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Uptier exchange transactions remain in vogue, notwithstanding litigation risk

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INTRODUCTION

The U.S. leveraged loan[1] market has grown exponentially since the end of the Great Recession. From 2010 to 2020, loan volumes have risen from approximately $500 billion to nearly $1.2 trillion.[2]

This ballooning loan volume can be attributed to a number of factors, including:

(1) the increased use of leveraged loans to fund merger and acquisition, recapitalization, and refinancing transactions;

(2) an extended period of historically low interest rates; and

(3) a surplus of cash available for deployment by institutional investors in search of yield.

This unprecedented access to financing for borrowers has resulted in the erosion of many lender protections and the proliferation of so-called covenant-lite loan documentation.

For example, financial maintenance covenants (*e.g.*, quarterly leverage or interest coverage tests) have all but disappeared from leveraged loan documentation.

In addition, incurrence covenants that require a borrower to satisfy pro forma financial metrics in order to take certain actions (*e.g.*, incurring debt, selling assets or paying dividends) often include carveouts that can render the covenants meaningless.

In addition to lacking meaningful financial covenants, leveraged loan documentation often contains loosely structured operating covenants that allow distressed borrowers to raise additional capital in a bid to stave off a comprehensive restructuring or bankruptcy.

The first wave of controversial financing transactions began in 2016, when distressed borrowers started using permissive investment and asset sale baskets — sometimes referred to as "trap doors" — to move collateral beyond the reach of existing secured creditors.

Illustrative of this tactic are transactions (most famously involving J. Crew) where borrowers use investment and other baskets to transfer encumbered assets to "unrestricted" subsidiaries, thereby excising the assets from the existing secured lenders' collateral package.

The newly unencumbered assets are then used to secure new financing.

More recently, a trend has developed where distressed borrowers access new capital by amending their existing secured debt documents to permit new "superpriority" secured debt — sometimes referred to as "uptier" exchange transactions.[3]

In other words, rather than removing collateral from the reach of existing creditors and financing the newly unencumbered assets, borrowers incur new indebtedness secured by superpriority liens having first claim to the borrowers' existing collateral.

A trend has developed where distressed borrowers access new capital by amending their existing secured debt documents to permit new "superpriority" secured debt — sometimes referred to as "uptier" exchange transactions.

A subset of the borrowers' senior lenders are typically tapped to provide the additional capital needed to fund uptier transactions.

While uptier exchange structures can vary, particularly aggressive formulations limit participation in the new money opportunity to a subset of existing lenders and "roll-up" some or all of the participating lenders' existing loans into the superpriority tranche.

The result of these transactions is that the nonparticipating lenders — who formerly held priority secured claims against the borrowers' assets — are subordinated not only to the new money but also to a significant portion of previously *pari passu* (and sometimes junior) debt.

As further discussed below, such "lender-on-lender violence," as the practice has been dubbed, is the subject of ongoing litigation in several deals.

ELEMENTS OF RECENT UPTIER TRANSACTIONS

The central feature of an uptier transaction is that one or more superpriority tranches of debt are incurred and secured by liens with priority over the liens securing the borrower's existing secured debt.

To execute an uptier transaction, the borrower typically amends its existing loan documents to permit the incurrence of superpriority debt and to remove any provisions prohibiting the subordination of existing loans.

The borrower will also likely need the amendment to allow the borrower to enter into a new intercreditor agreement to govern the relative priorities of the post-transaction tranches of debt.

> Nonparticipating lenders argue that various elements of uptier transactions violate the pro rata sharing provisions contained in existing loan documentation.

With the exception of certain provisions (*e.g.*, "pro rata sharing" provisions), the borrower typically only needs the consent of "required lenders"[4] for such amendments.[5]

Pro rata sharing provisions

Importantly, the borrower will craft its amendment to avoid amending the loan documents' pro rata sharing provisions.

Pro rata sharing provisions are a centerpiece of lenders' so-called sacred rights, and mandate that lenders receive their pro rata share of any distributions of collateral proceeds, based on the face amount of their ownership of the loans.

Loan documents also typically include turnover provisions that require a lender who received more than the lender's pro rata share of collateral proceeds to turn over any such excess distribution ratably to other lenders.

Amendments to pro rata sharing provisions often require the consent of every affected lender or every lender.

