
# Liability Management Overview

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# Governance/Disinterested Directors

# Governance/Disinterested Directors

- Control is key
  - While not necessarily intuitive, maintaining control often requires delegating some governance control to outsiders.
  - Absent the appointment of disinterested directors, creditors may be successful in obtaining standing to pursue actions on behalf of the company, as it is impossible to investigate and pursue claims against yourself. And whether or not any claims have merit is not the right question at the outset. Instead, creditors that are impaired look for any source of recovery, especially a deep pocket. So being "ahead" of such creditors is vital.
  - With all prior decisions coming under a microscope, to maintain control of investigating and potentially pursuing any "estate" actions, bringing in credible third-party disinterested directors is advisable.
  - Presence of credible third-party disinterested directors also reduces likelihood of fiduciary duty claims against a company board and sponsor.

# Governance/Disinterested Directors

**LEAST DELEGATION**

Disinterested directors can only make recommendations to the full Board, and cannot bind the Company.
E.g., iHeart (changed over time towards more delegation)

**MORE DELEGATION**

Disinterested directors may, depending on the direction of the full board as to each matter (i) exercise all the authority of the board, or (ii) make recommendations to the full Board for decision.
E.g., Gymboree Play & Music Transaction

**MOST DELEGATION**

Disinterested directors determine what matters constitute conflicts matters, and bind the Company on such conflicts matters.
E.g., EFH and Toys

**EXCERPT OF IHEART DELEGATION**

**WHEREAS**, the Board of Directors of the Company (the "***Board***") has determined it is in the best interest of the Company and the stockholders of the Company to constitute a special committee of the Board (the "***Committee***") composed of directors who are not otherwise affiliated with the Parent or significant stockholders thereof (i) to conduct any Negotiations, (ii) to direct the entry into or disapproval of contracts, in the name and on behalf of the Company, to which the Company is to be a party that would memorialize the result of any Negotiations to the fullest extent permitted by law, (iii) to evaluate and act on any course of action the Company may have with respect to the cash management and other intercompany arrangements and/or the Due from iHeart Note as a result of the Restructuring Transaction, to the extent such is within the scope of the Committee's delegation as set forth below, and (iv) to the extent that Section 141(c)(2) of the Delaware General Corporation Law does not permit the Board to delegate to the Committee the power or authority to approve, adopt, amend, or recommend an action or transaction deemed advisable by the Committee, to recommend that the Board approve, adopt, amend, or recommend such action or transaction.

**GYMBOREE PLAY & MUSIC DELEGATION**

FURTHER RESOLVED, that, in order to assist the Board in addressing matters relating to the US Transaction, the Special Committee shall have the power and authority to: (i) review and evaluate the US Transaction and consider whether or not it is fair to and in the best interests of the Company to proceed with the US Transaction, (ii) participate in, and/or consult with and advise management with respect to, in consultation with the Board, discussions and negotiations regarding the terms and conditions of the US Transaction and other other communications regarding the US Transaction, (iii) approve the US Transaction (subject to further Board approval), and recommend that the Board approve the US Transaction, if the Special Committee determines that the US Transaction is fair to and in the best interests of the Company, (iv) reject the US Transaction if the Special Committee determines the US Transaction is not fair to or otherwise not in the best interests of the Company, (v) consider such other matters as may be requested by the Board, or as the Special Committee may deem to be necessary or appropriate in order for the Special Committee to fulfill its duties and functions as are authorized herein, and make any recommendations to the Board with respect thereto that the Special Committee deems appropriate;

**EXCERPT OF TOYS DELEGATION**

**RESOLVED,** that, to the fullest extent permitted by applicable law, the Board hereby delegates to the Disinterested Directors the authority to investigate and determine, in the Disinterested Directors' business judgment and with the advice of Independent Counsel, whether any matter arising in or related to the Chapter 11 Cases constitutes a Conflict Matter, and that any such determination shall be binding on the Company; and further

**RESOLVED,** that, to the fullest extent permitted by applicable law, the Board hereby delegates to the Disinterested Directors the authority to conduct all investigations and analyses related to the Conflict Matters necessary or desirable in order to be fully advised with regard to such Conflicts Matter, in the Disinterested Director's business judgment and with the advice of the Independent Counsel, and to act on behalf of the Company and bind the Company in connection therewith, including taking any and all actions to negotiate, resolve, abide by, and implement the decisions and actions of the Disinterested Directors with respect to Conflict Matters, which responsibilities may include, but are not limited to, fact investigation, legal research, briefing, discovery, negotiation regarding proposed settlements of Conflict Matters, motions and orders regarding Conflict Matters, and the terms of the reorganization and related plan of reorganization and disclosure statement solely with respect to the terms of any such reorganization or related plan of reorganization or disclosure statement that constitute Conflict Matters, and communications and meetings with parties in interest in connection with the foregoing; and further

# D&O Insurance

# D&O Insurance

## Insuring Agreements (ABC Limits)

- ABC coverage provides a combination of balance sheet protection for the Company and personal asset protection for insured persons.
  - Side A: Personal asset protection for individual insureds in situations where indemnification is not available or provided.
  - Side B: Balance sheet protection for the Company to reimburse the Company for indemnification provided to individual insureds.
  - Side C: Balance sheet protection for the Company when named in a securities claim.
- Limits are shared by the insured person and the Company.
- Side A, B, and C coverage is subject to a single aggregate limit.

## Side A Difference-in-Condition ("DIC") Limits

- Side-A only coverage provides dedicated personal asset protection for the directors and officers in the event indemnification is not available or provided.
- Side-A losses most often result from financial insolvency or the settlement of derivative litigation.
- Side-A DIC polices can drop down when the underlying coverage is more restrictive or the underlying insurer does not pay loss (e.g., underlying ABC insurers cannot pay loss due to operation of the automatic stay).

