SPECIAL SITUATIONS CLIENT BULLETIN

Quick Guide for Assessing the Potential for Disparate Lender Treatment in a Credit Agreement: The "Tyranny of the Majority"

The past few years have seen several high profile examples of "lender-on-lender violence"— a phenomenon in which lenders holding the majority of a syndicated credit facility's debt (often in collaboration with the borrower and/or its financial sponsors) leverage their majority position to structure transactions that benefit themselves to the detriment of the other lenders. Often referred to as "liability management transactions", two forms of these transaction structures have attracted the most attention in the market in recent years: drop-down financings (such as J. Crew, Travelport, Cirque du Soliel and Revlon) and uptiering transactions (such as Trimark, Murray Energy, Serta Simmons and Boardriders).

Concerned by what could be viewed as a developing trend of inequality or imbalance within a lending syndicate and the attendant risks, many clients have asked us to help them assess the possibility of such a transaction being structured under their credit documents. This bulletin highlights the credit agreement provisions that lenders (or prospective lenders) should review to assess the potential for these types of liability management transactions and offers potential "fixes" that may be incorporated during the credit document drafting stage or as language to look for when reviewing an existing credit agreement.

I. Liability Management Transactions: Drop-Down Financings and Uptiering Transactions

As mentioned above, the two types of liability management transactions that have dominated the market in recent years are "drop-down financings" and "uptiering transactions".
A description of each of these transaction structures is provided below.

(a) Drop-Down Financings

In a drop-down financing, an asset of significant value (such as intellectual property or equity in a valuable subsidiary) is "dropped down" by the borrower, typically to an unrestricted subsidiary outside of the coverage of the lender group's existing collateral and guaranty package, through a transfer (or series of transfers) utilizing one or more permitted baskets carved out from the negative covenants. Upon the consummation of these transfers, the relevant asset is unencumbered and available to the borrower to secure additional indebtedness which is structurally senior to the existing credit facilities in relation to the "dropped down" assets.

The most well-recognized drop-down financing was the J. Crew transaction (2017). Using the permitted investment baskets in its credit agreement, the J. Crew Group transferred over 70% of its domestic trademarks valued at approximately $250 million to a foreign non-guarantor restricted subsidiary and then on to an unrestricted subsidiary, which removed these trademarks from the existing lenders' collateral package. Outside the coverage of the credit agreement's covenants, the unrestricted subsidiary was free to incur additional debt secured by a first priority lien on the transferred intellectual property.

The J. Crew transaction was the first in a series of high profile drop-down financings, which include Travelport (2020), Cirque du Soleil (2020) and Revlon (2020).

(b) Uptiering Transactions

In an uptiering transaction, the borrower and (typically) a majority group of lenders agree to restructure the existing credit agreement to permit the creation of one or more tranches of priming "super-priority" debt that are senior to the liens and/or claims of the existing lenders. The majority lenders will often then finance the new money portion of the new super-priority debt and may also exchange their existing debt for additional new super-priority debt. In connection with such exchanges, the departing lenders can, and often do, strip away covenant protections and corresponding events of default by way of exit consents, ensuring that the lenders left behind in the original credit agreement will not have the same seat at the table in any future restructuring discussions.

The TriMark (2020) restructuring is a recent example of an uptiering transaction. In TriMark, the borrower and its financial sponsors collaborated with a majority group of its existing lenders to amend the credit agreement to permit the borrower to incur incremental super-priority debt. The lenders in the majority group funded a new tranche of first-out super-priority debt and then exchanged their existing senior loans for a new tranche of second-out super-priority debt. The remaining minority lenders (who were not afforded the opportunity to participate in the new money financing or the exchange) found themselves effectively subordinated to these two new super-priority tranches. By way of exit consents, the majority lenders also effected other amendments to the existing credit agreement, including stripping out affirmative and negative covenants, amending the definition of "open market purchase" to permit the borrower to repurchase existing loans by way of a debt exchange on a non-pro rata basis and introducing certain procedural obstacles (including an amendment to the "no-action" clause to require all lawsuits to be instituted through the agent) to hinder the remaining lenders' ability to challenge the transaction. This transaction is still being litigated in the NY courts, with the plaintiff minority lenders having survived, in part, a motion to dismiss. [1]

In addition to the TriMark transaction, other uptiering transactions widely discussed in the market include Murray Energy (2018), Serta Simmons (2020) and Boardriders (2020).

