American Bankruptcy Institute

# New York City Bankruptcy Conference 2021

# Intercreditor Disputes


**Brian M. Resnick, Moderator**
*Davis Polk & Wardwell LLP*

**Marc Heimowitz**
*Coda Advisory Group LLC*

**Hon. Julie A. Manning**
*U.S. Bankruptcy Court (D.Conn.)*

**J. Soren Reynertson**
*GLC Advisors & Co.*

**Glenn E. Siegel**
*Morgan, Lewis & Bockius LLP*

**Arthur J. Steinberg**
*King & Spalding LLP*

# Intercreditor Disputes

May 20, 2021

Davis Polk | AMERICAN BANKRUPTCY INSTITUTE

Davis Polk & Wardwell LLP

# Agenda

## Recent Distressed Liability Management Transactions


Davis Polk

## Overview of Distressed Liability Management Transactions in the Loan Market


Davis Polk

## Distressed Liability Management Transactions in the Loan Market

### OVERVIEW

- Over the past several years, and in particular since the onset of COVID-19, two closely related forms of distressed liability management transactions have dominated the headlines
  - ***"Drop-down" financings***, in which lenders provide structurally senior financing secured by assets outside of an existing collateral package often, though not always, using unrestricted subsidiaries
    - The quintessential drop-down financing was the *J.Crew* transaction from 2016
    - More recent examples include:
      - *Travelport* (2020)
      - *Cirque du Soleil* (2020)
      - *Revlon* (2020)
  - ***"Uptiering" transactions***, in which lenders enhance the priority of their claims to an existing collateral and guarantee package, typically in connection with and consideration for providing priming new-money debt
    - One of the earliest uptiering transactions was the *NYDJ* transaction from 2017
    - More recent examples include:
      - *Murray Energy* (2018; litigated in 2020)
      - *Serta Simmons* (2020)
      - *Boardriders* (2020)
      - *TriMark* (2020)



## Distressed Liability Management Transactions in the Loan Market

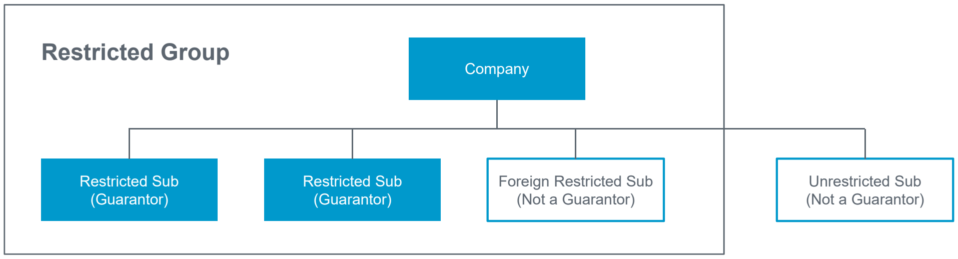
### LOANS VS. BONDS

- In contrast to liability management transactions <u>in the loan market</u>, exit consents, uptiering and drop down transactions have been commonplace in the bond market for many years, whether or not the opportunity to participate in those transactions are offered to all bondholders
- Despite a convergence in investor base (and covenants) between the two markets, the importation of bond market strategies has, in many cases, frustrated traditional expectations of loan market participants, including
  - pro rata treatment on payments and recoveries (or at least an equal opportunity to participate)
  - seniority in the capital structure
  - limitations on leakage from the credit group (e.g., via investments in non-guarantors)
  - dynamics between lenders and agents
- Although the loan market is far more liquid than it was 10 years ago, there still remain limitations (e.g., borrower and agent consent rights to assignments and disqualified lender lists) that do not exist in the bond market, leaving lenders with less flexibility to manage risk by disposing of investments

# Building Block #1

## CREDIT AGREEMENT TREATMENT OF SUBSIDIARIES

- A borrower and its restricted subsidiaries are subject to the representations, covenants and events of default in the credit agreement
- A borrower and certain (primarily domestic) restricted subsidiaries are required to guarantee and provide liens on their assets in secured financings. These are the "loan parties" or "credit parties"
- Certain (primarily foreign) restricted subsidiaries are not required to become Guarantors, but are nevertheless subject to the representations, covenants and events of default in the credit agreement
  - Debt incurred by any such non-guarantor restricted subsidiaries is structurally senior to the credit agreement obligations, but limited by the debt and lien covenants of the credit agreement
- Unrestricted subsidiaries are not required to become guarantors <u>and</u> are not subject to any of the representations, covenants, and events of default in the credit agreement, providing companies with maximum financing flexibility






# Building Block # 2

## PRO RATA SHARING WITHIN CREDIT AGREEMENTS

### Pro Rata Sharing/Waterfall Provisions

- Pro rata sharing provisions typically provide for:
  - Pro rata sharing among lenders of a given class of all payments received (including mandatory and voluntary prepayments) in respect of the applicable loans
  - "Turning over" any excess amounts received by any lender over such lender's pro rata share, which is to be distributed ratably by the agent to the rest of the class
  - Waterfall provisions which address pro rata application of proceeds of collateral following an event of default and acceleration
- Amendments to pro rata sharing provisions have evolved over time
  - Historically, amendments required consent of all lenders or, at a minimum, each affected lender
  - More recently, this requirement has been loosened in aggressive credit agreements, such that pro rata sharing provisions may be amended by a majority of lenders
- Majority lenders may, in such agreements, tranche the loans under the credit agreement into multiple classes benefiting from different priorities, resulting in certain classes becoming effectively subordinated
  - Proposed modifications to the waterfall provision could be used to coerce lender participation in an amendment or other financing, for fear that consenting lenders will receive priority over non-consenting lenders
  - Alternatively, majority lenders could amend the waterfall to elevate the priority of their own loans over the other loans

# Building Block # 2

## PRO RATA SHARING WITHIN CREDIT AGREEMENTS (CONT.)

**Pro Rata Sharing/Waterfall Provisions (cont.)**

- Even where amendments to pro rata provisions are subject to all “affected lender” consent, they are often drafted as protecting pro rata treatment only *within* a given class of loans
  - As a result, a borrower could create a new class that has a higher priority in the waterfall or benefits from non pro rata payment, so long as all holders within the existing class are offered the right to participate
- Where pro rata sharing provision can be amended by majority lenders, the majority could potentially modify the sharing provision to provide for selective payments
  - For example, the majority lenders could effectively “roll up” and enhance the priority of their loans by:
    - amending the credit agreement to permit a new super-senior loan
    - funding that super-senior loan
    - using the proceeds of that super-senior loan to repay solely the loans of the majority under the existing credit facility
- Finally, there are typically exceptions to the pro rata sharing/waterfall provisions, the most significant of which is for open market purchases/Dutch auctions
  - Open market purchases/Dutch auction provisions permit the borrower to repay or repurchase obligations of certain lenders on a non-pro rata basis
  - These provisions have been utilized in “exchange” and “roll up” transactions to allow the consenting or participating lenders to be effectively repaid ahead of other lenders of the same class



# Drop-Down Financings


Davis Polk

# Drop-Down Financings
## OVERVIEW

### Typical Transaction Structure

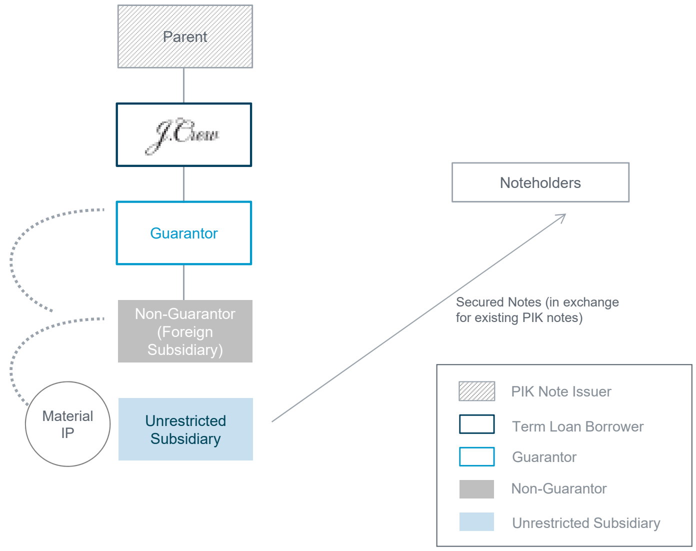
- Company forms/designates an unrestricted subsidiary or another non-guarantor subsidiary (such as a foreign subsidiary, joint venture or other excluded subsidiary) ("NewCo") which is not required to guarantee existing loan obligations
- Either NewCo is completely excluded from the restrictive covenants in the existing debt documents (in the case of an unrestricted subsidiary) or there is sufficient capacity (including after giving effect to concurrent amendments) in the existing loan documents for NewCo to incur structurally senior debt
- Company contributes, sells or otherwise transfers assets (often IP) to NewCo
  - Contribution/sale/transfer is permitted under the existing loan documents and results in an automatic release of liens on such assets in favor of existing lenders
- NewCo incurs (or guarantees) new debt financing that is secured by the contributed assets (and sometimes by the existing collateral package of Company and its other guarantor subsidiaries)
- As consideration for providing such new debt financing, participating lenders may also be entitled to exchange or "roll up" all or a portion of their existing loans into a pari passu or junior claim against NewCo (and, if applicable, the Company and its other guarantor subsidiaries)
- As to the NewCo assets, the new debt financing (as well as any exchanged or rolled-up loans) is structurally senior to the loans of the existing lenders



