

# Industry Outlook

Private credit, BDCs and  
everything in between

2019 Edition



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Dechert's multidisciplinary permanent capital team provides a round-up of legal and business considerations for private credit, BDCs and everything-in-between.

# Corporate and securities

*The SEC's implementation of recently passed BDC and CEF legislation is expected to revolutionize how they access the public capital markets and bring more speed and efficiency to the process.*

Among other things, new rules will permit BDCs and CEFs that qualify as a well-known seasoned issuer, or “Wksi” (as proposed, a Wksi is an issuer that is eligible to use Form N-2 for registration of a primary offering of securities on a delayed basis and has a worldwide public float of at least US\$700 million or has sold at least US\$1 billion in aggregate principal amount of registered debt (or other nonconvertible securities) in primary offerings for cash) to have their Form N-2 registration statements go effective automatically upon filing with the SEC and pay SEC filing fees at the time of an offering based on the amount of securities sold (i.e., on a pay-as-you-go basis), as opposed to at the time of the initial filling of the registration statement based on the amount of securities registered. The rules will also allow certain BDCs and CEFs to incorporate by reference the periodic and other reports that they previously filed with the SEC into their Form N-2 registration statements, thereby streamlining their registration statements.

One of the most controversial aspects of the two pieces of legislation is that they contain self-implementing provisions which will permit BDCs and CEFs to take advantage of the securities offering reform revisions set forth in the legislation even if the SEC has not promulgated rules to specifically implement them.

The self-implementing provision under the BDC legislation provides that if the SEC failed to adopt the securities offering reform revisions by March

23, 2019, a BDC “may deem those revisions to have been completed in accordance with the actions required to be taken by the [SEC].” Similarly, the self-implementing provision in the CEF legislation provides if the SEC fails to adopt rules to implement the securities offering reform provisions of the legislation by May 24, 2020, a listed CEF or a registered closed-end interval fund “shall be deemed to be an eligible issuer under the final rule of the [SEC] titled ‘Securities Offering Reform’ (70 Fed. Reg. 44722; published August 3, 2005).”

Given that the SEC only proposed the rules on March 20, 2019, BDCs are now faced with the decision of whether, how and to what extent to rely on the self-implementing provision in connection with updating their Form N-2 shelf registration statements at or around the time of the effective date of the self-implementation provision. We are working with our BDCs to determine appropriate ways to rely on the self-implementing provision to the fullest extent possible given the significant cost savings and other benefits afforded by the recent legislation.

CEFs are in a different situation in that the SEC promulgated proposed rules before their May 24, 2020 self-implementation date. As a result, CEFs have greater visibility into the likely contours of the final regulations and how they will affect the CEF capital raising process.

We expect the BDC and CEF community to be very active in responding to requests for comments on the proposed rules (which were proposed in one rulemaking package) and taking other steps to mold the final rules in a manner which puts them on an equal footing with operating companies in the registered securities offering process.

*Authored by Harry S. Pangas*

# Investment Company Act

*SEC rule proposal to allow more funds to invest in other funds, including BDCs and CEFs, in excess of current regulatory limits bodes well for continued growth in the BDC and CEF space.*

Specifically, Section 12(d)(1)(A) of the 1940 Act prohibits a mutual fund, CEF or BDC from: (i) acquiring more than three percent of the outstanding voting securities of another mutual fund, CEF or BDC; (ii) investing more than five percent of its total assets in any one mutual fund, CEF or BDC; or (iii) investing more than 10 percent of its total assets in mutual funds, CEFs or BDCs generally.

Among other things, the proposed rule provides that if an acquiring fund and its advisory group, in the aggregate, holds more than three percent of an acquired fund's outstanding voting securities, the acquired fund and each other member of the advisory group would be required to vote those securities either



by: (i) seeking instructions from its shareholders as to the voting of all proxies with respect to the acquired fund shares and to vote such proxies only in accordance with such instructions (i.e., "pass through" voting); or (ii) voting the shares held by it in the same proportion as the vote of all other shareholders (i.e., "mirror" or "echo" voting).



