The Rise of Uptier Transactions in the Leveraged Loan Market

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THE RISE OF UPTIER TRANSACTIONS IN THE LEVERAGED LOAN MARKET

ABSTRACT

The use of uptier transactions has exploded in the leveraged loan market, precipitated by economic pressure, flexible debt documentation, and permissive treatment by courts. In an uptier transaction, a borrower typically issues senior debt to a new or pre-existing group of lenders by exchanging outstanding debt for superpriority debt, thereby subordinating an existing class of lenders. The principal result of these transactions is that the borrower may obtain follow-on secured financing without offering the investment to all its lenders, thereby materially decreasing the value of each excluded lender’s investment. Due to the material effects of these transactions to unsuspecting lenders, they have been scorned as “hostile restructurings” that promote “theft” and “lender-on-lender violence.”

This Comment will explore (1) how uptier transactions affect a borrower’s capital structure; (2) why a borrower would pursue an uptier transaction and why a lender would consent; (3) the legal and equitable issues courts have addressed when analyzing contested uptier transactions; and (4) the consequences of each court’s ruling to the leveraged loan market. Finally, this Comment will conclude by recommending that Congress and the courts permit stakeholders in the leveraged loan market to self-regulate the treatment of uptier transactions as a practical solution.
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INTRODUCTION

Among other devastating consequences of COVID-19, the Pandemic placed considerable economic strain on the world. To combat the economic pressure, distressed corporate borrowers turned to liability management transactions ("LMTs") to amend their loan documentation to permit new issuance of debt not expressly contemplated by the existing documentation. These transactions typically come in one of two forms: (1) a “drop-down financing” in which a borrower issues senior debt to a new or pre-existing group of lenders by shifting assets outside the existing collateral structure (i.e., structurally senior), or (2) an “uptier transaction” in which a borrower exchanges outstanding debt for superpriority debt, thereby subordinating an existing class of lenders (i.e., contractually senior).

Drop-down financings and uptier transactions may vary based on the bespoke terms of the loan documents. However, a common marker is that a subset of lenders who participate in the transaction receive preferential treatment despite previously being similarly situated to other lenders, typically through enhanced economics and superiority treatment of their debt. Additionally, the subset of lenders excluded from the preferential transaction is not asked by the borrower to consent to the transaction and is often not informed until the transaction has progressed to such a point that it is too late to prevent or has already been executed. Not surprisingly, the actions taken by the borrower and participating lenders in these transactions have received pushback not only by disgruntled non-participating lenders, but also by market commentators who have labeled these transactions as “coercive” and “hostile restructurings” that

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1 See Liability Management Transactions, AM. COLL. BANKR. 3 (Mar. 18, 2023), https://www.americancollegeofbankruptcy.com/file.cfm/29/docs/liability%20management%20transactions%20cle.pdf ("Liability management transactions refer to transactions that allow an issuer or borrower to refinance or restructure its outstanding debt obligations outside of a formal bankruptcy proceeding.").


4 Id.

5 Id.


7 Jeff Raithel, In This Issue: Feature, Liability Management Overview, AM. BANKR. INST. J., June 2018, at 34, 34.

8 Diane Lourdes Dick, Hostile Restructurings, 96 WASH. L. REV. 1333, 1337 (2021). Professor Lourdes Dick coined the term “hostile restructurings,” which will be used throughout this Comment. While this Comment
promote “lender-on-lender violence,”9 “theft,”10 and even “cannibalistic assault.”11

Although LMTs existed before COVID-19,12 the economic challenges imposed by the Pandemic coupled with permissible debt documentation triggered a proliferation in their use and a marked growth in specific contract terms used to create the resulting loans.13 Some of the key macro-economic challenges faced by borrowers were federal fiscal policy in the form of rising interest rates, decreased capital markets activity, and global supply chain delays.14 For corporate borrowers, rising interest rates meant that profitability must increase to meet performance and payment obligations, or that capital must be allocated in other ways to cover the rising cost of using leverage to operate.15 That economic limitation was paired with supply chain issues in the form of does not agree with Professor Lourdes Dick on all issues surrounding LMTs, her characterization of LMTs as “hostile restructuring” is apt.


11 Id. (plaintiffs denouncing LMTs as “cannibalistic assault” given the consequences to non-participating lenders).

12 Liability Management Transactions, supra note 3 (noting that uptier transactions and drop-down financings have been a component of the leveraged loan market for years).