Because amendments associated with the uptier transactions do not change the pro rata sharing provisions, consent from every affected lender is not required.

Nonetheless, as discussed below, nonparticipating lenders argue that these amendments have the effect of impairing their pro rata sharing rights.

Open market purchases

Similarly, a borrower may seek to allow participating lenders to exchange their existing secured debt for superpriority debt in a manner that does not violate pro rata sharing or voluntary prepayment provisions.

For example, voluntary prepayments typically must be made at par and offered to all lenders.

In contrast, the assignment provisions of loan documents often permit the borrower to buy its own loans pursuant to either a "Dutch auction" or an "open market purchase" on a non-pro rata basis.

Some credit agreements also expressly permit cashless open market purchase transactions. Credit agreements typically do not define an "open market purchase" or include terms governing how open market purchases should be conducted.

In an uptier exchange transaction, the borrower takes assignment of the participating lenders' existing loans and then issues new superpriority loans to the participating lenders in exchange.

The amendment entered into to permit the incurrence of superpriority loans and the subordination of existing loans may also include changes to the open market purchase provision to more clearly permit the contemplated roll-up transaction (*e.g.*, to expressly permit open market purchases below or above par, and for consideration other than cash).

Affirmative and negative covenants

An additional, though not central, element of an uptier transaction can include stripping affirmative and negative covenants — and related events of default — out of the loan documents that govern the existing loans.

A covenant strip ensures the borrower will not need to obtain the consent of nonparticipating lenders in the future with respect to potential covenant breaches or waivers under the existing loan documentation.

Instead, the covenant protections are built into the new documentation governing the superpriority loans for the benefit of participating lenders.

CHALLENGES TO UPTIER TRANSACTIONS

Uptier transactions can serve as a lifeline to distressed businesses by providing access to much-needed new capital. Moreover, in some cases, uptier transactions may allow a borrower to deleverage pursuant to discounted exchanges.

Uptier transactions are also a boon for participating lenders, who may receive favorable economics in the form of fees, high interest rates, enhanced priority and sometimes premiums on exchanged loans. Further, participating lenders position themselves well for any future financing or restructuring discussions.

On the other hand, uptier transactions can be detrimental for nonparticipating lenders that are excluded from the transaction. These lenders may be left with deeply subordinated loans trading at steep discounts to pre-transaction value.

They face an increased risk that their loans will be undersecured in a future restructuring, and potentially subject to cramdown in a future chapter 11 plan. Moreover, their loans are subject to potential credit rating downgrades

In light of the profound impact that an uptier transaction can have on nonparticipating debt, nonparticipating lenders have sought to challenge uptier transactions on numerous grounds.

While the specific challenges vary depending upon the structure of the transaction and the terms of the applicable loan documents, some of the more common objections are discussed below.

Violation of pro rata sharing provisions

Nonparticipating lenders argue that various elements of uptier transactions violate the pro rata sharing provisions contained in existing loan documentation.

For example, nonparticipating lenders argue that amending the loan documentation to

(1) permit new superpriority tranches of loans,

(2) subordinate existing loans,

(3) reduce the principal amount of existing loans (as a result of rolling up certain existing loans into new superpriority loans) and

(4) authorize intercreditor agreements that govern post-transaction priorities affects the right of every lender to receive its pro rata share of collateral proceeds.[6]

Therefore, nonparticipating lenders argue that any such amendments requires the consent of every affected lender and cannot be approved by lenders holding a simple majority of existing loans.

Improper release of all or substantially all collateral and value of guarantees

In a similar vein, nonparticipating lenders allege that uptier transactions effectively release all or substantially all of the collateral securing the existing loans and all or substantially all of the value of the guarantees supporting the existing loans.

This challenge relies on the factual assertion that the value of the collateral and guarantees is insufficient to clear the superpriority loans, leaving the nonparticipating subordinated loans in an unsecured position with worthless guarantees.

Nonparticipating lenders argue that a transaction with such effect requires the consent of every lender (even if the transaction does not technically release collateral or guarantees).[7]

Failure of a roll-up exchange transaction to comply with open market purchase provisions

Nonparticipating lenders also challenge the open market purchase transactions that are used to effectuate the roll-up of participating lenders' existing loans into new superpriority loans.