# Drop-Down Financings
## STRUCTURAL SUBORDINATION

| Typical Structure | Applicable Credit Agreement Provision |
|---|---|
| Formation or identification of NewCo | • Definition of "unrestricted subsidiary" and "designation" provisions<br>• Collateral and guarantee/excluded subsidiary provisions |
| Transfer of assets to NewCo (often accompanied by a license of the transferred asset back to borrower) | • Investment covenant<br>• Asset sale covenant<br>• Collateral release provisions<br>• Sale leaseback covenant<br>• Limitations on release of all or substantially all of the collateral (if applicable) |
| Incurrence of new debt at NewCo (the "New Structurally Senior Debt"), which is either:<br>• unlimited (if NewCo is an unrestricted subsidiary); or<br>• subject to the existing credit facility covenants (if NewCo is an excluded restricted subsidiary) | • If applicable, restrictions on unrestricted subsidiaries guaranteeing, or being guaranteed by, credit parties<br>• If incurred at or guaranteed by an excluded restricted subsidiary, debt and lien capacity (typically subject to "non-guarantor" sub-limits) |
| Where applicable, exchange or "roll up" all or a portion of existing loans of the new creditors into New Structurally Senior Loans | • Pro rata sharing provisions<br>• Borrower buybacks or Dutch auction provisions<br>• Limits on prepayments junior debt (if applicable) |

# Drop-Down Financings
## J.CREW CASE STUDY






# Drop-Down Financings
## TRAVELPORT CASE STUDY

### Background

- Travelport was jointly acquired by two private equity firms in May 2019 for $4.4 billion
- In January 2020, Travelport entered into an agreement with WEX to sell eNett and Optal for $1.7 billion, but in May 2020, WEX took the position that it is no longer obligated to consummate the acquisition on the basis that an MAE on the eNett and Optal businesses had occurred due to the COVID-19 pandemic
- WEX's actions resulted in Travelport losing an important source of liquidity
- Later that month, Travelport transferred IP, including travel registration systems and patents valued at $1.15 billion, from loan parties under its credit agreement to unrestricted subsidiaries
- In early June, Travelport announced that it had obtained commitments for $500 million in financing from its equity sponsors
  - While the press release was silent as to the collateral arrangements for the new financings, it is presumed that the sponsor financings will be secured by the transferred IP

# Drop-Down Financings

TRAVELPORT CASE STUDY (CONT.)

### Investment Capacity for Transfer of IP

- Travelport's credit agreement provides the company with significant investment capacity
  - Investments baskets (whether ratio-based or dollar baskets) may be used to make investments in unrestricted subsidiaries, absent specific language to the contrary (including any relevant "J.Crew blocker")
  - While the Travelport credit agreement does include a form of "J.Crew blocker", the provision is narrow and prohibits only the investment of assets or equity interests of the eNett joint venture from being made in unrestricted subsidiaries
- In addition, the credit agreement includes a large dedicated unrestricted subsidiary investments basket and a large "similar business" investments basket (that may be used for this purpose as well)

### Designation of Unrestricted Subsidiary

- Consistent with many recent credit agreements, Travelport was permitted to designate unrestricted subsidiaries without complying with a leverage ratio test (which may otherwise prevent a distressed company with depressed EBITDA (and thus inflated leverage ratios) to consummate a drop-down financing)

**Cirque du Soleil:** Similar to *Travelport*, the Cirque du Soleil borrower appears to have relied upon large general investment capacity to invest IP in unrestricted subsidiaries, which was, in turn, used to collateralize a loan provided by its private equity sponsor



# Drop-Down Financings

TRAVELPORT CASE STUDY (CONT.)

### Further Developments

- Resignation of agent, after required lenders directed it to declare an event of default on the basis of the transfer of IP
- Travelport asserted that before consummating the IP transaction, it had obtained an independent valuation of the transferred IP assets, in compliance with the credit agreement requirements that the FMV of assets is to be determined "in good faith by the Company"
- Travelport further argued that the transfer of IP to the unrestricted subs was made "in strict accordance with the clear terms of the credit agreement" on the basis that six different investments baskets (including for investments in "similar businesses") provided Travelport with an aggregate of $1.27 billion of capacity for the transfers
- Successor administrative agent delivered a notice of acceleration at the direction of the required lenders and asserted counterclaims, including that
  - The IP transfer was "avoidable as an intentional fraudulent transfer" and "sham transaction" designed to circumvent the secured lenders' protections under the credit agreement
  - Travelport cannot utilize the $238 million "Similar Business" investment basket since, prior to the asset transfer, the newly formed subsidiaries were empty shells with no operational assets or business

# Drop-Down Financings

## TRAVELPORT CASE STUDY (CONT.)

**Further Developments**

- On September 25, Travelport's previous drop-down liability management transaction was unwound as part a debt exchange and restructuring transaction, pursuant to which, among other things, the company's existing lenders provided $500 million in new funding, which was partly used to repay in full sponsor financing obtained at the unrestricted subsidiary in June
  - In conjunction with the transactions, the company and the administrative agent have filed a stipulation dismissing all outstanding litigation claims against one another
  - The exchange was open to all lenders on a pro rata basis and received support from approximately 98% of the first lien lenders and 100% of the second lien lenders
  - Travelport's new capital structure consists of $1.63 billion of priority-term loans and $2.05 billion of first lien term loans; the existing second lien was exchanged at a discount into the first lien facility
  - The covenants in the credit agreements have been tightened to prevent any future asset transfers to unrestricted subsidiaries
- On October 12, the UK High Court in London sided with WEX on preliminary questions regarding which "industry" eNett and Optal participate in, finding that the two affiliates of Travelport were part of a broader payments industry, rather than the narrower travel payments industry, bolstering WEX's argument that there was a "disproportionate effect [on the target businesses], taken as a whole, as compared to other participants in the *industries* in which [they] operate"
  - The High Court ruling did not reach a final determination on the crux of the dispute of whether an MAE has occurred
- Travelport and WEX have since settled the COVID-related MAE litigation and on December 15, WEX announced that it completed the acquisition of payment services business eNett and eNett's minority owner Optal for a total consideration of about $577.5 million with cash on hand

Davis Polk 16

# Uptiering Transactions


Davis Polk

# Uptiering Transactions
## OVERVIEW

### Typical Transaction Structure

- Company incurs new money "super-priority" loans provided by a group of existing lenders
- In exchange, existing debt (whether senior, junior or subordinated) of participating lenders is exchanged for or "rolled up" into (typically, a lesser amount of) pari passu "super-priority" or "second" priority loans
- Existing loans of non-participating lenders are, effectively, subordinated to "third" priority
- Priorities may be affected by:
  - Incurring the new and rolled up loans under a separate credit facility and secured by separate classes of liens with priority as between the new (senior) and existing (junior) credit facilities dictated by an intercreditor agreement
  - Incurring the new and rolled up loans as new classes within the existing credit facility with priority dictated by the credit agreement waterfall
  - A combination of the foregoing
- Equity (or equity-like) instruments may be included to provide participating lenders with potential equity upside



# Uptiering Transactions
## CONTRACTUAL SUBORDINATION

| Typical Structure | Applicable Credit Agreement Provision |
|---|---|
| Incurrence of new debt by the borrower that is senior to existing loans | • Debt and lien covenants<br>• Limits on subordination of existing debt |
| Exchange/rollup of all or a portion of existing loans into senior debt that is pari with or junior to the New Superpriority Loans (but senior to the existing loans) ("Rolled Up Superpriority Debt") | • Pro rata sharing provisions<br>• Buybacks or Dutch auction provisions<br>• Limits on prepayment of junior debt (if applicable) |
| The New Superpriority Debt and the Rolled Up Superpriority Debt may take the form of:<br>• a new tranche of loans within the loan document, with priority governed by a waterfall; or<br>• debt under a separate credit facility, with priority governed by an intercreditor agreement | • Pro rata sharing/waterfall provisions (including related amendment requirements)<br>• Subordination/release of all or substantially all collateral<br>• Intercreditor restrictions |
| "Covenant stripping" and Exit Consent | • Gives "pro forma" effect to new indebtedness in determining Required Lenders<br>• Limits on exit consents |

# Uptiering Transactions

## SERTA SIMMONS CASE STUDY

### Background

- Serta Simmons Bedding is a manufacturer and distributor of mattresses in North America and owns and manages bedding brands
- In November 2016, Serta entered into credit facilities that included a $1.95 billion first lien facility, a $450 million second lien facility and a $225 million ABL facility
- In March 2020, as business continued to deteriorate in light of the COVID-19 pandemic, Serta began exploring strategic alternatives to raise additional liquidity and reduce its debt and interest expense and solicited proposals for liability management transactions and additional liquidity from both existing lenders and third parties
- A group of minority first lien lenders (the "Minority Lenders") proposed a transaction in which they would provide $200 million in new money loans and exchange of $630 million of existing first and second lien term loans into approximately $470 million of exchanged first lien loans
  - Similar to the *J.Crew* transaction, the exchanged loans would have been incurred and guaranteed by newly-created subsidiaries that would not have provided credit support under the existing credit facility and would have been secured by, among other things, transferred IP that had served as collateral under the existing credit facility
- Serta ultimately declined to pursue the transaction proposed by the Minority Lenders, and instead, in June 2020, entered into a transaction support agreement (the "TSA") to consummate a proposed transaction (the "Transaction") with 50.1% of holders of the first lien term loans and a majority of second lien term loan lenders, which led the Minority Lenders to initiate litigation



