STRUCTURED FINANCE SPECTRUM

ALSTON & BIRD

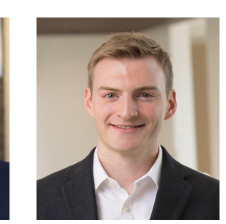
In this issue

SUMMER 2023

Editor’s Note

We hope everyone has enjoyed the summer and received some much-deserved rest and relaxation. As summer goes on, we find ourselves yet again at a very odd and, at times, perplexing reflection point in the structured markets and the economy more generally. The recession that was promised perpetually feels both around the corner and miles away. However, during the first six months of the year, a confluence of new and existing factors (including the regional banking crises, continued inflation, interest rates, and geopolitical conflicts) has led to an uptick in restructuring activity generally and, to a lesser degree, in structured finance, and it has brought interesting new opportunities and entrants into the structured markets.

We have focused the articles in this edition on current trends, opportunities, and practical considerations for weathering the potential downturn. We believe that understanding distressed and restructuring principles and considerations informs and elevates the ability to identify and capitalize on opportunities in this economic climate. In these unsettled times, we at Alston & Bird look forward to keeping you abreast of the latest market developments and finding bespoke solutions to your business needs. Please enjoy this issue and the rest of the summer!

Sincerely,
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Financial Restructuring & Reorganization

An Overview of Bank Lending Partnerships

Bank lending partnerships refer to collaborative arrangements between banks and other financial institutions, organizations, or platforms to extend lending services to a broader customer base or specific target markets. These partnerships aim to leverage the strengths and expertise of each party involved to enhance access to credit, streamline lending processes, and meet the diverse financing needs of borrowers. A few key concepts are as follows:

- Bank lending partnerships are typically established with specific objectives in mind, such as expanding the reach of lending services, tapping into new customer segments, accessing alternative distribution channels, improving risk management, or enhancing operational efficiency.
- Banks can form partnerships with various entities, including fintech companies, peer-to-peer lending platforms, microfinance institutions, and nonbank lenders. The choice of a partner depends on the strategic goals of the bank and the target market it intends to serve.
- Partnerships can take different forms, including joint ventures, strategic alliances, contractual arrangements, and platform integrations. Each model entails varying degrees of collaboration, risk-sharing, investment, and decision-making authority.

Banks entering into lending partnerships must navigate regulatory frameworks governing such collaborations, including compliance with banking regulations, consumer protection laws, and data privacy requirements. Regulatory scrutiny may vary depending on the jurisdiction, partnership structure, and the nature of the lending activities involved, but the participants want to ensure that the bank is considered the "true lender" and that the interest rates of the loans and the ancillary fees, such as late charges, may be enforced by the assignees of the loans. Toward that end, to avoid running afoul of the *Madden v. Midland Funding* ruling, which restricts the ability of nonbank entities to enforce interest rates beyond state usury limits, banks should be aware of certain guidelines and best practices.

Economic Interest

The bank should retain an economic interest in the loan transaction. In other words, it should have some skin in the game. Note that retention policies may vary depending on the structure of the transaction and other factors.

Operational Involvement

The bank should maintain its involvement in the key aspects of the lending process. While the bank's partners may assist in creating guidelines and processes, the bank should approve the structure, maintain oversight, and be able to modify and revise program guidelines at its discretion. Overall, the bank should exercise its lending authority and decision-making power in material aspects of the loan, such as loan approval, setting interest rates, and loan modifications. The bank's involvement should extend beyond superficial or administrative tasks to substantiate its role as the true lender.

Marketing, Branding, and Loan Documentation

The loan documentation, including the promissory note and related agreements, should clearly identify the bank as the lender and demonstrate that the bank has the legal right to enforce the loan terms. Again, while bank partners may play a role in marketing, the bank should approve these marketing and advertising materials and exercise full oversight over marketing and promotional matters. Marketing and promotional materials should directly refer to the bank. Additional loan documents should clearly disclose that the loans are originated by the bank.

State Law

While preemption covers many aspects of a bank lending program, there are specific state laws aimed at addressing the programs. Additionally, the lending partner may be subject to licensing and other regulatory requirements in certain states depending on its role in the transaction. In certain circumstances, it may be advisable to use carve-outs, usury limitations, and other targeted protections in certain states.

Conclusion

Bank lending partnerships can serve as a catalyst for financial institutions to adapt to changing industry dynamics, embrace technology-driven solutions, and enhance their lending capabilities. It's important to remember, however, that the legal landscape surrounding bank lending partnership issues, such as the true-lender analysis and the *Madden* ruling, are evolving and subject to change. ■

Practical Lessons from Recent Safe Harbor Cases on Ensuring a Smooth(er) Exercise of Rights

Safe harbors offer protections against certain provisions of the Bankruptcy Code (despite a contract counterparty's bankruptcy filing) on qualifying securities contracts, commodities contracts, forward contracts, repurchase agreements, swap agreements, master netting agreements, and similar instruments. These protections are designed to prevent a debtor's bankruptcy from causing a systemic disruption of the financial markets.

More specifically, upon commencement of a bankruptcy case by a debtor, among other things, (1) an automatic stay goes into effect, which prevents a creditor from taking enforcement actions against the debtor; (2) provisions of a contract triggered solely by the filing of the bankruptcy (ipso facto clauses) are rendered unenforceable; and (3) the bankruptcy trustee (which may be the debtor in possession) or another party with standing receives avoidance powers that allow for the nullification and/or clawback of certain prepetition transactions that improved a lender's position (such as the posting of additional collateral).

When the bankruptcy safe harbors apply, (1) the lender can accelerate, terminate, and liquidate the facility based on a bankruptcy ipso facto clause and exercise remedies against collateral and other credit enhancements without violating the automatic stay; and (2) safe harbor transfers will not be avoidable unless they were made with an actual intent to hinder, delay, or defraud the debtor's creditors.

In light of the foregoing, market participants typically expect that a safe harbor transaction will function in bankruptcy much like it would outside of bankruptcy—the repo buyer/lender will be able to promptly liquidate the contract and collateral until the repo buyer/lender is paid in full. Those expectations may not be met if the practicalities of exercising remedies have not been fully considered and accounted for in advance of the bankruptcy.

