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The Next Generation of Bankruptcy Cases: The Times They Are a-Changin'!

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A. Prepackaged and Prearranged Cases

The rise of prepackaged and prearranged chapter 11 cases illustrates the focus on pre-filing activities. In a prearranged case (also referred to as "pre-negotiated"), a debtor files a chapter 11 petition after reaching a deal with one or more of its creditor constituents in connection with the terms of a chapter 11 plan that will be filed shortly after the case is commenced. Thereafter, the time in chapter 11 is spent on operational fixes and obtaining creditor votes through the typical plan process (e.g., solicitation and confirmation).[2] The successful prearranged chapter 11 cases of *Chinos Holdings, Inc*. and its affiliated debtors (commonly referred to as "J. Crew")[3] is an example of a retailer going through a smooth proceeding and emerging in a short period of time. During what has been coined the "retail apocalypse," J. Crew filed bankruptcy with the support of its largest stakeholder constituencies and spent four months in the case addressing operational fixes available only under the Bankruptcy Code, such as the ability to reject burdensome contracts or leases and to compromise unsecured liabilities. J. Crew confirmed a chapter 11 plan with support from over 95% of its secured creditors, all of its key vendors, and the official committee of unsecured creditors appointed in the case.[4]

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[1] *See, e.g., Off. Comm of Unsecured Creditors of Motor Liquidation Co. v. JPMorgan Chase Bank, N.A. (In re Motors Liquidation Co.)*, Case No. 09-50026, 2009 WL 2446727 (Bankr. S.D.N.Y. July 31, 2009); *In re CIT Grp. Inc.*, Case No. 09-16565, 2009 WL 4824498 (Bankr. S.D.N.Y. Dec. 8, 2009); *In re Lehman Brothers Holdings Inc*., Case No. 08-13555, 2008 WL 4902202 (Bankr. S.D.N.Y. Nov. 6, 2008); *In re Wash. Mut., Inc.,* Case No. 08-12229 (Bankr. D. Del. Sept. 26, 2008).

[2] *See*, *e.g.*, 11 U.S.C §§ 1125, 1126, and 1129.

[3] *In re Chinos Holdings*, *Inc.*, Case No. 20-32181 (Bankr. E.D. Va. 2020).

Even swifter then a prearranged case and certainly the more popular restructuring path in recent years is a prepackaged chapter 11 filing. Prepackaged bankruptcy cases, in which the debtor solicits and obtains approval of its plan of reorganization before filing the case, originally gained traction in the 1980s, shortly after the modern-day Bankruptcy Code was enacted.[5] Unlike its predecessor, which prohibited prepackaged plans, the Code expressly allowed prepackaged chapter 11 cases.[6] For the first time, a debtor could file a reorganization plan with a petition and solicit votes before commencing its case.[7]

A prepackaged chapter 11 case, like a prearranged filing, requires the debtor to reach an agreement with at least one impaired group of creditors before the petition date. The plan typically involves a balance sheet restructuring in which general unsecured creditors, such as trade and litigation claimants, are left unimpaired. The debtor in a prepackaged case is not seeking to achieve operational fixes. The chapter 11 case is commenced to implement the plan, thus providing for confirmation to be quickly obtained.[8]

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[4] *See id.*, Mem. of Law in Support of Confirmation of the Second Am. Joint Prearranged Chapter 11 Plan of Reorg. Of Chinos Holding, Inc. & Its Affiliated Debtors, Docket No. 840; *see also id.*, Order Confirming the Second Am. Joint Prearranged Chapter 11 Plan of Reorg. Of Chinos Holding, Inc. & Its Affiliated Debtors, Docket No. 880.

[5] Dennis F. Dunne, Dennis C. O'Donnell & Nelly Almeida, *Prepackaged Chapter 11 in the United States: An Overview*, Global Restructuring Review (Mar. 4, 2022), available at https://globalrestructuringreview.com/guide/the-art-of-the-pre-pack/edition-2/article/prepackaged-chapter-11-in-the-united-states-overview.

[6] *Id.*

[7] *Id.*

[8] *See, e.g., In re Belk, Inc.*, Case No. 21-30630 (Bankr. S.D. Tex. Feb. 23, 2021) (less than twenty-four hours in chapter 11); *In re Mood Media Corp.*, Case No. 20-33768 (Bankr. S.D. Tex. July 30, 2020) (less than twenty-four hours in chapter 11); *In re SunGard Availability Servs. Cap., Inc.*, Case No. 19-22915 (Bankr. S.D.N.Y. May 1, 2019)

Both prepackaged and prearranged restructuring options allow debtors to avoid the steep costs associated with spending months in bankruptcy court and to implement components of a restructuring that cannot be accomplished out of court, such as binding or cramming down on dissenting creditors. Either filing can provide a distressed company with both liquidity and a sufficient pre-petition runway.

B. Liquidity Concerns and Options

The first step in assessing restructuring options is to determine if a company has the liquidity necessary to continue operations outside of chapter 11 so that there is a clear path to exit. The primary source for incremental liquidity is typically within the existing capital structure. A review of the company's key economic stakeholders will identify those who have already invested in the company and, thus, both have an interest in its success and may be open to providing additional funds to help the company through the distressed period. Incremental liquidity can come from utilizing available baskets under an existing credit facility, increasing the credit facility size with incremental term loans, or securing new money from a parent entity or shareholder, such as a sponsor. Ultimately the goal is to obtain funds to address liquidity needs; however, when there will be a future chapter 11 filing, the manner in which the money is given to the company and the related terms and conditions also play an important role. For example, companies must take measures to ensure that debt is not treated as equity and be aware of the priority of payments in the event of a filing.

