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Recent Challenges to Uptiering Transactions

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The unique circumstances of the last few years (and hard-charging investors) have forced many borrowers without adequate near-term liquidity to engage in more creative and aggressive liability-management transactions. These transactions have often taken the form of "uptiering" financings. While borrowers have historically engaged in these types of transactions, parties have pursued these strategies with greater vigor in recent years, causing some observers to call this an era of "creditor-on-creditor violence."

These "violent" transactions have led to an increase in litigation of relevant issues, and a growing body of related case law. The case law has been somewhat mixed. Some courts have strictly interpreted the applicable loan documents with respect to certain minority lender claims while others have followed a more holistic approach, resulting in unclear guidance for borrowers and lenders that are party to uptiering transactions.

Background

The amendment provisions of most credit agreements provide that the parties can amend the credit agreement with the consent of the majority of lenders. However, there are typically exceptions for certain provisions (often referred to as "sacred rights") that parties cannot amend without the consent of all lenders affected. These sacred rights often include amendments to the *pro rata* sharing provisions, amendments to the payments waterfall and the release of substantially all the collateral.

In an uptiering transaction, the borrower offers lenders under a new credit facility a claim that is senior to that of lenders under the existing facility. Existing lenders typically provide the new senior facility. These lenders also often negotiate to exchange at least a portion of their exiting exposure into the new senior facility. These transactions require amendments to the applicable debt and lien baskets under the existing agreement, typically with the support of majority holders only, and without notice to the minority lenders for them to participate.

Minority lenders challenging uptiering transactions have primarily argued that the transaction violates their "sacred rights" under the applicable credit agreement as a form of non-*pro rata* sharing and effective waterfall amendment and collateral release. Minority lenders have also argued that the transaction breaches the implied covenant of good faith and fair dealing, and results from tortious interference with the existing facility.

In response, borrowers and majority lenders have generally argued that such transactions are permissible based on a strict reading of the credit agreement. In this regard, these parties have often relied on a common exception to most *pro rata*-sharing provisions that accommodates Dutch auctions and "open market" purchases. Further, borrowers and majority lenders have drawn a distinction between lien subordination and lien release and generally structured transactions such that the priority between the facilities is accomplished pursuant to an intercreditor agreement, as opposed to amendments to the application-of-proceeds section in the existing credit agreement. This article surveys five recent (and more robust) opinions issued on this topic.

In re Murray Energy

In *Murray Energy*,[1] the U.S. Bankruptcy Court for the Southern District of Ohio considered a motion to dismiss a complaint brought by a nonparticipating lender, arguing, among other things, that the transaction violated a modified Dutch auction provision

1 *Black Diamond Commercial Fin. LLC v. Murray Energy Corp. (In re Murray Energy Holdings Co.)*, 616 B.R. 84 (Bankr. S.D. Ohio 2020).

under the credit agreement and required nonparticipating lender consent due to the subordination of the liens of nonparticipating lenders. On the issue of whether the transaction violated the modified Dutch auction provision, the court concluded that the issue could not be decided as a matter of law and declined to dismiss the cause of action. On the issue of lien-subordination, the court found that lien-subordination was not equivalent to a collateral release that would otherwise require the consent of all affected lenders, noting that the parties could have specifically referenced subordination in the applicable provision of the credit agreement but did not.[2]

In a later opinion, the court considered whether the parties were entitled to summary judgment on the issue of whether the transaction violated the modified Dutch auction provision under the credit agreement. The court concluded that a trial was necessary to determine, among other things, "whether a modified Dutch auction requires a range of offer prices or a minimum discount at which the debt will be repurchased."[3] The case was subsequently closed following a settlement reached by the parties.

Serta Simmons Bedding LLC

In *Serta*, the New York State Supreme Court,[4] then the U.S. District Court for the Southern District of New York (SDNY),[5] adopted a narrow approach to the interpretation of waterfall and collateral-release protections. In this case, Serta Simmons Bedding LLC engaged in an uptiering transaction that resulted in $875 million of new debt being exchanged for old debt. Certain nonparticipating lenders first moved for a preliminary injunction in New York State Court and argued that such an injunction was warranted because the uptiering transaction had the effect of impermissibly amending the credit agreement's waterfall provision in a way that altered the *pro rata* sharing of payments it required. The court refused to grant a preliminary injunction.[6]