# Uptiering Transactions

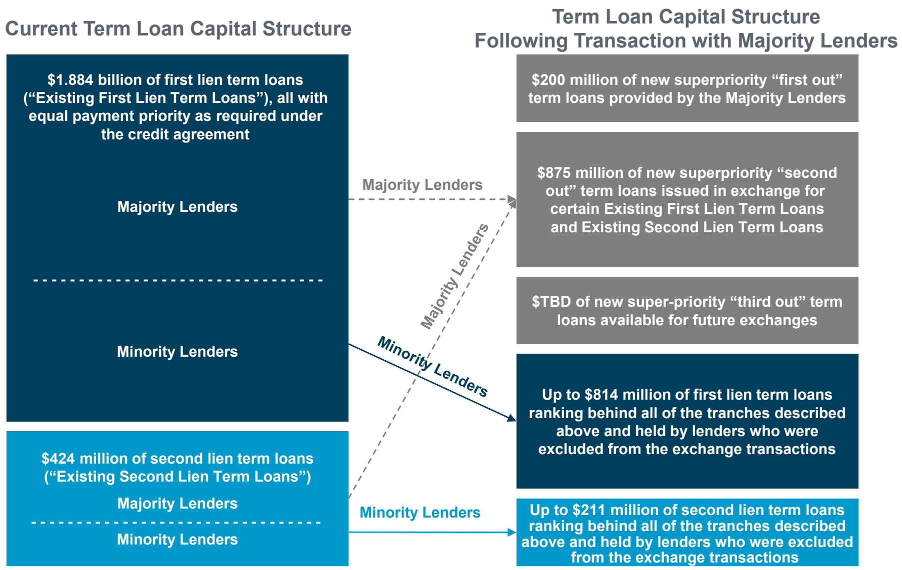
## SERTA SIMMONS CASE STUDY (CONT.)

### The Proposed Transaction

- Participating first lien lenders and second lien lenders would provide $200 million of new money in the form of super priority "first-out" term loans
- The participating lenders were also permitted to "roll up" existing first lien and second lien loans (at a steep discount) into $875 million of first lien "second-out" term loans
- Both new tranches of debt would be senior to the existing first and second lien term loans in priority (effected via an intercreditor agreement), thereby subordinating the loans of the Minority Lenders to over $1 billion in new super priority loans
- The new tranches were proposed to be established under *separate* credit agreements, rather than as new tranches *within* the existing credit agreement
- To permit the proposed transaction, the existing credit agreements would be amended by majority lenders to, among other things, permit (i) the incurrence of $200 million super priority loans, (ii) the roll up of $875 million of second-out loans and (iii) a future tranche of third-out superpriority debt in an undetermined amount
- Serta did not offer the deal to all lenders, but instead transacted with a majority of first and second lien term loan lenders

# Uptiering Transactions

## SERTA SIMMONS CASE STUDY (CONT.)






# Uptiering Transactions

## SERTA SIMMONS CASE STUDY (CONT.)

**Minority Lenders’ (Plaintiffs) Complaint**

- The Minority Lenders argued that the transaction “eviscerates the protections” of the existing credit agreement and, in particular, violates:
  - pro rata distributions of proceeds of collateral upon a default
  - the requirement that 100% of adversely affected lenders consent to any amendment the pro rata distribution provision or to effect the release of all or substantially all of the collateral

**Serta’s (Defendant) Reply**

- Company was expressly permitted to incur $200 million in “incremental equivalent debt”
- Credit agreement expressly permits the debt-to-debt exchange on a non-pro rata basis as part of an open market transaction
- Proposed amendments did not alter the Minority Lenders’ sacred rights under the credit agreement, as no changes were made to the pro rata sharing provisions within the credit agreement (rather, the relative priorities were set forth in an ICA)

**Majority Lenders’ (Defendant) Reply**

- The amendment provision that provides that changes to pro rata sharing provisions are an all affected lender vote only applies to amendments that “by their terms” alter the pro rata sharing provisions
- The payment waterfall in the credit agreement merely states that whatever proceeds go to the agent must be distributed according to the waterfall, but it does not guarantee that the agent receive a certain amount of collateral proceeds under the ICA
- The credit agreement does not provide that subordination of the loans is an all lender vote

# Uptiering Transactions
## SERTA SIMMONS CASE STUDY (CONT.)

### The Court's Decision

- The court denied the Minority Lenders' motion to enjoin the transaction, stating that, as to the breach of contract claim, the court could not find likelihood of success
- The court further concluded that the Minority Lenders' claim that the Majority Lenders breached their implied covenant of good faith and fair dealing was identical of the contractual breach claim, and therefore was unlikely to survive a motion to dismiss
- The court finally held that the Minority Lenders failed to establish the requirements necessary to enjoin the transaction because monetary damages could adequately compensate the Minority Lenders and "harm to plaintiffs' bargaining leverage as a secured lender is not sufficient to establish irreparable harm"
- In closing, the court reiterated that the transaction was designed to provide Serta with significant benefits -- in the form of additional liquidity and a reduction in debt -- and that Serta would face greater harm if the transaction did not proceed; the court could not "overlook the importance of such factors in light of the COVID shutdown and the eventual reopening of the world economy"

### Further Developments

- Litigation continues, and in particular certain funds have taken issue with the exchange as an "open market purchase", claiming that a privately negotiated exchange does not qualify and citing memoranda published by company's counsel that suggests an open market purchase would require a broker or agent and a set market price.



# Uptiering Transactions
## BOARDRIDERS CASE STUDY

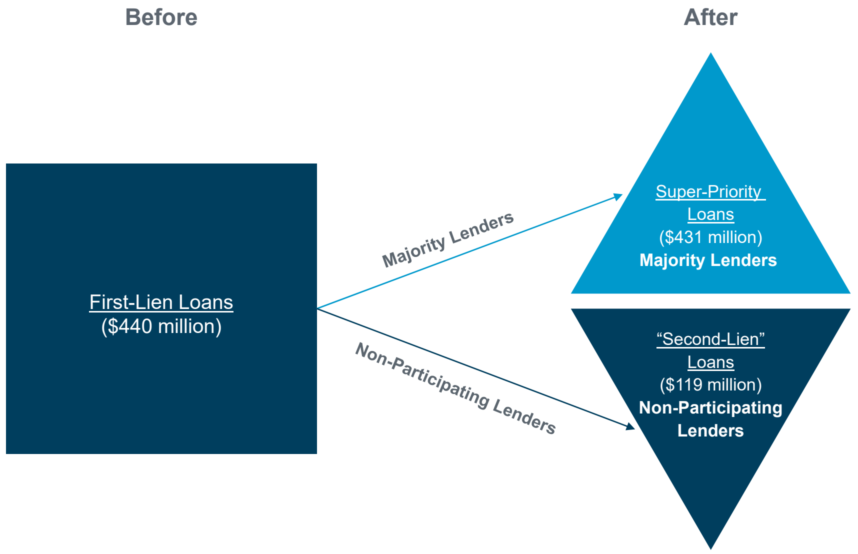
### Background

- Boardriders, a surfing and skateboarding apparel maker under brands that include Quiksilver and Roxy, has been sponsor owned since exiting from Chapter 11 in January 2016
- Temporary store closures and declining discretionary spending due to the COVID-19 pandemic exacerbated Boardriders' negative free cash flow, which was already impacted by costs associated with integrating Billabong (acquired in 2018) and a subsequent cyberattack, putting a strain on its liquidity and covenant compliance
- On August 31, Boardriders announced a recapitalization transaction that was negotiated among certain of the company's first lien term lenders comprising the majority lenders (the "Majority Lenders") and the equity sponsor

### The Proposed Transaction

- Boardriders and the Majority Lenders amended the existing credit agreement to (i) waive the negative covenants limiting debt and liens to provide new senior lien debt capacity and (ii) eliminate substantially all of the affirmative and negative covenants
- New senior lien debt was incurred pursuant to a superpriority credit agreement using the open market repurchase provisions to exchange existing loans of the Majority Lenders into new senior lien debt
  - The superpriority credit agreement provides for: (i) $45 million of new money super-priority "Tranche A" loans made by the Majority Lenders, (ii) $80 million of "Tranche B-1" loans consisting of $45 million of new money commitments and a roll-up of $35 million of loans held by certain affiliates of the sponsor; (iii) $286 million of "Tranche B-2" roll-up loans held by the Majority Lenders; and (iv) $20 million in the form of a super-priority delayed draw term loan facility provided by certain affiliates of the sponsor

# Uptiering Transactions
## BOARDRIDERS CASE STUDY (CONT.)






# Uptiering Transactions
## BOARDRIDERS CASE STUDY (CONT.)

**Non-Participating Lenders' (Plaintiffs) Complaint**

- On September 18, an ad hoc group of non-participating first lien lenders (the "Non-Participating Lenders") sent a demand letter to the company characterizing the transaction as "Serta on steroids" and demanding that the company repay all of their existing term loans in full in cash or exchange the existing term loans held by the lender group for superpriority term loans
- On October 9, the Non-Participating Lenders filed a complaint in New York Supreme Court seeking to challenge Boardriders' recently consummated uptiering transaction alleging that the transaction "unfairly favors" the equity sponsor and the Majority Lenders to the detriment of the Non-Participating Lenders
  - The complaint alleges that as a result of the unlawful "Private Roll-up Transaction", the Non-Participating Lenders have been subordinated in lien priority by up to $431 million of super-priority secured debt, of which $321 million was *pari passu* to the existing term loans held by the Non-Participating Lenders prior to the exchange
  - Similar to the arguments set forth by certain of the *Serta* plaintiffs, the Non-Participating Lenders argued that "nothing about [the transaction] resembles an open market purchase", alleging that:
    - An "open market" transaction requires that "the term loans are purchased via an established market made by one or more third-party broker dealers where competition among market participants (*i.e.*, the lenders) determines the price available for [Boardriders] and equity sponsor"
    - No debt was retired, but instead the company exchanged debt for new senior secured debt
    - The exchange of the Majority Lenders' old debt occurred at par rather than at the discounted market value which was "50-60% of par"
    - The "open market" purchases were not stand-alone transactions, but were a component of a broader integrated transaction, including the amendments, the new priming loans and a new subordination agreement
  - The complaint further alleges that the debt exchange required the consent of *all* lenders because the roll-up of Majority Lenders' existing term loans resulted in a reduction in their principal amount and such reduction directly and negatively affected the obligations of the Non-Participating Lenders