Companies should also focus on liquidity enhancement strategies before filing. Indeed, using the balance of revolver availability to build a cash war chest is a "known" strategy that can signal to the external market that a company may be in distress and exploring restructuring

(less than forty hours in chapter 11); *In re FULLBEAUTY Brands Holdings Corp.*, Case No. 19-22185 (Bankr. S.D.N.Y. Feb. 3, 2019) (four days in chapter 11).

options.[9] In addition to infusing much needed liquidity, a revolver draw increases a company's leverage over its credit facility lenders and may allow the company to fund its chapter 11 case using only cash collateral. Over the years, creative approaches have been used under debt documents, which have become increasingly covenant-lite, to execute liquidity-enhancing transactions. For example, in the past few years, there has been an uptick of "uptier" and "asset drop-down" transactions to provide companies with liquidity, optionality for future capital raising transactions, and a way to obtain essentially non-consensual priming.

In an uptier transaction, companies incur new debt that takes priority over existing debt. In drop-down transactions, assets are transferred to entities outside of the credit group, such as unrestricted subsidiaries, thus resulting in the release of lenders' liens. In such a transaction, a company is effectively able to re-pledge collateral to support new secured debt. Recent cases involving both uptier and drop-down transactions between sophisticated parties are further establishing their legitimacy.[10]

C. Restructuring Alternatives

Once liquidity is in hand, a distressed company will have runway to assess and implement its restructuring transaction options. Developing the slate of strategic options available requires identifying which stakeholders will have a seat at the pre-petition negotiation table. Typically, the company and its advisors focus on the creditors associated with the company's funded indebtedness. It is key to identify the "fulcrum" security holder—the party that holds the debt where value breaks or, in other words, the debt that is most likely to be converted into ownership

[9] *See, e.g.*, *Bed Bath & Beyond Inc.*, Case No. 23-13359 (Bankr. D.N.J. 2023) (utilizing a first-in, last-out loan that took priority in bankruptcy and was part of a DIP roll-up).

[10] *See, e.g.*, Mem. Op. at 15, *In re Serta Simmons Bedding, LLC,* Case No. 23-90020 (Bankr. S.D. Tex. June 6, 2023) (holding that the 2016 credit agreement permitted the contemplated transaction and did not violate the implied covenant of good faith and fair dealing).

or control of the company post-restructuring. For complex capital structures that have multiple layers of funded debt, negotiations tend to require careful strategizing to navigate priority, enforcement rights, hold-up value, and different forms of consideration, among other things.

The challenges presented by complex capital structures often leads to litigation, as junior creditors fight to protect their interests and avoid scenarios in which they will receive little to no recovery. In *LBI Media, Inc*., Case No. 18-12655 (Bankr. D. Del. 2018), Judge Christopher Sontchi issued a ruling rejecting the efforts of the debtors and senior creditors who sought to consummate a settlement that would have left certain junior creditors with nominal, if any, recovery. Specifically, the court declined to adopt a more expansive interpretation of the intercreditor agreement which would have made certain defensive actions of the junior creditors violative of the automatic stay.

The trend toward liquidating chapter 11 plans following asset sales, which has been increasingly common over the years, is perhaps even more prevalent today. Pre-petition organizing and contingency planning to address the costs and time in chapter 11 do not always result in a prepackaged or prearranged chapter 11 case. A sale of all or substantially all of a company's assets pursuant to section 363 of the Bankruptcy Code is another way for companies to implement swift restructurings.[11]

More work done outside of chapter 11 to ensure an efficient in-court process may continue to impact how chapter 11 cases are administered, particularly in the context of certain procedural and administrative relief. Whether the roles of key players, including certain statutory committees, will evolve at the same pace as case strategy is a trend that should be watched. Certain approaches

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[11] *See*, e.g., *BBGI US, Inc*., Case No. 20-11785 (Bankr. D. Del. July 8, 2020); *In re SHL Liquidation Indus. Inc.*, Case No. 20-12024 (Bankr. D. Del. Aug. 30, 2020); and *Insys Therapeutics, Inc*., Case No. 19-11292 (Bankr. D. Del. June 10, 2019).

and strategies may have taken twenty years, but at the clip that things are transforming now, we are likely to see—perhaps within the next five years—even more dramatic changes in the restructuring practice, including a continued increase in opportunistic investing and changes in governing debt documents.

II. Shaping Modern Practice

While it is impossible to cover the many ways that the insolvency world has changed over the decades, a few other trends have helped shape modern practice. These include: (1) the demand for a faster and more efficient reorganization process for small businesses, culminating in the passage of the Small Business Reorganization Act; (2) an increase in the importance of strategic corporate governance in chapter 11, particularly in relation to exculpation and third-party releases and the decision to retain a chief restructuring officer; and (3) the creative application of non-bankruptcy law to distressed situations.

