core assets and using the proceeds to fund operations and meet debt obligations is a frequently used restructuring technique. However, given the "fire sale" nature of distressed M&A, the selling price may be a fraction of the asset's fair market value (FMV). In an out-of-court restructuring, any sale of assets will NOT be completely free and clear of all claims unless the debtor obtains all necessary creditor consents.
Rights Offering	A rights offering would give creditors the right to purchase a pro-rata share of equity (calculated off their existing claim or interest) in the reorganized company. The purchase is at a discounted rate, with the norm being a ~20-25% discount
Debt Repurchase	If the debtor has enough cash, it can repurchase debt (i.e., a buyback) to avoid breaching a covenant or to lower its leverage ratios. Doing so enables the D/E ratio to return to a normalized level, reduces the total leverage ratio, and decreases the interest payments – but some prepayments may come with a call premium.
"Standstill" Agreements (or Forbearance)	Once a debtor has missed a payment on its debt obligations or breached a covenant, the debtor may request to enter into a standstill agreement. These agreements usually lead to modifications to the existing debt – but for now, time is given to the debtor to sort out a proposal. In return, the lender agrees to not take any legal action against the borrower for a period of time after the debtor has defaulted (e.g., foreclosure/litigation).
Covenant Waivers (or "Relief")	If the creditor sees this as a non-continuous breach, the breach of a covenant may be waived for the debtor (i.e., a one-time "pardon"). The lender may agree to loosen the debt covenants until maturity – e.g., the calculation of EBITDA can become more lenient with more add-backs. Alternatively, as part of the waiving the breach, future covenants may be modified to be more restrictive to protect the lender(s).
"Amend and Extend" Provision	An agreement to extend the maturity date of a debt instrument coming due. In exchange, the lender receives a higher yield on their extended loans (i.e., higher interest rate) and more protection through covenants.
Interest Payment Schedule Adjustment	Similar to the extension of the maturity date, a lender could modify the due date of interest expense payments. For example, one solution could involve the deferral of an interest expense payment into the next period.

https://www.wallstreetprep.com/knowledge/restructuring/

Informal / Out of Court Restructurings

Advantages

- Private (Maybe)
- Retention of Control
- Fewer Statutory Constraints
- Potentially Better Access to Public Markets
- Speed
- Less Expensive
- Avoids Formal Investigation of Past
- Flexibility in Dealing with Creditor and Equity Constituencies

Disadvantages

- Not a Collective Action
- No Control of Individual Creditors or Equity Holders
- No Injunctive Powers
- No Statutory Discharge
- Interest Continues to Accrue
- Subject to Involuntary Bankruptcy
- Difficult to Control Individual Secured Creditors
- Inability to Bind Dissenting Creditors
- Lack of Bargaining Leverage – Costs, Feasibility
- Loss of Trade Vendor Support
- Compliance with Securities Laws
- Negative Tax Implications
- No Relief from Burdensome Contracts and Unexpired Leases

Out-of-Court Restructuring vs. In-Court Restructuring

	Out-of-Court Restructuring	In-Court Restructuring
Advantages	• Less costlier than bankruptcies due to incurring less professional fees (e.g., RX, consulting) and court costs	• "Automatic stay" provision protects debtor from creditors' attempts of collection (e.g., litigation threats)
	• Closes faster than Chapter 11 – however, the emergence of pre-packs in Ch. 11 has reduced this convenience benefit	• Recoveries applies to entire class (i.e., voting passed and "cram down") – holdout problem becomes less of a concern
	• If an amicable solution is reached, the debtor and creditors will end with a greater amount of proceeds in most cases	• DIP financing becomes accessible because DIP lenders can be protected under priority (or "super priority")
	• Privatized process with confidential material not being required to be filed publicly	• Provisions enabling the rejection of executory contracts and unfavorable leases
	• Process is less disruptive to on-going operations – once enacted, the plan tends to move along quicker	• Under a 363 sale, debtor's assets could be sold in an auction clear of liens, which protects the acquirer
Disadvantages	• Not protected from collection efforts by creditors and lacks the formal decisiveness of the Court	• Expensive RX advisory fees, other professional fees (e.g., turnaround consultants), and court costs
	• Asset sales require unanimous approval and the liens on the assets and certain liabilities remain	• Creditors and equity holders lose bargaining strength (i.e., subject to the Court's rulings)
	• Probability of reaching a compromise decreases the more creditors there are, which favors simple capital structures	• Can often be time-consuming, especially for "free fall" filings or if process is dragged on by objections and side complications
	• No (or limited) access to financing as lenders avoid distressed borrowers without Court protections	• List of creditor claims, assets & liabilities of the debtor, and expected recoveries are disclosed publicly

SOME CONSIDERATIONS

- Nature of problem / efficacy of "solution"
- Short-term vs. Long-term
- Liquidity
- Capital Structure Complexity
- Debtor-Creditors Relations
- Information flow
- Constraints
- Execution risk; holdouts

Liability Management Exercises (LMEs)

Liability Management Exercises

- Liability management exercises or transactions ("LMEs") are simply transactions undertaken by a company to restructure its financial liabilities or otherwise address certain challenges or risk connected to its liability (leverage, liquidity, refi risk and maturities, etc.). Companies facing financial distress, liquidity constraints, or maturity walls may have a variety of transaction opportunities available to address their funded debt obligations
- Many define LMEs as synonymous with out of court restructurings. There are many types and variations of LMEs, some of which are intended to be short term fixes and others are intended to be longer term fixes. Whether these measures do in fact serve as a longer-term fix is often dependent on post-LME events, market conditions, etc.
- Common objectives of liability management include additional liquidity, deleveraging and the extension of upcoming debt maturities. Although these techniques can be used as part of a holistic restructuring they are often used in a variety of distressed and non-distressed situations and form part of a standard tool-kit of options that companies have at their disposal when maturities are looming.

LMEs 2.0

- While liability management transactions may take a variety of forms, in recent years In recent years, the term “LME” has been used by some market participants to refer to specific variations of LMEs that employ certain techniques such as (a) drop-down and unrestricted subsidiary (“unsub”) financings or spin-off, where unencumbered assets are transferred to non-guarantor restricted subsidiaries or unrestricted subsidiaries with existing valuable assets, which are used to raise and secure additional liquidity**;** and (b) senior debt incurrence and up-tiering, which involves the insertion of priority tranche(s) of debt and/or the up-tiering of selected existing debt.
- These techniques are used by distressed borrowers to, among other things, obtain liquidity, capture discount, and/or extend maturities by offering a group of lenders the benefit of a senior claim against all of the borrower’s or a specific subset of the borrower’s assets. This can prove critical to a company that may otherwise be unable to incur new debt or amend and extend its existing facilities through conventional means or may only be able to do so on unfavorable terms. J. Crew is the best-known example of an asset dropdown, while Serta is now regarded as the archetypal uptiering priming transaction.
- It is also important to note that both types of transactions may be adverse to certain lenders, either as a whole or to a specific subset (giving rise to the sometimes-used moniker “creditor-on-creditor violence”). Accordingly, these transactions are often challenged by creditors. Many liability management transactions resulted in lawsuits, and there are a number of important cases and unresolved issues currently being litigated or that have been settled without a final judgment on the issue being litigated (although that has not deterred the use of these tools to date).

