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Leakage: Plug The Holes BEFORE The Flood

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Proskauer University: Private Credit Building Blocks Series

- Program 1 | Wednesday, November 2, 2022
 - Introduction to Private Credit: Deal Process, Documentation, and Structure Considerations
- Program 2 | Wednesday, January 25, 2023
 - Leverage Ratios: Fundamentals and Pitfalls
- Program 3 | Wednesday, February 15, 2023
 - So You Thought You Were First?
- **Program 4 | Wednesday, March 22, 2023**
 - **Leakage: Plug The Holes BEFORE The Flood**
- Program 5 | Tuesday, April 18, 2023
 - Structural Risks: Sneaky Shenanigans
- Program 6 | Wednesday, May 24, 2023
 - Key Market Terms and Commitment Letter Basics
- Program 7 | Thursday, June 15, 2023
 - Practical Exercise: Tricks to Quickly Spot Issues in Financing Grids

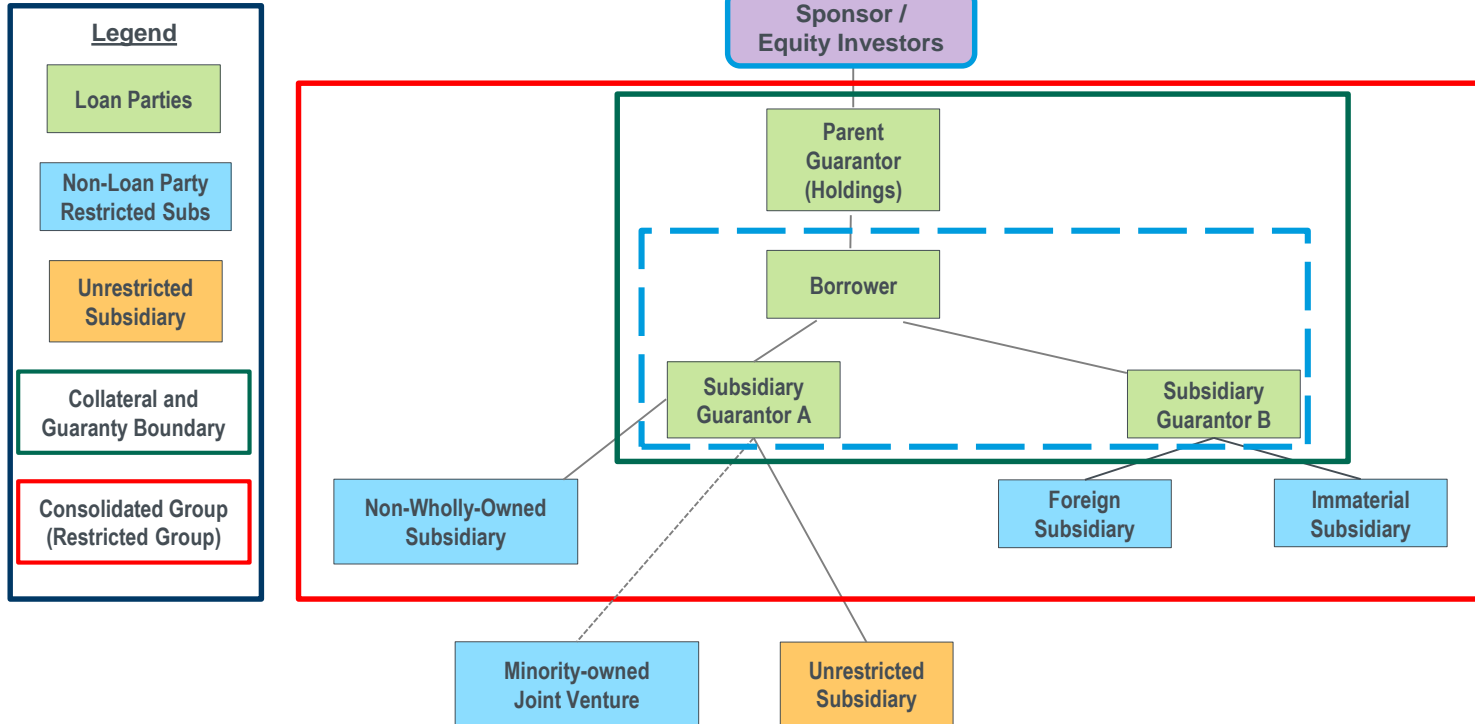
Overview

We will cover three related topics today:

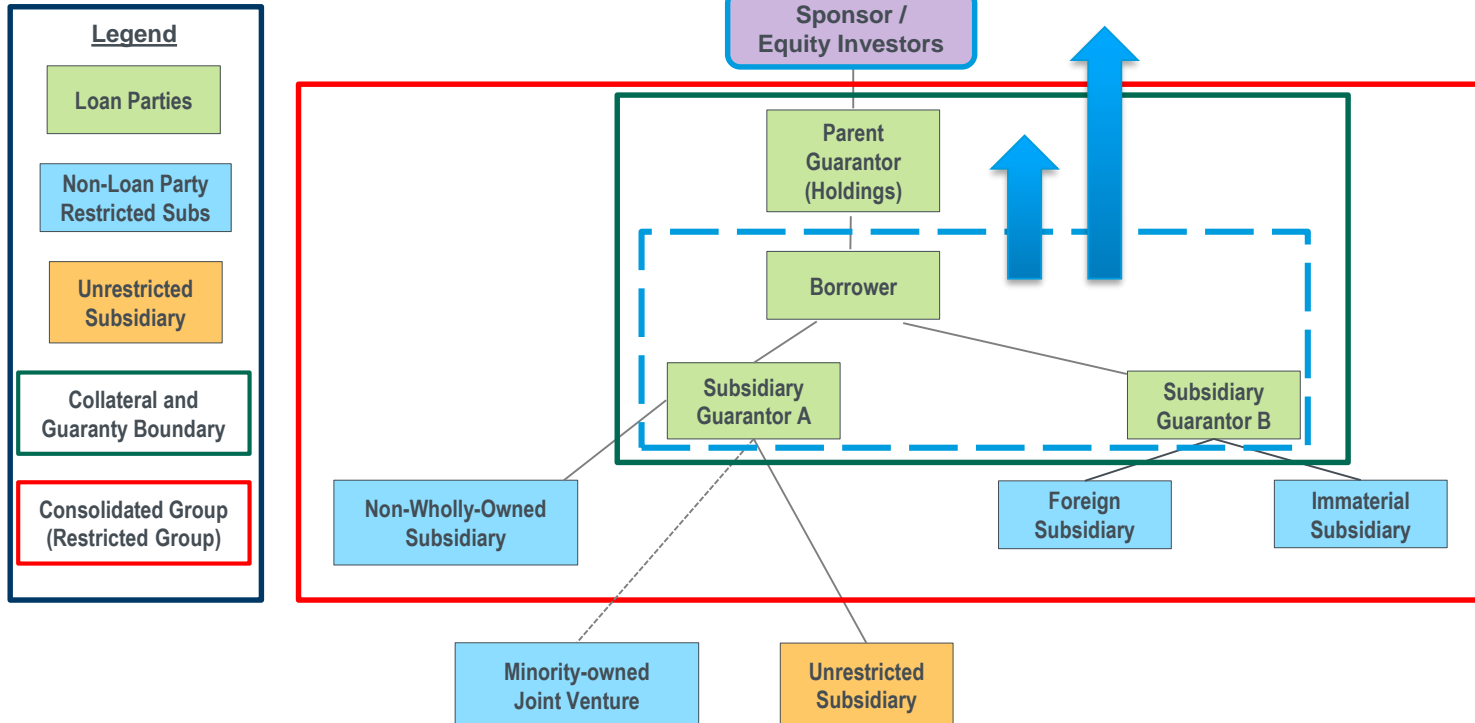
1. When we talk about “leakage” under our credit documents, what are we referring to?
2. How does leakage arise under our credit documents and how can we spot and mitigate potential risks?
3. What happened in connection with J.Crew and Chewy and how do we mitigate these risks?