A. The Small Business Reorganization Act

In at least partial response to the demand for faster and more cost-efficient ways to reorganize cases in appropriate circumstances, Congress passed the Small Business Reorganization Act of 2019 (the "SBRA"), Pub. L. No. 116-54, which became effective February 19, 2020. The SBRA provides qualifying small business debtors with an efficient and relatively inexpensive reorganization framework. For example, unlike in a traditional chapter 11 case, there is no creditors' committee unless ordered by the court in a small business case,[12] the debtor is not required to file a disclosure statement,[13] and the reorganization plan must be filed within ninety days of the petition date.[14]

[12] 11 U.S.C. § 1181(b).
[13] *Id*.
[14] 11 U.S.C. § 1189.

Once the SBRA became effective, it was quickly tested, as more than 1,350 small business subchapter V cases were filed between February and December 31, 2020. According to Congressman Ben Cline of Virginia, one of the drafters of the COVID-19 Bankruptcy Relief Extension Act of 2021, since the enactment of the SBRA, "80 percent of small business debtors have chosen to proceed under the provisions of this bill."[15]

B. The Evolution of Corporate Governance

The term "corporate governance" first appeared in the U.S. Federal Register in 1976.[16] Prior to that, companies enjoyed market success with little legal oversight, and their boards often went along with management decisions. The Securities and Exchange Commission led the efforts to develop corporate governance in an attempt to rein in the perceived foul play occurring in the markets while boards were asleep at the wheel.[17] The Protection of Shareholders' Rights Act of 1980 introduced a minimum standard for large public companies, creating rules for independent boards, requiring thorough audits, and safeguarding shareholder's rights.[18] Legislative reform took off from that point and survived Reagan-aligned opposition in the 1980s. The opposition was joined by legal and economic scholars who believed that further research was needed to develop a

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[15] *COVID-19 Bankruptcy Relief Extension Act of 2021: Hearing on H.R. 1651 Before the H. Comm. on the Judiciary,* 117th Cong. (2021) (statement of Rep Ben Cline, Member, H. Comm on the Judiciary).

[16] *See* Nicholas J. Price, *What Is the History of Corporate Governance and How Has It Changed?*, available at https://www.diligent.com/insights/corporate-governance/what-is-the-history-of-corporate-governance-and-how-has-it-changed/ (Oct. 3, 2018).

[17] *See* Dan Byrne, What is the history of corporate governance?, Corporate Governance Institute, available at https://www.thecorporategovernanceinstitute.com/insights/lexicon/why-does-corporate-governance-matter-a-look-back-at-history/#:~:text=In%20other%20ways%2C%20corporate%s20governance,United%20States%20during%20the%201970s.

[18] Protection of Shareholders' Rights Act of 1980, S. 2567, 96th Cong. (1980) ("A Bill [t]o establish Federal minimum standards relating to composition of corporate boards, duties of corporate directors, audit and nominating committees, shareholders' rights, and for other purposes. . . ."). The bill was never enacted, but several of its provisions appear in subsequent developments, including those prohibiting corporate insiders from serving as officers and directors at competing corporations, mandating independent auditor certification of financial statements as a requirement for the issue of a federal charter, and instituting federal regulatory mandates concerning executive pay. *See* Marc I. Steinberg, *The Federalization of Corporate Governance—An Evolving Process*, 50 LOY. U. CHI. L.J. 539, 540 & 540 nn.5–8 (2019).

comprehensive set of rules to govern companies. In the 1990s, investors and shareholders began voicing concern about the companies they worked with. In response to the high-profile bankruptcies of Enron and WorldCom, the first corporate governance code was introduced in 2002,[19] and the 2008 economic crash brought more attention to corporate governance issues, with everyone suddenly seeking transparency of business behavior and decision-making.[20] Further reform came in 2010 with the passage of the Dodd-Frank Act.[21] Throughout the rise and evolution of corporate governance rules and regulations, the Bankruptcy Code also evolved with the Bankruptcy Reform Act of 1978, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, and other key amendments.

As the rules of corporate governance, the Bankruptcy Code, and the relevant case law have evolved and changed over time, debtor entities have reacted by augmenting their corporate governance structures and creating clever plan provisions and case strategies to better position themselves and their officers to obtain the greatest relief possible under the provisions of the Bankruptcy Code. The following discussion briefly explores several such trending strategies, including the inclusion of ever-broadening exculpation and third-party release plan provisions and the rise of the corporate restructuring officer.

1. Exculpation and Third-Party Releases

Directors and officers of insolvent companies, particularly smaller entites, are often concerned about their individual liability in connection with the company's bankruptcy. It is not uncommon for creditors, creditors' committees, and equity holders to conduct lengthy investigations into the circumstances leading up to a bankruptcy filing, which may result in

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[19] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended at 15 U.S.C. §§ 7201–66 (2012)).

[20] *See* Byrne, *supra* note 17.

[21] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

fiduciary or other litigation against the directors and officers. Over time, exculpation and third-party releases have developed to provide directors and officers, in appropriate circumstances, with a bargained-for release of potential liability in exchange for a contribution to the debtor's estate.

Third-party releases originated in the 1980s to protect insurers from asbestos liability.[22] The idea was that a debtor (and its affiliates) with mass tort exposure could contribute funds to a trust that would administer victims' claims in exchange for a "fresh start" in the form of a release.[23] Ultimately, Congress codified this arrangement in section 524(g) of the Bankruptcy Code.