[1] *Though note that the NY Supreme Court in its decision to deny the TriMark defendants' motion to dismiss the plaintiffs' claim that the uptiering transaction had breached the sacred rights provisions of the credit agreement found that the minority lenders did, at least, state a viable claim that the transaction effected by the borrower, its sponsor and the majority lenders did implicate the sacred rights set out in the credit agreement and therefore required the consent of every lender because it effectively modified the waterfall provision in the collateral agreement (thereby altering the order of the application of proceeds) even though the order of distribution set out in this waterfall remained "facially unaffected".*

II. Main Provisions to Review When Assessing the Potential for Disparate Lender Treatment in a Credit Agreement

Both drop-down financings and uptiering transactions are capable of resulting in disparate treatment of different lender groups, and both transaction structures invariably involve a number of different credit agreement provisions and a corresponding level of legal sophistication necessary to cleverly wind the structures through these different provisions.[2] The potential for unequal lender treatment in connection with these transaction structures, however, primarily relies on two credit agreement provisions relating to borrower repurchases and lender voting. We discuss each in turn below, and also offer possible language "fixes" that, depending on the credit agreement, may make it more difficult for a group of majority lenders to successfully structure a drop-down financing or uptiering transaction to the detriment of the other lenders.

(a) Borrower Repurchase Provisions

For a group of majority lenders to be in a position to benefit at the expense of the other lenders in the group, they will typically need the ability to exit their existing loans through a non-pro rata debt exchange for a new senior tranche of debt. These "roll-up features" included in liability management transactions are often structured through borrower repurchase provisions.[3]

A fundamental principle in credit agreements is that all equally-positioned lenders should be treated equally or on a pro rata basis. Most credit agreements include a pro rata treatment provision that requires all payments of principal and interest, as well as other payments such as commitment fees, to be made on a pro rata basis to all lenders. As support for this pro rata treatment provision, most credit agreements also include some form of pro rata sharing clause which requires any lender who receives a payment in excess of its pro rata proportion to share the excess with the other lenders (typically by way of a purchase of an assignment or participation in each of the other lenders' loans).

Most credit agreements include a carve-out from the principal of pro rata treatment among lenders for borrower buybacks pursuant to either a "Dutch auction"[4] or other process in which

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[2] The few courts which have examined these structures have largely favored a strict technical reading of the contractual language over arguments which would look at the wider effect of the transaction or the spirit of the agreement.

[3] Note that it could be possible for "lender-on-lender violence" to involve a roll-up of junior debt into a new tranche of structurally senior debt which has been constructed by way of a drop-down financing, but credit agreements usually place restrictions on a borrower's ability to repurchase junior debt. This is, of course, another point to confirm when reviewing a credit agreement.

[4] In a Dutch auction, the borrower will typically specify a ceiling or, more commonly, a range of acceptable prices at which it is willing to repurchase its debt and either a total principal amount of the debt it is willing to repurchase or the total purchase price it is willing to pay in the repurchase, and each lender will have the ability to offer its debt at a price below the ceiling or within the range provided by the borrower. Once the lenders' offers have been received, the borrower will repurchase the debt offered below the ceiling price or within the specified price range, often with the debt offered at the lowest prices repurchased first. If the amount of debt offered by the lenders is in excess of the total amount the borrower has specified it is willing to repurchase, the lenders' debt will be repurchased on a ratable basis.

participation is open to all lenders. However, many credit agreements also allow the borrower to repurchase loans on a non-pro rata basis by way of "open market purchases". Indeed, the credit agreements in Serta Simmons, Boardriders and TriMark all included a carve-out for open market purchases which were utilized in structuring their uptiering transactions.