13 See Symposium, The Loan Market Response to Dropdown and Uptier Transactions, CREDITOR RIGHTS COALITION 5 (June 21, 2022), https://creditorcoalition.org/wp-content/uploads/2022/06/slides.Buccola.Nint.pdf (exhibiting that drop-down blockers, a contract term that may be included in credit agreements and can be used to thwart drop-down financings, increased in use between 2017–2020, from about 50% to slightly above 60% from a pool of over 600 leveraged loan credit agreements). Further permissive debt documentation will be explored below in Part III, including the “Serta Loophole.”


halted production of goods, shipments sitting idle in warehouses, and countless logistical problems posed by the Pandemic. These issues resulted in the stagnation of products that could not be sold or shipped to customers, delaying or preventing business.\textsuperscript{16}

With interest rate hikes in 2022 and 2023 signaling a possible ongoing rise in 2024,\textsuperscript{17} and supply chain issues continuing to delay the movement of goods, corporate borrowers will continue to experience internal and external pressures. As a result, borrowers will likely continue to turn to LMTs to manage their financial liability and restructure their debt by employing inventive uses of their capital structure and creative deal terms.\textsuperscript{18}

Borrowers engaging in an LMT often seek to protect themselves from upcoming maturity or interest payment dates and arduous financial covenants in their existing loan documents.\textsuperscript{19} Through such a transaction, a borrower may be interested in extending debt maturities or interest payment dates, thereby allowing more time to make good on its contractual obligations.\textsuperscript{20} Additionally, a borrower may seek to amend or remove covenants that impose obligations the borrower is unlikely to satisfy.\textsuperscript{21}

LMTs have made headlines due to the litigation they triggered, some of which remains active.\textsuperscript{22} In this litigation, non-participating lenders—that did not have notice of the transaction and were not offered an opportunity to participate

\begin{footnotes}
\footnotetext[19]{See generally Jason Kyrwood et al., Lessons for the Loan Market from Recent Liability Management Transactions, INT’L FIN. L. REV., Summer 2020, at 1.}
\footnotetext[20]{See Lourdes Dick, supra note 8, at 1369.}
\footnotetext[21]{See id.}
\end{footnotes}
in the new money financing—typically bring suit against both the borrower and the participating subset of lenders.\textsuperscript{23}

The aggressive nature of LMTs begins much earlier, however, when the borrower and participating lenders negotiate and effectuate the transaction without the non-participating lenders’ knowledge or consent.\textsuperscript{24} That secretive structure all but forces non-participating lenders to seek redress from courts. After all, non-participating lenders are left subordinated or secured by a now-diminished collateral structure with the value of their debt holdings materially diminished and unable to be sold without incurring significant investment loss.\textsuperscript{25}

While it is easy to see how LMTs can strain the relationship between the non-participating lenders and borrower, there is a similar tension between the participating and non-participating lenders. Importantly, the two competing lender groups have no fiduciary duties to each other, allowing them to freely negotiate with the borrower without considering the impact to competing lenders, often to their disproportionate advantage if the negotiation is successful.\textsuperscript{26} This environment cuts against the presumed financing dynamic in which a lender syndicate is aligned and collectively presents a common goal: to provide financing that will yield lucrative returns to all lenders, with beneficial terms applicable to all lenders.

Although the negotiation and dynamic at debt issuance may start with this common interest, the inherently adverse nature of LMTs can turn the collaborative relationship into a hostile one as lenders are pitted against each other to obtain superpriority economics and protections.\textsuperscript{27} The competitive tension created by pitting lenders against each other fosters beneficial commercial terms for the borrower. The participating lender group may be hesitant to seek overly generous terms from the borrower to avoid risking falling out of favor with the borrower and, ultimately, being subordinated or otherwise


\textsuperscript{24} See Kyrwood et al., supra note 19, at 1.

\textsuperscript{25} See Liability Management Transactions, supra note 3.

\textsuperscript{26} Bayside Cap. Inc. v. TPC Grp. Inc. (In re TPC Grp. Inc.), No. 22-10493 (CTG), AP. 22-50372 (CTG), 2022 Bankr. LEXIS 1856, at *12 (Bankr. D. Del. July 6, 2022) (“There is nothing in the law that requires holders of syndicated debt to behave as Musketeers. To the extent such holders want to be protected against self-interested actions by borrowers and other holders, they must include such protections in the terms of their agreements.”); Lourdes Dick, supra note 8, at 1375.

\textsuperscript{27} See Lourdes Dick, supra note 8, at 1372.
worse off than before. This is especially possible when the borrower initiates transaction discussions. In a borrower-driven LMT, lenders do not necessarily seek to subordinate other lenders, especially since certain lenders may serve together on other syndicates. However, when a group of invited lenders realize they may be left subordinated if they choose not to participate, they have little choice, especially given the current treatment of LMTs in which there are little or no adverse consequences for participating lenders.28

The recent explosion of LMTs in the leveraged loan market, and their anticipated prevalence against the current economic and fiscal backdrop, warrants renewed attention from borrowers, lenders, and courts.

