Private-Equity Sponsors in Bankruptcy: From *Innkeepers* and *Dynegy* to *Energy Future* and *Caesars*

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I. Initial Considerations

Director Issues

- In a healthy enterprise, directors owe duties to the company and its shareholders
  - Interests of the shareholders are generally aligned with the company's interests, except potentially when a transaction/decision involves the sponsor or an affiliated or related person
  - Creditors' rights are generally limited to those specified in their contracts
- When a company becomes insolvent, the directors' duties are still to the company. But creditors take the place of the shareholders as the residual beneficiaries of any increase in the company's value
  - Directors should make decisions that maximize the value of the enterprise for the benefit of all constituents, not shareholders alone
  - *See, e.g.*, *N. Am. Catholic Ed. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007); *Alpha Capital Anstalt v. New Generation Biofuels, Inc.*, No. 13-CV-5586, 2014 WL 6466994 (S.D.N.Y. Nov. 18, 2014).
- The expansion in the ultimate beneficiaries of fiduciary duties can create conflicts between a director's fiduciary duties to the portfolio company and its stakeholders and that director's representation of the private equity fund's interests as a shareholder
  - Directors may want to protect the sponsor from claims by third parties
    - (e.g., "The sponsor is running the company and should be responsible for its liabilities")
  - Risk of litigation increases
  - Portfolio company may consider engaging separate counsel that is independent of the sponsor

Director Issues (cont.)

- Duty of care
  - Directors must inform themselves of all material information reasonably available to them and relevant to decisions
  - Directors are entitled to rely on advice of experts and management, but reliance must be in good faith and reasonable
  - Directors must take an active and direct role in deliberations and may not delegate decision making
- Duty of loyalty
  - Directors must act in good faith in the best interest of the company, and must not use their positions to obtain improper personal benefits (for themselves or others to whom they are beholden) to the detriment of the Company
- Duty of good faith
  - Courts have recently focused on the obligation of directors to act in good faith in discharging these duties – the so-called "duty of good faith"
  - A breach of the duty of good faith may arise where there is "a systematic failure on the part of a board to exercise oversight" or a "conscious indifference" to its duties
  - Could be subsumed in above duties of care and loyalty – this is an evolving area of the law

Director Issues (cont.)

- Typically, the directors and officers of a corporation owe fiduciary duties solely to the Company
- Business Judgment Rule
  - Directors and officers will generally not be found to have breached their fiduciary duties if they satisfy the requirements for the application of the "business judgment rule"
  - The business judgment rule is a rebuttable presumption if the directors and officers acted on an informed basis, in good faith and in the honest belief that actions were in the best interests of the company
  - This safe harbor requires that disinterested and independent directors exercise due care with a good faith belief that actions are in the best interest of the company
  - Where the business judgment rule applies, courts won't second guess the reasonableness of business decisions
- Application of the business judgment rule can be rebutted with evidence that the directors and officers breached their fiduciary duties of care, loyalty or good faith
  - Where the board is not disinterested, directors may need to satisfy "entire fairness" standard (and may not have the benefit of the business judgment rule)
  - "Utmost good faith and most scrupulous inherent fairness of transactions"
  - "Fair dealing and fair price"
  - Very strict scrutiny – with burden on the directors

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Director Issues in Multiple Entity Context

- Generally, a parent corporation does not owe fiduciary duties to its wholly-owned subsidiaries or their creditors
  - Subsidiary may not assert claims against a parent's board of directors without piercing the parent's corporate veil
  - A parent company *does* owe fiduciary obligations to its subsidiaries if its subsidiaries have minority stockholders
- Directors of a subsidiary may support a parent's business strategy with no duty to second-guess the business judgment of its parent, as long as supporting the strategy does not violate any legal obligations owed by the subsidiary
  - A solvent, wholly-owned subsidiary may be operated for the benefit of, and receive direction from, its parent
  - "At most, one might conceive that directors of a wholly-owned subsidiary owe a duty to the subsidiary not to take action benefiting a parent corporation that they *know* will render the subsidiary unable to meet its legal obligations. Any lesser standard would undercut the utility of the business judgment rule by permitting creditors to second-guess good faith action simply because the subsidiary ultimately became insolvent." *Trenwick Am. Litig. Trust v. Ernst & Young*, 906 A.2d 168, 203 (Del. Ch. 2006)

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Director Issues in Multiple Entity Context (cont.)

- In a multi-debtor bankruptcy case, a debtor and its board of directors owe fiduciary duties to the debtors' creditors and each of the estates
  - "In a bankruptcy case, it is "Bankruptcy 101" that a debtor and its board of directors owe fiduciary duties to the debtor's creditors to maximize the value of the estate, and each of the estates in a multi-debtor case," and "in a case with multiple debtors, the debtors, as fiduciaries, have duties to refrain from favoring or appearing to favor one or another of their estates and its creditors over another." *In re Innkeepers USA Trust*, 442 B.R. 227, 235 (Bankr. S.D.N.Y. 2010)
  - The nature and extent of fiduciary duties of directors and officers involved in multi-debtor bankruptcy proceedings are not clearly defined, as there is limited case law discussing fiduciary duties in the multi-debtor context

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Additional Financial Support to Portfolio Company

- Sponsors often consider providing distressed portfolio companies with additional financial support
- May put new money in as debt rather than equity
  - More likely to receive priority treatment in bankruptcy over equity (although risk of equitable subordination/recharacterization exists)
  - Can include covenants, deadlines or consent requirements to protect investment in restructuring negotiations
  - Existing debt instruments and creditors may complicate the new money investment
  - May provide opportunities for sponsor to exploit position as debt holder to benefit its equity stake in the portfolio company
- Collateral Issues
  - May seek liens on any assets not already pledged
  - Or, junior liens on assets already pledged
    - Senior lien lenders often require intercreditor agreement with waivers of certain rights, such as rights to object to a priming DIP facility, object to the use of cash collateral, require adequate protection, object to a sale of collateral and receive post-petition interest, fees and expenses