Subsequent to the state court litigation, a group of different nonparticipating lenders filed a lawsuit in the SDNY against Serta Simmons, alleging that the uptiering transaction constituted a breach of the credit agreement, and the company moved to dismiss. The district court agreed with the borrower and majority-holders on the issue of whether the transaction violated the credit agreement's waterfall provisions, holding that the subordination of the minority lenders' debt was not the same as a lien release, which could not occur absent the consent of all affected lenders. On *pro rata*-sharing arguments, the district court did not believe that the amendment itself required minority lender consent, noting that "[w]hile the Amendments had the effect of extinguishing certain first-lien lenders' loans in exchange for an elevation of their priority rights under a new class of debt, the Amendments left untouched the *pro rata* rights of first-lien lenders *vis-à-vis* other first-lien lenders."[7]

However, the district court refused to grant Serta Simmons' motion to dismiss with respect to the plaintiffs' claim that the uptiering exchange could not be justified on the basis of the open-market purchase exception. The court observed that the phrase "open-market purchase" did not have a "definite and precise meaning." Thus, at the motion-to-dismiss stage of the proceeding, the district court could not conclude as a matter of law that, among other things, an open-market purchase under the agreement did not require that all lenders be privy to the debt-repurchase offer as advocated by Serta Simmons.[8]

The district court also allowed the implied covenant-breach claims to proceed, because even if the uptier transaction complied with the "letter" of the credit agreement, the nonparticipating lenders "adequately alleged that [the] Defendant deprived them of the benefit of their bargain in bad faith."[9] As of this article, the case remains pending.

TriMark

In *TriMark*, the minority Tranche B first-lien lenders sued the company, its sponsors and the majority first-lien lenders after the company issued new first-out super-senior debt and offered a debt-for-debt exchange with the majority lenders to exchange their debt under the existing facility for second-out super-senior debt.[10] The majority lenders amended the existing credit documentation to, among other things, allow the superpriority debt, subordinate the existing debt to the superpriority debt, and expand the scope of the no-action clause to impose substantial new restrictions on the ability of the existing lenders to bring suit to enforce their rights.[11] Next, the minority lenders brought suit to challenge the transaction, asserting that the amendments were void as invalidly adopted breaches of contract, breaches of the implied covenant of good faith and fair dealing, and tortious-interference claims.[12]

In a decision rendered after the *Serta* New York State Court decision but prior to the *Serta* SDNY decision, the New York State Court rejected arguments by the defendants that the plaintiffs did not have standing to assert their claims as a result of amendments to the no-action provision finding the amended no-action provision unenforceable. In doing so, the court noted that the amendments were "strategically deployed ... as part of a larger scheme to breach and then exit the agreement" and a "preemptive self-pardon."[13]

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2 *Id.* at 98-99.
3 *Id.* at 26.
4 *North Star Debt Holdings LP v. Serta Simmons Bedding LLC*, No. 652243/2020 (N.Y. Sup. Ct. June 20, 2020) (D.I. 88) (hereinafter "*Serta* New York State Court Decision").
5 *LCM XXII LTD. v. Serta Simmons Bedding LLC*, 2022 WL 953109 (S.D.N.Y. March 29, 2022) (hereinafter "*Serta* SDNY Decision").
6 *Serta* New York State Court Decision at 7-11.
7 *Id.* at 12-23.
8 *Id.* at 7-9.
9 *Id.* at 15.
10 *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent Corp.*, 2021 WL 3671541 (N.Y. Supp.) (N.Y. Sup. Ct. Aug. 16, 2021).
11 *Id.* at *4.
12 *Id.* at *1.
13 *Id.* at *7-9.

The court then rejected certain technical arguments by plaintiffs but found that the plaintiffs stated a viable claim that the amended agreement was invalid because it impinged upon the plaintiff's "sacred rights," at least with respect to the waterfall protections. The court found that the defendants' assertion that the waterfall protections only refer to application of proceeds within the credit agreement "is not the only reasonable way to read the contract." The court also allowed the plaintiffs' other breach-of-contract claims, including with respect to the applicable *pro rata* sharing provisions, to survive.[14]

However, the court dismissed the plaintiffs' good-faith and fair-dealing claims, finding that they were indistinguishable from a breach-of-contract claim. The court also dismissed the tortious-interference claims against the sponsors because they acted with an economic justification.[15] The case subsequently settled.

In re TPC Group Inc.