Neither private funds nor foreign funds is included within the scope of the proposed rule's definition of acquiring funds. As a result, (i) private funds and foreign funds that use U.S. jurisdictional means in the private offering of their securities and rely on Section 3(c)(1) or 3(c)(7) of the 1940 Act would remain subject to the 3 percent limitation noted above and (ii) foreign funds that are not private funds (i.e., they do not rely on Section 3(c)(1) or 3(c)(7) as an exemption from registration under the 1940 Act) would remain subject to the three percent/five percent/ten percent limitations noted above. Given the voting restrictions on an acquiring fund and its advisory group set forth in the proposed rule, we expect that a number of BDCs and CEFs will submit comments to the SEC requesting that private funds and foreign funds be permitted to rely on the same proposed rule as acquiring funds in order to broaden their potential investor base. Other funds may be leery of the possible concentration of voting power in the hands of a private funds, notwithstanding the voting restriction as described above, given the activist investor role that some private funds platforms have played in the BDC and CEF space from time to time.

*Potential relief from the SEC's "Acquired Fund Fees and Expenses" rule for traded BDCs in 2019 may result in their re-admittance into major stock indices four years after being kicked out of them and a run-up in the stock prices of traded BDCs over the next several years.*

In potential foreshadowing of the adoption of changes to the "Acquired Fund Fees and Expenses" (AFFE) disclosure requirements for which the BDC industry advocated since 2014, the SEC solicited comments in the proposing release for the revised fund of funds rule (see discussion above) on potential revisions to the AFFE requirements [as they apply to BDCs], including whether the SEC should "exempt certain types of acquired funds from the definition of acquired funds for the purposes of AFFE disclosure" and "[i]f so, which types of acquired funds should be exempted and why[.]"

While it is difficult to predict how the SEC will ultimately handle this issue, we remain hopeful that meaningful reform is afoot given the sustained lobbying effort by the BDC industry to educate Congress and the SEC about the unique harm suffered by traded BDCs as a direct result of the AFFE rule. The AFFE final rule release stated in 2006 that the SEC "does not believe the amendments will have an adverse impact on capital formation." This has proven not to be the case due to actions taken by Standard and Poor's and Russell Investment Group in 2014 to remove BDCs from the indices administered by them (e.g., the S&P 500 and the Russell 2000), which harmed capital formation for BDCs and ultimately diminished the amount of capital flowing to businesses for which BDCs are mandated to provide financing.

*Authored by Harry S. Pangas and Michael Sherman*

# CLOs/structured finance

*For the CLO market, initial indications are that 2019 will be a busy, but bumpy, year.*

Market participants and rating agencies are not expecting a material increase in defaults or delinquencies, and broader “Main Street” economic fundamentals remain strong. Rising interest rates generated some volatility in 2018, but because the vast majority of CLOs issue floating rate debt (and acquire predominately floating rate debt), CLOs are well equipped to handle any further rate rises.

We are seeing strong interest in the formation of new CLO focused investment funds, as well as large scale “FinCo” platforms that are being formed that may fill an increasing void created by reduced major bank lending in the leveraged lending space as a result of an increasing pullback from that business. Finally, outside of the main CLO market space, we continue to see strong demand for niche products such as collateralized bond obligations and securitizations of trust preferred securities. Investors remain drawn to secured credit and its attractive yields relative to other asset classes.

On the negative side, there is general anxiety about loosening credit standards in leveraged lending. In particular, there has been a heightened concern among market participants about the proliferation of covenant-lite loans (including the use of “adjusted” EBITDA calculations) and the amount of leverage companies in various industries have taken on during the protracted low interest rate environment. Further, recent studies suggest that when the current credit cycle bottoms out, actual recovery rates will be lower than historical recovery rates.

In the CLO space, these concerns are leading to increasing scrutiny of deal terms by both rating agencies and investors. That said, where some see stress, others see opportunity. Certain managers have issued CLOs with large allowances for CCC-rated assets on the investment theory that a CLO can and should take advantage of buying opportunities in a distressed environment. We predict innovation in the CLO market to continue apace with market and regulatory demands as it has since the end of the Great Recession.

Finally, on the regulatory front the latest iteration of the EU risk retention requirements has had a somewhat chilling effect on the European CLO market since the start of 2019. In particular, the proposed new data reporting requirements would be onerous and very difficult for the typical CLO manager to comply with. However, regulators have not yet finalized the particularities as to application of the new rules, and there is a strong lobbying effort underway seeking relief from the data reporting requirements as they apply to CLOs. This will bear close watching as the final outcome in the weeks ahead will go a long way to determining activity in the CLO (and securitization) markets in Europe for this year and beyond.



