



Special Report: The Corporate Loan & CLO Conundrum *Investigating their Covenants*

Introduction

As we exit an historically benign credit cycle, exhibiting strong growth and ample demand, we sharply enter an environment marked by severe illiquidity and its particular dearth of financing opportunities, a funding scarcity to which speculative-grade¹ corporations are certainly not immune.

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The vicious circle of illiquidity – excess supply and reduced financing capabilities leading to increased default risk leading to lower demand returning to reduced funding sources – has left the leveraged loan market, previously a key outlet for these sub-investment-grade companies to finance their businesses, largely frozen.

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A plethora of market research describing the difficulties facing corporate loans -- and by extension collateralized loan obligations (CLOs) – continues to be circulated. These difficulties include the increasing corporate default rates and decreasing recovery rates; the all-too-frequent downgrades of originally BB and B-rated assets to CCC levels, and their impact on CLO coverage test ratios; the challenges for CLO managers trying to build par coverage amid the “deep discount” purchase haircuts² imposed by deal indentures; CLO event of default risks, and so on and so forth.

With this in mind, our piece focuses on certain key features and covenants that may alter a given CLO's future payment streams and may distinguish one CLO from another:

- Summary – State of the Market
- Corporate Loans and Bonds Covenants – *Distinguishing* Characteristics and Covenants
- CLO Indenture Treatment for So-called “Defaulted Securities”
- Concluding Remarks

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¹ Speculative grade, also referred to as “sub-investment-grade” or “junk,” refers to companies or assets rated Ba1 or below by Moody's and BB+ or below by Fitch/S&P.

² E.g., Flanagan *et al.* “J.P. Morgan Securities Inc.: U.S. Fixed Income Strategy,” March 7, 2008.

Summary – State of the Market

The preceding, “default-benign” credit cycle (2002–2007), displaying high levels of liquidity and strong demand, *created the opportunity for corporations to borrow heavily, obtaining low coupons despite being supported by weak covenant packages.*

The performance of these borrowings – be they corporate bonds or bank loans³ – is a focal point for the economy in general, and for CLOs in particular.

While the performance of loans and bonds is crucial to the performance of CLOs, so too may the performance of CLOs be crucial to the performance of loans and bonds: CLOs are *the* largest investor in, and hence source of demand for, sub-investment-grade⁴ institutional loans. As such, any continuation (or revival) of the CLO market would bring with it the dual benefits of encouraging the syndication of loans – providing an additional, positive, financing alternative for companies – and increasing demand, which drives loan prices up, *ceteris paribus*.

Indeed the leveraged loan and CLO markets have been inseparable of late, growing in tandem from 2001 to mid 2007 (by which time the CLO “machine” had become responsible for purchasing as much as 60-65% of new-issue leveraged loans).⁵

CLOs’ collateral composition, too, evolved during the benign cycle, with the supply of first lien loans being finite, and with managers perhaps taking more liberties in their asset selection. Among others, we noticed a steady increase in CLOs’ average percentage exposure to:

- covenant light loans (from $\pm 5\%$ for CLOs issued in 2000 to $\pm 20\%$ for post 2006-vintage CLOs);⁶ and
- non 1st lien loans, including increased exposure to corporate bonds and structured finance securities.

Arguably the three determining factors⁷ in the performance of CLOs as a whole will be:

- (1) the default rates of their underlying corporate bonds and loans;
- (2) the timing of those defaults; and
- (3) the recoveries realized upon default.

Default rates on speculative grade companies, currently nearing the 5% level depending on the data source’s calculation technique, are regularly forecasted to reach between 8% and 14% by the end on 2009, with the three-year (2008-2010) cumulative default rate ranging from 20 to 30%.⁸

Various market research has described the additional burden on CLOs in a high default environment: the inversely correlated, proportionately low, associated recovery rates. While this supply and demand imbalance has proven a burden in the best of times, the scarcity of refinancing sources (including debtor-in-possession financing) is particularly troublesome as it may force defaulting companies to resort to Chapter 7 bankruptcy filings (liquidation) as opposed to being able to re-emerge via reorganization under Chapter 11. The liquidation process often decreases the value of the company’s assets, further reducing the realizable recovery on its debt.

³ The terms “loans,” “leveraged loans,” “corporate loans” and “bank loans” are used interchangeably throughout this report.

⁴ Sub-investment-grade indenture covenants are usually stronger than investment-grade indentures, with the latter often lacking debt incurrence and payment restriction covenants.

