KING & SPALDING

HOW DID THEY DO IT?

PetSmart & The Phantom Guarantee

King & Spalding Private Credit & Special Situations Investing

Situation Overview

In 2017, with consumer preference shifting from brick-and-mortar stores to e-commerce, a struggling PetSmart, Inc. (the "***Company***") purchased online-pet supply retailer Chewy.com ("***Chewy***") for $3 billion.

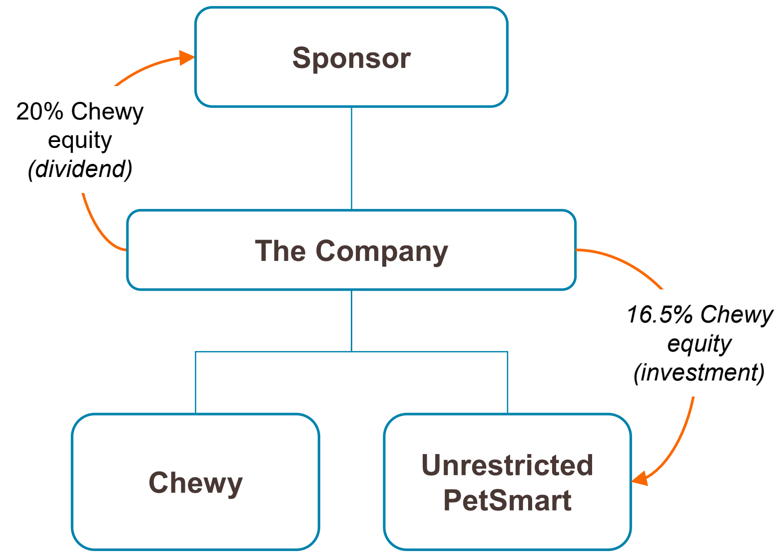
- The Company purchased Chewy for $3 billion, $1 billion of which was funded from proceeds of the Company's private equity sponsor BC Partners (the "***Sponsor***") equity contribution, and the remainder of which was funded through a combination of new-issue senior secured and unsecured debt.
- Given that some investors believed that Chewy's value was increasing exponentially, market participants soon speculated that the Company would spinoff Chewy to benefit the Sponsor or effectuate a J. Crew-like transaction.
  How did they do it? J. Crew & The Original Trap Door
- In June of 2018, as the market had predicted, PetSmart announced that it had spun-off 20% of Chewy's equity by way of a dividend to the Sponsor and transferred 16.5% of Chewy's equity to a newly-formed "Unrestricted Subsidiary" of the Company.
- Given that Chewy was no longer a wholly-owned subsidiary, PetSmart requested that agent under the Company's term loan credit agreement release the liens on Chewy's assets and its guarantee of the term loans, though Chewy would still be a "Restricted Subsidiary" under the loan documents and, therefore, continue to be subject to the credit agreement and indenture covenants.

Locked into billions of dollars in secured debt instruments that, by their terms, required all subsidiaries to provide guarantees and grant a security interest in their assets, how did the Company manage to spin out its most valuable subsidiary and release its guarantee of the Company's debt?

Step One: The Chewy Dividend & Investment

In June of 2018, the Company transferred a total of 36.5% of its equity interests in Chewy through a combination of a dividend to the Sponsor and an investment in an unrestricted subsidiary that utilized the existing restricted payment and investment baskets under its debt documents.

- The Company transferred 20% of Chewy's equity through a dividend to the Sponsor and 16.5% of Chewy's equity as an investment in a new, unrestricted subsidiary of the Company ("***Unrestricted PetSmart***").
- Under the Company's debt documents, spinning off Chewy's equity through a dividend required capacity under the restricted payments baskets equal to at least the fair market value ("***FMV***") of equity being spun off, and transferring Chewy's equity to an unrestricted subsidiary required capacity under the restricted payments and/or investment baskets equal to at least the FMV of equity being transferred.
  - By valuing Chewy at $4.54 billion, the Company was able to comply with the investments and restricted payment baskets under the Company's existing debt documents. In addition to the dollar baskets that were used, the Company determined that it could make restricted payments up to $1 billion by relying on an "Available Amount" basket that allowed the Company to make distributions up to the amount of post-closing equity contributions it had received from the Sponsor.

