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CLIENT ALERT

# Bankruptcy Court Holds That Noteholders' "Sacred Right" Was Not an Anti-Lien Subordination Provision in Permitting Uptier Transaction

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A Delaware bankruptcy court recently held that an issuer did not violate the "sacred rights" of senior secured noteholders by issuing new "superpriority" secured debt in a prepetition uptier transaction.[1] "Uptiering" transactions, a relatively recent trend in aggressive liability management, involve distressed borrowers accessing new capital by amending their existing secured debt documents to permit new "superpriority" secured debt.[2] Thus, rather than removing collateral from the reach of existing creditors (like what happened in J. Crew) and financing the newly unencumbered assets, a borrower incurs new indebtedness secured by superpriority liens having a senior lien to the borrower's existing collateral. A subset of the borrower's senior lenders are typically tapped to provide the additional capital needed to fund an uptier transaction. There have been few courts decisions that have analyzed challenges to such transactions, making the *Bayside Cap. Inc. v. TPC Grp. Inc. (In re TPC Grp. Inc.)* ("*TPC*") decision important and instructive.[3]

## Background

In 2019, TPC Group Inc. (the "Company") issued 10.50% senior secured notes due 2024 (the "Original Notes") under an indenture (the "Indenture") while simultaneously entering into a $200 million ABL facility. The Original Notes and the ABL facility were secured by the same collateral, so the parties entered into an intercreditor agreement (the "Intercreditor").

The Company's financial condition soon deteriorated. In 2021, the Company issued new 10.875% notes (the "New Notes") that were secured by the same collateral as the Original Notes but with a senior lien.[4] To achieve this lien subordination, the Company and a supermajority (i.e., 66.2/3%) of the holders of the Original Notes were required to amend the Indenture and the Intercreditor per their terms. The Company, however, did not offer the New Notes to all holders of the Original Notes. Here, the proposed holders of the New Notes also held a supermajority of the Original Notes that they retained and did not sell back to the Company in connection with the issuance of the New Notes.[5] In 2022, the Company made a second issuance for a total of approximately $204.5 million in principal amount of New Notes in the aggregate.

In June 2022, the Company filed for bankruptcy and sought approval of debtor-in-possession financing ("DIP Financing") from the holders of the New Notes. The DIP Financing included new money plus the roll-up of all of the

New Notes. Holders of approximately 10% of the Original Notes (the "Objecting Noteholders") objected to the proposed DIP Financing, arguing that the amendments to the Indenture and the Intercreditor violated their "sacred rights" under the Indenture and that the "uptiering" transaction was impermissible. Amendments to "sacred rights" under an indenture or loan agreement require the consent of all noteholders or lenders that are affected by the amendment. Therefore, because the Objecting Noteholders' consent to the amendments was not obtained, the Original Notes remained senior in priority to the New Notes.

Specifically, the Objecting Noteholders noted it was a "sacred right" that no change could be made to the Intercreditor or the Indenture "dealing with the application of proceeds of the Collateral that would adversely affect the Holders," without the consent of "each Holder affected thereby...."[6] The Objecting Noteholders asserted that subordinating their debt on the same collateral necessarily dealt with the "application of proceeds of the Collateral" because proceeds will be paid first to the new, senior lienholders. Effectively, the Objecting Noteholders argued that this "sacred right" provision was, in fact, a prohibition on lien subordination.

The Company, on the other hand, argued that the only provision of the Indenture that dealt with the "application of proceeds of the Collateral" was the waterfall, which governs how the indenture trustee allocates payments it makes on account of the Original Notes.[7] According to the Company, provided the indenture trustee distributes the funds that are paid to it ratably, no change has been made to a provision that "deals with the application of proceeds of the Collateral." The Company argued that the amendments did not change *how* the funds paid to the indenture trustee would be distributed (as opposed to *what* funds would be paid to the indenture trustee), and therefore, the section cited by the Objecting Noteholders had not been violated.

# Court's Holding

The court rejected the Objecting Noteholders' argument that the "uptiering" transaction violated their "sacred rights." As an initial matter, the court held that the provision relied upon by the Objecting Noteholders had to be considered in the broader context of the entire bond market. The court held that if the parties intended to expressly prevent the Company from issuing notes senior to the Original Notes, then they would have included an express anti-lien subordination provision, which the court characterized as "sufficiently commonplace" in the market. To prove its point, the court noted that when the parties amended the Indenture, they included such an anti-lien subordination provision in the amendment.

Second, the court considered the provision cited by the Objecting Noteholders in the context of the Indenture's amendment provision. Specifically, the Indenture, among other things, permitted the release of substantially all of the Collateral securing the Original Notes with supermajority consent. The court thought that the release of substantially all of the collateral was more significant than permitting a senior lien on the collateral, despite the Objecting Noteholders' arguments to the contrary. According to the court, it therefore would be illogical for there to be a higher, affected bondholder consent threshold for lien subordination (i.e., every affected holder) than to release substantially all of the Collateral (i.e., 66 2/3%). Thus, the court held that the sacred right requiring affected holder consent for amendments to provisions "dealing with the application of proceeds of Collateral" was not an anti-lien subordination provision.

