Anchorage Capital : Distressed Credit, Deep Technical Reference

For: Maxwell Nides, candidate, Senior Associate, Pat McGrath's Restructuring Desk, Anchorage Capital Advisors **Prepared:** May 23, 2026 **Companion to:** `anchorage_distressed_investor_primer.md` (framework + reading list)

How to Use This Document

This is the reference for what you would actually be calculating in a creditor committee meeting. It is the layer underneath the primer. You already know what an uptier is, what a DIP is, what a 363 sale is. This document covers what nobody bothered to teach you on the advisory side: the adversarial mechanics, the practitioner debates, the quantitative frameworks, and the specific decisions a PM at Pat's level makes when real capital is at risk.

Read it like a field manual. Skim until something feels unfamiliar, then drill on that part. The math in Section 3 is the muscle memory you cannot fake. The five questions in Section 6 are the ones Pat will use to separate people who have read about distressed from people who have lived in it.

A few rules of the road before you start:

The voice is not academic. There is no textbook neutrality here. The framing always asks: "if I had to call this trade at 2am with two hundred million on the line, what would I do." When this document says "an investor would..." it means the actual decision a Pat-tier PM makes, with the actual information available, under the actual time pressure.

Cases get cited because they matter to the trade, not because they are clever. Statutes get cited because the words on the page determine recovery, not because they are interesting jurisprudence.

The single most important thing to internalize: the entire document is written in investor voice. Where a lawyer says "the credit agreement permits..." an investor says "the basket capacity is X and the deal-away is credible if Y." Where a lawyer says "the court held..." an investor says "after Serta, this language repriced post-LME paper to..." If you read a paragraph and it sounds like a memo, re-read it. The voice you are training is the one that does not sound like a memo.

Table of Contents

SECTION 1 : LME MECHANICS: THE ADVERSARIAL LAYER

1.1 Uptier Exchange: What the Non-Participating Lender Actually Does

The advisory-side description of an uptier is: "a majority of lenders exchange existing debt for new super-senior debt; minority is left subordinated." That description is true but useless. The investor question is not "what is an uptier." The investor question is: "if I am the non-participating lender, what do I actually do, and what is my position worth."

The Litigation Option Value of Non-Participation

When you are a non-participating lender, you are not passive. You hold a litigation option. The economic value of that option is the difference between what you might recover through litigation and what you would recover by participating at the offered exchange price. The math runs like this.

Set the exchange offer at $0.85 of new super-priority paper for each $1.00 of old first lien. Set your basis at $0.72 (where you bought). The participation outcome is straightforward: you exchange at $0.85 of new paper, which is itself a discount instrument that will trade somewhere between $0.85 (par) and a discount if the company struggles. Call the post-exchange trading level $0.88, optimistic. Your gross gain on the trade is approximately $0.88 minus $0.72, or $0.16, before considering whether the company actually survives.

The non-participation outcome is multivariate. You hold the old first lien, now subordinated. Three things can happen.

The first scenario is that the LME succeeds operationally, the company stabilizes, the participating lenders earn their gain, and you sit at the bottom of a worse capital structure. Your recovery in this world is the residual after the new super-priority debt is repaid in full. Historical analogs (Murray Energy, Boardriders pre-litigation, Trimark) suggest non-participants in these scenarios recovered anywhere from 30 to 60 cents on the dollar over a 24 to 48 month hold period.

The second scenario is that the LME fails, the company files Chapter 11, and you are below the participating lenders in the waterfall. Recovery here depends on whether your fraudulent transfer claim survives, because if the priming was a fraudulent conveyance you can claw the super-priority back. If your claim does survive, your recovery is roughly pari with what the participating lenders get (which is to say, you both get a haircut, but the haircut is shared). If your claim does not survive, your recovery is whatever the waterfall delivers after the new super-senior is paid, which is often single digits on the dollar.

The third scenario is the one that matters most in practice: you litigate, and you settle. Most uptier challenges settle before judgment. The Serta district court litigation took five years to reach a damages trial. Most non-participating lender groups cannot wait that long. They settle for an enhancement above the original exchange offer, typically structured as additional new-money debt allocation or improved priority. The settlement value tends to land somewhere between 5 and 15 percentage points above the original participation economics for the holdout group, scaled by the credibility of the legal claim.

So the option value calculation is: take your estimated litigation outcome (probability weighted across the three scenarios), subtract the cost of litigation funding (if you syndicate the case), subtract the opportunity cost of capital being tied up, and compare to the certain $0.16 gain from participation. If your probability-weighted litigation outcome exceeds $0.16 plus the cost adjustments, you should hold out. If it does not, you should participate.

This is the math Pat would run on a napkin, fast, before deciding to participate or hold out. He would not need to look anything up.

Serta Simmons: What the Fifth Circuit Actually Held

The Fifth Circuit's December 31, 2024 ruling in Serta is the single most consequential LME decision in the modern era. The court held three things that directly reshape deal mechanics, and you need each of them cold.

First, the court held that "open market purchase" requires a genuine secondary market transaction. A privately negotiated exchange with a pre-selected majority group is not an open market purchase. The court read the credit agreement's exclusion to the pro rata sharing requirement strictly: an "open market" is a market open to all sellers, not a closed solicitation to chosen counterparties. This single holding closed off the dominant uptier structure used from 2020 to 2024.

Second, the court held that the plan's indemnification of participating term loan lenders against potential damages to excluded lenders violated 11 U.S.C. § 502(e)(1)(B). That section disallows contingent claims for co-liable parties. The court reasoned that because the participating lenders were potentially co-liable with the debtor for damages to excluded lenders, an indemnification claim against the debtor would be a disallowed contingent claim. This holding eliminates the practical backstop participating lenders had been relying on. It means a participating lender can no longer protect itself against the litigation risk by writing it into the plan. If you participate, the litigation risk sits with you.

Third, the court held that equitable mootness does not shield unlawful plan provisions from appellate review. This is procedurally enormous. Before Serta, the conventional wisdom was that once a Chapter 11 plan went effective and substantial distributions occurred, appellate courts would dismiss appeals as equitably moot. The Fifth Circuit said: not when the provision violates the Bankruptcy Code. The doctrine cannot be used to insulate unlawful plan terms from review.

The remand: the Fifth Circuit excised the indemnification provision from the plan and remanded for a damages determination. The damages trial closed in March 2026. A ruling is expected in summer 2026. Practitioners are tracking it as the quantification precedent that will tell every future non-participating lender what their litigation option is actually worth. Industry estimates put the potential damages at $200M to $340M against the participating lender group, which is the LBO co-investment math: priming gains for the in-group, damages for the in-group.

The Fifth Circuit also recognized "uptier exchange" as a recognized term of art in the credit market. This is small but signals something important: the court treated the uptier as a known maneuver, not a novel transaction. That framing matters for how subsequent courts approach similar challenges.

Mitel: The Single-Word Distinction That Created the Opposite Outcome

On the same day Serta came down, the New York Appellate Division, First Department, ruled in Mitel and upheld a structurally similar uptier transaction. The contrast is the entire lesson.

Mitel's credit agreement said "purchase by way of assignment." Serta's credit agreement said "open market purchase." The New York court found that "purchase by way of assignment" did not require open market execution. The borrower was authorized to "purchase by way of assignment and become an Assignee with respect to Term Loans at any time," and the court read that broadly: "at any time" included a cashless exchange via debt-for-debt swap with a select group of lenders.

The single word "market" was dispositive. Or rather, its absence. Mitel's drafters did not include "open market" qualifier; Serta's drafters did. That one drafting choice determined the legality of the transaction.

What this means for an investor reading a credit agreement: the buyback or assignment exception is now the most important non-economic provision in the document. If it says "open market," you are protected by Serta. If it says only "purchase by way of assignment" or some variant without the market modifier, you are exposed to Mitel-style uptiers.

The drafting workaround after Serta: borrowers now structure exchanges as direct amendments under the assignment provisions, taking pains to avoid the "purchase" framing altogether. The 2026 Cabinetworks LME closed at 98% and 99% participation rates using a universal pro-rata consent solicitation. No "purchase" terminology. No "open market" question. Just a consent solicitation under the basket amendments. This is the post-Serta playbook: avoid the purchase machinery, work the amendment provisions.

Revlon: The Citi Wire Transfer and the BrandCo Drop-Down

Revlon involved two distinct issues. The Citi misdirected wire matters because of what it taught about lender-side mistake doctrine. The BrandCo drop-down matters because of what it taught about modern blocker drafting.

The Citi wire: in August 2020, Citibank, acting as administrative agent for Revlon's lenders, accidentally wired $900M to the term loan lenders, paying off the loan in full. Citi expected to send the interest payment of about $7.8M; it sent the principal balance. Citi sued the lenders to recover the funds under New York's discharge for value doctrine. The Second Circuit ultimately held in Citi's favor on appeal in September 2022, but the district court initially ruled for the lenders on the theory that they were entitled to keep the money because they had no reason to question that Revlon had paid off the loan. The practical lesson for distressed PMs: when you receive a wire that exceeds expected interest payments by an order of magnitude, you cannot keep it just by claiming surprise. The discharge for value doctrine requires the recipient to have no knowledge or notice that the payment was made in error. Sophisticated distressed lenders cannot plead ignorance.

The BrandCo drop-down: in May 2020, Revlon executed a drop-down moving the company's most valuable IP brands (Revlon, Almay, Elizabeth Arden, and others) into BrandCo subsidiaries. Those BrandCo subsidiaries were unrestricted under the existing credit agreement. New super-senior debt was secured by liens on the BrandCo subsidiaries' equity and IP assets. Existing lenders lost access to the IP collateral. The drop-down was

structured under multiple investment baskets stacked together: the unrestricted subsidiary investment basket, the general investment basket, and the asset sale basket. Each individual basket was small. Stacked, they totaled enough to move billions of dollars of IP value.

The Revlon litigation tested the limits of basket stacking. The court ultimately allowed the structure to stand. The lesson: investors must read baskets together, not individually. The aggregate capacity across all unrestricted-sub and investment baskets is the actual drop-down vulnerability number, not the largest single basket.

Boardriders, Trimark, Murray Energy: The Pre-Serta Adversarial Landscape

Before Serta crystallized the doctrine, several uptier cases produced fact-driven, often confidential settlements. The investor takeaway from each:

Boardriders (NY Sup. Ct., October 2022): on a motion to dismiss, the court refused to throw out the non-participating lenders' fraudulent transfer and breach of contract claims, finding that the "open market purchase" theory was at least colorable. Boardriders settled before final judgment. The settlement terms were not public, but reporting indicated the non-participating lenders received improved economics relative to the original exchange offer.

Trimark (NY Sup. Ct.): similar fact pattern, similar outcome. The case settled, with non-participants extracting an enhancement. The pattern across these cases: the litigation option had real settlement value even when the underlying merits were uncertain.

Murray Energy: pre-bankruptcy uptier in 2018. Non-participating lenders sued. Murray filed Chapter 11 in 2019. The non-participants pursued their fraudulent transfer claims in bankruptcy court. Settlement structure: enhanced waterfall position in the bankruptcy plan.

The pattern that emerges across all these cases is that the litigation option value of non-participation, measured by settlement outcomes, has historically been between 5 and 15 percentage points above the original exchange economics. That is the empirical anchor for the Section 1.1 math above.

The Open Market Purchase Workaround: How Counsel Structures Around Serta

Post-Serta, sophisticated borrowers and their counsel have largely abandoned the "open market purchase" exception as the legal basis for uptier exchanges. The new playbook uses three different mechanics.

First, direct amendment of the credit agreement under the majority consent provisions. The exchange is not characterized as a purchase. It is characterized as an amendment that creates a new super-priority tranche and an exchange right for consenting lenders. The amendment itself is permitted under required-lender consent (typically 50.1%). The exchange right is not a purchase; it is a contractual right to exchange existing debt for

new debt at specified ratios. Better Health (February 2025) is the prototype. The Pari Passu newsletter has the cleanest practitioner explanation.

Second, the consent solicitation approach. The borrower runs a consent solicitation to all lenders simultaneously. Lenders who consent receive enhanced economics, typically priority new-money paper. Lenders who do not consent receive the un-enhanced economics, typically diminished priority. Because the consent solicitation is open to all lenders on equal terms, it is structurally pro rata even if the economic outcome is not. Cabinetworks (May 2026) is the cleanest example.

Third, the dual-track approach. The borrower simultaneously launches an uptier and a drop-down. The uptier captures the value transfer through priority enhancement. The drop-down captures the value transfer through collateral relocation. Each transaction stands alone under its own legal theory; together they accomplish what the open market purchase used to accomplish in one step. Oregon Tool (February 2025) is the case study, with the Pari Passu deep dive being the best free read.

Free Rider Problem: When Non-Participating Lenders Win by Not Participating

There is a counterintuitive dynamic in modern LMEs that an investor needs to understand. The free rider problem.

If a majority co-op group successfully extracts a priming exchange at 85 cents on the dollar, the in-group lenders have given up part of their potential upside to secure their priority. The non-participating lenders who hold out have not given up anything. If the company subsequently stabilizes and the in-group's priming proves unnecessary, the holdouts end up in a worse priority position but with more underlying claim value (because they did not exchange at 85). In a successful operational outcome, the holdouts can sometimes do better than the in-group on a per-dollar-of-original-claim basis.

This is the in-group's nightmare scenario. They took the risk and effort to negotiate the LME, accepted a haircut to lock in priority, and the holdouts free-ride on the stabilization their work created. The structural response from the in-group has been to make the haircut to non-participants so severe that the free-ride math does not work. But the threshold at which haircut severity becomes legally indefensible (and provokes successful fraudulent transfer claims) is exactly what the Serta litigation is settling.

Pat would say: the free rider problem is real but is dominated by the fundamental question of whether the company has a recoverable business. If the answer is yes, the holdouts can do well by not participating. If the answer is no, the in-group's priority enhancement is what saves them. The decision to participate or hold out is therefore a bet on the underlying business, not just a math problem on exchange ratios.

1.2 Drop-Down Transactions: J.Crew to Chewy to the 2026 Blocker Stack

The advisory-side description of a drop-down is: "transfer of collateral to an unrestricted subsidiary, used to raise new senior secured debt against that collateral while existing lenders lose access." That captures the mechanic. It does not capture the negotiation around blockers, which is where investors actually fight.

The Original J.Crew Maneuver (2016) and Why It Worked

J.Crew transferred 72.04% of its domestic trademarks (Madewell and J.Crew brands, valued by the company at approximately $250M, valued by some lenders at over $1B) from a restricted subsidiary into an unrestricted subsidiary. The structure was three steps. First, J.Crew transferred the trademarks from a restricted U.S. subsidiary to J.Crew Cayman. Second, J.Crew Cayman transferred the trademarks to J.Crew Brand Holdings LLC, which was an unrestricted subsidiary under the credit agreement. Third, J.Crew Brand Holdings LLC licensed the trademarks back to the restricted operating subsidiaries for use, with the license fee flowing back to support new debt issued at the unrestricted level.

The credit agreement permitted each step. The unrestricted subsidiary investment basket allowed the initial transfer. The general investment baskets and asset sale baskets layered in to permit subsequent steps. No individual basket was large enough to cover the entire $250M to $1B asset transfer. But stacking the baskets together (the inquiry the lenders had not made) allowed the entire transfer.

The investor lesson is that aggregate basket capacity, not individual basket capacity, is the real measure of drop-down vulnerability. Before J.Crew, almost no one ran the aggregate calculation. After J.Crew, everyone does.

J.Crew settled the litigation in 2018-2019 with a paydown and additional restrictions. The lenders extracted approximately $30M to $40M in concessions but did not unwind the transaction. J.Crew filed Chapter 11 in May 2020 anyway. Anchorage emerged as majority owner. The investor outcome: J.Crew lenders who held through to bankruptcy recovered the equity, which traded back to par-plus over the subsequent four years.

The Chewy/PetSmart Blocker (2019)

PetSmart in June 2018 transferred 36.5% of Chewy equity out of the lenders' collateral package. 20% went to a consortium of investors (including BC Partners, the PE sponsor). 16.5% went to an unrestricted subsidiary. Chewy equity was the most valuable asset on PetSmart's balance sheet (Chewy was growing 70% year over year while PetSmart's brick and mortar was declining). The transfer eliminated the equity backstop on PetSmart's $4.3B credit facility.

The mechanic was structurally identical to J.Crew but operated on subsidiary equity rather than IP. The credit agreement's investment baskets allowed each step. The unrestricted subsidiary basket plus the general

investment basket plus the parent payment basket combined to permit the transfer.

The lender response was to settle (lenders accepted a paydown of $300M plus enhanced economics on the remaining term loans). The structural innovation that came out of PetSmart was the "Chewy blocker," which addressed a specific gap in the J.Crew blocker. The J.Crew blocker had been focused on intellectual property transfers. It did not adequately restrict the transfer of subsidiary equity. The Chewy blocker added explicit restrictions on:

(a) Transfers of equity of restricted subsidiaries to unrestricted subsidiaries; (b) Designation of restricted subsidiaries as unrestricted (the "redesignation" mechanic); (c) Releases of guarantees from material subsidiaries; and (d) The fair value standard for determining when a transfer is permitted under investment baskets.

After Chewy, modern credit agreements typically include both the J.Crew blocker (IP-focused) and the Chewy blocker (equity-focused). They are stacked rather than replaced.

The Envision Blocker (2021) and the Two-Step Drop-Down

Envision Healthcare in April 2022 executed a more sophisticated drop-down. The mechanic was a two-step transfer using an intermediate unrestricted subsidiary as a buffer. The structure: Envision transferred assets first to "Intermediate Sub," which was an unrestricted subsidiary positioned at the holding company level. Intermediate Sub then transferred those assets to "Operating UnSub," which was a separate unrestricted subsidiary at the operating company level. Operating UnSub then issued new super-priority debt secured by those assets.

The reason for the two-step structure: by interposing Intermediate Sub between the restricted group and the eventual asset holder, Envision argued that the transfer through Intermediate Sub was a single permitted investment under the unrestricted-sub basket, and the subsequent transfer from Intermediate Sub to Operating UnSub was a separate transaction between two unrestricted subsidiaries that did not require basket capacity. The aggregate capacity needed was lower than the asset value transferred. The legal theory: each step was a separate transaction; basket capacity was tested step by step.

The lenders disagreed. They argued the two steps were a single integrated transaction and that the aggregate basket capacity required was the full asset value. The litigation went into Envision's eventual Chapter 11 in May 2023. The adversary proceeding was voluntarily dismissed after the plan effective date in November 2023, but not before extracting plan enhancements for the non-participating lenders.

The Envision blocker, which appeared in 2022-2023 credit agreements after the maneuver became known, addresses the two-step structure directly. The provisions typically include:

(a) An "integrated transaction" definition that treats multi-step transfers within a 12-month window as a single transaction for basket purposes; (b) An aggregate cap on total investments in unrestricted subsidiaries over the life of the credit agreement; (c) A fairness opinion requirement for transfers of material assets to unrestricted subsidiaries; and (d) A "no further investment" restriction that prevents subsequent rounds of investment after a substantial transfer has been made.

Modern credit agreements may include the J.Crew, Chewy, and Envision blockers all together. This three-blocker stack is what an investor expects to see in a 2025-2026 vintage credit agreement.

The Three Provisions an Investor Looks For

If you are reading a credit agreement to assess drop-down vulnerability, you look at three specific provisions in this order.

First, the unrestricted subsidiary investment basket. Specifically, what is the dollar capacity (starter) plus the EBITDA-grower (typically 50% to 75% of consolidated EBITDA) plus the available-amount basket. Sum these. The total tells you the maximum permitted investment in unrestricted subsidiaries. Compare that to enterprise value. If the unrestricted investment capacity exceeds 25% of enterprise value, drop-down vulnerability is high.

Second, the asset sale basket and the "permitted dispositions" definition. Specifically, the de minimis exception, the sale-leaseback exception, the licensing exception, and the intercompany transfer exception. Each of these can be a backdoor that does not count against the unrestricted-sub basket. Read them. The asset sale provisions are where IP transfers hide.

Third, the redesignation mechanic. Specifically, whether the credit agreement allows the borrower to "designate" a restricted subsidiary as unrestricted. If yes, what conditions apply (no default, certain financial tests, no specified prohibited assets). If the redesignation is permissive (no payment to lenders, no fairness opinion, no investor consent), drop-down vulnerability is high. Modern Chewy-blocker language typically requires either a paydown, a consent, or a fairness opinion before redesignation. Older language often does not.