LMEs (cont’d)

Examples of Liability Management Exercises/Transactions (many types)

- Uptier exchanges
- Drop-down exchanges
- Amend & Extend transactions
- Discounted debt buybacks
- Distressed exchanges (DDEs are one type of LME)

Potential Capital Structure Goals

- Extend maturity runway
- Reduce cash debt service requirements (e.g., interest, amortization)
- Capture trading discount and deleverage
- Augment liquidity
- Relax financial covenants

Considerations

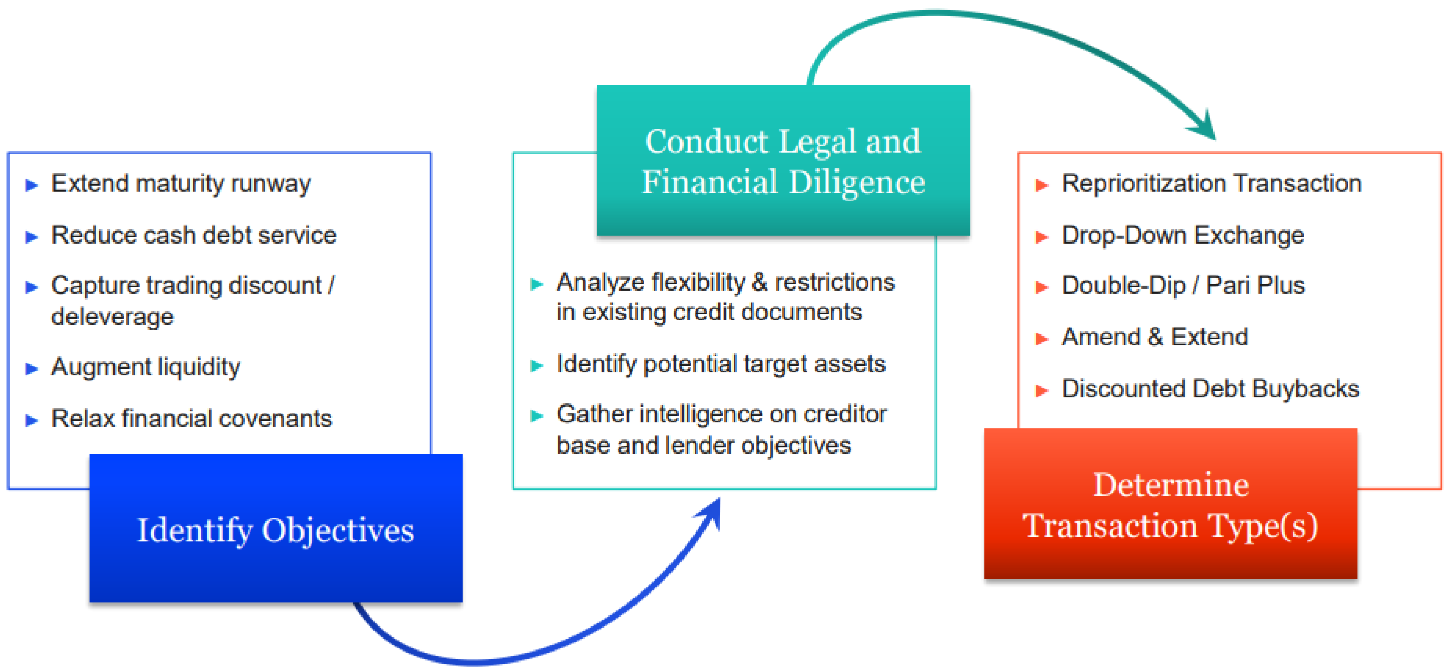
- Debt document flexibility/restrictions
- Stakeholder motivations
- Cross-holder dynamics
- Tax
- Litigation risk/appetite
- Credit default swap dynamic (“empty-creditor”)
- Ratings Impact

Other Possible Goals (of company or other certain stakeholders)

- Maintain equity optionality
- Buy time to address operational problems
- Buy time wait out changes in market
- Buy time (and build liquidity) in preparation for next step in restructuring process
- Improve creditor’s position in capital structure
- Opportunistic investment
- Extend date or timing of catalyst credit event (preference period, or other SOL, CDS tenor, etc.)

What is Liability Management

- Liability Management Exercises ("LMEs") are transactions undertaken by a company to restructure the liabilities on its balance sheet
- Increasingly, both public companies and private equity portfolio companies are pursuing out-of-court liability management transactions to address their capital structure goals
- These transactions tend to be bespoke and require detailed legal and financial diligence to address the company's goals while adhering to restrictions in applicable debt documents. In all scenarios, compliance with governing debt documents is key to mitigating risk while deploying strategies and pursuing transactions



Kirkland& Ellis: Liability Management Exercises

Goals and Objectives

Defining success is evaluating the company's key objectives

1 Extend Maturity

- ✓ Bridge to more favorable rate environment
- ✓ Extend runway for operational turnaround
- ✓ Breathing room for liability management
- ✗ No de-leveraging
- ✗ Usually requires higher rate and tighter covenants

2 Reduce Cash Debt Service

- ✓ Increase FCF via reduced interest expense
- ✓ Bridge through periods of cyclicality
- ✗ Usually requires higher overall rate paid at the back-end and tighter covenants

3 Capture Discount / De-Leverage

- ✓ Improve exit prospects
- ✓ Create headroom to incur new debt
- ✓ Lower leverage ratios for tuck-in acquisitions
- ✓ Bolster confidence of customers and suppliers
- ✗ Reduce liquidity if funded by cash

4 New Liquidity

- ✓ Fund M&A and expansions
- ✓ Fund working capital investments
- ✓ Ride out economic headwinds
- ✓ Fund dividends and distributions
- ✗ May cause net increase in leverage
- ✗ May require higher rates

5 Relax Covenants

- ✓ Extend runway for operational turnaround
- ✓ Breathing room for liability management
- ✗ No de-leveraging
- ✗ Usually requires higher rate and tighter covenants

Tools

- Credit document flexibility to facilitate liability management transactions
- Competitive tension between creditor groups (can be used to minimize cost and maximize flexibility)
- Potential alternative financing options

Considerations

- Length of time required to consummate a transaction
- Liquidity needs
- Tax impact
- Challenges in achieving full participation given competing lender priorities
- Credit default swap dynamics

Kirkland& Ellis: Liability Management Exercises

When to Consider an LME

- The earlier a company considers its LME options, the more it retains control and optionality. The closer the maturity wall gets, the more that power and control siphons out to creditors.
- While many terms can be amended with requisite lender consent, having maximum flexibility in the docs at the inception of the deal gives a company its best chance at controlling its destiny despite any unforeseen bumps in the road.

Kirkland& Ellis: Liability Management Exercises

More on LMEs 2.0

"There is nothing in the law that requires holders of syndicated debt to behave as Musketeers. To the extent such holders want to be protected against self-interested action by borrowers and other holders, they must include such protections in the terms of their agreements." – Judge Craig Goldblatt, TPC Group (U.S. Bankruptcy Court, Delaware).

- In contrast to liability management transactions in the loan market, exit consents, uptiering, and drop-down transactions have been *commonplace in the bond market for many years*, whether or not the opportunity to participate in those transactions is offered to all bondholders.
- Whether or not a particular transaction is feasible, and how it is structured, is highly dependent on the specific terms and language in a company's debt documents. Agreements vary greatly in the amount of flexibility under negative covenants, as well as the inclusion and formulation of restrictions on designation of unrestricted subsidiaries (and transfers of material assets thereto), borrower buyback provisions and restrictions on amendments to pro rata sharing and subordination provisions (to name some of the most important).
- Despite a convergence in investor base (and covenants) between the two markets, the importation of bond market strategies has, in many cases, frustrated traditional expectations of loan market participants. Those strategies include:
  - Pro rata treatment on payments and recoveries (or at least an equal opportunity to participate)
  - Seniority in the capital structure
  - Amendments voted on only by lenders with a continuing exposure post-amendment (contrast exit consents)
  - Limitations on leakage from the credit group (e.g., via investments in non-guarantors)
  - Dynamics between lenders and agents