# Additional Holdings

1. The Indenture contained a "no-action clause" purportedly prohibiting holders from taking action to enforce the terms of the Indenture unless at least 25% of them requested action be taken by the indenture trustee. The Company sought a declaratory judgment that the Objecting Noteholders' suit was barred because the Objecting Noteholders represented only 10% of the Original Notes. In the end, no party contended at oral argument that the "no-action clause" barred the Objecting Noteholders from advancing their principal argument that their "sacred rights" under the Indenture were being violated. In any event, the court noted that "sacred rights" are granted to each individual holder to ensure that an individual's rights cannot be taken away by an amendment to an indenture, regardless of how large or small those holders' share of the total outstanding indebtedness may be. Such "sacred rights" would be rendered meaningless, however, by strict application of a "no-action clause."

2. The court confirmed the long-held understanding that in syndicated transactions "an assignee stands in the shoes of the assignor" regardless of when the assignee purchased the debt.[8] Here, the Objecting Noteholders purchased their debt after the 2021 amendments to the Indenture.
3. Finally, the court responded to the Objecting Noteholders' arguments that not all noteholders were invited to participate in the uptier transactions by concluding that the uptiering "did not violate the letter of the applicable agreements in a manner that gives rise to a claim by the [Objecting Noteholders]."[9]

# Conclusion

For holders of significant amounts of 1L debt or ad hoc groups seeking to inject new, senior capital into a deteriorating company through an uptiering transaction, the *TPC* decision may serve as a road map on how this may be accomplished (depending on the outcome of pending appeals). Plainly, the validity of any uptiering transaction will depend on the language of the underlying documentation. For example, had the Indenture in this case not included a provision permitting a supermajority of noteholders to release substantially all of the collateral, we question whether the court would have reached the same conclusion.

For holders of smaller amounts of 1L debt or opportunistic investors, it will be especially important to fully understand the indenture documents in the context of these recent decisions before investing. Without the express protection of an anti-lien subordination provision, such investments can be risky. Even in the *TPC* case, when the Indenture was amended in 2021 to include an anti-lien subordination provision, it was not a "sacred right," as it only required a supermajority to permit the Company to issue additional senior debt.

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[1] *Bayside Cap. Inc. v. TPC Grp. Inc. (In re TPC Grp. Inc.)*, Nos. 22-10493 (CTG), 22-50372 (CTG), 2022 Bankr. LEXIS 1853 (Bankr. D. Del. July 6, 2022).

[2] Borrowers mayalso use an"uptier"transaction to exchange some or all their existing debt for a lower amount of debt with more favorable terms, whether in connection with a newloan or as a standalone transaction.

[3] *See LCM XXII Ltd. v. Serta Simmons Bedding, LLC*, 2022 WL 953109 (S.D.N.Y. Mar. 29, 2022), and *Audax Credit Opportunities Offshore v. TMK Hawk Parent*, 2021 NY Slip Op 50794(U), ¶ 2, 72 Misc. 3d 1218(A), 150 N.Y.S.3d 894 (N.Y. Sup. Ct. Aug. 16, 2021) (unreported) ("*Trimark*"), cases in which minority lenders were allowed to pursue various claims against majority lenders to challenge similar transactions. Significantly, both the *Serta* and *Trimark* decisions were brought in the context of a motion to dismiss in which the court must consider the evidence in the light most favorable to the non-moving party (i.e., the defendant), whereas the TPC decision was brought on summary judgment, in which a court may make a final determination on the merits as there are no significant facts in dispute.

[4] The indentures governing both the Original Notes and the New Notes are governed by New York law.

[5] There was some discussion that, while this transaction did involve the sale of new debt that would be senior to the old debt, unlike more aggressive uptier transactions, the majority holders here retained their positions in the original debt (now junior), rather than selling that debt back to the borrower and thus exiting the junior tranche. In any event, the court found that the label "uptier" transaction has no legal significance and therefore was not an issue for the court to resolve.

[6] *TPC*, 2022 Bankr. LEXIS 1853, at *26.

[7] *Id.* at *26-27.

[8] *Id.*, at *20 (citing *Septembertide Publ'g, B.V. v. Stein & Day, Inc.*, 884 F.2d 675, 682 (2d Cir. 1989)); *see also In re KB Toys Inc.*, 736 F.3d 247, 254 (3d Cir. 2013) (holding that a claim that would be subject to disallowance under § 502(d) in the hands of the original creditor is equally subject to disallowance after the claim is sold to a buyer).

[9] *Id.*, at *35.

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