As described above, borrowers rely on the open market purchase provision because it expressly permits the borrower to purchase loans on a non-pro rata basis.

> When considering an uptier transaction, parties should carefully evaluate whether more egalitarian structures might better serve their objectives.

However, disgruntled lenders have argued that such transactions are improper because the open market purchases

(1) do not retire existing loans, but instead improperly swap existing loans for new loans (more specifically, the nonparticipating lenders argue that other credit agreement provisions require such cashless exchanges to be offered to all lenders and on a basis that is *pari passu* or junior to the existing loans),

(2) constitute "prepayments" that must be offered to all lenders,

(3) are not priced on an arm's length basis and at market value, with instead the loans being improperly purchased far above their trading value (this objection may be applicable when existing loans are trading at a discount but exchanged at par),

(4) are not actually consummated in an open market, but instead are improperly based on privately negotiated terms, and/or

(5) are merely one component of broader integrated transactions, as opposed to true, standalone open market transactions.[8]

Breach of implied covenant of good faith and fair dealing

Nonparticipating lenders may further allege that uptier transactions breach the implied covenant of good faith and fair dealing because often the borrower

(1) proceeded in secret with the participating lenders,

(2) did not seek the consent of all of the lenders and/or

(3) did not offer nonparticipating lenders an opportunity to participate in the transactions.[9]

As further alleged evidence of bad faith, nonparticipating lenders may point to covenant strips from existing loan documentation as well as onerous terms of new intercreditor agreements (terms that, for example, waive nonparticipating lenders' rights to

(1) contest debtor-in-possession financing provided by the participating lenders,

(2) seek adequate protection,

(3) propose plans of reorganization or

(4) contest asset sales in a potential future chapter 11 filing by the borrower).

Moreover, in at least two recent deals, the amendments included a requirement that any nonparticipating lender wishing to sue the participating lenders must post a cash indemnity bond equal to the fees and costs of such litigation, including counterclaims.[10]

Plaintiffs characterized the addition of the indemnity requirement as "the epitome of bad faith."[11]

Allegations against sponsors

Additional allegations may be raised in sponsor-backed transactions.

For example, nonparticipating lenders have argued that sponsors engaged in tortious interference, self-dealing, conflicts of interest and bad faith by allegedly using their controlling power to induce a borrower to execute an uptier exchange with the sponsor's choice of lenders (which could include the sponsor) that offered more favorable terms to the sponsor than otherwise available in a transaction open to all lenders.[12]

Disgruntled nonparticipating lenders also have asserted breach of fiduciary duties by sponsor-employed board members for allegedly placing the sponsor's interests over the borrower's interests.[13]

Although many disgruntled nonparticipating lenders try to fight what they perceive as unlawful treatment, to date, courts have generally not stopped such transactions.

OBSERVATIONS AND ALTERNATIVES

Several recent uptier transactions are the subject of ongoing litigation — *Serta Simmons*,[14] *Boardriders*,[15] and *TriMark*.[16]

In each case, minority lenders sued the borrower, participating lenders, and sponsor(s), asserting many of the challenges described above.

Though not delivering a final ruling on the merits, the New York State Supreme Court in *Serta Simmons* denied the plaintiffs' request for a preliminary injunction to block the uptier transaction, and as a result Serta Simmons closed on its uptier transaction.

In the court's analysis of the plaintiffs' likelihood of success on the merits of the suit, the court noted that "[t]he Credit Agreement seems to permit[] the debt-to-debt exchange on a non-pro rata basis as part of an open market transaction."[17]

The court observed that "[s]ince the amendments do not affect plaintiff's [sic] so-called "sacred rights" under the Credit Agreement, plaintiffs' consent does not appear to be required."[18]

The Serta Simmons litigation has since shifted to federal court in the Southern District of New York.

On January 14, 2021, the court heard oral argument on the defendants' motions to dismiss and indicated that it would issue a decision on whether the litigation may proceed by April 2021.[19] *Boardriders* and *TriMark* are also on track for further litigation in 2021.

In the meantime, we expect uptier transactions to continue to provide attractive opportunities for borrowers, lenders and sponsors alike (assuming the borrowers' existing loan documentation does not prevent the execution of uptier transactions), notwithstanding the potential litigation risk.

However, when considering an uptier transaction, parties should carefully evaluate whether more egalitarian structures might better serve their objectives.