Run these three reads in five minutes. The output is a yes/no on whether the credit agreement has been adequately blocked against the J.Crew/Chewy/Envision attack vectors. If two of the three are weak, you should expect a drop-down within 18 months of any distress.

IP Transfer Valuation: The Fair Value Battle

When a transfer to an unrestricted subsidiary uses basket capacity, the asset transferred is valued at "fair value" for basket purposes. The fair value definition is litigated.

Three approaches dominate.

The borrower's approach: book value (depreciated cost basis). Often de minimis for IP that was developed internally over time. J.Crew valued the transferred trademarks at $250M; their depreciated book value was substantially lower.

The lender's approach: fair market value (third-party comparable transactions or DCF). For J.Crew's trademarks, lenders argued fair value was $1B+ based on the brand's revenue contribution.

The compromise: contractual definition in the credit agreement. Modern agreements often define fair value as the higher of (i) book value, (ii) third-party valuation by an independent firm, or (iii) the value determined by the board of directors in good faith. The "board determination" backstop is the practical control point: a sponsor-controlled board will determine the lower bound.

The investor reads the fair value definition carefully. If it requires only board determination, the borrower can drive the valuation low and effectively expand basket capacity. If it requires a third-party fairness opinion above a threshold (typical: $50M or 5% of total assets), the lender has more protection.

Transfer pricing is the related battle. When the transferred asset is licensed back to the restricted group, the license fee flows from the restricted group (where lenders sit) to the unrestricted sub (where new debt is supported). A high license fee weakens the restricted group and supports the new debt. A low license fee does the reverse. The "arm's length" requirement in most agreements is the constraint, but enforcing arm's length on a related-party license requires either a benchmark transaction or expert testimony.

The Pat-level read: assume the borrower will set the license fee to maximize transfer of cash flow to the unrestricted level. Underwrite to that assumption. If the credit agreement has a robust arm's length requirement with audit rights, you have some protection. If it does not, assume the worst.

1.3 Double-Dip Structures

A double-dip is a claim architecture where new debt has two parallel paths to recovery against the same obligor's value. The classic structure: a foreign or unrestricted subsidiary issues bonds. The parent company guarantees the bonds. The bond proceeds are then lent back to the parent. Bondholders end up with two claims against the parent: the direct guarantee claim and the indirect intercompany loan claim. In a subsequent Chapter 11, both claims get paid from the parent's estate. The bondholders' recovery is effectively doubled relative to a creditor with a single claim of the same face amount.

Core Architecture

The transactions that established the modern double-dip structure are At Home (2022) and Wheel Pros (2023). The mechanics in detail.

Step 1: An unrestricted subsidiary, call it FinanceCo, is established. It is outside the credit agreement's covenant perimeter.

Step 2: FinanceCo issues new bonds. The bonds are guaranteed by the parent company (which is inside the covenant perimeter and which is the entity whose value the lenders are competing for).

Step 3: FinanceCo lends the bond proceeds back to the parent via an intercompany loan. The intercompany loan is structured as a receivable on FinanceCo's books and a payable on the parent's books.

Step 4: In a subsequent Chapter 11, the bondholders assert two claims. The first is the direct guarantee claim against the parent for the face value of the bonds. The second is FinanceCo's intercompany loan claim against the parent for the face value of the intercompany loan. FinanceCo's claim is then distributed pro rata back to the bondholders.

The result: bondholders receive recovery on $1 of face value as if they had $2 of face value claims, capped at the parent's estate value.

Recovery Rate Impact

The investor question on a double-dip is what it does to recovery rates for the rest of the capital structure.

Take a simplified scenario. Parent company has $500M of enterprise value at emergence. The capital structure pre-Chapter 11 includes $300M of first lien debt (no double-dip), $200M of senior unsecured bonds (no double-dip), and $200M of double-dip bonds (with $200M intercompany claim).

In a no-double-dip world, the $500M of value would flow: $300M to first lien (100% recovery), then $200M to senior unsecured pari debt (recovery of $200M / $400M = 50%, split between the senior unsecured bonds and the double-dip bonds if they ranked pari).

In the double-dip world, the same $500M flows: $300M to first lien (100%), then $200M to senior unsecured pari, BUT now the senior unsecured pari pool is $200M of senior unsecured bonds plus $200M of double-dip bonds plus the $200M intercompany loan claim from FinanceCo, for a total of $600M of claims. The $200M of value distributes pro rata: each claim gets 33.3%. So $66.7M to the senior unsecured bonds (33.3% recovery), $66.7M to the double-dip bonds (33.3%), and $66.7M to FinanceCo's intercompany claim. The FinanceCo recovery then distributes pro rata back to the double-dip bondholders. Net to double-dip bondholders: $66.7M (direct) + $66.7M (via FinanceCo distribution) = $133.4M, or 66.7% recovery on $200M face.

The senior unsecured non-double-dip bondholders went from 50% recovery to 33.3% recovery. The double-dip bondholders went from 50% recovery to 66.7% recovery. The double-dip captured value at the expense of the pari but non-dip creditors.

Intercreditor Provisions That Limit or Eliminate the Double-Dip

The defensive response from sophisticated lenders is to write intercreditor provisions that limit or eliminate the double-dip's effect. Three approaches dominate.

First, the "At Home / Sabre" blocker, which restricts the parent from issuing guarantees to debt of unrestricted subsidiaries. If the parent cannot guarantee FinanceCo's bonds, the guarantee leg of the double-dip is closed.

Second, the intercompany loan subordination provision. The credit agreement subordinates any intercompany payables owed by the borrower to its unrestricted subsidiaries to the credit agreement obligations. In bankruptcy, the intercompany loan claim is structurally subordinated to the first lien debt, eliminating the second leg.

Third, the "double-dip blocker" itself, which explicitly prohibits any transaction that creates dual claims against the borrower in respect of the same indebtedness. This is the cleanest contractual response but is also the most difficult to draft (because the borrower's counsel will fight definitional scope).

The double-dip has never been adjudicated. No court has yet been asked to enforce or strike a double-dip in a Chapter 11 case where the recovery math is contested. The Wheel Pros and Bausch Health cases have the structures in their capital tables, but the Chapter 11 outcomes for those entities are still pending or have not generated dispositive rulings. The legal question is: when bondholders assert two claims against a single obligor in respect of one debt issuance, will courts allow both claims to receive distributions, or will courts treat the claims as duplicative? The answer matters enormously for recovery math. The market currently prices double-dip bonds at a premium to non-double-dip bonds at the same priority level, indicating that the market expects courts to honor the structure. But the precedent has not been set.

Spirit Airlines (2024 Ch11) had a double-dip structure but settled without litigation on the issue. Bausch Health's restructuring is unfolding now. Wheel Pros is in active Ch11 (filed 2024). One of these cases will likely produce the first definitive ruling on double-dip enforceability. Pat will care about that ruling more than almost any other 2026 development.

1.4 Co-Op Mechanics: Internal Dynamics

The advisory description of a creditor cooperation agreement is: "binding among signatories; restricts deal-making outside the group." That captures the legal structure. It does not capture how co-ops actually work, where the friction points are, and how a PM at Pat's level negotiates them from the inside.

How Co-Ops Form

Co-ops form through a sequence that takes weeks to months. The sequence matters because the timing of each step determines who controls the eventual co-op.

Initial outreach: a lender (or its advisor, typically Houlihan, PJT, or Lazard) contacts other holders of the same tranche or related tranches. The outreach is informal at first, a series of phone calls. The advisor's pitch is some version of "we are seeing distress signals; we should coordinate." The initial outreach is non-confidential and does not involve material non-public information.

NDA execution: lenders who are interested sign an NDA. The NDA establishes the legal framework for sharing material non-public information about the credit. It typically includes a standstill provision restricting the lenders from buying or selling the debt while in possession of MNPI. The standstill period is negotiated; it can be 30 days, 60 days, or open-ended (until the co-op terminates or the lender exits the group).

Wall crossing: after the NDA, the company or its advisor presents material non-public information to the co-op group. This is the actual exchange of confidential information. After wall crossing, the lenders cannot trade until they are either released from the wall (because the information becomes public) or have completed an exit process specified in the NDA.

Standstill obligations: while wall-crossed, the lenders are restricted from trading. They are also typically restricted from communicating about the company outside the co-op group. The standstill is the price of admission.

Co-op agreement execution: after the wall-crossing meeting, the lenders negotiate the actual cooperation agreement. This is the binding document. Key provisions include: scope of cooperation (which tranches, which actions), lock-up on alternative transactions (cannot deal individually with the company), transfer restrictions (cannot sell debt to non-co-op holders, or can sell only with co-op consent), termination conditions, voting commitments on plan or amendment proposals, and governance of the co-op (steerco selection, advisor selection, decision-making).

Effective date: the co-op is effective when a threshold of signatories is reached, typically 50.1% of the applicable tranche or 33.4% if the goal is blocking sacred-rights amendments.

The Tension Between Co-Op Membership and Secondary Market Trading

The single most uncomfortable internal dynamic in a co-op is the tension between staying inside the co-op (which means you cannot trade) and exiting the co-op (which means you lose the benefit of coordination).

A PM holding $50M of debt at $0.72 has an information advantage from the wall-crossing meeting. The information advantage is exactly what the standstill prevents the PM from monetizing through trading. If the company announces a positive development and the bond price rises to $0.85, the in-co-op PM cannot trade. The out-of-co-op PM can.

The structural response: many co-ops provide an "exit ramp." A member can exit the co-op by paying a termination fee, by returning all confidential information, and by certifying that the member has not used the confidential information to inform trading. The exit ramp is rarely used because terminating the relationship destroys the co-op's coordination value, but the option exists.

Pat's view on this is that the in-co-op information is rarely actionable in the trading sense. The information that matters is the company's actual plan for the LME or restructuring, which is the same information the co-op is being formed to address. Trading on it would be trading on the very thing the standstill is designed to protect. The actionable information is the long-term position the co-op extracts, which is a one-time event, not a trading opportunity.

The Blocking Threshold

The 33.4% threshold (one-third plus one) is the floor for blocking sacred-rights amendments under most credit agreements and is also relevant under §1126 of the Bankruptcy Code for class voting.

In credit agreements, sacred rights typically require either each-affected-lender consent or 100% consent. Below sacred rights, certain amendments require supermajority consent (often 66.7%). Below that, most amendments require simple majority (50.1%). The mathematics: if you have 33.4% of a tranche, you can block any amendment requiring 66.7% supermajority. If you have 50.1%, you control simple majority decisions.

In bankruptcy, §1126(c) provides that a class of claims accepts a plan if creditors holding at least two-thirds in amount and more than one-half in number of allowed claims in the class accept. So 33.4% in amount blocks plan confirmation in that class. The "more than half in number" component is a separate consideration that can sometimes work in non-participating lenders' favor (if there are many small claims voting "no" alongside large claims voting "yes," the numerosity test can be the binding constraint).

The investor implication: a co-op needs to hit 33.4% to be a blocking position. Below 33.4%, the co-op cannot block. Above 33.4%, the co-op can extract concessions. The marginal value of getting from 30% to 35% is enormous. The marginal value of getting from 50% to 55% is far smaller (because at 50% you already have effective control of most amendments).

Lender outreach in a co-op formation prioritizes the marginal lenders needed to cross 33.4%. Once that threshold is hit, the co-op has the leverage to negotiate. Above 50.1%, the co-op can dictate. The negotiation strategy of a sponsor or borrower against a co-op is mirror image: get the co-op below 33.4% to neutralize the leverage. This is why borrowers will sometimes offer enhanced economics to small lenders in exchange for promising not to join the co-op (or for leaving the co-op): the marginal lender can be the difference between a blocking position and no leverage.

The Defection Problem and Co-Op Breakup

Co-ops are inherently unstable. The collective action problem is that each member benefits from coordination, but each individual member also has an incentive to defect if the defection produces better economics.

The borrower exploits this by approaching individual co-op members with side deals. The side deal might be: "if you leave the co-op and sign onto our proposed exchange, we will give you an additional 5 points of new-money allocation." If one member defects, the co-op loses both that member's claim amount and that member's signal value (because other members start to question whether others will defect).

The structural defenses are written into the co-op agreement.

Transfer restrictions: co-op members cannot sell their debt without co-op consent. This prevents a defecting member from selling to a non-member who would then deal with the borrower.

Voting commitments: co-op members commit to vote a specified way (yes or no) on enumerated transactions. A member who votes against the co-op's specified position breaches the agreement.

Lock-up provisions: co-op members commit not to enter into individual agreements with the borrower outside the co-op framework. This prevents the side-deal defection.

Breach remedies: damages provisions specify what a defecting member owes. Damages are typically calibrated to be substantial enough to deter defection but rarely litigated to judgment.

The reality is that co-ops break up when one of three conditions is met. First, the borrower offers terms that are better for the co-op than continuing to fight. The co-op votes to accept. Second, the borrower files Chapter 11, which dissolves the out-of-court co-op (though many co-ops convert to ad hoc committees in the bankruptcy). Third, the co-op loses enough members to fall below the blocking threshold, at which point the remaining members have no leverage and the co-op effectively dissolves.

The borrower's optimal strategy is to fracture the co-op below 33.4%. The co-op's optimal strategy is to lock in enough members above 50.1% that defection is mathematically impossible.

Tiered Co-Ops and the Carve-Out Premium

The 2025-2026 innovation in co-op structures is the tiered co-op. The mechanic: the co-op is divided into a "steerco" (typically 5 to 10 institutions, holding the largest positions) and the broader co-op (50 to 200 institutions). The steerco gets enhanced economics; the broader co-op gets base terms.

The justification: the steerco invests time and capital in negotiations. The steerco's counsel and advisor fees, the principals' time on weekly calls, the legal exposure from being signatories on negotiation documents are all real costs. The broader co-op contributes claim amount but does not bear these costs in the same way.

The carve-out premium structure formalizes this. In the Wachtell Liability Management Year in Review (January 2026), the structure is described as follows: the new-money issuance under the LME is allocated first to the steerco at preferential pricing (often a 5 to 10 point discount to par on the new instrument). After the steerco's preferential allocation is filled, the remaining new money is offered to the broader co-op at standard pricing. Additionally, the steerco may receive a "structuring fee" of 1 to 3% of the total transaction value, distributed pro rata among steerco members.

The critique of tiered co-ops is that they recreate the very dynamic co-ops were designed to prevent. The original purpose of a co-op was to prevent the borrower from privileging some lenders over others. A tiered co-op privileges some lenders (steerco) over others (broader co-op) within the co-op itself. This is the "From Shield to Sword" critique in the Pari Passu article (February 2026).

The investor question: if you are a co-op participant, do you push for steerco status, accept broader co-op terms, or stay outside the co-op? The answer depends on your position size, your willingness to invest in the negotiation, and your read on the steerco premium versus the broader co-op recovery.

Pat's framework on this: if your position is large enough that the steerco premium meaningfully changes your IRR, fight for steerco status. If your position is too small for the steerco premium to matter, take the broader co-op terms and free-ride on the steerco's work. If you are large enough to be a steerco candidate but unwilling to commit the resources, you have made the wrong choice; either go all in or stay out.

Antitrust Risk: The Next Frontier

The pending Optimum and Selecta antitrust challenges (filed late 2025) ask whether co-ops violate Sherman Act. The legal theory: co-op members are competitors in the secondary debt market, and the co-op restricts their competitive behavior (price, terms of supply of credit). If a court finds that co-op restrictions constitute a per se illegal restraint of trade or even a rule-of-reason violation, the entire defensive architecture of distressed lenders collapses.

The defense to the antitrust claim is that co-ops are not horizontal price-fixing among competitors but vertical coordination among holders of a single security responding to an issuer's actions. The case law on similar issues (joint venture antitrust analysis, syndicate antitrust analysis) tilts in favor of the defense, but the issue has not been finally decided.

The investor implication: if antitrust risk materializes, co-op architecture would need to be rebuilt around legally protected vehicles (such as creditor committees in bankruptcy, which have antitrust immunity) or around looser coordination structures (information-sharing without binding commitments). Pat's risk management read on this: it is a tail risk worth monitoring but not yet at a level that should change deal mechanics.

1.5 Covenant Package Analysis: How an Investor Reads a Credit Agreement

The investor reading of a credit agreement is fundamentally different from the lawyer reading. The lawyer reads to advise on what is permitted. The investor reads to identify where value can leak, where the borrower can prime, and what the maximum harm to existing lenders is under a determined sponsor attack.

Starter, Grower, and Builder Basket Interaction

The three basket types are the architectural core of the modern credit agreement. They interact in ways that can make total basket capacity far larger than any individual basket suggests.

Starter basket: a fixed dollar amount. Example language: "Investments in Unrestricted Subsidiaries not exceeding $150,000,000 in the aggregate at any time." Simple, finite, but typically the smallest of the three.

Grower basket: a dollar amount tied to a financial metric, typically Consolidated EBITDA or total assets. Example language: "Investments in Unrestricted Subsidiaries not exceeding the greater of (a) $150,000,000 and (b) 75% of LTM Consolidated EBITDA." The grower scales with the company. Over time, as EBITDA grows (or as definitional add-backs expand reported EBITDA), the grower basket capacity grows.

Builder basket: an accumulating basket that builds based on retained net income, equity contributions, and similar inflows. Example language: "Investments in Unrestricted Subsidiaries not exceeding the Available Amount." The Available Amount is then defined as a sum of cumulative Consolidated Net Income from a starting date, plus retained excess cash flow, plus equity contributions, plus the dollar amount of declined mandatory prepayments. The builder basket can be enormous in mature credits.

The three baskets stack. A borrower can use the starter, the grower, and the builder simultaneously for the same investment. So the total capacity for any single investment is starter PLUS grower PLUS builder. For a credit with five years of operating history and reasonable EBITDA growth, the builder alone can be 50% to 100% of total debt. Add the grower and starter, and total investment capacity often exceeds the equity value of the company.

The investor implication: the total basket capacity tells you the maximum drop-down vulnerability. Sum the three. Compare to enterprise value minus existing debt. If the sum exceeds enterprise value minus existing debt by even a small margin, the borrower has the capacity to drop down essentially all unencumbered value.

Why the Definition of Consolidated EBITDA Is the Most Important Definition

The grower basket scales with EBITDA. So the EBITDA definition controls the grower basket capacity. The EBITDA definition is the single most negotiated definitional provision in the credit agreement, and it is where the most damage is done in lender protection terms.

The pro-borrower drafting moves:

(a) Add-backs for "cost savings" and "synergies" expected to be realized over a forward look-back period (typically 24 to 36 months). Aggressive: the add-back is allowed for any initiative "commenced or expected to be commenced" within the period, with no requirement that the synergies be realized. This is the EBITDA inflation engine. A sponsor announces a $50M cost savings program in Q1 2025; under this language, the $50M is added to EBITDA from Q1 2025 onward, even if the program is never executed.

(b) Add-backs for "non-recurring" items that are then defined broadly. The borrower decides what is non-recurring. A "non-recurring" restructuring charge of $20M every year is, definitionally, non-recurring in each individual year, even though it recurs annually.

(c) Pro forma adjustments for acquisitions. The acquired company's EBITDA is added to the borrower's EBITDA from the acquisition date forward, AS IF the acquisition had occurred at the beginning of the LTM period. So a Q3 acquisition adds three quarters of acquired EBITDA to the trailing twelve months retroactively. Add this on top of any synergies.

(d) Capitalized software development costs. Software development costs that would otherwise reduce reported EBITDA are capitalized and added back. Combined with the SaaS-rollup business model, this can inflate EBITDA by 15 to 25%.

(e) Stock-based compensation. The classic add-back, but sometimes still present.

The lender-protective drafting moves:

(a) A cap on synergy add-backs as a percentage of base EBITDA (typically 10 to 15%). (b) A requirement that synergies be realized within a defined period (12 to 18 months from announcement) or the add-back must be reversed. (c) Third-party verification of cost savings. (d) Look-back period limits (12 months maximum from announcement to realization).

The Realogy precedent (a now-classic example cited in Gatto) was a credit agreement where add-backs were unconstrained, resulting in reported EBITDA of $700M against actual EBITDA closer to $400M. The lenders

allowed massive leverage based on the inflated EBITDA number.