I. What is “leakage”?

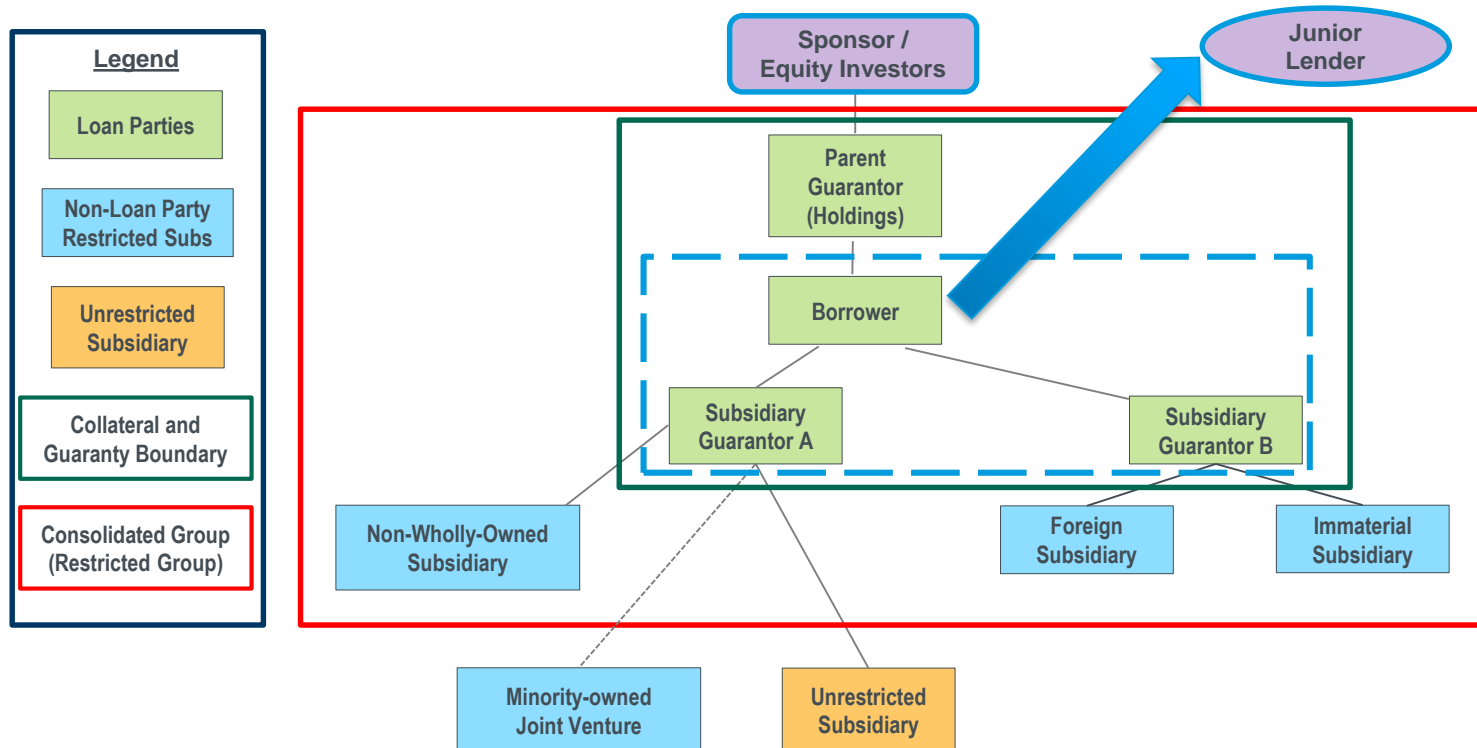
Defining Leakage – Structure and Credit Support



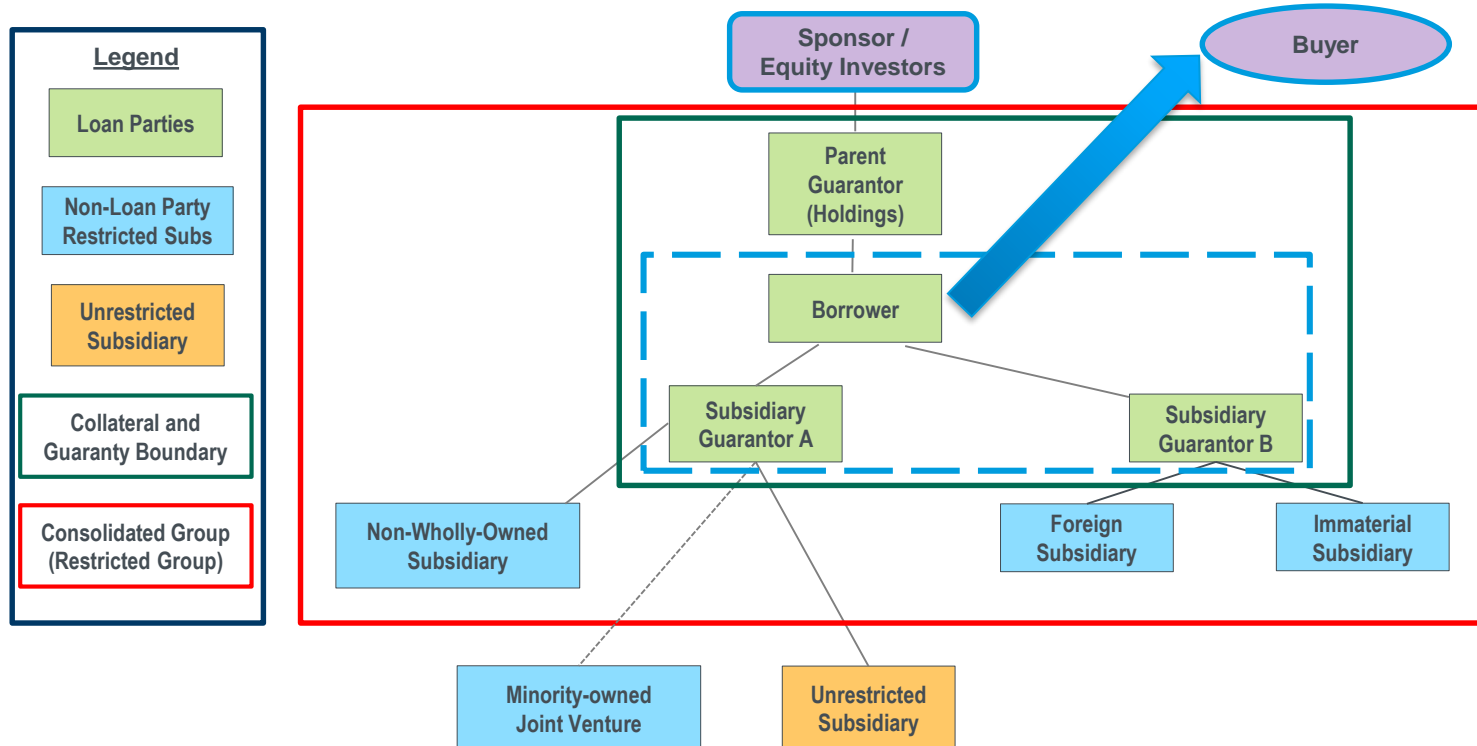
How Does Leakage Occur? – Restricted Payments



