You Can't Subordinate Me, I Am a Senior Secured Creditor, Right?

August 23, 2022

Highly leveraged companies, in default under their existing credit agreements, are constantly looking for new, creative ways to raise badly needed liquidity. Lenders are also often looking to protect their existing loans and, if possible, improve their existing lending positions while putting additional capital to work. The problem is that these companies have typically previously provided a blanket lien on all of their assets and have no additional collateral to provide to support the additional indebtedness. After studying the existing credit documents, many companies and their sophisticated advisors have developed creative alternatives for raising indebtedness. In the recent past, we have seen companies move collateral away from existing secured lenders to unrestricted subsidiaries in order to raise new senior indebtedness (*i.e.,* as in *J Crew*).[1] More recently, however, we have seen companies raise new senior secured loans with the help of a majority of their existing lenders, in what has been labeled an "uptier" transaction.

The most aggressive form of an "uptier" transaction is one in which the borrower enters into a new loan agreement or indenture with the majority lenders, and the majority lenders exchange their existing loans for the new loans or bonds. Immediately prior to the debt exchange, the majority lenders agree to amend the existing loan agreement or indenture to allow the borrower to issue superior liens in the collateral securing the existing debt. Thereafter, the borrower grants the new lenders a superior or "priming" lien in the Borrower's collateral to secure the new loan. As a result, the minority lenders are left holding loans secured by liens subordinate to those held by the majority lenders under the new loans.[2] As most recently described by the Hon. Judge Craig T. Goldberg, a Delaware bankruptcy judge, in *Bayside Capital Inc. vs. TPC Group, Inc.*, such transactions "take advantage of technical constructions of loan documents in ways that some view as breaking with commercial norms."[3]

In *Bayside Capital Inc. vs. TPC Group, Inc.*, TPC, as borrower, issued $930 million senior secured notes maturing in 2024 and carrying a 10.5% interest rate (the "2019 Notes") to various lenders in August of 2019, pursuant to an indenture (the "2019 Indenture") that governed the lenders' rights with respect to the financing. As the financial condition of TPC declined, TPC issued (i) $152 million in additional notes in February 2021 (the "2021 Notes") and (ii) $51.5 million in additional notes in 2022 (the "2022 Notes," and collectively with the 2021 Notes, the "New Notes"), each maturing in 2024 and each secured by the same collateral as the 2019 Notes, but with a superior lien to that of the lien securing the 2019 Notes. This was accomplished by 66 2/3% of the holders of the 2019 Notes (the "Majority Noteholders") agreeing to amend the 2019 Indenture to permit the issuance of additional indebtedness and liens prohibited under the original version of the 2019 Indenture.[4] Under the terms of the 2019 Indenture, the Majority Noteholders were permitted to amend the negative covenants prohibiting the issuance of additional indebtedness, the incurrence of additional liens, and the amendment of the related Intercreditor Agreement, because the relevant sections were not included in the list of amendments that would require the approval or consent of each affected holder of a 2019 Note (a "2019 Noteholder"). Those sections that require each lender's consent to amendment are often called "sacred rights."

On June 1, 2022, TPC filed for relief under chapter 11 of the Bankruptcy Code. Under their plan, TPC sought to enter into a debtor-in-possession loan (the "DIP Loan") with the Majority Noteholders. The DIP Loan would provide $85 million in new money but would roll up $238 million that was outstanding on the petition date under the New Notes. The 2019 Noteholders that did not participate in the exchange for the New Notes (the "Minority Holders") challenged the DIP Loan, arguing that the Majority Noteholders violated their rights under the 2019 Indenture by amending the 2019 Indenture in connection with the issuance of the New Notes without their consent.