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Risks to Sponsors Associated with Providing Support

- Risk of substantive consolidation
  - Bankruptcy court may treat the assets and liabilities of different related entities as one entity if legal corporate separateness has not been adequately respected and creditors generally did not rely on separateness (similar to piercing the corporate veil)
  - Solvent entity may be consolidated with an insolvent one, thereby diminishing the value of the solvent entity to the sponsor's detriment but to creditors' benefit
- Heightened risks associated with insider status
  - In addition to preference, fraudulent transfer, equitable subordination and recharacterization risks, votes of insiders are disregarded in certain situations for purposes of confirming a plan of reorganization
    - Section 1129(a)(10) of the Bankruptcy Code provides that if a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, *determined without including any acceptance of the plan by any insider*
  - Parties may also assert liability based on theories of aiding and abetting, tortious interference with contract and breach of the implied covenant of good faith and fair dealing
- Risk of liability under a "lender liability" theory
  - Though there are various "lender liability" theories, the likelihood of lender liability typically increases when the lender has exercised significant control over the borrower's business activities that resulted in tortious conduct or has assisted the borrower in tortious conduct
  - Risk of lender liability likely is not an incremental risk for a sponsor with a significant equity position in the borrower

Indemnification and D&O Insurance

- Indemnification and D&O insurance
  - Companies often indemnify directors and officers (whether under the charter, bylaws, contract or state corporation law), but such indemnification obligations have limited value to directors and officers if the company is unable to pay or files for Chapter 11
  - Availability of continuing D&O insurance is critical
    - Sponsors may push a distressed company to pay its D&O insurance premiums up front or before filing for Chapter 11
    - May encourage company to purchase tail insurance policies before filing for Chapter 11
  - All counterparties have a strong incentive to review D&O policies carefully
    - Depending on structure of the policies, insurance coverage for directors may be blocked by a bankruptcy filing if payments to directors may reduce recovery by the company (policies may be deemed "property of the debtor's estate")
      - Need clear priority of payments provisions or separate Side A coverage
    - In a bankruptcy, creditors may object to payment by the company of deductible or retention amounts, which, under some policies, are a condition to the availability of insurance coverage
    - Wording of "Side A" coverage (direct claims against directors): directors often want to make sure coverage is available unless the company has actually paid the director the indemnified amount (vs. company is obligated to indemnify)
    - "Insured vs. insured" exclusion

II. Common Claims Against Equity Sponsors in Portfolio Company Bankruptcies

Preference

- "Preferential transfers" made prior to the Chapter 11 filing can be avoided and/or recovered
- A "preferential transfer" is a transfer of cash or other property
  - To or for the benefit of a creditor;
  - For or on account of an antecedent debt;
  - Made while the debtor was insolvent;
  - Made within 90 days before filing (*or one year in the case of **insiders***); and
  - That enables the creditor to receive more than it would in a liquidation
- A transfer can be a payment, grant of collateral or transfer of property or other value
- Avoidance is designed to nullify benefits received by creditors who are selectively favored in the period before a bankruptcy filing

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Preference: Common Defenses

- Contemporaneous exchange for new value
  - The debtor and creditor must demonstrate that they intended for the transfer to be "contemporaneous" and the transfer must in fact be "substantially contemporaneous"
    - Two weeks or less – generally okay
    - More than one month – generally not okay
  - Tangible or quantifiable benefits required to qualify as "new value" – money or money's worth
    - Forbearance by a creditor is generally not sufficient
- Ordinary course of business
  - The transfer at issue must be a payment of a debt incurred by the debtor in the ordinary course of its business or financial affairs; AND
    - Made in the ordinary course of business or financial affairs of the debtor and the transferee (subjective test); OR
    - Made according to ordinary business terms (objective test)
  - Both long-term and short-term debts may qualify for this defense
- New value given by the creditor

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Fraudulent Transfer

- Fraudulent transfers made prior to Chapter 11 filing can be recovered
  - Actual: transfer made or obligation incurred with actual intent to hinder, delay or defraud any creditor
  - Constructive: transfer made or obligation incurred in which debtor:
    - received less than reasonably equivalent value in exchange, and
    - (i) was insolvent prior to, or rendered insolvent by, such transfer or obligation, (ii) had unreasonably small capital, (iii) intended to incur, or believed debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured or (iv) made such transfer or incurred obligation to an insider under an employment contract and not in the ordinary course of business
- Two year look-back under the Bankruptcy Code; up to six years under state law

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Fraudulent Transfer (cont.)

- Leveraged buyouts are often challenged as both actual and constructive fraudulent transfers. Dividend recapitalization transactions are also frequent targets of such challenges
- Risk of fraudulent conveyance allegations is one reason why purchasers of assets or businesses from distressed sellers often insist on consummating transactions through Chapter 11
- While repayment of money actually borrowed is generally considered to constitute *per se* "reasonably equivalent value"
  - An important exception to this rule is recognized in New York where the transferee is an officer, director or major shareholder of the transferor
  - In Delaware, courts have addressed this policy concern by providing a statutory safe harbor for insider transfers that are good-faith efforts to rehabilitate an insolvent debtor
- Courts are split as to whether the grant of collateral for preexisting debt can constitute a fraudulent transfer (majority rule is "no")
  - Some courts require that such grants of collateral are coupled with something more, such as a corresponding forbearance by the creditor