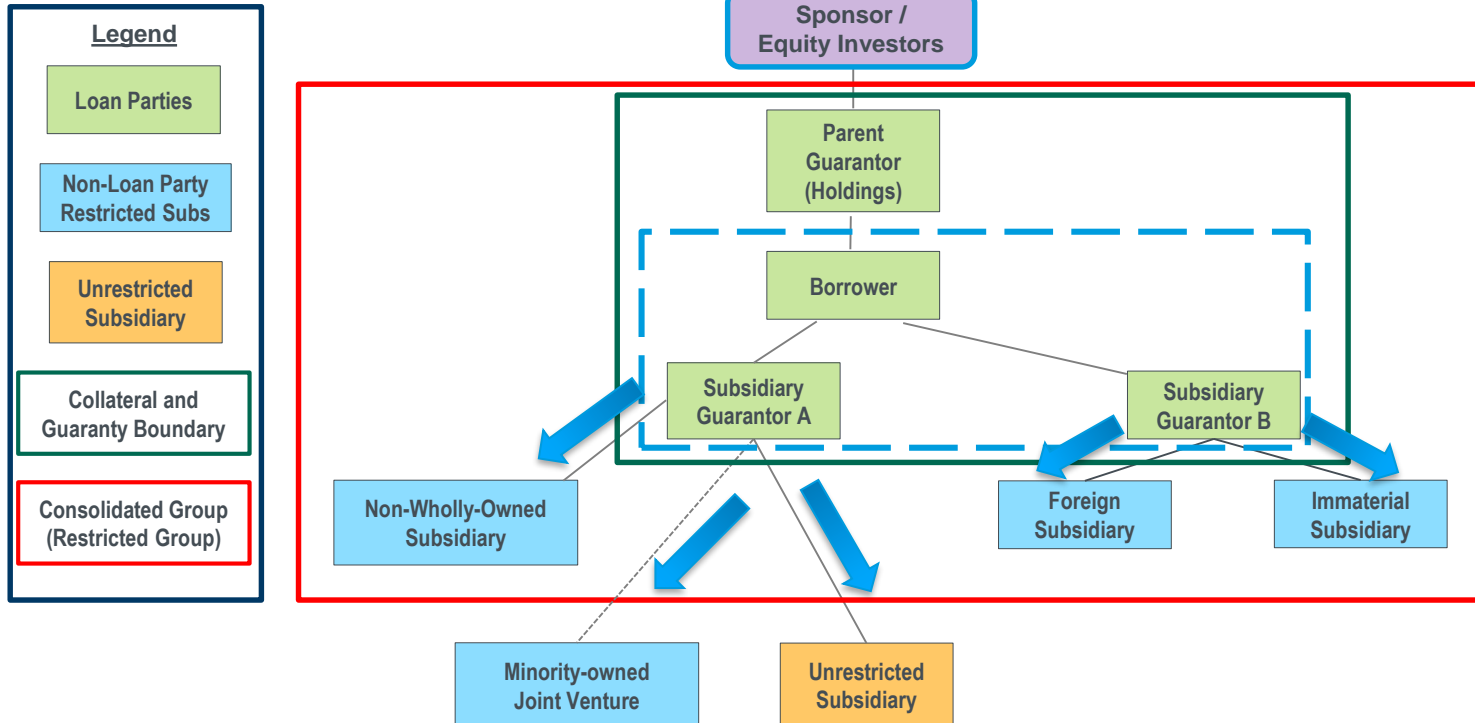
How Does Leakage Occur? – Restricted Debt Prepayments



