LENDER ON LENDER VIOLENCE: MECHANICS AND TRENDS

Luke A. Barefoot, Thomas S. Kessler and Miranda Hatch
Cleary Gottlieb Steen & Hamilton LLP, USA

"Against the backdrop of prevailing credit conditions … [n]ovel approaches like 'up-tier' and 'drop-down' transactions, while offering potential remedies, also threaten litigation ramifications among lenders"

Introduction

Liability management transactions, commonly known as "position enhancing transactions" or more unofficially as "lender-on-lender violence", constitute a recent restructuring trend in the United States. These transactions occur in various restructuring scenarios, each with unique characteristics yet sharing a common theme. They involve groups of lenders collaborating with the company to restructure its debt and infuse fresh capital, with participating lenders reaping the benefits while deliberately excluding certain other investors, and often leading to subsequent litigation.

This article explores the specific tactics utilized by participating lenders to capitalize on covenants or provisions within loan agreements, enabling them to leverage transactions to their advantage over the objections of non-participating lenders. Additionally, we analyze the anticipated market impact of these transactions and project their impact in Europe and the United Kingdom.

Exploring transaction mechanics

Transactions commonly referred to as 'up-tier' and 'drop-down' transactions demonstrate situations where lenders holding pari-passu debt, and therefore sharing recoveries on a pro-rata basis, may face prejudice due to agreements between the borrower and a subset of lenders within the same class. In such instances, the borrower collaborates with a subset of lenders to amend the underlying credit documentation, thereby allowing preferential treatment of this subset to the detriment of lenders not included in the participating group. This trend garnered significant attention during the restructuring of Serta Simmons, Boardriders, and more recently in Envision and Wesco Incora.

The primary focus of our question is the specific methods by which participating lenders of a company utilize covenants or provisions in loan documents to achieve this, despite objections from non-participating lenders. How do companies manage to issue new debt that supersedes existing lenders or utilize collateral attached to existing debt for new transactions?

One form of "lender on lender violence" is 'drop-down' transactions, wherein the company, operating within the constraints of its existing debt documentation (utilizing permissive investment and asset sale provisions), transfers certain assets to entities outside the credit support group, such as an unrestricted subsidiary (i.e. a subsidiary that is not subject to any covenants or restrictions binding the company under its existing debt documentation). This action enables the subsidiary to assume financing that is structurally senior to other debt, allowing the company to extend its financial runway while also benefiting from a liquidity injection. The company may grant certain of its creditors the opportunity to swap existing debt for new debt of the unrestricted subsidiary, now positioned with structural seniority to the existing debt and the only debt secured by the assets of the unrestricted subsidiary. These certain creditors may use the transaction to reduce the number of creditors who will have access to the 'dropped down' assets, thereby eliminating the risk of diluted recoveries posed by the other creditors. This type of drop-down financing was most notably observed during the restructuring of J. Crew.

This phenomenon also materializes in the form of 'up-tier' transactions, which require amendments to existing credit documentation and frequently lead to litigation. Typically, the company and a subset of its lenders under a financing agreement amend the financing documentation to allow themselves to extend additional super-senior financing. A portion of participating lenders' existing loans will typically merge into this super-senior tranche. As minority lenders are 'primed' without their consent, this dichotomy creates two classes of creditors within the original group of *pari-passu* lenders. Those lenders left outside of these agreements often face the prospect of diminished recovery and, in certain situations, little to no recovery.

While up-tier and drop-down transactions have been making headlines for a few years now, the newest hot topic is the "double-dip" transaction. More like the drop-down transaction, a "double-dip" transaction is a type of financing that allows a new-money creditor to have two paths to recovery relating to the same claim or transaction, often against the same corporate affiliate. This structure has been used for many years across Europe and the United States.

The basic mechanics of a "double-dip" transaction usually include the following: (i) the company identifies or creates a subsidiary, the "double-dip" creditor will advance funds to the subsidiary, in the form of loans or notes, (ii) a restricted group entity under the company's existing debt will facilitate a guarantee of the loans or notes of the subsidiary, giving the "double-dip" creditor a direct claim against the restricted group entity, and (iii) the proceeds of the loans or notes are then used to fund an intercompany loan from the subsidiary to other entities, including the restricted group entity. An intercompany receivable is created on account of such loan and held by the subsidiary. In some recent structures, the subsidiary has pledged the intercompany receivable to the double-dip creditor as security for the loans or notes.