# Uptiering Transactions
## BOARDRIDERS CASE STUDY (CONT.)

**Non-Participating Lenders' (Plaintiffs) Complaint (cont.)**

- The Non-Participating Lenders argue that Boardriders' uptiering transaction went beyond *Serta* in that:
  - The defendants amended the existing credit agreement to eliminate *all* of the affirmative and negative covenants, including reporting requirements, and nearly all events of default other than payment- and bankruptcy-related defaults, but retained them in the Majority Lenders' superpriority credit agreement governing the rolled up debt, all without prior notification to, or participation of, the lender group as a whole, leaving the Non-Participating Lenders with a "stripped-down, covenant-bare promissory note"
  - The existing credit agreement was further amended to prevent the Non-Participating Lenders from bringing any future litigation by adding requirements that the Non-Participating Lenders (i) post a cash indemnity bond equal to the fees and costs of such litigation, including counterclaims and (ii) enforce their rights only if they have majority lender status and direct the agent to act on their behalf
  - The ICA included several provisions that were alleged to include off-market subordination provisions, such as waiver of unsecured creditor rights and "indefinitely waiv[ing] their ability to enforce an event of default under the credit agreement"
  - The defendants rejected several plaintiffs' attempts to engage in any loan restructuring process and "intentionally hid," and prevented the plaintiffs from participating in, the transaction



# Uptiering Transactions
## BOARDRIDERS CASE STUDY (CONT.)

**Defendants' Motions to Dismiss**

- On December 8, Boardriders, its equity sponsor and certain defendant lenders filed motions to dismiss arguing:
  - Plaintiffs lack standing to bring the claims based on the collective action requirements and failure to post a cash indemnity bond as required under the amended credit agreement
  - The amendments were valid and could be properly effected with the consent of the Required Lenders, as (i) subordinating the liens securing the term loans, (ii) changing or removing the affirmative and negative covenants or (iii) modifying the requirements for lenders to pursue claims against Boardriders do <u>not</u> constitute sacred rights under the credit agreement
  - Drawing parallels to *Serta Simmons*, Boardriders alleged the plain language of the credit agreement expressly allows it to make open market purchases on a non-pro rata basis and that the implied covenants of good faith and fair dealing are superseded by the "clear and unambiguous terms" of the credit agreement
  - The sponsor's role as the Company's majority owner is the "quintessential 'economic interest' that serves as a complete defense" to any tortious interference claim

# Uptiering Transactions

## TRIMARK CASE STUDY

**The Transaction**

- TriMark USA is a foodservice equipment and supplies distributor to restaurants. The COVID-19 pandemic brought an abrupt end to indoor restaurant dining and put tremendous strains on TriMark's business
- On September 14, 2020, TriMark announced a recapitalization transaction executed with majority first lien term lenders (the "Majority Lenders") whereby:
  - TriMark and the Majority Lenders entered into (i) a superpriority credit agreement issuing new money superpriority "first out" loans and superpriority "second out" roll-up loans that rank ahead of the existing lenders and (ii) a superpriority ICA that subordinated the existing non-participating first lien debt to the Majority Lenders' super senior debt
  - TriMark and the Majority Lenders entered into an amendment to the existing credit agreement to, among other things, remove all affirmative and negative covenants, including reporting requirements
- On November 7, an ad hoc group of non-participating minority first lien term lenders (the "Minority Lenders") filed a complaint in New York Supreme Court calling the recapitalization a "cannibalistic assault by one group of lenders in the syndicate against another"
- On January 8, TriMark, its equity sponsors and a number of lender defendants filed motions to dismiss focusing on the validity of the amendment to the existing credit agreement through which the recapitalization was effectuated



# Uptiering Transactions

## TRIMARK CASE STUDY (CONT.)

**Minority Lenders' (Plaintiffs) Complaint**

- The Plaintiffs raised several concerns, many consistent with those raised in *Serta Simmons* and *Boardriders*:
  - The uptiering transaction was not an "open market purchase" but a prepayment of debt through a private debt exchange which should have been executed pro rata under the existing credit agreement
  - There were several problematic amendments:
    - Removing all affirmative and negative covenants such that "a holder of the legacy debt would have no basis upon which to make an informed decision about whether to hold or sell First Lien Debt, or to be able to understand the risk of the investment", while retaining them in their new superpriority credit agreement
    - Modifying the definition of "open market purchase" to include transactions "below or above par for cash, securities, or any other consideration with one or more Lenders that are not made available for participation to all Lenders"
    - Modifying the indemnity such that only the agent and their related parties are entitled to indemnification and removed the "bad faith" carve out
    - Limiting plaintiffs right to sue against TriMark and the Majority Lenders, having to first post bond for the full amount of estimated fees and expenses for the lawsuit plus the full amount of potential liability that could be awarded as estimated by the agent in its sole discretion
  - By virtue of reducing the value of and principal amount of first lien debt, 100% lender approval was required
  - By effectively releasing all or substantially all of the collateral, 100% lender approval was required

# Uptiering Transactions
## TRIMARK CASE STUDY (CONT.)

**Defendants' Arguments in Support of Dismissal**

- The recapitalization provided the company with $120 million of new money – "liquidity that will serve as an essential bridge for TriMark to the other side of the COVID-19 pandemic"
- Similar to the *Boardriders* and *Serta Simmons* defendants, TriMark alleged the amendments were valid as they did not alter any sacred rights of Minority Lenders, specifically:
  - Reduction in Principal: the plaintiffs suffered no reduction in their principal; the only reduction of principal was that owed to the Majority Lenders who agreed to such a reduction in selling their loans in the open market and "a lender is not directly adversely affected by the reduction of the principal amount of another lender's loan"
  - Release of Collateral: citing *Murray Energy*, TriMark argued the amendment resulted in a subordination of the Minority Lenders' interest in collateral, not a release and subordination is not a sacred right
- In response to plaintiffs' claim that the defendant lenders' term loans should be excluded from "Required Lenders" as they were "subject to the [open market purchase provisions]", TriMark argued the Majority Lenders' vote should not be excluded since at the time that the amendments were entered into, the term loans were still held by them regardless of whether such lenders committed to assign their interests to TriMark at a later date



# What's going on here . . .
## GOALS AND STRATEGIES

- In formulating responses to these cases it is important to bear in mind the goals and strategies of various constituents:
  - **Borrowers:** These strategies are typically a last resort
    - Bridge to a more normalized operating environment
    - Reduce the aggregate principal amount of existing debt (and correspondingly interest burden)
    - Address upcoming maturities, obtain needed covenant relief from potential financial or other defaults
    - Maximize flexibility in a challenging operating or financing environment, address extreme liquidity conditions
  - **Lenders:**
    - Enhance credit support for existing exposures, including improving priority vis-à-vis other existing lenders
    - Maximize return on existing exposures by supporting borrowers' operations during a period of distress (and avoid an in-court restructuring), by providing additional liquidity, covenant relief or maturity extension
    - Prevent other lenders from taking actions that will disadvantage their existing exposures ("do unto others before they do unto you")
    - Earn a return on capital that meets internal return hurdles, in addition to transaction and other fees
    - Ensure a seat at the table to maximize recovery in the event of an in- or out-of-court restructuring

# Documentation Considerations


Davis Polk

## Documentation Considerations

### INVESTMENTS COVENANT AND UNRESTRICTED SUBSIDIARIES

**Documentation Checklist**

**Investments Covenant:**

- ✓ What is the aggregate basket capacity for drop-down transactions considering all available baskets as a whole (taking into account ratio-based baskets, cumulative credit, baskets that can be reallocated from the restricted payments covenant and investment capacity that may have been built by earlier capital contributions)?
- ✓ Is there a cap on [non ordinary course] investments by credit parties in non-credit party restricted subsidiaries? Would one be appropriate given the operations of this borrower?
- ✓ Does the document contain *J. Crew* language, i.e., language that permits investments by loan parties in non-loan party restricted subsidiaries to be further invested by the non-loan party for any purpose, which would include making investments in unrestricted subsidiaries?
- ✓ Are there limitations on moving certain types of assets outside the credit group, e.g. intellectual property, or distinct lines of business?
- ✓ Are there specific provisions permitting the movement of IP within the corporate group that would permit a drop-down transaction?
- ✓ Is there a leveraged or interest coverage ratio test on use of cumulative credit for investments?
- ✓ When investing assets, how is the value of the assets to be determined? By the borrower in good faith? With third party verification if over a threshold?