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Equitable Subordination

- A bankruptcy court can subordinate a debt claim to other debt claims if the creditor engaged in inequitable conduct that resulted in injury to other creditors or conferred an unfair advantage on the creditor
- Where the creditor is an insider, the party seeking to apply equitable subordination need only show "material evidence of unfair conduct"
- Where the creditor is not an insider, the party seeking to apply equitable subordination bears a higher burden of proof and must show that the creditor engaged in egregious conduct, such as fraud, spoliation or overreaching
- High risk that creditors will assert that loans by shareholders should be equitably subordinated – settlement value

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Recharacterization

- Bankruptcy courts can recharacterize debts as equity to give effect to what is determined to have been the true nature and substance of the transactions. No showing of misconduct is required
- The overarching inquiry in a recharacterization case is the intent of the parties at the time of the transaction
  - Courts sometimes try to divine the parties' intent by considering a variety of factors, including (among other things): (i) how the parties referred to the loan; (ii) whether the loan had a fixed maturity; (iii) whether the creditor had the right to enforce the payment of principal; and (iv) whether the loan conferred voting rights
- Emergency financings provided by existing equityholders are at risk for recharacterization
  - A loan by existing shareholders should be made on arm's-length terms and documented and accounted for as a loan
  - Communications with lenders, customers, vendors and other third parties should make clear that it is a loan, not an equity investment
- Strong incentive for private equity sponsors to have separate counsel represent the portfolio company in the transaction

Multiemployer Pension Plan Withdrawal Liability

- ERISA, as amended by the Multiemployer Pension Plan Amendments Act of 1980 (MPPAA), imposes withdrawal liability on employers for funding shortfalls in multiemployer pension plans when they cease contributing to a multiemployer pension plan
  - An employer "withdraws" when it either "(1) permanently ceases to have an obligation to contribute under the plan, or (2) permanently ceases all covered operations . . . ." 29 U.S.C.§1383
  - A "partial withdrawal" occurs when an employer either reduces the amount of its contribution by 70%, or ceases to have an obligation to contribute at one or more of its facilities, or under one or more of its collective bargaining agreements. 29 U.S.C.§1385
- A transaction, however, may be exempt from withdrawal liability if it falls under an exemption.
  - ERISA provides a safe harbor when an employer "ceases to exist by reason of . . . a change in corporate structure described in §1362" (including basic reorganization) so long as the "change causes no interruption in employer contributions or obligations to contribute under the plan." 29 U.S.C.§1398
  - ERISA exempts an employer that ceases to contribute to a plan as the result of a bona fide, arm's-length sale of assets to an unrelated party, so long as the purchaser commits to contribute at a level pegged to the seller's contributions, posts a bond for five years equal to the seller's contributions and the seller remains secondarily liable for any withdrawal by the purchaser for the first five years. 29 U.S.C.§1384
- An employer will be held liable for a withdrawal, regardless of its form, "[i]f a principal purpose of any transaction is to evade or avoid liability under this part . . . ." 29 U.S.C. 1392(c)

Multiemployer Pension Plan Withdrawal Liability (cont.)

- Withdrawal liability may be imposed jointly and severally on each trade or business that is under common control with the withdrawing employer
- ERISA does not define "trade or business," but case law suggests that joint and several liability for plan underfunding turns on the extent of an equity sponsor's "investment plus" power over the portfolio company's financial and management activities
  - *Sun Capital I*: In 2013, the First Circuit adopted the "investment plus" test. Under the "investment plus" test, merely making investments in portfolio companies for the principal purpose of making a profit would not be sufficient to cause a private equity fund to be treated as a trade or business. Rather, additional factors would have to be present to distinguish the private equity fund from a mere passive investor
  - The following factors, taken together, would be sufficient:
    - The partnership agreement and private placement memoranda indicate that the private equity fund will be actively involved in the management and operation of the portfolio companies;
    - The general partners of the private equity fund are granted broad authority to participate in the management of the portfolio companies, including the authority to make decisions about hiring, terminating and compensating agents and employees of the portfolio companies;
    - The private equity fund's controlling stake allows it to participate in the management and operation of the company to a degree beyond that of a passive investor; and
    - The private equity fund receives a direct economic benefit from its involvement in management that a passive investor would not receive

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Multiemployer Pension Plan Withdrawal Liability (cont.)

- A trade or business is generally considered to be under "common control" if:
  - the trade or business owns, directly or indirectly, a controlling interest (generally, an 80% or greater interest) in the withdrawing employer;
  - the withdrawing employer owns, directly or indirectly, a controlling interest in the trade or business; or
  - a parent organization (generally, a trade or business) owns, directly or indirectly, a controlling interest in the withdrawing employer and the trade or business
- Thus, if a private equity fund is considered to be a trade or business for ERISA purposes and owns a controlling interest in a portfolio company, the private equity fund may be exposed to withdrawal liability in connection with the portfolio company's pension plan obligations
- *Sun Capital II*: The First Circuit remanded *Sun Capital I* to the Massachusetts district court to determine, among other things, whether the two Sun Capital funds that owned the portfolio company had the requisite ownership to be considered part of a controlled group with the portfolio company. On March 28, 2016, the Massachusetts district court ruled "yes"
  - The Sun Capital funds owned 70% and 30% each of an LLC that was formed to acquire the portfolio company
  - The Massachusetts district court ruled that the funds were part of a "partnership-in-fact," noting that ERISA permits the disregard of organizational formalities and finding that the two funds acted in concert
- After *Sun Capital II*, an equity sponsor may be held liable as part of the controlled group even if it does not own an 80% or greater interest in the portfolio company

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Single Employer Pension Plan Termination Liability