For example, in the June 2022 bankruptcy of First Guaranty Mortgage Corporation (FGMC), some of FGMC's lenders/repo buyers sought a "comfort order" from the presiding bankruptcy court that the transactions in question were protected by the safe harbors and that the exercise of rights would not violate the automatic stay. The lenders/repo buyers asserted that the comfort order was necessary because certain third parties (custodians and third-party servicers) were slow to act because they feared violating the automatic stay and the underlying mechanics of the documents allegedly were inconsistent and failed to provide clear direction.

In particular, the third parties took the position that the underlying documents were inconsistent about (1) whether, upon the bankruptcy filing, they were required to follow the directions from the lenders/repo buyers or, conversely, from the debtor/repo seller; and (2) who would indemnify them for following the directions. Obtaining the comfort order delayed the exercise of the repo buyer/lender's safe harbor rights and the liquidation process. The comfort order did not mark a weakening of the safe harbors; it was simply the path of least resistance given the concerns of the third parties. This case underscores the importance of having clear underlying mechanics in the documents and maintaining clear, regular communications with the parties needed for successfully implementing such remedies to ensure the parties are in alignment on what happens in a bankruptcy scenario.

FGMC also serves as a reminder that the value of having safe harbor rights is constrained if debtor cooperation is necessary to effectively exercise the safe harbor remedy. The safe harbors are not self-executing (i.e., they do not force any party to act). In *FGMC*, a repo lender/buyer was required to seek assistance from the bankruptcy court to segregate and safeguard its cash collateral.

While the safe harbors may allow the repo buyer/lender to direct third parties to send collections to the repo buyer/lender (and not the repo seller/debtor), once the debtor holds the cash collateral, the safe harbor provisions rarely offer any peculiar protections against a debtor dissipating cash collateral. One of these rare exceptions is arguably located in Section 559, which supports an argument that cash proceeds of repo collateral do not become property of the debtor's estate until the repurchase price is paid in full. Other provisions of the Bankruptcy Code (Section 363, primarily) protect lenders' interests in cash collateral. But lenders must act to protect their interests in cash collateral under these provisions.

The February 2023 bankruptcy of Reverse Mortgage Funding (RMF) offers a similar reminder that safe harbor rights do not exist in a vacuum and must be evaluated in the context of particular cases and of the potential need for debtor cooperation and involvement. The safe harbors simply allow the lenders to exercise their contractual rights without violating the automatic stay, but *permission* to act does not equate to *ability* to act. So—*just as in a nonbankruptcy scenario*—if a debtor has possession of a lender's collateral, the lender may be unable to force the debtor to turn over that collateral without a court order. The same is true if the debtor's signature or authorization is required to effectuate a remedy, which was the issue in *RMF*. In these circumstances, the lender's exercise of rights will require ongoing economic leverage and a good working relationship with the debtor.

Accordingly, a repo buyer/lender should temper its internal expectations about the obstacles to recovering collateral in the debtors' possession and be prepared to act promptly in a bankruptcy case to protect its rights. Similarly, a repo buyer/lender should ensure it can exercise remedies without obtaining debtor authorizations and approvals or temper its internal expectations that litigation may be required before the affected remedies can be exercised.

These observations have always been true. Neither *RMF* nor *FGMC* weaken safe harbor protections.

In other news for those who rely on safe harbor protections, in May 2023, the Southern District of Indiana reversed the August 2022 *BWGS* bankruptcy court decision. There, in the context of a leveraged buyout (LBO) and private stock acquisition, the acquiring company (Sun Capital) purchased BWGS's non-publicly-traded stock from an employee stock ownership plan under a stock purchase agreement. Sun Capital financed the purchase of the stock with a bridge loan from Bank of Montreal.

A month later, Sun Capital refinanced the bridge loan, eliminating recourse to Sun Capital, by causing BWGS to pledge all of its assets to support the new loan. The bankruptcy court, looking at the purpose of the safe harbors, decided that BWGS's pledge was not made in connection with a securities contract because it had no bearing on the systemic risks that the safe harbors were intended to mitigate. The district court disagreed with this approach to statutory interpretation and undertook a straightforward analysis of the relevant statutes.

As a contract for the purchase and sale of stock (clearly a security), the stock purchase agreement was a securities contract. The bridge loan was also a securities contract because it was an "'extension of credit for the clearance or settlement of [a] securities transaction.'" Thus, the district court concluded that the repayment of the bridge loan was made in connection with a securities contract and covered by the safe harbor provisions. The district court rejected the bankruptcy court's opinion that such language should be confined to credit provided to purchase publicly traded securities. The district court's decision in *BWGS* reflects good plain-language statutory analysis, which should give the structured market comfort. The bankruptcy court's sentiments reflect the widespread notion that Congress wasn't looking to protect LBOs of private stock with safe harbors.

The foregoing cases highlight the following practical suggestions:

- Ensure a common understanding of safe harbors with contract counterparties and related third parties, such as trustees and administrative agents, at the beginning of deals (and upon amendments and forbearances) to ensure all parties understand the impact, application, and intent of safe harbors and the remedies mechanics in any bankruptcy. This is a key function of any safe harbor opinion.
- Ensure at the front end of a deal or upon an amendment or forbearance that the language in the documents is clear: (1) that the third parties should act upon the repo buyer/lender's direction upon a repo seller/borrower bankruptcy; and (2) that the repo buyer/lender's indemnity provision (and any penalty provision on third parties for disregarding lender instructions) is sufficient to encourage a prompt exercise of safe harbor rights upon a repo seller/borrower bankruptcy.
- Evaluate whether or not there are ways to minimize the collateral in the debtor's possession.
- Analyze the approvals, consents, and authorizations needed to exercise rights and remedies—such as the ability to replace a servicer or administrator sign-offs and the titling and location of collateral—and consider alternative mechanics that permit the exercise of rights absent debtor consent if it's feasible within the documentation.
- Ensure that any risk that can't be mitigated is clearly communicated internally and underwritten appropriately.

Having a practical game plan for execution goes a long way in mitigating procedural hurdles and expediting a successful remedies exercise in a bankruptcy scenario. Walking through each step of the remedies process with counsel long before a bankruptcy is near is the best way to flush out any hidden pitfalls and successfully chart a course around them. ■

Opportunities for Real Estate Debt Funds in the Age of Bank Retreat

Real estate debt funds can benefit from the current real estate market, which *The Economist* has referred to as a "hellish-perfect-dumpster-fire-storm", but risks need to be identified and mitigated from the term sheet onwards.