How Does Leakage Occur? – Dispositions and Asset Sales



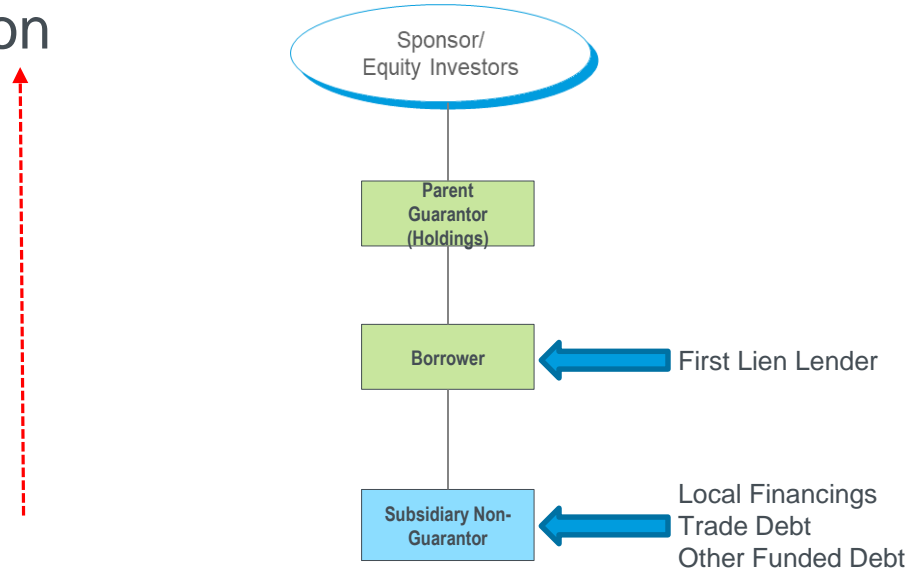
How Does Leakage Occur? – Investments



Why is Leakage a Concern? – Structural Subordination

- Leakage may result in conversion of Collateral to non-Collateral to support junior capital, resulting in structural subordination

Recovery Payment Priority



II. How does leakage arise under our credit documents and how do we mitigate leakage?

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Restricted Payments

What are Restricted Payments?

- Dividends and distributions to, and repurchases and redemptions of equity of, parent entities.
- Returns to junior capital (equity) ahead of senior capital (debt).

What leakage can occur in connection with a Restricted Payment?

- Cash may flow out of the Loan Parties to the Sponsor, leaving less liquidity to support operations and debt service.
- Restricted Payments are generally not limited to cash RPs. Other assets (including equity interests) may be able to be sent up to Sponsor and other equity holders.

Restricted Payments

- How do we limit leakage through Restricted Payments?
 - Generally, Borrower and its Restricted Subsidiaries are not permitted to make Restricted Payments other than certain customary exceptions and negotiated exceptions.
 - Note that Holdings is generally not subject to the Restricted Payments covenant.
- Not all Restricted Payments constitute leakage – Restricted Payments from non-Loan Party Restricted Subsidiaries, Unrestricted Subsidiaries or minority owned JVs into a Loan Party are beneficial Restricted Payments.

Notable Restricted Payment Baskets

Tax Distributions

- Sponsor friendly definitions may not be limited to actual tax liabilities

Available Amount

- Starter Basket
- Builder Basket (retained ECF or 50% CNI)
- Other components (equity issuances, capital contributions, returns, re-designation of subsidiaries, declined proceeds)
- Certain components may require some deleveraging and no EoD or no payment/Bankruptcy EoD

Unlimited RPs subject to a leverage condition

- Generally requires some deleveraging (0.50x - 1.50x) and no EoD or no payment/bankruptcy EoD

General basket

- Generally requires no EoD or no payment/bankruptcy EoD

Restricted Debt Prepayments

What are Restricted Debt Prepayments?

- Voluntary prepayments of Junior Indebtedness prior to maturity
- Returns to junior capital (Junior Indebtedness) ahead of senior capital (senior Indebtedness)

What Indebtedness is subject to the negative covenant?

- Contractually subordinated Indebtedness
- Junior lien Indebtedness
- Unsecured Indebtedness (consider exceptions to Indebtedness definition)
- May be subject to dollar thresholds (such as the cross-default threshold)

Notable Restricted Debt Prepayment Baskets

Available Amount

- Certain components may require some deleveraging and no EOD or no payment/Bankruptcy EOD

Unlimited RDPs subject to a leverage condition

- Generally requires some deleveraging (0.25x - 1.25x) and no EoD or no payment/bankruptcy EoD

General basket

- Generally requires no EoD or no payment/bankruptcy EoD
- May permit re-allocation of general RP basket into RDP basket

Dispositions and Asset Sales

What are Dispositions or Asset Sales?

- Sale by a Restricted Subsidiary of assets (including Equity Interests of a Subsidiary)

What leakage can occur in connection with a Disposition?

- More flexible documents may not require Dispositions under certain baskets to be for fair market value or may not require cash consideration (or may require only limited cash consideration)
- More flexible documents may also only require Dispositions to flow through the restrictions in the covenant to the extent **consideration** is in excess of a threshold.

Dispositions and Asset Sales

- While documents generally require proceeds of certain Dispositions to be used to prepay the Loans, there are notable limitations:

Which baskets apply to the Asset Sale sweep?

- Generally just the “unlimited basket” in more Sponsor favorable deals.