Since then, courts have struggled to draw appropriate boundaries with respect to exculpation and third-party releases for non-debtors, creating a labyrinth of circuit- and sometimes district-specific precedent.[24] Most recently, the Second Circuit Court of Appeals approved non-consensual third-party releases of direct claims against non-debtors in *Purdue Pharma*,[25] but the court found its authority to grant those releases under sections 105 and 1123 of the Bankruptcy Code—not section 524(g).

2. The Rise of the CRO and the Future of the J. Alix Protocol

Companies facing financial challenges often hire a chief restructuring officer ("CRO") to facilitate the company's turnaround and return it to financial strength. As a "C-level" executive, the CRO is typically charged with operating the company and guiding it through a restructuring or liquidation process. While CROs have been relatively common since the 1990s, they are not defined—or even referenced—in the Bankruptcy Code.[26]

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[22] *How asbestos saved the Sackler family from bankruptcy*, THE ECONOMIST (Sept. 9, 2021), available at https://www.economist.com/united-states/2021/09/09/how-asbestos-saved-the-sackler-family-from-bankruptcy.

[23] *Releases: How Did We Get Here and What Is Next?*, Patterson Belknap: Bankruptcy Update (Mar. 28, 2022, available at https://www.pbwt.com/bankruptcy-update-blog/releases-how-did-we-get-here-and-what-is-next.

[24] See generally Matthew Gensburg, *Circuit Review of Third-Party Injunctions & Releases Under Sections 105(a) and 524(e)*, GKC on Law (July 27, 2022), available at https://www.gcklegal. com/circuit-review-of-third-party-injunctions-releases-under-sections-105a-and-524e/.

[25] *Purdue Pharma L.P. v. City of Grande Prairie (In re Purdue Pharma L.P.),* 69 F.4th 45 (2d Cir. 2023).

[26] Kevin M. Baum, *The Basics for Retaining a CRO*, 30-OCT AM. BANKR. INST. J. 50, 50 (Oct. 2011).

The murky nature of a CRO—not quite a company executive and not quite a bankruptcy professional—led to the creation of the J. Alix Protocol, an approach to CRO retention resulting from the United States Trustee's 2001 settlement agreements in, among other cases, *In re Safety-Kleen Corp.*[27] Those early settlement agreements provided a blueprint for debtors seeking to retain post-petition CROs who were not "disinterested," a requirement for retention under section 327(a). The result was predictability: Debtors and CROs that complied with the J. Alix Protocol were generally safe from retention objections by the U.S. Trustee.

Yet, as commentators have observed, the J. Alix Protocol carries no force of law,[28] and at least one court has squarely rejected the legal foundation of the protocol altogether. In *In re McDermott International, Inc.*, Judge David R. Jones approved the retention of a CRO under section 327(a), squarely holding that the financial advisory firm employing the CRO was disinterested and instructing future debtors to file a "single application for employment under § 327(a) seeking to employ the best financial advisory professionals to render the best financial advisory services for the benefit of debtors who so need their talents."[29]

Moreover, the Fifth Circuit Court of Appeals recently reiterated its long-standing precedent that section 524(e) of the Bankruptcy Code generally prohibits non-debtor exculpation. In *NexPoint Advisors, L.P. v. Highland Capital Management, L.P. (In re Highland Capital Management, L.P.)*, the Fifth Circuit explained that "exculpation in a Chapter 11 reorganization plan [must] be limited to the debtor, the creditors' committee and its members for conduct within the scope of their duties and the trustees within the scope of their duties."[30] While the court

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[27] *In re Safety-Kleen Corp.*, Case No. 00-2303, Docket Nos. 2825, 2920 (Bankr. D. Del. 2000).

[28] Clifford J. White III, William K. Harrington & Nan Roberts Eitel, *Future of USTP's CRO "Protocol,"* 37-SEP AM. BANKR. INST. J. 24, 24 (Sept. 2018).

[29] *In re McDermott Int'l, Inc.*, 614 B.R. 244, 254–55 (Bankr. S.D. Tex. 2020).

[30] *NexPoint Advisors, L.P. v. Highland Cap. Mgmt., L.P. (In re Highland Cap. Mgmt., L.P.)*, 48 F.4th 419, 437 (5th Cir. 2022) (internal citations omitted).

approved the exculpation of certain independent directors, it conditioned that approval on the fact that those directors were court-approved. Because a section 363 order approves only the debtor's use of property—not employment of professionals—it is not clear whether a CRO employed utilizing the J. Alix Protocol would be entitled to exculpation under this standard.

C. A Step Beyond the Texas Two-Step: Bankruptcy Outside of the Code

Restructuring professionals can—and will—continue to develop new strategies that blur the line between the Bankruptcy Code and generally applicable non-bankruptcy law. Over the last twenty years, creative practitioners have developed several tools to add a bankruptcy enhancement to an otherwise non-bankruptcy transaction. The two main trends that have developed in this area are the Texas Two-Step and liability management transactions.

The so-called "Texas Two-Step" is a series of transactions designed (usually) to allow a large company's mass tort liability to be treated in a bankruptcy without placing the entire enterprise into chapter 11. While Texas state law has authorized divisive mergers since 1989, the first Texas Two-Step was not filed until nearly thirty years later, when Georgia-Pacific spun its liabilities into Bestwall, which subsequently declared bankruptcy. Since then, several other companies have attempted the Texas Two-Step with varying degrees of success.