⁵ See Antczak, Lucas *et al.* “UBS Investment Research: CDO Insight” (Jan. 23, 2008) for a worthwhile history of loans and CLOs.

⁶ Preston, Pauley “Structured Products Research: 2009 CLO Outlook,” a Wachovia Capital Markets, LLC publication (Dec. 19, 2008) provides an effective vintage-level breakdown across the 549 CLOs in their sample set.

⁷ On a per-deal and per-tranche basis, other key factors may include: prepayment speeds, interest rate scenarios and the managers’ abilities to build par and/or excess spread during the coming years.

⁸ E.g., S&P views a three-year worst-case scenario default rate of 23% for non-financial, speculative-grade companies.

As CLOs struggle to overcome the dual burden of high defaults and low recoveries, one important additional variable is the timing of the defaults. Given their intricate cashflow waterfalls and structural features (principal and interest coverage ratios, turbo features and other diversion mechanisms, etc.), and their ability to generate excess spread on performing securities, the default-timing profile becomes important, as it may help determine the future cashflow streams and the allocations available for each tranche. While a delayed default is usually preferable for all tranches in the deal, the lumpiness (such as we saw for ABS CDOs) of defaults may provide an additional “test” of the structural protection afforded by CLOs.

This research paper aims, then, to show how bond and loan covenants (strong or weak) may affect all three of these bond and loan-level performance metrics and, with them, the performance of certain CLOs.

Corporate Loans and Bonds - *Distinguishing* Characteristics and Covenants

The key outcome from this section is the realization that company-level and market-wide default probability approximations for corporate bonds and loans need not be the same; to further this point, even for a single corporation, the likelihood of default on each of its bonds need not be identical.

Why?

Even for structurally similar instruments issued by the same company, various aspects may distinguish their market prices, assumed default probabilities and expected recoveries upon default, including – as applicable -- differences in:

- (1) their related covenants and clauses;
- (2) their currency denominations;
- (3) their prepayment, optional redemption and maturity profiles;⁹ and
- (4) their credit spreads and index benchmarks and optionality.

Part (4) is of timely consideration: in October 2008 we began to notice several borrowers exercising their option to revert *from paying* LIBOR + credit spread *to paying* Prime + credit spread – 1% on their loans. As LIBOR, typically more than 1% lower than Prime, began to exceed Prime by 25 to 35 basis points, the option to revert to Prime meant borrowers were able to save 1.25% to 1.35%.¹⁰

Parts (2) to (4) above are largely transparent and fall beyond the scope of this piece.

A covenant is a restriction or requirement. Much like a curfew – if you don't have one, you can't break one.

Essentially, the more numerous the restrictions imposed, the earlier a company is likely to trigger one during tough times; the earlier a covenant is triggered, from a lender's perspective, the more likely that some substance remains in the troubled company to effectuate a meaningful recovery.

For covenant light loans, the absence of certain covenants would decrease the probability of defaulting on the loan but, if and when it may default, may (arguably) substantially lower its expected recovery.

From a lender's perspective, the leveraged loan market offered enticing opportunities, not entirely dissimilar from venture capital: the loans were historically supported by restrictive financial and operating covenants – which allowed lenders significant control over the borrower's activities – and a (typically first) priority interest in

⁹ CLOs typically purchase the longer maturity term loans (often term loan B) available in a credit agreement.

¹⁰ CLOs then, ultimately the lenders, were negatively affected by the decreased interest cashflow stream.

the assets with which the borrower secured the loans; together, the covenants and the priority interest increased the likelihood of high, if not full, recovery upon the borrower's default.

The covenants, here, more particularly encourage the borrowing company to manage across its capital structure,¹¹ serving both its creditors and shareholders. This is achieved by allowing creditors to monitor the company's performance against certain restrictions, and potentially secure more favorable terms if the company's financial condition deteriorates from where it was when credit was extended.

(Right): This table highlights the superior recovery rates historically realized on leveraged loans and, more generally, by seniority level in the borrower's liability structure.

Average Issuer-weighted Corporate Debt Recovery Rates			
(measured by 30-day post-default trading prices)			
	2006	2007	1982-2007
Bank Loans			
Sr. Secured	76.02%	67.74%	70.47%
Sr. Unsecured	--	--	54.02%
Bonds			
Sr. Secured	74.63%	80.54%	51.89%
Sr. Unsecured	55.02%	51.02%	36.69%
Sr. Subordinated	41.41%	54.47%	32.42%
Subordinated	56.11%	--	31.19%
Jr. Subordinated	--	--	23.95%
Pref. Stock			
Trust Pref.	7.12%	--	11.66%
Non-trust Pref.	6.75%	--	23.22%

Source: Moody's Investors Service, Inc.

