ONPOINT / A legal update from Dechert's Financial Restructuring Group

Liability Management Transactions (Part I): Uptier Transactions

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Key Takeaways:

- While there are many different types of liability management transactions, two forms of these transactions have recently become more common: (i) uptier transactions (which are discussed in Part I of this OnPoint), and (ii) drop-downs transactions (which will be discussed in a to-be-published Part II).
- Uptier transactions are where a borrower teams up with a majority of its financial creditors and amends the existing financing agreements to permit the issuance of new senior priming debt. In many instances, the majority creditors will subsequently exchange their existing debt for new senior priming debt. The non-participating minority creditors are then essentially left with subordinated debt.
- Uptier transactions have been challenged by minority creditors. Recent rulings in the NYDJ, TriMark, Serta and Boardriders cases are instructive.
  - These cases suggest that tailor-made "No-action" clauses are ineffective to bar non-participating creditors' claims.
  - In all of these cases, breach-of-contract claims brought by minority non-participating creditors impaired by these out-of-court uptier transactions, have survived motions to dismiss.
  - In three of these cases, claims asserted with respect to the implied covenant of good faith and fair dealing have also survived a motion to dismiss.
- The increase in uptier transactions in recent years explains the current market attention to these transactions; however, creditor-on-creditor violence is not a new phenomenon. Cases addressing the proper exercise of majority v. minority creditors' rights and related disputes were as relevant in the 19th century as they are today.

A syndicated loan is a loan extended by a group of lenders (i.e., a syndicate) to a single borrower, typically under a single agreement with common terms. By pooling their resources, the lenders share the benefits and risks of the transaction. Generally speaking, the spirit of such arrangements among lenders is all for one, one for all. ***But not always.***

- The Honorable Joel M. Cohen (NY Sup. Ct.)[1]

[1] *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp.* ("TriMark"), Index No. 565123/2020 (NY Sup. Ct. Aug. 16, 2021) (emphasis added).

This OnPoint will focus on the "not always" situations that are becoming more frequent and may become even more commonplace as the economy slows down and corporate liquidity is challenged by rising interest rates and inflation. We will discuss in a two-part series the two main types of transactions borrowers have used to achieve what is essentially a non-consensual priming. This Part I discusses "uptier" transactions, and a to-be-published Part II will discuss "drop-down" transactions.

What is an Uptier Transaction?

Generally, financing agreements (either secured loan agreements or indentures) contain protections for senior secured creditors that prevent a borrower from issuing new debt that would dilute or subordinate a creditor's collateral position or otherwise release collateral, absent their consent. However, there is a recent trend of distressed borrowers who, with the support of majority creditors, are effectuating transactions that effectively "prime" the minority creditors without their consent. Non-participating creditors, in some cases creditors holding a simple minority under the same facility, go to sleep as first-lien creditors and wake up subordinated.

Under an uptier transaction, the majority creditors (which typically refers to holders of loans or notes in an amount greater than the requisite majority required to modify the financing agreement) agree to amend the existing financing agreements to permit the issuance of new senior debt and, in many instances, subsequently exchange their existing debt for the new senior debt. The non-participating minority creditors are left with subordinated liens. Below is a chart that details how an uptier transaction works under loan agreements and bond indentures:

Existing Indebtedness:	Borrower and creditors are party to an existing financing agreement.
Amendment Provision:	Financing agreement's amendment section provides that, other than with respect to enumerated "sacred rights," financing agreement may be amended by the majority creditors.
Negotiation:	Majority creditors negotiate with the borrower to amend provisions of financing agreement to allow for the issuance of new senior debt and granting of priming liens, among other things.
New Senior Debt:	With the existing financing agreement now amended to allow for issuances of new senior debt, majority creditors typically fund new senior debt with cash and often exchange their existing debt for the new senior debt.
Pro Rata/Open Market Purchases:	Loan agreements typically provide that payments to lenders must be received on a pro rata basis; however, many loan agreements provide an exception to this pro rata construct to permit borrowers to carry out non-pro rata debt purchases on the "open market".
Press Release:	Borrower announces recapitalization transaction, often without prior notice to minority creditors.
Aftermath:	Borrower uses transaction to obtain an infusion of liquidity to extend its runway, commonly at the direction of their sponsors. Majority creditors use the uptier transaction to reduce the amount of debt secured by a senior lien, thus reducing the dilutive impact the minority creditors would have on their recoveries absent the uptier transaction.