While most credit agreements typically subject borrower buybacks to certain conditionality,[5] they often lack a hard definition for an "open market purchase" and do not detail the process for how borrower repurchases should be conducted. This ambiguity can create opportunities for disparate treatment of lenders. For example, under the characterization of an "open market purchase", a borrower may potentially directly negotiate a buyback with one or more select lenders without approaching the other lenders, repurchase loans on non-arm's length terms and at off-market prices or use cash or non-cash consideration in the buyback.[6] Indeed, if a credit agreement contains a broad, undefined concept of open market purchase as an exception to the requirement of pro rata treatment of lenders, then there is a foundation upon which a roll-up exchange (which is a feature of most priming transactions) could be built. [7]

Possible Drafting "Fixes"

If the group of majority lenders cannot exit their existing loan exposures, they are unlikely to agree to amend the credit agreement to permit the borrower to incur additional and/or super-priority debt, engage in covenant-stripping amendments or other modifications adverse to the remaining lenders that feature in some transactions of this genre. As such, the most straightforward solutions to address the risk associated with borrower repurchases may be to eliminate borrower repurchases altogether or to otherwise require borrower buybacks to be pro rata among the lenders.

If neither of these approaches is possible, because of borrower/sponsor resistance or otherwise, an alternative solution may be the inclusion of language in the credit agreement to specifically define what constitutes an "open market purchase". Requiring borrower open market purchases to be, for instance, conducted at arm's length and, possibly, through a broker, made available to all lenders for proportionate participation, for cash consideration only and at current trading prices (or at a price below par) would provide lenders with at least some measure of clarity as to the parameters of any potential borrower buyback going forward.

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[5] *Such conditionality may include (i) that the repurchased debt be immediately retired, (ii) that no default or event of default be outstanding at the time of, or immediately following, the buyback and (iii) that proceeds from a draw on a revolver not be used to finance the buyback.*

[6] *In TriMark, the borrower and the majority lenders, in furtherance of their uptiering transaction, actually went so far as to make amendments to the credit agreement to specify that the theretofore undefined concept of "open market purchase" would include transactions "below or above par for cash, securities, or any other consideration with one or more Lenders that are not made available for participation to all Lenders."*

[7] *It is worth noting here that there are clear arguments that allowing a borrower to repurchase its loans in the market can benefit not only the borrower (and, by extension, its financial sponsor) but also the lenders. As long as the credit agreement is clear on the parameters within which a borrower can engage in buybacks and they are carried out in a way that is not detrimental to minority lenders or divisive to the lender group as a whole, allowing the borrower to de-leverage at a discount with available excess cashflow would be viewed by many as a credit-positive event for lenders.*

A cap on a borrower's open market purchases of its own loans or a restriction on a borrower's ability to make open market purchases on or around the date of a roll-up exchange could also complicate the structuring of a divisive liability management transaction.

It is also worth mentioning that unless the borrower buyback language (including any detailed definition of "open market purchase" or any procedural or other restrictions) is wrapped into or implicated by the list of sacred rights requiring all-lender or all affected-lender consent, then a majority group of lenders could just add the amendment to these provisions as an additional step in structuring a liability management transaction.

(b) Voting Provisions

As a general rule, waivers, amendments and other modifications to the terms of a credit agreement must be approved by the "required lenders", which is typically defined as those lenders holding a simple majority (i.e., over 50%) of the aggregate principal amount of the relevant credit exposures (including undrawn revolving commitments and outstanding term and revolving loans). Exceptions to this general rule are generally provided for amendments to so-called "sacred rights", which represent lenders' critical rights or core economic terms and which will require the consent of all lenders or every affected lender to be amended.