**Unrestricted Subsidiaries:**

- ✓ Are there any unrestricted subsidiaries in place at closing that could be used to consummate a drop-down transaction in future without complying with applicable “designation” requirements?
- ✓ Is there a ratio that must be satisfied as a condition to designating unrestricted subsidiaries?
- ✓ What limits, if any, exist on unrestricted subsidiaries guaranteeing, or being guaranteed by, the credit parties?
- ✓ Are there any significant exclusions from the requirement to provide guarantees and collateral?
- ✓ Is the exclusion of foreign subsidiaries appropriate given the transaction structure and tax regulations?

# Documentation Considerations

## INVESTMENTS COVENANT AND UNRESTRICTED SUBSIDIARIES (CONT.)

| Potential Documentation Fixes | Sample Language |
|---|---|
| • Ensure there is no *J.Crew* trapdoor or loophole: | …any Investment made by any Restricted Subsidiary that is not a Loan Party to the extent that such Investment is financed with the proceeds received by such Restricted Subsidiary from an Investment in such Restricted Subsidiary by a Loan Party as permitted under this Agreement (except that no Investment may be made in Unrestricted Subsidiaries in reliance on this clause) |
| • Include a cap on investments by loan parties in non-loan parties in the exception permitting investments in restricted subsidiaries: | …any Investment in the Borrower or any Restricted Subsidiary; *provided* that Investments by a Loan Party in any Restricted Subsidiary that is not a Loan Party shall not exceed the greater of $[ ] and [ ]% of LTM EBITDA |
| • Consider all investment baskets as a whole as potentially permitting investments in unrestricted subsidiaries or non-loan party restricted subsidiaries and consider an aggregate cap or override: | Notwithstanding the foregoing, in no event shall any Loan Party make investment in, or dispose of assets to, [subsidiaries that are not Loan Parties][Unrestricted Subsidiaries] in an aggregate amount exceeding the greater of $[_] and [_]% of LTM EBITDA. |
| • Consider including anti-*J.Crew* language protecting against investments of material IP or other assets in non-loan party subsidiaries: | Notwithstanding the foregoing, in no event shall any Loan Party (a) Dispose of any [Material Intellectual Property][Material Asset] to any subsidiary that is not a Loan Party, (b) contribute or otherwise Invest any [Material Intellectual Property][Material Asset] to or in any subsidiary that is not a Loan Party or (c) designated any subsidiary as an Unrestricted Subsidiary if such subsidiary owns any [Material Intellectual Property][Material Asset].<br>"Material Intellectual Property" means any intellectual property owned by any Loan Party that is, [in the reasonable determination of the Borrower], material to the operation of the business of the Borrower and its Restricted Subsidiaries, taken as a whole.<br>"Material Asset" means any asset owned by any Loan Party that is, [in the reasonable determination of the Borrower], material to the operation of the business of the Borrower and its Restricted Subsidiaries, taken as a whole. |



# Documentation Considerations

## SUBORDINATION

**Documentation Checklist**

- ✓ Does the loan documentation require a 100% vote for a claim subordination of the existing loans?
- ✓ Does the loan documentation require a 100% vote for a lien subordination of the existing loans?
- ✓ Does the amendment to pro rata sharing require a 100% vote for an amendment having the effect of releasing substantially all collateral/guarantees?

| Potential Documentation Fixes | Sample Language |
|---|---|
| • Most credit agreements require the consent of 100% of lenders to release all or substantially all of the collateral, but do not expressly require the same consent for a subordination of the existing loans to one or more new classes of super-priority loans or a new super-priority credit facility (whether payment or lien subordination). To address this consider the adding the following to the amendment section:<br>• Note that variations of this language has found its way into documents; some have identified those provisions as "inadequate" because (i) it is limited to "Indebtedness", (ii) it only applies to certain "material" indebtedness or (iii) it excludes subordination otherwise permitted | …no amendment, waiver or consent shall] without the prior written consent of each Lender directly affected thereby, (i) subordinate, or have the effect of subordinating, the Obligations hereunder to any other [Indebtedness], or (ii) except as provided by operation of applicable Law, subordinate, or have the effect of subordinating, the Liens securing the Obligations to Liens securing any other [Indebtedness]; |

# Documentation Considerations

## PRO RATA SHARING AND OPEN MARKET PURCHASES

**Documentation Checklist**

- ✓ Are “pro rata” provisions subject to 100% or all affected lender vote?
- ✓ Which pro rata provisions are referenced? Pro rata sharing? Pro rata treatment of payments? Waterfall?
- ✓ What are the exceptions to the pro rata provisions?
- ✓ Do the pro rata provisions protect all lenders, or only lenders within a class (so that the borrower could create a new class and offer that new class non-pro rata treatment)?
- ✓ Does the credit agreement permit “open market” buybacks and how is that defined (if at all)? Will there be a market test or opportunity for lenders to participate? Is there a cap?
- ✓ Does the credit agreement permit “Dutch auctions” and how is that defined? Is there a cap?
- ✓ What is the vote required to modify the open market purchases or Dutch auction exceptions to the pro rata sharing?

| Potential Documentation Fixes | Sample Language |
|---|---|
| • Consider subjecting changes that have the effect of modifying any pro rata sharing or waterfall provisions to 100% (or all affected) lender vote: | …change Sections [*include pro rata sharing, pro rata treatment, post default waterfall an borrower/sponsor buyback mechanics if appropriate*] or any other provision hereof in a manner that would have the effect of altering the ratable reduction of Commitments or the pro rata sharing of payments otherwise required hereunder, without the written consent of each Lender |
| • Consider re-visiting “open market purchases” by: | Limiting to Dutch auctions or other procedures that require the buyback offer to be made on the same terms to all lenders, and make modification of this provision another “sacred right”<br>Defining “open market purchases” to include a requirement that the purchases are required to be made through a third party market maker or through an established market<br>Capping the amount of loans that can be acquired through an open market purchase<br>Prohibiting open market purchases in connection with a concurrent debt exchange/refinancing |



# Documentation Considerations

## OTHER CONSIDERATIONS

**Also consider…**

- Requiring exit consents, i.e. consents granted by lenders who are immediately thereafter rolled into the structurally or contractually senior loans, to be offered to all lenders
- Adding language that prevents “exit consents” in connection with an uptier transactions. Interestingly Trimark appears to include such language:
  - “Required Lenders” is defined as “Lenders having or holding more than 50.0% of the outstanding Term Loans…; provided that…<u>the total outstanding Term Loans subject to Section 9.04(g) *[“open market purchase” provision]*… shall be excluded for purposes of making a determination of Required Lenders</u>”, the purpose of which was to ensure that “holders of those loans could not, on their way out the door, agree to amendments that might harm the other First Lien Lenders they left behind”
- Creating a “guarantor coverage test” in lieu of restrictions on investments by credit parties in non-credit parties in appropriate circumstances
- CLO Concentration Limitation as a solution?

***Read the Fine Print!***

- Review remedy limitation provisions to determine individual or minority lender rights to bring independent causes of action (vs. all claims being brought by the agent at the direction of the majority lenders)
- Review provisions referencing intercreditor arrangements (including defined terms and provisions authorizing agents to enter into intercreditor agreements)

# Collective Action Provisions – Recent Developments

2

Davis Polk

## Collective Action Provisions – Recent Developments

### INTRODUCTION

- Most credit agreements include a "collective design"– treating lenders as a single group represented by an agent
- Accordingly, most documents allow an agent or trustee to exercise certain creditor rights and remedies at the direction of some, but not all, of the members of its lending syndicate, typically a group constituting the majority (or, in the case of remedies with respect to bonds, a smaller percentage of 25-35%) of the outstanding obligations and commitments. The actions this group can direct include:
  - Accelerating loans
  - Terminating lending commitments
  - Foreclosing on collateral
  - Granting amendments or waivers
  - Credit bidding
- Courts have long respected collective action provisions, often deferring to unambiguous language in the documents and preferring that inter-creditor disputes be resolved in the documents
- There are several recent examples of bankruptcy courts upholding collective action provisions in credit agreements over the objections of minority lenders, strengthening the general collective action principle
  - In *Alta Mesa Resources* and *Empire Generating*, the courts upheld actions of the respective administrative agents directed by the Required Lenders with respect to the debtors' proposed asset sales. In particular, in an oral ruling that the *Alta Mesa* court admitted was a "major decision," the court held that (i) the agent could consent to the release of liens on the collateral with only the Required Lenders' consent, and (ii) relying on the court's equitable powers and the collective action provisions in the loan documents, the dissenting lenders were barred from presenting evidence to oppose the sale or taking any other actions at the sale hearing that would contravene the agent's consent

## Collective Action Provisions - Recent Developments

INTRODUCTION (CONT.)