The Pat-level read: when reviewing a credit agreement, do not trust reported EBITDA. Re-derive it from the EBITDA definition. Apply your own add-back haircuts. Then compute leverage and basket capacity from the haircut EBITDA. The credit agreement allows the borrower to operate on the inflated number; you should underwrite to the deflated number.

MFN: What It Actually Protects (Less Than You Think)

Most Favored Nation provisions in credit agreements are designed to protect lenders against the borrower issuing new debt at more favorable terms (typically meaning a higher interest rate spread) that would prejudice the existing lenders. The classic protection: if the borrower issues new debt at a spread more than 50 basis points above the existing debt spread, the existing debt's spread automatically increases to match (or to within 50 bps of) the new debt's spread.

The 50 basis point sunset is the canonical MFN structure: protection applies only if the new debt is at least 50bps higher. The "sunset" terminology refers to a separate provision: the MFN protection itself expires after a defined period (typically 6 to 12 months from the original closing date). After the sunset, the borrower can issue new debt at any spread without triggering MFN.

The pro-borrower drafting moves that have largely gutted MFN:

(a) Sunset periods of 6 months. Plenty of time for the borrower to wait out the protection. (b) Exclusions for "bridge financing" or "incremental facilities under existing baskets." If the new debt is structured as an incremental facility, the MFN often does not apply. (c) Exclusions for "permitted refinancing debt." Refinancing existing debt at higher spreads sometimes avoids MFN. (d) Exclusions for debt under specified baskets (typically the general debt basket up to a stated dollar amount). (e) Exclusions for "PIK toggle features" or other non-cash components that change the all-in yield without changing the headline spread.

The cumulative effect of these exclusions is that MFN now provides protection in a narrow window of cases and for a limited time. In a credit agreement with a 6-month sunset and multiple basket-based exclusions, MFN is essentially a check-the-box provision with little practical bite.

The investor implication: do not rely on MFN to discipline the borrower's pricing on new debt. If you want pricing protection, you need to negotiate it explicitly, typically through a mandatory consent right on new debt issuance above a threshold or through a coupon reset tied to specific events. MFN as a generic protection does little work in the modern credit agreement.

Permitted Holder and Change of Control Carve-Outs

Change of control puts are designed to give lenders an exit if the borrower's ownership changes. The classic provision: if a "Change of Control" occurs (defined as a transfer of more than 50% of voting equity to a third party), each lender has the right to put its debt back at par.

The pro-borrower drafting moves:

(a) Permitted Holder definitions that include not just the sponsor but the sponsor's affiliates, co-investors, employees, and "permitted transferees." When the sponsor sells the portfolio company to a fellow PE shop (a "sponsor-to-sponsor" trade), the transferee is often a Permitted Holder. So the put is not triggered.

(b) Permitted Holder definitions that include the sponsor's funds (Fund I, Fund II, Fund III). A transfer from Fund I to Fund III is not a Change of Control.

(c) The "majority of independent directors" carve-out. If after a transaction the board still has a majority of directors who would qualify under the original credit agreement, no Change of Control.

(d) Pre-IPO carve-outs. If the company goes public, the IPO is structured to avoid triggering change of control even though the sponsor's stake reduces.

The effect is that PE sponsors can rotate their portfolio companies among their own funds, sell to fellow PE shops, or take the company public without triggering the change of control put. The change of control protection rarely fires in modern credit agreements.

The investor implication: do not rely on change of control puts as a structural protection. Build your underwriting around the sponsor's actual ability to extract value, not the formal change of control machinery. The sponsor will not lose control without negotiating a replacement structure, and the replacement structure typically provides the sponsor with all the same flexibility.

Maintenance vs. Incurrence Covenants in Stressed Credits

Maintenance covenants must be satisfied every quarter regardless of borrower action. Typically: maximum leverage ratio of 6.0x or maximum total net leverage of 6.5x. The lender measures every quarter; the borrower must comply.

Incurrence covenants are only tested when the borrower takes a specific action. Typically: the borrower may not incur additional debt unless the post-incurrence leverage is at or below 6.0x. The lender does not test on a standalone basis; the lender tests only when the borrower acts.

Covenant-lite credit agreements typically include incurrence covenants but no maintenance covenants. The borrower can operate with leverage well above the incurrence trigger as long as the borrower does not take a new action requiring the test.

The 2024-2026 leveraged loan market is approximately 85% cov-lite. The maintenance covenant is largely a feature of investment grade and some sponsor-LBO-related deals; it is rare in distressed-tier sponsor credit agreements.

The investor implication for distressed work: the absence of maintenance covenants means the lender has no contractual mechanism to force a borrower into discussions before a defaultable event. The borrower can deteriorate slowly without triggering any covenant. The lender's first formal opportunity to engage may be a missed coupon or a missed maturity, at which point the borrower has already had years to engineer the cap structure for the negotiation.

The compensating control: the lender's leverage comes from the incurrence covenants. If the borrower wants to issue new debt, refinance, or do an acquisition, the lender's consent is required. So the lender can extract concessions at each incremental event. But the lender cannot proactively force a renegotiation in a covenant-lite credit; the borrower must take the action.

LME-Relevant Baskets Specifically

The baskets that matter for LME purposes are not always the largest in dollar terms. They are the ones that are specifically used to engineer the LME structure. The categories:

Debt incurrence baskets: ratio-based (typically the borrower can incur additional debt as long as post-incurrence leverage is at or below the incurrence trigger) plus fixed-dollar baskets (a starter dollar amount independent of leverage). The fixed-dollar baskets are critical for distressed scenarios because at distressed leverage levels the ratio test fails, but the fixed-dollar baskets remain available.

Lien capacity baskets: how much new debt can be issued on a secured basis, and against what collateral. Critical for uptier mechanics (which create new super-priority debt) and for double-dip mechanics (which create new pari-passu debt at a separate entity level).

Restricted payment baskets: how much can be paid out as dividends or buybacks. Less directly LME-relevant but indirectly important because the RP baskets are often the source of value transferred to unrestricted subs (a payment to UnSub is sometimes characterized as a restricted payment or an investment, depending on structuring).

Investment baskets in unrestricted subsidiaries: directly the drop-down attack vector. The capacity to transfer assets to UnSubs.

Asset sale baskets: how much asset value can be transferred outside the credit perimeter through sales (rather than investments). Some IP transfers are structured as sales rather than investments because the sale basket has different capacity.

For LME analysis, you read each of these basket types and compute aggregate capacity. The aggregate capacity tells you the maximum size LME the borrower can execute without violating the credit agreement. If the aggregate capacity is 30% of total debt, an LME of that size is feasible; the borrower can extract 30% of value to fund a new super-priority tranche. If aggregate capacity is 5% of total debt, LME is structurally constrained; the borrower cannot extract enough to create a meaningful new tranche.

Pat would do this calculation in 10 minutes when first looking at a credit. The output is a single number: aggregate LME capacity as a percentage of total debt. If that number is above 25%, the credit has structural LME risk. If it is below 10%, the credit is well-protected.

SECTION 2 : BANKRUPTCY: THE INVESTOR'S ANALYTICAL FRAMEWORK

2.1 DIP Financing: What the Investor Is Actually Negotiating

The advisory description of DIP financing is: "debtor-in-possession loan; super-priority during Ch11." That is the statute. The investor is not financing the company. The investor is buying control of the restructuring outcome through the priority pyramid.

Roll-Up Mechanics

The DIP is a new-money loan. The roll-up is the conversion of pre-petition debt held by the DIP lender into post-petition DIP debt. The roll-up jumps the rolled-up debt from its pre-petition priority into the super-priority position of the DIP.

The mathematical reason this matters: pre-petition debt typically trades at a discount in distressed situations (50 to 80 cents on the dollar). Post-petition DIP debt trades at par or near par because it has the highest priority in the cap structure. So rolling up $100M of pre-petition debt that was trading at $60M of market value into $100M of DIP debt represents a $40M instant gain to the holder.

The roll-up ratio is the key term. In the 2024-2025 DIP market, the typical ratio of roll-up to new money has been:

For sophisticated distressed PE-owned credits: 1:1 to 2:1 (one dollar of new money brings one to two dollars of roll-up). Anthology Education (2024) had a 2:1 roll-up ratio. Wesco/Incora (2023) had 4:1, which was extreme and contested.

For middle-market or simpler credits: 1:1 or sometimes lower. The roll-up is less aggressive when the DIP lender does not have a dominant prepetition position.

The justification for the roll-up: the prepetition lender's collateral is already first in line; the roll-up just formalizes that priority in the post-petition context. The court asks: would a comparable lender provide the same DIP without the roll-up? If no, the roll-up is the consideration for the new money. If yes, the roll-up is unnecessary value transfer to the prepetition lender.

The ConvergeOne ruling (S.D. Tex. District Court, September 25, 2025) is the most important recent decision on roll-up unfairness. The court found that the plan's exclusive equity backstop rights for the majority lenders constituted unequal treatment under §1123(a)(4). The 30% recovery differential between the in-group and out-group lenders was found to violate the equal treatment requirement. The lesson for DIP roll-ups: if the roll-up benefits some prepetition lenders disproportionately compared to similarly situated others, plan confirmation can be challenged on §1123(a)(4) grounds.

The investor question for any DIP with a roll-up: is the roll-up benefit shared pro rata across the prepetition class, or is it concentrated among select lenders? If concentrated, the structure may not survive plan confirmation. The Anthology resolution after the §1123(a)(4) objections came in was a partial pro-ration of the roll-up to address Vector Capital's objection. The negotiated outcome typically includes a modified ratio that spreads benefit more broadly.

Adequate Protection: The Calculation in Practice

Section 364(c) and (d) of the Bankruptcy Code permit super-priority and priming DIP financings respectively. The statute requires "adequate protection" for any pre-petition secured creditor whose lien is being primed.

Section 361 specifies three forms of adequate protection:

(a) Cash payments equal to the decrease in the value of the prepetition creditor's interest in the property; (b) Additional or replacement liens to compensate for the decrease; (c) Other relief that constitutes the "indubitable equivalent" of the creditor's interest.

The calculation in practice goes like this. The pre-petition first lien has a $200M claim secured by collateral valued at $250M. The DIP is $100M secured by a priming lien on the same collateral. The DIP lien dilutes the first lien position. The court requires adequate protection equal to the diminution in value.

Approach 1, equity cushion: if the first lien is over-secured by a sufficient margin (the equity cushion exceeds the priming amount), no cash adequate protection payment is required. The equity cushion itself is the protection. In the example above, the cushion is $50M; if the DIP is $50M or less, the cushion absorbs the priming. If the DIP is $100M, only $50M is absorbed by cushion, and adequate protection equal to $50M of diminution is owed.

Approach 2, replacement liens: the DIP grants a lien on previously unencumbered collateral (post-petition receivables, cash collateral that builds up post-petition). The replacement lien protects the first lien's diminution by giving it priority on the new collateral.

Approach 3, cash payments: the debtor makes monthly cash payments to the prepetition first lien lender to compensate for the diminution. Typically calibrated to the interest rate on the first lien (so the prepetition lender continues to receive interest current pay) plus any agreed dollar amount.

The most contested adequate protection question is the valuation of the collateral. The first lien argues low collateral value (because higher diminution justifies higher protection). The DIP lender (often the same party) argues high collateral value (because higher value means less diminution and less adequate protection). The valuation is fact-intensive; the court typically holds a hearing with expert testimony.

The investor implication for the holder of distressed pre-petition first lien debt: the adequate protection negotiation is where you preserve value during the bankruptcy. If you are not paid adequate protection in some form, your collateral position erodes over time. Demanding either current-pay interest or replacement liens during the case is critical to maintain economic position.

DIP-to-Exit Conversion

The DIP-to-exit conversion is the structure where the DIP automatically converts to the exit term loan at plan confirmation. This is the Anchorage signature mechanic, made famous in J.Crew and At Home.

The economic significance: a separate exit term loan requires the debtor to re-syndicate financing at emergence. The exit financing is a new transaction, with new fees, new diligence, and competitive risk (other lenders can bid). The DIP-to-exit conversion eliminates the re-syndication. The DIP lender locks in the exit position at the time of DIP commitment.

The structural mechanics:

(a) The DIP commitment letter and credit agreement include an explicit conversion mechanism. Upon plan effective date, the outstanding DIP balance converts dollar-for-dollar into the exit term loan, with specified terms (rate, maturity, covenants).

(b) The DIP/exit financing is approved by the court as a single transaction at DIP approval. The plan disclosure statement describes the exit financing as the converted DIP. Creditors voting on the plan are voting on a known exit financing.

(c) The DIP lender does not lose the exit mandate to a competing bidder because there is no competitive process at emergence.

The fee economics that make this work: the DIP earns its origination fees (typically 1-3%) plus its commitment fees plus its undrawn fees plus its OID. If the DIP converts to exit, those fees are non-refundable. If the DIP did not convert and exit financing went to another lender, the original DIP would receive only the DIP fees, not exit fees. The total fee economics on a DIP-to-exit structure is 50-100% higher than a standalone DIP.

For an investor, the DIP-to-exit conversion is also the mechanism that turns the DIP into a control instrument. The exit term loan is paired with an equity allocation; the DIP lender's pre-arranged exit position locks in the equity stake. J.Crew: Anchorage's $400M DIP converted to the exit term loan and to majority equity at emergence. At Home: similar, with the DIP converting to 98% of reorganized equity.

The competing DIP bidder problem: if you are a competing distressed PM trying to displace the prepetition lender's DIP-to-exit structure, you need to offer better terms by a sufficient margin to overcome the prepetition lender's structural advantages. Typical competing bid economics include: lower interest rate (50-100bps below the prepetition lender's rate), smaller roll-up percentage, less restrictive covenants. Even with these advantages, displacement is rare because the prepetition lender's information advantage and incumbent relationships dominate.

First-Day Motions as Value-Leakage Signals

The first-day motions in a Chapter 11 case can erode the secured creditor's collateral position. The investor monitors these motions for signals.

Critical vendor motions: the debtor seeks authority to pay pre-petition claims of "critical vendors" to maintain operations. The court typically grants this for vendors who would otherwise refuse to do business with the debtor. Each dollar paid to a critical vendor is a dollar that does not go through the bankruptcy waterfall. If $50M is paid to critical vendors and the first lien lender would have recovered 60 cents per dollar in the waterfall, that is $30M of value transferred from the first lien to the vendors.

The investor reads the critical vendor motion to assess: (a) how broadly is "critical" defined; (b) what dollar amount is sought; (c) what conditions are imposed on the vendor (continued credit terms, future pricing). A narrow critical vendor program with reasonable dollar limits is acceptable. A broad program covering $200M of unsecured claims is value leakage.

Cash management motions: the debtor seeks authority to continue its existing cash management system, often involving cross-entity transfers and uses. The investor reads the cash management motion to identify where cash flows. Cross-entity transfers to non-debtor affiliates can move value outside the estate.

Wages and benefits motions: typically uncontroversial but provides current pay to employees that bypasses bankruptcy claims process.

Customer programs motions: the debtor seeks authority to continue customer warranties, gift cards, refunds. Material if the dollar amount is significant.

The cumulative effect of first-day motions can be hundreds of millions of dollars of value transferred outside the standard bankruptcy waterfall. The investor monitors and, where appropriate, objects.

2.2 363 Sales: The Investor's Playbook

The advisory description of a 363 sale is: "sale of assets free-and-clear of liens during Ch11; can be faster than plan confirmation." That is mechanically true. The investor question is how to structure a credit bid, how to compete in the auction, and how the sale interacts with the rest of the case.

Credit Bidding Under §363(k)

Section 363(k) gives secured creditors the right to credit-bid their debt in a sale of the collateral. The credit-bid is the secured creditor's claim, applied as currency. So a secured creditor with $500M of debt can credit-bid up to $500M of value in the sale, paying the consideration with the debt rather than with cash.

The mechanics step by step:

Step 1: the bidder qualifies. The bidder must be a "qualified bidder" under the bid procedures order, meaning the bidder satisfies financial and procedural requirements (proof of funds for the cash component, NDA execution, no conflicts of interest).

Step 2: the bid is submitted in writing prior to the bid deadline. The bid includes the cash component, the credit-bid component, and the agreed asset purchase agreement terms.

Step 3: the auction occurs. The bidders are present (or represented by counsel and bankers); the stalking horse bid is the starting point; competitive bids must exceed the stalking horse by the minimum overbid increment (typically 1-2% of bid value or a stated dollar amount, whichever is greater).

Step 4: the highest and best bid is selected. The selection is by the debtor in consultation with the official committee of unsecured creditors. The selection is then submitted for court approval.

Step 5: court approval. The court reviews the bid procedures, the auction process, and the consideration to confirm compliance with §363 and the bid procedures order. Approval typically happens within days of the auction.

The "cause" exception to credit-bidding is set forth in §363(k) itself: the court may, "for cause," order that a secured creditor not be permitted to credit-bid. The most prominent application of the "cause" exception is the

Fisker decision.

Fisker Automotive (D. Del. 2014): the court limited Hybrid Tech Holdings' credit-bid to $25M against its $168.5M claim. The court found "cause" because Hybrid Tech had purchased the claim at a deep discount from the original Department of Energy ($25M paid for $168.5M face). The court reasoned that allowing credit-bid for the full face amount would chill other bidders and that the actual economic value of Hybrid's claim was the purchase price, not the face. The bid cap was set at the purchase price.

The investor lesson: if you have purchased prepetition debt at a deep discount, the court may limit your credit-bid to your purchase price rather than your face amount. This is the "secret of distressed credit acquisition strategy": large discounts on claim purchases can result in capped credit-bidding rights.

The RadLAX case (SCOTUS 2012, RadLAX Gateway Hotel) confirmed that in a plan sale context (a sale under the plan rather than under §363), the secured creditor must have a credit-bid right unless the court provides for "indubitable equivalent" of the secured claim. So credit-bidding is essentially statutorily guaranteed in plan sales.

The Free Lance-Star case (Bankr. E.D. Va. 2014) found "cause" to limit credit-bidding when the secured lender had engaged in inequitable conduct (over-securing the debtor, refusing to negotiate in good faith). The lesson: bad-faith behavior by a secured creditor can result in loss of credit-bidding rights.

Credit-Bidding Across Multiple Tranches

The investor question: if you hold across multiple tranches (first lien, second lien, unsecured), can you credit-bid all your debt, or only the secured portion?

The answer: under §363(k), only the secured portion can be credit-bid. The unsecured deficiency claim is not credit-biddable.

But there are nuances. If you hold both the first lien and the second lien, you can credit-bid the first lien fully and the second lien up to the secured portion (determined by the collateral value remaining after the first lien is satisfied). If the collateral is worth less than the first lien, the second lien is unsecured and cannot be credit-bid.

The intercreditor dispute angle: the second lien lender may dispute the first lien's valuation, arguing the collateral is worth more (which would make the second lien partly secured). The dispute is fact-intensive and often resolved through expert testimony.

Stalking Horse Bid Protections

The stalking horse is the first bidder in a 363 sale. The stalking horse establishes the floor bid and provides certainty to the debtor. In exchange, the stalking horse receives protections.

Market standard 2024-2026:

Break-up fee: 2.0% to 3.0% of the proposed purchase price, payable if the stalking horse is outbid. The break-up fee is structured as an administrative expense claim, payable from the sale proceeds before unsecured creditors. The break-up fee is a hard cap; it does not increase if the auction surprise winner pays significantly more.

Expense reimbursement: capped at 1.0% to 2.0% of the purchase price, sometimes structured as the lesser of a percentage and a fixed dollar amount. Reimbursement covers due diligence, legal, banker, and miscellaneous costs.

Matching rights: the stalking horse has the right to match the highest competing bid by raising its own bid. The matching right is typically one-time (the stalking horse gets one chance) or two-bid (the stalking horse can match twice). Beyond that, competitive bidding ends and the highest-bid winner is selected.

No-shop period: during the period after the stalking horse bid is signed and before the bid deadline, the debtor cannot solicit alternative bids except in limited circumstances (a "fiduciary out" allowing engagement with unsolicited inquiries from third parties that the board determines are superior).

Minimum overbid increment: the first competing bid must exceed the stalking horse bid by a stated minimum (typically 2-5% of the stalking horse bid). Subsequent overbids must exceed the prior bid by smaller increments (often $500K to $5M).