As traditional bank lending has become more restricted in recent years and banks have pulled back significantly over the last six months following failures at Silicon Valley Bank, Signature Bank, and, more recently, First Republic Bank, there has been a growing demand for alternative financing options. Real estate debt funds are filling this gap by providing flexible and tailored financing solutions to real estate investors and developers. Interest in real estate debt tends to spike during a market disruption or downturn, given debt is considered safer than equity due to its position in the capital stack, and returns from the underlying real estate can be likened to a bond when there is strong cash flow behind the loan.

By offering alternative financing options, debt funds can access a wider range of borrowers and investment opportunities, which can help to generate higher returns. The top 30 real estate debt funds focused on Europe raised $80.29 billion in the five years up to June 2022, according to *Real Estate Capital*, and much of this dry powder is still left to deploy.

Whilst allocations continue to grow in a range of strategies not traditionally the focus of debt funds, including senior lending and high-yield debt, mezzanine financing remains particularly attractive to investors, given its ability to provide high returns of up to 8% or 9%, whilst also benefitting from the risk protection of a senior financing that has 35% to 45% of equity ahead of it.

Investors have traditionally been attracted to the risk-adjusted returns of debt funds. However, given that real estate values have been dropping in recent months and years, particularly in office and retail, investors are justifiably concerned about the impact of these declines on their investments. Investment teams therefore should be placing more and more weight behind the mitigation of downside risk. This means that on deals, for example, tighter financial covenants, such as loan-to-value and debt-service coverage ratios, should be placed on borrowers, cash traps utilised, and a greater focus placed on reporting and enforcement planning.

Due to the market downturn and the corresponding demands from investors, debt funds must place a greater emphasis on risk management. Many funds are conducting more thorough due diligence and stress testing of their investments and are working closely with borrowers to ensure that they can meet their financial obligations. By focusing on risk management, debt funds can reduce the likelihood of default and in turn protect their investors' capital.

There are a number of legal issues for debt funds to consider in the current economic climate:

- **Due diligence:** Real estate debt funds should place more weight than usual on thorough legal due diligence on borrowers and assets as well as financial, environmental, tax, and technical due diligence on potential investments. This is particularly important in the current economic climate, where borrowers may be more vulnerable to financial distress. Legal due diligence will likely need to be conducted in the jurisdiction of the borrower, the asset, and the loan agreement, so ample time to conduct this due diligence should be built into the deal timeline.

- **Risk management:** Debt funds must have robust risk management policies that ensure they can manage their exposure to market risks, such as interest rates and credit risks. They must also have adequate systems that manage liquidity risks, particularly in this volatile market.

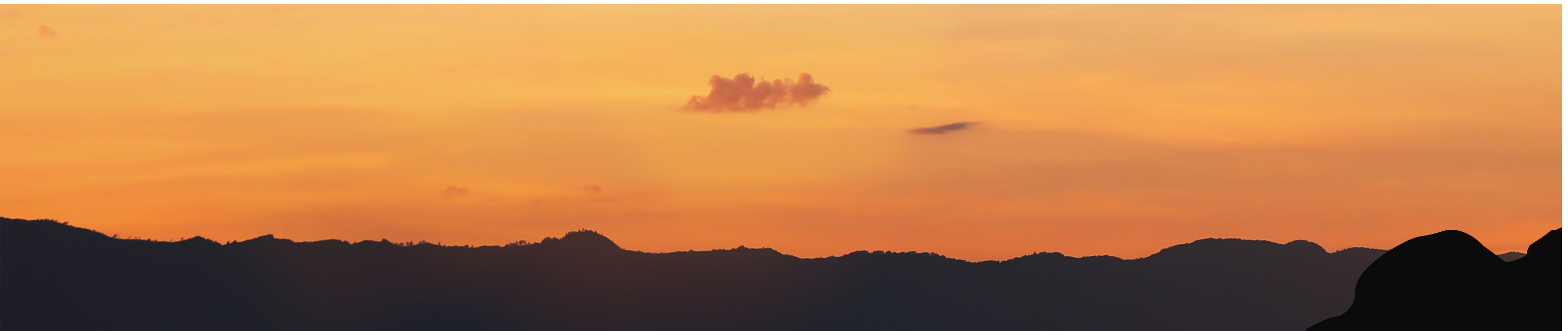
- **Documentation:** Debt funds should ensure that all loan documentation is thoroughly negotiated, including loan agreements, property and asset management agreements, and security agreements. In the current climate, more of an emphasis is being placed on mitigating downside risk, so a legal review starting at the term sheet stage is preferable to ensure that appropriate covenants, traps, and other safeguards are included.

- **Compliance and reporting:** Debt funds should place greater focus at the back end on monitoring borrower compliance with financial and other covenants, including financial reporting requirements and restrictions on the use of loan proceeds, such as capital or operational expenditures).

- **Management of defaults:** Debt funds should have a clear plan for managing defaults, including workout strategies and procedures and post-event-of-default enforcement procedures. The plan should include procedures for dealing with distressed borrowers and managing the enforcement process.

With a combination of strong and thorough risk mitigation and due diligence at the front end and with strong asset management and monitoring of reporting at the back end, real estate debt funds can continue to provide investors with strong and stable returns, even in the current climate.

Finally, looking to the future in this space in the United Kingdom, HM Treasury and HM Revenue & Customs have recently launched a consultation on the reserved investor fund, a proposed unregulated UK-based vehicle for both professional institutional investors and high-net-worth retail investors. The structure is open to investment in all asset classes and is likely to be an attractive vehicle for commercial real estate investors to hold UK property. Reserved investor funds are likely to be particularly attractive because they do not require Financial Conduct Authority approval and can be launched quickly to market, they will offer tradeable units with no transaction tax incurred on disposal, and they would benefit from Stamp Duty Land Tax seeding relief. ■



Bankruptcy Remote Structures: Recent Nonconsolidation Opinion Concerns

The hallmark of structured finance is the isolation of the assets being underwritten and relied upon for repayment of the securities backed by those assets. In commercial real estate (CRE) financing, that isolation occurs both at the property level and the issuer level. Here, we focus on the borrowers in CRE securitizations.

Each commercial property financed through securitization should be owned by a bankruptcy remote, single (or special) purpose entity (SPE), usually a Delaware limited liability company. The SPE organization documents should include three critical provisions: (1) limitation of purpose to owning, operating, and financing the specific property to be financed; (2) limitation on the debt that may be incurred to the mortgage loan that will be included in the securitization and trade payables not exceeding 2% to 4% of the mortgage loan principal balance; and (3) separateness covenants designed to require the SPE to operate and hold itself out as separate and distinct from its affiliates.