As with recovery rates, covenants and clauses may affect the default probability of the instrument, and the timing of such default.

Examples:

- (1) A cross-default covenant or clause is not always in place (more often absent when the bonds are structurally subordinated to the bank loans);
- (2) Even when in place, cross-default clauses
 - may require noteholder payment acceleration to trigger the cross-default (see below)
 - may not be "air-tight," and may allow certain cushion
- (3) Debt covenant defaults may be waived by senior note holders.

Part (3) is particularly timely as it may (arguably) benefit CLO equity holders, at the possible expense of the AAA and AA tranche holders. Senior noteholders (of corporate debt) may agree to waive certain debt covenant defaults in exchange for increasing the promise on their notes. Banks – often senior lenders – may be particularly incentivized to negotiate waivers in the current environment, as they seek to at least temporarily avoid facing impairment charges on defaulted securities.¹²

¹¹ CLOs similarly try to overcome a similar potential conflict of interest, attempting to ensure the manager manages across her capital structure by subordinating certain collateral management fees in the deal's priority of payments, and often having the manager purchase a portion of her deal's equity (i.e., most junior) piece.

¹² Example: In December 2008, senior holders of INEOS debt – largely held by European CLOs – voted to extract an additional 1.75% to 2.25% on their loans, in exchange for covenant relief.

Example: Charter Communications, Inc.¹³

From their Form 8-K filing with the SEC, dated 1/15/09:

“Two subsidiaries of Charter Communications, Inc. (the “Company”), CCH I Holdings, LLC and Charter Communications Holdings, LLC, did not make scheduled payments of interest due on January 15, 2009, on certain of their outstanding senior notes set forth in the table below. The interest payments total \$73.7 million in the aggregate (as set forth in the table below).

	Interest Due (\$ mm)	Principal Amount Outstanding as of 9/30/08 (\$ mm)
<i>CCH I Holdings, LLC:</i>		
11.125% senior notes due January 15, 2014	8.4	151
13.500% senior discount notes due January 15, 2014	39.2	581
12.125% senior discount notes due January 15, 2015	13.1	217
<i>Charter Holdings:</i>		
10.250% senior notes due January 15, 2010	0.9	18
11.75% senior discount notes due January 15, 2010	0.9	16
11.125% senior discount notes due January 15, 2011	2.6	47
13.500% senior discount notes due January 15, 2011	4	60
12.125% senior discount notes due January 15, 2012	4.6	75
Total	73.7	1,165

If such interest payments are not made within the 30-day grace period provided by each of the governing Indentures, an event of default would occur under the indentures governing the notes, permitting holders of at least 25% in principal amount of any outstanding series of notes on which the interest payment was not made to declare the full amount of the applicable notes immediately due and payable.

An event of default on the notes, without such an acceleration of amounts due under the notes, would not trigger cross-defaults on any of the other debt of the subsidiaries of the Company. If payment is not made with respect to any series of notes within the 30-day grace period, and the notes are accelerated, all amounts due with respect to such affected notes become immediately due and payable. If notes issued by the Company or any of its subsidiaries accelerate, and such notes, together with the amount of any other notes of the Company or any of its subsidiaries that accelerate, represent \$100 million or more in principal amount, events of default would occur under other debt instruments of the Company or certain of its subsidiaries which could lead to the acceleration of indebtedness under such documents.”

¹³ To keep this topical, Charter Communications’ first lien loans are among the 50 most widely held by CLOs, according to Preston, Pauley “Structured Products Research: CLO Market Update,” a Wachovia Capital Markets, LLC publication (Feb. 5, 2009).