The Pat-level economics: a 2.5% break-up fee on a $500M sale is $12.5M. The stalking horse has economic motivation to bid even if expected to be outbid, because the break-up fee covers transaction costs and provides risk-adjusted return on the bid effort.

When to Credit-Bid Versus Sell the Claim into Auction

The investor decision: do you credit-bid for the business or sell your claim into the auction and take cash?

The credit-bid choice: you take the business at the credit-bid value, which is approximately your debt principal. You then own the business as equity. The exit is operational improvement and sale or IPO in 3-7 years. The IRR depends on operational performance.

The cash sale choice: you tender your claim into the auction, which results in another bidder buying the assets and paying your claim. You get cash at the implied price (your claim's recovery percentage). The IRR is realized immediately.

The decision framework runs on several variables:

(a) Your underwriting of the business at emergence. If you believe the business will be worth 1.5x your debt principal at emergence and 2.0x in 3 years, credit-bidding is attractive (you get a 1.5x to 2.0x outcome on your basis). If you believe the business is worth only 0.8x of your debt principal, you should sell the claim into auction for the cash recovery.

(b) Your fund's hold period and liquidity needs. Distressed funds with 5-7 year drawdown structures can hold post-emergence equity. Funds with shorter horizons or LP redemption pressures cannot.

(c) The auction dynamic. If you believe a higher bidder is going to appear (a strategic buyer, a competing PE shop), selling the claim into auction captures that bidder's value. If you believe the auction will not produce a higher bid (because the business is too distressed for strategic buyers), credit-bidding is the protective play.

(d) Operational expertise. Credit-bidding for the business requires you to operate it, hire executives, manage the post-emergence transition. If your fund does not have operational depth, the credit-bid exposes you to execution risk. Anchorage has both the legal sophistication for credit-bidding and a deeper bench than purely financial credit funds. Other funds without operational capacity should be more careful.

Pat would say: the credit-bid is the highest-conviction trade. You are saying "I would rather own this business than take cash." If you do not have that conviction, take the cash. If you do have it, credit-bid and structure the post-emergence equity for the long hold.

2.3 Plan Confirmation: Where Recoveries Are Actually Set

The advisory description of plan confirmation is: "court approval of the Chapter 11 plan; binds all creditors." That captures the legal effect. The investor question is what mechanisms exist to challenge a plan you do not like and what the cram-down math actually looks like.

The Absolute Priority Rule and the New Value Exception

Section 1129(b)(2)(B)(ii) of the Bankruptcy Code states that a Chapter 11 plan can be confirmed over the rejection of an impaired unsecured class only if no class junior to the rejecting class receives or retains any property on account of its prepetition claim or interest. This is the absolute priority rule (APR).

In its simplest form: if unsecured creditors reject the plan, equity holders cannot retain anything. The cram-down only works if the rejecting class is fully paid or if no junior class receives anything.

The new value exception comes from Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership, 526 U.S. 434 (1999). The Supreme Court held that pre-existing equity holders cannot retain or receive equity through a Chapter 11 plan unless their new contribution is subjected to a market

test. The market test requires that the opportunity to provide new value be open to potential outside investors, not just to existing equity holders. The Court did not decide whether new value, properly market-tested, is permissible under APR; it left that question open.

In practice, the market test is implemented through one of several mechanisms:

(a) Auction for the equity allocation. The plan provides that the equity allocation can be obtained by any party who pays the equivalent value. Outside investors may bid.

(b) Rights offerings open to all creditors. The plan provides rights offerings to all creditors who would be impaired, allowing them to purchase equity at a stated price. This effectively market-tests the value because creditors who would otherwise receive a recovery can elect to take equity instead.

(c) Sale process for the company itself. If a §363 sale is conducted prior to plan confirmation, the sale establishes the equity value, and the plan distributes that value.

The investor implication for distressed equity recovery scenarios: if the plan provides equity to pre-existing holders without a market test, the plan is vulnerable to challenge on APR grounds. The challenge typically comes from unsecured creditors who would receive nothing under the plan. If the challenge succeeds, the plan must be modified to provide a market test, which often results in unsecured creditors receiving an equity allocation.

The Hertz scenario is the canonical recent application. Hertz emerged from bankruptcy with existing equity receiving over $1B of value. The plan structure included a rights offering open to all unsecured creditors (the §1145-exempt rights offering). The unsecured creditors who participated in the rights offering received equity at the rights offering price. Existing equity holders also received an equity allocation. The APR challenge was avoided because the rights offering was the market test, and the structure was unique in that both existing equity and unsecured creditors received value.

Till v. SCS Credit Corp. and the Cram-Down Interest Rate

Till v. SCS Credit Corp., 541 U.S. 465 (2004) addressed the question of what interest rate must be paid to a secured creditor when the creditor is being crammed down (forced to accept deferred payments rather than the lump sum it would prefer).

The Supreme Court split. The plurality opinion (Justices Stevens, Souter, Ginsburg, Breyer) adopted a formula rate: the prime rate plus a risk adjustment of 1 to 3 percentage points. The risk adjustment is calibrated to the specific creditor's risk of nonpayment. The formula was originally articulated in Chapter 13 (consumer bankruptcy), but the plurality opinion suggested it applies in Chapter 11 as well.

The concurring opinion (Justice Thomas) would have used the contractual rate when available. The dissent (Justices Scalia, Kennedy, O'Connor, Rehnquist) advocated a market rate determined by reference to

comparable lending transactions.

The result: the lower courts split. Some apply Till's formula rate in Chapter 11. Others (particularly the Second Circuit in MPM Silicones and the Sixth Circuit) apply a market rate.

In re MPM Silicones (Momentive Performance Materials), 874 F.3d 787 (2d Cir. 2017): the Second Circuit held that when an efficient market for the relevant type of loan exists, the cram-down rate should be the market rate, not the Till formula. The court reasoned that Till was decided in the consumer bankruptcy context where no efficient lending market for the debtor was available. In Chapter 11 corporate cases, where active lending markets exist, the market rate is the appropriate benchmark.

The practical implication: secured creditors being crammed down in Chapter 11 often receive a rate substantially above the prime-plus-1-to-3 formula. In the 2020s, market rates for distressed-tier loans have been SOFR + 600 to 900 basis points, depending on credit quality. The Till formula would produce something closer to SOFR + 300 to 500 (depending on the risk adjustment). The market rate is typically 200 to 400 basis points higher than the Till formula.

The investor implication: when underwriting a cram-down scenario, model the secured creditor's recovery using the market rate, not the Till formula. The market rate produces higher cram-down payments to the secured creditor, which compresses the value available for junior creditors.

Classification Manipulation

The Bankruptcy Code requires that all claims placed in a class be "substantially similar" (§1122). The debtor controls the initial classification, but creditors can object.

The classification manipulation problem: the debtor wants to gerrymander classes to maximize the number of accepting classes and to dilute opposing votes. The classic maneuver:

(a) Place high-dollar opposing creditors into a class with smaller, friendly creditors. Per §1126(c), a class accepts the plan if creditors holding at least two-thirds in amount AND more than one-half in number of allowed claims in the class accept. If the debtor adds many small friendly claims to the class, the "more than half in number" test can be satisfied even if the dollar amount is dominated by an opposing creditor.

(b) Separate substantially similar claims into different classes to isolate opposition. If trade unsecured claims and bond unsecured claims have substantially similar legal characteristics, placing them in different classes can isolate bond holders' opposition.

(c) Gerrymander by giving accepting classes a slightly different treatment to justify separate classification. A nickel difference in recovery rate has been used to justify separate classification.

The objection process: a creditor objects to classification before plan confirmation. The objection challenges the "substantially similar" classification. The court rules on the objection. Courts vary in how strict they are. The Bankruptcy Code does not provide a clear test for "substantially similar"; case law has developed a flexible standard focused on legal nature and economic similarity.

The most aggressive classification manipulation cases have led to plan confirmation challenges. In re Greate Bay Hotel & Casino (S.D.N.Y.): the court rejected a classification that gerrymandered to create an accepting impaired class.

The investor implication: in a case where you are opposing a plan, attack the classification scheme early. If you can convince the court to reclassify, you can convert a class that was accepting into a class that is rejecting, killing the plan.

Equitable Mootness

Equitable mootness is a federal common-law doctrine. Once a Chapter 11 plan has been substantially consummated and the relief sought on appeal would unravel the plan to the prejudice of innocent parties, the appellate court can dismiss the appeal as equitably moot.

The doctrine is judge-made and applied inconsistently across circuits. Some circuits apply equitable mootness aggressively; others (the Third Circuit in particular) have narrowed its application.

The Serta Fifth Circuit decision (December 31, 2024) rejected equitable mootness as a bar to review of the plan's indemnification provision. The court held that equitable mootness cannot be used to insulate unlawful plan provisions from appellate review. This is a significant narrowing of the doctrine in the Fifth Circuit.

The investor calculation: if you are considering an appeal of a confirmed plan, you must overcome the equitable mootness defense. You typically do this by seeking a stay of the plan's effective date pending appeal. A stay prevents substantial consummation and preserves the appeal's viability. Stays are difficult to obtain (the appellant must show likelihood of success on the merits plus irreparable harm), but they are essential for any appeal that might otherwise be defeated by equitable mootness.

Post-Serta, equitable mootness is a less reliable defense. Confirmed plans containing unlawful provisions are subject to appellate review even after substantial consummation. The implication is that plan confirmation orders are less final than they were a few years ago. Pre-confirmation litigation strategy must reflect this: you can settle, you can object, you can litigate, knowing that the plan order itself is not necessarily the end of the matter.

2.4 Fraudulent Transfer: The Litigation Overlay

Fraudulent transfer claims are the investor's nuclear weapon. They can claw back transfers that occurred up to six years before bankruptcy and unwind capital structure events that took place pre-petition. They are the legal basis for most successful challenges to drop-downs, uptiers, and LBO leverage.

The Two-Year Versus Six-Year Lookback

Section 548 of the Bankruptcy Code allows the trustee to avoid transfers made within two years before the bankruptcy filing if the transfer was either actually fraudulent (intent to hinder, delay, or defraud creditors) or constructively fraudulent (transferred for less than reasonably equivalent value while the debtor was insolvent or undercapitalized).

State law fraudulent transfer statutes (the Uniform Fraudulent Transfer Act or its successor, the Uniform Voidable Transactions Act, adopted in some form by most states) have longer lookback periods, typically four to six years.

Section 544(b) of the Bankruptcy Code allows the trustee to invoke state fraudulent transfer law if any actual creditor of the debtor would have had standing under state law to assert the claim. So a Chapter 11 trustee or creditor committee can reach back four to six years using state law, even though the Bankruptcy Code itself only allows two years.

The investor implication: drop-downs, uptiers, and other LME transactions executed up to six years before bankruptcy can be challenged. The Boardriders LME was executed in 2020; the company has not yet filed Chapter 11, but if it does within the next two years (by 2026), the LME would be within the six-year state lookback. The structural risk for LME participants is that the longer lookback creates clawback exposure for transactions completed years before the filing.

Constructive Fraudulent Transfer: Reasonably Equivalent Value

The constructive fraudulent transfer test under §548(a)(1)(B) requires showing:

(a) The transfer was made while the debtor was insolvent (balance sheet insolvency, equitable insolvency, or undercapitalization);

(b) The transfer was for less than reasonably equivalent value (REV).

The "reasonably equivalent value" standard is fact-intensive. The court compares what the debtor gave up to what the debtor received. For an LBO, the question is whether the debtor received reasonably equivalent value in exchange for the security interests granted to the LBO lenders. For an uptier, the question is whether the non-participating lenders received reasonably equivalent value for their loss of priority.

The TOUSA case (11th Cir. 2012) involved upstream guarantees granted by subsidiaries to secure debt of the parent. The court held that the upstream guarantees were constructive fraudulent transfers because the subsidiaries did not receive reasonably equivalent value for the guarantee obligations (the subsidiaries got no direct economic benefit from the debt that they were guaranteeing). The case established that upstream guarantees in LBO contexts can be vulnerable to fraudulent transfer claims.

The Lyondell case (S.D.N.Y. 2011) involved an LBO. The court held that the LBO payments were potentially constructively fraudulent transfers because the company received less than reasonably equivalent value for the consideration paid out to the sellers and to the LBO lenders. The court allowed the case to proceed on the constructive fraudulent transfer theory.

In LME contexts, the constructive fraudulent transfer claim from a non-participating lender argues: the company released collateral or subordinated debt to the participating lenders without receiving reasonably equivalent value. The participating lenders got priority enhancement; the company got no equivalent benefit. The case for REV deficiency is strongest when the LME does not raise meaningful new capital (because if it did, the company could argue it received the new capital as REV).

Section 546(e) Safe Harbor and Merit Management

Section 546(e) of the Bankruptcy Code provides a safe harbor for certain transfers in securities transactions, including margin payments, settlement payments, and certain other transactions involving financial institutions. The safe harbor protects these payments from being clawed back under §544 or §548.

Pre-2018, the 546(e) safe harbor was read broadly. In the LBO context, payments from the acquired company to selling shareholders were often protected because they were made through financial institutions (banks acting as paying agents). This protected LBO transactions from constructive fraudulent transfer claims in many cases.

Merit Management Group, LP v. FTI Consulting, Inc., 583 U.S. ___ (2018) narrowed the safe harbor. The Supreme Court held that the safe harbor applies only to transfers where the financial institution is the actual transferor or transferee, not where the financial institution merely acts as a conduit. In Merit, the financial institutions acted as paying agents only, so the 546(e) safe harbor did not protect the underlying transfer.

The Tribune case is the canonical post-Merit application. Tribune's LBO involved payments to selling shareholders. The original Tribune litigation found that the 546(e) safe harbor protected the payments because they flowed through financial institutions. After Merit, the question was reopened: the financial institutions were conduits, not transferors. The Second Circuit ultimately held that the 546(e) safe harbor did not protect the Tribune LBO payments. Tribune's selling shareholders are now potentially exposed to clawback for transactions completed in 2007.

The investor implication: 546(e) is a narrower safe harbor than it was pre-Merit. LBOs completed in the past six years (the state law lookback) without proper safe-harbor structuring are exposed to constructive fraudulent transfer claims. For LMEs specifically, the safe harbor analysis depends on the structure of the transaction. Cashless uptiers (no payment of money, just exchange of paper) may not implicate 546(e) at all, depending on how the transaction is characterized.

LME-Specific Fraudulent Transfer Claims

The structure of an LME fraudulent transfer claim from a non-participating lender:

(a) Identify the transfer: the priming exchange transferred priority from the non-participating lenders to the participating lenders. The non-participating lenders lost senior collateral position; the participating lenders gained it.

(b) Allege constructive fraudulent transfer: the company did not receive reasonably equivalent value for this transfer. The company received the same dollar amount of debt before and after the exchange; the only thing that changed was priority. So the company received no value at all from the transfer.

(c) Allege the company was insolvent at the time of the LME: the LME was undertaken specifically because the company was distressed (typically the trigger for an LME is a maturity wall or covenant trigger or liquidity crisis), so insolvency is often demonstrable from the company's own financial statements.

(d) Seek recovery: damages equal to the value lost by the non-participating lenders, recoverable from the participating lenders.

The defense to the claim: the company did receive value, in the form of additional new money raised in the LME, or in the form of debt forgiveness (if the LME involved discount on participating lenders' debt), or in the form of business continuity (the company avoided default and bankruptcy). Each of these defenses is contestable.

The Serta damages trial (closing March 2026, ruling expected summer 2026) is the first major case to address the quantification of damages from an unlawful LME. The trial follows the Fifth Circuit's December 2024 ruling that Serta's uptier exchange violated the credit agreement. The damages number will set the benchmark for non-participating lenders' future fraudulent transfer claims.

Litigation Funding in Distressed

Litigation funding is a tool that has emerged in distressed credit. Specialty firms (Burford Capital, Bench Walk Advisors, Parabellum Capital, Longford Capital) finance distressed creditor litigation in exchange for a share of recovery.

The economics: a creditor committee or non-participating lender group has potential fraudulent transfer claims worth $200M nominally. The litigation cost is $20M to $40M to pursue through judgment. The lenders do not want to bear the litigation cost (which is real cash outflow), nor do they want to bear the time and execution risk (which extends fund hold periods). The litigation funder takes the case. The funder pays the litigation costs. In exchange, the funder receives 20% to 35% of the eventual recovery.

The investor decision: take the litigation funding deal, or pursue the litigation in-house? The answer depends on (a) the strength of the claims, (b) the lender's appetite for litigation risk, (c) the lender's fund structure (drawdown vs. evergreen), and (d) the lender's relationship with litigation funders.

For a single-position distressed PM, the funding deal is often the right answer: the funder bears the risk, the PM gets a clean cash recovery, the litigation does not tie up fund capital. For a sophisticated multi-strategy distressed fund with in-house legal capacity, in-house litigation can be the better economic outcome because the fund captures the full recovery.

Pat's view: Anchorage has the legal sophistication to run litigation in-house. The litigation funders are useful for smaller participants who lack the resources. For Anchorage's positions, the in-house approach captures more value. But the litigation funders are useful counterparties because they price the litigation risk and provide a market signal on the strength of the claim.

SECTION 3 : QUANTITATIVE FRAMEWORKS

3.1 Recovery Waterfall, Built From Scratch

The recovery waterfall is the foundation of distressed valuation. The investor builds it from the capital structure up, applies enterprise value scenarios across the structure, and identifies the fulcrum in each scenario. Every distressed underwriting starts here.

Example Capital Structure

The example below is calibrated to a typical mid-cap LBO that has experienced operational stress. The capital structure includes:

- $50M revolving credit facility (RCF), undrawn but committed
- $400M first lien term loan, fully drawn
- $200M first lien secured notes, pari with the first lien term loan
- $150M second lien notes
- $250M senior unsecured notes

- $100M subordinated notes
- $50M trade payables
- $30M accrued interest (12 months at blended rate)

Total funded debt: $1,000M. Total claims including unsecured trade and accrued interest: $1,080M.

Three TEV Scenarios

The three TEV scenarios are calibrated to a realistic range of outcomes for a distressed credit.

Bear scenario: $400M TEV. Reflects severe operational deterioration plus a difficult exit environment. Implied multiple of approximately 4.0x on stressed EBITDA of $100M.

Base scenario: $650M TEV. Reflects partial operational recovery and a normalized exit environment. Implied multiple of 6.5x on EBITDA of $100M.

Bull scenario: $900M TEV. Reflects full operational recovery plus multiple expansion. Implied multiple of approximately 9.0x on recovered EBITDA of $100M.

Waterfall Mechanics

The waterfall applies enterprise value to each priority layer in order. Each layer is reduced by:

(a) Wind-down and administrative costs: assume 4% of TEV in any scenario, capturing professional fees, retention bonuses, and timing-related costs. Some investors use a flat dollar amount; the percentage approach scales appropriately.

(b) Priority claims: administrative claims, wages, taxes, post-petition operating expenses. Assume $30M flat in any scenario.

(c) Reorganization fees: investment banker fee at 1.0% to 1.5% of TEV, plus legal and other professional fees. Assume $20M flat across scenarios for analytical simplicity (in practice this scales with case complexity and duration).

Post-deductions, the TEV available for the debt waterfall:

Bear: $400M - $16M (4% wind-down) - $30M (priority) - $20M (reorg fees) = $334M Base: $650M - $26M - $30M - $20M = $574M Bull: $900M - $36M - $30M - $20M = $814M

Waterfall Application Across Layers

The RCF and first lien term loan are pari (both first lien secured). They have a collective claim of $450M (RCF undrawn but committed; in practice, undrawn revolvers typically draw before the bankruptcy filing as the borrower preserves liquidity). Assume the RCF is drawn to $50M at filing; total first lien claim is $450M.

Bear scenario: - $450M of first lien claim against $334M of available TEV - First lien recovery: $334M / $450M = 74.2% - First lien notes (pari with the term loan): same 74.2% recovery on $200M = $148.4M - First lien term loan and RCF: same 74.2% recovery on $450M (including notes) ... wait, recalculation: $200M first lien notes are pari with the $450M first lien debt. So total first lien claims are $650M ($50M RCF + $400M term loan + $200M notes). Recovery on $650M of claims from $334M of value: 51.4%. All of value goes to first lien. Nothing goes lower. Fulcrum is the first lien. - Second lien notes: 0% recovery. $150M wiped. - Senior unsecured notes: 0% recovery. $250M wiped. - Subordinated notes: 0% recovery. $100M wiped. - Trade payables and accrued interest: 0% recovery (subordinate to first lien deficiency claim).