- ERISA imposes termination liability on employers for distressed and involuntary terminations of single employer pension plans that are guaranteed by the Pension Benefit Guaranty Corporation ("PBGC")
  - ERISA provides three different methods for plan termination:
    - Voluntary "standard" termination of a plan under ERISA § 4041(b), which requires full funding of all future benefits. This method is often impractical or impossible for an employer in financial distress
    - Voluntary "distress" termination under ERISA § 4041(c), which requires that certain procedural steps be taken and stringent financial criteria be met
    - Involuntary termination of a plan under ERISA § 4042, which includes certain exemptions, including filing a "petition for liquidation"
- PBGC is entitled to assert certain claims against the employer and against each member of the employer's "controlled group" upon termination of a qualified pension plan. *See* ERISA § 4007(e)(2).
  - Joint and several liability
  - A "controlled group" under ERISA means, in connection with any person, a group consisting of such person, and all other persons under common control with such person
  - This includes equity holders holding at least 80% of the employer's equity, and other portfolio companies of the equity holder, where the equity holder holds at least 80% of the equity of the portfolio companies

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Single Employer Pension Plan Termination Liability (cont.)

- There are three types of claims the PBGC generally asserts upon termination of a qualified pension plan
  - Claims for missed minimum contribution payments
    - Typically unsecured, other than amounts attributable to post-petition labor (which will be given administrative priority)
    - However, if missed contribution payments total greater than $1 million, a lien arises on "all property and rights to property, whether real or personal, belonging to such person and any other person who is a member of the same controlled group of which such person is a member." ERISA § 302(f)(1)
    - Note that automatic stay will not prevent liens from arising against assets of controlled group members that are not in bankruptcy
  - Claims for unfunded benefit liabilities
    - Generally equate to the present value of the plan's expected benefit liabilities minus the present value of the plan's assets; typically unsecured in their entirety
    - Can result in a lien on 30% of collective net worth of all "controlled group" members (except as prevented by the automatic stay)
  - Claims for a termination premium equal to $1,250 for every participant/beneficiary under the plan
    - Payable in cash by the debtors ***after*** they emerge from bankruptcy and are thus not dischargeable in a reorganization
    - Treated almost entirely as general unsecured in a liquidation

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WARN Act Liability

- The Worker Adjustment and Retraining Notification Act (“WARN Act”), 29 U.S.C. § 2101-2109, requires covered employers to give 60 days’ advance written notice to affected employees in the case of either a permanent or extended temporary plant closing or mass layoff
  - Applies to any business enterprise that employs either (i) 100 or more employees, excluding part-time employees, or (ii) 100 or more employees who, in the aggregate, work at least 4,000 hours per week, (including part-time employees, but excluding overtime hours)
  - Failure to comply gives rise to potential civil actions for damages in the form of back pay for each day of the violation and benefits under any employee benefit plan which would have been covered if the employment loss had not occurred
- Equity sponsor may be liable if considered a “single employer”
  - Department of Labor promulgated a five-factor test, now used by the Third Circuit, which includes the following factors:
    - Common ownership;
    - Common directors and/or officers;
    - De facto exercise of control;
    - Unity of personnel policies; and
    - Dependency of operations

WARN Act Liability (cont.)

- *Sun Capital* (In re Jevic): In 2014, the Delaware District Court issued an opinion holding that a private equity fund, Sun Capital Partners, Inc., was not liable as a “single employer” under the WARN Act
  - Sun Transportation, LLC, a wholly owned subsidiary of Sun Capital, acquired Jevic, a trucking company, in a leveraged buyout in 2006. In connection with the acquisition, Sun Capital and Jevic entered into a management services agreement providing for Sun Capital’s consulting services to Jevic and compensation therefor. In 2007, Jevic began experiencing financial difficulty. After working through several options to avoid a loan default by Jevic, Sun Capital ultimately decided not to invest any additional funds into Jevic, and after an unsuccessful sale attempt, Jevic’s board of directors authorized a Chapter 11 filing, and Jevic sent termination notices to its employees. The notices were received by Jevic’s employees on May 19, 2008, and Jevic filed its Chapter 11 petition on May 20, 2008
  - Court found that none of the latter three factors indicating a “single employer” for WARN Act purposes were met:
    - De facto control: Sun Capital’s exercise of control as a stock owner, Jevic’s failure as the “natural and probable” consequence of Sun Capital’s decision not to invest additional funds and the presence of two board members on five-member board were not enough to meet this factor
    - Unity of Personnel Policies: Insufficient evidence of unity because Sun Capital did not directly hire or fire Jevic employees, pay Jevic employee salaries or share personnel records with Jevic
    - Dependency of Operations: Management Services Agreement did not provide sufficient evidence of day-to-day involvement by Sun Capital

III. Heightened Risks for "Insiders" Under the Bankruptcy Code

Heightened Risks for Insiders

- "Insiders" of the debtor are exposed to certain heightened risks
  - Extended preference period
    - One year as opposed to 90 days
  - Heightened scrutiny with respect to fraudulent transfer, equitable subordination, recharacterization and insider trading claims
    - Elements of such claims may be easier to plead and certain defenses may not apply
  - Under certain circumstances, votes of insiders may be disregarded for purposes of confirming a plan of reorganization
- For this reason, equity sponsors will try to avoid insider status when possible, while claimants will attempt to cast equity sponsors as insiders