These transactions are commonly seen as a recent trend, however, they are not a new phenomenon. While the language of financing agreements has evolved over time (often referred to as "technology"), the question as to whether a majority may act for its own benefit to the detriment of the minority is not a new issue. *See e.g., Hackettstown Nat. Bank v. D.G. Yuengling Brewing Co.*, 74 F. 110 (2nd Cir. 1896) (finding that the majority violated the covenant of good faith and fair dealing by agreeing to amend the terms of notes in a manner that harmed the minority).

Recent challenges to Uptier Transactions

Recent uptier transactions have led to lawsuits by minority creditors to enforce rights they believe exist under financing agreements that prohibit these transactions. In turn, majority creditors and borrowers have attempted to enforce tailor-made "no-action" clauses to prevent minority creditors from bringing these lawsuits. While there are nuances to each uptier transaction and related litigation, minority creditors by and large have asserted the following:

i. **Breach-of-Contract Claims:** Violation of the pro rata payment provision of the credit agreement by the exchange of old debt for new super senior debt by majority creditors; and,

ii. **Breach of the Implied Covenant of Good Faith and Fair Dealing Claim:** Either by the undisclosed or secret nature of the transaction or by the attempt to impair the rights of non-participating minority creditors in bad faith, when borrowers agreed to subordinate existing debt in connection with a transaction where only the majority creditors are allowed to participate, by providing the new senior debt and exchanging their pre-existing debt into the senior debt.[2]

Recent "Uptier" Decisions

Below is a chart and summaries of several recent cases that have defined the current playing field of uptier transactions:

Cases	No-Action Clause	Breach-of-Contract Claims	ICGFFD Claims
NYJD	N/A	✓	✓
TriMark	NO BAR	✓	✗
Serta Simmons Bedding	NO BAR	✓	✓
BOARDRIDERS	NO BAR	✓	✓

✗ Claims dismissed
✓ Claims survive dismissal

[2] Minority creditors have also brought claims against sponsors which have allegedly tortiously interfered with non-participating creditors rights under the financing agreement.

(i) *Not Your Daughter's Jeans (NYDJ)*[3]

In 2017, majority lenders amended the existing credit agreement to allow the majority to lend incremental financing on a priming basis. Minority lenders sued arguing that NYDJ and the majority lenders secretly conspired to elevate the priority of the majority participating lenders, in bad faith and without providing any notice to them.

At a hearing on the majority lenders' motion to dismiss, the court declined to dismiss the minority lenders' complaint saying, the "[r]easonable commercial expectations of the lenders participating in the arrangement are being undermined by some of the lenders getting together and saying look, if we don't tell the other guys what we're doing, we can cut them out of the picture. It doesn't seem very fair."

(ii) *TriMark*[4]

In 2020, majority lenders amended the existing first-lien credit agreement to allow issuance of new super senior priming debt. Thereafter, TriMark entered into a super senior credit agreement secured by the same collateral that secured the existing first-lien debt and exchanged the existing old debt for the new debt. This uptier transaction left the minority lenders in a ***third*** lien position, and they sued in New York State Court.

In August 2021, the court denied in part the defendants' motion to dismiss. The court found that plaintiffs had stated a viable claim that the transactions were invalid because they violated plaintiffs' "sacred rights." The ruling was based on the view that a change to the definition of "Intercreditor Agreement" in the financing agreement could be seen as effectively modifying the application of proceeds provision in the financing agreement, which required unanimous consent. The court also rejected the defendants' efforts to use an amended "no-action" clause in the financing agreement to prevent the minority lenders from bringing suit. However, the Court dismissed the implied covenant of good faith and fair dealing claim since it was duplicative of the breach-of-contract claim.