## What is Covered?

- "Claim" is broadly defined and generally includes any written demand for monetary or non-monetary damages arising out of a "Wrongful Act."
- "Wrongful Act" is generally defined as any action taken (including inaction) or statement made (including omissions) in an insured capacity.
- Claims generally include allegations of:
  - Breach of duty (fiduciary, loyalty, etc.)
  - Fraud
  - Illegal personal profit
  - Violations of law
  - Regulatory issues

# D&O Insurance

## Who is Covered?

- Directors and officers.
- Employees (for securities claims).
- The Company, including subsidiaries (>50% owned).
- Other individuals or entities scheduled via endorsement.

## Standard Exclusions

- Finally adjudicated fraud or illegal personal profit.
- Matters covered under other types of insurance (e.g., errors & omissions, pollution, property damage, bodily injury, etc.).
- Matters related to notices provided to prior D&O insurance programs.
- Claims not noticed in accordance with the policy's reporting requirements.

## Run-Off Availability

- D&O Policies typically allow companies to purchase an extended reporting period (also known as a "run-off" policy or "tail" policy) in the event of a change of control, merger, dissolution, or similar event.
- Run-off coverage may be purchased for a period up to six years following the date of the change in control.
- Run-off coverage only covers claims on account of wrongful acts occurring before the date of the change in control.
- The cost of run-off coverage typically is between 1.5 and 2.5 times the current annual premium for the D&O program.

## Considerations

- Prior to a chapter 11 filing, companies should consider working with their restructuring professionals to undertake a review of all relevant D&O policies and to engage with the company's insurance brokers and carriers to clarify the scope of the company's D&O coverage, enhance coverage, and to purchase and prepay for any run-off coverage (if necessary).
- Depending upon the facts, it often makes sense to purchase the run-off policy before commencing chapter 11 cases.

# D&O Insurance

- Case Study—The *Goggin* Decision
  - In *Goggin v. National Union Fire Insurance Company of Pittsburgh, PA,* the Delaware Superior Court recently highlighted the risk to sponsor director designees of customary "capacity exclusions" in D&O insurance policies. The capacity exclusion could mean that D&O coverage may not be available for claims asserting or based on conflicts between the sponsor and the portfolio company or that claim that the breaches by directors were tied to their roles as investors too.
    - **Facts:** Two directors of U.S. Coal, Goggin and Goodwin, undertook debt and capital transactions with investment vehicles in which they were investors and managers.
    - **Court's Ruling:** The court observed that the complaint's 21 counts were "largely based on [Goggin's and Goodwin's] self-interested dealing" and noted a policy exclusion for acts "arising out of" an action taken by an insured in any capacity other than that of employee or director. The court found that these were self-dealing transactions and no coverage existed.
  - **Considerations:** Sponsors and portfolio companies should consider undertaking a review of all relevant D&O policies and potentially remove or adjust any applicable capacity exclusion language, if present, to limit its scope. Because these exclusions are not universal, and lead carriers (including AIG and Chubb) routinely issue policies without them, insurance professionals reviewing policies should consider negotiating to mitigate or remove the impact of these provisions.

# Privileged Communications

# Privileged Communications

- Understanding the scope and limits of attorney-client privilege is essential, particularly in the sponsor-portfolio company context and when considering liability management or other complex strategic transactions.
- The attorney-client privilege: confidential communications between Kirkland & Ellis, LLP ("K&E") and a portfolio company (or its Board members) for the purposes of obtaining or rendering legal advice likely will be protected from disclosure by the attorney-client privilege.
- BUT the privilege has limits, particularly when third-parties are included in communications or are privy to privileged information. Recent decisions have highlighted challenges in maintaining privilege over communications with:
  - portfolio company Board members who are also sponsor employees;
  - board observers and sponsor deal team members who are not members of the board;
  - financial advisors, counterparties, and other third parties involved in evaluating and executing transactions.
- **Case Study—PetSmart SDNY Privilege Ruling:** on March 28, 2019, the U.S. District Court for the SDNY determined that certain communications between lawyers and sponsor employees who were also board members of the lawyers' client were not privileged.
  - Court noted the record did not clearly demonstrate board members sought advice in their capacity as board members (rather than sponsor employees) because, among other things, there was insufficient protocol at the board level, challenged emails were not sent to other non-sponsor board members of the client, and emails were sent to sponsor—not company—e-mail addresses.
  - Decision highlights nature of *in camera* review: a court will likely review documents to decide contested privilege issues. In the case of a bench trial, an *in camera* review is akin to presentation of evidence but court reviews the documents in isolation and without context.
- **Case Study—J. Crew NY State Court Privilege Ruling:** on December 3, 2018, a New York State court judge held that attorney-client privilege was waived when J. Crew's outside restructuring counsel included J. Crew's financial advisors (bankers, valuation advisors, and solvency advisors) on privileged communications.
  - Court rejected application of the *Kovel* doctrine, which provides that privilege is not waived where a third party is necessary for effective consultation between attorney and client (in the nature of an interpreter). After *in camera* review, court held that documents did not reflect that the presence of financial and other advisors on communications was necessary for effective legal consultation.

# Privileged Communications

- Strategies to Understand, Maximize, and Protect Privilege
  - There is no "silver bullet" for protecting privilege and the baseline assumption should be that communications (including emails and texts), documents, and notes are potentially discoverable.
  - However, crucial strategies and protocols can help maximize protection of privilege in the liability management context. Among other things, companies considering strategic transactions should:
    - fully brief boards at the outset regarding privilege issues, limitations, and procedures;
    - establish and adhere to clear communication protocols, including for communications: at the board-level, between the sponsor and portfolio company, and with non-attorney advisors;
    - consider excluding third parties, including board observers and financial advisors, from board meetings when necessary;
    - draft documents and materials to be shared with financial advisors and other third parties with discoverability in mind;
    - ensure that communications with counsel clearly reflect legal advice (including by marking "Privileged and Confidential");
    - establish and demonstrate clear record where sponsor-affiliated board members communicate with counsel in their capacity as portfolio company board members (as opposed to sponsor employees);
    - establish and demonstrate clear record to support assertion of common interest doctrine and other defenses to claims of waiver.
  - Litigation counsel should be involved as early as possible in the process to brief the board and management, vet and advise on privilege issues, and coordinate with transactional counsel to anticipate potential lender challenges.