What amount must be applied?

- Subject to the reinvestment right, typically 100% of net cash proceeds. Larger market, Sponsor favorable deals include step-downs based on leverage.

When do prepayments need to be made?

- Prepayments are generally subject to the Borrower’s right to reinvest the proceeds within a period of time (up to 1+ year, with up to an additional 6 months if a binding commitment to reinvest is entered into in the initial reinvestment period).

Dispositions and Asset Sales – Reinvestments

- Outside of the most Lender favorable deals, reinvestment is not limited to be reinvestment in assets constituting Collateral.
 - “Assets used or useful in the business”
 - Assets of a Loan Party that are excluded from Collateral or not required to be perfected
 - Assets of a non-Loan Party
- Some Sponsor favorable deals require prepayment **only** with the proceeds of Dispositions of **Collateral**

Notable Disposition Baskets

“Unlimited” Basket

- Generally requires 75% of consideration (other than Designated Non-Cash Consideration) to be in the form of cash (may be limited to consideration over a threshold)
- Designated Non-Cash Consideration Basket is a dollar capped basket that treats certain non-cash consideration as cash for the purposes of 75% threshold.
- Documentation may otherwise deem other non-cash assets as cash (such as assumed liabilities or short-term notes)
- Generally requires sale to be for fair market value

General basket

- Generally requires no EoD or no payment/bankruptcy EoD
- Not typically subject to a requirement for cash consideration or fair market value

Dispositions – the Unlimited Basket in Practice

Borrower intends to sell an operating Subsidiary Guarantor for \$100m, constituting fair market value. The Credit Agreement requires 75% cash consideration, with a Designated Non-Cash Consideration Basket of \$25m.



Borrower can sell the Subsidiary Guarantor for \$50m in cash and a \$50m note due in 5 years.

While only 50% of the consideration is in the form of cash, Borrower can utilize the \$25m Designated Non-Cash Consideration Basket to deem a portion of the note as cash.



Borrower then reinvests the \$50m of cash proceeds in a non-Loan Party Restricted Subsidiary using investment capacity to purchase assets useful for such non-Loan Party.



The result of the transaction is to turn a \$100m Collateral Asset (the Subsidiary Guarantor) into a \$50m long-dated note that constitutes Collateral and \$50m of non-Collateral assets.

Sale Leasebacks

- Credit documents may also permit sale leaseback transactions.
 - Borrower sells an asset (usually equipment or real estate) to a third party and leases it back. Its effect is to convert an owned asset to cash and a debt obligation.
- To the extent permitted, we generally seek a cap on the value of SLBs. There are pitfalls in more Sponsor favorable documents:
 - Loose transactions with affiliates covenant
 - No asset sale prepayment for SLB proceeds
 - Loose determinations of FMV

Investments

What are Investments?

- The making of loans, advances, equity purchases, note purchases and asset acquisitions.
- We generally think of Investments as “good” as they are value accretive, but Investments can constitute leakage.

What leakage can occur in connection with an Investment?

- Investments in non-Loan Party Restricted Subsidiaries
- Investments in Unrestricted Subsidiaries
- Investments in minority-owned JVs
- Investments in the form of loans to related persons

Notable Investment Baskets

Available Amount

- Certain components may require some deleveraging and no EOD or no payment/Bankruptcy EOD
- More Sponsor favorable agreements may not have any conditionality for use

Unlimited Investments subject to a leverage condition

- Generally requires closing leverage
- May require no EoD or no payment/bankruptcy EoD more Lender favorable forms

General basket

- May include unutilized amounts under the RP and RDP general baskets

Permitted Acquisitions

- Generally uncapped in market deals, but with a sub-cap on acquisitions of non-Loan Parties

All four of these baskets permit investments in non-Loan Parties (including, in connection with the first three baskets, Unrestricted Subsidiaries).

Notable Investment Baskets

Investments in Restricted Subsidiaries

- Investments by a Loan Party in a Loan Party (OK)
- Investments by a non-Loan Party Restricted Subsidiary in a non-Loan Party Restricted Subsidiary (OK)
- Investments by a Loan Party in a non-Loan Party Restricted Subsidiary (subject to cap)

Investments in JVs and Similar Businesses

- Capped basket(s) for investments in non-Loan Parties (not necessarily a Restricted Subsidiary)

Investments in Unrestricted Subsidiaries

- Capped basket

Consider how all seven highlighted baskets may be combined to consummate Investments in non-Loan Parties.
Consider shared baskets to limit stacking.