On January 30, 2023, the Third Circuit dismissed the chapter 11 case filed by LTL Management, LLC, the debtor-subsidiary of Johnson & Johnson created through a Texas Two-Step.[31] While the court took care not to foreclose the Texas Two-Step entirely, its ruling raises serious questions about the ongoing viability of the strategy. Although it is too soon to tell whether the era of the Texas Two-Step may be coming to a close, a new strategy has come into focus:

[31] *LTL Mgmt. LLC v. Those Parties Listed on App. A to Compl. (In re LTL Mgmt., LLC)*, 58 F.4th 738, 763–64 (3d Cir. 2023), as amended and superseded by 64 F.4th 84 (3d Cir. 2023).

liability management transactions. As discussed below, these types of transactions may offer a new avenue for creative practitioners to raise much-needed liquidity outside of bankruptcy.

III. Recent Trends and Future Questions in Financing and Restructuring

While lenders had severely curtailed the flexibility of borrowers to incur additional debt in the aftermath of the 2008–2009 financial crisis, the trend was reversed in the following decade, as the bull economy fueled investments, including the leveraged loan market. This renewed willingness to lend led to looser restrictions and, in particular, the ability of borrowers to amend restrictive covenants in their loan documents, often through amendment with the consent of a simple majority of lenders. The onset of COVID-19 renewed the interest of companies (and often their private equity sponsors) to reevaluate the limitations in their debt covenants in the hope of taking advantage of the right to amend and thereby extend the runway for stabilizing the company or even making it profitable.

When one group of lenders privately negotiates with the borrower for itself, those left out of the negotiations often find themselves economically disadvantaged. As one judge in New York's Supreme Court (Commercial Part) put it when confronted with a "priming" loan done by some but not all of the lenders:

> A syndicated loan is a loan extended by a group of lenders (*i.e.*, a syndicate) to a single borrower, typically under a single agreement with common terms. By pooling their resources, the lenders share the benefits and risks of the transaction. Generally speaking, the spirit of such arrangements among lenders is all for one, one for all. But not always.[32]

The bankruptcy market has coined the phrase "lender-on-lender violence" to describe the new behavior by a modern breed of lenders that freely try to advantage their own holdings at the

[32] *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp.*, 72 Misc.3d 1218(A) (N.Y. Sup. 2021), 150 N.Y.S.3d 894 (Table), N.Y. Slip Op. 50794(U) at 1.

expense of others in the same deal. Various types of similar disputes related to a borrower's need for liquidity outside of chapter 11 are making their way through the courts, and bankruptcy courts are often first encountering these cases in the middle of ongoing non-bankruptcy litigation. The market has also had the opportunity to adjust to this new normal, and lenders have begun to alter new credit agreements in order to restrict the possibilities for priming or less than ratable exchanges of debt. This year's NCBJ Annual Meeting provides an opportunity to revisit these transactions to ensure that the bankruptcy judiciary is aware of this trend in transactions and to consider how both the law and the markets are adapting.

So-called "uptier" transactions (in which existing loans are exchanged for a new level of super-senior loans similar to a roll-up in bankruptcy, but without the benefit of judicial oversight) are among the most prominent example of priming to emerge in recent years.[33] They offer distressed borrowers opportunities to seek liquidity, which routinely requires amending the terms of existing credit agreements with less than unanimous consent among lenders. There have been a number of different arrangements to structure these transactions. Generally, creditors who hold a majority of the debt agree to amendments and swap their existing debt for new enhanced debt. These amendments are structured such that the new debt takes super-priority (or sometimes a new first lien after stripping the old debt of a pre-existing first lien), diminishing the value for those who retain the original and effectively junior debt.

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[33] As one bankruptcy court noted in the case of *Serta Simmons*, the name used to characterize the transaction is secondary to its consequence, which "is to effectively remove a borrower's most valuable assets from the non-participating lenders' collateral base until the participating lenders are paid in full." *Serta Simmons Bedding, LLC v. AG Centre St. P'ship (In re Serta Simmons Bedding, LLC)*, Case No. 23-90020, Adv. No. 23-9001, 2023 WL 3855820, at *5 n.2 (Bankr. S.D. Tex. June 6, 2023). The court preferred to characterize such transactions as "Position Enhancement Transactions." *Id.* In describing how they function, the court noted that "[t]he fact [that] one person says they know drop-downs but not uptiers is to suggest that financial transactions fit nicely into static 'buckets.' In the modern world of commercial finance, they simply do not." *Id.* The form of such transactions, the court suggested, is secondary to its function in the syndicated credit market. *Id.*

Court rulings on uptier transactions reveal a mixed record to-date. In a nutshell, courts have been asked to review whether amendments by fewer than all applicable lenders validly permitted the challenged transaction. The determination typically turns on whether the borrower amended a so-called "sacred right" (one that requires the consent of the affected lender to be valid against that lender) or a majority (or super-majority). Litigants frequently assert the implied covenant of good faith and fair dealing, tortious interference, state law fraudulent transfer or insider preference claims, unjust enrichment, and other equitable relief. The following discussion offers context, considering the market conditions that have given rise to these "looser" loan agreements, as well as the changes in the syndicated credit market that followed the uptick in uptier transactions and related litigation.