# Market Overview and Types of Liability Management Transactions

# Liability Management Overview

**Increasingly, 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 design a transaction that addresses the company's goals, in light of the restrictions in its debt documents and the company's particular situation and goals. In all scenarios, compliance with governing debt documents is key to mitigate risk while deploying strategies and pursuing transactions.

**Potential Capital Structure Goals**

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

**Considerations**

- Debt document flexibility/restrictions
- Stakeholder motivations
- Crossholder dynamics
- Corporate structure
- Litigation risk /appetite
- Credit default swap dynamics

**Analysis of Key Debt Document Provisions**

- Permitted Investments
- Permitted Debt / Liens
- Sale-Leaseback
- Asset Sales / Prepayments
- Pro Rata Sharing / Lien Subordination
- Unrestricted / Non-Guarantor Subsidiaries

**Potential Liability Management Transactions**

- Execute amendment to extend maturity using various "carrots" and "sticks"
- Exchange debt into new debt with an improved position in the capital structure (e.g., collateral, structural seniority)
- Transfer assets outside of the guarantor/collateral package of existing debt to facilitate an exchange transaction
- Discounted debt repurchases

# Amend & Extend Transactions

**An Amend & Extend (“A&E”) transaction provides companies with a maturity extension in exchange for certain credit enhancements.**

- A variety of “carrots” and “sticks” can be used to incentivize holders to participate in the transaction and reduce the risk of “holdouts.”
  - Key “carrots” can include improved rate, enhanced covenants, par paydown, and greater collateral coverage.
  - Key “sticks” include exit consents provided by transaction participants to subordinate liens and strip covenants.

**BENEFITS TO BORROWERS**

- Provides management time to execute on its business plan and “grow” back into its capital structure
- Generally cheaper form of capital relative to raising new primary issuance
- Not mutually exclusive from other exchange alternatives that a company may need to pursue
  - A&E transactions, via amendments to more restrictive senior debt, can provide for additional flexibility in crafting exchanges targeting junior creditors

**CONSIDERATIONS**

- Fees and enhanced rate detrimental to liquidity over time
- May limit future flexibility to pursue other capital structure alternatives
- Often conducted at par as opposed to a discount to par
- In distressed scenarios, typically relies on operational turnaround rather than comprehensive capital structure solution

# General Exchange Offer Considerations

**Exchange offers represent a broad range of transactions that typically involve the exchange of existing debt or preferred securities into newly created, like-kind, or common equity securities or a combination thereof**

- These transactions are typically heavily negotiated between an issuer and its security holders, as issuers attempt to realize certain benefits through the strategic use of "carrots" and "sticks"

| GENERAL EXCHANGE OFFER CONSIDERATIONS | | |
|---|---|---|
| POTENTIAL ISSUER BENEFITS | POTENTIAL "CARROTS" TO HOLDERS | POTENTIAL "STICKS" TO HOLDERS |
| ► Deleverage capital structure through debt discount capture and/or debt-for-equity exchange<br>► Improve liquidity<br>► Extend maturities of existing debt<br>► Reduce annual interest expense<br>► Covenant relief and increased financial flexibility | ► Gain on existing securities through exchange at a premium<br>► Increase in coupon payments<br>► Improved security or seniority in capital structure<br>► Obtain new, more "stable" security designed to trade at par<br>► Potential to participate in improved performance and equity upside in the business | ► Loss of position in capital structure (i.e., getting primed)<br>► Threat of missing out on economic and structural benefits to be received by participating holders<br>► Loss of covenant protection through strip by majority |

# General Exchange Offer Considerations

**TACTICAL CONSIDERATIONS IN EXCHANGE OFFERS**

- In a debt-for-debt exchange transaction, holders of a company's indebtedness are typically asked to exchange their bonds for new bonds with lower face value with an extended maturity and modified interest terms (i.e., PIK coupon), and potentially equity securities and/or warrants
- Although the new package represents a discount to face value, it should equal or exceed the market value of the bonds to be exchanged
  - Equity or warrants in the deleveraged company can provide exchanging bondholders upside potential
- Par buyers (i.e., entities which purchased bonds at or near face value) are likely to be more reluctant to exchange at a discount than hedge funds or other entities that typically have purchased bonds at a substantial discount to face
- Bondholders who do not tender (hold-outs) will retain their original claims
  - Important to set high threshold for acceptance (i.e., 90%+)
  - Exchanging bondholders will consent to strip all covenants, including change of control put rights, leaving holdouts with illiquid paper with no covenant protection

# Uptiering Exchanges

**The most common type of uptiering exchange is when a company offers to exchange unsecured bonds for a lower principal amount of secured bonds that are either pari passu with or subordinated to the company's existing secured debt (*i.e.,* "1.5 lien" or second lien).**

- More generally, an uptier exchange can be any transaction in which a debtholder improves their position, either by gaining liens on collateral or improving their position with respect to such collateral (*i.e.,* moving from second to first lien).