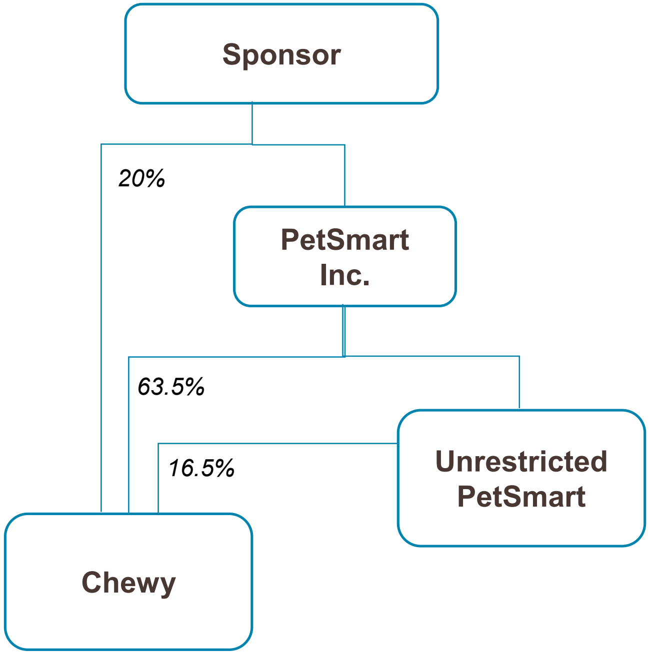


Step Two: Guarantee & Lien Releases

Under the Company's existing secured debt documents, any subsidiary that ceased to be a wholly-owned subsidiary was released from its lien and guarantee obligations under the Company's debt documents.

- After the dividend and investment transactions, Chewy was no longer a wholly-owned subsidiary of the Company.
  - Under fairly standard boilerplate provisions in the credit agreement concerning administrative agent action, to the extent that a restricted subsidiary ceased to be a wholly-owned subsidiary of the Company pursuant to transactions authorized under the credit agreement, the agent was required to release the liens on the restricted subsidiary's assets and it guarantee of the term loans.
  - Under the note indentures, Chewy's liens and guarantee are released automatically upon any release of its liens and guarantees under the credit agreement.
- As a non-guarantor restricted subsidiary, Chewy was still subject to the covenants in the debt documents, but the term loan lenders and noteholders no longer had a direct claim against Chewy or a security interest in any of Chewy's assets and their interest in Chewy was now structurally junior to Chewy's liabilities and limited to the value of the Company's equity in Chewy.

Post-Transaction Structure



Post-Transaction Term Loan Litigation and Aftermath

Immediately following the Company's announcement of the transaction, Citibank, the agent under the credit agreement, refused the Company's instruction to provide documentation evidencing the release of Chewy's guarantee and termination of the lien on Chewy's assets.

- On June 26, 2018, the Company filed a lawsuit against Citibank for breach of contract and requested a declaratory judgment blessing the transactions and requiring the agent to provide the documentation evidencing the release of Chewy's guarantee under the credit agreement and termination of the lien on Chewy's assets.
- In response to the Company's lawsuit, an ad hoc group of term loan lenders formed and directed Wilmington Trust, the successor agent following Citibank's resignation as agent, to bring various counterclaims against the Company on the grounds that, among other things:
  - the Company did not have sufficient investment and restricted payment capacity under the indentures to effectuate the transaction and therefore breached the indentures, which resulted in a cross default and Event of Default under the credit agreement;
  - the transaction violated the "Affiliate Transactions" covenant in the credit agreement requiring that transactions with Affiliates be "on terms substantially as favorable to [PetSmart] as would be obtainable by [PetSmart] at the time in a comparable arm's-length transaction with a Person other than an Affiliate"; and
  - the dividend of Chewy equity to the Sponsor constituted a fraudulent transfer because the Company was insolvent (or rendered insolvent as a result of) the transaction.