- Under section 316(b) of the Trust Indenture Act, outside of bankruptcy, an issuer cannot impair a bondholder's right to receive principal and interest – even if consented to by a majority of holders
- Specifically, section 316(b) of the Trust Indenture Act provides:

  Notwithstanding any other provision of the indenture to be qualified, **the right of any holder of any indenture security to receive payment of the principal of and interest** on such indenture security, on or after the respective due dates expressed in such indenture security, **or to institute suit for the enforcement of any such payment** on or after such respective dates, **shall not be impaired or affected without the consent of such holder**…
- In *CNH Diversified Opportunities v. Cleveland Unlimited*, the New York Court of Appeals recently decided that a group of minority noteholders' right to sue the issuer for deficiency payments "survived" after the indenture trustee, at the direction of the majority noteholders, undertook a strict foreclosure that resulted in a debt-for-equity exchange and purportedly extinguished the dissenting minority's rights to seek any further payment on the notes
- The decision will likely impact the ability to use strict foreclosure as an alternative to a court-supervised reorganization with respect to indentures containing TIA § 316(b)-type language and governed by New York law



## Collective Action Case Studies

*ALTA MESA RESOURCES, INC.*

**Relevant Case Background**

- Alta Mesa Resources ("Alta Mesa"), a Houston-based E&P company that runs upstream oil and gas businesses, filed for chapter 11 protection in September 2019 in the US Bankruptcy Court for the Southern District of Texas
- Kingfisher Midstream, LLC ("KFM"), the midstream affiliate of Alta Mesa, along with certain of its affiliates (collectively, together with the Alta Mesa debtors, the "Debtors") filed for chapter 11 on January 13, 2020 and requested that the cases be jointly administered with the Alta Mesa debtors
  - Alta Mesa further requested that the court modify prior orders in the Alta Mesa debtors' first-day motions and bid procedures, among other relief, to include Kingfisher

**Proposed Sale**

- In December 2019, the court approved the Debtors' bid procedures for a combined sale of the Alta Mesa and Kingfisher assets for $320 million
- At the Kingfisher first-day hearing, a group of lenders expressed their concern with the sale, notwithstanding that the agent under both the Alta Mesa and Kingfisher credit facilities consented to the sale. Various other parties, including an ad hoc group that made a competing offer for the debtors' assets, opposed the bid procedures and the Debtors' request for bid protections for a joint venture as stalking horse bidder, and the court denied the Debtors' stalking horse approval while otherwise approving the bid procedures
- Ultimately, notwithstanding the arguments of the non-consenting lenders discussed below and additional objections from the UCC and noteholders regarding the terms of the sale, on January 24, 2020, following a sale hearing, the court entered two orders approving the "free and clear" sales of the Alta Mesa and Kingfisher assets to the joint venture

# Collective Action Case Studies

*ALTA MESA RESOURCES, INC.* (CONT.)

**Whether the Non-Consenting Lenders Had Standing to Object to the Asset Sale**

- At the Kingfisher first-day hearing, the court said it wanted to understand the parties' positions with respect to the administrative agent's assertion that it had the legal authority to consent to the proposed Asset Sale on behalf of all lenders even though certain lenders had not consented. The court requested briefing on whether the non-consenting lenders had "standing" to object to the Asset Sale

**Arguments for Standing**

- KFM Only Lenders Brief:
  - A non-crossover group of KFM lenders (the "KFM Only Lenders") argued that they had standing to oppose the Asset Sale because the Kingfisher credit facility is a syndicated facility in which each lender is in "direct contractual privity" with the borrower, each lender made separate loans, and each lender signed the agreement as a party. Accordingly, the KFM Only Lenders asserted that lenders under the Kingfisher credit agreement are "creditors" pursuant to the Bankruptcy Code and have standing under section 1109(b) of the Bankruptcy Code
  - They further asserted that nothing in the credit agreement precluded them from objecting to the bid procedures and Asset Sale because they never expressly or specifically waived such right to object. In particular, the agent was never delegated the exclusive authority to exercise "all remedies," and even if the agent were delegated exclusive and broad authority to enforce "remedies," that power would not be specific enough to create a waiver of the KFM Only Lenders' right to object to the sale and bid procedures. In addition, they asserted, the credit agreement did "not contain any express or specific prohibition against the KFM Only Lenders raising objections to bid procedures or a bankruptcy sale"
  - The KFM Only Lenders also argued that, pursuant to the credit agreement, the agent had limited, not plenary, agency and that the credit agreement provides that "for the duties of the Administrative Agent to exist, the duties must be enumerated." Thus, according to the KFM Only Lenders, the agent's exclusive authority to enforce collateral rights did not create an exclusive right to enforce Loans, Obligations and Liabilities



# Collective Action Case Studies

*ALTA MESA RESOURCES, INC.* (CONT.)

**Arguments for Standing (cont.)**

- Bank of Texas Brief:
  - Bank of Texas ("BOKF") was a lender under both the Alta Mesa and Kingfisher credit facilities
  - BOKF argued that it had standing to directly pursue claims and object to the Asset Sale, citing excerpts from both credit agreements. In particular, BOKF argued that the administrative agent performs administrative functions and the lenders "otherwise control their own destinies"
  - BOKF also asserted that (i) it was a party-in-interest under section 1109 of the Bankruptcy Code and no contractual language in the credit agreement could deprive a lender of its statutory standing, and (ii) the agent could not demonstrate any express right granted to the agent to consent on behalf of BOKF under section 363(f)(2) of the Bankruptcy Code. Without such an express provision, BOKF argued, silence or ambiguity favored preserving the obligation of the debtor to obtain BOKF's independent consent
  - BOKF further added that, even if it were estopped from arguing that the Debtors had failed to obtain the consent of all lienholders as required by section 363(f)(2) of the Bankruptcy Code, BOKF had standing to challenge the sale under section 363(b) of the Bankruptcy Code

# Collective Action Case Studies

*ALTA MESA RESOURCES, INC.* (CONT.)

**Arguments Against Standing**

- KFM Debtors' Brief
  - In their omnibus reply, the KFM Debtors asserted that the agent was acting at the direction of the Required Lenders under Section 8.2 (Remedies) of the credit agreement to protect and enforce its rights under the Loan Documents. Thus, even if the non-consenting lenders had standing under the Bankruptcy Code to object to the sale transaction, their objections are irrelevant because the credit agreement provided the Required Lenders (or the agent acting at the direction of the Required Lenders) with exclusive authority to consent to the Asset Sale
  - In addition, the KFM Debtors argued that, under Section 9.12(c) of the credit agreement: "the Lenders irrevocably authorized the Administrative Agent to release Liens on the Collateral (i) in connection with any foreclosure sale or other disposition of Collateral after the occurrence of an Event of Default or (ii) to the extent permitted under any Loan Document, in each case, as long as Lenders holding greater than 50% of the commitments under the Credit Agreement (the 'Required Lenders') direct the Administrative Agent to do so"
    - This section further provided that "no person other than the Administrative Agent has the right to realize upon any of the Collateral individually, to enforce any Liens on Collateral, or to enforce the Security Documents, and all powers, rights and remedies under the Security Documents . . . may be exercised solely by Administrative Agent on behalf of the Persons secured or otherwise benefitted thereby"



# Collective Action Case Studies

*ALTA MESA RESOURCES, INC.* (CONT.)

**Arguments Against Standing (cont.)**

- Administrative Agent's Brief
  - The agent asserted that the entire 363 sale process was a disposition of collateral falling within the agent's exclusive authority under the credit agreement. In particular, the agent's brief asserted that the credit agreement provided "the Agent, the sole holder of the liens securing the debt under the Credit Agreement, with irrevocable and exclusive authority regarding the enforcement of rights and remedies as to any sale or disposition of the Collateral following default, which is the situation presented here"
  - With respect to BOKF's argument that it could veto a sale under section 363 of the Bankruptcy Code, the agent argued that it, as the administrative agent directed by the majority of lenders, "has the right to consent under Section 363(f)(2)" of the Bankruptcy Code to a sale transaction. In particular, the agent cited to Section 7.03 of the Alta Mesa credit agreement, which stated that, in the event of insolvency, "the Administrative Agent shall, at the request of, or may with the consent of, the Majority Lenders proceed to enforce its rights and remedies under the Security Instruments, the Guaranties, and any other Loan Documents for the ratable benefit of its, the issuing Lenders and the Lenders by appropriate proceedings." Thus, the agent argued, BOKF explicitly granted the agent the right to consent on behalf of all of the Prepetition Secured Parties so long as the Administrative Agent had the consent of the required/majority lenders
- Alta Mesa Debtors' Brief
  - The Alta Mesa Debtors argued that the consent of the agent was binding on all lenders, including BOKF, for two reasons:
    - The agent's consent constitutes an exercise of its delegated power over default remedies
    - Section 9.01 of the AMH Credit Agreement vests in the majority lenders the exclusive power to amend, waive or consent to departures from any provision in the AMH Credit Agreement (or other AMH Loan Documents)

# Collective Action Case Studies

*ALTA MESA RESOURCES, INC.* (CONT.)