## ILLUSTRATIVE UPTIERING EXCHANGE

1 **Company exchanges $600mm of Unsecured Notes for $400mm of New Second Lien Notes (66.67% offer price)**

- Exchange at discount to par provides $200mm of deleveraging
- Exchange typically conducted at a premium to market prices

2 **Participating Unsecured Noteholders receive improved position by gaining second lien on collateral in exchange for discount capture provided to company / residual stakeholders**

- Creditors derisk downside exposure while capping upside
- Non-participating noteholders effectively subordinated to participating noteholders

**Capital Structure**

| | FACE VALUE | ADJ. | PF VALUE | CURRENT LEVERAGE | PF LEVERAGE |
|---|---|---|---|---|---|
| ABL Facility | $ — | $ — | $ — | 0.0x | 0.0x |
| Term Loan | 1,200 | — | 1,200 | 6.0x | 6.0x |
| New Second Lien Notes | — | 1 400 | 400 | 0.0x | 2.0x |
| **Total Secured Debt** | **$1,200** | **$400** | **$1,600** | **6.0x** | 2 **8.0x** |
| Unsecured Notes | 1,000 | (600) | 400 | 5.0x | 2.0x |
| **Total Debt** | **$2,200** | **($200)** | **$2,000** | **11.0x** | **10.0x** |

**Memo**: Illustrative LTM EBITDA

*Discount to company / residual stakeholders*

## BENEFITS / CONSIDERATIONS

**Benefits to Borrowers**

- **Delevers through discount capture**
- **Can be used to address maturities, reduce cash interest expense, relax covenants, etc.**
- **Can provide liquidity injection to company by requiring exchange participants to also provide new money (*i.e.*, a "pay-to-play" exchange)**
- **Exit consents to strip covenants can be used to incentivize participation**

**Considerations**

- **Often requires scarcity value to incentivize participation**
  - At conflict with hold-out problem; limits uptier exchanges ability to provide for a comprehensive capital structure solution
- **Gives rise to substantial cancellation of debt income**
- **May need equity kicker (*e.g.*, penny warrants or preferred equity)**

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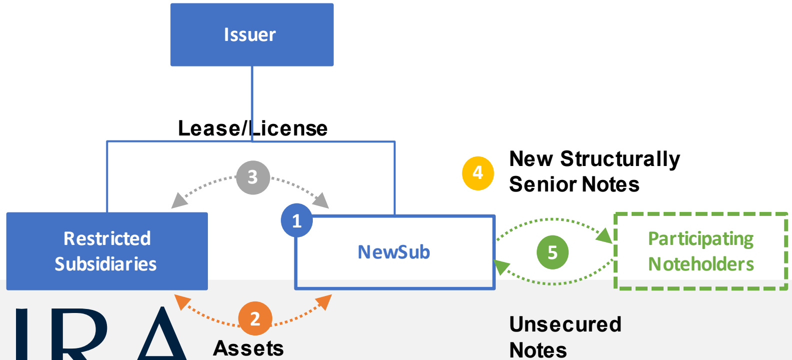
# "Drop-Down" Exchanges

**In a "drop-down" exchange, a company places certain assets into an unrestricted subsidiary or designates a restricted subsidiary as unrestricted, and then use such assets as negotiating leverage or collateral for new financing or new debt securities which are offered in an exchange.**

- Unrestricted subsidiaries are not subject to debt document covenants, including debt incurrence and lien restrictions.

## ILLUSTRATIVE "DROP-DOWN" EXCHANGE

1. **Form an unrestricted subsidiary ("NewSub")**
   - Unrestricted subsidiaries are not subject to covenants under debt documents
2. **Company contributes assets to the NewSub**
   - Requires Permitted Investments and/or Asset Sale basket capacity
3. **Company enters into intercompany agreements (*e.g.*, leases, licenses) so that the transferred assets can be utilized by the Restricted Subsidiaries**
4. **NewSub issues and guarantees new debt, the "New Structurally Senior Notes"**
   - Notes have structural seniority with respect to the assets in New Sub
5. **The Company exchanges current debt for the New Structurally Senior Notes, at a discount**




## BENEFITS / CONSIDERATIONS

**Benefits to Borrowers**

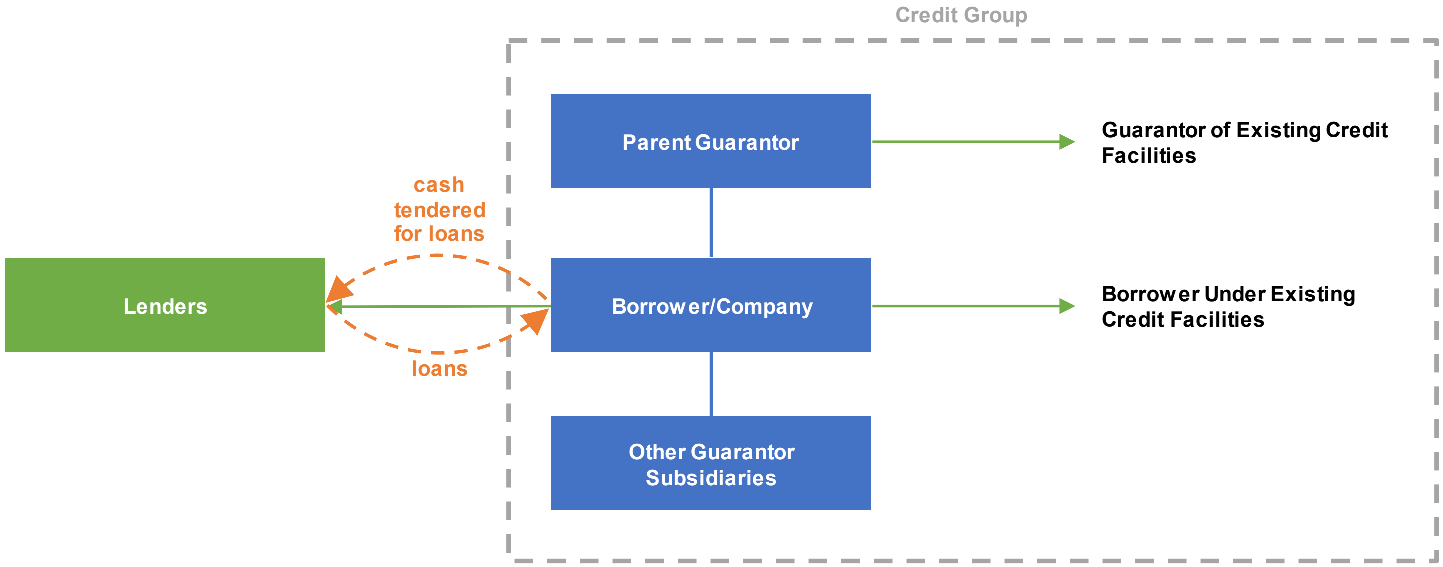
- **Delevers through discount capture**
- **Can be used to address maturities, reduce interest expense, relax covenants, etc.**
- **In certain situations, noteholder appetite may be even greater than a secured debt exchange**
  - If secured debt is trading below par, structural seniority to the transferred assets is often viewed more favorably
  - Appetite will be materially influenced by the type of assets contributed to the Unrestricted Subsidiary
- **Exit consents to strip covenants can be used to incentivize participation**