Corporate Governance & Fiduciary Duties

Caveats regarding applicable law

- Presentation assumes we are dealing with a ***U.S. domiciled for-profit entities*** -- and not nonprofit corporations or benefit corporations (nuanced distinctions in the law)
- Presentation focuses on **U.S. law** and not foreign law.
  - To the extent foreign law may apply (e.g., if a director sits on a foreign subsidiary's board), then there may be very important differences in a corporate fiduciary's legal obligations and potential penalties for a breach of duty. Unlike the U.S., some foreign jurisdictions, for example, may require a board of foreign entity to direct the commencement of an insolvency proceeding once the foreign entity becomes insolvent and the failure to do so may result in personal liability and potentially even criminal liability.
- Distinctions among law of different states: for ease of discussion, **Delaware law** (statute and common law) is the primary focus on this presentation. But depending on the facts and circumstances, a different state's law may govern and there may be important differences between Delaware law and the law of other states with respect to corporate governance and fiduciary duties. Apply **internal affairs** doctrine.
- Intersection of **federal bankruptcy law** and law of fiduciary duties (tension, conflict, primacy, etc.)
- Potential applicability of **other statutes** (e.g., WARN Act, FLSA, ERISA, UFTA, federal and state securities law, etc.)
- Impact of **form of entity (e.g., corporation vs LLC vs LP vs MLP)** to one's analysis
- Consider **additional theories of liability beyond just breach of fiduciary duty** such *as tortious inference with contract, aiding and abetting breach of fiduciary duty, civil conspiracy, fraud, civil RICO, corporate waste, breach of contract, breach of implied covenant of good faith and fair dealing, unjust enrichment*, etc.
- Impact of **applicable governance-related agreements** (e.g., these may create additional obligations or they may modify or waive certain fiduciary duties, etc., especially in LLC/LP context)
  - But remember the "**twice-tested principal**" (see discussion below)
- Impact of **corporate separateness** and application of the law on an **entity-specific basis** (e.g., *conflicts, dual-fiduciaries, fairness, insolvency*, etc.)
- <u>**Context matters. Facts and circumstances matter.**</u>

Some of the many complicating factors

1. Corporate separateness: Considering the separate and unique interests, governance structures, duties, and stakeholders with respect to each individual entity within a single corporate family or enterprise (e.g., parent vs. individual subsidiaries); Consider also entity level analysis for insolvency analysis as well as disparate treatment or conflict between entities
2. Insolvency vs. solvency: Considering the impact of insolvency with respect to some or all of the entities within the corporate family
3. Corporation vs Alternative Legal Entity (LLC, LP, MLP)
4. Impact of governing agreements for the entity on the duties of that entity's fiduciaries
5. Impact of jurisdiction and applicable law:
    a) US vs. Foreign?
    b) What is that applicable state law for analysis of a fiduciary's duties?
    c) Interplay of bankruptcy law and process
    d) Interplay of other applicable law (in addition to contracts, there are other potentially applicable state and federal statutes, common law, etc.)

- Be wary of the dangers of "dual fiduciary" risks
- We wary of control issues
- Consider carefully the impact of entity-level analysis for purposes of fiduciary duties, conflicts, and insolvency
- Consider carefully the impact of insolvency on decisions that disparately affect parent and subsidiary
- Few things serve as a perfect solution or panacea. But there are best practices and measures to mitigate risk.

Fiduciary Duties of Directors & Officers of a Corporation

- **Primary fiduciary duties under Delaware law:**
  - **Duty of Care**: Directors and officers must be diligent and informed, and exercise prudent and unbiased business judgment.
  - **Duty of Loyalty**: Directors and officers must act in good faith and in the best interests of the company, and deal fairly with the company
- **Solvent Corporations** – Directors and officers owe fiduciary duties to the corporation and derivatively its stockholders as the residual owners.
- "Zone of Insolvency" – Essentially a defunct concept. Directors and officers continue to owe fiduciary duties to the corporation.
- **Insolvent Corporations** – Directors and officers owe a fiduciary duty to the entire "corporate enterprise" or the "community of interests that [sustain] the corporation." When a company is insolvent, however, the community grows to include creditors. At that point, creditors become the primary beneficiaries of the fiduciary duties and stockholders become the secondary beneficiaries of the fiduciary duties.
  - Recent case law has clarified that directors ***do not owe direct*** fiduciary duties to creditors when the corporation is insolvent or in the zone of insolvency. Rather, as with its shareholders, all duties to creditors in these contexts are derivative: They flow through the duties owed to the company (i.e. the specific corporate entity).

“Twice-Tested” Principle

- Under Delaware law, corporate acts are reviewed for their compliance with two sets of rules:
  - The technical rules of the corporate contract between the directors and stockholders that address the legality of the act taken by the corporation.
  - An overlay of equitable rules to ensure that otherwise legal acts are taken in compliance with the board's fiduciary duties to the corporation.
- In Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971), the court articulated one of the most famous equitable principles: “inequitable action does not become permissible simply because it is legally possible.” Another variation on this bedrock principle of Delaware law is that corporate actions must be twice-tested: once by the law and again by equity. 2021 WL 776742, at *25 (Del. Ch. Mar. 1, 2021) (relying on Schnell, 285 A.2d at 439, and holding that “technical compliance with the Operating Agreement’s removal procedures d[id] not foreclose Plaintiffs’ claim” of a breach of fiduciary duty)
- Delaware courts call this review the twice-testing principle (Sample v. Morgan, 914 A.2d 647, 672 (Del. Ch. 2007); Carsanaro v. Bloodhound Techs., Inc., 65 A.3d 618, 641-42 (Del. Ch. 2013), abrogated on other grounds by El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248, 1264 (Del. 2016)).
- Key takeaway: Even when an LLCA of LPA (or other contract such as a credit agreement) seemingly “permits” a particular action by a fiduciary, this doesn’t necessarily mean the coast is clear for that fiduciary to take any such action.

To “whom” (or “what”) is the fiduciary duty owed?

- Variations of language: To whom/what is the duty owed? To whom does the duty “run”?
- Compare above inquiry to the questions: (i) Who is the [primary] beneficiary of the duty, (ii) Who must/may be considered in discharging that duty, and (iii) Who may enforce that duty.
- In context of solvent company, duty to “company” (vs. company and shareholder)
- In context of insolvency company, duty to the “company” (vs. “enterprise”)
- As we discuss below a person may be a fiduciary of different entities and may a owe duties to different entities simultaneously. This may, depending on facts and circumstances, create a conflict of interest.
- ***People seems to have a hard time grasping the notion of owing a duty to the entity alone (as opposed to a particular group of stakeholders that may be the beneficiary of the duty or have the right to derivatively enforce such duties)***:
  - “Every once in a while, some stickler might point out that that’s not “technically” right and that fiduciary duties are actually owed to the corporation itself. But that line of inquiry is typically stamped out quickly enough to prevent it from developing into full blown heresy, usually by chalking it up to an older, outmoded way of thinking about fiduciary duties.” Gubler, Zachary J. (2024) "The Neoclassical View of Corporate Fiduciary Duty Law," University of Chicago Law Review: Vol. 91: Iss. 1, Article 3. Available at: https://chicagounbound.uchicago.edu/uclrev/vol91/iss1/3
  - **Such criticism is often grounded in a an arguably myopic view of the context in which these duties exist.**

IMPORTANT CAVEAT: Certain states (for example, Pennsylvania) have constituency statutes that explicitly allow the board of directors to consider the interests of constituencies other than the stockholders, including employees, customers, suppliers, and creditors (15 Pa C.S.A. §515(a)). The DGCL contains no such provision.

