

# **Navigating Industry Trends: Intercreditor Issues and Uptier and Drop-Down Financing Transactions**

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# Liability Management Transactions: Some examples

## Drop down financings

J. Crew (2016)  
PetSmart/Chewy (2018)  
Neiman Marcus (2018)  
Travelport (2020)  
Revlon (2020)  
Cirque de Soleil (2020)  
Envision (2022)  
Bausch Health (2022)

## Uptier transactions

Murray Energy (2018)  
Boardriders (2020)  
Trimark (2020)  
Serta (2020)  
TPC (2021)  
Incora (2022)  
Diamond Sports (2022)  
Mitel (2022)  
Rodan + Fields (2023)

# LMT: The Borrower's Objectives

- Reduce debt or debt service
  - De-lever the balance sheet
  - Reduce interest expense
- Avoid default and bankruptcy
- Extend debt maturity
- Generate liquidity/Raise additional capital
- Reduce risk to sponsor and participating lenders of loss on investment

# LMT: From the Lender Perspective

- Fundamental change to the basis on which Lender made loans
- Senior secured debt is subordinated in right to payment either by
  - loss of collateral that then secures new debt or
  - incurrence of new “super-priority” priming secured debt
- With no right to consent and my not be offered opportunity to participate new super-priority debt
- Did the Lender really understand that it had agreed in the loan documents to these transactions?
- If it had, would it have made the loans on the same terms?

# Drop-Down Financing: Basic Elements

Step 1

Formation or designation of unrestricted subsidiary or non-loan party under existing credit facility or indenture