**Considerations**

- **Should be structured to mitigate basis for fraudulent conveyance and fiduciary duty challenges by creditors**
- **Gives rise to substantial cancellation of debt income**
- **Unconventional structure may invite litigation from creditors**
- **Practical difficulty in identifying assets that could be contributed to the Unrestricted Subsidiary**

# Discounted Debt Repurchases

- The Company (or a Subsidiary) would repurchase existing loans at discounted prices through (1) open market purchases and/or (2) Dutch Auctions.
- The repurchased loans will be cancelled.
- This transaction typically does not require consent from lenders other than those selling.



# CDS-Related Dynamics

**CDS can materially alter a party's motivations and thus their willingness to participate in liability management transactions**

- Understanding these dynamics is important for issuers as they work with advisors to design and implement these types of transactions

| Capital Structure Exposure | CDS Exposure: Long Risk *(written protection)* | CDS Exposure: Short Risk *(bought protection)* |
|---|---|---|
| Long[1] *(e.g., bondholder)* | ▸ **Parties who are long bonds and have also written CDS protection will benefit from maximizing bond value, as well as the credit quality of the issuer**<br>    ▸ In distressed scenarios, maximizing the "credit quality" of issuer can take the form of ensuring that a credit event does not occur before the CDS contract expires<br>▸ **It may be profitable for investors to extend additional capital to issuers to avoid losses on CDS contracts, depending on their positions**<br>▸ **Party would prefer high market prices of reference entity bonds** | ▸ **Some parties try to hedge away credit risk of a bond investment by being long bonds and purchasing CDS protection**<br>▸ **<u>If betting on the timing of default</u>, investors are incentivized for a credit event to occur before the CDS contract expires**<br>    ▸ Allows investors to collect on payoff of CDS contract in addition to recovery on the underlying bond<br>▸ **<u>In a rate arbitrage "basis" trade</u>, lack of exposure to default risk may cause reluctance to participate in conventional credit-enhancing transactions**<br>    ▸ Debtors would have to find a way to settle CDS or break basis<br>▸ **Party may prefer high or low market prices of reference entity bonds depending on the weighting of its hedged position** |
| None *(e.g., CDS seller outside cap structure)* | ▸ **Speculative investors may take on long risk positions in CDS versus the underlying bond due to enhanced market liquidity or to express a unique view on the timing of a credit event**<br>    ▸ Primary concern of investor is to ensure that credit event does not occur before expiration of the CDS contract they have written<br>▸ **Investor may be willing to provide additional capital to avoid payouts on CDS contracts**<br>▸ **Party would prefer high market prices of reference entity bonds** | ▸ **Speculative investors may take on short risk positions in CDS versus the underlying bond due to enhanced market liquidity and imperfections in the repo market**<br>▸ **Primary concern of investor is to ensure that credit event occurs before expiration of the CDS contract they have purchased**<br>▸ **Party would prefer low prices of reference entity bonds** |

1. Holder can also be short through the repo markets, although this is less likely. Incentives would simply be reversed from those set forth above.