Duties owed to the Corporation (or entity)

- **Directors owe fiduciary duties to the corporation itself—rather than any particular constituent thereof.**
  - Friedman v. Wellspring Cap. Mgmt., LLC (In re SportCo Holdings, Inc.), No. 19-11299, 2021 WL 4823513, at *6 (Bankr. D. Del. Oct. 14, 2021) ("Under Delaware law, corporate officers and directors owe the corporations they serve duties of care and loyalty . . . ."). Courts are frequently imprecise on this point. Andrew S. Gold, Dynamic Fiduciary Duties, 34 CARDOZO L. REV. 491, 493 (2012) ("Courts regularly state that directors' fiduciary duties are owed to both shareholders and the corporation. Yet it has long been recognized that shareholders and corporations can have divergent interests." (footnote omitted)).
- But because in normal times the duties can only be enforced by shareholders, there is a tendency to think of the directors as representing the shareholders. Thus, many courts have held that directors owe no duties to creditors of solvent corporations—but that does not necessarily mean directors owe duties directly to shareholders either.
  - Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 VA. L. REV. 247, 278 (1999). 85. Id. at 293–94 ("[C]ase law makes clear that directors owe their fiduciary duties primarily to the corporation itself. Although this duty to 'the corporation' can perhaps be interpreted to mean a duty exclusively to the shareholders of the corporation, we agree with those who argue directors should be viewed as owing fiduciary duties to the corporation as a separate legal entity, apart from any duties they might also owe to shareholders." (footnote omitted)); see also Lisa M. Fairfax, Just Say Yes? The Fiduciary Duty Implications of Directorial Acquiescence, 106 IOWA L. REV. 1315, 1345–46 (2021) ("Of course, directors have a duty to the corporation and its shareholders. However, case law is clear that such a duty does not require directors to accede to the demands of shareholders. Instead, directors can take actions to protect the corporate enterprise against shareholders, including a majority of shareholders.").
- **However, if the corporation is insolvent, the duties can also be enforced by creditors, which underlines that the "focus" of the duties are on the firm.**
  - N. Am. Cath. Edu. Programming Found. Inc v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) ("When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value."); see also Ben Franklin Retail Stores, Inc. v. Kendig (In re Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 653 (Bankr. N.D. Ill. 1998) (holding Delaware companies liable in bankruptcy proceedings); In re O.P.M. Leasing Servs., Inc., 28 B.R. 740, 760–61 (Bankr. S.D.N.Y. 1983). The Delaware court's decision that the duties are owed "to the corporation," avoids the many problematic questions that courts and commentators wrestled with in the 1980s and 90s, including: (i) what is the scope and nature of such duties?; (ii) do directors of insolvent corporations continue to owe fiduciary duties to shareholders and other constituencies?; and (iii) at what point in time, and to what extent, do directors of a financially-distressed corporation owe fiduciary duties to creditors of the corporation? See generally Laura Lin, Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors, 46 VAND. L. REV. 1485 (1993) (discussing conflicts of interest between shareholders and creditors); see also Mark J. Roe, Bankruptcy and Debt: A New Model for Corporate Reorganizations, 83 COLUM. L. REV. 527, 583 (1983) (discussing bankruptcy in the context of shareholders).

Gheewalla (2007): the significantly altered landscape

- Summary of what was described as a "significantly altered landscape for evaluating a creditor's breach-of-fiduciary-duty-claim" following the Delaware Supreme Court's 2007 decision in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*.

PRE-GHEEWALLA	**POST-GHEEWALLA**
Directors owe fiduciary duties to creditors once a corporation "enter[s] the vicinity of insolvency."	Directors owe fiduciary duties to creditors only once a corporation actually is insolvent.
Creditors may bring direct or derivative claims to enforce fiduciary duties.	Creditors may only bring derivative claims to enforce fiduciary duties.
Directors have an "obligation to manage the corporation conservatively as a trust fund for the creditors' benefit."	Directors do not owe any particular duties to creditors; rather, their fiduciary duty runs "to the corporation for the benefit of all of its residual claimants," including creditors.
Director decisions are subject to entire fairness review because of the "inherent conflict" arising when fiduciary duties are owed both to creditors and stockholders.	Directors may, in an exercise of their business judgment, "favor certain non-insider creditors over others of similar priority." In addition, directors' ownership of common stock alone "does not give rise to a conflict of interest."
Directors could be liable for continuing to operate an insolvent entity and incurring greater losses for creditors under a theory known as "deepening insolvency."	The theory of "deepening insolvency" is rejected.

https://www.morrisnichols.com/insights-delaware-court-of-chancery-issues-significant-opinion-on-corporate-creditors-addresses-fiduciary-duties-standing-and-measure-of-insolvency

Some initial questions to ask

- Applicable state law (assuming U.S. for profit entity)? **Internal affairs doctrine**.
- Dealing with a **corporation vs. alternative legal entity** (e.g., LLC, LP, MLP)?
- Impact of governing corporate documents and impact on duties (definitions, modifications, waivers, beneficiaries, exculpation, indemnification, etc.)
- **Other applicable law**? Contractual agreements, statutes (state and federal law), common law considerations, etc.? There are multiple laws that potentially guide or constrain conduct.
- Who are the **fiduciaries**? Who owes fiduciary duties?
- What are the **duties**? What do they entail?
- Is the relevant entity solvent or **Insolvent**?
- **To what/whom does a fiduciary owe the duty? (to what entity or entities)** / Duties and considerations vis a vis: entity vs. enterprise? Parent vs. Subsidiary dynamic, **dual fiduciaries**? Are there multiple competing duties owed to different entities? diverging interests?
- Who are the **beneficiaries** of the fiduciary duties?
- Who are the potentially injured **stakeholders**?
- **Whose interests can be "considered"?** Besides shareholders and creditors, can one consider "other" stakeholders? (e.g., employees, community, environment, etc.)
- What can be the **fiduciary's goal**? (e.g., maximizing value, long-term vs short-term, risk preference, preserving value, liquidating, reorganizing, etc.)
- **Who can enforce**? (Corp. v. LLC; Chap. 11 impact)
- How does one properly "**discharge" one's fiduciary duties**?
- What to do a fiduciary faces a **potential conflict** of interest?
- What does a fiduciary do if it observes others potentially breaching a fiduciary duty?
- **Roles of advisors, counsel**, etc.
- How does a fiduciary best **mitigate risks of liability? Safe harbors, documentation, best practices**, etc.
- Steps to Take to "Cleanse" Potentially Conflicted Transactions

Exploring the fiduciary’s goals

- What is the language that guides the goal or mandate of the fiduciary of an insolvent entity?
- What does it mean to:
  - “manage for the benefit of…”
  - “act in the best interests of…”
  - “maximize value” (Maximize value of what (entity vs enterprise)? Short-term vs. long-term? Is there any limit to the risk-taking a board can engage in when seeking to maximize value?)
- Even if not required, can a board seek to “preserve value” as opposed to maximize value? Is maximizing value ever inconsistent with the concept that creditors are the “primary” beneficiary?
- **Quadrant helps:** In *Quadrant Structure Products Co. Ltd. v. Vertin*, 115 A.3d 535 (Del. Ch. 2015), creditors brought a derivative claim against the board of an insolvent company for its decision to amend operating guidelines to permit riskier and more speculative investments rather than pursuing a conservative strategy and preparing for liquidation. The court rejected the creditors’ claim, finding that directors “cannot be held liable for continuing to operate an insolvent entity in the good faith belief that they may achieve profitability, even if their decisions ultimately lead to greater losses for creditors.” Thus, after Quadrant, directors of an insolvent corporation still are permitted to pursue business strategies aimed at maximizing enterprise value.
- How does a fiduciary reconcile competing and possibly diverging interests as between shareholders and creditors, diverging interests among shareholders, diverging interests among creditors, diverging interests among entities within corporate family?
- Can there ever be “downstream” duties? Upstream duties?
- Analysis of subsidiary interests as distinct from parent entity interests

Impact of Insolvency

- Courts historically use two specific "tests" to determine when a company is insolvent in the fiduciary duty context:
  - (i) the value of a company's liabilities (including contingent liabilities) exceeds the fair market value of its assets (the "balance sheet test"), or
  - (ii) a company's cash flow is no longer sufficient to pay obligations as they become due in the ordinary course of business (the "equitable insolvency" or "cash flow" insolvency test").
- Consider that insolvency is technically assessed on an entity-by-entity basis and the complexity that may insert into the insolvency analysis.
- Insolvency does not by itself change the nature of a director's fiduciary duties or the standard by which a director's conduct will be judged.
- Insolvency does increase the number of constituencies that can challenge a director's actions by giving creditors standing to bring derivative claims against directors for breach of fiduciary duty.
- Delaware courts have stressed that <u>directors of an insolvent Delaware corporation</u> still "do not owe any particular duties to creditors." Rather, "[t]hey continue to owe fiduciary duties to the corporation for the benefit of all of its residual claimants, a category which now includes creditors."