To provide additional comfort regarding isolation and bankruptcy remoteness for large loans, typically $20 million and above, including single-asset, single-borrower deals, the SPE structure should also include: (1) an independent director whose vote is required for certain major actions, principally a voluntary bankruptcy proceeding; and (2) a reasoned legal opinion of counsel, which evaluates all relevant factors concerning the loan and SPE borrower structure under current bankruptcy case law and concludes that if the SPE parent, guarantor, or other specified affiliates (affiliate debtor parties) were involved in a bankruptcy proceeding, the assets and liabilities of the SPE borrower would not be substantively consolidated with the assets and liabilities of one or more of the affiliate debtor parties (the "nonconsolidation opinion").

Substantive consolidation is an equitable remedy utilized by bankruptcy courts in resolving complex bankruptcies in pursuit of the congressional goal of promoting reorganizations. It is not a statutorily prescribed remedy; it arises out of the equitable powers of the court under section 105 of the U.S. Bankruptcy Code (11 U.S.C. Sec. 101 et seq.) and thus involves broad discretion that may be exercised based on all relevant facts and circumstances before the court.

The nonconsolidation opinion differs from customary opinions, such as enforceability and authority opinions, in that the considerable uncertainties of bankruptcy require that the legal conclusion not be viewed apart from the underlying reasoning and assumptions as to the relevant facts. Accordingly, the facts of the transaction are crucial to the analysis and bear significantly on the legal conclusion. This is clear in the framing of the opinion request, which typically reads substantially as follows:

> whether, in connection with a bankruptcy proceeding instituted by or against any one or more of the Affiliate Debtor Parties under the United States Bankruptcy Code, a federal court exercising bankruptcy jurisdiction and reasonable judgment *after full consideration of all relevant factors*, in a properly briefed, argued and presented case, and properly applying applicable, currently-reported decisional law, would order the substantive consolidation of the assets and liabilities of the SPE with those of any one or more of the Affiliate Debtor Parties. [emphasis added]

The factual assumptions must be based upon written provisions in the transaction documents or other credible evidence for counsel to reasonably rely on them in the legal analysis. This view and expectation of nonconsolidation opinions has been widely recognized and described in legal publications concerning structured financings for over 30 years. See, for example, "Special Report by the Tribar Opinion Committee: Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions," 46 Business Lawyer 718 (1991); and "Special Report on the Preparation of Substantive Consolidation Opinions," 64 Business Lawyer 411 (2009).

The CRE structured finance industry recognizes and relies on the benefits of a nonconsolidation opinion, as evidenced by customary loan seller representations and warranties in a CRE securitization, which include a "Single Purpose Entity" representation that states, in part, "and each Mortgage Loan with a principal balance of $20 million or more has a counsel's opinion regarding non-consolidation of the borrower."

Two key benefits of the opinion are: (1) counsel familiar with bankruptcy proceedings, substantive consolidation, and bankruptcy remote structures is involved to facilitate the structure and implementation of the SPE criteria and to advise the borrower on those matters; and (2) providing additional evidence for the lender to present to a bankruptcy court that it reasonably relied on separateness in extending credit to the SPE borrower. Creditor reliance is an important factor bankruptcy courts consider in determining whether consolidation is appropriate.

Guaranties of the SPE borrower obligations by a parent or other affiliate are an important consideration in the substantive consolidation analysis. For example, a parent entity that provides a full credit guaranty of the SPE borrower loan would weigh against the lender's claim that it relied on the separateness of the SPE and its assets and thus would weigh in favor of consolidation.

The analysis of other types of guaranties and indemnities demands a closer look. Since the CRE loan is nonrecourse, the lender usually requires a nonrecourse carveout guaranty (also referred to as a "bad acts" guaranty) from the parent or other affiliate (the "affiliate guarantor") providing that the SPE borrower and the affiliate guarantor will both be liable:

- For losses and damages resulting from certain acts of the borrower, which generally include (1) fraud or intentional misrepresentation; (2) misappropriation of rents, insurance proceeds, or condemnation awards; (3) intentional material physical waste of the mortgaged property; and (4) breach of the environmental covenants contained in the related loan documents.
- For the full amount of the mortgage loan (the springing guaranty) in any of the following events: (1) a petition for bankruptcy, insolvency, dissolution or liquidation pursuant to federal bankruptcy law, or any similar federal or state law, is filed by, consented to, or acquiesced to by the SPE borrower; (2) the SPE borrower or affiliate guarantor have colluded with or solicited petitioning creditors to cause an involuntary bankruptcy filing; or (3) voluntary transfers of either the mortgaged property or controlling equity interests in the SPE borrower made in violation of the loan documents.

Because the nonrecourse carveout guaranty requires active and intentional breach of specific undertakings by the SPE or its affiliates and is not triggered by a credit default due to insufficient operating revenues, it does not generally rise to the level of concern presented by other credit guaranties; rather it is a deterrent to specific bad acts. Similarly, an environmental indemnity by a parent/sponsor provides additional support and incentive for compliance with environmental laws and is triggered only by their violation, but it is not a credit guaranty.

On the other hand, a completion or performance guaranty could have a credit component, depending upon the terms. If funds have been escrowed or reserved in amounts estimated to cover all or substantially all of the costs, the credit component is significantly less, and should not prevent counsel from rendering the opinion. If funds have not been escrowed or reserved, or if the amount escrowed or reserved is significantly less than estimated costs, the analysis becomes more acute.

Each case is different and requires counsel to evaluate the facts and circumstances in light of current bankruptcy case law. Current case law does not specify a clear level or amount of credit guaranty that merits consolidation, and counsel must make an informed judgment. See, e.g., *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005), *cert. denied*, 126 S.Ct. 1910 (U.S. 2006); and *In re Food Fair Inc.* 10 B.R. 123 (Bankr. S.D.N.Y. 1981).

Nonconsolidation opinion precedent and practice includes instances when counsel has provided the opinion if the transaction documents specify credit limits on guaranties of 10%, 15%, and even 20% of the loan principal balance. However, for some transactions the scope and extent of guaranties may exceed counsel's comfort level in rendering the opinion. In such circumstances, the lender may have to weigh the benefit of receiving the nonconsolidation opinion against receipt of the guaranty. Each has its own benefits and limitations.

In a few recent transactions involving loans on properties in transition or undergoing restoration or construction that incorporate credit guaranties or performance and completion guaranties, counsel has either excluded the guaranties from the scope of the opinion or assumed a particular limit on the credit exposure that is not included in the transaction documents.