In addition, it appears Japanese banking authorities are actively examining whether or not to institute some form of risk retention for securitization products offered to Japanese investors. This would have a huge impact on U.S. CLO managers, as Japanese banks have been large buyers of AAA-rated CLO liabilities, particularly those from so-called “open-market CLOs” that are otherwise relieved from U.S. risk retention requirements as a result of the LSTA court decision in early 2018. Taken as a whole, the regulatory matters in Europe and Japan could, in a worst-case scenario, effectively remove a large number of CLO investors from the marketplace.

*Authored by Christopher Desmond and Christopher Duerden*

## Restructuring

Lower interest rates reduce the number of bankruptcies and restructurings, and stable markets and international relations similarly tend to have that effect. However, when rates rise and volatility increases, we normally see an uptick in restructurings. While we experienced an increase in rates in 2018, we remain in the midst of an unusually sustained period of lower rates, making predictions regarding restructuring activity more difficult than usual.

Areas where we expect to see continued activity in the United States include the retail and energy sectors. Both have experienced distress in the last few years and restructuring activity in that space continues. The fundamental underlying reasons in the retail

area – encroachment from online sellers and changing consumer behavior – persist and will continue to do so. In the energy markets, softening oil prices in early 2019 portend continuing operating troubles and renewed distress among marginal players. In addition, there are signs of distress across many varied and unrelated U.S. industries, suggesting that the long predicted downturn may be upon us.

We also expect to see, and have seen for several years, the need for restructurings and bankruptcies in the emerging markets. Those include Latin America, the Middle East and Asia, and we expect that trend to continue.

*Authored by Michael Sage*

# Tax

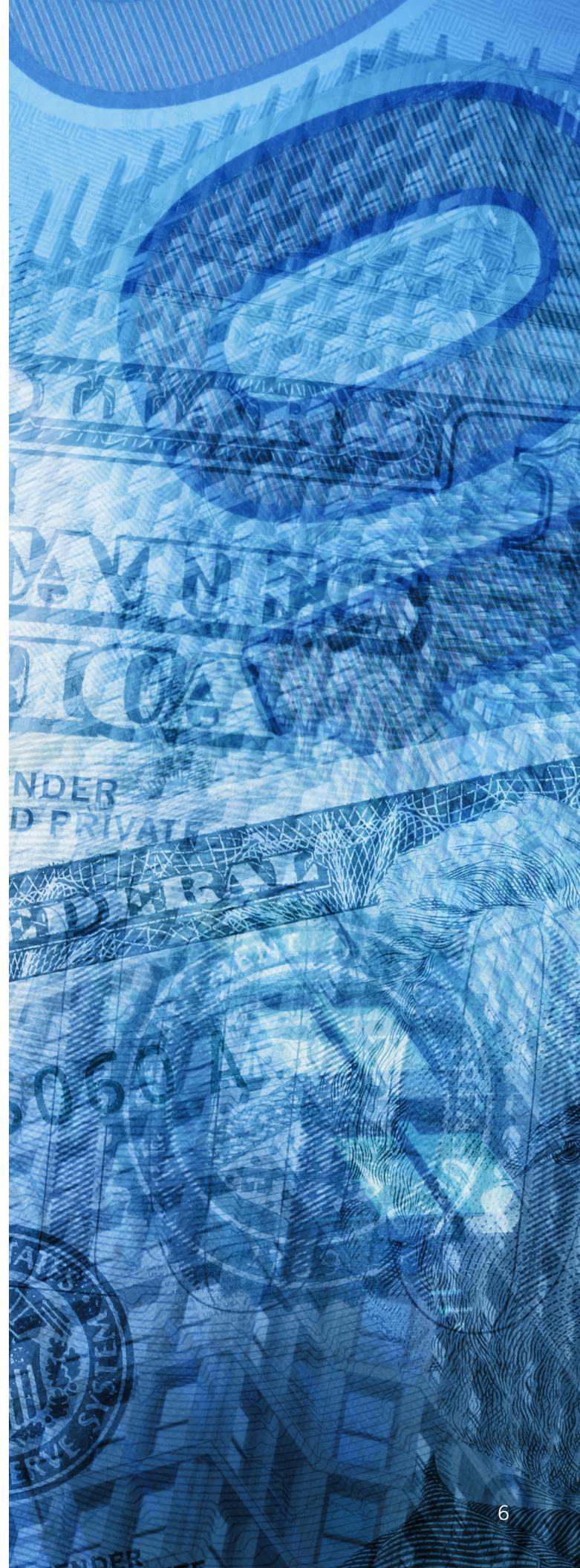
*Strong demand for tax efficient credit fund structures and potential impact of legislative/political developments.*