A. Recent Litigation

Serta Simmons Bedding, LLC v. AG Centre St. P'ship (In re Serta Simmons Bedding, LLC), Case No. 23-90020, Adv. No. 23-9001, 2023 WL 3855820 (Bankr. S.D. Tex. June 6, 2023)

The bankruptcy court in *Serta* upheld a pre-bankruptcy liquidity transaction. Dispensing with assertions of inequitable conduct by the majority lenders who participated in the deal, the court noted that the Objecting Lenders themselves had also tried to structure a deal to enhance the debt that they held. Citing internal communications among the Objecting Lenders after the deal was announced, the court found that their "true motives" in bringing the lawsuit indicated an "objective lack of good faith."[34] The court suggested that the Objecting Lenders were bringing the litigation because they were unable to close their own self-interested deal with the debtor. This characterization by the court supported its decision that the contract was unambiguous in how amendments were permitted and rejected arguments of inequity and unfairness.

[34] *Serta Simmons*, 2023 WL 3855820, at *6.

The court stressed that sophisticated lenders could have designed the initial credit agreement to preclude subordination of debt through subsequent amendments of the agreement. Such terms were not unimaginable at the time of the initial agreement. The court also focused on the fact that both parties characterized the underlying credit agreement as a "loose" one.[35] In addition, the court considered factual determinations to answer the question of whether the implied covenant of good faith and fair dealing was violated under New York law, while deciding as a matter of law that the transaction clearly constituted an "open market purchase" that permitted a non-pro-rata exchange of existing debt.[36] The court was unwilling to take a stance on the efficacy of uptier transactions and instead exhibited judicial restraint on rewriting the terms of an agreement. The court also focused on evidence that a range of different lenders set out to amend the credit agreement to prioritize their own debt, which went a long way toward showing that subordinating amendments were not precluded by either the terms of the credit agreement or by good faith obligations among counterparties.

When they initially sought relief under chapter 11, the *Serta* debtors themselves filed an adversary proceeding seeking a declaratory judgment to validate their capital structure. The debtors' aim was to ensure that the automatic stay applied to actions pending in other courts that sought to reverse the pre-bankruptcy transaction that effectively subordinated the debt of the Objecting Lenders. The bankruptcy court extended the stay to ensure coverage of these pre-petition actions, explaining that the requested relief was a core proceeding under 28 U.S.C. § 157(b). The

[35] *Id.* at *13.

[36] Adversary Docket No. 142 (stressing that the "open market purchase" requirement for non-pro-rata changes to the credit agreement was unambiguous and clearly satisfied in the process where different lenders sought to amend the agreement to ensure priority for their debt.) This summary judgment order is now being appealed in the Fifth Circuit.

plaintiffs in these pre-bankruptcy lawsuits had initially sought to enjoin the transaction in 2020, but the New York courts denied the motion for injunctive relief.[37]

ICG Global Loan Fund 1 DAC v. Boardriders, Inc., 2022 WL 10085886 (N.Y. Sup. Ct. Oct. 17, 2022)

The claims related to the uptier transaction in this adversary proceeding, which also alleged breach of the operative credit agreement and New York's implied covenant of good faith, survived a motion to dismiss. The court found that there was "nothing in the sacred rights provision that expressly prohibit[ed] the subordination of any lenders' liens."[38] Nevertheless, the court did not accept such a narrow construction of the sacred rights at this stage of the proceeding, because it could work to "essentially vitiate the equal repayment provisions."[39] In addition, the court found it plausible that the majority creditors who recast their debt had their pre-existing debt reduced to zero, and thus the sacred rights clause could have been violated due to this element of the transaction.

The *Boardriders* court also allowed the breach of the implied covenant claim to proceed. Focusing on how the transaction came about, the court suggested the need for a fact-specific inquiry to resolve this particular claim. In allowing the claim, the court pointed to the plaintiffs' allegations that the defendants "worked in concert and in secret" to negotiate the transaction, even though the plaintiffs "made multiple attempts to gauge whether the Company needed additional capital, which [the] plaintiffs allege[d] they were willing to provide."[40] This allegation of secrecy vis-à-vis a contractual counterparty provided the basis for allowing the claim of bad faith to survive

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[37] *N. Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC*, 2020 WL 3411267, at *5–6 (N.Y. Sup. Ct. June 19, 2020) (also finding that a focus on irreparable harm given the possibility of a later bankruptcy for the distressed debtor "invites speculation" rather than demonstrating a harm that could not be remedied with monetary damages).

[38] *Boardriders*, 2022 WL 10085886, at *7.

[39] *Id.*

[40] *Id.* at *9.

the motion to dismiss. There was nothing that suggested that the transaction needed to be shaped in this way—and with such consequences for the non-majority creditors—in order to extend additional liquidity to the debtor.