The essence of the nonconsolidation opinion requires counsel to evaluate *all* factors in the transaction and assess whether those factors would lead a court to substantively consolidate the assets of the SPE with those of an affiliate guarantor in a bankruptcy proceeding under current law. To exclude a specific, acknowledged fact or agreement from the scope of the opinion or make an assumption that is not based on transaction documents or credible evidence eviscerates the very purpose of the opinion and renders its use questionable. More concerning, it provides a roadmap for a court to hold in favor of consolidation and jeopardizes the creditor reliance factor that is essential to a favorable ruling for the lender in most courts.

The lender may have to weigh the benefit of receiving the nonconsolidation opinion against receipt of the guaranty.

This problem has been identified in some cases in the exceptions to the loan seller representations regarding the SPEs referenced above.. In other cases, it has been identified only through follow-up questions on whether the exclusions, qualifications, or assumptions were included in the opinions. The issue's importance also has been recognized in the risk factor section of certain offering circulars containing loans with problematic exclusions, qualifications, or assumptions, which reads substantially as follows:

> At origination, each of the borrowers delivered to the lender a counsel's opinion regarding non-consolidation of the related borrowers; however, such opinion did not express an opinion regarding the substantive consolidation of the assets and liabilities of the related borrowers with those of the related guarantors or the related pledgors due to the existence of the potential obligations of the guarantors under the related full recourse guaranties or the pledgors under the related pledge agreements. We cannot assure you that such guaranties or pledges would not be considered by a bankruptcy court as a significant factor in determining whether to substantively consolidate the assets and liabilities of any of the borrowers with those of the related guarantors or the related pledgors.

Nonconsolidation opinions containing these exclusions, qualifications, and assumptions conflict with recognized opinion practice, do not accurately evaluate the risk of substantive consolidation in bankruptcy, and are viewed as credit negative. A recipient of the SPE representation should reasonably expect that the nonconsolidation opinion is consistent with the TriBar Report, Substantive Consolidation Opinion Report, and other publications about the scope, content, and requirements for factual assumptions therein. Securitization participants and counsel should make these expectations clear when requesting the opinion and should carefully review the opinion to avoid accepting a misleading and potentially damaging opinion. ■

Bank Failures

Between March 2023 and May 2023, the rapid failure of three regional banks raised fears that the country's banking sector would be facing a large-scale crisis:

- On March 10, 2023, the California Department of Financial Protection and Innovation (CA DFPI) shut down Silicon Valley Bank (SVB) and appointed the Federal Deposit Insurance Corporation (FDIC) as its receiver.
- On March 12, 2023, the New York Department of Financial Services took possession of Signature Bank and also appointed the FDIC as its receiver.
- On May 1, 2023, the CA DFPI appointed the FDIC as the receiver of First Republic Bank and entered an agreement with JPMorgan Chase & Co. to assume all the deposits and substantially all the assets of First Republic.

In the cases of both SVB and Signature Bank, the federal government invoked a systemic risk exception, meaning that the FDIC would guarantee all uninsured deposits at both banks. This unprecedented step was extremely important in calming depositor fears in the immediate aftermath of the bank failures.

Several months after these failures, it appears that the worst is over, and a string of bank failures is not imminent. However, steps taken by regulators in response to these events suggest there will be a lasting impact on the banking industry and, by extension, the financial services industry as a whole.

The Causes and Consequences

The federal stimulus during the COVID-19 pandemic drove huge quantities of money into the banking system in the form of deposits. Many banks deployed that excess cash into longer duration assets and securities portfolios.

Since March 2022, the Federal Reserve has raised interest rates by 5 percentage points—an unprecedented rate hike over such a short period of time in modern U.S. history—in an effort to combat significant inflation. As interest rates rose, deposits flowed out of the U.S. banking system and banks found themselves underwater on their securities portfolios.

These factors had a disproportionate impact on SVB, primarily because of the significant short-term growth in deposits (from $43 billion in 2019 to $191 billion at its height in 2021) and the concentration of its customer base in startup and venture capital companies. In response to a liquidity crunch caused by customer withdrawals, SVB sold $21 billion of its bond portfolio, resulting in a $1.8 billion loss. The public announcement of that loss spooked the market and resulted in an unprecedented digital run on SVB, which lost approximately $42 billion in deposits over a 48-hour period—the first "Twitter-fueled" bank run.

The causes of the Signature Bank and First Republic failures were similar, although not identical, to that of SVB. Signature Bank's primary customer base had a detrimental impact. A significant portion of Signature Bank's business served venture capital firms and digital assets. Signature Bank's uninsured deposits neared 90%. In light of these factors, the bankruptcy of FTX (discussed in the February 2023 *Structured Finance Spectrum*) and SVB's failure had an immediate impact on Signature Bank's liquidity as withdrawal requests increased rapidly, eventually resulting in the government's decision to close Signature Bank.

> It is still unclear whether, and to what extent, these failures and the result ing economic environment will affect the structured finance market.

First Republic's story was similar, with deposit withdrawal requests nearing $100 billion in light of the factors discussed above and fueled by depositor fears in the wake of the SVB and Signature Bank failures. First Republic held on for longer than the other two banks, thanks in large part to a $30 billion boost to its liquidity by an influx of uninsured deposits from the nation's 11 largest banks and $105 billion in emergency borrowing from the Federal Reserve and the Federal Home Loan Bank. Nevertheless, deposits continued to leave First Republic, and the FDIC arranged for the bank to be acquired by JPMorgan Chase on May 1, 2023.

On April 28, 2023, the Federal Reserve published a report examining the factors that contributed to SVB's failure, and the FDIC published a report detailing the causes of Signature Bank's failure. Both reports concluded that management had failed to adequately manage risk as their institutions grew in size and complexity, and that both banks had over-relied on uninsured deposits. Each agency also accepted some accountability for a failure to take additional measures sooner after the regulators became aware of the banks' vulnerabilities.

It is still unclear whether, and to what extent, these failures and the resulting economic environment will affect the structured finance market. At a minimum, market participants will need to understand their banking partners' uninsured deposit status and any significant industry concentrations similar to those that led to the demise of the three banks. Market participants should also be mindful of potential changes to the legal and regulatory regime around deposit insurance because several proposals to change the current structure emerged following the failures.