For the remainder of 2019, we anticipate strong demand from non-U.S. investors for tax efficient options to gain exposure to U.S.-originated loans (these include BDCs, treaty-based structures and “season and sell” structures). As a result of the recent reduction in the maximum U.S. federal corporate income tax rate from 35 percent to 21 percent, leveraged blocker structures may become more appealing in situations where a more tax efficient option is unavailable or the applicable tax leakage is viewed as a worthwhile trade-off for a less complicated structure.

Tax reform also included provisions restricting the deductibility of interest expense. Their impact on the private credit market is worth watching in 2019 (and beyond). Very broadly, such provisions generally limit the deductibility of business interest expense (net of business interest income) to 30 percent of a business’s annual adjusted taxable income (“ATI”). ATI approximates, but does not necessarily equal, EBITDA through 2021 and EBIT for years thereafter. Thus, through 2021, deductions for depreciation, amortization or depletion are added back in computing ATI. However, beginning in 2022, such deductions will no longer be added back in such computation, thereby creating an unexpected burden on capital expenditures after 2021. Businesses with gross receipts below US\$25 million are generally exempt from this limitation.

*Authored by Ari Zak*

In Europe, two items are likely to impact the private credit market in 2019: Brexit and the entry in force of the Anti-Tax Avoidance Directive (“ATAD”) in several European Union (EU) member states.





Certain credit providers, such as private debt funds, are considering restructuring, or have already restructured, their organizations in anticipation of a “hard” Brexit. The tax impacts of these restructurings in different EU jurisdictions are or were amongst the key elements taken into consideration by credit providers relocating all or of part of their teams.

In addition, the entry into force of ATAD leads to a partial harmonization of the tax rules regarding the deductibility of financial charges across the EU. Although these rules are already implemented in

certain EU member states, such as Germany or the UK, they are new in certain other jurisdictions, such as in France. In practice, as the deduction of the net financial charges is now closely related to the operational results of the borrowing entity (or, as the case may be, of the tax consolidated group of the borrowing entity), it is likely that the debt allocation between the different entities (or sub-groups) of multinational groups will be reconsidered.

*Authored by Sabina Comis*

# Leveraged finance

While the drumbeat of a potential economic downturn bangs louder, the position of private credit managers as the dominant source of financing for small and medium-sized entities (“SMEs”) and middle-market companies and as an increasingly viable alternative to traditional bank-led financings in other markets has become entrenched.

With increased experience and sophistication in the private credit industry, and greater market shares, has come increasing exposure to leverage. Managers using leverage are boosting their returns and demonstrating the flexibility and quick access to liquidity for lenders that has fueled the growth of the private credit industry. Those who are also increasing their work-out expertise and maintaining a supply of dry powder during this period of growth will be particularly well placed for any downturn.

The private credit industry at this stage is a mature and robust alternative to traditional bank lending and a permanent and critical component of the financing markets and global economy. We expect this growth of private credit to continue and believe private credit funds are well positioned to handle a downturn in markets.

*Authored by Jay Alicandri*



# Fund formation

*Better capital treatment for notes issued by private debt funds drives increasing demand.*

Greater demand over the last few years has driven debt fund products to become more diverse and specialized. One new product that illustrates this continuing specialization is a fund that invests in loans or debt securities and issues notes instead of equity to investors. Demand for this type of structure has been increasing because the notes issued by such a fund can be rated, and insurance companies receive better capital treatment for the notes than if they made a similar investment in fund equity.

A traditional private equity fund that invests in loans or debt securities is usually structured to offer equity interests to investors. Depending on the structure of the private fund, equity is typically created in the form of partnership interests, limited liability company interests or shares, and debt instruments are issued. Distributions (including incentive fees) are allocated to the investors and the sponsor of the fund according to a payment “waterfall.”

