Feast or Famine: Private Credit Restructuring Year in Review

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

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

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

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

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

Deluxe Entertainment and CLOs: A New Frontier for Distressed Investors

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

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

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

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

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

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

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

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

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

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

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

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

Corporate Governance Considerations: Nonvoting Board Observers in Tibet Pharmaceuticals

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Year Ahead: Private Credit Restructuring in 2020

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

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