In *In re TPC Group Inc*., minority holders of 10.5 percent secured notes issued in the amount of $930 million challenged an uptiering transaction in which their notes were primed by more than $200 million of 10.875 percent new secured notes. The new notes were to be rolled into debtor-in-possession (DIP) financing in connection with a subsequent chapter 11 filing by the issuer, causing the U.S. Bankruptcy Court for the District of Delaware to prioritize summary-judgment motions early on in the issuer's chapter 11 case.[16]

The sacred right at issue in *TPC* was the waterfall protection set forth in § 9.02(d)(10) of the applicable indenture, which provided that "an amendment, supplement or waiver under this Section 9.02 may not ... (10) make any change in the provisions in the Intercreditor Agreement or this Indenture dealing with the application of proceeds of Collateral that would adversely affect the Holders." The basic dispute between the parties was how broadly or narrowly to read this section.[17]

The bankruptcy court acknowledged that the *Trimark* court had "expressed an openness" to reading such waterfall protections broadly and acknowledged that "[t]he *Trimark* court was certainly right that both constructions of the language at issue there were plausible based on the language in isolation." However, the bankruptcy court found that there were other "tools of construction, beyond the words themselves," that could provide guidance to the dispute at hand, noting that "New York law provides that contractual language must be understood through the lens of the customs as generally understood in the particular business."[18]

In the context of an indenture, the court observed, among other things, that the inclusion of express antisubordination clauses was sufficiently commonplace that "provisions providing for ratable distribution (in the absence of an express antisubordination clause) would more naturally apply to distributions within a class, and not prohibit subordination of an entire class to another, different class," noting that the *Serta* court had reached a similar conclusion. Therefore, the court sided with the defendants and determined that § 9.02(d)(10) should not be read as an antisubordination provision in disguise. The plaintiffs initially appealed the bankruptcy court's decision, but they subsequently agreed to dismiss the appeal with prejudice.[19]

Boardriders

In *Boardriders*, a group of minority-term loan lenders recently commenced a lawsuit against the company after their debt was primed by approximately $431 million.[20] The minority lenders argued that the transaction violated the credit agreement's open-market-purchase requirements and its *pro rata* sharing and lien-release provisions, and breached the implied covenant of good faith and fair dealing.[21]

The defendants filed a motion to dismiss, which the court largely denied. The court found that it was reasonable for the plaintiffs to interpret the credit agreement's open-market-purchase exception to require the debt exchange be offered to all lenders. The court observed that "open market" can be "reasonably susceptible of more than one interpretation" such that "ambiguity exists" regarding whether the transaction must be open to all lenders.[22] Similar to *TriMark*, the court also adopted a more holistic view of the transaction, noting that while there was no express prohibition on lien subordination in the credit agreement, the court was obligated to "consider the context of the entire contract."[23] As such, the court refused to be bound by the defendants' technical arguments that, if accepted, would "essentially vitiate the [credit agreement's] equal repayment provisions."[24] Finally, the court found that the plaintiffs' allegations "that defendants worked in concert and in secret to deprive plaintiffs of the benefit of their bargain" were sufficient to allege a violation of the implied covenant of good faith and fair dealing.[25] This case remains pending.

Key Takeaways

Although decisions on uptiering transactions have been varied, there are a few takeaways from them. To date, there has been little guidance on the applicability of the open-market-purchase exception to *pro rata* sharing protections. The exception is a relatively common one, and the issue is likely to be the subject of further litigation. Lenders should keep in mind that judicial guidance has not been uniform regarding the scope of waterfall rights and protections — it is unclear whether a court will strictly adhere to the agreement's language or take a more holistic approach. Credit agreements that require affected lender consent (including entry into any new intercreditor agreement) to subordinate liens and rights to receive payment and do not contain or limit open-market-purchase provisions are more protective of minority lender rights. abi

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14 *Id.* at *10-12.
15 *Id.* at *11.
16 *In re TPC Grp. Inc.*, No. 22-10493 (CTG), 2022 WL 2498751 (Bankr. D. Del. July 6, 2022).
17 *Id.* at 3.
18 *Id.* at *11 (citations and quotations omitted).
19 *Id.* at 11-12.
20 *ICG Global Loan Fund 1 DAC v. Boardriders Inc.*, No. 655175/2020 (N.Y. Sup. Ct. Oct. 9, 2020) (D.I. 160).
21 *Id.* at 11, 19, 21-22.
22 *Id.* at 23.
23 *Id.* at 19.
24 *Id.*
25 *Id.* at 24.