(iii) *Serta*[5]

In 2020, with the support of the majority lenders, Serta issued two new tranches of debt, both of which ranked senior to Serta's existing ~$2 billion first-lien loans. These new senior tranches included a new money tranche provided by majority lenders and a tranche in which the majority lenders exchanged their existing first lien debt into. To facilitate the transaction, Serta's majority lenders consented to a series of amendments to the loan documents.

Minority lenders sued in the Southern District of New York. In March 2022, the court denied in part the motions to dismiss. With respect to the no-action clause, the court determined that because the minority lenders sought damages and injunctive relief stemming from an allegedly improper transaction, their contractual claims were not barred by the no-action clause.

The court found that the minority lenders had adequately pled that the exchange transaction did not constitute an "open market purchase," finding that undefined concept was susceptible to multiple meanings. Therefore, the court permitted the minority creditors to continue with the claim that the exchange violated the pro rata payment provision in the credit agreement. In addition, the court allowed the minority creditors' claim for breach of the implied covenant of good faith and fair dealing to proceed, noting the secretive nature of the negotiations surrounding the transaction

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3 *Octagon Credit Inv., LLC v. NYDJ Apparel, LLC., et al.*, No. 656677/17 (N.Y. Sup. Ct. 2018).
4 *Audax Credit Opportunities Offshore Ltd., et al. v. TMK Hawk Parent, Corp., et al.*, 150 N.Y.S. 3d 894 (N.Y. Sup. Ct. 2021).
5 *LCM XXII Ltd., et al. v. Serta Simmons Bedding, LLC*, No. 21-cv-3987, 2022 WL 953109 (S.D.N.Y. Mar. 29, 2022).

could support an allegation of bad faith, and majority lenders' exercise of their consent rights could have impermissibly deprived minority lenders of the benefit of their bargain.

(iv) *Boardriders*[6]

In 2020, Boardriders pursued an uptier exchange whereby its existing loans were layered by new money and an exchange to benefit its majority lenders. The exchange was completed pursuant to a provision in the credit agreement permitting open market purchases. As part of the transaction, the existing credit agreement was amended with majority lenders consent to (i) permit superpriority debt incurrence; (ii) direct the agent to enter into an intercreditor agreement that subordinated liens securing the first existing lien debt; (iii) strip covenants and reporting rights; and (iv) waive all existing defaults.

The minority lenders sued in New York State Court. In October 2022, the court denied in part the motion to dismiss. As an initial matter, the court rejected the defendants' efforts to use an amended "no-action" clause to prevent the minority lenders from suing.

The court then allowed the breach-of-contract claim to go forward, reasoning that the lack of an express prohibition against subordinating lenders' liens cannot be understood as an authorization to vitiate the equal repayment provisions and alter the entire context of the contract. With respect to the undefined "open market" term, the court held that the term is "reasonably susceptible of more than one interpretation" and "the Credit Agreement does not unequivocally foreclose the allegations in the complaint." The court also allowed the breach of the implied covenant of good faith and fair dealing claim, concluding that they adequately pleaded that the transaction was carried out in secret and that majority lenders abused their ability to amend the credit agreement to effectuate the transaction.

Conclusion

It remains to be seen what effect the recent litigation will have on future uptier transactions. The survival of breach of contract claims and implied covenant of good faith and fair dealing claims brought by minority creditors at the motion to dismiss phase adds another layer of complexity to the analysis of uptier transactions, beyond just determining whether the financing agreements contain the "technology" that arguably allows or prevents such transactions. In addition, if challenges to the uptier transactions are ultimately determined by courts to violate the contractual provisions or the implied covenant of good faith and fair dealing, it remains to be seen what remedies courts should apply. Should the new money tranche be subordinated to the existing debt? Should the majority claims also be subordinated? Are the minority lenders entitled to monetary damages? Finally, will the debt markets change to incorporate contractual protections specially designed to prevent uptier transactions and what impact will this have on liability management transactions in the future? The final chapter on uptier transactions has yet to be written.

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6 *ICG Global Loan Fund 1 DAC, et al. v. Boardriders, Inc., et al.*, No. 655175/20 (N.Y. Sup. Ct. 2018).

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