Post-Transaction Term Loan Litigation and Aftermath (cont'd)

- In April of 2019, the Company and Wilmington Trust settled the litigation over the Chewy transaction.
- In connection with the settlement, the credit agreement was amended to provide lender parties a 50 bps consent fee, increase the interest rate by 125 bps, tighten covenants, and require a $250 million par paydown within 12 months of the amendment effective date.
- In exchange for, and in connection with, the amendment (which was signed by over 90% of the lenders), Wilmington Trust delivered the documentation required to evidence the release and termination of the applicable guarantees and security interests as a result of the Chewy transactions and each lender acknowledged and agreed that the Chewy transactions were permitted under the credit agreement, ratified the transactions and provided customary releases with respect to the transactions to the Company and Sponsor.
- In June of 2019, the Company took Chewy public and sold 40.9 million shares at a price of $22.0 per share for gross proceeds of $900 million. The Company used approximately $221 million of proceeds to purchase first lien notes and approximately $679 million of proceeds to purchase the term loans

Key Takeaways

The tactics employed by the Company and its Sponsor to carve out Chewy from the collateral and guarantee package of the term loan and notes to and dividend equity in Chewy to the Sponsor raise a number of key points for lenders to consider when assessing potential alternative transactions that can be effectuated under debt documents and the related risk of value leakage.

- The Company and Sponsor identified and utilized a creative strategy by capitalizing on investment and debt capacity and certain boilerplate provisions in the debt documents to effectuate the dividend of Chewy equity and unrestricted subsidiary investment transactions.
- The Company relied on a sizable “Available Amount” basket to materially increase the Company’s restricted payment capacity to distribute a sizeable minority equity interest in Chewy to both the Sponsor and an unrestricted subsidiary.
- However, even if the Company transferred a single share of Chewy equity to the Sponsor, an unrestricted subsidiary or other third party, under the applicable loan documents the agent would have been required to release the Chewy guarantee and security interest.
- By transferring Chewy’s shares to an unrestricted subsidiary, which is not subject to the debt documents and the claims of the lenders, the Company could freely monetize the value of such equity, either by raising debt secured by these shares, effectuating a dividend of the Company’s equity interests in the unrestricted subsidiary to the Sponsor or selling the equity to a third party without any restrictions on the use of proceeds from the sale
- Though lenders initially challenged the transaction, they ultimately consented to it in exchange for a paydown of the term loans and other economic and non-economic concessions from the Company

Considerations for Lenders

LEAKAGE RISKS

- Lenders should be careful to include "PetSmart" protections in their debt documentation, either by not only requiring all subsidiaries to be guarantors but by also stating that guarantees (and the liens securing such guarantees) will not released just because a wholly-owned subsidiary becomes a non-wholly owned subsidiary, particularly in cases where the other equity continues to be held by affiliates within the broader capital structure (e.g., the Sponsor).
- Similar to the J. Crew transaction, the Company and Sponsor used a newly formed unrestricted subsidiary to consummate the PetSmart transaction, but importantly, such step was not necessary to effectuate the release of the liens and guarantee. ***The transfer of a single share of Chewy's equity to a non-Company party was the only necessary step.***

PetSmart reminds us of the potential value of certain protections against leakage, including:

- Where possible require all subsidiaries (and not just wholly-owned subsidiaries) to be guarantors.
- Where guarantors are limited to wholly-owned subsidiaries consider (x) including restrictions on the formation, or creation or designation of non-wholly owned subsidiaries in the future (y) provide that the company may not engage in a transaction in which a wholly-owned subsidiary becomes non-wholly-owned to the extent the intent of such transaction is to reduce the collateral and/or guarantee or (z) provide that collateral and guarantees will not be released if a guarantor goes from wholly owned to non-wholly owned.
- Require the borrower to certify that the transaction giving rise to such release was permitted under credit agreement.