Improved T&C May Avoid Lender-on-Lender Violence

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Aggressive “lender-on-lender violence” transactions, which used to happen mostly in in-court restricting processes, have been increasingly utilized in the context of out-of-court restructurings in recent years. Jennifer Selendy, Max Siegel, and Samuel Kwak analyze recurring issues in disputes over such transactions in this article from *Turnarounds and Workouts*.

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Serta, *Boardriders*, *TriMark*, and *TPC Group*. These are recent examples of a group of lenders striking a deal with a distressed borrower to the benefit of themselves and in the detriment of other lenders in the same priority class. This so-called “lender-on-lender violence” transaction used to happen mostly in the context of an in-court restructuring process. This aggressive deal structure, however, has been increasingly utilized in the context of out-of-court restructurings.

Common structures of a “lender-on-lender violence” transaction include priming, uptiering, and financing through an unrestricted subsidiary. A “priming” transaction usually involves a borrower issuing a new debt that is secured by the same collateral as but is more senior to an existing debt. An “uptiering” transaction usually involves an incremental financing by the majority of lenders in the most senior class on a super-priority basis and an exchange of an existing debt held by those lenders with a new debt more senior to the existing debt. After an “uptiering” transaction, the debt held by the excluded minority lenders (which used to be in the first priority) is demoted to the third in priority order, below two tranches of debt held by the majority lenders. Lastly, an unrestricted subsidiary transaction usually involves a borrower, on the consent of the majority of lenders, transferring valuable assets in the collateral pool for existing debts to a subsidiary (existing, newly created, or newly designated as so) that is exempt from the covenants of those existing debts and arranging that subsidiary to issue a debt secured by those assets. While these structures operate differently in the mechanical sense, they all include a “priming” component and share a common theme: upon consummation of a transaction, a group of lenders that believed to have the first priority over certain collateral are subordinated to other lenders with respect to that collateral.

The private credit market has been frothy over the past few years due to extremely low interest rates. Increased competition among lenders to purchase any debt securities gave borrowers leverage in negotiating credit documents. Also, in today’s credit market, the initial lenders rarely hold the debt for the long haul: shortly after the closing of deal, those lenders sell the debt to syndicates of other investors. These circumstances have led to execution of numerous credit documents with only boilerplate and vague covenants. In a distressed situation, the lack of clarity in a credit document incentivizes lenders to form a majority coalition and strike a deal with the borrower to immunize themselves from negative consequences of the borrower’s distress at the expense of other lenders. A dispute between the majority lender group and the minority lender group over the deal then follows.

A dispute over lender-on-lender violence transactions involves numerous critical issues: the application of no-action clauses, the scope of sacred rights against certain amendments, the covenant of good faith and fair dealing, the right to *pro rata* distribution of payments, just to name a few. In this article, we want to focus on the rights that go straight to a lender’s right to payments and its ability to vindicate that right: no-action clauses and sacred rights regarding priority claims to collateral proceeds (sometimes known as “waterfalls”).

No-Action Clauses

The purpose of a no-action clause is to protect a borrower against individual lawsuits that are frivolous or not in the economic interest of the borrower and its creditors as a group. Under a no-action clause, the administrative agent or indenture trustee is delegated the right to bring suit on rights that are common to all lenders or noteholders. Typically, these provisions require that a specified percentage of creditors ask the agent or trustee to pursue a cause of action.

Considering the restrictive nature of a no-action clause and the fact that priming transactions are typically approved by a majority of lenders, a recurring issue is when a plaintiff (particularly a minority lender) can bring an action regardless of a no-action clause. The dearth of case law on this issue has left the door open for abuse of no-action clauses as a means to discourage bringing a lawsuit to challenge lender-on-lender violence transactions. However, there is a line of authorities that recognizes an exception to a no-action clause's application to actions by individual lenders. In *Cypress*, a noteholder brought an action to challenge an amendment to an indenture supported by the borrower and other noteholders. The *Cypress* court concluded that the action by an individual noteholder at issue was not foreclosed by the no-action clause in the indenture because the noteholder's demand to the indenture trustee to bring an action to challenge the amendment would be "futile" because the trustee had already consented to the amendment.

A New York court subsequently developed the reasoning of *Cypress* into a doctrine. *Eaton Vance*—the leading New York case on this issue—identified two circumstances that allow a plaintiff to circumvent a no-action clause: (1) when a trustee is alleged to have engaged in malfeasance or abdication of its responsibilities, and (2) when a lender's contractual rights are alleged to have been violated. Each of these circumstances may allow lenders excluded from a priming deal to bring an action challenging it.

When a suit involves malfeasance by an administrative agent or indenture trustee, courts have recognized that it would be futile for a plaintiff to demand the agent or trustee to bring an action alleging malfeasance by itself. An agent's or trustee's entry into a priming transaction is arguably akin to malfeasance in that it chose not to faithfully vindicate the contractual rights of excluded lenders. Thus, it follows that it would be futile to require a plaintiff to ask the agent or trustee to challenge the very lender-on-lender violence that it allowed.

Whether suits alleging a violation of contractual rights are excluded from the reach of a no-action clause is less straightforward and prompts the question of which contractual rights are outside the scope of a no-action clause. Recent decisions in *TriMark* and *In re TPC Group* provide valuable insight into this issue. In *TriMark*, the court concluded that an overly restrictive no-action clause which was amended without the notice to or consent of plaintiffs (lenders who were excluded from the deal at issue) did not preclude the plaintiffs' action. The *TriMark* court specifically noted that the majority lender group allegedly amended the no-action clause "as part of a larger scheme to breach and then exit the agreement" and designed it to operate as a "preemptive self-pardon, of sorts." The *TriMark* court also noted that, the original credit agreement's authorization of the majority of lenders to amend the no-action clause cannot reasonably be constructed to give those lenders "*carte blanche* to make it exorbitantly expensive, if not impossible, for [the excluded lenders] to enforce their *un*-amendable consent rights" under the credit agreement.