This Comment will explore (1) how uptier transactions affect a borrower’s capital structure; (2) why a borrower would pursue an uptier transaction and why a lender would consent; (3) the legal and equitable issues courts have addressed when analyzing contested uptier transactions; and (4) the consequences of each court’s ruling to the leveraged loan market. This Comment will conclude by recommending that Congress and the courts permit stakeholders in the leveraged loan market to self-regulate the treatment of uptier transactions.

I. OVERVIEW OF LIABILITY MANAGEMENT TRANSACTIONS

As mentioned above, LMTs typically come in the form of an uptier transaction or a drop-down financing. To understand the treatment of and response to such transactions, it is helpful to be familiar with the structure of each transaction. Therefore, Part I will break down the most important details of each transaction structure from kickoff to closing. Part I.A will analyze uptier transactions and Part I.B will focus on drop-down financings.

A. Uptier Transactions

In an uptier transaction, the borrower offers new or pre-existing lenders an opportunity to provide new money financing by exchanging existing debt for superpriority debt.29 By injecting new money into the borrower, the participating lenders’ new debt is made contractually senior to the debt provided for in the existing debt instrument, subordinating the class of lenders not invited to participate.30 The contractual seniority is provided for in the new loan

28 See id. at 1379–1387.
29 Jason Kyrwood et al., supra note 19, at 2.
30 Id.
documentation, with collateral or payment priority in favor of the participating lenders.31

The chart below illustrates a typical uptier transaction. Before the uptier transaction is effectuated, the First-Lien loans comprise the entire First-Lien lender base. However, once the transaction is executed, the First-Lien lender base is fractured, with the majority lenders participating in the uptier and receiving Super-Priority loans, while the minority lenders who were not invited to participate are subordinated. Although the minority technically retains First-Lien loans, they are effectively Second-Lien because they are subordinate to the now Super-Priority Loans.

**Figure 1: Uptier Transaction Structure**32

![Diagram of Uptier Transaction Structure]

To effectuate the uptier transaction, the existing loan documentation must be amended since loan documents typically include carefully-drafted protections to maintain the quality of the credit and provide uniform treatment among lenders. Such provisions include “pro rata sharing,” “payment waterfall,”33 and certain

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31 *Id.*
32 This chart is modeled after a chart in the *ICG* complaint. *Boardriders Complaint,* supra note 23, at *23.
By amending the existing loan documentation to loosen or eliminate such provisions, the borrower and participating lenders are free to execute the transaction purportedly without violating the existing loan documentation.

The existing loan documentation may not require unanimous consent to be amended in this fashion, depending on its terms. Consequently, the opportunity to participate is generally offered only to a subset of lenders holding a simple majority (i.e., 51%) or greater (e.g., 67%) of the existing debt as necessary to effectuate the transaction. The existing loan documentation also typically provides that the majority has the authority to direct the administrative agent, in furtherance of consummating the transaction. Accordingly, the borrower and majority lenders will collaborate to make the necessary amendments to the existing loan documentation through an “exit consent,” which is the approval of the amendment effectuating the transaction by the same majority lenders who will become the contractually-senior debt holders. In a three-step process, the borrower and majority: (1) amend the existing loan documentation without the consent of the minority lender group; (2) exchange the majority lenders’ debt for superpriority debt, taking priority over all other lenders, including the minority whose claims were previously pari-passu with the majority; and (3) implement any other necessary changes to the existing loan documentation in furtherance of the transaction.

Key to the transaction is the exchange of some or all of the majority’s existing debt into new contractually-senior debt. Typical characteristics of the exchange include a discount to par (i.e., the principal face amount of the subject debt), extended maturities as compared to the existing debt, and a reduction in interest expense and overall indebtedness due to the exchange. Additionally, the exchange may loosen or strip covenants under the existing loan