These "sacred rights" typically include: (i) increases to lender's commitments; (ii) reductions of principal amount; (iii) extensions to the payments dates; (iv) reductions of interest margins or fees payable; (v) amendments to the pro rata provisions; (vi) releases of all or substantially all of the collateral and (vii) other fundamental aspects of the credit agreement terms, such as voting rights.

Importantly, subordination (of right of payment or lien priority) is often excluded from the list of sacred rights, and courts have rejected the argument that the sacred right protecting against releases of collateral is implicated by amendments causing (even deep) lien subordination. As such, the subordination of existing loans through the addition of one or more tranches of super-priority debt, which is a fundamental feature of uptiering transactions, would appear (at present) to only require the consent of a majority group of lenders in credit agreements which do not incorporate an anti-subordination sacred right. It is worth noting that the courts in *Murray Energy* and *Serta Simmons* rejected the argument that the subordination of the existing loans through the addition of one or more super-priority tranches of debt equated to an effective release of all or substantially all of the existing lenders' collateral (which was covered by sacred right protections), even though the expected recoveries on those loans in a default scenario would likely be severely reduced thereby.

Possible Drafting "Fixes"

Including a specific subordination sacred right would likely prevent a majority group of lenders from layering in a super-priority tranche of debt in an uptiering transaction. Simply including an additional sacred right which prevents the subordination of the loans or liens under the credit agreement to any other indebtedness without the written consent of each lender would likely suffice. Alternatively, or additionally, broadening the pro rata provisions sacred right to specify that it include any amendments that have *the effect* of modifying these provisions could also provide a measure of protection.

However, there are some situations where there is utility in allowing for the possible addition of a super-priority tranche of debt. For example, the optimal solution to a borrower's short-term liquidity crisis that threatens lender recovery may be the infusion of cash pursuant to a super-priority tranche of debt (provided by existing lenders or otherwise). If the consent of all lenders or all affected lenders is needed to permit such a financing, a single or small minority group of disengaged or reluctant lenders could present an issue for the borrower and the wider lender syndicate. A compromise solution might be to require the consent of only the required (majority) lenders to add a new super-priority tranche of subordinating debt so long as every lender is afforded the ability to participate pro rata in the funding of and/or exchange into such debt.

(c) Exit Consents

As a final note, it is also probably worth a short discussion of "exit consents", which have been features of recent liability management transactions (*e.g.*, Boardriders and TriMark). These consents involve the majority lenders (who constitute "required lenders" under the credit agreement) agreeing to certain amendments adverse to the remaining lenders in connection with their exit from the credit pursuant to a liability management transaction. On their "way out the door", the majority lenders may, among other things, strip away lender covenant protections, widen covenant baskets and loosen default provisions. These exit consents have been upheld by courts, though the effect is to completely change the risk profile for those lenders left behind.

Possible Drafting "Fixes"

Language requiring the calculation of a required or majority lender vote to give pro forma effect to a transaction being effected in connection with a proposed amendment (or series of amendments), or language requiring any consideration for an exit consent to be offered to all lenders (as is found in many bond indentures), could address some of the risk associated with the prospect of an exit consent scenario.

Conclusion

Though there has been quite a lot written about the recent incidences of "lender-on-lender violence", and even though these transactions might implicate a number of different credit agreement provisions in sometimes novel ways through clever legal structures, the recent transactions which have garnered so much attention probably would not have happened if the relevant credit agreements detailed clear and fair processes for borrower buybacks and/or provided that amendments permitting subordination of the existing debt and/or liens require all lender or all affected-lender consent (or some other mechanism requiring a more equal treatment of all lenders). It is possible that the courts could begin to look beyond the technical drafting which has enabled the structuring of the recent liability management transactions and consider the wider effect of these transactions and the impact they have on such things as the pro rata provisions. Until then, the market must critically read credit agreements and assess them for the permissive drafting which has created the opportunities for these types of liability management transactions to date.

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