Cross River Bank Consent Order

Cross River Bank (CRB) is a leading banking-as-a-service provider that regularly partnered with fintech companies. In April 2023, the FDIC published a consent order it had previously entered into with CRB in March 2023. The order states that the FDIC determined CRB had engaged in unsafe and unsound banking practices related to its compliance with fair lending laws and regulations. Many within the industry view the order as a shot across the bow, putting on notice any bank that partners with fintechs or nonbank lenders that the FDIC will scrutinize those relationships closely. Because CRB is one of the larger, more sophisticated fintech partner banks, competitors with similar fintech partnerships have assumed that the FDIC, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Consumer Financial Protection Bureau may put those partnerships under the microscope.

The consent order places several restrictions and requirements on CRB, including the following:

- CRB must provide to the FDIC a list of all products offered by CRB along with all third parties that offer CRB products and receive written nonobjection from the FDIC before offering any new CRB products or allowing any third parties to offer any new CRB products.
- CRB must undergo an independent review of the bank's information systems and fair lending compliance and report the findings to the FDIC. Upon receiving nonobjection from the FDIC for each report, CRB must develop plans responding to each report's recommendations.
- CRB must develop a plan to address internal controls to ensure fair lending compliance for current and future third parties, which includes periodic assessments that must be conducted at least annually and oversight of marketing materials distributed by third parties related to CRB products.
- CRB must increase supervision and oversight of internal controls, credit underwriting practices, and its internal audit system relating to the bank's marketplace lending activities.

Other banking regulators have also signaled that banking-as-a-service is a concern. For example, the acting OCC comptroller, Michael Hsu, delivered a speech in September 2022 in which he discussed the need to better understand bank-fintech arrangements and expressed concern that the current partnership environment, "if left to its own devices, is likely to accelerate and expand until there is a severe problem or even a crisis."

As a result of these developments, it is likely that compliance requirements and the costs for nonbank lenders and fintechs to do business with partner banks will increase. Additionally, fintechs and nonbank lenders should expect much more fulsome and intrusive oversight and monitoring by bank partners and by their regulators moving forward. ■

Disqualified Lender Provisions: Broader Borrower/Sponsor Powers Pose Problems for Secondary Loan Market Participants

Lenders, market-making trading desks, and buyside investors must be leery of the ever-expanding powers afforded borrowers and sponsors under disqualified lender provisions in syndicated credit facilities. Most credit agreements in the $1.5 trillion broadly syndicated loan (BSL) market prohibit lenders from being able to assign or participate loans to a party on a disqualified lender list. Typically, a DQ list (often referred to as a "blacklist") includes competitors of the borrower and specific entities identified by the borrower/sponsor at the closing of the credit facility.

Historically, the breadth of DQ provisions in credit agreements tracks the market guidance provided by the Loan Syndications & Trading Association (LSTA). The most recent LSTA market advisory from June 2022 noted that the DQ structure is intended to provide a balance between allowing borrowers to exclude competitors (and other entities for legitimate business reasons) from becoming lenders in their capital structure while not unduly impeding liquidity in the secondary market. For this to occur access to the DQ list needs to be readily available. Unfortunately, in practice, the DQ list is not regularly posted, and access to the list is often difficult to obtain.

Most credit agreements allow a lender to request a copy of the DQ list from the administrative agent. Often, multiple requests are needed to facilitate an agent response for the DQ list, and then days will pass before receiving it. Then, instead of providing the full list, the agent will often ask the requesting lender who the prospective assignee is, further slowing down the process. For loan traders, speed of information is paramount because there may be competition for bids on loans. Parties that wait to find out whether an end buyer is on the DQ list may lose out on a trading opportunity while other more cavalier trading desks move forward.

Secondary trades are generally entered into before performing diligence on the DQ list (in part due to the inability to quickly access the list). Parties assume the risk that an end buyer may be a DQ entity. Under these circumstances, a trading desk creating liquidity for loans may find itself in the unenviable position of having its end buyer be incapable of purchasing the loan by assignment or participation. Under LSTA standard terms and conditions (to which nearly all secondary BSL trades adhere), if the parties are unable to settle a loan trade by assignment or participation, the parties still remain obligated to settle the trade in a mutually agreeable alternative structure that allows the parties to obtain the economic equivalent of the trade. This unfortunate situation results in prolonging settlement and creating friction between the seller and its end buyer on the resolution of the unsettled trade.

These issues are being compounded by the broadened scope of the DQ provisions in credit facilities. Traditionally and consistent with the LSTA market advisory, credit agreements would provide that DQ entities were limited to (1) entities that are competitors of the borrower's business and identified in writing to the administrative agent from time to time; and (2) other entities that are on a DQ list as of the closing date of the credit facility. However, **more recent credit agreements now allow for DQ lists to be updated to include not only new competitor entities after the closing date but noncompetitor entities after the closing date of the facility (such as distressed debt investors)**.

We have seen the impact of these broadened DQ provisions affecting loan market participants in litigation disputes in Serta and, more recently, Byju's. In Serta, a dispute with Apollo hinged on whether Apollo was on the DQ list at the closing of the facility or improperly added after the fact when Serta discovered that Apollo was looking to become a lender by assignment. The Apollo/Serta dispute settled before court resolution. In June 2023, educational technology company Byju's filed a complaint in New York Supreme Court challenging its lenders acceleration of a $1.2 billion term loan. Byju's sought to disqualify certain lenders from being able to accelerate the loans because they were purportedly DQ entities. Byju's maintained that the credit agreement not only prohibited assignments to buyers whose primary activity is the "acquisition of distressed debt" but also allowed for these distressed debt buyers to be added to the DQ list at any time. Byju's asserted that certain distressed debt lenders were never meant to have been allowed as lenders and that once those entities were disqualified, they were restrained from exercising rights to take enforcement actions.

> A trading desk creating liquidity for loans may find itself in the unenviable position of having its end buyer be incapable of purchasing the loan by assignment or participation.

Another holistic problem for market participants is the lack of recourse lenders have against administrative agents for mistakenly allowing a prospective buyer that is on the DQ list into a credit facility as an assignee. Almost all credit agreements provide that the administrative agent shall have no liability for failing to properly monitor the DQ list. Under expanded sponsor-friendly DQ provisions, borrowers have more tools to (1) try and force disqualified entities to sell their loans at either par, the price the entity paid to acquire its loan, or the market price; (2) limit DQ entities from receiving information; and (3) prohibit DQ entities from having voting/enforcement rights. It is not hard to see how exercising these expanded borrower powers could lead to significant investment losses for a buyside investor. Having limited contractual recourse against an administrative agent that fails to properly monitor the DQ list compounds the problem.