Other Leakage Considerations

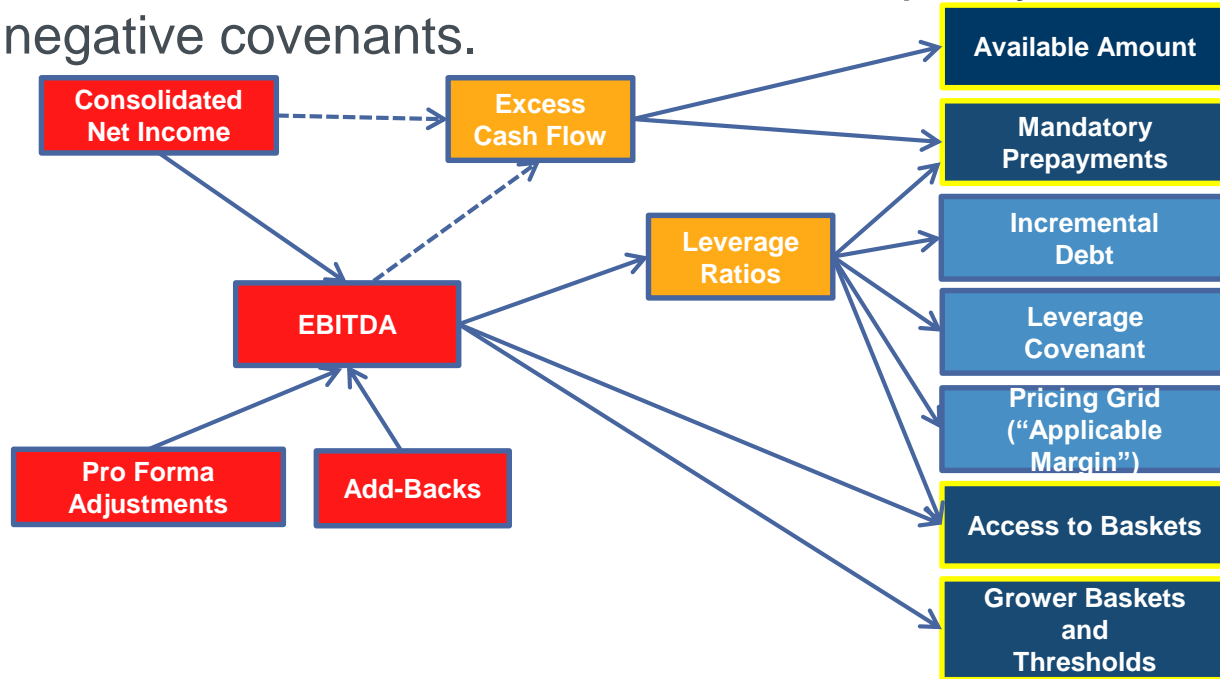
- Affiliate Transactions Covenant
 - Leakage in connection with affiliate transactions presents certain heightened considerations. Note that many Credit Agreements only add restrictions on transactions with Affiliates in excess of a dollar threshold (not tied to the fair market value of the transaction).
 - This threshold can be used to stack additional leakage on top of existing baskets, such as caps on Sponsor management fees.
 - Transactions between Restricted Subsidiaries with Affiliates that are Unrestricted Subsidiaries should be covered (but this not always addressed).

Negative Covenants – Leakage Mitigants

- Consider blocking baskets during the continuance of an Event of Default or a subset of Events of Default.
- Consider how baskets can be aggregated and utilize shared caps to minimize stacking of baskets.
- Consider the distinction between “consideration” and “value” in how basket usage is determined.
- Consider including caps on transactions with non-Loan Parties where assets or other value flows to the non-Loan Party from a Loan Party.

Leakage Beyond the Negative Covenants

- Loose financial definitions increase capacity for leakage under the negative covenants.



Minority Lender Considerations

- Typically, each of the highlighted covenants may be modified or waived with the consent of the Required Lenders. Additional negative covenant exceptions may be added with the consent of the Required Lenders.
- Outside of specific enumerated “sacred rights”, minority lenders will not have any ability to block transactions consented to by the Required Lenders.

III. J.Crew and Chewy – A Brief Primer

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J.Crew – What Happened?

- By combining (i) a basket for Investments in non-Loan Party Restricted Subsidiaries, (ii) the Available Amount basket and (iii) the general Investments basket, J.Crew was able to transfer the J.Crew brand and related IP rights from Loan Parties to a non-Loan Party Restricted Subsidiary.
- Using a “trap-door” basket for investments in Unrestricted Subsidiaries, J.Crew then transferred all of the IP to an Unrestricted Subsidiary that was not subject to the negative covenants under the Credit Agreement.

J.Crew – What Happened?

- The Unrestricted Subsidiary then issued new notes secured by the transferred IP and made an exchange offer to the holders of J.Crew's PIK notes, which had a maturity date inside of J.Crew's senior term loans.
- The result of this was to give junior creditors a senior lender position secured by one of the most important assets of the J.Crew credit group, which was no longer collateral under the previously existing senior loans.