Double-dip transactions may be used defensively to both shore up claims of existing creditors as well as to reduce lending capacity, decreasing the likelihood that subsequent loans can be layered on top and threaten priority.

Judicial scrutiny

It is no surprise that such transactions often lead to legal disputes, especially in bankruptcy proceedings when borrowers are unable to fend off financial distress. In recent years, the Southern District of Texas has emerged as a hotspot for bankruptcy filings, with 2023 being no exception, as it witnessed the highest number of corporate Chapter 11 filings in the country.

Wesco Incora and Envision both filed for bankruptcy in the district in 2023. The Envision minority lenders filed an adversary complaint against the uptier transaction, but the case was voluntarily dismissed before being heard after a global settlement was reached. Judge Isgur issued an opinion largely denying summary judgment sought by defenders of the Wesco Incora transaction, which involved the issuance and private placement of new notes under an existing indenture to increase a lender groups' voting power to the necessary threshold to greenlight an uptiering transaction. However, significant issues remain for trial, including whether Wesco Incora and the participating noteholders violated the terms of the indenture, as well as the plaintiff's tortious interference claim. Bankruptcy practitioners and distressed investors alike will be closely following the resolution of Wesco Incora, which could become a roadmap for challengers of liability management transactions, or "what not to do" for parties designing them.

These more recent cases build on the significant litigation born from the Serta transaction, which itself is still going through the judicial scrutiny process. The Bankruptcy Court for the Southern District of Texas recently upheld Serta's liability management transaction, ruling that the transaction was permitted under the relevant debt terms and not conducted in bad faith. This decision was driven by the belief that sophisticated investors should be responsible for assessing the permissibility of such transactions under governing documents, allowing companies the latitude to take advantage of perceived "loopholes" in covenants. Interestingly, this decision contrasts with a ruling by a US District Court judge in New York who refused to dismiss a complaint filed by non-participating creditors prior to Serta's bankruptcy. The decision in the Serta case is currently under appeal by non-participating creditors.

In the future, we may also gain a clearer understanding of the legality surrounding double-dip transactions. While few cases have litigated the issues, assuming the governing debt documents permit the double-dip structure, claims arising from double-dip transactions are likely enforceable in a bankruptcy proceeding. The arguments typically considered to be a potential basis to challenge a double-dip transaction include claiming the transaction to be a fraudulent transfer, moving for substantial consolidation of the two entities, and recharacterizing the claim as equity.

The interpretation of these issues by courts in different jurisdictions remains uncertain, with companies likely to continue to seek out favourable jurisdictions. While each case is unique, adverse findings regarding bad-faith arrangements may impact judicial outcomes. In general, bankruptcy judges tend to favor decisions that facilitate debtor restructuring, in contrast to the potentially less flexible or reorganization-resistant approach of non-bankruptcy judges.

Transatlantic implications

The legal landscape in this area is constantly evolving, with numerous decisions still pending, awaiting resolution. While lender-on-lender disputes have not yet permeated the UK and Europe extensively, there is an expectation that they will become increasingly prevalent, driven partly by the overlapping involvement of private equity players in both US and European restructurings.

Recent events in Europe, exemplified by the restructuring of Greek gaming giant Intralot in 2021, underscore these evolving legal dynamics. However, it is crucial to recognize the regulatory nuances specific to Europe. Alterations to the inter-creditor rankings regarding collateral, not initially envisioned in the original financing, mandate unanimous lender consent, which would then trigger the need to utilise mechanisms like the English scheme of arrangement or restructuring plan to bind dissenting lenders. Furthermore, market participants have been careful to limit the scope of the terms of an exit consent in light of a past English court decision that admonished against aggressive tactics used in that regard.

In the broader context of corporate restructuring, the evolving landscape of heightened interest and borrowing rates within a constrained credit environment compels issuers to explore innovative strategies for buying time. Consequently, companies are poised to leverage existing covenant frameworks and pursue additional financing avenues.

Concurrently, a discernible trend towards covenant tightening and heightened thresholds for various actions is evident. Restrictive measures, such as limitations on the issuance of new notes under existing indentures and constraints on lien-stripping opportunities, underscore this shift.

Against the backdrop of prevailing credit conditions, corporate entities are anticipated to encounter persistent challenges in restructuring existing debt obligations. Novel approaches like 'up-tier' and 'drop-down' transactions, while offering potential remedies, also threaten litigation ramifications among lenders. The implications of such approaches on European insolvency proceedings, particularly in comparison to their US counterparts, remain a subject of inference.