Specifically, variations on the following three aspects of a typical uptier transaction should be considered:

(1) the priority of the new money loan;

(2) which lenders are invited to participate; and

(3) roll-up structure.

New money priority

A central feature of an uptier transaction is the incurrence of a superpriority new money loan. However, borrowers should first consider whether they have available *pari passu* debt capacity under their existing loan documentation.

If not, can the borrower obtain majority consent to increase the size of its *pari passu* debt basket to raise sufficient new capital? *Pari passu* deals do not prime existing loans and are therefore less controversial.

Of course, additional *pari passu* debt does not provide participating lenders with the benefit of a superpriority claim against collateral proceeds.

However, a number of potentially available tools used together could incentivize incumbent or new lenders to extend *pari passu* loans (*e.g.*, attractive interest rates, fees, call protection and most favored nation rights).

Moreover, collateralized loan obligation lenders — which constitute a significant portion of leveraged loan lenders — may be inclined to consent to a *pari passu* amendment (even if they do not provide new capital) in order to preserve the credit rating of their existing loans.

Participating lenders

Litigation risk may be mitigated by providing all existing lenders with the opportunity to participate in an uptier transaction.

Naturally, lenders prepared to offer financing would prefer to limit participation so that the benefits of holding a superpriority position are not dispersed among the rest of the lender class.

However, borrowers can seek to incentivize such lenders to agree to an all-lender deal by reserving an outsized portion of the new money opportunity for the negotiating lender group, and compensating the negotiating group for providing backstop commitments with respect to the balance of the capital raise.

While minority lenders could nevertheless take issue with the transaction, their litigation posture would be weakened by having received the invitation to participate.

Roll-up

Exchanging a favored group of lenders' existing loans for superpriority loans with priority over other lenders' existing loans is perhaps the most controversial aspect of uptier transactions (likely the basis for plaintiffs' characterization of uptier transactions as a "cannibalistic assault" and "lender-on-lender violence").[20]

Borrowers can consider pursuing several alternative roll-up structures in order to potentially mitigate litigation risk.

First, the roll-up could be provided to all lenders so long as they consent to an amendment. This structure incentivizes lenders to approve an amendment in order to avoid being primed by new superpriority loan tranches.

This structure may be more appropriate for transactions that do not include new money capital, but that instead, for example, seek to convert cash interest into interest that is payable-in-kind.

In that case, the borrower needs to obtain as many individual lender consents as possible because the amendment involves changing interest terms (*i.e.*, a "sacred right"). Second, the roll-up could be provided to all lenders so long as they consent to an amendment *and* provide new money capital.

This approach incentivizes incumbent lenders to both consent to an amendment and to write new money checks in order to avoid being primed.

Third, the roll-up could be provided to all lenders so long as they consent to an amendment and provide new money capital, with outsized roll-up economics reserved for backstop lenders.

As with the prior alternative, this structure incentivizes participation in the amendment and capital raise, while also providing key lenders with additional consideration.

While these alternatives might mitigate litigation risk, they may not be as attractive to groups of key lenders that hold a majority of the existing loans because their portion of the superpriority tranche would be diluted by other participating lenders.

Ultimately, the ability to implement less controversial alternatives will largely depend on

(1) the borrower's needs

(2) party dynamics and

(3) negotiating leverage under the circumstances.

Notes

1 While there is not a uniform definition of a "leveraged loan," S&P Global defines the term as "[a] loan that (1) is rated BB+ or lower, or (2) is either not rated or rated BBB– or higher but (a) has a spread of LIBOR+125 or higher and (b) is secured by a first or second lien." *Leveraged Commentary & Data (LCD): Leveraged Loan Primer*, (https://bit.ly/3uY5qPY) S&P Global Market Intelligence, 2020, at 31.

2 S&P Global Market Intelligence, "How Big is the Leveraged Loan Market?," (https://bit.ly/3bZHt1X) *Leveraged Loan Primer* (last visited Jan. 5, 2021). As of December 1, 2020, "the total par amount outstanding has remained at roughly $1.2 trillion for the last 13 months." Marina Lukatsky, "US leveraged loan returns soar in November on vaccine hopes, led by riskier debt,"(https://bit.ly/3uSvNqd) S&P Global Market Intelligence (last visited Jan. 5, 2021).