Typically, the waterfall has four basic prongs. First, investors’ capital is returned. Second, the investors receive a preferred return (a “pref”) on their capital. A pref is a negotiated minimal return (usually between 6-8 percent) that investors receive before the sponsor may start receiving any portion of its profit. Third, the sponsor “catches-up” to the investors who have received the pref. This clause is meant to make the sponsor whole so that their incentive fee is a function of the fund’s total return

and not solely the return in excess of the preferred return. Finally, distributions are made between the investors and the sponsor according to a fixed split (often 80/20 or 90/10).

The underlying economics of the new note structure is very similar to a traditional fund equity arrangement. However, instead of only receiving equity interests for their capital commitment, investors receive a combination of notes and equity. Usually the split between debt and equity is 97 percent/3 percent, and the equity is stapled to the debt (i.e., there is no ability to trade the securities separately). Voting rights and most other provisions in the organizational documents do not change.

Note funds have often been set up as parallel or feeder funds to more traditional fund structures to allow sponsors to access additional capital. The waterfall in a note fund is very similar to the waterfall described above with a few minor changes. In the first prong of the waterfall, note principal is returned. After the principal, the capital contributed by investors for the 3 percent equity interest is returned. After those payments, interest on the notes is paid and a “pref” on the 3 percent equity interest is paid. If the pref on the equity is 6 percent, then the interest on the notes is also usually 6 percent. The remainder of the waterfall is the same as for traditional equity funds.



Ratings agencies such as Egan Jones typically consider final terms, strategy and the sponsors track record for similar funds.

#### **More CLO equity funds being formed**

For many years we have assisted many of our debt-focused sponsor clients in forming new funds to acquire the debt portions of CLOs, a form of securitization where payments from debt issued by multiple middle-sized and large business loans are pooled together and passed on to different classes of owners in various tranches. CLOs typically issue a series of tranches of interest-paying bonds and a small slice of equity.

More recently, we have been helping sponsors set up funds dedicated to acquiring the equity portion of CLOs. The clients forming these funds already participate in the CLO market and have investors that are active purchasers of CLO securities. Often such funds participate in the equity portions of at least some CLOs set up by the sponsor. Other sponsors have developed hybrid funds that combine investments in CLO equity and some CLO debt tranches.

Generally CLO debt and equity funds have traditional private equity terms. For example, the terms are approximately 10 years, and the investment periods are three years. If the fund is formed to participate in the CLOs created by the sponsor, there is no incentive compensation and little to no management fee. We expect this market to remain busy.

*Authored by Timothy Clark*

# Mergers and acquisitions

The mergers and acquisitions markets continue to be strong, despite (or perhaps because of) a growing concern of a pending economic downturn. This is true for M&A by and amongst BDCs and other fund entities. A significant driver of BDC M&A has historically been the drive to enhance shareholder value, leading to consolidation transactions that increase assets under management and allow fixed fees to be spread across a broad portfolio. This has been coupled by acquisitions and externalization transactions by asset managers seeking to enter the BDC space as an avenue of growth and, for whatever reason, prefer to “buy” rather than “make” a new BDC. Finally, although acquisitions by BDCs looking to expand their product offerings has been a smaller driver of deals, it is nonetheless an important consideration for BDCs looking for an edge to compete for borrowers.

2018 was marked by the announcement of a number of large BDC consolidations, including Golub Capital BDC’s proposed acquisition of Golub Capital Investment Corp, the merger of FS Investment Corporation and Corporate Capital Trust, Inc., and Triangle Capital Corporation’s asset sale transaction with an affiliate Benefit Street Partners L.L.C. and subsequent externalization transaction with Barings LLC. Whether consolidation activity amongst BDCs will continue throughout 2019 is unclear. BDCs often perceive consolidation as a means to improve their ability to compete for transactions and execute loans. Larger combined BDCs also allow managers to improve liquidity and public float and spread fixed, non-advisory costs over more assets. But these transactions are complex and difficult to negotiate – diligence can be time consuming, there are significant valuation concerns (particularly when stock is used as consideration), and the proxy solicitation process can be expensive and drawn out. These concerns, combined with volatile market conditions, may limit the number of consolidation deals that actually close.