Step 2

Transfers Intellectual Property or other asset

Borrower

Unrestricted Subsidiary or Non-Loan Party



License back of IP Step 4

Step 3

Loans secured by Intellectual Property or other asset



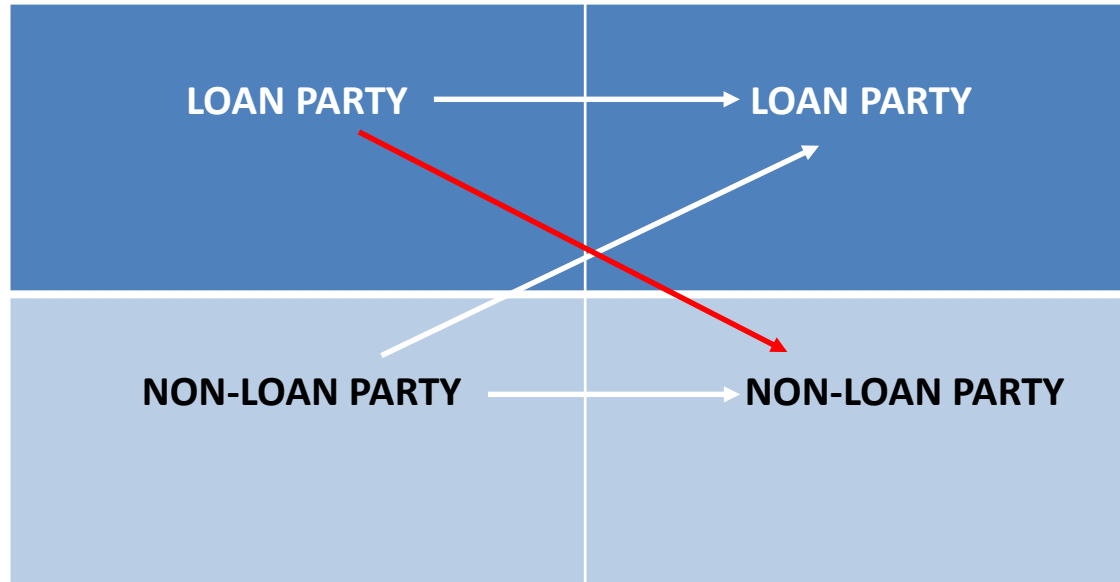
Repay or exchange debt

Step 5

Existing Lenders

Sponsor or subset of Existing Lenders

# Covenant Implications: Leakage and the Matrix



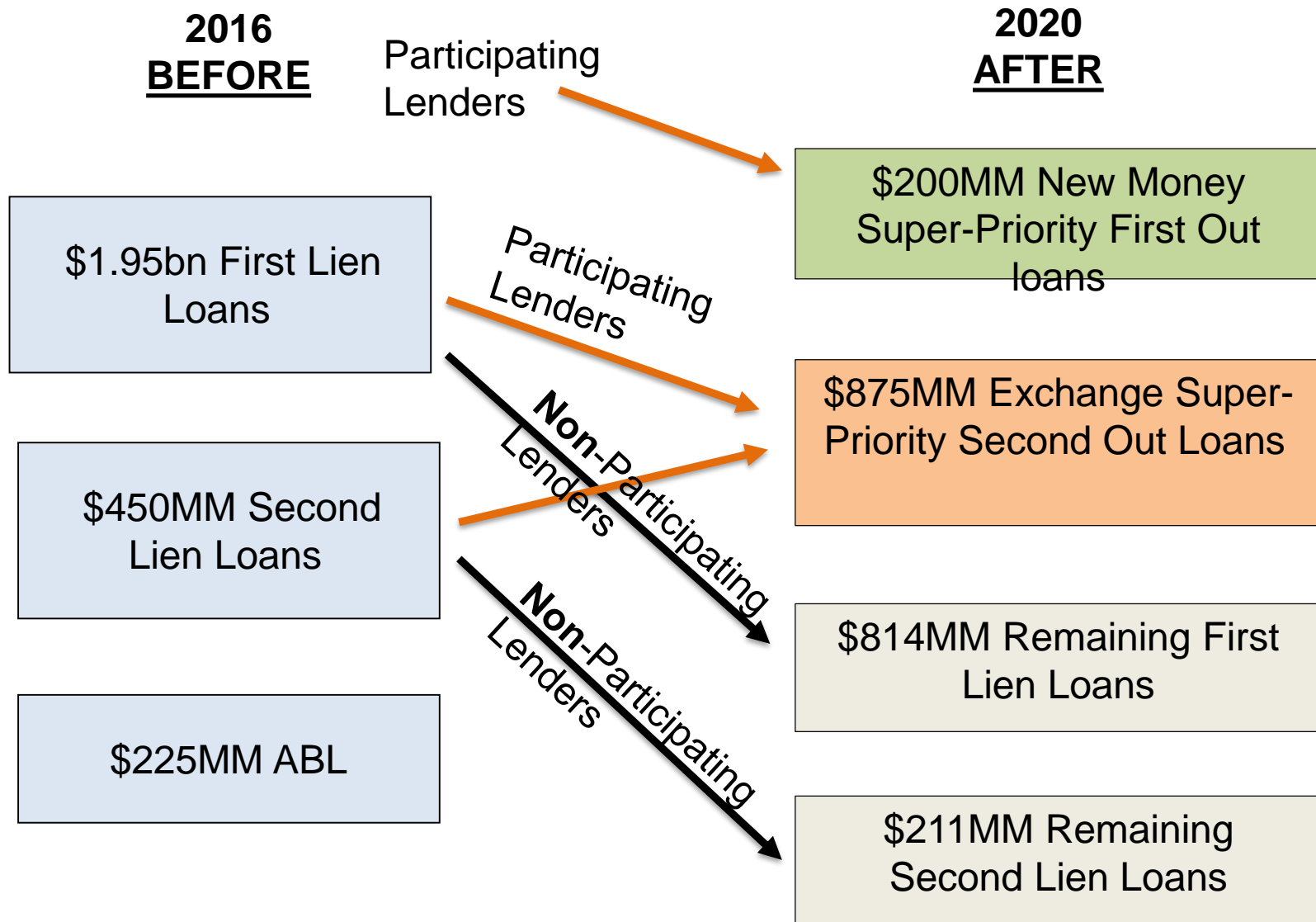
Loan Party to Loan Party = No problem

**Loan Party to non-Loan Party = Watch out**

Non-Loan Party to Loan Party = No problem