Discharging Fiduciary Duties in the Context of Insolvency

- Assuming that decisions are made on an informed, good-faith, disinterested basis, “directors are not liable for decisions they make and actions they take in an effort to prolong the corporation’s viability, even in the face of bankruptcy.” *In re Midway Games*, 428 B.R. 303, 315 (Bankr. D. Del.2010).
- Delaware law gives protection against challenges to a board’s decision on when/whether to file for bankruptcy if the board’s decision was informed, in good-faith, and disinterested. *See In re Troll Commc’ns, LLC.*, 385 B.R. 110, 122 (Bankr. D. Del. 2008) (“Deepening insolvency has been rejected as a valid cause of action or a theory of damages under Delaware law.”).
- Delaware courts have made clear that fiduciaries of an insolvent corporation are not required to cause the company to cease operations, liquidate or declare bankruptcy. On the contrary, although the “efficient liquidation of an insolvent [corporation] might well be the method by which the firm’s value is enhanced in order to meet the legitimate claims of its creditors,” disinterested and independent fiduciaries of an insolvent corporation are “free to pursue value maximizing strategies, while recognizing that the [corporation’s] creditors have become its residual claimants.” *Quadrant quoting Prod. Res.*, 863 A.2d at 791 n. 60.
- Indeed, even when a corporation is insolvent, “its directors may, in the appropriate exercise of their business judgment, take action [including the incurrence of more debt] that might, if it does not pan out, result in the [corporation] being painted in a deeper hue of red.” In other words, Delaware law does not recognize a cause of action for “deepening insolvency.” *Id.*
- Delaware courts will not second guess such business decisions so long as they are made in good faith and disinterested and independent fiduciaries of an insolvent company who, in good faith, undertake a strategy intended to benefit the company’s residual claimants will not be held liable “just because the strategy failed.”
- *Quadrant I, 102 A.3d at 185; see also Nelson v. Emerson*, C.A. No. 2937-VCS, 2008 WL 1961150, at *2 (Del. Ch. May 6, 2006) (“The directors of an insolvent company who, in good faith, undertake a strategy to benefit the company’s equity holders cannot be held liable just because the strategy failed.”). *Trenwick*, 906 A.2d at 204; Official Comm. of Unsecured Creditors v. Tennenbaum Capital Partners, LLC (In re Radnor Holdings Corp)., 353 B.R. 820, 842 (Bankr. D. Del. 2006) (“[C]alling a discredited deepening insolvency cause of action by some other name does not make it a claim that passes muster.”); Fedders, 405 B.R. at 541 (“Simply alleging that a corporation was insolvent and took on further debt to continue operating is not enough to plead a claim for breach of fiduciary duty.”). In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106, 124-125 (Del. Ch. 2009) (recognizing that “to impose liability on directors for making a ‘wrong’ business decision would cripple their ability to earn returns for investors by taking business risks”).

Fiduciary duties and specific transactions

- **Applicability of the principals and concepts are potentially relevant and impactful in the context of certain specific corporate transactions such as:**
    - LMEs
    - Spinoffs
    - LBOs
    - Leveraged financing
    - Dividend recaps
    - De-SPAC

Risk to Professionals (legal and financial advisors)

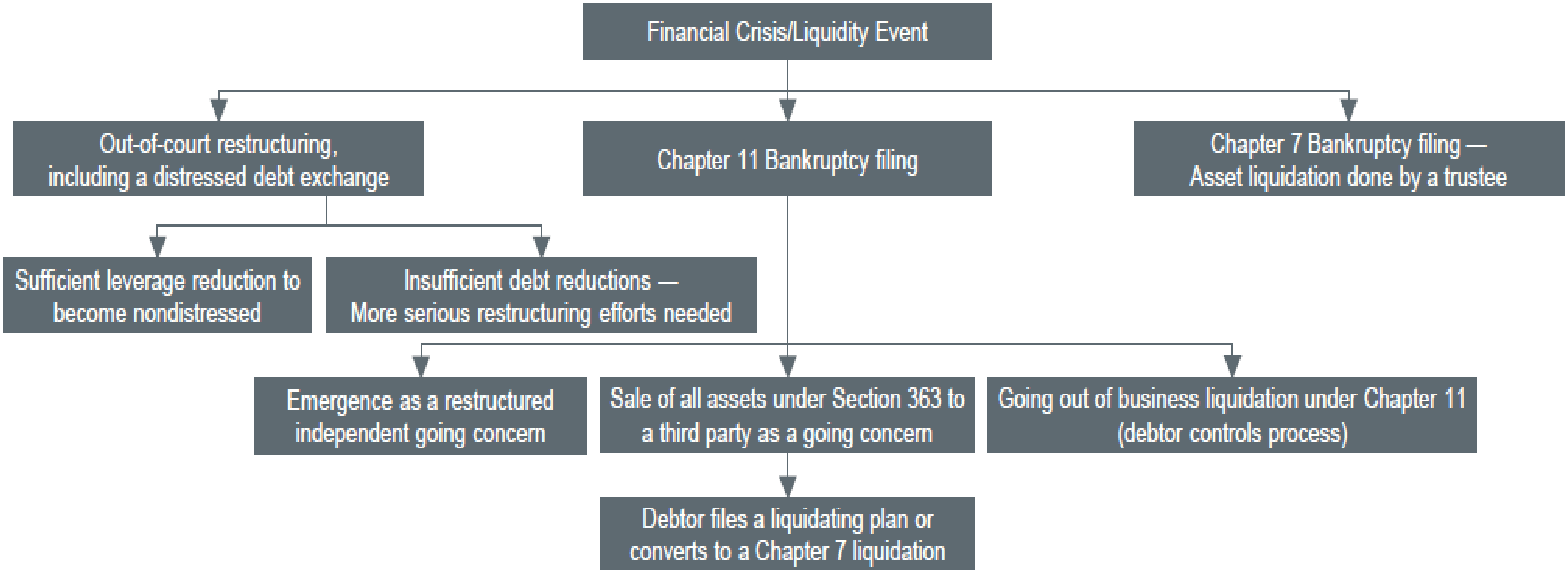
- Issues of conflict of interest, malpractice and aiding and abetting breach of fiduciary duty
- As CZR examiner noted:
  - "It is important to understand that it is not unusual for lawyers to represent portfolio companies of their private equity clients, although doing so can raise some ethical issues once there are public shareholders. Nor is it unusual for the same law firm to represent a parent corporation and its 100% owned subsidiary. In each of these circumstances, however, the situation changes once the company being represented becomes insolvent."
  - "Once insolvent, a company's residual beneficiaries change from its equity holders to its creditors. When the subsidiary is insolvent, actions that may be in the interest of the parent may not be in interest of the subsidiary. Nonetheless, there certainly are circumstances where a parent and its insolvent subsidiary can be represented by the same counsel, such as when they are litigating against a common defendant.
  - The situation is different, however, when the parent and insolvent subsidiary are on opposite sides of the same transaction and the same law firm purports to represent both entities. In that case the interests of the two entities diverge. And, once such a divergence of interest occurs, a lawyer can only undertake or continue representing multiple clients if it is clear that the lawyer can competently represent both clients and if both clients provide informed consent based on a full disclosure by the lawyer of the issues involved in the simultaneous representation."