Regardless of the state of the economy generally, the BDC space is still appealing for asset managers that are looking to expand and have yet to find a foothold in the space. The externalization of Triangle by Barings LLC mentioned above and the externalization of KCAP Financial, Inc. by BC Partners, both demonstrate this trend. We would expect





asset managers to target BDCs that have not been able to attain critical mass, or those whose stock prices have significantly lagged NAV. This move into BDCs is part of a larger trend by traditional asset managers to acquire alternative credit managers, as evidenced by American International Group, Inc.'s acquisition of Covenant Credit Partners, ORIX Corporation USA's acquisition of NXT Capital, Inc., and the acquisition of Benefit Street Partners, the external adviser to Business Development Corporation of America, by Franklin Resources Inc.

A number of BDCs have been using M&A in order to expand their product offering and offer a more complete solution for potential borrowers. The activity in the asset backed loan ("ABL") industry is a great example of this, as BDCs have added internal ABL capability to allow them to offer a full suite of financing options to borrowers with competitive pricing. Recent examples of this are Hercules Capital Inc.'s acquisition of Gibraltar Business Capital in 2018 and BDCA's acquisition of Siena Capital Finance in 2019. Given the intense competition among non-bank lenders, we expect BDCs to continue use the M&A markets to supplement their organic growth and find new opportunities in the market. This type of activity, though, is by definition opportunistic, and it remains to be seen how many targets are available at prices that BDCs would be willing to pay.

*Authored by Adam Rosenthal*



# About Dechert's permanent capital practice

Dechert's multidisciplinary permanent capital team advises asset managers in all aspects of their capital strategies. We have particularly deep experience in BDCs, having worked with this structure since it was first authorized by law in 1980. We also act for 41 of the top 50 global private debt firms as identified by *Private Debt Investor* in 2017.

Our lawyers possess a detailed understanding of the most current trends and developments, the latest regulatory hurdles, up-to-the-minute market terms and an insider's perspective when it comes to regulatory compliance. We are committed to turning our experience and expertise into value for our clients.

# Dechert's permanent capital team

## Co-heads of Dechert's permanent capital practice



**Thomas J. Friedmann**  
Partner  
Boston  
+1 617 728 7120  
[thomas.friedmann@dechert.com](mailto:thomas.friedmann@dechert.com)



**Richard Horowitz**  
Partner  
New York  
+1 212 698 3525  
[richard.horowitz@dechert.com](mailto:richard.horowitz@dechert.com)

## Asset-backed securitization and real estate finance



**Malcolm S. Dorris**  
Partner  
New York  
+1 212 698 3519  
[malcolm.dorris@dechert.com](mailto:malcolm.dorris@dechert.com)



**Matthew R. Hays**  
Partner  
Chicago  
+1 312 646 5804  
[matthew.hays@dechert.com](mailto:matthew.hays@dechert.com)



**Ralph R. Mazzeo**  
Partner  
New York | +1 212 698 3635  
Philadelphia | +1 215 994 2417  
[ralph.mazzeo@dechert.com](mailto:ralph.mazzeo@dechert.com)

## Asset management M&A



**Michael S. Darby**  
Partner  
Philadelphia  
+1 215 994 2088  
[michael.darby@dechert.com](mailto:michael.darby@dechert.com)



**Stephen R. Pratt**  
Partner  
Philadelphia  
+1 215 994 2296  
[stephen.pratt@dechert.com](mailto:stephen.pratt@dechert.com)



**Jon S. Rand**  
Partner  
New York  
+1 212 698 3634  
[jon.rand@dechert.com](mailto:jon.rand@dechert.com)



**Adam D. Rosenthal**  
Partner  
Philadelphia | +1 215 994 2623  
New York | +1 212 641 5612  
[adam.rosenthal@dechert.com](mailto:adam.rosenthal@dechert.com)

## Corporate and securities



**Matthew J. Carter**  
Partner  
Washington, D.C.  
+1 202 261 3395  
[matthew.carter@dechert.com](mailto:matthew.carter@dechert.com)



**James A. Lebovitz**  
Partner  
Philadelphia | +1 215 994 2510  
New York | +1 212 698 3610  
[james.lebovitz@dechert.com](mailto:james.lebovitz@dechert.com)