Insider Status: Statutory Insiders

- There are two types of insiders: "statutory" insiders and "non-statutory" insiders
  - Statutory insiders are those enumerated in Section 101(31) of the Bankruptcy Code
- Statutory insiders of corporations include:
  - Directors and officers of the debtor;
  - Persons in control of the debtor;
  - Partnerships in which the debtor is a general partner or general partners of the debtor; or
  - Relatives of a general partner, director, officer or person in control of the debtor
- Statutory insiders of partnerships include:
  - General partners in or of the debtor;
  - Relatives of a general partner in, general partner of, or person in control of the debtor;
  - Partnerships in which the debtor is a general partner; or
  - Persons in control of the debtor
- Affiliates or insiders of an affiliate (as if such affiliate were the debtor) are also included in the definition of statutory insiders
  - The term "affiliate" is defined to include any "entity that directly or indirectly owns, controls, or holds with power to vote" at least 20% of the outstanding voting securities of the debtor or an affiliate of the debtor. 11 U.S.C. § 101(2), 31(E)

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Insider Status: Non-Statutory Insiders

- Because the Bankruptcy Code's definition of insider "*includes*" the specifically enumerated categories, courts have concluded that "insider" status is not limited to the enumerated categories and have developed a separate, unenumerated category of "insider"
- Determinations of non-statutory insider status are made on a case-by-case basis and require fact-intensive analyses. Legal test focuses on:
  - Closeness of the relationship between the debtor and creditor
  - Whether dealings between the two were conducted at less than arm's length
- In considering whether dealings between a creditor and debtor were conducted at less than arm's length, courts look to a variety of factors, including whether:
  - The creditor appointed board representatives or had board observer status
  - A personal, business or professional relationship existed between the debtor and the alleged insider, such that the alleged insider could gain an advantage because of affinity or access to additional information
  - The creditor attempted to, or actually did, exercise inappropriate influence or control
  - Loans or financings were undocumented or had atypical terms
  - The creditor selected new management for the debtor
  - The creditor was the debtor's sole source of financial support
  - Evidence suggests that the debtor desired to treat the creditor differently from other unsecured creditors

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Insider Status: Non-Statutory Insiders (cont.)

- The fact-intensive nature of the inquiry results in some outcome uncertainty in every case
- In cases involving creditors and/or equity sponsors with board representation, courts often look favorably on appointees who respect corporate formalities and are sensitive to potential conflicts of interest
  - Director appointees should both recuse themselves from discussions, deliberations and votes regarding transactions with their employer institutions or their affiliates, and ensure that any such recusals are properly reflected in the corporate minutes
  - A creditor's or equity sponsor's ability to designate board members and the fact that such creditor or equity sponsor designated board members will not itself make such creditor or equity sponsor an "insider" for purposes of the Bankruptcy Code. The appointed board member, however, will be an "insider" of the debtor
- Where an entity has various relationships with the debtor (i.e., as equity investor, lender, financial advisor, hedge provider and/or by having the ability to appoint members of the debtor's board), a court will conduct an analysis of all dealings between the parties

IV. Case Studies

Innkeepers: Background

- In June 2007, Innkeepers USA Trust ("Innkeepers") entered into an agreement to be acquired by an affiliate of Apollo Investment Corporation for $1.5 billion (cash plus assumption of debt)
  - The buyout required Innkeepers to take on hundreds of millions of dollars in debt
  - The subsequent general macroeconomic downturn accompanied by reduced consumer spending led to economic distress for Innkeepers
- In July 2010, Innkeepers filed for bankruptcy protection with a pre-arranged reorganization plan that contemplated the sale of hotel properties to Cerberus Series Four Holdings LLC and Chatham Lodging Trust ("Cerberus") for $1.12 billion
  - At the time of filing, Innkeepers had $1.42 billion in debt
  - On May 16, 2011, Cerberus executed a "Binding Commitment Letter" to purchase the 64 hotels for the full $1.12 billion

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Innkeepers: Original Plan Support Agreement

- Innkeepers and its affiliated debtors and debtors in possession entered into a plan support agreement ("PSA") with its secured creditor, Lehman ALI Inc. ("Lehman"), dated July 17, 2010
- The PSA provided for Lehman to receive 100% of the equity issued by the reorganized debtors. Remaining secured lenders would receive new secured notes, with a value not less than their collateral
  - Lehman has prepetition liens on assets of 20 of the debtors, but the PSA provided for them to receive the equity of all 92 reorganized debtors
- PSA terminated if, among other occurrences, the deal embodied in the PSA were shopped to other parties
- After objections were filed by creditors, United States Bankruptcy Judge Shelley Chapman held that "the Debtors have failed to meet their burden for assumption of the PSA under either 'heightened scrutiny' or under the less stringent 'business judgment' test." *In re Innkeepers USA Trust*, 442 B.R. 227 (Bankr. S.D.N.Y. 2010)
  - PSA was not a "disinterested business transaction" because it was always subject to a side deal with Apollo Investment Corporation, the existing equity holder, which permitted it to receive equity through the contemplated plan
  - Judge Chapman found that Apollo Investment Corporation was also "directly and inextricably involved in the negotiations" of the PSA

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Innkeepers: Successful Plan Proposal

- In 2011, the debtors achieved confirmation of a new plan that gained the support of its secured and unsecured lenders
- The plan was the result of an extensive marketing process which increased Innkeepers' enterprise value by approximately $150 million. Under the terms of the plan:
  - A joint venture between the private-equity firm Cerberus Capital Management, L.P. and the real estate investment trust Chatham Lodging purchased the equity in entities that own and operate 65 of the debtors' hotels for approximately $1.1 billion
  - Chatham Lodging also purchased five of the debtors' hotels that serve as collateral for loan trusts serviced by LNR Partners LLC for approximately $195 million