Counsel liability

- The existence of a conflict, however, does not automatically create liability.
- For there to be aiding and abetting liability there needs to be a “knowing participation” in the breach. A lawyer providing routine legal services does not meet that standard.
- Though difficult, however, pleading such a claim is not theoretically impossible. Delaware courts, however, have found lawyers potentially liable for aiding and abetting where they were alleged to have affirmative knowledge of some fraud or where their involvement in the breach went beyond their role as counsel. See Sample, 935 A.2d at 1065 (Del. Ch. 2007); CMS Inv. Holdings, LLC v. Castle, C.A. No. 9468-VCP, 2015 WL 3894021, at *21 (Del. Ch. June 23, 2015); Royal Indemnity Co. v. Pepper Hamilton LLP, 479 F. Supp. 2d 419, 431 (D. Del. 2007); but see Zazzali v. Hirschler Fleischer, P.C., 482 B.R. 495, 519 (D. Del. Bankr. 2012); In re Brown Schools, 368 B.R. 394, 413 (D. Del. Bankr. 2007).
- Even if a disabling conflict did exist, that would not by itself give rise to a claim for malpractice. Schafrann v. N.V. Famka, Inc., 14 A.D.3d 363, 364 (N.Y.A.D. 2005). To establish liability in the non-aiding and abetting context, New York law would require clear proof that the conflict caused non-speculative damages. To prevail in a malpractice action under New York law, a plaintiff would have to establish that counsel failed to exercise the ordinary reasonable skill and knowledge commonly possessed by a member of the legal profession, and that the firm’s breach of that duty proximately causes the plaintiff to sustain actual and ascertainable damages. Carrasco v. Pena & Kahn, 48 A.D.3d 395, 396 (N.Y.A.D. 2008).
- See recent litigation and settlement by law firms in the GWG litigation trust matter.

Advising LMEs

Decision Paths



A traditional bankruptcy process can be effective in the right situations, but when dealing with a company that does not have the capacity to fund a protracted process, has serious concerns about the public nature of a bankruptcy proceeding, or needs a quick turnaround, other options may be a better fit. These include out-of-court workouts, assignments for the benefit of creditors (ABCs), receiverships, Article 9 sales, exchanges, and other out-of-court restructurings

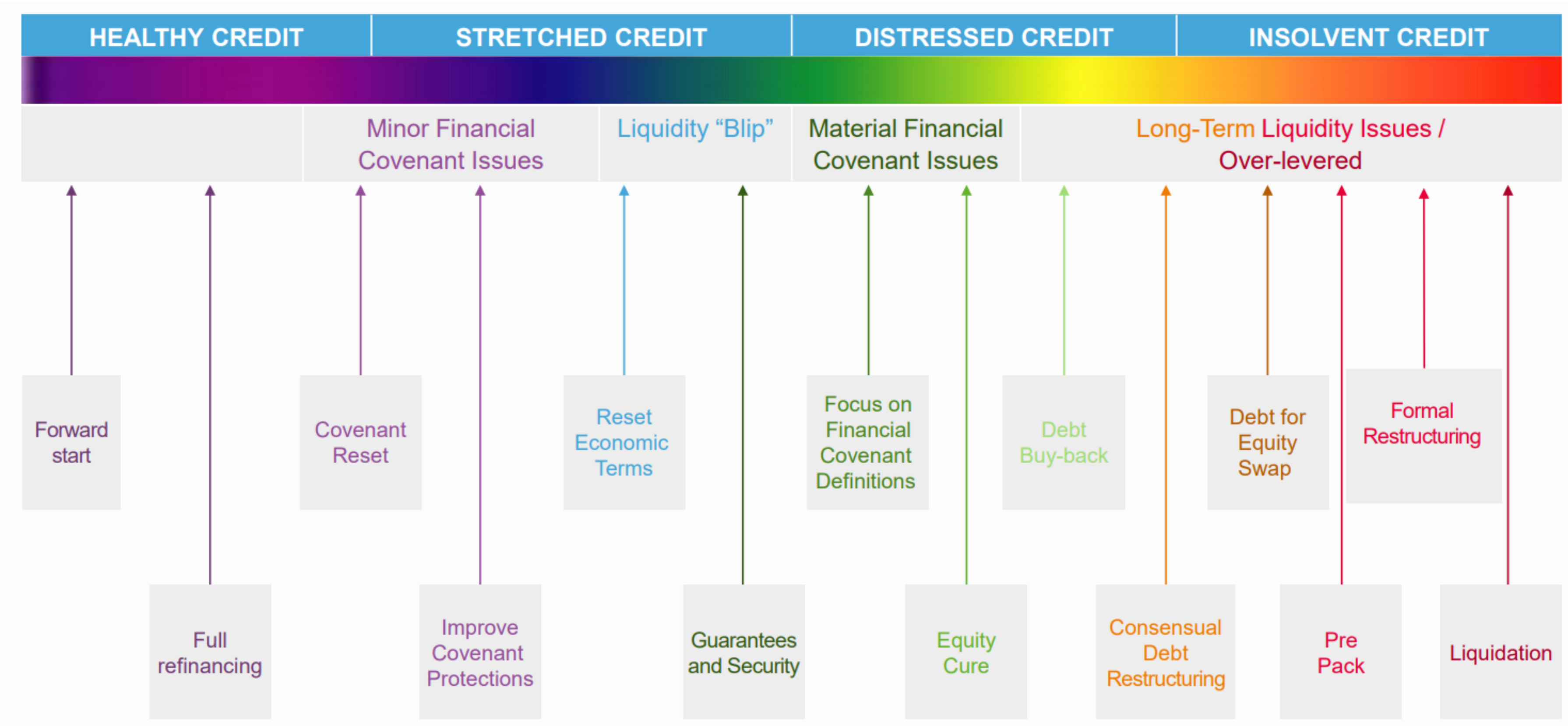
Wide Spectrum of Options

Minor → Severe

Situation	• One-time operating, covenant compliance issue	• Interest affordable, but unable to meet amortization/debt maturity	• Interest currently unaffordable, but turnaround will allow payment in future (w/o any new cash needed)	• All interest unaffordable in the foreseeable future, but company operationally cash flows	• Cash infusion needed for survival
Goal	• Obtain covenant relief	• Debt principal rescheduling	• Deferral of interest expense	• Equitization of debt	• Equitization of debt/new money raise
Tools	• Covenant waiver negotiations	• Special situation financing • Sale of discrete assets • Exchange offer to extend maturity	• Special situation financing • Sale of discrete assets • Exchange offer – new notes to lower interest burden (i.e., PIK) • Distressed merger • New cash infusion	• Deleveraging exchange offer • Distressed merger • Comprehensive restructuring in Chapter 11 • Sale/merger	• Comprehensive restructuring probably through Chapter 11 • Sale/merger

Shareholder Infusion Options	Contractual enhancement, or one time equity infusion may be sufficient	Sponsor debt infusion to bridge liquidity	Complete restructuring with new money (or purchase by sponsor) only feasible options

Another depiction of the Spectrum of Options



Clifford Chance, *Fundamentals of Financial Markets 2024 - Introduction to Restructuring and Insolvency*