**Harry S. Pangas**  
Partner  
Washington, D.C.  
+1 202 261 3466  
[harry.pangas@dechert.com](mailto:harry.pangas@dechert.com)



**Gregory A. Schernecke**  
Partner  
Philadelphia  
+1 215 994 2687  
[gregory.schernecke@dechert.com](mailto:gregory.schernecke@dechert.com)



**Eric S. Siegel**  
Partner  
Philadelphia  
+1 215 994 2757  
[eric.siegel@dechert.com](mailto:eric.siegel@dechert.com)



**Kenneth E. Young**  
Partner  
Philadelphia | +1 215 994 2988  
New York | +1 212 698 3854  
[ken.young@dechert.com](mailto:ken.young@dechert.com)

## Derivatives and structured products



**Matthew K. Kerfoot**  
Partner  
New York  
+1 212 641 5694  
[matthew.kerfoot@dechert.com](mailto:matthew.kerfoot@dechert.com)

## Direct lending and fund finance



**Jay R. Alicandri**  
Partner  
New York  
+1 212 698 3800  
[jay.alicandri@dechert.com](mailto:jay.alicandri@dechert.com)



**Philip Butler**  
Partner  
London  
+44 20 7184 7442  
[philip.butler@dechert.com](mailto:philip.butler@dechert.com)



**Sarah B. Gelb**  
Partner  
Philadelphia  
+1 215 994 2763  
[sarah.gelb@dechert.com](mailto:sarah.gelb@dechert.com)



**David Miles**  
Partner  
London  
+44 20 7184 7558  
[david.miles@dechert.com](mailto:david.miles@dechert.com)



**Jeff Norton**  
Partner  
New York  
+1 212 698 3550  
[jeff.norton@dechert.com](mailto:jeff.norton@dechert.com)



**Scott M. Zimmerman**  
Partner  
New York  
+1 212 698 3613  
[scott.zimmerman@dechert.com](mailto:scott.zimmerman@dechert.com)

# ERISA



**Andrew L. Oringer**  
Partner  
New York  
+1 212 698 3571  
[andrew.oringer@dechert.com](mailto:andrew.oringer@dechert.com)

## Fund formation



**Gus Black**  
Partner  
London  
+44 20 7184 7380  
[gus.black@dechert.com](mailto:gus.black@dechert.com)



**Timothy M. Clark**  
Partner  
New York  
+1 212 649 8732  
[timothy.clark@dechert.com](mailto:timothy.clark@dechert.com)



**Carl A. de Brito**  
Partner  
New York  
+1 212 698 3543  
[carl.debrito@dechert.com](mailto:carl.debrito@dechert.com)



**Russel G. Perkins**  
Partner  
New York  
+1 212 698 3852  
[russel.perkins@dechert.com](mailto:russel.perkins@dechert.com)

## Investment Company Act / BDC regulatory



**William J. Bielefeld**  
Partner  
Washington, D.C.  
+1 202 261 3386  
[william.bielefeld@dechert.com](mailto:william.bielefeld@dechert.com)



**Stephen H. Bier**  
Partner  
New York  
+1 212 698 3889  
[stephen.bier@dechert.com](mailto:stephen.bier@dechert.com)



**James M. Curtis**  
Partner  
Washington, D.C.  
+1 202 261 7734  
[james.curtis2@dechert.com](mailto:james.curtis2@dechert.com)



**Allison M. Fumai**  
Partner  
New York  
+1 212 698 3526  
[allison.fumai@dechert.com](mailto:allison.fumai@dechert.com)



**David J. Harris**  
Partner  
Washington, D.C.  
+1 202 261 3385  
[david.harris@dechert.com](mailto:david.harris@dechert.com)



**Jeremy I. Senderowicz**  
Partner  
New York  
+1 212 641 5669  
[jeremy.senderowicz@dechert.com](mailto:jeremy.senderowicz@dechert.com)



**Michael L. Sherman**  
Partner  
Washington D.C.  
+1 202 261 3449  
[michael.sherman@dechert.com](mailto:michael.sherman@dechert.com)



**David A. Vaughan**  
Partner  
New York | +1 212 698 3540  
Washington, D.C. | +1 202 261 3355  
[david.vaughan@dechert.com](mailto:david.vaughan@dechert.com)