Base scenario: - Total first lien claim of $650M ($50M RCF + $400M term loan + $200M notes) - $574M available TEV - First lien recovery: $574M / $650M = 88.3% - First lien deficiency: $650M - $574M = $76M deficiency, ranks as senior unsecured - Second lien notes: 0% recovery (still below first lien deficiency) - Senior unsecured notes plus first lien deficiency: $250M + $76M = $326M of senior unsecured claims, against $0 of remaining TEV. 0% recovery. - Subordinated notes: 0% recovery. - Fulcrum is the first lien (partially paid).

Bull scenario: - $650M of first lien claim - $814M available TEV - First lien recovery: 100% ($650M paid in full) - Remaining TEV: $814M - $650M = $164M - Second lien notes claim: $150M - Second lien recovery: $150M / $150M = 100% (if there is enough TEV to cover) - actually $164M is greater than $150M, so second lien gets 100% with $14M left over - Remaining TEV: $14M - Senior unsecured notes: $250M claim. $14M of $250M = 5.6% recovery - Subordinated notes: 0% recovery - Trade payables: covered by the bankruptcy reorganization (assume paid through normal course) - Fulcrum is the senior unsecured notes (very thin recovery, just on the bull case).

How the Fulcrum Migrates

Across the three scenarios: - Bear: fulcrum is first lien (51.4% recovery) - Base: fulcrum is first lien (88.3% recovery) - Bull: fulcrum is senior unsecured (5.6% recovery)

This migration is what an investor reads. The fulcrum is not a single security; it is a probability-weighted answer. At a bear-case probability of 30%, base-case probability of 50%, and bull-case probability of 20%:

First lien probability-weighted recovery: 30% × 51.4% + 50% × 88.3% + 20% × 100% = 15.4% + 44.2% + 20% = 79.6%

If the first lien is trading at 75 cents on the dollar, that is approximately 95% of the probability-weighted recovery. So either the first lien is fairly priced or slightly cheap.

Second lien notes probability-weighted recovery: 30% × 0% + 50% × 0% + 20% × 100% = 20%

If the second lien notes are trading at 25 cents on the dollar, that is overpriced relative to the probability-weighted recovery. Either the market is overpaying for the option value (the bull scenario), or the bull-case probability should be higher.

Senior unsecured probability-weighted recovery: 30% × 0% + 50% × 0% + 20% × 5.6% = 1.1%

If senior unsecured is trading at 5 cents on the dollar, that is overpriced.

The trade construction here:

Long first lien at 75 (probability-weighted recovery of 79.6%) - cheap. Short or avoid second lien at 25 (probability-weighted recovery of 20%) - overpriced. Short or avoid senior unsecured at 5 (probability-weighted recovery of 1.1%) - massively overpriced.

This trade construction is the cap-arb pair: long first lien, short the lower tranches. The trade pays off in the bear and base scenarios (first lien gets paid; lower tranches go to zero). The trade hurts in the bull scenario (first lien is paid; lower tranches recover; the short on lower tranches loses).

Including Make-Whole and Adequate Protection Claims

The waterfall above is simplified. Real cases include:

Make-whole claims: if any of the bonds (typically the first lien notes and the senior unsecured notes) have make-whole provisions, the make-whole is a claim. Whether it is allowed depends on the indenture language and the solvent-debtor exception analysis. In the bull scenario where the debtor may be solvent, the make-whole on the senior unsecured notes could be allowed at the contract rate. In the bear and base scenarios where the debtor is insolvent, the make-whole is generally disallowed under §502(b)(2) as unmatured interest.

Adequate protection claims: if the DIP primed the first lien during the case, the first lien may have an allowed adequate protection claim for diminution in value. This claim is administrative priority. So in the bear and base scenarios, the first lien might have an additional administrative claim of, say, $30M to $50M, which gets paid before the priority claims and reorganization fees in the waterfall. This further squeezes the value available for the first lien recovery.

Accrued interest at contract rate vs. judgment rate: if the over-secured first lien is entitled to post-petition interest at the contract rate under §506(b), that adds to the first lien claim. Assume the first lien has a contract rate of 7.5% and the case lasts 18 months: the additional interest claim is $450M × 7.5% × 1.5 = $50.6M. In the bull scenario, this is absorbed by the surplus value. In the bear and base scenarios, the additional interest worsens the first lien recovery percentage.

These adjustments make the waterfall more accurate but do not change the fundamental fulcrum identification.

3.2 Implied Recovery Analysis: Working Backward From Market Price

The market gives you a price. The investor extracts information from that price about what the market thinks is going to happen. This is the implied recovery analysis.

From Bond Price to Implied Default and Recovery

Take a bond trading at 45 cents on the dollar with a 10% coupon and 3 years to maturity. The yield to maturity is calculated by finding the discount rate that equates the present value of cash flows (interest plus principal) to the current price.

For a 3-year bond paying 10% annual coupon priced at 45 cents: - Annual cash flows: $10 (interest) for 3 years, plus $100 (principal) at maturity - Present value at discount rate r: $10/(1+r) + $10/(1+r)² + ($10 + $100)/(1+r)³ = $45 - Solving for r: yield to maturity is approximately 47%

The 47% YTM is the market's implied compensation for holding this bond. The risk-free rate is, say, 4.5%. The credit spread is 47% - 4.5% = 42.5%.

A 42.5% credit spread is consistent with significant probability of default. Using the simplified formula:

Spread = Probability of Default × Loss Given Default - Risk Premium

If Loss Given Default is 50% (a typical mid-tier bond recovery), then: Probability of Default ≈ Spread / Loss Given Default = 42.5% / 50% = 85%

So the market is pricing in approximately 85% probability of default. That is a near-certainty of default. The bond is trading on recovery, not on yield.

If instead the bond is trading at 65 cents: - YTM ≈ 24% - Spread ≈ 19.5% - Implied PD ≈ 19.5% / 50% = 39%

The market is pricing about a 39% probability of default. The bond is trading partially on yield, partially on recovery.

The investor uses this analysis to assess whether the market's view aligns with the investor's underwriting. If the investor thinks the probability of default is 50% but the market is pricing 85%, the investor should be long the bond (it is cheap relative to the investor's view).

Triangulating Implied TEV From Cap Structure Pricing

A more powerful application: use the prices of multiple tranches to triangulate the market's view of TEV.

Suppose the capital structure is: - First lien at $0.85 - Second lien at $0.40 - Senior unsecured at $0.05

The first lien is trading at $0.85. The implied recovery for the first lien is roughly 85% (with some adjustment for time value and yield). For first lien recovery to be 85%, the TEV must be sufficient to cover 85% of the first lien claim.

The second lien is trading at $0.40. The implied recovery is 40%. For second lien recovery to be 40%, the TEV must be sufficient to cover the first lien fully (the first lien comes first in waterfall) plus 40% of the second lien. So the TEV is approximately the first lien amount plus 40% of the second lien amount.

If first lien is $450M and second lien is $150M: - TEV implied by first lien at 85: $450M × 85% = $382.5M (this is the value going to first lien; for 85% recovery, TEV must be at least $382.5M) - TEV implied by second lien at 40: $450M (first lien full) + $150M × 40% = $510M - TEV implied by unsecured at 5: $450M + $150M + ($250M × ... = the unsecured recovery is so small that it is in the noise

The inconsistency: if first lien is 85% recovery, TEV is approximately $383M. But at $383M of TEV, the second lien recovery should be 0% (all TEV consumed by first lien). The market is pricing second lien at 40%, implying $510M of TEV. The market is internally inconsistent.

This inconsistency tells you something. Either (a) the market has not done the waterfall analysis (entirely possible in less-followed credits), (b) the market is pricing convexity in the second lien (a bet that TEV could be higher than the first lien's price implies), or (c) one of the prices is wrong and represents a trade opportunity.

The Pat-level read: market inconsistencies are tradeable. If the cap-arb implies that the first lien is overvalued (low TEV) but the second lien is undervalued (in the higher TEV scenario), the trade is to be long the second lien or short the first lien, depending on which side has more conviction.

The Fulcrum Radar

The fulcrum radar is a tabular tool the investor uses to identify which tranche is the fulcrum across multiple TEV scenarios.

The table:

Tranche	Claim ($M)	Bear ($400M TEV)	Base ($650M)	Bull ($900M)
RCF / 1L TL	450	51.4%	100%	100%
1L Notes	200	(pari with above)	(pari)	(pari)
2L Notes	150	0%	0%	100%

Tranche	Claim ($M)	Bear ($400M TEV)	Base ($650M)	Bull ($900M)
Sr Unsec	250	0%	0%	5.6%
Sub	100	0%	0%	0%

The fulcrum migrates: bear/base it is the first lien (partially); bull it is the senior unsecured (very thin).

Overlay the market prices:

Tranche	Market Price	Recovery in Most-Likely Scenario	Trade
1L TL	75	80% (probability-weighted)	Cheap, long
2L Notes	25	20% (probability-weighted)	Slightly rich
Sr Unsec	5	1%	Very rich, avoid
Sub	2	0%	Essentially lottery ticket

The trade construction follows from this analysis: long first lien at 75 (looking for 80%+ recovery), avoid lower tranches, possibly short senior unsecured at 5.

This is the fulcrum radar in action. Pat would do this calculation in 10 minutes for any name. The output is a single page of analysis identifying the trade.

3.3 DIP Economics: Sizing the Return

The DIP provides the lender with multiple components of return. The investor calculates the all-in yield and compares it to the opportunity cost of holding the prepetition claim.

Worked Example

Assume the DIP terms: - $300M total commitment - 700 basis points over SOFR (call SOFR 5.0%, so all-in coupon 12.0%) - 3% OID (so the DIP is funded at 97 cents on the dollar; the lender provides $291M cash for $300M of DIP claim) - 2% upfront fee on commitment ($300M × 2% = $6M) - 12-month duration - 60% roll-up of prepetition exposure (assume prepetition was $250M trading at 60 cents; the roll-up takes $150M of prepetition claim and rolls into DIP priority)

Cash economics over 12 months:

(a) Cash interest: $300M × 12% × 1 year = $36M (assuming the DIP is fully drawn)

(b) OID accretion: $9M (recognized over the life)

(c) Upfront fee: $6M

(d) Roll-up value: $150M of prepetition claim with market value of $90M (60 cents on $150M) is rolled to par value as DIP claim, worth approximately par at emergence. Value pickup: $150M - $90M = $60M

Total economic return over 12 months: $36M + $9M + $6M + $60M = $111M On cash deployed: $291M - $90M (because the rolled-up portion does not require new cash) = $201M of new cash deployed IRR: $111M / $201M ≈ 55% over 12 months

The 55% IRR is the headline number. It is roughly composed of: - 18% from interest income - 4.5% from OID - 3% from upfront fee - 30% from roll-up

The roll-up alone is more than half the return. This is why the roll-up is the contested term in any DIP negotiation.

When Roll-Up Makes DIP Economics Worse

The roll-up only adds value if the prepetition claim is trading at a discount to par. If the prepetition claim is trading at par or near par (less than 10% discount), the roll-up is essentially worthless.

The breakeven analysis: if prepetition is trading at 95 cents on the dollar, rolling $150M of prepetition claim creates a value pickup of only $150M × 5% = $7.5M. Adding $7.5M to the other return components yields:

Total return: $36M + $9M + $6M + $7.5M = $58.5M On cash deployed: $300M - $142.5M (the $150M roll-up does not require new cash) = $157.5M IRR: $58.5M / $157.5M ≈ 37%

Still attractive, but the marginal value of the roll-up has compressed from 30% IRR contribution to 5%.

If prepetition is trading at par (100 cents), the roll-up adds zero value. The DIP economics become:

Total return: $36M + $9M + $6M + $0M = $51M On cash deployed: $300M (no roll-up to reduce new cash) IRR: 17%

Now the DIP looks like a normal senior loan with high fees. Still profitable but not the extraordinary return that the roll-up generated when prepetition was trading at 60 cents.

The investor implication: roll-ups are most valuable when prepetition is most distressed. The DIP-with-roll-up structure is designed for situations where the prepetition lender has bought in at a deep discount and wants to lock in the priority enhancement before bankruptcy resolution. If you are providing a DIP without holding

distressed prepetition debt, the roll-up provides little economic benefit (because there is no value pickup) but a lot of complexity and potential litigation risk (because non-rolled lenders may object).

The competing DIP bidder calculation: a competing bidder offering a DIP without roll-up can offer lower interest rates (because the bidder is not capturing the roll-up value), but the bidder must offer rates low enough to compensate for the absence of the roll-up value pickup. In our example, the prepetition lender extracts $60M of value from the roll-up. A competing bidder offering a DIP at 9% all-in (300bps lower than the prepetition lender's 12%) saves the debtor $300M × 3% = $9M per year, or $9M over 12 months. The savings to the debtor are real but small relative to the $60M of value the prepetition lender extracts from the roll-up.

This is why prepetition lenders almost always win the DIP. The roll-up creates value that no competing bidder can match.

3.4 LME Participation Decision: The Framework

The decision to participate or hold out in an LME has four possible outcomes. The investor maps each outcome and decides based on probability-weighted analysis.

The Four-Outcome Decision Tree

Outcome 1: You participate, and the business stabilizes. You exchange at the offered exchange price. The new paper is super-priority and trades well. Your basis in the new paper is the exchange ratio applied to your original basis. The business stabilizes; the new paper trades up. Recovery: 95-100% of the new paper's par value, depending on how the post-LME credit trades.

Outcome 2: You participate, and the business goes to Chapter 11 anyway. You exchanged at the offered exchange price. The new paper is now in a Chapter 11 case. Your new paper has the super-priority position you negotiated for. Recovery depends on the bankruptcy outcome, but the super-priority typically protects against the worst outcomes. Recovery: 60-80% in most scenarios.

Outcome 3: You hold out, and the LME succeeds. You did not exchange. Your original debt is now subordinated. The business stabilizes. The other lenders' new super-priority paper trades well. Your subordinated paper trades poorly. Recovery: 30-50% over a 24-48 month hold period as the business pays down the new senior debt and eventually deleverages.

Outcome 4: You hold out, and the LME fails (business goes to Chapter 11). You did not exchange. Your original debt is below the new super-priority paper in the cap structure. If your fraudulent transfer claim survives, you can claw back the priming; if it does not survive, you are deeply subordinated. Recovery:

depends entirely on the litigation outcome. Successful FT claim: 60-90% (the priming is unwound). Failed FT claim: 5-25%.

Probability Assessment

The investor assesses each probability based on credit-specific analysis.

For a name like Newfold (PE-owned hosting rollup, declining revenue, leveraged, repeatable LMEs): - P(business stabilizes) ≈ 30% - P(business goes to Ch11) ≈ 70%

For a name like Cabinetworks (industrial, cyclical, recently completed LME with massive participation): - P(business stabilizes) ≈ 70% - P(business goes to Ch11) ≈ 30%

The other variable: P(LME succeeds) versus P(LME failure ultimately produces Ch11). LME success is partly a function of participation rate. If you hold out, you are betting that the LME fails OR that you can extract enhanced economics through litigation.

Calculating Expected Recovery

For Newfold-type credit: - Participate, stabilize (30% × 95%) = 28.5% of stabilization weight - Participate, Ch11 (70% × 70% = 49% of total) recovery 70% = 34.3% - Total participate expected: 28.5% + 34.3% = 62.8%

- Hold out, LME succeeds, business stabilizes (30% × 95% LME success × ...) → depends on whether you litigate and settle
- Hold out, LME fails or business files Ch11 (70% × FT outcome) → range based on litigation success

The exact math depends on calibration. The point is that the participation decision is a probability-weighted calculation, not a binary yes/no.

Blocking Threshold Modifying the Math

The participation decision changes dramatically if you have a blocking position.

If you have 33.4% or more of the affected class, you can block sacred-rights amendments. The borrower must negotiate with you. Your option value increases substantially because you control the LME timeline.

If you have 25% (below the blocking threshold), you are a price-taker. You participate or hold out based on the math, but you cannot negotiate.

If you have 35% but a tightly coordinated co-op holds 60%, your blocking position is theoretical only because the co-op has the votes. Your leverage depends not just on your dollar amount but on the other lenders'

coordination.

The Pat-level negotiation: at 33.4%, you can demand improved economics. The borrower will typically offer 5-10 points of additional new-money allocation or improved priority for the participating-blocking-position holder. This is the practical application of the blocking position math: it converts to settlement value.

Settlement Value Quantification

The 5-15 percentage point enhancement above original exchange economics is the typical settlement range for non-participating lenders with credible litigation claims. The range varies by credit and by the strength of the claim:

Strong legal claim (clear-cut Serta-style "open market purchase" issue): 10-15 points enhancement Moderate legal claim (contested but not clear-cut): 5-10 points enhancement Weak legal claim (limited litigation theory): 3-5 points enhancement, often with non-economic concessions

A non-participating lender with a strong legal claim and a meaningful position can extract 10-15 points of enhancement just by signaling willingness to litigate. The settlement happens before judgment is reached. The investor calibrates the litigation funding cost (often borne by litigation funder) against this enhancement to determine whether the holdout is economically attractive.

SECTION 4 : MARKET MECHANICS AND TRADING

4.1 Loan Market Mechanics

The loan market operates under LSTA conventions that an advisor never has to know but a PM lives in. The settlement timeline, the wall management, and the distressed designation are the operational reality.

Par Versus Distressed Settlement

The LSTA settlement convention divides loans into two categories. Par loans settle on T+7 (seven business days from trade date). Distressed loans settle on T+20 (twenty business days from trade date). The distressed designation captures the additional documentation, due diligence, and risk management required for a stressed credit.

The distressed designation is determined by reference to defined criteria. A loan can be designated distressed by:

(a) Voluntary designation by the parties to the trade.

(b) Broker-driven designation. When a dealer's distressed desk takes the trade, the dealer typically designates it distressed.

(c) Transfer agent flagging. The administrative agent under the credit agreement may flag the loan as distressed based on default events, missed payments, or covenant breaches.

Once distressed, the loan typically remains distressed through settlement and may carry the designation into subsequent secondary trading.

The T+7 versus T+20 distinction matters operationally because of carrying costs. The seller's settlement obligation is to deliver the loan plus accrued interest from trade date to settlement date. The buyer's obligation is to fund the purchase price plus accrued interest. The extension from T+7 to T+20 means the seller carries the loan (and earns the interest) for an additional 13 business days. This is delayed compensation: the seller is paying the buyer for the time value of the additional settlement period.

The LSTA Standard Terms and Conditions for Distressed Trade Confirmations specifies the precise mechanics. The trade confirmation states the trade date, the settlement date, and any delayed compensation factor. Sophisticated counterparties verify the delayed compensation calculation themselves rather than relying on the dealer's confirmation.

Counterparty Risk in Distressed Trading

Counterparty risk in distressed loan trading manifests in three scenarios.

First, the seller's risk during the extended settlement period. If the seller has agreed to deliver but the loan's price has moved up substantially before settlement, the seller may attempt to break the trade. This is more common in opaque OTC markets than in dealer-intermediated trades.

Second, the buyer's risk during the settlement period. If the loan's price has fallen substantially before settlement, the buyer may attempt to break the trade. The LSTA documentation makes this difficult but not impossible. Sophisticated buyers verify with the seller's bank during the settlement period.

Third, the credit risk of the underlying loan itself. If the borrower defaults or files Chapter 11 between trade date and settlement date, the trade may settle into distressed paper or into bankruptcy claims. The LSTA Standard Terms address this through standstill provisions: settlements continue notwithstanding the borrower's intervening default.

MNPI Walls and Loan Trading Operations

When a buyside firm has a portfolio team that is wall-crossed (has material non-public information from a co-op meeting or direct discussion with the company), the firm cannot trade the loan. The information wall

management is operational.

The wall structure typically separates:

(a) The portfolio team: the investment professionals who have wall-crossed and have MNPI.

(b) The trading desk: the execution personnel who do not have MNPI and need to be able to trade other names.

(c) Compliance: oversight personnel who monitor the wall and grant exemptions when wall-crossed information is released or when the trading desk needs to act.

The mechanical implementation: the portfolio team works in a separately accessed system. Email and instant message communications between the portfolio team and trading desk are restricted on relevant names. Trading desk personnel are explicitly excluded from any meetings or calls involving wall-crossed information.