Recent litigation and **the notable increase in expanded DQ provisions for the benefit of sponsors and borrowers shed new light on the importance of loan-trading market participants to carefully review credit agreements (particularly distressed investors) before entering into trades to avoid unanticipated problems down the road**. Going in with eyes wide open for potential risks is always better than trying to rectify an unforeseen problem after it occurs.

One way to strike a fairer balance of the competing interests of borrowers/sponsors and lenders would be to make sure DQ provisions are more vigorously negotiated by lenders at the time of loan origination to establish better terms. Before the recent credit market volatility, the demand for broadly syndicated loans exceeded the supply, resulting in more leverage for borrower/sponsors to expand the breadth of DQ provisions. Now that credit is getting tighter, lenders may finally be in a position to have more bargaining power in negotiating better terms.

With the likelihood of more credits going stressed/distressed and borrowers having a challenging time with refinancing in the foreseeable future, **we can expect more situations where borrowers/sponsors will try to flex their muscles under expanded DQ provisions and limit certain buyers they believe will be difficult partners in their capital structure**. Lenders would be wise to try and use this time to shift the balance of power. ■

Significant Cross-Border Financial Restructurings—Adler Group Puts the UK Back on the European Restructuring Map by Choosing UK Plan over German or Dutch Options

On 21 April 2023, the English High Court released its 164-page judgment approving the German real estate group Adler's English restructuring plan under Part 26A of the Companies Act 2006 involving €3.2 billion of German law-governed bonds issued by Adler. The Adler restructuring plan was opposed by an ad hoc group of holders of 2029 notes (AHG) who alleged that the plan unfairly deprived them of pari passu treatment and that the valuations on which Adler's restructuring plan was constructed were too high.

The main objective of the Adler restructuring plan was to avoid Adler's imminent insolvency by injection of €937.5 million of senior secured loans (the 'new money') and providing a stable platform from which Adler Group can proceed with a solvent wind-down by asset sales over time in improved market conditions. This demonstrates that post-Brexit, the UK is still one of the venues of choice for significant cross-border financial restructurings involving corporate groups largely based outside of the UK and having issued debt that is not governed by English law.

It is important to highlight that the Adler restructuring plan was sanctioned by the English Court despite there being no obvious nexus with England (other than the UK plan company incorporated solely for the purposes of establishing jurisdiction for English courts) and in preference to other European restructuring procedures of jurisdictions to which the group was more closely connected (e.g., German StaRUG or Dutch Wet Homologatie Onderhands Akkoord).

Background

Adler Group S.A. (the 'parent') was the holding company of the group, which focused on the purchase, management, and development of income-producing, multifamily residential real estate in Germany. The parent was incorporated in Luxembourg, and the plan company, AGPS BondCo PLC (the 'plan company'), is a new, UK-incorporated subsidiary of the parent.

The parent issued senior unsecured bonds governed by German law with maturities in 2024, 2025, January 2026, November 2026, 2027, and 2029 (collectively, the 'SUNs'). A subsidiary of the parent, Adler Real Estate AG, was an issuer of certain other senior unsecured notes, including those with a note maturity date of 27 April 2023 (the 'Adler RE 2023 SUNs'), which was the main reason for the urgency of the restructuring plan as the group did not have sufficient funds to repay these notes on maturity. If the Court did not sanction the plan, the key members of the Adler Group would have had no choice but to file for insolvency proceedings.

The holders of the SUNs were the plan creditors. They were divided into six classes, and each class has considered and voted on the plan. The Adler plan has altered only the rights of plan creditors (holders of the SUNs rather than holders of the other notes issued by other group subsidiaries). It was agreed that a significant portion of the proceeds from the new money funding will be used to refinance the Adler RE 2023 SUNs and the Adler Real Estate AG 2024 notes to avoid a sale of assets at a deep discount and protect value for all stakeholders of the group.

Establishing Jurisdiction of English Courts—Substitution of the Luxembourg Incorporated Issuer with a UK Issuer to Establish a Sufficient Connection with England and Complete a Restructuring

The German law SUNs were originally issued by the Luxembourg parent. The Adler Group engaged the jurisdiction of the English High Court by substituting the newly incorporated plan company for the parent as the issuer of the SUNs. This was achieved by the substitution procedure under the terms and conditions of the SUNs.

The parent then issued irrevocable and unconditional guarantees to the holders of the SUNs for the plan company's obligations and liabilities under the SUNs and, in particular, payment of the principal and interest due under the SUNs. The plan company and the parent also entered into a series of agreements with the issuer substitution under which the plan company was substituted as the principal debtor for all obligations arising from or in connection with the SUNs together with a reimbursement deed and a consideration agreement. Finally, the parent issued back-to-back loan notes on the same terms as the SUNs to the plan company.

This issuer substitution and its validity as a matter of German law was one of the issues disputed by the AHG. Despite the objections from the AHG, the High Court judge accepted the plan company's evidence that the issuer substitution was completed in accordance with the substitution clause (which is market-standard in German bonds), and therefore it was valid.

Key Terms of the Restructuring Plan—Equity Retains 77.5%

The plan's main terms are:

- An extension to the maturity of the shortest-dated series of notes.
- New covenants such as a covenant to preserve the loan-to-value ratio of the group's assets.

- Suspension of cash interest payments on all series of the SUNs for two years with an uplift in interest in return.
- Amendments to allow the group to incur additional indebtedness (the new money to be provided by the steering committee and other SUN holders who elected to participate in the funding).

In consideration of injecting the new money, the relevant creditors received a 22.5% equity interest in the parent with existing shareholders retaining their 77.5% equity interest in the group. The judge commented that the retention of equity by the current shareholders of the group was 'the point on which I have had the greatest concern about approving the Plan. I can see no obvious reason why the shareholders who have provided no support for the Plan and no additional funding should get the upside if the Plan succeeds.'

Despite concerns, the judge decided that it was not appropriate to refuse to sanction the plan. The providers of the new money were most likely to be affected by the retention of equity by the existing shareholders. Given that they had negotiated such terms, the Court could only assume that in doing so, they took a commercially rational approach which it would not be appropriate for the Court to challenge. 'Secondly, there was no basis for finding that the opposing creditors had been shut out of the negotiations. Thirdly, and finally, he accepted evidence that the Shareholders were prepared to provide new money on terms which were not available in the market from anyone else.'