# Notable Liability Management Transactions in the Market

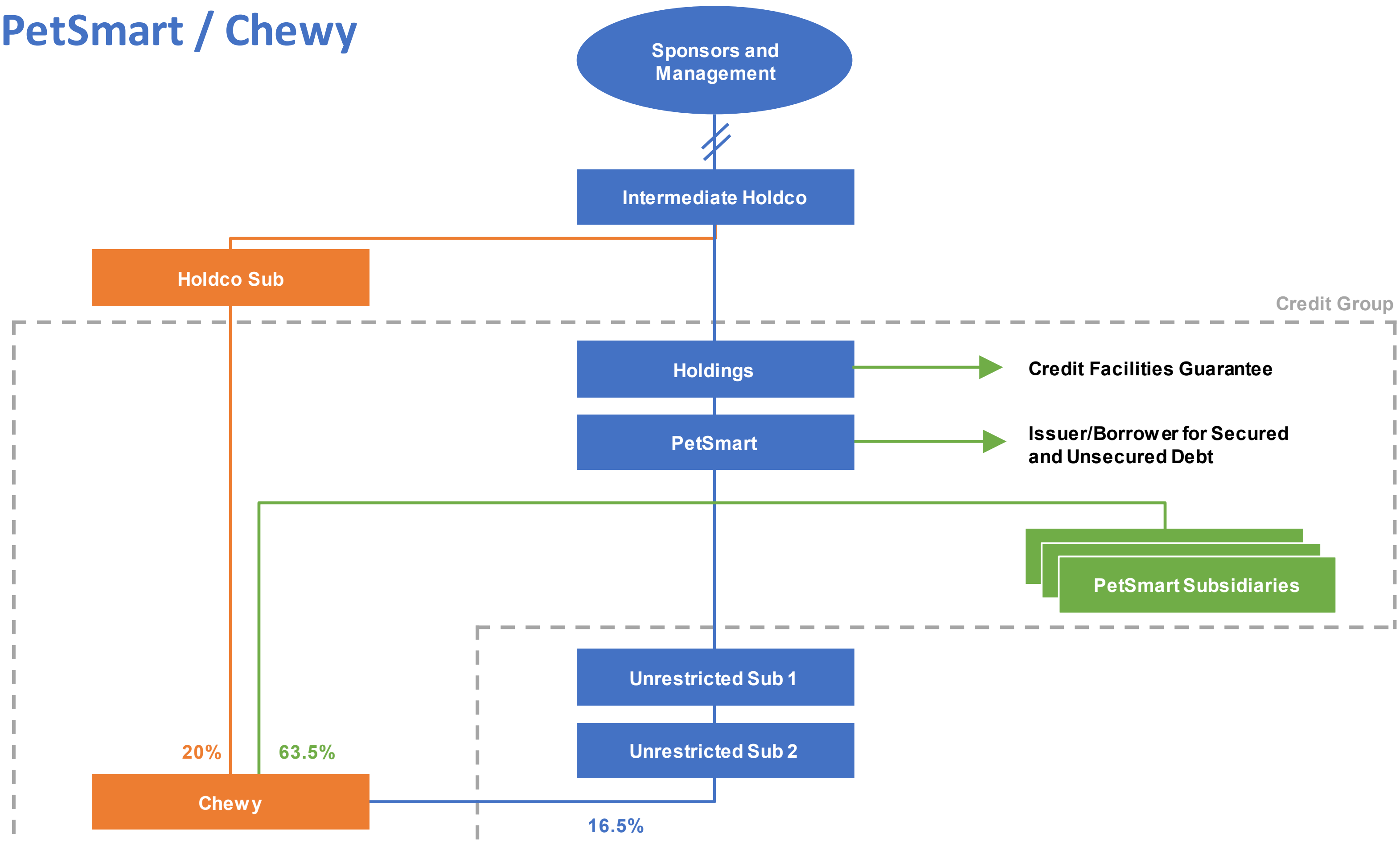
# Notable Liability Management Transactions in the Market

## PetSmart / Chewy

- In June 2018, PetSmart declared and paid a dividend in the form of 20% of the common stock of its online retailer ("Chewy") to its parent company. Separately, PetSmart invested 16.5% of the common stock of Chewy in the form of a capital contribution to a wholly-owned new unrestricted subsidiary of PetSmart.
- The transactions were each approved by special committees of disinterested directors of PetSmart and Holdings, as applicable, each of which was advised by its own legal and financial advisors.
- As a result of these transactions, Chewy was no longer a wholly-owned subsidiary of PetSmart and, accordingly, its guarantee of the obligations under the Term Loan was released. The release of Chewy's guarantee of the obligations under the Term Loan caused the guarantee of PetSmart's outstanding senior notes to be released.
- Chewy remained a restricted subsidiary under PetSmart's credit agreements and the indentures governing its outstanding senior notes and a guarantor of the obligations under its ABL Facility.
- These transactions provided PetSmart with additional flexibility to address its capital structure and evaluate potential strategic opportunities.

# Notable Liability Management Transactions in the Market

## PetSmart / Chewy

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# Notable Liability Management Transactions in the Market

## PetSmart / Chewy Aftermath of Liability Management

- The transactions did not come without scrutiny as they were subject to litigation after lenders alleged a fraudulent transfer. However, the dispute was settled in mid-April 2019 through a loan amendment that restricted lenders' rights to pursue further litigation.
- On April 29, 2019 Chewy filed a Form S-1 Registration Statement announcing an IPO of Class A common stock.
- On June 3, 2019, Chewy filed an amended S-1, disclosing that PetSmart will offer 36 million shares at an offering price expected to be between $17.00 and $19.00 per share.
  - PetSmart's proceeds of the Chewy IPO were slated for voluntarily prepayment of certain secured debt.
  - Chewy's proceeds of the IPO were slated for general corporate purposes.
- On June 13, 2019, Chewy announced that the initial public offering of its common stock would be $22.00 per share.
- On July 18, 2019, PetSmart announced a buyback of $205 million worth of its notes due 2025 at par funded entirely by the proceeds from the Chewy initial public offering.

# Notable Liability Management Transactions in the Market

## Neiman Marcus

- Late 2014, Neiman Marcus acquired MyTheresa and designated the acquired entities as "Unrestricted" under the credit agreement
- Spring 2017, Neiman Marcus:
  - designated the MyTheresa entities as "Unrestricted" under the indentures
  - formed an Unrestricted Subsidiary and contributed three parcels of real property to the Unrestricted Subsidiary and leased the properties back to Neiman Marcus.
- Fall 2018, Neiman Marcus distributed the equity of the Unrestricted Subsidiaries that held MyTheresa to a parent company outside of the credit party group.
- As a result of these transactions, MyTheresa was no longer a direct or indirect Subsidiary of any borrower or guarantor.