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Dynegy: Background

- Before September 2011, Dynegy Inc.'s only asset was ownership of 100% of the equity in Dynegy Holdings, LLC ("Dynegy Holdings"), which in turn owned a variety of subsidiaries engaged in the business of electric power generation, transmission and distribution
- Dynegy Holdings had three significant forms of indebtedness
  - $1.9 billion credit facility (the "Old Credit Facility"), under which Dynegy Holdings was the borrower and Dynegy Inc. was the guarantor, consisting of a $1,080 million revolving credit facility, $850 million term letter of credit facility and $68 million senior secured term loan facility
  - $3.37 billion covenant "lite" Senior Notes and $200 million covenant "lite" Subordinated Notes
  - Guarantee of the indebtedness owing under the Roseton and Danskammer leases, arising from an asset-backed sale-leaseback transaction involving the Roseton and Danskammer facilities in May 2001
- In the first quarter of 2011, it became clear that Dynegy Holdings was on the brink of breaching covenants in the Old Credit Facility
  - Icahn Enterprises LP and Seneca Capital LP, significant Dynegy Inc. stockholders, appointed three of four members of Dynegy Inc.'s board
  - Dynegy Inc. began to pursue a stockholder-focused agenda to restructure the company and its subsidiaries' indebtedness

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Dynegy: Background (cont.)

- Dynegy Holdings completed a series of intercompany restructurings, the net effect of which was to shift valuable assets to Dynegy Inc. and away from the reach of Dynegy Holdings' creditors
- Phase 1, which was completed in August 2011, facilitated a refinancing of Dynegy Holdings' secured bank debt, averting a potential bank default
  - Dynegy reorganized the ownership structure of its subsidiaries such that substantially all of its gas-powered and coal-powered generation facilities would be held in two bankruptcy-remote silos, known as GasCo and CoalCo
  - As a result of the ring-fencing transactions, Dynegy Holdings owned 100% of the equity interests of DGI, a newly formed shell intermediate holding company, which owned all the equity interests of Dynegy Gas HoldCo and Dynegy Coal HoldCo, the holding companies that own all the equity interests of entities of the gas and coal silos
  - In connection with the reorganization, GasCo and CoalCo obtained $1.1 billion and $600 million, respectively, under new senior secured credit facilities. A portion of the proceeds of these loans was used to retire the Old Credit Facility

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Dynegy: Background (cont.)

- Phase 2, which was completed in September 2011, involved the transfer of CoalCo (then valued at $1.25 billion) to Dynegy Inc. in exchange for an "undertaking" provided by Dynegy Inc.
  - The "undertaking" was immediately amended so that Dynegy Inc. could reduce its payment obligations over the course of the payment stream for each dollar in face amount of Dynegy Holdings bonds that was acquired or retired by Dynegy Inc., even if such debt was acquired or retired at a discount to the face amount. This rendered the undertaking unsaleable to third parties
- Dynegy Holdings filed for Chapter 11 in November 2011. The Bankruptcy Court granted the motion of a group of Dynegy Holdings' bondholders to appoint an examiner to investigate the prepetition asset transfers.

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Dynegy: Examiner Report

- Among other things, the examiner concluded that Dynegy Holdings' transfer of its assets to Dynegy Inc. was both an actual fraudulent transfer and a constructive fraudulent transfer to the extent that Dynegy Holdings was insolvent at the time of conveyance
  - The examiner concluded that DGI was an alter ego of Dynegy Holdings
    - Within weeks of its formation, DGI transferred assets to Dynegy Inc., leading the examiner to conclude that DGI was used to shield an acknowledged transfer of value away from Dynegy Holdings' creditors
    - The same three officers of Dynegy Inc. were on the boards of both Dynegy Holdings and DGI
  - The examiner found that the transfer of assets was for less than reasonably equivalent value
    - Power plants were transferred to Dynegy Inc. in exchange for an illiquid, unsecured and highly unusual financial instrument, called an "undertaking." Essentially, the sale to Dynegy Inc. of these assets was not a real sale, as the consideration paid by Dynegy Inc. for the assets was insufficient.
  - Dynegy Holdings had intentionally engaged in a multistep plan to avert defaults on secured debt and to reduce unsecured debt while increasing value for stockholders
- The examiner also found that Dynegy Holdings' board of directors breached its fiduciary duties in approving the transfer of the coal assets

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Caesars: Background

- In January 2008, TPG Capital, LP ("TPG") and Apollo Global Management, LLC ("Apollo") took Caesars private in a leveraged buyout. After assumption of existing debt and issuance of new debt, Caesars Entertainment Operating Company ("CEOC") was left with $17 billion in debt, and the Caesars family overall with $24 billion
- The onset of the 2008 financial crisis occurred six months after the LBO, and Caesars suffered declines in revenues from CEOC's network of regional casinos
- On February 6, 2012, Caesars Entertainment Corporation ("CEC") sold 1.4% of its common equity in an IPO. Following the IPO, the Sponsors continued to reduce their holdings
- Between the closing of the LBO and 2013, CEOC issued and CEC guaranteed debt at various levels of the capital structure. As of June 30, 2014, non-CEOC debt totaled $7.1 billion and CEOC debt totaled $19.6 billion, consisting of:
  - $6.2 billion Credit Facilities
  - $6.3 billion Senior Secured Notes
  - $5.4 billion Second-Priority Senior Secured Notes
  - $345 million Other Secured Borrowings
  - $490 million Subsidiary Guaranteed Debt
  - $761 million Unsecured Senior Notes
  - $84 million Other Unsecured Borrowings