Part (a) - Recovery Differences: Seniority and Structural Subordination

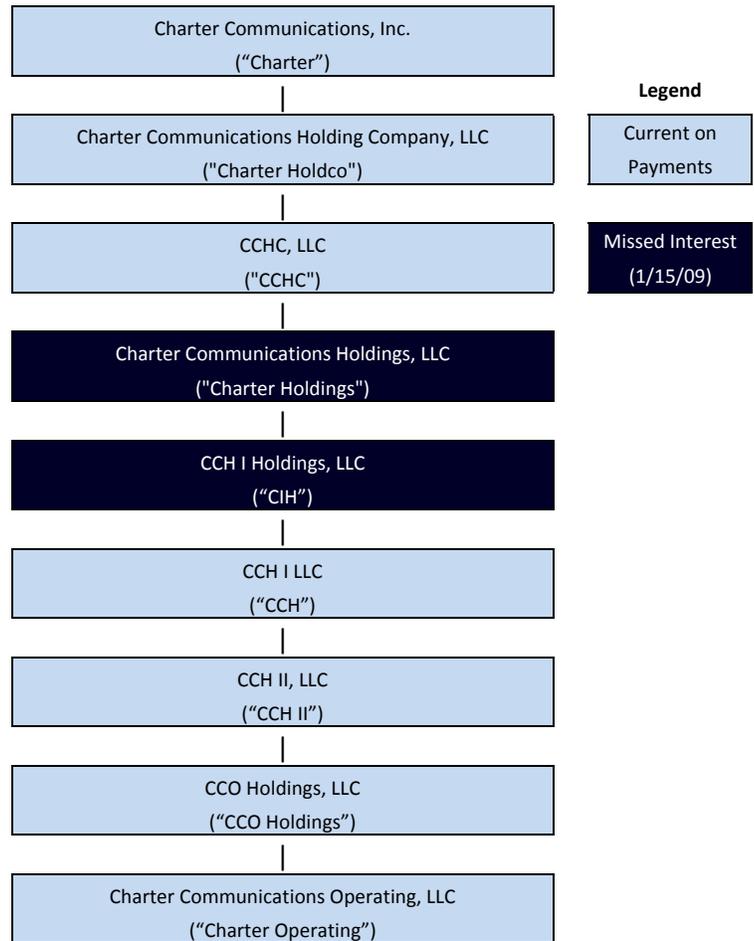
(Right): Charter Communications Operating, LLC is the operating subsidiary of, among others CCH, CCH II and CCO Holdings, all of which may from time to time borrow amounts under Charter Operating’s revolving credit facility.

As such, the financial condition of each of these holding companies – and in particular their ability to access funds -- is dependent on Charter Operating’s continued ability to satisfy its covenant restrictions:¹⁴

From CCH’s prospectus we have:

“Because of our holding company structure, the outstanding notes are ... *structurally subordinated* in right of payment to all liabilities of our subsidiaries. Restrictions in our subsidiaries’ debt instruments limit their ability to provide funds to us.”

Charter Communications - Simplified Organizational Structure



(Below): From this sample of Charter’s capital structure¹⁵ we see, by way of the Moody’s Recovery Assumption,¹⁶ how recoveries may be influenced by the debt’s seniority (loans vs. bonds and 1st lien vs. 2nd lien, etc.) and abovementioned structural positioning.

Issuer / Borrower	CUSIP	Tranche ID	Facility ID	Security Type	Security Level	G'TD	Cross Default	Moody's Recovery Assumption	Rating as of 2/5/2009		
									Moody's	S&P	Fitch
Charter Comm Operating, LLC		LN381977	LN322625	Term Loan	1st Lien	Y		94%	C	B1	CCC
Charter Comm Operating, LLC	16117LAN9	LN322613	LN322625	Revolving Loan	1st Lien	Y		94%	C	B1*-	NA
Charter Comm Operating, LLC	161175AA2			Secured Note	2nd Lien	Y		77%	B3*-	C	CCC
CCO Holdings, LLC	14986HAB7	LN321911		Term Loan	3rd Lien			71%	C	B3*-	CCC
CCO Holdings, LLC	1248EPAC7			Note	SU		Yes	66%	Caa1*-	C	C
CCH I LLC	12502BAC7			Note	Backed SS	Y	No	40%	Caa3*-	C	C
CCH I LLC	12501BAN4			Note	SU	Y	Yes	23%	Caa3*-	D	C
Charter Comm Holdings, LLC	16117PAZ3			Note	Backed SS		Yes	15%	Ca*-	C	C
Charter Comm, Inc.	16117MAE7			Conv. Note	SU		Yes	13%	Ca*-	C	C

Legend: Comm = Communications; Conv. = Convertible; G'TD = Guaranteed; SU = Senior Unsecured; SS = Senior Secured; *- = on watch negative

¹⁴ Charter Operating has, for example, a “Consolidated Leverage Ratio” that may not exceed 5:1.

¹⁵ Data courtesy of Bloomberg Finance L.P.

¹⁶ Derived directly from the loss given-default (LGD) estimates provided on their website.