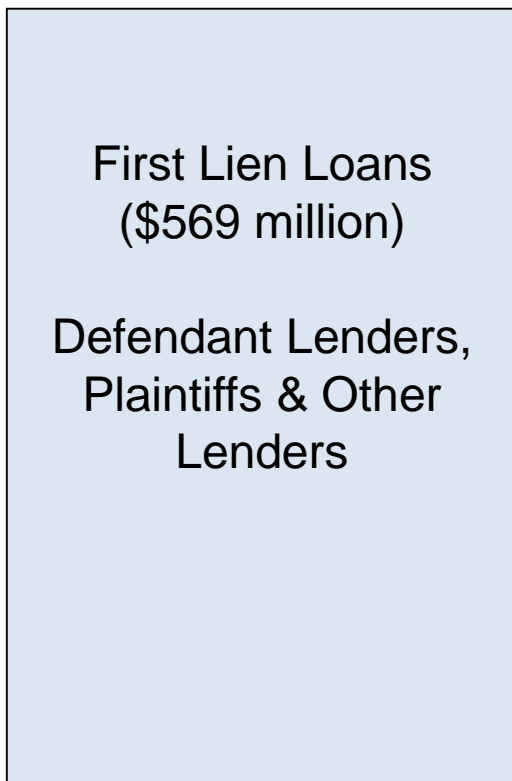
Non-Loan Party to non-Loan Party = No problem

# Serta: Before...and After an Uptiering Transaction

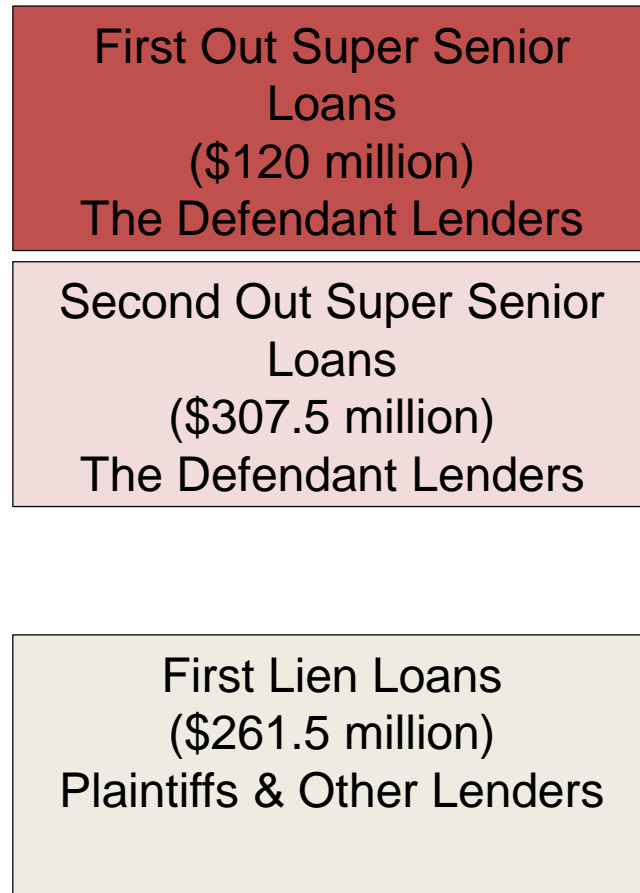


# TriMark: Before...and After

## BEFORE



## AFTER





# Uptiering Decisions

Trimark	August 19, 2021	New York State Court
Serta	March 29, 2022	US District Court for SDNY
TPC	July 6, 2022	Delaware Bankruptcy Court
Boardriders	October 17, 2022	New York State Court
Serta	June 6, 2023	Texas Bankruptcy Court