Bayside Cap. Inc. v. TCP Grp. Inc. (In re TPC Grp. Inc.), Case No. 22-10493 (CTG), Adv. Proc. No. 22-50372 (CTG), 2022 WL 2498751 (Bankr. D. Del. July 6, 2022)

This bankruptcy court ruling focused on trade practice to interpret the credit agreement at issue as objectively understood in the marketplace. In doing so, the court upheld the challenged transaction. In particular, the court found that the "inclusion of express anti-subordination clauses [were] sufficiently commonplace that . . . a provision providing for ratable distribution . . . would more naturally apply to distributions *within* a class, and not prohibit subordination of an entire class to another, different class."[41] The Supplemental Indenture being contemplated included some "sacred right" provisions requiring unanimous consent to amend the Credit Agreement, while other provisions required only a two-thirds supermajority to, for instance, release all collateral. This "hierarchy of consents" was meaningful because it reflected the intent of the parties to permit significant economic changes to the indenture if a supermajority vote were obtained. Considering that the indenture required only a supermajority to outright *release all collateral*, the court asserted that a less drastic amendment to the contract subordinating the existing lien to that of new lender could not reasonably be interpreted as a sacred right requiring unanimous consent.[42]

The question came to the bankruptcy court as part of the debtor's effort to obtain a debtor-in-possession loan with a group of noteholders who already held what were purported to be senior notes following the pre-bankruptcy transaction that amended the indenture. The court needed to determine the efficacy of the pre-bankruptcy transaction in order to evaluate the permissibility of

[41] *TPC Grp.*, 2022 WL 2498751, at *11.
[42] *Id.* at *11–12.

the DIP loan, which relied on the pre-existing seniority of putative lenders. As such, the bankruptcy court deemed that the matter was a core proceeding under 28 U.S.C. § 157(b).

Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp., No. 565123/2020 (JMC), 2021 WL 3671541 (N.Y. Sup. Ct. Aug. 16, 2021)

This matter settled after some claims survived a motion to dismiss. Notably, the motion to dismiss was granted on the implied covenant of good faith and fair dealing claim. The New York court held the implied covenant could not be used to create new terms in the contract that were not negotiated. The court found that any remaining claim under the implied covenant would be duplicative of the breach claim that was also asserted.[43] The court further found that consents given by lenders on the eve of transferring their loans to the borrower (to facilitate an exchange) counted toward the amendment because only loans held by the borrower at the precise time of voting would be disqualified.[44] As such, the case stands for the proposition that so-called chronological closings of related transactions should be respected.

B. Key Trends

The recent spate of litigation over "lender-on-lender violence" suggests a few trends and highlights common legal questions that emerge when uptier transactions are in dispute. Although the number of issues that have been judicially decided is limited, bankruptcy courts interpreting credit agreements under New York law have carefully evaluated the specific terms employed by sophisticated parties in responding to challenges to uptier transactions. New York courts appear to give more leeway to entertain the possibility that uptier transactions may have violated the terms—explicit and implied—of otherwise "loose" credit agreements.

[43] *TMK*, 2021 WL 3671541, at *13.
[44] *Id.* at *10.

As with any uncertainty in commercial transactions, one would expect the market to respond by expressly defining the possibilities for uptiering in new credit agreements. But the response of the market has been as mixed as the response of the courts. This section first characterizes the major legal questions posed by the rulings to date. It then considers the relationship between developments in the law and the market as these transactions have become more commonplace.

1. Legal Questions

a. Open Market Purchases

In order for lenders to exchange existing rights and obligations under a credit agreement on a non-pro rata basis, such transactions typically must be conducted as open market purchases. The meaning of this term remains contested. The *Serta* court defined it as "something obtained for value in competition among private parties."[45] This meant that a privately-negotiated deal between the distressed debtor and majority lenders met the carveout. The deal itself did not need to be offered to everyone in the market; rather, there simply needed to have been some opportunity for other parties to agree to a transaction. In the *Boardriders* ruling, the court was more sympathetic to a reading of the open market exception that required the transaction to be "offered to all Lenders" rather than something that any other lender could have tried to negotiate with the distressed debtor.[46] As yet, there is little clarity on how a transaction must be conducted to comport with a term requiring existing lenders to make an "open market purchase" if such a purchase is altering existing contractual rights on a non-pro rata basis. The issue will soon be addressed further: In the *Serta* bankruptcy, a direct appeal to the Fifth Circuit focuses on whether the bankruptcy court erred in determining that the disputed transaction constituted an "open market purchase."

b. Sacred Rights

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[45] *Serta Simmons*, 2023 WL 3855820, at *11.
[46] *Boardriders*, 2022 WL 10085886, at *9.

Much of the litigation thus far centers on how to interpret sacred rights provisions, which identify the circumstances under which unanimous consent among lenders is required to amend an existing credit agreement. While interpretive questions are idiosyncratic to the particular sacred rights provisions of a credit agreement, the litigation generally focuses on how broadly to interpret these rights in the absence of specific prohibitions on subordination in the sacred rights clause. Interpretive practice has varied. Some courts suggest a plausible construction of the provisions with the acknowledgement that allowing subordination without unanimity would negate other provisions in the credit agreement, such as an equal payments provision. Other courts have focused on the text of the particular sacred rights provision, explaining that a tighter provision could have structured to explicitly preclude subordination without unanimous consent.

c. Implied Covenant of Good Faith and Fair Dealing

Courts have generally been less than receptive, although not entirely dismissive, of the idea that position enhancement transactions breach New York's implied covenant of good faith and fair dealing. Commentators instead suggest a need to impose default rules particular to credit agreements, such as a rule precluding uptiering unless parties specifically opt into the possibility of subordination without unanimity. That being said, the reach of the broader implied covenant of good faith still remains a live question under New York law. In *Boardriders,* the court did not dismiss a claim for violation of the implied covenant of good faith and fair dealing.[47] (But see *TMK*, which did.[48]) The court suggested that the majority creditors worked in secret to deprive the plaintiffs of the benefit of their bargain, i.e., pro rata distribution of loan repayments, and could

