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Bankruptcy Ruling Bolsters Uptier Transactions Challenges

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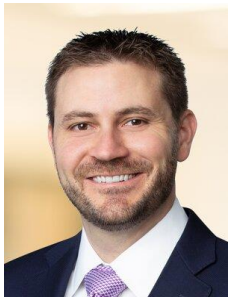
(January 13, 2023, 2:40 PM EST)



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The leveraged loan market in the U.S. has grown rapidly over the past decade. The market has more than doubled in size, reaching $1.3 trillion in November, after hitting a low of under $600 billion in 2011 and 2012.[1]

This growth coincided with a loosening of covenants, including financial covenants and common contractual provisions requiring lenders to be repaid and treated equally.

As a result, lenders party to leveraged loan credit facilities have found themselves more vulnerable to self-help efforts by distressed borrowers, including through so-called uptier transactions, where a borrower and certain of its existing lenders change the repayment or lien priority of a subset of the existing loans to the detriment of the other lenders.[2]

An uptier transaction by mattress manufacturer Serta Simmons Bedding LLC in LCM XXII Ltd. v. Serta Simmons Bedding LLC in the U.S. District Court for the Southern District of New York in March[3] was the first of a trio of similar transactions to surprise market participants in 2020.

In that case, a majority group of secured term loan lenders made new superpriority loans to Serta and also exchanged a portion of their original loans for new loans with a higher repayment and lien priority than loans of nonexchanging lenders.[4]

After Serta defeated an attempt by the nonexchanging lenders to enjoin its transaction, which closed on June 8, 2020, food service equipment supplier TriMark USA LLC[5] completed a similar uptier on Sept. 14, 2020, and apparel company Boardriders Inc.[6] completed its own uptier on Aug. 31, 2020.

An Oct. 17 court decision — ICG Global Loan Fund 1 DAC v. Boardriders Inc. in the New York Supreme Court — on the Boardriders uptier transaction provides further insight in the developing patchwork of federal and state court decisions which have trailed these transactions.[7]

In the decision, New York Supreme Court Justice Andrea Masley denied motions to

dismiss the nonexchanging lenders' key claims that the Boardriders uptier violated their contractual rights.

The Boardriders Transaction

In 2018, Boardriders borrowed $450 million in broadly syndicated first lien term loans. Boardriders became financially distressed in 2020, and a group of lenders holding a majority of the loans, including Boardriders' equity sponsor, teamed up with Boardriders to execute the uptier transaction.[8]

The Boardriders transaction was a paradigmatic example of an uptier. In exchange for providing new loans to Boardriders, the lenders and the exchange of their outstanding loans, lenders holding a majority of the original loans received three new tranches of loans with varied priorities:[9]

- First priority, or new loans made by exchanging lenders other than the equity sponsor;[10]
- Second priority, or new loans made by the equity sponsor and new loans issued in exchange for certain original loans of the equity sponsor; and[11]
- Third priority, or new loans issued in exchange for the original loans held by other participating lenders.[12]

As a result of the uptier transaction, nonexchanging lenders found their loans effectively converted from first priority loans to fourth priority loans without their involvement in the transaction.[13] Mechanically, the uptier consisted of three steps.

First, Boardriders and the majority lender group amended the original credit agreement to allow for the incurrence of new priority loans and to remove various protective covenants — including, among others, covenants regarding the amount of secured debt that Boardriders was permitted to incur.

Second, Boardriders and the exchanging lenders executed loan documentation for the new loan tranches, including an intercreditor agreement that subordinated the nonexchanging loans.[14]

Finally, Boardriders repurchased the participating lenders original loans in exchange for an equal amount of the new, third-priority senior loans.[15]

The purchase agreements were titled "Open Market Purchase Agreements," to reflect Boardriders' position that the transactions met the requirements under the original credit agreement for the repurchase of existing loans on a non-pro rata basis.[16]

The Boardriders Litigation

In October 2020, a group of nonexchanging lenders who were not invited to participate in the uptier transaction sued Boardriders, the equity sponsor and the exchanging lenders in New York Supreme Court.

They alleged that the uptier transaction breached various provisions of the original credit agreement and violated the implied covenant of good faith and fair dealing, and that the equity sponsor had tortiously interfered with the original credit agreement.