Examples of Out of Court Measures

Out-of-Court Remedies	
Debt Refinancing	The refinancing of debt is an ideal option, as it involves revisions to the interest rates, repayment schedules, and pricing terms of an existing agreement. The concern is whether lender(s) would want to refinance the debt of a borrower at risk of default – hence, there may be unfavorable terms if approved.
Debt-for-Equity Swap	In a debt-for-equity swap, an existing debt is exchanged for a pre-determined amount of equity in the debtor. The exchange often coincides with lender not wanting to force debtor into bankruptcy – or the belief that the equity can hold value someday.
Debt-for-Debt Swap	In a debt-for-debt exchange, the existing debt is exchanged for a new issuance with a longer tenor, and other terms of the debt are changed to favor the lender – all while reducing the near-term obligations. Or, the borrower can propose to unsecured debt holders an exchange of their debt with secured debt with a lien for a lower principal amount (i.e., certain debt holders move up the priority waterfall in return for a reduction in principal and interest).
Cash Interest to Payment-in-Kind (PIK)	To provide the debtor with more short-term liquidity, a creditor can agree to convert some (or all) of the cash interest terms to PIK, which causes the interest to accrue to the principal as opposed to requiring cash payments upfront. While the near-term cash outlay is reduced, the accruing interest expense increases the principal amount due at maturity.
Equity Interests	Debt-for-equity swaps would fall into this category, however, there are also other types of equity interests that can be given to lenders in return for renegotiated terms. E.g., Warrants, Conversion Feature, Option to Co-Invest
Debt Issuance	The debtor can participate in new round of debt financing to implement growth initiatives, but terms are unlikely to be in their favor – and there is a low chance of much investor interest with the requisite risk appetite. The existing senior creditors likely push back against putting another lien on the company, or a covenant breach may occur from raising more debt.
Equity Injection	Equity issuances would likely receive less scrutiny from lenders (although there is a dilutive impact created for existing shareholders, the new capital may be in their interest as their chance of recovery is low). But again, considering the risk of equity being at the bottom of the capital stack, it may be challenging to raise new equity.
Distressed M&A	Selling non-core assets and using the proceeds to fund operations and meet debt obligations is a frequently used restructuring technique. However, given the "fire sale" nature of distressed M&A, the selling price may be a fraction of the asset's fair market value (FMV). In an out-of-court restructuring, any sale of assets will NOT be completely free and clear of all claims unless the debtor obtains all necessary creditor consents.
Rights Offering	A rights offering would give creditors the right to purchase a pro-rata share of equity (calculated off their existing claim or interest) in the reorganized company. The purchase is at a discounted rate, with the norm being a ~20-25% discount
Debt Repurchase	If the debtor has enough cash, it can repurchase debt (i.e., a buyback) to avoid breaching a covenant or to lower its leverage ratios. Doing so enables the D/E ratio to return to a normalized level, reduces the total leverage ratio, and decreases the interest payments – but some prepayments may come with a call premium.
"Standstill" Agreements (or Forbearance)	Once a debtor has missed a payment on its debt obligations or breached a covenant, the debtor may request to enter into a standstill agreement. These agreements usually lead to modifications to the existing debt – but for now, time is given to the debtor to sort out a proposal. In return, the lender agrees to not take any legal action against the borrower for a period of time after the debtor has defaulted (e.g., foreclosure/litigation).
Covenant Waivers (or "Relief")	If the creditor sees this as a non-continuous breach, the breach of a covenant may be waived for the debtor (i.e., a one-time "pardon"). The lender may agree to loosen the debt covenants until maturity – e.g., the calculation of EBITDA can become more lenient with more add-backs. Alternatively, as part of the waiving the breach, future covenants may be modified to be more restrictive to protect the lender(s).
"Amend and Extend" Provision	An agreement to extend the maturity date of a debt instrument coming due. In exchange, the lender receives a higher yield on their extended loans (i.e., higher interest rate) and more protection through covenants.
Interest Payment Schedule Adjustment	Similar to the extension of the maturity date, a lender could modify the due date of interest expense payments. For example, one solution could involve the deferral of an interest expense payment into the next period.

https://www.wallstreetprep.com/knowledge/restructuring/

Important: constraints, motivations, market and context

- Terms of the credit documents: Borrower or creditor friendly? How flexible or restrictive are the terms from the perspective of the lender and the borrower? See especially covenants, EOD/remedies, credit support, and amendment provisions
- Information access
- Timing
- Broader industry and market environment
- Market prices, capital markets, alternatives
- Constituency mix and motivations
- Negotiation context, leverage, etc.
- BATNA and scenario analysis
- Logistical and other practical issues
- Relationships
- Governance structure, fiduciary duties and related issues
- Company dynamics

Ask:

- What is the business problem that needs to be addressed? How should it be solved?
- Is the proposed course of action addressing the problem or is it serving another purpose?
- What are the interests and motivations of all the parties and stakeholders?
- What are the constraints faced?
- What was accomplished exactly? Examine harm and benefits for all stakeholders
- Explore from all perspectives?

Determining Your Path Forward

- Attitudes, leverage and positions of other parties that will play role in process
- Willingness of minority creditors to holdup process
- What's your end game and other goals?
- The number of creditors and their legal priorities, rights, and remedies
- Path to exit/resolution; what are you bridging to?
- Consider perspectives, rights, obligations, constraints of all stakeholders

- How does scenario analysis look for all stakeholders at the table? Valuation under varying scenarios? What is timing and quantum of net value "allocated" among stakeholders in different scenarios (given legal analysis and strategic landscape)

- The "**Sword of Damocles**": sometimes (depending on facts and circumstances) the most effective action is to refrain from commencing a legal proceeding.
  - *When would this approach work?*
  - *When would this approach not work?*

- Sophistication, size and history of debtor
- Fundamental business circumstances and prevailing economic conditions
- Depth of financial problems and outlook
- Types and sizes of claims (including contingent claims and "springing" claims)
- Costs, expense and time under various options and scenarios
- Company's ability to operate on a pre-debt service, pretax basis
- Liquidity and access to financing
- Management reliability, skills, etc. Management continuity, motivation and incentives
- Board incentives and motivation
- Company's internal controls, reporting, and transparency
- Impact on customer, vendor and other counterparty relationships
- Reputational impact on stakeholders
- Pending and anticipated litigation
- Burdensome leases and contracts
- Impact on governmental licenses and regulatory issues

Conditions Conducive for a Workout

- Integrity of management, board, and sponsor
- Ability to recover for difficulties driving distress
- Economic and business conditions favorable
- Small number of creditors
- Adequate financial records and controls
- Past and current relationship with creditors amicable

Creditor Considerations When Considering Workout

- Information deficit
- Negative cash flow may make workout untenable (interim funding?)
- Debtor slow walking to play out optionality or explore alternatives
- Missed opportunities for enforcement
- Debtor slow walk to run out clock for litigation (protect against avoidance actions)
- Creditor remains exposed to risk that debtor files bankruptcy petition anyway
- Creditor faces avoidance risk

Quadrant and the rise of LMEs and intra-creditor class conflict

In Quadrant, the Court clarified the following:

(i) directors cannot be held liable for "continuing to operate[an] insolvent entity in the good faith belief that they may achieve profitability, even if their decisions ultimately lead to greater losses for creditors";

(ii) as a matter of business judgment, directors can favor certain creditors (if non-insiders) over others of similar priority without breaching their fiduciary duties;

(iii) when directors make decisions that "increase or decrease the value of the firm as a whole and affect providers of capital differently only due to their relative priority in the capital stock, directors do not face a conflict of interest simply because they own common stock or owe duties to large common stockholders"; and

(iv) for creditors to bring derivative claims, there is no requirement that the corporation be "irretrievably insolvent" (rather, the traditional balance-sheet, cash-flow and/ or capital tests for insolvency apply), nor that the corporation be "continuously insolvent" throughout the litigation process (rather, the creditor has standing as a plaintiff so long as the corporation was insolvent at the time the complaint was filed and the plaintiff remains a creditor of the corporation).

Perspective: Impact illustrated in law firms' advice to boards

- "Juxtaposing the advice lawyers gave to distressed debtors before and after *Gheewalla* and *Quadrant* provides important evidence of the paradigm shift in the approach boards are counseled to take when a firm approaches insolvency."
- "For example, in an article written for clients in 2001, lawyers at a leading law firm wrote that "***[w]hen a corporation becomes insolvent, . . . [r]ather than pursuing high-risk strategies for the benefit of shareholders, directors must seek to protect creditors' claims to corporate assets and earnings***.""
- "After *Quadrant,* a leading law firm wrote in a client alert that ***directors can now favor some creditors over others without having to worry about liability***. Another leading law firm wrote that ***Quadrant protects directors "adopting a high-risk business strategy that might benefit controlling shareholders when a corporation is insolvent . . . .***""
- "In other words, pre-Gheewalla, the advice was stern, directional, and protective of the creditors' bargain. Post-Quadrant, the advice is vacuous and provides little directional guidance to the board. Advice focuses instead on the freedom from liability the board now enjoys so long as the board can plausibly justify its actions."

Source: Ellias, Jared A., and Robert J. Stark. "Bankruptcy Hardball." California Law Review 108, no. 3 (2020): 745–87. https://www.jstor.org/stable/26977921.