# The Arguments: Non-Participating Lenders versus Company and Participating Lenders

- Three main claims by non-participating lenders
  - Pro rata sharing argument: Failure to obtain each lender approval for change to pro rata sharing provision
  - Release of collateral argument: Failure to obtain each lender approval for functional release of collateral
  - Breach of implied covenant of good faith and fair dealing: Uptiering deprived non-participating lender of priority in bad faith
- Other arguments
  - Sponsor tortious interference with contract
  - Fraudulent transfer

# Uptiering: Pro Rata Sharing Breach of Contract Claim by Lenders—Part I

- General rule for amendments to credit agreement: 50.1% of commitments/loans must approve any amendments
- Exception for significant matters: “Sacred rights” which require all lender approval or approval of each lender adversely affected by amendment
- Credit agreement/note indenture include “pro rata sharing” provision that requires that payments be shared pro rata among Lenders
- Amendment to change pro rata sharing is a “sacred right” that requires approval of each lender
- By incurring new super-priority debt there was an amendment to pro rata sharing provision
- Since not each lender did not consent to new super-priority debt, breach of credit agreement/note indenture

# Uptiering: Pro Rata Sharing Breach of Contract Claim by Non-Participating Lenders—Part II

- Exceptions to “sacred right” requirement of each Lender approval for amendment to pro rata sharing provision
- All lender consent required to alter pro rata sharing of payments except in connection with an “open market purchase”
- Non-participating Lenders say debt exchange in uptiering is not an “open market purchase”
- Elements of “open market purchase” per Black’s Law Dictionary:
  - any buyer or seller may trade (including all of the lenders, not just a few selected by the borrower to be the participating lenders)
  - prices and product availability are determined by free competition
  - a typical open-market purchase is one accomplished through a broker or agent
  - requires the purchaser to pay a set market price
- Exchange transaction not an “open market purchase”
  - Not available to all buyers and sellers
  - Free competition did not determine the market price
  - No third party broker to canvass the market
  - Loans not purchased at market value but exchanged the loans at par value despite trading value of discount to par

# Pro Rata Sharing: Response from Company and Participating Lenders--Serta

- No amendments to pro rata sharing provisions required
  - To amend debt covenant to allow new tranche using “incremental equivalent debt” with separate credit agreement
  - Priority of loans would be in a separate intercreditor agreement
- “Pro rata sharing” is only intended to apply within the same class of debt, not relative to new class
- Exchange debt was permitted to be non-pro rata under Section 9.05(g) which allowed “open market purchases” of the term loan debt on a non-pro rata basis,
- Amendments to allow the new debt to have priority and to authorize the agent to enter into a separate intercreditor agreement only required majority Lender approval
- Absence of “anti-subordination” provision means it is permitted

# Uptiering: Release of All Collateral Claim by Non-Participating Lenders - Serta

- Non-Participating Lender:
  - “Sacred right” includes all lender consent for an amendment to release all or substantially all of collateral
  - The creation of the new super-priority priming debt means that the lien of non-participating lenders is effectively released since no value left over after payment of priming debt
- Company/Participating Lender: No part of uptiering transaction involved a release of liens

# Uptiering: Non-Participating Lender claim of breach of implied covenant of good faith and fair dealing--Serta

- Non-participating lenders' bargained for first-lien, priority, pro rata rights
- Rights "subverted" by creation of new tranche of super-priority debt
- Participating lenders engaged in "furtive" negotiations with select few creditors without knowledge of non-participating lenders
- Systematic changes to credit agreement to modify any provision that makes impermissible transaction permissible
- Court says: Even discretionary right may not be exercised in bad faith to frustrate other party's right to benefit of agreement

## The Cases: What did they find? Serta (SDNY case)

- Declined to grant the participating lenders motion to dismiss the case brought by the non-participating lenders
- Finds that amendment to create priming debt could be construed to be a change to pro rata sharing provision
- “open market purchase” could be construed to not mean the type of uptiering transactions subject to the litigation
- Serta court grants motion to dismiss claim of non-participating lenders based on release of collateral argument