Subsequently, the defendants filed motions to dismiss, arguing as a threshold matter that the plaintiffs did not have standing to bring the action pursuant to an amended no-action clause contained in the post-uptier amended agreement, and that in the alternative, the uptier was permitted by the plain terms of the original credit agreement.[17]

Opinion on Motions to Dismiss

In considering the motions to dismiss, Justice Masley rejected the defendants' argument that the nonexchanging lenders lacked standing to bring the claims.[18]

The Boardriders court concluded that the plaintiffs sufficiently alleged that the no-action clause had been amended "in bad faith to prevent [the nonexchanging lenders] from suing to enforce their rights under the Credit Agreement"[19] and, on this basis, refused to dismiss the action for lack of standing.

Moving to the breach of contract claims, the Boardriders court concluded that the nonexchanging lenders had sufficiently alleged a breach of the pro rata sharing provisions of the original credit agreement to survive the motions to dismiss.[20]

As so-called sacred rights, the pro rata sharing provisions could not be amended by a simple majority lender vote, but instead required the consent of each affected lender.[21] The court adopted the plaintiffs' argument that the uptier transaction had effectuated a de facto amendment to the pro rata sharing provisions, reasoning that "[a]ccepting the Company's argument would essentially vitiate the equal repayment provisions."[22]

Third, the plaintiffs successfully argued that the repurchase by Boardriders of the exchanging lenders' loans violated provisions of the original credit agreement that prohibited the reduction of the principal amount of the loans without the consent of all lenders.[23]

In agreeing with the plaintiffs' contention, the court noted that the original credit agreement did "not specify whose term loans may not be reduced or forgiven."[24]

Fourth, the court concluded that the plaintiffs had sufficiently pled a breach of the open-market repurchase provisions of the original agreement.[25]

In substance, the plaintiffs alleged that the repurchase transaction could not be an open-market repurchase because it was neither "open" —having been conducted in secret — nor "market," having been completed at a price well above the market price for the loans, which were trading at 40 to 50% of par at the time of the uptier.[26]

The plaintiffs' claim for breach of the implied covenant of good faith and fair dealing also survived the motions to dismiss, with the court concluding that the allegations were

sufficient to show that defendants worked in concert and in secret to deprive plaintiffs of the benefit of their bargain, i.e., pro rata distribution of loan repayments, in bad faith.[27]

The only count the court dismissed was a claim against the equity sponsor for tortious interference the original credit agreement.[28]

The court held that the equity sponsor had an independent economic interest in carrying out the uptier

transactions and absent any showing of malice, fraud or illegality, the economic interest was a sufficient basis upon which to dismiss the claim.[29]

What Does It Mean?

The Boardriders decision provides nonparticipating lenders with another favorable court decision to cite when challenging future uptier transactions.

Notably, Boardriders leaves plaintiffs with multiple potential routes to a breach of contract claim and also leaves open a potential claim under the implied covenant of good faith and fair dealing, giving the nonexchanging lenders more ammunition than they were afforded by other recent uptier transaction rulings.[30]

The Boardriders court rejected the defendants' narrow proposed reading that the pro rata provisions did not expressly prohibit the defendants' actions, contrary to recent interpretations in the TPC Group Inc. and Serta decisions.[31]

In doing so, the Boardriders court found that accepting the defendants' argument would undermine the equal repayment provisions and be contrary to the court's obligation to consider the context of the entire contract, rather than particular words in isolation.

Boardriders also bolsters two holdings from prior cases.

First, Justice Masley's decision to allow the nonexchanging lenders to bring their claims despite an amended no-action clause that arguably prevented them from doing so was in line with the Trimark and TPC Group decisions on similar no-action amendments.

This signifies the defendants' argument that nonconsenting lenders lack standing to bring such claims may not be a successful defense going forward.

Second, Boardriders further solidifies the viability of the economic interest defense as protection for equity sponsors against claims that they tortiously interfered with the pre-existing credit agreement.[32]

Despite some gains for nonexchanging lenders, it is important to keep in mind that the Boardriders decision was in response to the defendants' motion to dismiss, and not a judgment entered after a full trial or presentation of evidence.

It is therefore unlikely that the court's decision to allow most of the claims to survive the motion to dismiss will give parties considering future uptier transactions too much pause, at least at this juncture.

What Is on the Horizon?

All signs point to uptier transactions continuing to be seriously considered by liquidity-constrained borrowers with few other options to raise money.