The risk of wall breach: a single email from the portfolio team to the trading desk discussing the wall-crossed information can taint the trading desk and force the firm to abstain from trading. The compliance protocols are designed to prevent this.

The portfolio team also has restrictions on what they can communicate externally. They cannot share wall-crossed information with other investors, even those who might be aligned (such as fellow co-op members). The co-op agreement typically allows information sharing within the co-op but does not waive the wall obligations vis-a-vis other parties.

Net Short Disclosure: The Windstream Origin

The net short disclosure issue arose from the Windstream restructuring (2019-2020). Aurelius Capital Management was a senior unsecured creditor of Windstream. At the same time, Aurelius held a meaningful net short position via credit default swaps. Aurelius pushed Windstream's default, knowing that the default would trigger payment on its CDS position. The net short position created an economic incentive for Aurelius to push the company into default rather than to negotiate a workout.

The credit market reaction was a push for disclosure. New credit agreements began including net short provisions. The LSTA developed model language. The typical net short provision:

(a) Requires lenders to disclose if they hold a net short position (short position via CDS exceeding their long position in the loan).

(b) Disenfranchises net short lenders from voting on amendments and waivers.

(c) Treats net short lenders as defaulting lenders for some purposes, including yank-a-bank rights (allowing the borrower or other lenders to force a buyout of the net short lender).

(d) Restricts information rights of net short lenders, preventing them from receiving sensitive information that could be used to inform their short position.

The structural weakness of net short provisions: they are entirely self-disclosure based. The borrower or other lenders have no way to verify whether a lender has a net short position absent the lender's voluntary disclosure. The provisions are designed to deter the practice but cannot detect it. Sophisticated funds that want to maintain a long-short position will typically take care to manage the disclosure (which may include not signing onto credit agreements with net short provisions, or signing onto them while structuring positions to be technically compliant).

By 2024-2025, net short disclosure provisions are near-market-standard in new term loan issuances. Some funds (including some sophisticated long-short shops) have effectively been excluded from primary lending markets as a result.

4.2 Claims Trading

Claims trading is the secondary market for bankruptcy claims. The investor buys claims from holders at a discount, betting that the eventual recovery exceeds the purchase price.

Rule 3001(e) Mechanics

Federal Rule of Bankruptcy Procedure 3001(e) governs the transfer of claims in a bankruptcy case. The rule has two subsections.

Rule 3001(e)(1) applies to transfers before objection to the claim is filed. The transferee must file evidence of transfer with the court. The court typically substitutes the transferee for the transferor on the claims register without notice or hearing (unless the transferor objects within 21 days of the filing).

Rule 3001(e)(2) applies to transfers after objection to the claim has been filed. The procedure is more involved: the transferee must file evidence of transfer plus a motion to be substituted. The court holds a hearing.

The practical implication: most claims trading occurs under (e)(1) because the bulk of trading happens before claims are objected to. The transferee gets relatively quick substitution and ownership of the claim with all attached rights, including voting rights on the plan, distribution rights, and the ability to assert objections of the claim's prior owner.

The 21-day objection window matters because during that window, the transferor can object to the transfer (typically on the grounds that the transfer was for inadequate consideration). Bankruptcy courts have authority

to disallow or reduce a claim that was transferred for inadequate consideration if the transfer was inequitable. In practice, transferor objections under 3001(e) are rare; the more common scenario is that the transferor has signed an assignment for adequate consideration and is not objecting.

The claims register entries are public. Counterparty names and amounts are filed. The price is generally not filed (the assignment documents typically do not require disclosure of consideration). This creates an information asymmetry that distressed PMs use: the names of acquirers and the amounts being acquired are visible, but the price at which the claims are trading is not. This allows distressed funds to accumulate positions without telegraphing the price level.

Big Boy Letters: What They Protect and What They Do Not

In a distressed claim trade, the buyer is often more sophisticated than the seller. The seller may be an unsecured creditor (a trade vendor, for example) who is not a distressed credit investor and may not understand the value of the claim. The buyer is offering a price; the seller is accepting because the buyer's offer is the seller's best alternative to litigation or waiting through the bankruptcy.

A "big boy letter" is a contractual provision that the buyer obtains from the seller. The seller acknowledges that the buyer may have material non-public information about the borrower that affects the value of the claim, and that the buyer is not obligated to share this information. The seller waives any claim it might have against the buyer for selling at a price that turned out to be less than the eventual recovery.

The protection that big boy letters provide:

(a) Defense against the seller's later civil claim for breach of fiduciary duty or fraud. The seller cannot argue, "I would not have sold at that price if I had known what you knew." The big boy letter explicitly waives the reliance argument that is required for such a claim.

(b) Defense against private securities fraud claims under Rule 10b-5 in cases involving the trade of bankruptcy claims (which may or may not be deemed securities, depending on the structure).

The protection that big boy letters do NOT provide:

(a) Protection against SEC enforcement under Rule 10b-5. The SEC does not need to prove reliance in an enforcement action. Even if the seller waived reliance, the SEC can prosecute insider trading or market manipulation. This is particularly relevant in public-company bankruptcy contexts, where bond claims may be classified as securities.

(b) Protection against affiliated party fraud claims. A big boy letter from a seller does not waive the seller's affiliate's potential claims.

(c) Protection in jurisdictions outside the U.S. or in different regulatory regimes. The big boy letter is a contract; it operates only between the parties.

The practical implication: big boy letters are useful and standard, but they are not a complete defense. Sophisticated distressed PMs do not rely on big boy letters to permit aggressive trading in public-company contexts. They manage MNPI carefully and avoid trades that could expose them to SEC enforcement.

Accrued Interest on Transferred Claims

When a claim is transferred during the bankruptcy, the accrued interest issue arises. Bankruptcy interest accrual depends on:

(a) Whether the claim is over-secured (entitled to post-petition interest at the contract rate under §506(b)) or under-secured (post-petition interest accrual stops at filing, except for the solvent-debtor exception).

(b) The contract terms of the underlying debt.

(c) The intercreditor and waterfall provisions governing distributions.

For a transferred claim, the calculation involves splitting the recovery between the transferor (for the period before the transfer) and the transferee (for the period after).

The standard approach: the transferor and transferee agree on a cutoff date (typically the trade date). The transferor is entitled to the recovery attributable to the period before the cutoff; the transferee is entitled to the recovery for the period after. The split is documented in the assignment agreement.

If the underlying claim is over-secured, the post-petition interest accrual creates value during the bankruptcy. A claim purchased on day 100 of a case that ends on day 500 has 400 days of post-petition interest accrual entitled to the transferee. The transferor was entitled to the first 100 days. The economic split typically reflects this.

In practice, the assignment agreement specifies whether the transferee receives "all distributions including interest from and after the trade date" or "all distributions whenever made." The "all distributions" formulation means the transferee gets the full claim including any retroactive interest. The investor reads the assignment agreement carefully to identify which formulation applies.

4.3 Post-Reorg Equity

When a Chapter 11 plan distributes equity to creditors at emergence, the equity is the residual claim on the reorganized company. The investor decides whether to hold or sell, and the framework is more sophisticated

than a simple market price comparison.

The Stub Trade

The stub trade is the investor's choice to hold post-reorg equity rather than selling at emergence. The economics: the equity is a call option on the reorganized company's recovery. If the reorganized company performs well, the equity appreciates. If it performs poorly, the equity loses value (but the investor's basis in the equity is typically very low because the equity was a recovery on debt, not a separate purchase).

The valuation framework treats the equity as a call option:

Strike price: the implied value of the debt converted into equity. If the investor held a $100M claim and received 10 million shares in exchange, the implied strike is $10 per share.

Underlying value: the per-share value of the reorganized company at emergence. If the company emerges at $500M enterprise value with 50 million shares outstanding (post-emergence), the per-share value is $10. So the equity is "at the money" at emergence.

Volatility: distressed exit companies are highly volatile. 40-60% annualized volatility is typical.

Time to expiration: the holding period. If the investor plans to sell in three years, the time horizon is 3 years.

Risk-free rate: the prevailing risk-free rate.

The Black-Scholes value of an at-the-money call with these parameters is approximately 20-35% of the strike value. So an equity stub at "book value" has an option value of 20-35% above book if held for the holding period.

This option value is what the stub trade is capturing. The investor who sells at emergence is foregoing the option value. The investor who holds is paying for the option value through the opportunity cost of the capital tied up in the equity.

Section 1145 vs. Section 4(a)(2)

When a plan distributes securities to creditors, the securities can be issued under §1145 of the Bankruptcy Code or under §4(a)(2) of the Securities Act.

Section 1145: securities issued in exchange for an existing claim, in connection with the plan, are exempt from registration under the Securities Act. The securities are freely tradable. There are exceptions for "affiliates" (typically defined as 10% holders or with comparable influence) and for "underwriters" (parties who purchase securities for resale).

Section 4(a)(2): securities issued in private placement to accredited investors. These are restricted securities and subject to resale restrictions under Rule 144.

Most plans distribute under §1145 to maximize liquidity for creditors. But certain distributions (typically to large investors who would be deemed underwriters or affiliates) may be made under §4(a)(2). The §4(a)(2) distributions are subject to lock-up periods.

For the investor receiving post-reorg equity, the §1145 vs. §4(a)(2) distinction matters:

§1145 securities can be sold immediately at emergence. Subject to the 10% affiliate threshold, the investor can liquidate.

§4(a)(2) securities are restricted. The investor must comply with Rule 144 (typically a 6-month holding period from acquisition for non-affiliates, plus volume limitations for affiliates).

The investor holding §4(a)(2) equity has limited exit options during the lock-up period. The investor holding §1145 equity has full liquidity but may face market dynamics (overhang from other holders also selling).

Lock-Up Provisions and Trading Dynamics

When a plan distributes equity to many creditors simultaneously, there is a coordinated overhang of potential sellers at emergence. The plan typically includes lock-up provisions to manage this.

Typical lock-up structures:

(a) Staggered lock-ups. Different creditor classes have different lock-up periods. For example, the largest holders may be locked up for 180 days, while smaller holders may be locked up for 90 days. This creates staggered liquidity rather than a single dump.

(b) Volume restrictions. Even after lock-up expiration, holders may be restricted to selling no more than X% of their holdings per quarter. This stretches the selling pressure over a longer period.

(c) Right of first refusal. Some plans give the reorganized company or designated parties the right of first refusal on equity sales above a threshold. This allows the company to manage its capital structure as creditors monetize.

(d) Coordinated selling agreements. Some plans require holders to coordinate sales through a designated agent (typically the underwriter on the original distribution). This prevents simultaneous market-flooding.

The trading dynamics at lock-up expiration are predictable. The market typically experiences a price drop in the days leading up to lock-up expiration as sellers prepare. The drop can be 10-20% for highly held names. Sophisticated investors trade this: they buy at the bottom of the lock-up expiration dip and hold for the post-overhang recovery.

The Pat-level read: lock-up expiration is a known event. The trading desk has been positioning for it for months. The buyer in the post-lock-up dip is usually a fund that has been waiting for the price compression. The seller is a fund that needs to exit (either due to fund redemptions or to mark equity at cost-of-capital). Both sides know this. The dynamic is predictable; the trade is positional.

Governance Overlay

For Anchorage, the post-reorg equity is not just a financial position. It is a control position. The plan typically gives the equity-receiving creditors certain governance rights:

(a) Board seats. The plan establishes the board composition. Major creditors may receive observer seats or full board seats. Anchorage's typical position in a DIP-to-equity scenario is a board seat.

(b) Veto rights. Certain major decisions (M&A, refinancing, dividend payments) require board approval. With a board seat, Anchorage can influence these decisions.

(c) Information rights. Major equity holders receive ongoing information rights (monthly financials, board meeting attendance, materiality of board action notification).

(d) Tag-along and drag-along rights. If a majority of equity holders sells, they can drag-along other holders into the same sale (the minority is "dragged" into selling). Conversely, tag-along rights allow minority holders to participate in any sale by the majority.

The governance package is part of the investment thesis at Anchorage. The DIP-to-equity playbook is not just about the financial return on the equity; it is about controlling the post-emergence operational and strategic decisions. The board seat is what makes the long-hold (3-7 years) attractive: Anchorage can influence the company's direction over that period.

This is why Anchorage's stub trades are typically not exits at lock-up expiration. They are holds with active governance involvement. The economic return is supplemented by the strategic value of being on the board and influencing M&A decisions.

SECTION 5 : SECTOR DEEP DIVES

The three sectors below are Max's actual deal experience at Evercore: Newfold (web hosting), Cabinetworks (building products), and Tropicana plus the broader gaming sector (consumer / hospitality OpCo-PropCo). The advisory view is documents and structures. The investor view is unit economics, asset value, and the specific calculations that determine recovery.

5.1 Web Hosting and PE-Owned SaaS Rollups: Newfold Frame

Newfold Digital is a Clearlake Capital plus Siris Capital portfolio company. The company is a roll-up of legacy hosting brands (Bluehost, HostGator, Domain.com, Constant Contact, and others) accumulated over multiple acquisitions since 2018. The 2025 LMEs (October and December) restructured approximately $3.5B of debt.

Unit Economics of Web Hosting

Web hosting at the consumer and SMB tier is a melting-ice-cube business. The unit economics:

ARPU: small business shared hosting plans typically range from $10 to $20 per month, or $120 to $240 per year. Domain renewals and add-on services (SSL certificates, business email, security packages) add another $50 to $100 per year for engaged customers.

Customer acquisition cost: legacy brand acquisition is approximately $20 to $40 per customer, blended across digital marketing, partnerships, and channel referrals. New entrants (Wix, Squarespace, Shopify) have driven up CAC for the legacy players because they have superior product-market fit and capture customers before they would have gone to legacy hosting.

Customer lifetime: legacy hosting plans have customer lifetimes of 24 to 48 months. Customers churn for reasons including business closure (small business failure rate is roughly 20% in first two years, 50% by year five), upgrade to higher-tier hosting providers, or simply forgetting to renew when they no longer need the service.

Logo churn: 12% to 18% annually for the legacy hosting portfolio. Some segments (small business primary hosting) churn at the high end; some segments (long-tenured customers with multiple services) churn lower.

ARPU decline: existing customers see real ARPU decline of 2% to 4% per year as competitive pricing pressure compresses renewal pricing. New customer ARPU has been declining 4% to 6% per year as the market shifts to lower-tier products.

These dynamics combine into a revenue decay model that the investor must run.

The Revenue Decay Model

Starting position: Newfold has approximately $1.2B of annual revenue at the time of the 2025 LMEs (estimates vary; S&P and Moody's reports indicate revenue declined from approximately $1.4B in 2023 to $1.2B in 2025).

Year 1 (base year): $1.2B revenue. Year 2: 17% logo churn means losing 17% of revenue from customer attrition. Net new customer additions add roughly 8% (the company's new sales offset some but not all churn). Net subscriber change: minus 9%. ARPU decline of 3% on the remaining base. Total revenue decline: approximately 12%. Year 2 revenue: $1.06B.

Year 3: 17% churn continues, 8% new customer additions, 3% ARPU decline. Year 3 revenue: $930M.

Year 4: same dynamics. Year 4 revenue: $819M.

Year 5: same dynamics. Year 5 revenue: $721M.

Revenue CAGR over the 4-year decline: minus 12% per year. This is the melting ice cube.

EBITDA implications: hosting has 25-30% EBITDA margins at scale. Decline scenarios are worse because fixed costs are sticky (datacenter contracts, technology infrastructure, customer service costs do not decline proportionally with revenue). If Year 1 EBITDA margin is 28% ($336M on $1.2B revenue), Year 4 EBITDA margin may be 22-24% on declining revenue ($180-195M EBITDA on $819M revenue). The combination of revenue decline and margin compression compresses EBITDA from $336M to approximately $190M over four years.

EBITDA Quality Issues

PE-owned SaaS rollups typically report Adjusted EBITDA that overstates underlying cash EBITDA. The aggressive add-backs to investigate:

Integration cost add-backs: $30M to $80M per year, classified as one-time but recurring annually as new acquisitions are integrated. For Newfold, integration costs are typically related to platform migrations of acquired hosting brands onto unified infrastructure. These costs do not decline; they reset as new acquisitions occur.

Capitalized software development costs: $40M to $80M per year, capitalized as software assets rather than expensed. Hosting infrastructure requires constant software maintenance and feature development. Capitalization reduces reported operating expense and inflates EBITDA. The cash impact is identical to expensing.

Management fee add-backs: PE sponsor management fees of $10M to $25M per year, added back as if they were non-operating. These are real cash outflows but excluded from Adjusted EBITDA under the typical credit agreement.

Restructuring and severance add-backs: $15M to $40M per year of "non-recurring" restructuring costs. These tend to recur because the cost base is constantly being rationalized after acquisitions.

Synergy add-backs: 75% of LTM EBITDA grower basket capacity in some agreements. Synergies are projected, not realized. The borrower can add synergies from announcements that never materialize.

The investor haircut: apply a 15-20% reduction to Adjusted EBITDA to derive cash EBITDA. So if Newfold reports $580M Adjusted EBITDA, cash EBITDA is approximately $460M to $500M.

Apply leverage to cash EBITDA: $3.5B of debt on $480M cash EBITDA is 7.3x leverage. At 6.5x multiple of cash EBITDA, the implied enterprise value is $3.12B. Subtract the $3.5B debt: equity value is negative $380M. The first lien is impaired in the base case.

Liquidation Analysis

If Newfold goes to liquidation rather than reorganization, the asset components and their realizable values:

Domain portfolio: Network Solutions holds approximately 13 million domains under management. Domain registries have ongoing renewal value, but the going-concern value to a third party is lower than the registry's reported value. A liquidation buyer would pay perhaps 50-70% of LTM domain renewal revenue, which translates to $300M to $500M for the Network Solutions portfolio.

Customer base value: Constant Contact has approximately 600,000 email marketing customers paying $20 to $60 per month. The recurring revenue stream is approximately $300M annually. A liquidation buyer would pay 2-3x recurring revenue: $600M to $900M for the Constant Contact business.

Hosting customer base: legacy Bluehost, HostGator, and other hosting brands have a combined customer base of perhaps 6-8 million. Liquidation value of each customer is perhaps $30-50 in a forced sale: $180M to $400M combined.

IP and brands: the hosting brand names (Bluehost, HostGator) have brand equity for an acquirer in the space. Liquidation value of $100M to $200M is a reasonable estimate.

Real estate and infrastructure: $50M to $150M in datacenter contracts and physical infrastructure.

Total liquidation: $380M to $1.06B, with a midpoint near $700M. Against $3.5B of debt, the recovery is approximately 20% in a liquidation scenario.

LME Mechanics and Recent Activity

The 2025 LMEs were structured to avoid Serta exposure. Specifically:

October 2025: roughly $100M of new senior secured financing from PIMCO and GoldenTree, structured as a consent solicitation across all existing lenders. Tiered exchange: consenting lenders moved up to first-out priority; non-consenting moved down. Participation rate approximately 90%.

December 2025: an additional $100M raise from existing owners Clearlake and Siris Capital, structured as a preferred equity contribution. This provided liquidity for ongoing operations without further dilution of the credit structure.

Both transactions used consent solicitation mechanics (not "open market purchases") to avoid the Serta legal theory. The structures are post-Serta compliant.

The post-LME credit structure is approximately: - New senior secured 1st-out term loan: $100M, market trading near par - First lien term loan moved to 2nd-out: approximately $1.5B, market trading at 65-70 cents - Original unsecured notes converted to subordinated: approximately $400M, market trading at 25-35 cents - Trade payables and other: $200M

The first-lien-now-2nd-out is interesting because the discount of 30-35 points off par reflects market concerns about Newfold's ability to repay even with the new financing. The senior secured 2nd-out paper is essentially trading on the question of whether Newfold will need a second LME within 24 months. The probability is high enough that the market refuses to price the paper higher than 70 cents.

Sector Outlook 2026

The web hosting sector is in secular decline. New entrants (Squarespace, Wix, Shopify) are capturing the consumer and small business segment with superior products. Legacy hosting (Newfold's portfolio) is left with declining customers in the bottom-tier price segment. Margin compression is structural.

The investor read on Newfold: the LME bought time. The fundamental business is declining. Within 18-24 months, either Newfold finds a path to operational stabilization (unlikely given the sector dynamics) or returns to the market for another LME or files Chapter 11.