**Court's Holding**

- On January 21, 2020, Judge Isgur held that the administrative agent had exclusive authority "to take all the necessary actions that they need to maximize their recovery of their secured claims," and no other read of the documents was a "fair reading." Hr'g. Tr. 72:12-22. Moreover, under the documents, "[o]nly the Administrative Agent may give consent" to the sale. *Id.* at 73:2-5. The court also explained that "I am exercising [my] equitable power and not allowing the banks to make any arguments today that would upset what the Administrative Agent has consented to." *Id.* at 73:15-17
  - At the hearing, the court focused in part on Section 9.12(c) of the credit agreement, which provided that:
    - Notwithstanding anything contained in any of the Loan Documents to the contrary, no Person other than the Administrative Agent has any right to realize upon any of the Collateral Individually, to enforce any Liens on Collateral, or to enforce the Security Documents, and **all** powers, rights and remedies under the Security Documents . . . may be exercised solely by Administrative Agent on behalf of the Persons secured or otherwise benefitted thereby (emphasis added)
  - Looking at this provision, the court explained that "if it has to do with rights against the collateral, which 363(f)(2) does, you gave that to the agent"
- Although the court found that the non-consenting lenders retained standing to raise issues that are not directly related to issues concerning the collateral, ultimately, doing so would violate the loan documents, pursuant to which the lenders were barred from taking actions that would contravene actions of the agent. Thus, the court concluded, the non-consenting lenders were prevented from "arguing against anything that the agent has consented to" and were barred from presenting evidence to oppose the sale at the sale hearing. *See id.* at 74:18-21 ("I'm going to preclude the dissenting lenders from addressing any issues based on standing as to 363(f) on a pure basis and because they are breaching their contract as to all other matters")
- Noting the importance of this decision, the court stated that it was a "major decision" that "deserves review" by the district court, and he invited the parties to begin working on their appeals



# Collective Action Case Studies

*EMPIRE GENERATING CO.*

**Relevant Case Background**

- Empire Generating Co. and certain affiliates (collectively, the "Debtors"), which own and operate a combined cycle dual-fuel power plant in upstate New York, filed for chapter 11 protection in May 2019 in the Bankruptcy Court for the Southern District of New York
- The Debtors entered into an RSA with lenders holding 55% of the Debtors' prepetition secured credit facility (the "Majority Lenders"). The RSA contemplated a full credit bid by the Majority Lenders, subject to higher and better offers, of the $353.4 million outstanding under the credit facility
- As contemplated by the RSA, the Debtors executed a purchase agreement with the Majority Lenders. Prior to the petition date, the Debtors also received an offer for the same assets from a lender of less than a majority of the Debtors' prepetition secured credit facility (the "Minority Lender" and, together with the other objecting lender, the "Minority Lenders")
- The Debtors, in their business judgment, concluded the Minority Lenders' offer was not higher or better than the Majority Lenders' offer
- As part of their first-day motions, the Debtors filed a bidding procedures motion seeking court approval of (i) procedures to sell substantially all of their assets and (ii) bid protections for the Majority Lenders as stalking horse bidder

# Collective Action Case Studies

*EMPIRE GENERATING CO.* (CONT.)

**Objections to Proposed Sale**

- The Minority Lenders objected to the proposed sale and RSA on numerous grounds—including that:
  - the plan was a *sub rosa* plan designed to strip the Minority Lenders of their rights
  - the Majority Lenders could not direct the collateral agent because they were interested parties that "controlled" the debtors
  - ample cause existed to limit or prohibit the credit bid because of the improper process and its "inconsistency with the Loan documents" (*Minority Lenders' May 28, 2019 Objection*)
- The Minority Lenders further argued that they had standing to object because the loan documents did not expressly waive the Minority Lenders' right to object to the RSA or the sale. In addition, they asserted that their delegation of certain rights to the collateral agent (with respect to DIP financing and cash collateral) was not a bar on their ability to object or be heard with respect to the RSA and sale
- The Minority Lenders also asserted that the credit bid violated the intercreditor agreement, which required the pro rata distribution of proceeds from a sale of the collateral. The Minority Lenders argued that, because there was not full disclosure of the post-reorganization governance terms, it was not clear that the intercreditor agreement would be satisfied. In particular, they argued that, "[t]o be pro rata, distribution of interests must be accompanied by governance terms that provide at least as much protection for minority owners as provided under the Intercreditor Agreement"



# Collective Action Case Studies

*EMPIRE GENERATING CO.* (CONT.)

**Majority Lenders' Reply**

- In their reply, the Majority Lenders responded that the Prepetition Loan Documents used collective action clauses to confer important rights (including the right to credit bid) exclusively to the Prepetition Agent and unambiguously prohibited individual lenders from acting separately to enforce such remedies
- The Majority Lenders further argued that when the Minority Lenders purchased debt in the Credit Facility, they each irrevocably authorized the Collateral Agent to exercise such powers, rights and remedies under the other Loan Documents, and that the court "should refrain from accepting the Minority Lenders' invitation to rewrite the collective action provisions of the Loan Documents to give them more negotiating leverage than they bargained for when they bought their debt"
- Moreover, the Majority Lenders argued, each prepetition lender also agreed to be bound by the terms of the intercreditor agreement, which in turn provided that:
  - "The Collateral Agent, acting upon an Act of Secured Parties, *shall have the exclusive right to enforce rights, exercise remedies* (*including* setoff (but subject to Section 5.5(a)) and *the right to credit bid the Secured Obligations*) and make determinations regarding the release, sale, disposition or restrictions with respect to the Collateral. In exercising rights and remedies with respect to the Collateral, the Collateral Agent, acting upon an Act of Secured Parties, may enforce the provisions of the Collateral Documents and exercise remedies thereunder, all in such order and in such manner as they may determine in the exercise of their sole discretion." Citing Intercreditor Agreement § 3.1(a) (emphasis added); *see also* § 7.8(b) [Exhibit A, Items 9 & 14]

# Collective Action Case Studies

*EMPIRE GENERATING CO.* (CONT.)

**Court's Holding**

- On June 4, 2019, the court approved the RSA and bid procedures over the objections of the Minority Lenders. In so doing, the court explained that the Minority Lenders had agreed in the intercreditor agreement to delegate credit-bidding authority to the administrative agent
  - The court further explained that all claims would be paid in full pursuant to the proposed plan, and that the transaction being contemplated was a good one from the debtors' perspective
  - The court also noted that the post-sale corporate governance issues raised by the Minority Lenders were state law issues, and that the RSA reserved the Minority Lenders' right to make their arguments in state court
  - Moreover, the court remarked that the minority lenders "bought the debt [knowing] what they were getting into"
- The Minority Lenders continued to object throughout the case to various issues pertaining to the sale and chapter 11 plan, and the court overruled those objections
- The Minority Lenders appealed the court orders approving the RSA assumption motion and bid procedures motion, and later appealed confirmation of the debtors' plan, which appeals remain pending



# Collective Action Case Study

*CNH DIVERSIFIED OPPORTUNITIES V. CLEVELAND UNLIMITED*

**Relevant Case Background**

- In December 2010, Cleveland Unlimited, Inc. ("CU"), a telecommunications company, defaulted on its obligation to pay principal and interest to the holders of its $150 million aggregate principal amount senior secured notes
- A group of noteholders owning 96.3% of the notes ("Majority Noteholders") instructed the trustee to exercise a strict foreclosure on the stock of CU, which had been pledged to secure the notes; holders of 3.3% of the notes ("Minority Noteholders") did not consent to the transaction
  - In a strict foreclosure, the secured party accepts collateral in full satisfaction of the obligation it secures
  - In this case, the pledged CU equity was transferred to the indenture trustee, who then distributed it to the Minority Noteholders and to CUI Acquisition Corp., a holding company created for the benefit of the Majority Noteholders
  - As a consequence of the foreclosure, the notes were deemed paid and cancelled in accordance with article 9 of the UCC and, with limited exceptions, the obligations of CU and the guarantors under the indenture were terminated
- The Minority Noteholders commenced an action for breach of contract and breach of guaranty against CU and the guarantors and sought payment of principal and interest on the notes, contending that the indenture's terms had been violated when their right to payment of principal and interest had been terminated without their consent
- New York Supreme Court and Appellate Division granted summary judgment in favor of the defendants; Minority Noteholders appealed to the New York Court of Appeals

# Collective Action Case Study

*CNH DIVERSIFIED OPPORTUNITIES V. CLEVELAND UNLIMITED* (CONT.)

**Court of Appeals Ruling**

- On October 22, 2020, the Court of Appeals, in a split decision, held that the cancellation of the notes without the consent of the Minority Noteholders violated section 6.07 of the indenture and that the Minority Noteholders were entitled to partial summary judgment
- Section 6.07 of the indenture, which tracks section 316(b) of the Trust Indenture Act ("TIA"), provides:

> **Notwithstanding any other provision of this Indenture, the right of any Holder to receive payment of principal of, premium, if any, and interest and Additional Interest, if any, on a Note, on or after the respective due dates expressed in such Note, or to bring suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such Holder**

- The majority opinion focused on the interplay between the indenture's remedies provisions, which allowed for majority action, and the prohibition against impairment of the right to payment without the individual consent of each noteholder
  - The court agreed that the Majority Noteholders were empowered to act, without the consent of all noteholders, to direct a specific remedy – the strict foreclosure – and that the trustee was authorized to follow the directive
  - However, the court concluded that section 6.07 was nonetheless violated by the "purported cancellation of the Notes without the dissenting Minority Noteholders' consent," which terminated the legal rights of the Minority Noteholders to receive payment of principal and interest
- The dissent wrote that the Minority Noteholders had consented to the strict foreclosure by consenting to the terms of the Collateral Trust Agreement, which provided that the trustee, at the direction of the majority noteholders, could take remedial action in an event of default
  - The majority was not persuaded by this argument, reasoning that because the noteholders' consent to the terms of the Collateral Trust Agreement was effectuated in the indenture, such consent was qualified by section 6.07 of the indenture



# Collective Action Case Study

*CNH DIVERSIFIED OPPORTUNITIES V. CLEVELAND UNLIMITED* (CONT.)