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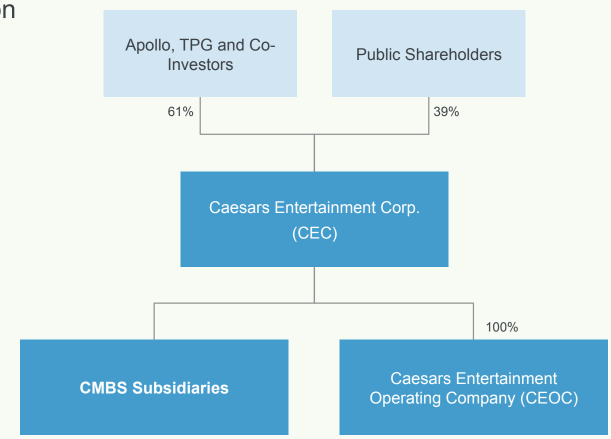
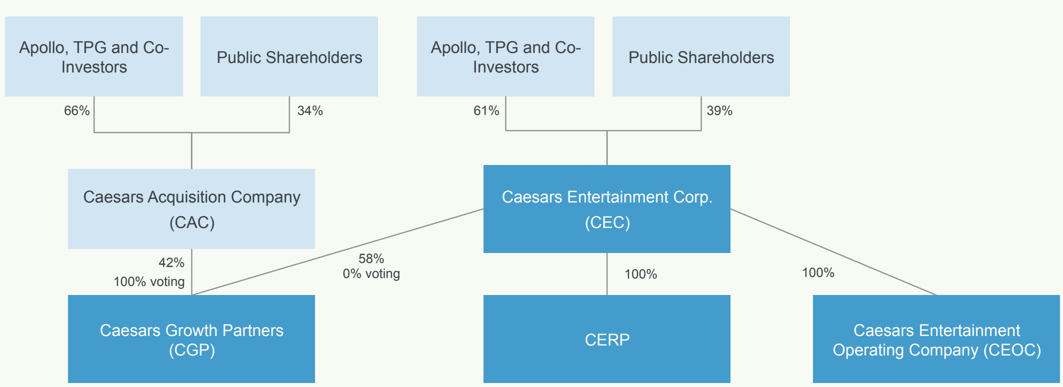
Caesars: Background (cont.)

- Before a series of contested intercompany transactions, Caesars' organizational structure was simple, with most operating assets concentrated in CEOC. Caesars then completed a series of restructuring transactions, several of which have been challenged in recent litigation



Caesars: Background (cont.)

- In February 2013, CEC creates Caesars Acquisition Company ("CAC"), distributing subscription rights to existing shareholders
- In July 2013, CEC incorporates Caesars Growth Partners ("CGP"), to which it contributes its interest in Caesars Interactive Entertainment, Inc. ("CIE") and CAC contributes cash. The resulting organizational structure is shown below



Caesars: Background (cont.)

Through a series of transfers, both before and after the creation of CGP and CAC, substantial assets are transferred out of CEOC's direct or indirect ownership and to CGP and other CEC subsidiaries

- August 2010: Certain property-specific trademarks are assigned to the CMBS issuers, which were not liable for CEOC's debt
- Between April 4 and November 2011: 96.4% interest in Caesars Interactive Entertainment, Inc. ("CIE") transferred from a CEOC subsidiary to a CEC subsidiary
- August to September 2013: Las Vegas properties Project Linq and Octavius Tower transferred from a CEOC subsidiary to Caesars Entertainment Resort Properties, LLC ("CERP") through a series of intercompany transfers
- October 2013: CEOC transferred its equity interest in Planet Hollywood Resort & Casino Las Vegas and its JV interests in Horseshoe Baltimore Casino, together with 50% of management fees, to CGP
- March 2014: CEOC transferred four casino properties, The Cromwell, The Quad, Bally's Las Vegas, and Harrah's New Orleans, together with 50% of the management fees payable to CEOC from those four properties, to CGP
- March 1, 2014: CEC caused CEOC to enter into an agreement under which CEOC and other licensor entities will grant Caesars Enterprise Services, LLC, a new joint venture of CEOC, CERP, and CGP, a non-exclusive, irrevocable, worldwide, royalty-free license to all IP owned or used by the licensors

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Caesars: Background (cont.)

- Several termination acts also purportedly released CEC from its guarantees
  - On May 5, 2014, CEC sold 5% of its ownership interest in CEOC to third-party buyers for $6.2 million, and promptly declared that CEC's guarantee was released
  - On June 27, 2014, Caesars issued a "belt and suspenders" announcement that CEOC had elected to effect the automatic release of CEC's guarantee of each series of notes for the additional reason that CEC's guarantee of other notes specified in the applicable indentures had been released
  - On August 22, 2014, CEC and CEOC consummated a transaction with respect to certain unsecured notes that resulted in the consensual release of CEC's guarantee of such notes by a majority of non-affiliate noteholders, pursuant to the terms of the relevant indentures
- CEOC filed for Chapter 11 bankruptcy on January 15, 2015

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Caesars: Background (cont.)

- On September 3, 2014, holders of CEOC's 2016 and 2017 unsecured notes filed an action against CEC and CEOC in the Southern District of New York in which they alleged, *inter alia*, that CEC and CEOC:
  - Violated section 316(b) of the Trust Indenture Act by releasing the parent guarantees without unanimous noteholder consent
  - Breached the governing indentures, which included provisions mirroring the language of section 316(b)
- The defendants filed a motion to dismiss, arguing that section 316(b) applies narrowly to the *legal* right to payment
- On January 15, 2015, the court held in favor of the plaintiffs and denied the motion to dismiss. The court adopted the plaintiffs' position that "CEC's ultimate plan is to push CEOC into bankruptcy while protecting Apollo and TPG from CEOC's creditors"
- The earliest parent guarantee trial against CEC is scheduled to commence May 9, 2016

Caesars: Examiner Report (March 15, 2016)