The potential for a money judgment is unlikely to dissuade a borrower that is already facing the imminent prospect of a bankruptcy filing absent the new liquidity provided by the uptier transaction.

Likewise, lenders with covenant-lite loans and the prospect of ending up as disadvantaged, subordinated

lenders, will have an incentive to be part of the group engaging in the uptier transactions.[33]

Given these dynamics, uptier transactions are not likely to subside in the near term.

Two new complaints have been filed since the Boardriders decision: on Nov. 3, a Southern District of New York suit challenging the Serta uptier, which was assigned to Justice Masley, and on Oct. 31 a new challenge to an uptier transaction by Wesco Aircraft Holdings Inc., an aircraft parts distributor that does business as Incora.

Two other uptier transactions have been announced or completed: one by Mitel Networks Corporation, a Canadian telecommunications company and another by Diebold Nixdorf, a supplier of banking and retail technology products.

Further, Boardriders filed a court notice on Nov. 16 indicating that it will appeal Justice Masley's Oct. 17 decision discussed in this article.

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[1] FitchRatings, "The 2022 Annual Manual, A Primer of the U.S. Leveraged Finance Market" at p. 7, (2022) (https://assets.ctfassets.net/03fbs7oah13w/3e3qKKqWt9mQR3E5RcK4D7/63e473c3b19a640ca6d4dffedfcc331f/2022_Lev_Fin_Annual_Manual.pdf) (last visited January 9, 2023); See also S&P Global Market Intelligence, "After risk-on run, US leveraged finance market tops $3 trillion in size," (last visited January 9, 2023) Rachelle Kakouris.

[2] Although we discuss uptier transactions primarily in the context of the leverage loan market, they can and do happen in the high-yield bond market as well.

[3] LCM XXII Ltd. V. Serta Simmons Bedding LLC, 21 Civ. 3987, 2022 WL 953109, at *9, *15, (S.D.N.Y. Mar. 29, 2022)("Serta").

[4] Id. at *2-3.

[5] Audax Credit Opportunities Offshore Ltd. v.TMK Hawk Parent, Corp., 2021 WL 3671541 (Sup. Ct. N.Y. Cty. Aug. 16, 2021) ("TriMark").

[6] ICG Global Loan Fund 1 DAC v. Boardriders, Inc., No. 655175/2020, 2022 WL 10085886 (N.Y. Sup. Ct. Oct. 17, 2022) ("Boardriders").

[7] Id.

[8] Id.

[9] Id. at *10.

[10] Id.

[11] Id. at *10-11.

[12] Id.

[13] Id. at *8.

[14] Id. at *10-12.

[15] Id. at *22

[16] Id.

[17] Id.

[18] Id. at *15-17.

[19] Id. at *17.

[20] Id. at *21-23.

[21] Id. at *6-7.

[22] Id. at *19.

[23] Id. at *21.

[24] Id.at *20.

[25] Id. at *23.

[26] Id. at *22.

[27] Id. at *24.

[28] Id. at *25.

[29] Id.

[30] In TriMark, the minority lenders' breach of contract claims survived, but the claim for breach of the implied covenant of good faith and fair dealing was dismissed. Trimark at *2. In Serta, the breach of contract cause of action survived on 'open market repurchase' argument, but not on the 'pro rata sacred' rights argument that survived in Boardriders. Serta at *38 - 40. Good faith and fair dealing arguments also survived in Serta. Id.at 40.

[31] In re TPC Grp. Inc., No. 22-10493 (CTG), 2022 WL 2498751 (Bankr. D. Del. July 6, 2022) (limiting unanimous consent requirements to only those sacred rights specifically enumerated); see also, Serta, at *10.

[32] Boardriders at *25.

[33] Although the markets have not yet fully reacted to the trend of recent uptier transactions by demanding that all credit documentation require unanimous lender consent to subordination of the lenders' liens or payment priority, there is a noticeable trend in new credit agreements to include this with certain exceptions. See Covenant Review Trendlines Topical Report, "Lens on loopholes: A look at the percentage of Index loans with J. Crew, Serta and Chewy provisions" (last visited January 9, 2023) Steve Miller; Reorg Research, "Covenant Trends: Expanded Sacred Rights Provisions in Recent Credit Agreements Provide Varying, Sometimes Circumventable Protections Against Lien Subordination Amendments" (last visited January 9, 2023) Julian Bulaon, Reorg Research.