J.Crew – Market Solutions

- Prohibit Unrestricted Subsidiaries from owning any interest in IP that is material to the business of the Loan Parties/Restricted Subsidiaries and prohibit transfers of material IP to Unrestricted Subsidiaries (including limitations on exclusive licenses of such IP by an Unrestricted Subsidiary)
 - More Sponsor favorable forms may restrict only the designation of a Restricted Subsidiary as an Unrestricted Subsidiary if it owns material IP. This does not restrict further assignments.
 - Consider expanding the protection to “crown-jewel” assets.

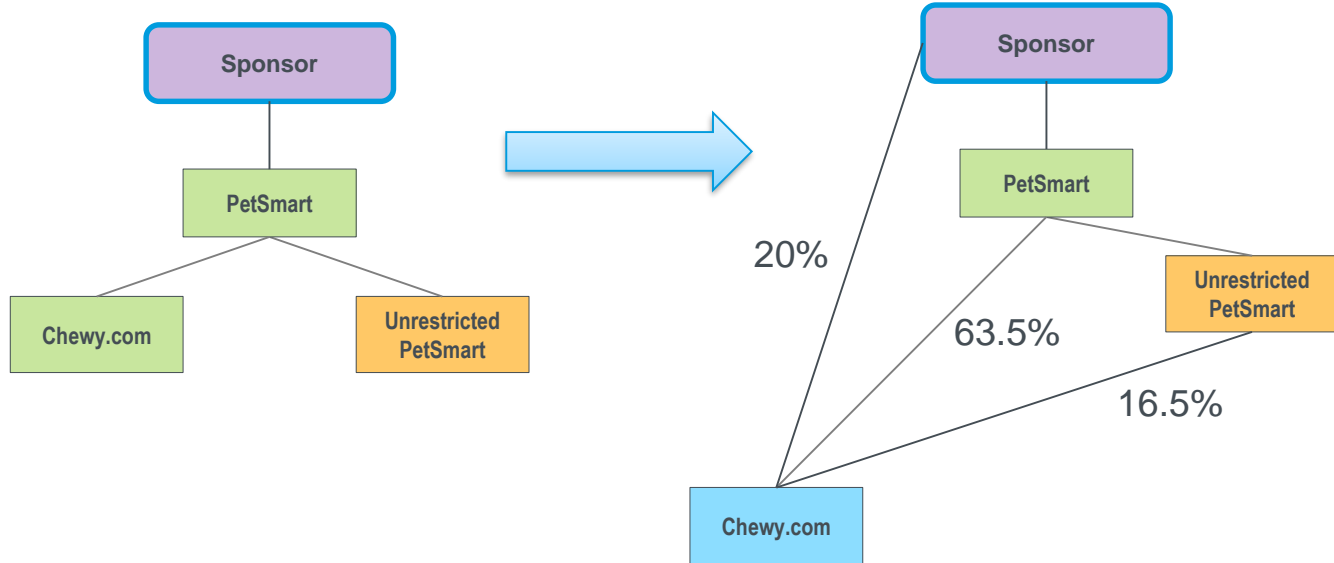
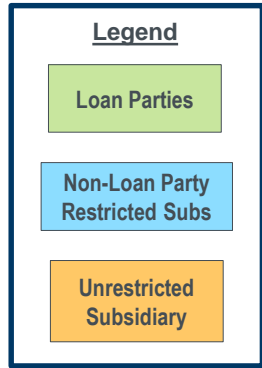
Chewy – What Happened?

- Sponsor made equity contributions of approximately \$1 billion to PetSmart, equal to 1/3 of the purchase price, to acquire the stock of Chewy.com and the rest of the acquisition was financed with debt. The equity contribution built PetSmart's Available Amount basket by \$1 billion.
- In reliance on the Available Amount basket, PetSmart (i) distributed 20% of the common stock of newly acquired Chewy.com to a parent entity outside of the Loan Party group, and (ii) invested 16.5% of the common stock of Chewy.com to a newly-formed Unrestricted Sub.

Chewy – What Happened?

- The Available Amount was built by equity contributions regardless of whether or not they were otherwise utilized or applied.
- The credit documentation provided for an automatic release of liens on assets of Chewy.com because it was no longer a wholly-owned subsidiary of PetSmart.
- Finally, PetSmart exchanged junior debt for debt of Chewy.com, and secured the new debt on a priority basis by such 16.5% ownership position of Chewy.com.

Chewy – What Happened?



Chewy – Market Solutions

- Prohibit any Unrestricted Subsidiary from owning any equity of, or holding any debt of or lien on the assets of, any member of the restricted group.
- Condition the release of liens and guarantees if a Loan Party becomes an Excluded Sub as a result of becoming non-wholly-owned:
 - Transaction permitted by the credit documents, consummated with a non-affiliate, for a “bona fide business purpose”, and/or the “primary purpose is not the release of guarantees or liens”.
 - Specify that the FMV of any Loan Party released from its guaranty/lien is deemed an Investment in a non-Loan Party as of the date of the release and can only be released if Investment capacity exists therefor.

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