3 Borrowers are also using uptier transactions to exchange some or all of their existing debt for a lower amount of debt with more favorable terms, whether in connection with a new, additional loan (as discussed below) or as a standalone transaction.

4 While there is not a uniform definition of "required lenders," credit agreements typically define the term as lenders holding more than 50% in principal amount of the loan.

5 "Serta's, Boardriders' Superpriority Uptier Exchanges Can Likely Be Replicated Under Most Existing Credit Facilities; Simple Drafting Changes Could Block Them in Future Facilities," Reorg, Sept. 22, 2020, at 4. Reorg Covenants Prime reviewed over 200 private sponsored credit agreements between 2017 and 2019; only five of these 200 private sponsored credit agreements required consent from all lenders to amend lien priorities. *Id.*

6 Compl. ¶¶ 4-10, 53-54, *North Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC*, No. 652243/2020 (N.Y. Sup. Ct. filed June 11, 2020) (D.I. 1) (*Serta* state court compl.); Compl. ¶¶ 33-36, 47-49, 68-73, *LCM XXII LTD. v. Serta Simmons Bedding, LLC*, No. 20-cv-5090 (S.D.N.Y. filed July 2, 2020) (D.I. 1) (*Serta* SDNY compl.); Compl. ¶¶ 3-5, *ICG Global Fund 1 DAC v. Boardriders, Inc.*, No. 655175/2020 (N.Y. Sup. Ct. filed Oct. 9, 2020) (D.I. 1) (*Boardriders* compl.); Compl. ¶¶ 60-74, *Audax Credit*

Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp., No. Unassigned (N.Y. Sup. Ct. filed Nov. 7, 2020) (D.I. 1) (*TriMark* compl.).

[7] Compl. ¶¶ 55-57, *Octagon Credit Investors LLC v. NYDJ Apparel LLC*, No. 656677/2017 (N.Y. Sup. Ct. filed Nov. 1, 2018) (D.I. 1) (NYDJ compl.); Serta state court compl. ¶¶ 44-45, 55-56, 79-82; *Serta* SDNY compl. ¶¶ 56, 68-73; *Boardriders* compl. ¶¶ 55-66, 80; *TriMark* compl. ¶¶ 7-10, 75-79.

[8] *Serta* SDNY compl. ¶¶ 2 & n.1, 50-54; *Boardriders* compl. ¶¶ 4-7, 76-78, 157-171; *TriMark* compl. ¶¶ 60, 65, 75-76.

[9] *Serta* SDNY compl. ¶¶ 74-81.

[10] *Boardriders* compl. ¶ 91; *TriMark* compl. ¶¶ 1, 72, 74, 123-131.

[11] *Boardriders* compl. ¶ 91.

[12] *Serta* state court compl. ¶¶ 88-97; *Serta* SDNY compl. ¶¶ 1, 64-66, 75-81; *Boardriders* compl. ¶¶ 1-13, 173-187; *Trimark* compl. ¶¶ 52-53, 120-31.

[13] *Serta* SDNY compl. ¶¶ 1-5, 60-67.

[14] *North Star Debt Holdings L.P. v. Serta Simmons Bedding LLC*, No. 652243/2020 (N.Y. Sup. Ct. June 11, 2020); *LCM XXII LTD. v. Serta Simmons Bedding LLC*, No. 20-cv-5090 (S.D.N.Y. July 2, 2020).

[15] *ICG Global Fund 1 DAC v. Boardriders Inc.*, No. 655175/2020 (N.Y. Sup. Ct. Oct. 9, 2020).

[16] *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent Corp.*, No. Unassigned (N.Y. Sup. Ct. Nov. 7, 2020).

[17] *North Star Debt Holdings L.P. v. Serta Simmons Bedding LLC*, No. 652243/2020, order at 8 (N.Y. Sup. Ct. June 20, 2020) (D.I. 88).

[18] *Id.*

[19] *LCM XXII LTD. v. Serta Simmons Bedding LLC*, No. 20-cv-5090, order at 1 (S.D.N.Y Oct. 22, 2020) (D.I. 78).

[20] *TriMark* compl. ¶¶ 1, 9.

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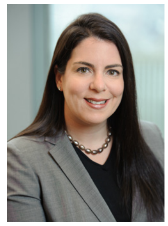

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