[47] *Boardriders*, 2022 WL 10085886, at *9.
[48] *TMK*, 2021 WL 3671541, at *2.

have been acting in bad faith, particularly given the willingness of the plaintiffs to find a means to extend additional liquidity to the debtor.[49]

d. Other Claims

Some additional claims have also been offered in these cases. For instance, tortious interference claims against the private equity firm controlling the distressed debtor were rejected in one instance. The trend tends to be that private equity firms are able to assert an economic interest defense to dismiss a tort claim because complaints do not allege malice, fraud, or illegality in a way that precludes such a defense under governing law.[50]

2. Market Response

In the most recent performance enhancement transaction ruling, the *Serta* court set the stage for its decision by stressing broader change in the market for syndicated commercial loans. It noted that the $1.4 trillion market boomed in the aftermath of the 2008 financial crisis. The growth of the market, and the general ease of accessing credit in the low-interest-rate environment that followed, brought about the evolution of "looser" loan agreements negotiated by debtors. This led to, among other things, terms that allowed existing lenders under a credit agreement to reassign their rights and obligations through open market purchases on a non-pro rata basis.[51] The possibility for debtors to facilitate lender-on-lender violence if future liquidity needs arose emerged as a result of this new economic environment.

The consequences of this change in the syndicated credit market began to manifest before COVID-19, subsequently becoming more prominent as an increasing number of debtors faced

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[49] This is in part because of allegations specific to the matter, in which the credit agreement was amended in such a way that the amended no-action provisions limited the "plaintiffs' ability to sue." *Boardriders*, 2022 WL 10085886, at *9. Negotiations were also held in secret in spite of the non-majority lenders' attempt to determine whether the debtor required additional capital, which these lenders were allegedly "willing to provide." *Id.*

[50] *See, e.g., id.* at *9–10.

[51] *Serta Simmons*, 2023 WL 3855820, at *2.

distress upon the onset of the pandemic. One might have expected lenders to exclude the possibility of subordinating amendments in the post-pandemic environment, particularly as interest rates began to rise and reshape debtor/creditor dynamics once again. Interesting, though, is the fact that recent years have not entirely changed this element of credit agreements. Even while "Serta-blockers"—which require greater consent for amendments to credit agreements that effectively lead to subordination—are becoming more common, one report suggested that "around 67% of loans in the CS Leveraged Loan Index still allow majority consent for uptier amendments as of Q1 2023."[52] This report also notes that some credit agreements now explicitly allow open market purchases of revised debt to involve "privately negotiated" purchases of existing debt.

The point is that demand remains for the optionality provided by loose credit agreements with potential for subsequent amendment. Sophisticated lenders are consenting to credit agreements that maintain the possibility for future uptier transactions. Is this because contract terms are sticky and slow to adapt? Do lenders still perceive a benefit to maintaining the possibility of uptiering? How have uptier transactions priced in the risk of such lender-on-lender violence in extending credit under new agreements? There are many questions that remain about the impact of the evolving legal regime on the structure of the syndicated credit market. What is interesting is that persistent legal uncertainty has not caused wholesale adaptations in the structure of new credit agreements.

Concern has been raised about the implications of performance enhancement transactions for the broader credit market. At the level of the discrete transaction, courts have generally not wanted to intervene in agreements struck between sophisticated market actors.[53] But at the macro-

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[52] Justin Forlenza, *Justin Forlenza Speaks on Open Market Purchases*, Creditor Rights Coalition (May 12, 2023), available at https://creditorcoalition.org/justin-forlenza-speaks-on-open-market-purchases/.

[53] *See, e.g., Serta Simmons,* 2023 WL 3855820, at *14 (noting that "[w]hile the result may seem harsh, there is no equity to achieve in this case. Sophisticated financial titans engaged in a winner-take-all battle. There was a

level, the risk of such transactions threatens to drive up the cost of capital and to induce the extension of additional credit—not necessarily to create a viable pathway forward for a distressed debtor, but to maximize expected recovery upon a potential future default.

Recent scholarship attempts to identify legal rules that can manage the perverse consequences that permitting these transactions threatens for the broader credit market. One recent piece of scholarship suggests imposing *a fiduciary duty on controlling debt holders* to ensure that they cannot instigate lender-on-lender violence in relation to minority lenders in a syndicated loan.[54] Another work suggests amending Article 9 of the UCC to ensure that bargained-for consent and priority among all secured creditors in a credit agreements is protected from amendment without consent of the affected secured lender.[55] While neither markets nor courts have stepped in to limit performance enhancement transactions to date, concerns about the practice remain, and it seems likely that disputes over new uptiering transactions will continue to arise.

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winner and a loser. Such an outcome was not only foreseeable[;] it is the only correct result. The risk of loss is a check on unrestrained behavior.")

[54] Under this proposal, the duty should be a default rule that is waivable only if the waiver is explicit in the credit agreement. Ryan Schloessmann, *Covenant Control: The Case for Treating Uptier Transactions as a Form of Corporate Control,* 90 U. CHI. L. REV. 1197, 1234 (2023).

[55] The author of this work analogizes between this proposed amendment to the UCC and the "absolute priority" rule in bankruptcy law. Jackson Skeen, *Uptier Exchange Transactions: Lawful Innovation or Lender-on-Lender Violence?*, 40 YALE J. ON REGUL. 408, 450–51 (2023).