For a distressed PM, the trade on Newfold is to buy the 2nd-out term loan at 65-70 cents on the bet that even in a Chapter 11 scenario, the 2nd-out priority preserves a 50-60% recovery on the position, with potential upside from any operational stabilization. The trade is the cap-arb pair: long 2nd-out at 65, short the subordinated at 30. Convexity favors the long; the short locks in the assumption that the lower priority will recover less.

5.2 Building Products and Manufacturing: Cabinetworks Frame

Cabinetworks Group (formerly KCMA, now Platinum Equity portfolio per the most recent deal documents) is a cabinet manufacturer. The May 2026 LME closed with 98% and 99% participation rates across two phases.

Industry Economics

The U.S. cabinet industry has approximately $14B of annual revenue. Three segments dominate:

Stock cabinets: ready-to-assemble or assembled stock units, sold through home centers (Home Depot, Lowe's) and direct-to-builder. Lowest margin, most cyclical, most exposed to imports. Approximately 35% of market.

Semi-custom cabinets: cabinets with options for finishes, sizes, and configurations. Sold through kitchen and bath dealers, direct to homebuilders, and through home centers. Mid-margin, mid-cyclical. Approximately 45% of market.

Custom cabinets: fully bespoke. Highest margin, least cyclical. Approximately 20% of market, fragmented among smaller players.

Cabinetworks is primarily in the stock and semi-custom segments through brands including Merillat, Mid Continent Cabinetry, KraftMaid, and others.

Revenue drivers: U.S. housing starts (new construction) account for approximately 30% of cabinet demand. Repair and remodel account for the other 70%. Repair and remodel is more stable than new construction; it dropped less in the 2008-2009 housing crisis and recovered earlier.

Housing starts in 2024 were approximately 1.4M units annually. The 2008-2009 trough was 550K. The 2020-2022 peak was 1.6M. The current 1.4M is below the long-run normalized run rate of approximately 1.7M, reflecting affordability pressures (high mortgage rates, elevated home prices) but not crisis-level.

Tariff impact: April 2026 implementation of 145% Chinese cabinet tariffs is a structural change. Cabinetworks competes with imported Chinese cabinets in the stock and semi-custom segments. The 145% tariff makes imported product approximately 200-250% the cost of domestic. Domestic producers like Cabinetworks gain pricing power and market share.

Cabinetworks Financials

Revenue estimates (from S&P/Moody's reports and S-1 disclosures): - 2023: $2.1B - 2024: $2.0B - 2025: $1.9B (declining with housing slowdown) - 2026E: $1.95B (modest recovery from tariff tailwind)

EBITDA margin in the 11-12% range. Reported EBITDA of $180-230M. After investor add-back haircut of 15%, cash EBITDA is approximately $155-195M.

Leverage at the time of the LME: approximately 7.5x to 8x cash EBITDA. Total funded debt approximately $1.45B pre-LME.

LME Mechanics

The May 2026 LME was structured as a universal pro-rata consent solicitation. The mechanics:

Phase 1 (May 8): all term loan lenders offered the opportunity to consent to amendments. Consenting lenders received a new $100M of first-out priority debt (their existing position moved to second-out, but they received additional senior allocation). 98% of term loan lenders consented.

Phase 2 (May 18): all unsecured noteholders offered the opportunity to consent to an exchange. Consenting noteholders exchanged their unsecured notes for new senior secured notes due November 2031. The unsecured exchange did not raise new money but moved noteholders from unsecured to secured priority. 99% of noteholders consented.

This is the cleanest post-Serta structure currently in market. No "open market purchase" terminology was used. The consents were universally offered. Non-consenters were treated equally to consenters (they remained in their original position, no priming).

The post-LME credit structure: - New 1st-out term loan: $100M, market trading near par - Original term loan moved to 2nd-out: approximately $850M, market trading at 80-85 cents - New senior secured notes (former unsecured): approximately $400M, market trading at 90 cents - Trade payables: $100M

The 2nd-out term loan at 80-85 cents reflects market expectation of operational stabilization with the tariff tailwind, partially offset by execution risk and macro uncertainty.

Asset Liquidation Analysis

If Cabinetworks goes to liquidation:

Manufacturing equipment: NADA values for production cabinetry equipment in good operating condition are approximately 60-70% of acquisition cost. Cabinetworks has multiple manufacturing facilities with significant equipment investment. Liquidation value: $120M to $250M.

Real estate: Cabinetworks owns approximately 60% of its manufacturing footprint (10-15 facilities). Owned real estate liquidation value: $150M to $300M, depending on location and condition.

Inventory: finished goods, work-in-progress, raw materials. Liquidation value: $50M to $100M.

Trade name and customer relationships: $20M to $50M.

Total liquidation: $340M to $700M. Against $1.45B of debt, liquidation recovery is approximately 30-45%.

This is meaningfully higher than Newfold's liquidation recovery because Cabinetworks has hard assets (manufacturing equipment, real estate, inventory) that have value in non-distress contexts.

Sector Outlook 2026

The 2026 cabinet sector outlook is bifurcated:

Positive catalysts: - 145% Chinese cabinet tariffs (April 2026) drives domestic share gains - Repair and remodel demand has been resilient - Housing market normalization in 2026-2027 could increase new construction demand

Negative catalysts: - Macro uncertainty affecting consumer durable spending - Affordability constraints on housing - Competition from other domestic producers (American Woodmark, MasterBrand) - Supply chain costs (lumber, hardware, finishes)

The investor read on Cabinetworks: the May 2026 LME provides 18-24 months of runway. The tariff tailwind is meaningful. If operational performance stabilizes by 2027, the second LME may not be needed. If operational performance deteriorates (recession, supply chain disruption), another LME or Chapter 11 follows.

For a distressed PM, the trade is more attractive than Newfold because the asset coverage is better. The 2nd-out term loan at 80-85 cents has potential 90-100% recovery in a positive scenario and 50-65% recovery in a Chapter 11 scenario. The asymmetric payoff favors the long position.

5.3 Gaming and Hospitality: Tropicana Frame and OpCo/PropCo Structure

Tropicana Brands Group is the juice company (PAI Partners portfolio, carved out of PepsiCo in 2022). It is not the Las Vegas casino. The May 2025 LME involved $400M of new cash with select lenders moved ahead in priority via non-pro-rata treatment.

But the broader sector framework here is gaming and hospitality, where OpCo/PropCo bifurcation creates unique distressed mechanics. Anchorage has historical exposure to gaming credits (Caesars/CEOC, Tropicana Vegas), so the investor needs to know both.

Tropicana Brands Group (Juice Frame)

The juice industry economics: U.S. juice consumption has been declining for two decades. Health-conscious consumers move from juice to bottled water, sparkling water, and other beverages. Branded juice has lost market share to private label.

Tropicana, Naked, and KeVita are the primary brands. PAI acquired the juice business from PepsiCo in 2022 at approximately $3.3B enterprise value. The business has approximately $2.3B of revenue and EBITDA of $200-250M (estimates vary across reporting periods).

The May 2025 LME mechanics:

Total raise: $400M new cash from select lenders.

Structure: an ad hoc group of first lien lenders (approximately 60% of term loans) participated in the new money raise. These lenders received first-out priority on a new term loan, plus their existing term loans were moved to second-out. Non-participating lenders' term loans were moved to third-out. So the participating lenders ended up with first-out and second-out priority; non-participants ended up at third-out.

Pricing: the participating lenders effectively received 91 cents per dollar of original claim through the new financing and the second-out preservation. Non-participating lenders ended up at 70 cents implied recovery in the new structure.

This is canonical non-pro-rata lender-on-lender warfare. The participating lenders captured value at the expense of non-participants. The legal theory was that this was an amendment under required-lender consent (not an open market purchase), so the Serta legal theory does not apply.

The non-participating lenders did not sue. The reason: the participating ad hoc group held approximately 60% of the term loan, which gave them required-lender consent. The amendment was structurally legal under the credit agreement. The non-participants had no claim of breach.

This is the post-Serta playbook: structure the LME as an amendment under required-lender consent, not as a purchase. The borrower can extract value from non-participants through priority modification, with no direct breach of the credit agreement.

Gaming OpCo/PropCo Structure: The General Framework

The gaming sector developed the OpCo/PropCo structure in the post-Caesars era (2017 onward). The mechanics:

OpCo: the operating company. Holds the gaming license, runs the casino, employs the workforce. Generates EBITDA from operations.

PropCo: the property company. Owns the real estate (the building, the land, sometimes the casino chips and gaming equipment). Receives rent from the OpCo under a master lease.

The structure was created to extract value for sponsors via spin-offs and to provide tax-advantaged structures (PropCo as REIT). The major PropCos: VICI Properties (formerly Caesars REIT), Gaming and Leisure Properties Inc. (GLPI), MGM Growth Properties (subsumed into VICI).

The PropCo leases assets to multiple OpCo tenants. GLPI's tenants include Penn Entertainment (Hollywood Casinos), Bally's (legacy Tropicana, Bally's), Boyd Gaming. VICI's tenants include Caesars Entertainment, MGM Resorts, multiple regional operators.

The lease economics: triple-net leases. The OpCo pays all property taxes, insurance, and maintenance. The OpCo also pays base rent plus percentage rent based on revenue thresholds. Rent escalators tied to CPI or

fixed bumps. Rent coverage ratio (EBITDAR / Rent) is the key metric.

EBITDAR = EBITDA + Rent. This is the cash flow available to service rent. The rent coverage ratio is EBITDAR divided by Rent. Healthy operators have rent coverage of 2.0x or higher. Stressed operators are at 1.5x or lower.

EBITDAR Versus EBITDA: Why It Matters

For a normal operating company, EBITDA is the cash flow metric. For an OpCo with significant lease obligations, EBITDA is misleading because the rent expense is fixed and contractual. EBITDAR (adding back rent) is the better measure of operating cash flow available to all stakeholders, including the landlord.

In a normal corporate analysis, you compare EBITDA to interest expense plus principal repayment to assess debt service capacity. In a gaming OpCo, you compare EBITDAR to rent plus interest plus principal repayment, because rent is functionally equivalent to a senior debt obligation.

EBITDA-to-EBITDAR conversion: if EBITDA is $200M and Rent is $150M, EBITDAR is $350M. The rent coverage ratio is 2.33x. The all-in coverage ratio (EBITDAR over Rent plus Interest) gives the stakeholder-wide view.

For investors in gaming OpCo debt, the rent coverage ratio is the early-warning indicator. A coverage ratio below 1.5x typically signals the OpCo is in trouble. The OpCo cannot reduce rent (the PropCo is a non-debtor with fixed contractual rent), so the only way to fix the coverage ratio is to improve EBITDA (operating turnaround) or restructure the rent (negotiate with the PropCo, which requires the PropCo's consent).

Bally's at 1.69x rent coverage in 2026 is the most stressed gaming OpCo in the GLPI portfolio. Without significant operational improvement, Bally's may need to restructure its lease arrangements, which would require either GLPI's consent or a Chapter 11 process to compel restructuring.

Gaming License as a Zero-Liquidation-Value Asset

The gaming license is required to operate a casino. Without the license, the building is just a building. The license has enormous going-concern value but essentially zero liquidation value.

The reason: gaming licenses are state-regulated. Transfer of a gaming license requires state regulatory approval. Approval typically takes 12 to 24 months, requires extensive disclosure of the new owner's background, financial capability, and integrity, and is often subject to public hearings. In a liquidation context, the buyer cannot operate the casino during the approval process. The 12-24 month gap between purchase and operation makes the license effectively unsellable in a distressed sale.

This has profound implications for Chapter 11 strategy in gaming. A 363 sale cannot easily transfer the operating business because the license transfer takes too long. Instead, the gaming OpCo restructures through a plan that preserves the license. The plan reorganizes the debt without transferring the license to a new entity.

The investor implication: credit-bidding in a gaming case has limited value because the credit-bidder must wait 12-24 months for license approval. During that period, the casino either continues operating (and the credit-bidder is the equity owner-in-waiting) or shuts down (destroying enterprise value). Most gaming Chapter 11s are negotiated workouts rather than 363 sales for this reason.

The Non-Debtor Landlord Problem

When a gaming OpCo files Chapter 11, the PropCo (the landlord) is typically a non-debtor. The PropCo is not in bankruptcy and is not subject to the bankruptcy court's jurisdiction. The PropCo has contractual rights under the master lease.

The non-debtor landlord problem: the OpCo wants to restructure the lease (typically by reducing rent). The PropCo does not have to agree. The bankruptcy court does not have the power to compel the PropCo to reduce rent because the PropCo is not in bankruptcy.

The OpCo's options:

(a) Negotiate with the PropCo. Offer something in exchange for rent reduction. The PropCo will demand consideration: an equity stake in the reorganized OpCo, a longer lease term, an upfront payment.

(b) Reject the lease. Under §365 of the Bankruptcy Code, the OpCo can reject the lease. Rejection terminates the lease and gives the PropCo a damages claim (typically capped at the greater of one year or 15% of the lease term, capped at 3 years' worth of rent). But the OpCo no longer has the right to occupy the property. The OpCo must find a new property or shut down.

(c) Assume the lease. The OpCo assumes the lease, which means the OpCo cures all pre-petition defaults and agrees to perform going forward. This requires the OpCo to be able to perform; if the lease economics are unsustainable, assumption merely defers the inevitable.

The Caesars/CEOC case (2015-2017) is the archetype. Caesars Operating Company (CEOC) filed Chapter 11 with a complex capital structure including a parent guarantee and a master lease to Caesars Entertainment Properties. The case involved fraudulent transfer claims against the parent guarantor, intercreditor warfare among CEOC's secured and unsecured creditors, and ultimately the spin-off of VICI Properties as a new PropCo REIT.

The outcome: $17B of debt shed through the restructuring; VICI born as a PropCo REIT. CEOC emerged as a leaner OpCo. The complexity of the case (it spanned multiple districts, involved multiple debtors, and required SCOTUS-bound jurisdictional disputes) makes it the case study for OpCo/PropCo distress.

Current Gaming Operator Health

The 2025-2026 gaming operator landscape:

Caesars Entertainment: post-CEOC, has rebuilt to leverage of approximately 4.5x. Rent coverage of approximately 2.5x. Stable.

MGM Resorts: leverage of approximately 4.0x. Rent coverage of approximately 3.0x. Stable, with strong Las Vegas Strip exposure.

Penn Entertainment: leverage of approximately 5.0x. Rent coverage of approximately 2.0x. Adequate.

Boyd Gaming: leverage of approximately 3.5x. Rent coverage of approximately 3.0x. Strong.

Bally's Corporation: leverage of approximately 7.0x. Rent coverage of approximately 1.7x. Most stressed in the sector.

Wynn Resorts: leverage of approximately 5.5x. Rent coverage not applicable (no PropCo structure). Adequate.

The investor opportunity in gaming distressed is currently concentrated in Bally's (most stressed) and potentially in regional operators that have weaker franchise positions. The OpCo/PropCo structure means that distressed gaming credits typically involve a non-debtor landlord that must be negotiated with separately, making the cases more complex than typical corporate distressed.

For Anchorage specifically: gaming was a historical specialty (Caesars/CEOC was a major case). The structured complexity of gaming distressed plays to Anchorage's "smaller / more complex capital structures" mandate in ACO IX. If Bally's experiences further deterioration, Anchorage would be a likely participant in any restructuring discussion.

SECTION 6 : PAT McGRATH'S ACTUAL QUESTIONS: THE ADVERSARIAL VERSION

These five questions are the technical questions Pat uses to separate people who know the concepts from people who have used them. Each question gets three components: (a) what Pat is actually testing, (b) the complete correct answer, and (c) the follow-up he will ask if you answer (b) correctly. Read each one twice. The follow-up is where the conversation actually develops; getting (b) right just earns you the right to engage with (c).

Q1

"You're holding $50M face of Newfold first lien at 72 cents when the LME is announced. The exchange offer is 85 cents of new super-priority paper for every $1 of old first lien. You have 5 other lenders who you think will participate. Do you participate, and walk me through your exact decision framework."

(a) What Pat is actually testing

Pat is testing whether you can construct a probability-weighted decision tree under time pressure. He is testing whether you understand that the participation decision is not "is the offer good" but "what is my expected recovery in each outcome, what are the probabilities, and what is my best option given the decision tree." He is also testing whether you correctly identify the optionality of being a non-participant and how the blocking threshold modifies your leverage.

He is testing one more thing that is harder to articulate: whether you instinctively reach for legal protection or for economic analysis first. A Davis Polk associate by training reaches for "what does the credit agreement permit." Pat needs you to start with "what is my expected recovery." The legal analysis is a constraint, not the decision.

(b) The complete correct answer

The decision framework runs in this order.

First, my basis is 72 cents. My total position is $50M face, so my cost basis is $36M. The exchange offer is 85 cents in new super-priority paper. If I participate, I receive $42.5M of new super-priority paper for my $50M of old first lien. My implied gain on participation, assuming the new paper trades to par, is $42.5M minus $36M, or $6.5M of gain. The IRR depends on how quickly the new paper trades up.

Second, I need to assess the non-participation outcome. If I do not participate, my $50M of first lien is subordinated below the new super-priority paper. My recovery depends on three scenarios:

Scenario A: The LME succeeds and Newfold stabilizes. In this scenario, the new super-priority paper gets paid in full over time. My subordinated first lien gets paid after the new paper, but Newfold's cash flows may not be sufficient for full repayment. Historical analogs suggest recovery of 30-50% on subordinated holdout positions over a 24-36 month hold.

Scenario B: The LME succeeds initially but Newfold files Chapter 11 within 18 months. In this scenario, my legal claim is whether the LME was a fraudulent transfer or otherwise invalid. If my claim survives, I can claw back the priming. If it does not, I am deeply subordinated.

Scenario C: I litigate, the litigation has settlement value, and I extract an enhanced position. Historically this produces 5-15 percentage points of enhancement above the original exchange economics.

Third, I assess probabilities. Newfold is a melting ice cube. Revenue is declining 12% per year. The first LME was October 2025. The second was December 2025. The pattern suggests recurring LMEs. My probability assessment:

P(Newfold stabilizes operationally): 25% P(Newfold needs another LME within 18 months): 50% P(Newfold files Chapter 11 within 24 months): 25%

Fourth, I weigh the participation case against the non-participation case.

Participation expected recovery: weighted across scenarios. If stabilizes, 95% of new paper par. If another LME, the new paper may itself be primed. If Chapter 11, the new paper has super-priority and likely recovers 75-85% (assuming the priming holds). Weighted: 25% × 95% + 50% × 75% + 25% × 80% = 23.75% + 37.5% + 20% = 81.25% of $42.5M = $34.5M expected recovery on the new paper.

Non-participation expected recovery: subordinated first lien outcomes weighted. If stabilizes, 40% recovery on the subordinated first lien. If another LME, my position is further primed but I may have a litigation claim. If Chapter 11, recovery depends on the FT claim. Weighted: 25% × 40% + 50% × 25% (with litigation enhancement) + 25% × 40% (with FT claim success) = 10% + 12.5% + 10% = 32.5% of $50M = $16.25M.

Participation looks better by approximately $18M of expected recovery against my $36M basis.

Fifth, I check the blocking threshold. I hold $50M of approximately $1.5B of first lien paper. That is 3.3%. Far below the 33.4% blocking threshold. I cannot block on my own. With 5 other lenders, the combined position depends on their sizes. If they collectively hold another 30%, the group has approximately 33% and could block. If they hold 10%, the group has 13% and cannot block.

If the group cannot reach 33%, the LME will pass regardless of my decision. My choice is purely about what happens to me, not about whether the LME proceeds. In this case, I participate.

If the group can reach 33%, we have leverage. We can demand enhanced economics, perhaps 5 to 10 points above the original 85 cents offer. The participation case improves further. I still participate (or hold out to extract the enhancement, depending on the coordination).

Final decision: I participate. The participation outcome dominates the non-participation outcome on probability-weighted recovery, and my position is too small to block.

(c) The follow-up Pat asks if you get this right

"Okay. Now assume you have 35% of the term loan, not 3.3%. Same exchange offer. What changes?"

The follow-up is testing whether you understand that being a blocking position changes the game entirely. At 35%, you are not deciding whether to participate; you are deciding what enhanced terms you can extract. The conversation shifts from "participation math" to "negotiation strategy." The right answer at 35%: hold out, signal that the LME cannot proceed without your consent, and demand 92 cents (an additional 7 percentage points) plus enhanced priority on the new paper. The borrower has to choose between giving you the enhancement and going back to the drawing board. In most cases, the borrower gives the enhancement.