Part (b) - Default Probability and Default Timing Differences

CCH's 11.125% notes (CUSIP 12501BAN4) were among those whose interest payment was not paid on January 15, 2009.

This missed interest payment alone does not constitute an Event of Default under CCH's governing documents. (The "D" for "Default" rating assigned to it by S&P does not mean that it has entered a legal default,¹⁷ but rather reflects S&P's assessment of the likelihood of its subsequently entering default, given its missed interest payment.) Based on our examination of CCH's prospectus Charter Operating's credit agreement¹⁸ the missed interest payment alone would result in an Event of Default, as follows:

- (1) Relative to the CCH note itself: *only* if this missed interest payment is not "cured" within 30 consecutive days (the "grace period").
- (2) Relative to the Charter Operating's loans: *only* if this missed interest payment is not "cured" within the grace period *and* the sum of all such similar missed payments (by CCH and certain of its subsidiaries) exceeds \$200mm in aggregate.

The second clause of part (2) above is what we refer to as the cushion. Since interest payments aggregating only \$73.7mm have been missed by Charter, Charter Operating's credit facility will be spared an Event of Default – or at the very least see a delay in its occurrence -- until the aggregate of all missed payments, not cured within their respective grace periods, exceeds the cushion. (Noteworthy is that the structural subordination is evident here too: while there's a \$200mm cushion on CCH -- and similar -- interest deferrals, the credit agreement allows only a \$100mm cushion for cumulative interests payments missed by any and all of CCO Holdings, LLC, Charter Operating itself and any of its subsidiaries.)

Part (c) – Example Summary

- We noticed that recoveries may differ among seemingly similar liabilities due to the structural positioning; and
- We explored how varying cross-default cushioning may delay (and perhaps entirely stave off) loan defaults.

CLO Indenture Treatment for So-called "Defaulted Securities"

The various intricacies of corporate debt covenants lead to the question: *might a particular bond or bank loan that is only "lightly" in default -- or may not itself be "in default" according to its governing document but may have a related non-cross-defaulting or structurally subordinated instrument which is in default -- be able to escape being considered a Defaulted Security for purposes of the CLO's indenture?*

We believe the answer is sometimes "Yes" (and hence possibly a worthwhile reason for writing this report) but first let's discuss why this is a useful realization.

Note that indenture definitions may differ from deal to deal and, in particular, often differ by the CLO deal's vintage.

¹⁷ We have verified this with the S&P analyst responsible for assigning the "D" rating on January 15, 2008.

¹⁸ Relating to their \$8 billion facility borrowing (LN322625), as amended and restated as of March 6, 2007. The 3rd lien loans, for example, were issued via a separate credit agreement.

“Carrying Value” Impositions

In the event a bond or loan is considered a Defaulted Security per the CLO deal’s indenture, certain “carrying value” impositions will be effectuated (typically in the over-collateralization (“O/C”) test numerator), which may act as a disinclination for the manager to persist with such asset.¹⁹

A defaulted asset would typically not be accounted for at par for purposes of the O/C test, but – again, this may differ from deal to deal -- at the rating agency’s recovery rate assumption for such asset’s asset class or, potentially more severely, *at the minimum of*:

- (1) the rating agency’s recovery rate assumption for such asset’s asset class (e.g., corporate bonds); and
- (2) the asset’s current market value,²⁰ which is often (arguably unfairly) a depressed level, particularly immediately post default.

On a positive note, there is (typically) no maximal holding period restriction for CLOs wanting to carry Defaulted Securities.

“Defaulted Security” Definition

The Defaulted Security definition typically includes language similar to that of *at least one* of the following, relevant, simplified clauses:

A Collateral Debt Security (CDS) shall be considered to be a Defaulted Security if:

- (1) any bankruptcy, insolvency or receivership proceeding has been initiated in connection with the issuer of such CDS; or
- (2) such CDS is in default under the related Underlying Instruments (i.e., its indenture or other governing documents); or
- (3) there has occurred and is continuing a default with respect to the payment of interest or principal which payment default entitles the holders thereof, with notice or passage of time or both, to accelerate the maturity of all or a portion of the principal amount of such obligation.

Example: Solutia, Inc. (“Solutia”)

While perhaps less timely than our prior example, the ability to witness and identify (purely as an aside) the post-default behavior of CDO managers who held certain Solutia debt makes this exercise, we hope, similarly valuable.