This is a further example of the absence of any absolute priority rule in the UK plan, with the Court instead focusing on the overall fairness of the proposed plan and the general reluctance to interfere with the commercial deal struck by the parties.

Cross-Class Cram-Down

One of the features of the UK restructuring plan is the ability for the English Court to use its 'cross-class cram-down' power, which allows a restructuring plan to be imposed on a dissenting class of creditors if the following conditions are met:

- **Condition A:** No worse off test—the dissenting class would not be any worse off than they would be in the event of the relevant alternative (whatever the Court considers would be most likely to occur in relation to the company if the plan was not sanctioned—here, a liquidation).
- **Condition B:** Genuine economic interest test—the plan has been agreed by 75% of a class of creditors who would receive a payment or have a genuine economic interest in the company in the event of the relevant alternative.

The 2029 noteholder class did not meet the required 75% approval threshold (although a majority—about 62%—did vote in favour of the plan). This meant the cross-class cram-down power has been used to impose the terms of the restructuring plan on the holders of the 2029 notes.

Did the Restructuring Plan Diverge from the Pari Passu Principle?

The pari passu principle is a fundamental principle of English insolvency law. It provides that all unsecured creditors must share equally any available assets of the company in proportion to the debts which the company owes to each of them.

The AHG contended that the plan was unfair because it would violate the pari passu principle. Their argument focused on the fact that the plan preserved the existing maturity dates of the SUNs (other than the 2024 notes, which were extended by a year). The AHG argued that if the plan were sanctioned, they would rank last in payment as holders of the latest maturing series of notes (due to time subordination) and be further subordinated because of the new money injection and interest accrual on the other reinstated SUNs.

On the other hand, in a formal liquidation, all the SUNs would rank pari passu. The AHG contended that the courts have only departed from the pari passu principle when it was necessary to rescue the company as a going concern (and this was not the case here because the Adler restructuring plan contemplated an orderly wind-down).

Adler argued that the existing maturity dates (apart from the 2024 notes) should be preserved because, among other things, they reflect commercial reality (notes with later maturity dates carried a greater commercial risk reflected in the prices paid when the noteholders purchased them).

The Court held that the plan did not depart from the pari passu rule despite preserving the existing maturity dates. The Court based its conclusion on its finding of fact on the valuation evidence that if the plan is implemented it is likely that creditors will be paid in full.

> The substitution of the plan company for the parent to establish the English law nexus was a novel element of this cross-border restructuring.

The Court ultimately ruled that it is not its role to consider whether the plan was the best plan available or that it could not be fairer. The best judges of whether creditors were better off under the plan are the plan creditors themselves and (aside from the 2029 notes) they had voted overwhelmingly in favour of the plan.

Recognition of the Adler Restructuring Plan in Germany

Although there remains some legal uncertainty as to whether a UK plan would be recognised in Germany, the English Court does not require absolute certainty, only that there is a reasonable prospect that the Court's time is not being wasted by a plan that will not be effective in achieving its purposes. Adler put forward expert witness evidence to the Court regarding the likelihood of recognition in Germany, and following review of the evidence, the English Court was satisfied on the balance of probabilities that there is a reasonable prospect that the plan would be recognised in Germany.

Although challenging recognition in Germany may be one of the avenues for creditors to oppose a UK restructuring plan where the company has assets in Germany and the plan purports to compromise debt governed by German law, such a challenge is unlikely to be straightforward.

Conclusion

The Adler restructuring plan is the first UK restructuring plan amending German law governed debt issued by a Luxembourg holding company. The substitution of the plan company for the parent to establish the English law nexus was a novel element of this cross-border restructuring.

In contrast, adopting a co-obligor structure, which has become a common structure used to obtain jurisdiction in the UK, would have resulted in the need for additional documentation. The issuer substitution provision was a matter of German law (given that the SUNs were governed by German law) but is uncommon in bonds governed by New York or English law. Whether this feature will be incorporated into New York or English bond terms by issuers over time remains to be seen.

UK restructuring plans or schemes of arrangement are sometimes challenged in the jurisdictions where the assets are located. The Adler restructuring plan is no different, and the issuer substitution has been challenged by a noteholder who had lodged a complaint in a German regional court. In addition, certain 2029 noteholders have purported to accelerate their notes, the effect of which is disputed. Whether or not these challenges are ultimately successful remains to be seen, but they are significantly more difficult now given that the plan has already been sanctioned in the English Court. ■

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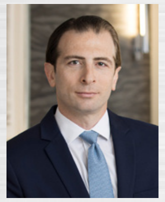

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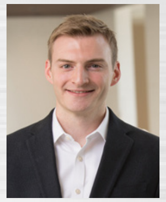

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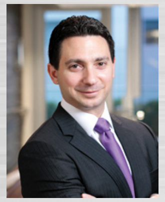

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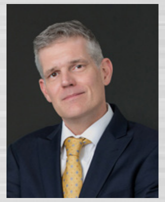

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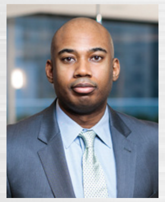

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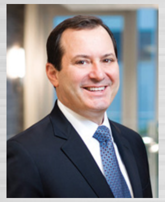

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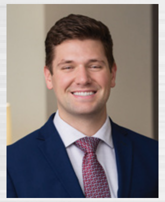

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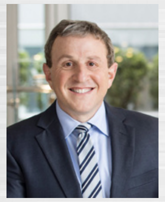

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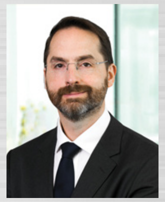

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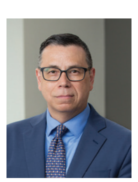

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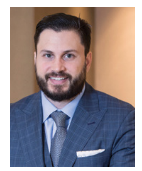

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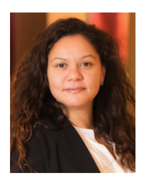

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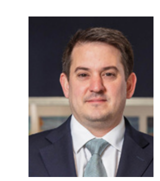

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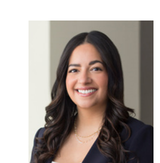

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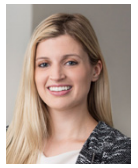

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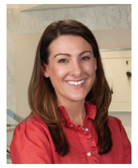

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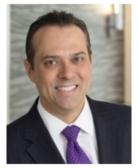

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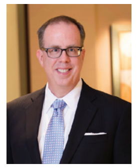

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