## Structured finance and CLOs



**Christopher Desmond**  
Partner  
Boston  
+1 617 728 7170  
[christopher.desmond@dechert.com](mailto:christopher.desmond@dechert.com)



**Christopher P. Duerden**  
Partner  
Charlotte  
+1 704 339 3113  
[christopher.duerden@dechert.com](mailto:christopher.duerden@dechert.com)



**Charles Malpass**  
Partner  
London  
+44 20 7184 7686  
[charles.malpass@dechert.com](mailto:charles.malpass@dechert.com)



**John M. Timperio**  
Partner  
Charlotte  
+1 704 339 3180  
[john.timperio@dechert.com](mailto:john.timperio@dechert.com)



**James Waddington**  
Partner  
London  
+44 20 7184 7645  
[james.waddington@dechert.com](mailto:james.waddington@dechert.com)



**Cynthia J. Williams**  
Partner  
Boston  
+1 617 654 8604  
[cindy.williams@dechert.com](mailto:cindy.williams@dechert.com)

## Tax structuring



**Adrienne M. Baker**  
Partner  
Boston  
+1 617 728 7151  
[adrienne.baker@dechert.com](mailto:adrienne.baker@dechert.com)



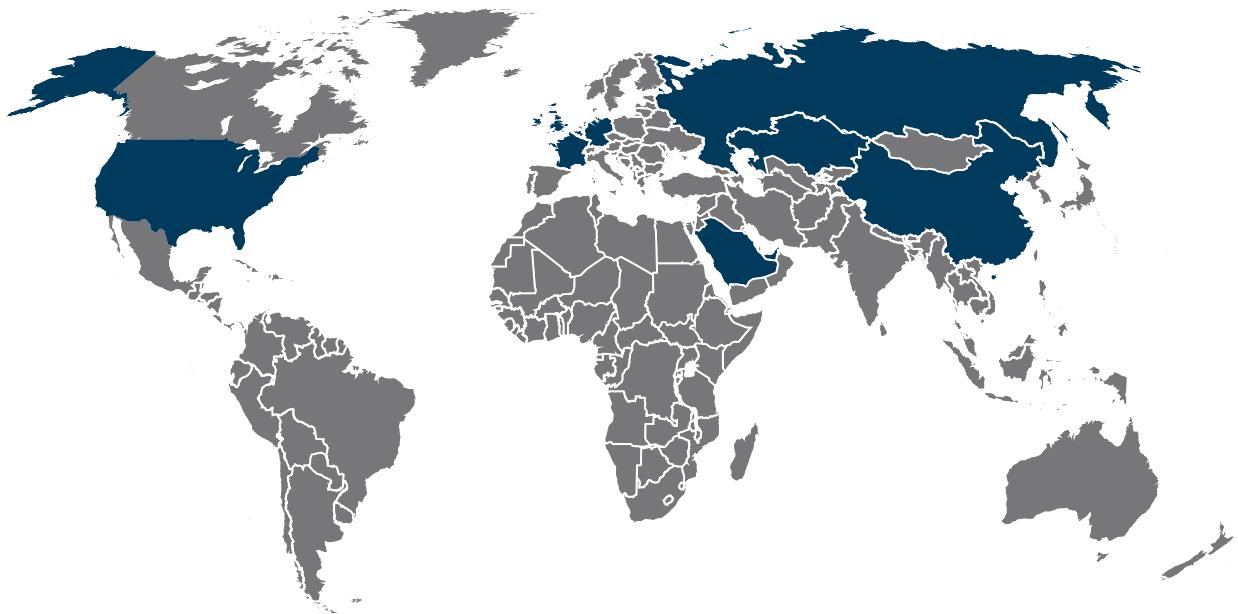
**Sabina Comis**  
Partner  
Paris  
+33 1 57 57 81 66  
[sabina.comis@dechert.com](mailto:sabina.comis@dechert.com)



**Joseph A. Riley**  
Partner  
New York  
+1 212 698 3528  
[joseph.riley@dechert.com](mailto:joseph.riley@dechert.com)



**Ari M. Zak**  
Partner  
New York  
+1 212 698 3655  
[ari.zak@dechert.com](mailto:ari.zak@dechert.com)



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