**Reconciling *CNH* with *Marblegate***

- Interestingly, although the *CNH* indenture was not TIA-qualified, both the majority and the dissent sought to square their opinions with the Second Circuit's 2017 decision in *Marblegate Asset Management LLC v. Education Management Corp.*, which held that section 316(b) of the TIA (which section 6.07 of the CU indenture mirrored) protects only the formal right to payment, and does not protect dissenting noteholders from actions that have the practical effect of impairing their right to payment
- The majority opinion distinguished the fact pattern of *CNH* from that of *Marblegate*
  - In *Marblegate*, the notes at issue were never extinguished and the legal right of the noteholders to bring suit for the enforcement of payment was not impacted; rather, because the *Marblegate* issuer was stripped of its assets, the practical ability of the non-consenting noteholders to receive payment was impaired
  - In *CNH*, by contrast, the notes were extinguished, thereby terminating the legal right of the Minority Noteholders to receive payment
- The dissent, by contrast, highlighted similarities with *Marblegate*, emphasizing that in both cases the disaffected noteholders "consent[ed] to the procedure . . . through the unmodified indenture documents" which permitted the transactions in question
- The dissent went on to say that the majority opinion "needlessly disconnects the law of the two courts most relevant to the markets in which these securities are traded" and that "confusion will surely follow"

# Collective Action Case Study

## *CNH DIVERSIFIED OPPORTUNITIES V. CLEVELAND UNLIMITED* (CONT.)

**Observations**

- The *CNH* decision will likely impact the ability to use strict foreclosure as an alternative to a court-supervised reorganization with respect to indentures containing TIA § 316(b)-type language and governed by New York law
  - With respect to TIA-qualified indentures, strict foreclosure may remain viable; although federal courts would be required to follow *CNH* in interpreting New York law, they could part ways in the TIA context
  - In non-TIA qualified indentures, the issues raised by *CNH* can be addressed at issuance by including express contractual language that limits the application of any § 316(b)-like provision
- However, the *CNH* decision will not impact the viability of a *Marblegate*-like transaction, where the notes remain in place but recourse is limited to entities with limited assets

# Faculty

**Marc J. Heimowitz, CFA** is the founder and managing member of Coda Advisory Group LLC in New York, where he focuses on providing advice to and advocating for parties-in-interest involved in restructurings and special situations, and acting as an unconflicted professional fiduciary for litigation and liquidation trusts. Prior to founding Coda, Mr. Heimowitz was a portfolio manager for Claren Road Asset Management, a long-short credit hedge fund owned by The Carlyle Group. Prior to Claren Road, he was a managing director, head of Credit Special Situations, and co-head of the Distressed Trading Desk for Citigroup Global Capital Markets. Mr. Heimowitz has 23 years of buy-side and sell-side experience managing and analyzing investments related to companies in stress or reorganization, including bankruptcy reorganizations and liquidations, out-of-court restructurings, rescue financings and distressed acquisitions. He has steered multiple creditor committees and actively advanced or opposed the interests of restructuring constituencies on behalf of institutional investors, debtors, bank groups, securityholders, broker-dealers and underwriters. In his personal capacity, Mr. Heimowitz also acts as independent board director for multiple businesses operating in diverse sectors. He is an advisory board member of ABI's New York City Bankruptcy Conference and a founding advisory board member of the University of Pennsylvania Institute for Restructuring Studies. Mr. Heimowitz received his B.S.B.A. in finance with high honors from the University of Florida and his J.D. from Columbia University School of Law in 1993, where he was a Harlan Fiske Stone Scholar.

**Hon. Julie A. Manning** is the Chief Bankruptcy Judge for the District of Connecticut in Bridgeport, initially sworn in on Sept. 9, 2013, and named Chief Judge on Sept. 9, 2014. Prior to her appointment, she was in private practice for 25 years, representing corporations, partnerships, financial institutions and insurance companies in bankruptcy and commercial litigation cases throughout the U.S. From 1999 until her judicial appointment, she was a partner with the law firm of Shipman & Goodwin, LLP, where she chaired the firm's Bankruptcy and Creditor Rights Group, co-chaired the firm's Finance and Investment Practice Group, and was a member of the firm's Partnership Review Committee and Compensation Committee. As a practicing attorney, Judge Manning was listed in the Bar Register of Preeminent Women Lawyers, was repeatedly named a *Connecticut Super Lawyer* and *New England Super Lawyer*, and was listed as one of *The Best Lawyers in America* in the area of Bankruptcy and Creditor/Debtor Rights. She is a member of ABI, the Connecticut Bar Association and the National Conference of Bankruptcy Judges, for which she serves on its Public Outreach Committee and Endowment for Education Board. During law school, Judge Manning clerked with the Office of the U.S. Trustee. She received her B.A. from Fairfield University and her J.D. from Suffolk University School of Law.

**Brian M. Resnick** is a partner in Davis Polk & Wardwell LLP's Restructuring Group in New York. He has experience in a broad range of corporate restructurings and bankruptcies, representing debtors, creditors, banks, hedge funds, asset-acquirers and other strategic parties in connection with bankruptcy cases, out-of-court workouts, DIP and exit financings, bankruptcy litigation and § 363 sales. His recent significant representations include Dean Foods, Arch Coal, Patriot Coal and Bonanza Creek Energy in their chapter 11 cases, ad hoc groups of bondholders in various energy restructurings including Blackhawk Mining, Jones Energy, Legacy Reserves, Midstates Petroleum and Memorial Production Partners, ad hoc groups of the Government Development Bank for Puerto Rico bondholders and Commonwealth Bondholders in connection with the Commonwealth's debt restructuring, and Lehman Brothers International (Europe) in the Lehman bankruptcy cases. Outside of the firm, Resnick is a frequent author, lecturer and panelist around the country on a broad range of bankruptcy topics, and serves as a contributing author to *Collier on Bankruptcy* and a member of the New York City Bar Association's Committee on Bankruptcy and Corporate Reorganization. In 2020, he was inducted as a Fellow of the American College of Bankruptcy. Mr. Resnick is regularly recognized as a leader in his field, including by *Chambers USA*, *IFLR 1000* and *Super Lawyers*. He was profiled in *The Wall Street Journal*'s "Bankruptcy Beat," which chronicled his transition from Juilliard-trained professional musician to partner in one of the world's top insolvency and restructuring practices, and *Bloomberg Law*'s "Davis Polk Lawyer Goes from Pit Musician to Tony Winner," regarding his 2019 Tony Award as co-producer of *Hadestown* on Broadway. Mr. Resnick received his B.M. and M.M. from The Juilliard School and his J.D. from Columbia Law School, where he was a Harlan Fiske Stone Scholar and a member of the *Columbia Business Law Review*.

**J. Soren Reynertson** is the managing partner of GLC Advisors & Co. in New York, an advisory firm he co-founded in 2009. He was previously a managing director in UBS's Restructuring Group and was based in London and New York. He also was head of the European Strategic Finance Group at Morgan Stanley in London., and he held positions with AlixPartners and PriceWaterhouse. Throughout his career, Mr. Reynertson has worked with companies, municipalities and their creditors on exchange offers, out-of-court workouts, bankruptcy reorganizations, debt financing and M&A. Recent engagements include iHeart, First Energy Solutions, Commonwealth of Puerto Rico, City of Detroit, Jefferson County, Atlantic City, Toys "R" Us, Basic Energy, Colt Defense, Radio Shack, Caesars, Foxwoods, Landsbanki and Nortel. He received his B.A. from Emory University and his M.B.A. from Columbia Business School.

**Glenn E. Siegel** is a partner with Morgan, Lewis & Bockius LLP's Business and Finance Practice in New York and former co-head of the firm's Bankruptcy and Restructuring Group. He has decades of experience in high-level bankruptcy matters and has advised major stakeholders in numerous bankruptcy cases. Mr. Siegel's clients include shareholders, bondholders, indenture trustees, creditor committees, secured creditors, debtors, and other participants in bankruptcy and workout matters. In the chapter 11 bankruptcy of automotive parts maker Delphi Corp., he counseled the largest debtor-in-possession lender in its acquisition of Delphi, and in the chapter 11 bankruptcy of Residential Capital, he counseled the largest residential mortgage-backed securities (RMBS) trustees to achieve a settlement of billions of dollars in claims. Mr. Siegel is a frequent lecturer on issues pertaining to public debt-holders, including claims-trading, second-lien loans and subordination, and he frequently authors or co-authors articles on bankruptcy-related topics and developments. He is admitted to practice in New York and New Jersey and before the U.S. Supreme Court, the U.S. Courts of Appeals for the Second and Sixth Circuits, the U.S. District Courts for the Northern, Eastern and Southern Districts of New York and the District of New Jersey, the State of New York Court of Appeals and the Supreme Court of New Jersey. Mr. Siegel was named Lawyer of the Year for Bankruptcy and Creditor/Debtor Rights/Insolvency and Reorganization Law, New York, in *The Best Lawyers in America* for 2020 and has been recognized in *The Legal 500 for Corporate Restructuring*. An ABI member, he co-chaired ABI's New York City Bankruptcy Conference from 2008-12. Mr. Siegel received his B.A. from Brooklyn College in 1979, his J.D. from Boston University School of Law in 1982 and his LL.M. in corporate law from New York University School of Law in 1984.

**Arthur J. Steinberg** is a senior financial restructuring partner in the New York office of King & Spalding LLP. In his 40 years of practice, he has represented a broad range of clients, including examiners, trustees, corporate monitors, debtors, creditors' committees, secured and unsecured creditors groups/individuals, distressed investors and asset-buyers, and parties to bankruptcy-related litigation. He also has acted as a receiver and Investment Company Act trustee for failed hedge funds and investment advisors. Mr. Steinberg has participated in many of the largest bankruptcy cases and has played an important role in forging a compromise among the key creditor constituencies. Listed in *Chambers USA* and *New York's Best Lawyers*, he is a frequent lecturer and speaker on a variety of bankruptcy issues. Mr. Steinberg received his B.A. in economics *cum laude* from Columbia University and his J.D. from New York University School of Law, where he was elected to the Order of the Coif.