The Minority Noteholders' challenge hinged on one central question: did the amendments to the 2019 Indenture violate the minority noteholders rights under § 9.02(d)(10) of the 2019 Indenture? That section provides that the consent of the Minority Noteholders is required to "make any change in the provisions in the Intercreditor Agreement or this Indenture dealing with the application of proceeds of Collateral that would adversely affect the Holders." The Bankruptcy Court concluded that the specific language of the 2019 Indenture focused on the "application of proceeds of the Collateral" and that the subordination did not change the allocation of proceeds of the collateral vis-à-vis each

2019 Noteholder. In other words, Judge Goldblatt took a narrow interpretation of the language relating to the prohibition and noted that if the 2019 Noteholders wanted to prohibit the debtor from issuing notes that allowed a creditor to be paid prior to the 2019 Noteholders, the documents should have had a clear anti-subordination clause prohibiting any indebtedness to be senior to the 2019 Notes. Judge Goldblatt noted that the 2019 Indenture had a hierarchy of consents for particular amendments — there being 10 sacred rights that required unanimous consents — and concluded that allowing subordination of the 2019 Notes was a less drastic intrusion on the rights of an individual holder than simply releasing all of the collateral, which only required the 2/3 majority. Judge Goldblatt similarly interpreted the language in the intercreditor agreement to "restrict relative rights of the holders vis-à-vis each other."

While the Bankruptcy Court in TPC took a narrow interpretation of the specific language in the 2019 Indenture and related intercreditor agreement, future courts are likely to be called upon to interpret whether the granting of a superior lien is tantamount to a releasing of liens, given the Uniform Commercial Code's first to file lien priority policy.[5] Based upon cases to date, it appears that courts which have been asked to interpret these indenture, credit agreement, and intercreditor agreement provisions believe the parties to be sophisticated and represented by competent counsel who are capable of drafting very specific language. Accordingly, these courts have taken the position that if lenders want to prohibit lien subordination, they could simply add specific language prohibiting lien subordination to the "sacred rights" provision prohibiting the release of all or substantial all the collateral. While many new lending transactions have added lien subordination to the sacred rights, it is by no means universal. While "uptier" transactions can be catastrophic to lenders that are excluded from the "uptier" transaction, it seems some lenders do not want an outright prohibition, as they never know when they might want to be part of the majority (*i.e.,* receiving new notes in an "uptier" transaction).[6]

Given the language in existing credit agreements and indentures and the alternative lending options they provide to both borrowers and certain lenders, "uptier" transactions are likely here to stay. Lenders need to be aware of the potential use of "uptier" transactions and carefully review the specific language in governing documents to assess the potential risks associated with such transactions.

For More Information

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1 For instance, see *J. Crew Group, Inc., et al. v. Wilmington Savings Fund Society*, FSB, No. 650574 (Supreme Court NY Feb. 1, 2017) (*i.e.*, J. Crew transferred its trademarks (the collateral) to an unrestricted subsidiary), discussed in the Chapman Client Alert, Companies Are Using Covenants to Restructure Their Capital Structure and Prime Existing Debt — What Lenders and Debt Investors Need to Know.

2 Typically, the minority lenders are not invited to participate in the "uptier" transaction.

3 *In re TPC Group. Inc.*, U.S. Bankr. Ct. Del. 2022 WL 2498751 at *1.

4 Often, 50.1% of lenders are required to amend the credit documents in an "uptier" transactions; however, under the 2019 Indenture two-thirds (66 2/3) of the lenders holding the 2019 Notes were required to amend the relevant provisions under the 2019 Indenture and the related Intercreditor Agreement.

5 Absent an Intercreditor Agreement, lenders that are first to file a UCC-1 financing statement create a perfected security interest in the collateral, which means they have priority over a later filed and/or perfected lien.

6 There may be other provisions in a credit agreement or indenture that should be reviewed that may prohibit an "uptier" transaction, such as pro-rata redemption requirements in Indentures or pro-rata sharing clauses in credit agreements. However, often such provisions can similarly be amended or waived by a majority of the lenders or noteholders and thus would need to be added to the sacred rights to be an effective protection for such lender or noteholder.

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