The *TPC* court went further and stated that rights expressly granted to individual noteholders, including their "sacred rights" (which require consent of each adversely affected noteholder to certain amendments), are enforceable through individual lawsuits, notwithstanding a no-action clause. The *TPC* court's confirmation that a no-action clause does not bar an action to vindicate a contractual right expressly granted to individual noteholders represents a significant step forward for challenges to lender-on-lender violence transactions that implicate individual contractual rights of minority lenders.

Modification of Waterfall and "Application of Proceeds"

Another key issue in disputes over priming deals is the contour of "sacred rights" granted to each individual holder. Specifically, credit documents often require consent by all adversely affected holders for any amendment that alters certain critical features of a credit document, such as the order of "application of proceeds." Recent disputes over lender-on-lender violence have raised an issue about the scope of that consent right.

There are three arguments as to the scope of the consent right granted to individual lenders with respect to the "application of proceeds." <u>First</u>, some argue that a lender's consent is required only when an amendment modifies the payment priority of that lender with respect to payments for other claimholders in the same tranche. Under this argument, subordination of a lender's claim to another tranche of debt does not require that lender's consent because the new debt is issued in a different, more senior tranche, which is not governed by the original indenture or credit agreement. Second, some also argue that the consent right addresses the waterfall with respect to the tranches of debt that were issued alongside each other and are covered by the waterfall in an existing intercreditor agreement. Under this argument, an amendment does not require a consent of a lender unless it seeks to subordinate that lender's debt to other debt that is already subject to an agreement setting forth its priority as to the subordinated debt. For example, the "application of proceeds" might cover only the priority of a first lien tranche versus an existing second lien tranche or senior noteholders versus asset-based lenders. Third, others—particularly plaintiff minority lenders—argue that the consent right with respect to the "application of proceeds" includes an anti-subordination right, meaning that a transaction subordinating a lender's debt to a new tranche of more senior debt, sharing the same collateral, requires a consent of that lender.

Until recently, there has been virtually no caselaw analyzing the term "application of proceeds," but this issue came up in both *TriMark* and *TPC Group*. In *TriMark*, the minority lender group alleged that the majority lender group breached the original credit agreement by entering into a transaction with the borrower—which included an amendment of the original credit agreement— that would uptier the majority lender group's debt above the minority lender group's debt. The *TriMark* court denied the defendants' motion to dismiss, concluding that "the [original] agreement reasonably can be read to require Plaintiffs' consent for the [a]mended [a]greement." By concluding so, the court recognized the possibility of the consent right with respect to the "application of proceeds" operating as "prohibit[ing majority lenders] from placing any tranche of debt above [minority lenders'] place in the waterfall, even if the order of distribution [within the class] remains facially unaffected."

However, the *TPC* court interpreted a similar amendment provision and reached the opposite conclusion. Specifically, the court read the consent right with respect to the waterfall not to include a prohibition against subordination of a class of creditors to another, different class.[1] Instead, it interpreted the provision as governing solely the ratable distribution of collateral proceeds within the class of existing noteholders once received by the indenture trustee.

Because *TriMark* and *TPC* courts reached opposite conclusions, the issue of whether the consent right with respect to the "application of proceeds" should be interpreted to include a sacred right against subordination remains unsettled. The lack of clarity on this issue will likely continue to generate disputes over priming transactions.

Future of Lender-on-Lender Violence

Priming transactions and disputes over such transactions primarily originate from alleged ambiguity in consent right provisions. Hence, a lender or an investor can reduce the risk of being victimized by a lender-on-lender violence by ensuring that a credit document under its consideration contains a robust consent right against subordination.

Credit documents executed in recent transactions suggest that the market might be conscious of the lender-on-lender violence risk in drafting those documents. For example, the Credit Agreement for Tupperware Brands Corp.'s $880 million financing in November 2021 includes a consent right provision requiring that each affected lender to be offered an opportunity to participate in any "priming" debt to be offered to other lenders on a *pro rata* basis.[2] It is noteworthy that Tupperware's 2021 financing was for refinancing of its prior debt that was issued under a credit agreement that did not contain a similar consent right provision.

As demonstrated in recent court decisions in disputes over lender-on-lender violence, the inquiry about whether the transaction at issue violated the excluded lenders' "sacred rights" under the applicable credit document is dependent on the language of provisions allegedly establishing "sacred rights," as well as the structure of the transaction at issue. Hence, it is yet unclear whether any formulation of "sacred rights" provision would manage to work as a complete safeguard against any lender-on-lender violence risk. Given the lack of clarity in case law, robust contract drafting (for those originating a credit deal) and paying close attention to terms of credit documents (for those considering purchasing debt instruments from the secondary market) are, as of now, the best preventive measures available against the risk of lender-on-lender violence.

[1] In reaching this conclusion, the *TPC* court also noted that the indenture at issue included a provision allowing release of all or substantially all collateral with a 2/3 majority vote. It reasoned that such a release was more “drastic” than subordination. The noteholders that entered the challenged deal held more than 2/3 of the notes under the indenture at issue.

[2] Section 9.02(b)(xiii)(E), Credit Agreement, dated November 23, 2021 (available at: https://www.sec.gov/Archives/edgar/data/0001008654/000100865421000092/tupperware-creditagreeme.htm).

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