LMEs: United States vs. Europe

The European market for LMEs 2.0 (e.g., drop-downs/unsubs and up-tiers, etc.) is less developed than the U.S. market. This can be attributed to:

Directors' duties regimes: – in the U.S., directors are generally protected by the "business judgment rule" (i.e. courts will defer to board decisions and be reluctant to substitute their business judgment for that of the directors or to question business decisions, unless the decision of the board cannot be attributed to any rational business purpose). By contrast, directors' duties regimes in Europe are different, and can see directors personally liable (including on a criminal basis) for transactions while an entity is in the zone of insolvency. Given the relative lack of LME precedent in Europe, directors may feel more cautious than U.S. directors when considering the implementation of an LME.

Intercreditor agreements: the English law model for intercreditor agreements, for example, may present challenges for LMEs that include uptiering or other modification to ranking with respect to the collateral, particularly where unanimous lender consent would be required to effect those modifications.

The creditor / sponsor community in Europe: it has been noted that the lender community in Europe is smaller and more collaborative than in the U.S., which may mean that there is less inclination for creditors and sponsors to pursue the more "aggressive" LMEs described above. Will this last?

Case law considerations: exit consents are commonly used in connection with exchange offers in the U.S., which will strip the covenants (and other key provisions) of a debt instrument for non-consenting creditors. However, where the debt is English law governed debt, case law may limit the scope of exit consents the debtor wishes to employ.

Differences in restructuring processes: in Europe, in-court restructuring processes (e.g., English scheme of arrangement) provide a flexible framework within which debtors can seek to restructure debt, often resulting in these processes being more limited in time and cost. These processes also typically give directors a good deal of comfort as they offer a court-approved transaction and usually provide for directors to be released from liability in relation to their involvement in the restructuring (and its preparation). Furthermore, the scheme of arrangement is a corporate law process and so does not have the attendant risks which can accompany commencing insolvency proceedings. In Europe, these factors may make a more formal in-court process more appealing than a LME transaction, with its attendant litigation risk. The dynamic is different in the US – where the alternative to a LME transaction is an often lengthy and costly chapter 11 process – and may be another reason why LME transactions have been more prevalent in the U.S.

https://www.akingump.com/en/insights/alerts/liability-management-exercises-a-transatlantic-perspective

"Opportunistically Investing In LME Situations"

- "The increased use of LMEs has created a unique opportunity for experienced sub-investment grade credit investors to earn equity like returns by buying leveraged loans and high yield trading at a discount to par in the $3 trillion secondary market."
- "There are several ways to source attractive risk adjusted investment opportunities in LME situations:

  1. Acquire short-dated debt in the secondary market in anticipation of LME outcomes. We are focused on capital structures that are trading at stressed levels with near term debt maturities. A disciplined credit investor who acquires the debt at an attractive basis can generate double digit returns when the debt is either refinanced with the proceeds of newly issued credit or exchanged for an amended credit in a LME. Often, the new credit re-rates as a result of the LME creating a cleaner capital structure, longer dated maturity obligations, enhanced liquidity, and/or reduced leverage.

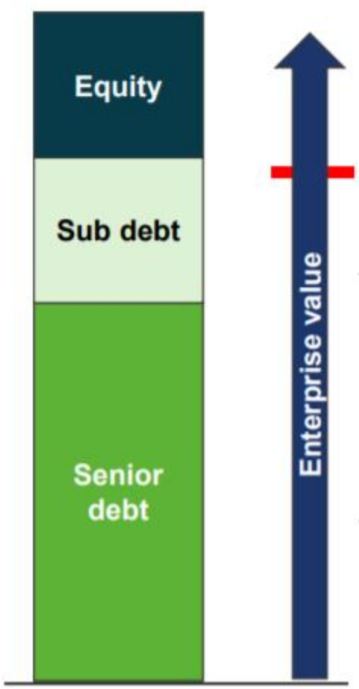
  2. Leverage relationships with sponsors to provide new capital in LME situations. Over the past twelve months, 81% of LME transactions have been conducted by sponsor backed companies. Financial stakeholders are more motivated to conduct LME and are familiar with the transaction's benefits on a borrowers cash flow. We have leveraged our broad relationships with the sponsor community to source opportunities to structure and provide flexible LME solutions. As a result of opening our balance sheet at a time of stress and uncertainty, we are typically able to structure increased credit protections and more favorable terms.

  3. Utilize LME as a tool in traditional distressed debt situations. In many distressed companies we have sought to utilize LME to avoid costly and lengthy in-court restructuring processes. LME can be utilized to provide ample flexibility to distressed capital structures to improve their cash flows and ultimately increase recovery values for creditors as an alternative to traditional restructurings. Over the past five years, the recovery rate on first lien loans experiencing payment default was 50.2%, while the recovery rate on those in distressed exchanges was 67.5%."

https://www.hgvora.com/documents/FG/hg_vora/news/643199_Investment_Opportunities_Created_by_LME_Transactions_HG_Vora_Jan_2025.pdf

Traditional Exchanges

- In the cases in which just renegotiating the terms of the debt (interest rate, maturity, amortization) is not enough to solve the distress, some kind of exchange may need to be arranged
- An exchange is a trade in which the original debt is exchanged with a mix of new debt (for a lower amount), equity securities and, potentially, cash. The exchange will try to target the desired post restructuring capital structure
- Valuation determines how the value of the company will be redistributed:

Book value	Value break	Issues	Typical dynamics
	❶ On the cusp of value brake	• Equity out of the money but still deeply involved • Banks close to whole but no influence • Yet limited pressure from liquidity	• Shareholders reluctant to let the business go • Covenant reset, debt rescheduling or restructuring depend on liquidity issues, with banks asking for equity injection • Working capital facilities could be provided by existing banks
	❷ Out of money	• Equity out of the money and “sitting on the fence” • Banks suffering losses, recovery unclear, many parties joining the table • Pressing urgency from liquidity needs	• Business requires fundamental restructuring and liquidity • Subordinated debt holders with limited options, senior debt holders try to minimize write offs • New money as new investment and financing only super senior
	❸ Sticking plaster	• Equity disinterested • Fierce discussions on recovery and potential litigation • Bankruptcy value destruction looming	• Untimely or inadequate reaction to adverse events • No material recovery expected • Bankruptcy proceeding likely alternative to debt restructuring

Exchanges

- **Executing an out of court restructuring agreement**
  - In case of bank debt, the execution usually consists of an amendment of the loan agreement
  - All loan agreements usually require the consent of 100% of the lenders for amendments that change maturity, interest rate and amortization scheme and principal amount
  - Bank loan can also be converted into equity or quasi-equity instruments
  - Restructuring of bonds can be accomplished with only the bondholder committee participants
  - The committee will want all bondholders to share the pain and will solicit the participation of the bondholders outside the committee via a formal exchange or tender offer
  - The success of the offer will raise the so-called *holdout problem*

- **The holdout problem**
  - Participation to exchange offer is voluntary and some debtholder may opt to not participate because they would be better off, assuming that the exchange is executed anyway
  - But if too many decide to hold out, all will be worse off because the exchange will not be successful in resolving its financial distress potentially leading the company to file for insolvency (insolvency can bind holdouts forcing *cram down*, but the recovery will be lower)
  - Sometimes holdouts may be involuntary (for example: retail investors, or under certain regulation)
  - The problem of holdouts escalates with the complexity of the capital structure

- **How to mitigate the holdout problem**
  - Moral coercion: players involved likely to be the same on other restructurings on which they can be retaliated
  - Covenant stripping: the exchange offer can include a provision according to which the tendering bonds are also voting in favor of authorizing an amendment to the indenture which deletes all covenants
  - Support a *pre-packaged* Ch11: the exchange offer also contain a solicitation to support a pre-pack Ch. 11 in case the offer fail to reach a minimum participation
  - High minimum participation requirement: it means that only a minimum number of holdouts will be tolerated so that if the offer is successful then the distress is likely to have been solved. The firm usually maintains the right to unilaterally waive the requirements

Questions?

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