On December 17, 2003, Solutia and 14 of its U.S. subsidiaries filed voluntary petitions for reorganization under Chapter 11 of the U.S. Bankruptcy Code.

As of that date, we found at least 18 cash-flow²¹ CBOs and CLOs with exposure (in excess of 0.1% of their total asset par) to one or more of the following Solutia debt instruments:

- A senior secured bond - CUSIP: 834376AF2 (“AF2”)
- A senior unsecured bond - CUSIP: 834376AC9 (“AC9”)

¹⁹ This may prove rather unfortunate, generally, as research suggests that the ultimate recovery realized on a defaulted security typically exceeds the immediate and even 30-day post-default value. Any deal-driven incentive to sell a security prior to the “optimal time,” may therefore prove a hindrance.

²⁰ As determined according to the CLO indenture’s specifications.

²¹ As a side note, Solutia debt was at the time also referenced by at least seven synthetic CDOs.

AF2 and AC9 continued paying full interest through 2006 and beyond; despite its bankruptcy filing, which triggered an Event of Default clause in each bond's underlying indenture, AF2 and AC9 nevertheless could have escaped the Defaulted Securities definition in at least four of these 18 CDOs, as those deals lacked both conditions (1) and (2) – either of which, alone, would have sufficed -- in the Defaulted Securities definition above: a bankruptcy initiation in connection with the issuer and an Event of Default in the underlying indenture. The presence of condition (3) alone was ineffective, as the company continued to meet the interest payments on these bonds.

The result is that these four CDOs would have been able to continue holding their Solutia bonds without suffering the ill-effects of having to carry them, say, at a meager 30%²² -- Moody's recovery rate assumption for corporate bonds whose Moody's Obligation Rating does not differ from their Default Probability Rating -- for purposes of the O/C test.

Interestingly, possibly unaware of their specific document's language, two of these four deals liquidated their entire Solutia exposure immediately upon Solutia's announcement of Chapter 11 filing. The third and fourth deals held their exposures into 2005 and beyond. Noteworthy, too, was that the third deal -- perhaps mistakenly but possibly intentionally -- carried its Solutia exposure, as if defaulted, at 30%.

A Final Note on Solutia

In sum, five collateral managers (responsible for seven of the 18 CDOs) liquidated their entire exposure to Solutia debt on the day that Solutia filed for bankruptcy. Additionally, one of the remaining managers (responsible for two deals) sold a substantial portion of her exposure on that day, with the remainder being sold at a later stage.

In dollar volume terms, more than 40% of exposure to Solutia debt was liquidated on December 17, 2003. After some minor spurts thereafter, roughly 30% of the immediately-pre-default exposure was liquidated three to 12 months after the bankruptcy filing. The remainder, approximately 23%, was held for more than a year post filing.

Concluding Remarks

For the reasons discussed above, and others, the coming years promise to be challenging for corporate loans, CLOs, and the economy as a whole.

At the time of writing, many uncertainties remain: on the macroeconomic level, the outlook depends heavily on the effectiveness of current and future government intervention initiatives; on the corporate loan level, the feasibility of (and ability to effectuate) any loan amendment processes or covenant negotiations, given the wide dispersion of loans (including to CLOs), remains just one logistical difficulty facing this asset class.

To put a positive spin on an otherwise bleak outlook, we wish to suggest that chaos, too, may bring opportunity: with (performing) corporate loans as a whole trading in the 60s (below historically realized recovery rates for *defaulted loans*) and CLOs trading at historically depressed levels²³ there are no doubt certain attractive entry points for well-positioned purchasers who can stomach spread and mark-to-market volatility.

²² From our analysis of the more than 90% of these CDOs' sale of Solutia bonds, the *lowest* recovery rates realized upon sale were \$84 and \$43 for the AF2 and AC9 bonds, respectively.

²³ We're seeing AAA CLOs trading at spread levels of typically 550 to 600 basis points (dollar price levels roughly in the 70s), and AA and below-rated notes trading more regularly on a dollar basis: AAs are mostly trading in the 30s to young 40s, single-As in the mid-teens, with BBBs and BBs in the mid-teens and below.

That is not say that we believe we have reached a bottom, but rather that the thorough, diligent investor may be able to extract healthy returns by carefully selecting quality instruments that have been unduly discounted collectively with the pool.

Having said that, we wish to remind our readers that each deal is different and that, in addition to some of the collateral-level considerations we hope to have done justice to herein, each deal brings with it a slew of structural nuances and intricacies desirous of attention. As always, *caveat emptor*.

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