# Notable Liability Management Transactions in the Market

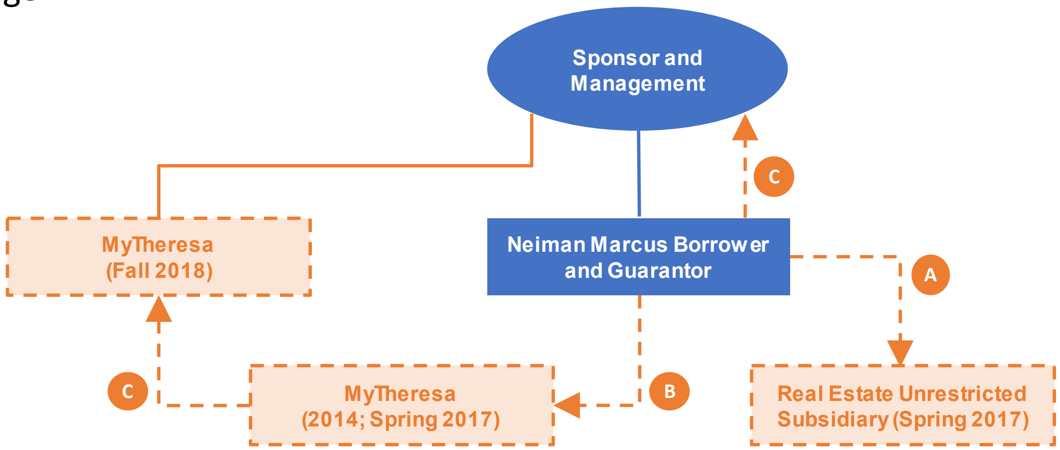
## Neiman Marcus

- June 2019, Neiman Marcus and substantially all of its lenders and noteholders entered into a restructuring of its existing debt whereby lenders and noteholders agreed to extend maturity by three years and Neiman Marcus agreed to provide additional collateral.
  - A portion of the equity and assets of certain MyTheresa entities were pledged to Second Lien Noteholders and Third Lien Noteholders
  - Bringing MyTheresa and the real estate assets back into the Collateral was key to negotiating the overall restructuring package

A. Neiman Marcus transferred certain real estate to an Unrestricted Subsidiary

B. Neiman Marcus acquired MyTheresa where it sat below the credit group as an Unrestricted Subsidiary

C. Neiman Marcus distributed equity of MyTheresa such that it was no longer a subsidiary of the credit group

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# Notable Liability Management Transactions in the Market

## J. Crew

- In December 2016, J. Crew transferred a majority of its intellectual property assets to a new unrestricted subsidiary ("IPCo"). J. Crew then offered to exchange existing payment-in-kind or PIK notes issued by J. Crew's parent company for new notes issued by IPCo and preferred stock and common equity issued by J. Crew's parent company. 99.9% of PIK noteholders participated in the exchange offer.
- J. Crew also required an amendment to its term loan to permit the exchange of the PIK notes for new IPCo notes. 88% of term loan lenders ultimately consented.

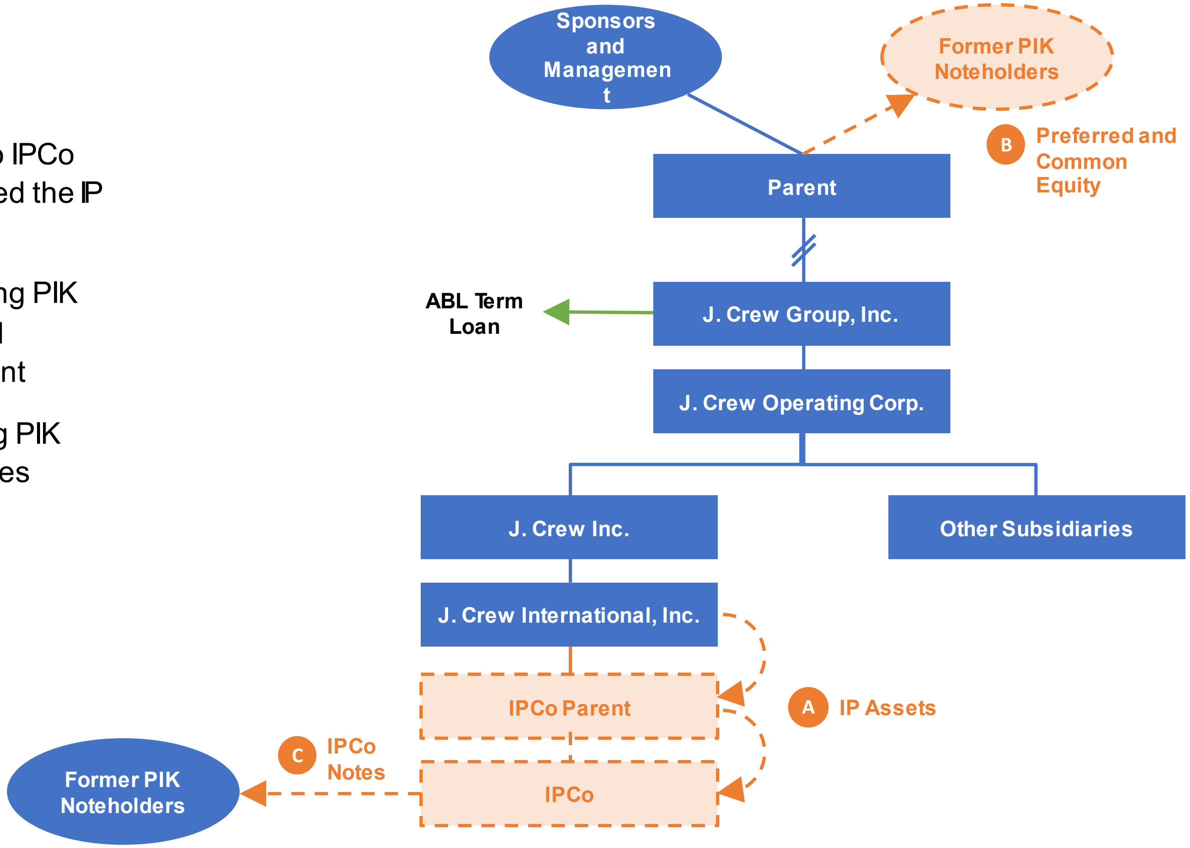
# Notable Liability Management Transactions in the Market