# Serta in Bankruptcy

- January 23, 2023: Serta files for Chapter 11 in Southern District of Texas
- January 24, 2023:
  - Serta files complaint seeking (i) 2020 transactions permitted and (ii) no violation of implied covenant of good faith and fair dealing
  - Court determines that it should determine issues rather than Federal court in New York
- March 28, 2023: Bankruptcy Court holds hearing on summary judgment motions—finds that term “open market purchase” is clear and 2020 transactions constitute open market purchase
- May 15, 2023: Trial on confirmation order and issue of breach of covenant of good faith and fair dealing

# Serta Bankruptcy Court Decision—June 6, 2023: Bankruptcy Judge Says

- Parties keenly aware 2016 Credit Agreement was a “loose document”
- Non-participating lenders tried to do same to participating lenders
- Could have avoided with addition of sentence to the 2016 Credit Agreement
- Each party “received the bargain they struck”
- Lender exposure can be minimized with careful drafting
- Such outcome was not only foreseeable, it is only correct result

# Covenant Implications—Uptiering: “Anti-Subordination” Provisions

No amendment, waiver or consent shall..., except as expressly permitted herein or in any other Loan Document, subordinate the Obligations or the Liens granted under the Security Documents to any other Indebtedness or Lien, as the case may be, without the written consent of each Lender;

- Make sure voting covers both debt and liens
- Consider adding “or has the effect of subordinating”
- Address changes to debt and lien baskets so that the subordination does **not** become “expressly permitted herein”
- Review debt and lien baskets for issues on priority
- Limit right to amend provision governing right to enter into intercreditor agreement

# Covenant Implications—Uptiering: Waterfall and Pro Rata Sharing Provisions

(e) (i) change Section [waterfall] or Section [pro rata sharing of payments] in a manner that would alter the pro rata sharing of payments or order of application required thereby or (ii) change Section [waterfall] or any other applicable provision of this Agreement in a manner that would alter the distribution to each Lender of payments from or on behalf of the Borrowers for the account of such Lender received by Administrative Agent, in each case without the written consent of each Lender directly and adversely affected thereby;

- Use of “Incremental Facility”
- Address the priority of application of payments to all “Secured Obligations”
- Clarify that pro rata sharing and waterfall apply to all debt subject to credit agreement, not each “class”
- Any exceptions for “open market purchases”—clarify that not intended to allow new categories of debt with a higher priority in right of payment as part of exchange or refinancing
- Consider expanding shared “payments” to cover other forms of consideration, e.g. exchange debt

# LSTA Market Advisory for Liability Management Exercises—July 24, 2023

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,
- (ii) subordinate, or have the effect of subordinating, the **Liens** securing the Obligations to Liens securing any other Indebtedness, or
- (iii) modify Section [include **pro rata sharing**, pro rata treatment, post default waterfall and borrower/affiliate 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.

# Serta Blocker: Borrower Friendly Variations

- Exclude DIP facilities or use of cash collateral in a bankruptcy case
- Limit application to “debt for borrowed money”
- Exclude indebtedness “otherwise permitted” by the credit agreement (but limit to otherwise permitted on the Closing Date)
- Exclude subordination to debt issued in exchange for existing debt
- Exclude subordination to new senior debt if the subordinated lender is given opportunity to participate in the new senior debt (on same terms as other similarly situated lenders)

# Serta Protection with a Twist

(A) release all or substantially all of the Collateral Lien granted pursuant to the Loan Documents (except as otherwise permitted herein or in the other Loan Documents, including pursuant to Article 8) (B) subordinate the Lien on a **material portion** of the Collateral, taken as a whole, securing the Secured Obligations to any other **Indebtedness for borrowed money**, other than purchase money indebtedness, capitalized lease, or similar obligations **and/or any debtor-in-possession financing in respect of which each of the Lenders is offered a bona fide opportunity to participate in the case of any such debtor in possession financing**, and/or (C) expressly contractually subordinate the Secured Obligations in right of payment to any other Indebtedness, in each case, without the prior written consent of each Lender; or