- Among other things, the examiner concluded that there were reasonable or strong claims relating to over 15 transactions, including claims against the parent CEC and certain of its directors, with a damages estimate up to $5.1 billion
  - The examiner concluded that in 2012, TPG and Apollo implemented a strategy to strengthen their position in the event of a CEC or CEOC bankruptcy. The examiner found evidence that CEOC was insolvent as early as 2008
  - The examiner found that "assets were removed from CEOC to the detriment of CEOC and its creditors"
    - "As a result, claims of varying strength arise out of these transactions for constructive fraudulent transfers, actual fraudulent transfers (based on intent to hinder or delay creditors) and breaches of fiduciary duty by CEOC directors and officers and CEC. Aiding and abetting breach of fiduciary duty claims, again of varying strength, exist against the Sponsors and certain of CEC's directors. None of these claims involve criminal or common law fraud"
    - Damages estimates related to these claims exclude value that could be recovered from Caesars Interactive (social gaming business), lost profits on properties transferred and interest
  - A transaction with newly formed CERP, as well as the creation of Caesars Enterprise Services ("CES"), are where the interests of CEOC and CEC "most clearly diverged"
    - The sale of assets by CEOC to CEC, which then transferred the assets to CERP, had the same law firm representing both the buyer and the seller in the transaction. In the transfer of a license to CES, the same law firm represented both the licensor and the owner of the sublicensee

EFH: Background

- In October 2007, Kohlberg Kravis Roberts & Co, Texas Pacific Group and Goldman Sachs's merchant banking arm closed a $45 billion leveraged buyout of TXU Corp., the largest leveraged buyout in history. TXU Corp. was renamed Energy Future Holdings Corp. ("EFH"). Financing consisted of:
  - $26.1 billion in new credit facilities
  - $11.25 billion in bridge loans
  - $8 billion in equity from deal sponsors.
- The buyout left the company with about $44 billion of debt, $32 billion supported by Texas Competitive Electric Holdings Company LLC ("TCEH"), EFH's retail energy business, and the remaining $12 billion supported by Oncor, EFH's regulated transmission business
- A 19.75% interest in Oncor was sold for $1.3 billion in November 2008
- On April 15, 2013, EFH disclosed that they had proposed a prepackaged bankruptcy plan to senior creditors. On October 15, 2013, EFH disclosed three competing proposals from creditors for a consensual restructuring. On November 1, 2013, the company made $270 million in interest payments due to unsecured TCEH creditors, after failing to agree on a proposal for consensual restructuring
- On March 31, 2014, EFH declined to make interest payments to bondholders, triggering a 30-day grace period to make payments, negotiate an agreement with creditors or face default. On April 29, 2014 EFH, TCEH, Energy Future Competitive Holdings Company LLC ("EFCH") and Energy Future Intermediate Holding Company LLC ("EFIH") filed for Chapter 11 bankruptcy pursuant to an RSA under which TCEH would be spun off to the TCEH first lien creditors on a tax-free basis

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EFH: Interested Directors

- Immediately after the Chapter 11 filing, Wilmington Savings Fund Society filed a motion seeking discovery related to EFCH and its affiliates. The motion alleges that the debtors failed in their "duties to run the [d]ebtors' business in a competent and rational manner", and laid out the "significant conflicts of interests affecting management, the Sponsor Group, and the [d]ebtors' professionals"
- In a different ruling, Judge Sontchi was critical of EFH's "flawed and insufficient corporate governance," and ruled that procedures for the sale of Oncor must be approved by independent directors of TCEH and EFIH

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EFH: Special Counsel

- EFH filed an application to retain Sidley Austin as special counsel for "sponsor matters"
- Sidley's engagement letter reads as follows:
  - "We will evaluate whether the Clients have or may have claims or causes of action against Kohlberg Kravis Robert & Co. LP, TPG Global, LLC and GS Capital Partners (collectively, the "Sponsors") arising out of (i) that certain Merger Agreement dated February 25, 2007 pursuant to which the Sponsors, together with entities advised by or affiliated with the Sponsors, became the direct or indirect shareholders of the Clients (the "Merger"), (ii) all transactions relating to the Merger, including the acquisition financing arranged for the Merger, (iii) advisory fees, management fees and financing fees paid by the Clients to the Sponsors from the date of the Merger through the present, and (iv) such other events or transactions as may hereafter be identified by the Clients"
- In closing arguments immediately preceding court approval of the RSA, debtors' counsel noted Sidley Austin's role in thoroughly vetting sponsor-related claims

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EFH: RSA (Balancing the Conflicting Interests of Different Subsidiary Creditors)

- In addition to EFH's complex capital structure and a potential $7 billion tax liability, conflicts between creditors of different subsidiaries forced multiple reconsiderations and abandonments of the RSA
  - The initial RSA pitted the interests of EFIH creditors against TCEH creditors (in particular junior creditors of TCEH, who wouldn't have recovered at all)
  - Upon an offer for a controlling interest in Oncor, on July 24, 2014, EFH abandoned the RSA in favor of a court-supervised bid for Oncor. But junior creditors of TCEH argued that this would in practice eliminate their recovery due to excessive procedural restrictions on the sale
  - There were 18 months of creditor disputes and intercompany litigation about a wide variety of issues
- On December 3, 2015, U.S. Bankruptcy Judge Christopher Sontchi confirmed the debtors' sixth amended plan of reorganization, as well as approved the related intercompany settlement agreement
  - TCEH is to be spun off, tax-free, with the equity going to TCEH first lien lenders
  - TCEH's unsecured creditors, partnering with Hunt Consolidated of Texas, are to acquire Oncor, pending regulatory approval
    - On March 24, 2016, the Public Utility Commission of Texas approved the Oncor acquisition
  - Oncor will be reformulated as a real estate investment trust
  - Holders of claims against EFH and EFIH will be paid in full, in cash

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