## J. Crew

A. J. Crew International transferred IP assets to IPCo Parent which transferred the IP assets to IPCo

B. IPCo exchanged existing PIK notes for preferred and common equity in Parent

C. IPCo exchange existing PIK notes for new IPCo notes



# Tax Considerations in Liability Management Transactions

# Tax Considerations in Liability Management Transactions

## Cancellation of Debt Income

- Liability management transactions require careful consideration of potential cancellation of debt income ("CODI") issues. CODI can arise from:
- Discounted repurchases of debt, debt-for-debt exchanges, or debt-for-property exchanges, undertaken by either the issuer of the debt or related parties (including significant shareholders or certain affiliates thereof).
- Modifications of debt terms, potentially including modifications that are intended to be temporary (e.g., pursuant to a forbearance agreement). This includes changes in interest rate, payment schedules, and maturity dates; addition of collateral; additions or changes to obligor or guarantor groups; and numerous other potential changes.
- Payment of fees, including in connection with entering into forbearance agreements, consent solicitations, plan support agreements, and similar transactions.
- CODI can arise even if all modifications are favorable to creditors. The amount of CODI will generally be determined by reference to trading values if any exist, and "trading" is defined very broadly—it can include mere indicative quotes from BVAL, Markit, and similar pricing services, even if the debt is not actually traded (e.g., a single-bank ABL). Additionally, transactions that give rise to CODI can also potentially give rise to a taxable exchange to creditors, destroy the fungibility of debt tranches, and create "tax original issue discount" (essentially, additional interest expense, which the issuer may or may not be able to deduct).
- CODI can give rise to cash tax liability unless the "bankruptcy" or "insolvency" exclusions apply. The application of the insolvency exclusion to out-of-court transactions requires a highly fact-specific analysis.

# Tax Considerations in Liability Management Transactions

## Section 382

- Changes in the equity ownership of a company can trigger an “ownership change” under Section 382. This can result in significant limitations on the ability to utilize NOLs and other tax attributes (including to offset CODI in a liability management transaction).
- Companies that are considering a liability management transaction should carefully evaluate their position under Section 382 to ensure they have not undergone an ownership change. Additionally, if the company is close to having an ownership change, the company should consider implementing an “NOL poison pill” or other measures to protect its tax attributes.
- The potential application of Section 382 to any potential liability management transaction should be considered. There are favorable bankruptcy-only Section 382 rules that should be taken into account if in-court options are being considered.

# Trends and Lessons Learned

# Liability Management — Trends

| | |
|---|---|
| Every Creditor for Themselves | ▸ **Creditors are increasingly willing to cut side deals and leave similarly situated holders out of liability management transactions**<br>– Trend towards non-pro rata transactions that benefit first movers<br>– Lender cooperation agreements are weak and cannot be relied on<br>– Side arrangements are often undisclosed and invisible from other participants |
| Thought Leadership | ▸ **Creditors can play a meaningful role in shaping the direction of liability management transactions**<br>– Creditors that participate in structuring are less likely to be left behind in non-pro rata transactions |
| Litigation | ▸ **Litigation is a key part of the story**<br>– Companies and creditors increasingly accept that litigation may be a cost of doing business in this context<br>– Certain borrower strategies actually require litigation |
| Risk | ▸ **Sponsors and public company boards have higher risk tolerance**<br>– Less concern about reputational risk<br>– Growing view that fiduciary duties may compel exploring liability management strategies |

# Liability Management — Lessons Learned

A number of important lessons can be learned from recent liability management transactions regarding, among other things, debt documents, timing, creditor dynamics, and the effective structure of a proposal.

| | |
|---|---|
| Debt Documents | ► **Careful attention should be paid to how a company's debt documents treat the use of, *e.g.*, investment, restricted payment, and asset sale baskets, as such provisions may supply the company with attractive opportunities to maximize value for its stakeholders**<br>– By proactively identifying and utilizing creative strategies unlocked by a company's debt documents, a company may be able to create value that can serve as consideration in a targeted exchange<br>– Even if such baskets are not ultimately used, the identification of those baskets can be highly valuable, as an offer to "close a loophole" or otherwise tighten certain covenants has served as a material "carrot" for creditors in recent transactions (*e.g.*, Neiman Marcus) |
| Timing | ► **Developing a comprehensive liability management "playbook" well in advance of any potential distress catalyst is critical to maximizing value, and companies that wait to understand their capital structure issues and formulate a game plan are often too late**<br>– In certain instances, companies simply do not have the time—whether on account of constrained liquidity or impending debt maturities—to structure a comprehensive liability management transaction or secure rescue financing<br>– In other instances, companies lose substantial investment or debt flexibility under their debt documents (through, *e.g.*, ratio covenant governors) that could have helped the company provide significant value to facilitate a transaction |
| Creditor Dynamics | ► **Understanding the company's debtholders, and any potential cross-holdings and/or CDS exposure across a company's capital structure, is critical to being able to structure and propose an executable transaction**<br>– Creditors who are sellers of CDS may be ready sources of new capital and/or may be willing to structure a deal on attractive terms to help facilitate a transaction that extends a company's runway<br>► **Extensive cross-holdings across a company's capital structure can work for or against a company, however, depending on whether the company is interested in pursuing a global or selective deal, respectively** |
| Deal Structure | ► **Combining "carrots" and "sticks" with an aggressive timeline can help put pressure on counterparties to accept a deal they might have otherwise opposed**<br>– Splitting creditor groups such that only creditors who consent to the transaction will receive the "carrots" offered in the deal, while those who oppose the transaction will risk the imposition of certain "sticks," can help drive high participation levels, especially under a compressed timeline<br>– Typical "carrots" include a partial paydown at par, increased interest rate or amortization, consent fees, and collateral, while "sticks" can include consent solicitation, layering, the stripping or subordination of liens |