Q2

"Cabinetworks files Chapter 11. You're the second lien. First lien is fully covered at any reasonable TEV. Walk me through how you think about your DIP strategy. Do you provide the DIP, do you try to block a first lien DIP, or do you let the first lien control the case and fight at plan?"

(a) What Pat is actually testing

Pat is testing your understanding of second lien strategy when the first lien is over-covered. The standard advisory framing is that the second lien is largely irrelevant when the first lien is over-covered. Pat needs you to flip that and articulate the second lien's actual leverage points, which are limited but real.

He is also testing whether you understand that DIP financing is the control point in Chapter 11. Whoever provides the DIP shapes the case. If the first lien provides the DIP with a roll-up, the first lien locks in a strong negotiating position from day one. If you can disrupt or condition the first lien DIP, you can extract concessions.

(b) The complete correct answer

Cabinetworks at the time of filing has approximately $1.5B of debt: $950M of first lien (post-LME, including the new 1st-out plus the moved-down 2nd-out) and $400M of senior secured notes (converted from unsecured), with the rest in other obligations. Stipulating that the first lien is fully covered at any reasonable TEV: that means TEV is at least $1.0B, and the senior secured notes will recover at least partially.

As the second lien (functionally meaning the senior secured notes that are below the term loan), my strategy depends on whether I am over-covered, partially covered, or wiped out.

If TEV is $1.5B or higher, I am fully covered. Both the first lien and I are paid out. I should be relatively passive: the case is about timing and ensuring the plan distributes value to me in cash or equivalent.

If TEV is $1.0B to $1.4B, I am partially covered. The first lien is whole; my class receives a partial recovery. My strategy is to maximize my recovery percentage.

If TEV is below $1.0B, I am wiped out. My economic recovery is zero. My strategy shifts to extracting value through other mechanisms (litigation, plan voting leverage if I am in an impaired class with voting power).

Assume TEV is approximately $1.2B. I am partially covered. My expected recovery is approximately 50%.

DIP strategy options:

Option 1: Let the first lien provide the DIP. If the first lien provides a typical DIP-to-exit conversion structure, they lock in priority and roll up some pre-petition debt. The DIP becomes the exit term loan; the first lien becomes the equity-receiving creditor at confirmation. My class either receives a recovery in the plan or is squeezed out. The first lien has limited incentive to negotiate with me because they control the case.

Option 2: Provide a competing DIP. I can offer a DIP that competes with the first lien's DIP. To win, I need to offer better terms (lower interest rate, lower fees, smaller or no roll-up). The first lien will match or beat my offer because they have structural advantages (their existing first lien priority, their information about the company). I am unlikely to win, but the threat may force the first lien to improve their DIP terms (lower roll-up, current pay interest to me as adequate protection).

Option 3: Object to the first lien DIP. I can object on grounds including: roll-up size, scope of priming, adequate protection for my position, exclusivity provisions. Objections rarely defeat a DIP but can extract concessions.

Option 4: Negotiate for enhanced post-petition treatment. Ask the first lien for adequate protection (current pay interest on my partially-secured claim, replacement liens). Ask for committee participation. Ask for a carve-out from the DIP for my benefit.

My best strategy is Option 3 plus Option 4: object to the first lien DIP and negotiate for enhanced treatment as a condition of withdrawing my objection. The objections create leverage. The negotiation captures value.

Specifically:

(a) Adequate protection: I demand current-pay interest on my over-secured portion (the portion of my claim covered by collateral value after the first lien) at the contract rate.

(b) Adequate protection for diminution: I demand replacement liens on post-petition assets to compensate for any decline in collateral value.

(c) Carve-out: I negotiate for a carve-out from the DIP super-priority in the amount of my anticipated recovery (or some agreed lower amount), ensuring that even if value erodes during the case, I retain some recovery.

(d) Plan considerations: I negotiate now (during the DIP discussions) for treatment under the plan. The DIP order can pre-agree certain plan parameters: minimum recovery to my class, equity allocation if I am the fulcrum.

This is the practical playbook for a second lien in an over-covered first lien situation. The DIP negotiations are the leverage point. The plan itself is largely set once the DIP order is approved.

The alternative scenario is if TEV is below $1.0B and I am out of the money. Then my strategy shifts to litigation. I look for fraudulent transfer claims (against the LME participants), adequacy of disclosure in the Chapter 11 case, classification objections to plan confirmation. The economic recovery is zero but I can extract nuisance value through litigation costs imposed on the first lien.

(c) The follow-up Pat asks if you get this right

"Suppose the first lien offers you a 100% recovery in the plan in exchange for not objecting to the DIP. You're at the bottom of the second lien class, where there are some smaller noteholders who you think won't oppose the plan. Do you take the deal, or do you push for more?"

The follow-up tests whether you understand the dynamic of being the lead negotiator for your class. Smaller noteholders will follow your lead. If you settle, the class settles. If you fight, the class fights. The right answer: explore whether you can get more without breaking the deal. The first lien is offering you 100% recovery; they are pricing the cost of dispute. If you push for principal at face plus accrued interest at contract rate (which is often higher than 100% if the case has lasted long enough), the first lien might say no and you lose the 100%. But you can push for ancillary considerations: covenant releases, dispute resolution favorable to your interests, board observer rights post-emergence, an undertaking by the reorganized company to refinance your notes within 18 months. These are typically not contested but provide real value.

Q3

"I'm looking at a credit agreement and I see a grower basket defined as the greater of $150M and 50% of Consolidated EBITDA, with Consolidated EBITDA defined to include cost savings addbacks for any initiative 'commenced or expected to be commenced' within 24 months. What does that tell you about the borrower's ability to do a drop-down, and how does it affect your decision to buy the debt?"

(a) What Pat is actually testing

Pat is testing whether you can read EBITDA definitional language as a measure of basket capacity. The literal language of the grower basket is just a formula; the EBITDA definition determines what the formula produces.

He is testing whether you understand that "expected to be commenced" language is the loosest possible synergy add-back framework. This language allows the borrower to add expected synergies from announcements that have not yet been made. It is the worst case for lender protection.

He is also testing whether you can convert this analysis into a buy or pass decision on the underlying debt.

(b) The complete correct answer

The grower basket is structured to scale with reported EBITDA. The definition of Consolidated EBITDA controls the actual basket capacity.

The synergy add-back: "any initiative commenced or expected to be commenced within 24 months." This is the worst-case lender language. It allows the borrower to:

(a) Add back synergies for initiatives that have been announced internally but not publicly disclosed.

(b) Add back synergies that are expected to be announced within the next 24 months, not just initiatives that have already been announced.

(c) Add back synergies regardless of whether the savings are actually realized. The language does not require realization; only that the initiative was commenced or expected to be commenced.

In practice, this typically inflates reported EBITDA by 15-30% over actual cash EBITDA. For a borrower with $200M of actual cash EBITDA, the reported EBITDA could be $250M to $260M, possibly higher in aggressive cases.

The grower basket is the greater of $150M and 50% of Consolidated EBITDA. At reported EBITDA of $260M, 50% is $130M. The greater is the $150M floor, so the grower basket is $150M.

But wait. If the borrower can also stack the starter basket (typically $50M for this size of credit) and the builder basket (cumulative net income plus equity contributions, often $100M+ in a mature credit), the total investment capacity in unrestricted subs is $150M + $50M + $100M = $300M.

For a credit with approximately $1.5B of debt and an enterprise value of perhaps $1.8B-$2.0B, $300M of unrestricted-sub investment capacity is 15-20% of enterprise value. That is high.

In a stress scenario, the borrower can use this capacity to drop down approximately $300M of value to an unrestricted subsidiary, fund new super-priority debt at that subsidiary, and effectively prime the existing lenders by $300M.

The probability of this happening in the 18 months following the credit agreement closing depends on the borrower's stress level. For a credit purchased at distressed prices, the probability is high. For a credit at investment-grade pricing, the probability is low.

The decision framework on whether to buy the debt:

If the bond is trading at par or near par (less than 5% discount), I generally do not buy. The drop-down vulnerability gives the borrower a structural option to extract value at my expense. The 5% discount does not compensate me.

If the bond is trading at 70-80 cents, I might buy, but I need to discount my expected recovery for drop-down risk. Assume the drop-down extracts 15-20% of enterprise value before I get any recovery. If my expected recovery without drop-down risk is 60%, my expected recovery with drop-down risk is 45-50%. At 75 cents, that is barely break-even.

If the bond is trading at 50-60 cents, I might buy aggressively. The drop-down risk is more than priced in. My downside is constrained because I am already at a deep discount; my upside is the potential reversal of the drop-down through litigation if the borrower executes it.

The key analytical step is to compare the basket capacity (which determines drop-down severity) to the enterprise value cushion (which determines my recovery). A high basket capacity plus a thin enterprise value cushion is a structural sell signal. A low basket capacity or a thick enterprise value cushion is acceptable.

The specific language "commenced or expected to be commenced" is the worst version. If I see this in a credit I am evaluating, I add a 10-15% discount to my expected recovery to compensate for EBITDA inflation enabling broader basket capacity than the headline number suggests.

(c) The follow-up Pat asks if you get this right

"Now assume the company is also rated Caa1 with a stable outlook. The maturity is in 30 months. Spreads are tight. The bond trades at 91 cents. Do you buy?"

The follow-up tests your ability to integrate the structural analysis with current market pricing and macro context. A Caa1 stable outlook means the rating agencies expect default risk to be elevated but not imminent. The 30-month maturity means there is a hard catalyst. Spreads being tight means the market is not pricing in the structural risk you have identified.

The right answer: at 91 cents on a 30-month maturity, the YTM is approximately 13-15%. The basket capacity gives the borrower a structural option that may be exercised before the maturity. If I buy at 91, my expected return depends on whether the borrower exercises the option. If yes, I lose 15-20 cents (drop-down + post-LME repricing). If no, I earn the coupon and get repaid at par. The probability of exercising the option in 30 months: 50-60%. My expected return: 50% × (91 - 75) + 50% × (91 - 105) = 8% gain and 14% loss, net negative. I pass at 91 cents. I would buy at 75 cents.

Q4

"The reorganized company emerges with $800M of exit debt and $200M of equity distributed to the old fulcrum class. The exit debt trades at 95 on emergence day. The equity is locked up for 180 days. You were the fulcrum and you're getting the equity. Do you hold or do you sell as soon as the lock-up expires, and what's the analytical framework?"

(a) What Pat is actually testing

Pat is testing whether you understand the post-emergence trading dynamics and the option value of holding equity. He is testing whether you can size the option value relative to the foregone cash. He is testing whether you understand the predictable overhang at lock-up expiration and how to trade around it.

He is also testing whether you frame post-emergence equity as a binary "hold or sell" decision or as a continuous "how much to sell at what pace" decision. The continuous framing is the more sophisticated answer.

(b) The complete correct answer

The economic framework for post-emergence equity:

I received $200M of equity in exchange for my fulcrum claim. The equity is the residual claim on the reorganized company. The reorganized company has $800M of exit debt and $200M of equity outstanding, for a total enterprise value of $1.0B.

The equity at emergence is essentially at-the-money on the company. If the company performs at expectations, the equity stays around $200M of value. If it performs better, the equity appreciates. If worse, it loses value.

The option-pricing framing: the equity has option value because of volatility. Distressed-exit companies typically have 40-60% annualized equity volatility. Over a 12-month period, the equity could realistically range from 50% to 200% of its emergence value.

Black-Scholes value of an at-the-money call with 50% volatility and 12-month expiration is approximately 22% of strike. So holding the equity for 12 months has approximately 22% option value above the cash sale value at emergence (after accounting for the time value of the deferred cash).

The lock-up dynamic: the 180-day lock-up creates an overhang. Many holders will sell at lock-up expiration. The market knows this. The market typically prices in a 10-15% discount in the weeks leading up to lock-up expiration.

If I sell immediately at lock-up expiration, I am selling at the overhang discount. I receive approximately 85-90% of what the equity would be worth absent the overhang.

If I hold past lock-up expiration, I capture the recovery as the overhang clears. Typically 30-60 days after lock-up expiration, the price recovers to pre-overhang levels.

The continuous selling framework: rather than a binary decision, I plan a phased sale.

(a) Sell 20% in the first 30 days after lock-up. The price is at the overhang discount. I am giving up some value but capturing liquidity for cash deployment elsewhere.

(b) Sell 30% over the next 60-90 days. The price is recovering from the overhang. The yield on remaining holdings is improving.

(c) Hold 50% for 1-3 years. This is the option value bet. The company either appreciates (if operations improve) or declines (if it does not). I am holding for the asymmetric upside.

The phased approach captures the overhang discount on early sales (necessary for cash) while preserving option value on the bulk of the position.

The exception: if the company has fundamental problems and the equity is essentially worth zero in any reasonable scenario, I sell as much as possible at lock-up expiration. The overhang discount is the worst price I will get; the price will continue declining as fundamentals deteriorate.

The Anchorage-specific consideration: Pat does not just trade the equity. He sits on the board. His decision to hold or sell is also a governance decision. If I hold the equity, I retain board influence over the reorganized company's strategy. If I sell, I lose that influence.

For Anchorage's DIP-to-equity playbook (J.Crew, At Home), the typical hold period is 3-7 years. The board seat is part of the investment thesis. So the right answer for Anchorage is: hold the majority of the equity for the long hold, sell at the margins for liquidity.

For a smaller fund without the resources to sit on the board and influence operations, the answer might be different. Sell more aggressively at lock-up expiration. Capture the value and redeploy capital.

(c) The follow-up Pat asks if you get this right

"Six months after emergence, the equity has traded down to 60% of emergence value. The company missed its first quarter guidance. The CEO is being replaced. Your board observer says he expects another miss in Q2. Do you sell now or hold?"

The follow-up tests whether you can update your thesis as new information arrives. The Q1 miss plus CEO replacement plus expected Q2 miss is a deteriorating fundamental picture. The 60% trading level reflects this.

The question is whether to cut losses or hold the option.

The right answer: I sell. The trade thesis was that the equity would appreciate from operational stabilization. The Q1 miss plus the CEO change indicate that stabilization is not happening. The pattern (one miss, leadership change, another expected miss) is classic operational deterioration. The risk of further decline outweighs the option value. I cut.

The harder version of this question: what if the equity is at 60% but the company's competitive position has actually improved (gained market share, won a major contract)? The underlying business is better, but the earnings are below guidance. Now the answer changes. I might hold, because the business is improving even if reported earnings are below expectation. The trade thesis is still alive.

The Pat-level skill is distinguishing between these two scenarios in real time. The Q1 miss is data. The CEO change is data. The board observer's view is data. The question is whether the data points to deterioration or to a temporary setback in a stabilizing business. The answer requires judgment, not just analysis.

Q5

"What's the difference between a successful LME and a failed one from a creditor's perspective? Not mechanically, but economically. When does participating in an LME destroy value for the participating lender?"

(a) What Pat is actually testing

Pat is testing whether you understand that successful and failed LMEs are not just about whether the company avoids bankruptcy. He is testing whether you can frame LME outcomes from the participating lender's economic perspective, where the question is about your return on the trade, not the company's survival.

He is also testing whether you understand the value destruction case: when participating in an LME locks in a worse outcome for the participating lender than holding out. This is the counterintuitive case that distressed PMs must internalize.

(b) The complete correct answer

A successful LME from a creditor's perspective has three characteristics:

(a) The exchange ratio at par or near par to expected recovery. If the participating lender exchanges $100 of original claim for $90 of new super-priority paper, the discount of $10 must be compensated by the priority

enhancement. If the priority enhancement is worth $15 to $20 of expected recovery improvement, the trade is positive.

(b) The new instrument trades at or above the implicit recovery value. If the new super-priority paper trades at 90 cents in the secondary market immediately after the exchange, the participating lender has captured the priority enhancement and locked in the gain.

(c) The company stabilizes operationally, allowing the new super-priority paper to be repaid in full over time. The exit is at par.

A failed LME from a creditor's perspective has the opposite characteristics:

(a) The exchange ratio is unfavorable: the participating lender exchanged for less new paper than the priority enhancement justified.

(b) The new instrument trades below the implicit recovery value because the market sees through the priority enhancement to the underlying business deterioration.

(c) The company files Chapter 11 within 24 months, and the priority enhancement is challenged or unwound through litigation.

The value destruction case for participating lenders happens in a specific scenario: when the LME provides priority enhancement that turns out to be worthless because of subsequent bankruptcy or because of legal challenge.

Consider a participating lender that exchanged $100M of first lien at par for $85M of new super-priority paper. The expected gain was the priority enhancement: the new paper had a higher recovery percentage in distress than the old first lien.

But what if the company files Chapter 11 within 12 months? The participating lender now has $85M of super-priority paper. If the priority is challenged by non-participants under a Serta-style theory, the participating lender may have to disgorge some or all of the priority enhancement. The participating lender ends up with $85M of paper that no longer has its claimed priority. The economic outcome is worse than not participating at all (where the participating lender would have held the full $100M of original first lien).

The Serta indemnification holding (the Fifth Circuit December 2024 decision that plan indemnification of participating lenders violates §502(e)(1)(B)) is the key risk-shifting development. Pre-Serta, participating lenders could rely on plan indemnification to backstop their litigation exposure. Post-Serta, that backstop is gone. The litigation risk now sits with the participating lender directly.

So a participating lender today faces a worse risk profile than a year ago. The same exchange offer that would have been clearly attractive in 2023 is now ambiguous in 2025 because the legal protection of the structure is weaker.

The value destruction case is most severe when:

(a) The company's underlying business is genuinely deteriorating (not just experiencing a temporary stress). The LME does not solve the operational problem.

(b) The exchange ratio is aggressive (the participating lender accepted a meaningful haircut for priority enhancement, only to find the priority enhancement is worth less than expected).

(c) The legal structure of the LME is vulnerable to challenge (post-Serta, this is more common).

(d) The participating lender does not have a blocking position and was essentially a price-taker in the exchange. The price-taker outcomes are systematically worse than the negotiator outcomes.

Pat's framework on this question: the LME is not a free trade. The participating lender is taking a position on the underlying business AND on the legal sustainability of the priority enhancement. If either bet is wrong, the LME destroys value for the participating lender.

The participating lender wins when (a) the business actually recovers and (b) the priority enhancement is legally durable. The participating lender loses when either condition fails.

For a distressed PM evaluating an LME offer, the participation decision requires underwriting both bets. The business underwriting is the operational analysis (revenue trajectory, EBITDA quality, competitive position). The legal underwriting is the credit agreement analysis (does the structure survive Serta-style scrutiny, are non-participants able to mount credible legal challenges).

If both bets are positive, participate. If either bet is negative, hold out or restructure the offer.

(c) The follow-up Pat asks if you get this right

"Give me an example of a recent LME where you think the participating lenders made a mistake. Not where the company subsequently filed Chapter 11. Where the lenders made the wrong call at the time, based on what they knew."

The follow-up tests whether you can apply the framework to specific named deals. The right answer involves picking a named LME and walking through why the participating lenders' analysis was flawed at the time of the LME.

A good answer: the Boardriders 2020 uptier (eventually settled). The participating lenders accepted an exchange at par, but the underlying business (action sports apparel and equipment) was secularly declining. The COVID disruption was real but not the only problem. The LME bought time. The settlement with non-participants (which improved holdout economics) showed that the legal structure was not robust. With benefit of hindsight, participating lenders should have demanded better economics or refused to participate. With the

framework Pat is teaching, that analysis was available at the time of the LME: the secular decline of action sports retail was visible in the financials; the credit agreement's open-market-purchase exception was contestable.

Another good answer: Envision Healthcare 2022. The multi-step LME with the intermediate unrestricted sub was structurally aggressive. Participating lenders accepted positions in new super-priority paper, but the underlying business (physician staffing under No Surprises Act pressure) had unfixable revenue issues. The legal structure of the two-step drop-down was vulnerable to challenge (which materialized in the subsequent Chapter 11). Participating lenders ended up with paper that recovered approximately 30-40% in the Chapter 11. Non-participants who held out ended up with broadly similar recovery after litigation. The LME provided minimal value to participants.

The skill the follow-up is testing: can you do this analysis on a named deal, not just in the abstract. Pat will press for specifics if your first answer is too theoretical.