34 Kyrwood et al., supra note 19, at 3.
36 See Kyrwood et al., supra note 19, at 2.
37 See, e.g., ICG Glob. Loan Fund I DAC v. Boardriders, Inc., No. 655175/2020, 2022 N.Y. Misc. LEXIS 10375, at *6, *9 (N.Y. Sup. Ct. Oct. 17, 2022) (noting that the administrative agent could only be directed by the “Required Lenders” which was defined under the credit agreement as “[l]enders . . . the sum of whose outstanding [l]oans at such time represents at least a majority of the sum of all outstanding [l]oans.”).
38 See Kyrwood et al., supra note 19, at 2–3.
39 Pari-passu means: “[e]qually and without preference.” This term is generally used to refer to the one or more tranches of debt that are equal in relative priority. Pari-Passu, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/commercial-lending/pari-passu/ (last visited May 25, 2024).
40 Kyrwood et al., supra note 19, at 2.
documentation to provide more flexibility for the borrower going forward with respect to the existing credit facility.\textsuperscript{41} That increased flexibility may permit further amendments in the future. Alternatively, it is possible that the new money financing may include tighter covenants and higher interest rates, significantly furthering the interests of the majority, but necessary for the borrower to obtain the new financing, and placing recovery for the minority further out of reach.

Once the exchange is complete, the majority will hold newly-issued superpriority debt that takes contractual priority over the existing debt.\textsuperscript{42} Additionally, the newly-created superpriority debt may include several tranches of superpriority claims, also making recovery for minority lenders more difficult.\textsuperscript{43} By way of example, in the TriMark transaction the borrower issued $427.5 million in superpriority debt in two different tranches: First-Out and Second-Out Super Senior Debt.\textsuperscript{44} Both tranches subordinated the non-participating lenders’ previously first lien debt—the highest priority in the existing credit facility—into now third lien debt, made junior by $427.5 million.\textsuperscript{45} Meaning, even if the borrower, TriMark, was able to make good on the First-Out obligations, there was an additional tranche that required payment before any subordinated non-participating lenders could recover.

The principal result of an uptier transaction is that a majority subset of lenders now hold the highest priority debt at the expense of previously pari-passu minority lenders who were not given the opportunity to participate.\textsuperscript{46} This is particularly problematic for the minority because as non-participants in the exchange, they receive less than they bargained for when they negotiated the existing credit facility. Placed in a materially-worse position, by no fault of their own, the minority’s chance of recovery in a distressed scenario is placed far from reach, while their motive for investing in the borrower is neglected by the majority lenders and borrower itself.

Typical consequences for the minority lender group include stripped or loosened covenants\textsuperscript{47} and a lower position in the payment waterfall.\textsuperscript{48} For

\begin{itemize}
  \item \textsuperscript{41} Id.
  \item \textsuperscript{42} Elberg et al., supra note 2.
  \item \textsuperscript{44} Id. at *13.
  \item \textsuperscript{45} Id.
  \item \textsuperscript{46} Kyrwood et al., supra note 19, at 2.
  \item \textsuperscript{47} Id.
  \item \textsuperscript{48} Lourdes Dick, supra note 8, at 1371.
\end{itemize}
example, in the TriMark transaction, the existing loan documentation provided that if the borrower incurred new debt, it was limited to debt that ranked equal or lower in payment priority to the existing first lien debt, held by all first lien lenders.\textsuperscript{49} In other words, the borrower could not issue new debt that would place any new or existing lenders above existing senior lenders in priority. To accomplish the exchange, that provision was removed during the amendment process.\textsuperscript{50} In the same transaction, the existing loan documentation required any debt exchange (which is a component relied on in an uptier transaction) to be on a pro rata basis, thereby including “all” first lien lenders in a potential exchange.\textsuperscript{51} The borrower and majority amended that section to allow non-pro rata debt exchanges to “one or more” first lien lenders.\textsuperscript{52} The removal and modification of those limiting sections, among others explored below, facilitated the subordination of the minority lender group, pushing them lower in the payment waterfall as new senior classes of claims were created for the newly-issued debt.

An additional effect to minority lenders is that they do not have the option to participate in a follow-on investment in a business they originally saw opportunity in. As further investment by the majority lender base augments the business’s valuation, the minority is left out of the opportunity. This result further exacerbates the harm to the minority whose now-subordinated debt will trade at a lower value, stagnating its liquidity.\textsuperscript{53}

Since uptier transactions occur outside of bankruptcy, the priority scheme dictated by the Bankruptcy Code (the “Code”) does not control, and instead the contractual ordering of the waterfall governs, prescribed by the borrower and majority lenders without minority consent. Additionally, because of the secretive nature of obtaining the requisite consents to execute the amendments, the minority lenders are typically left unaware of their subordination until it is too late to prevent or it has already been accomplished. Thus, as uptier transactions have increased in popularity, minority lenders have turned to the courts for recourse.

\textsuperscript{49} TriMark, 2021 N.Y. Misc. LEXIS 4475, at *14.
\textsuperscript{50} Id.
\textsuperscript{51} Id.
\textsuperscript{52} Id.
\textsuperscript{53} See, e.g., id. at *12–15.
B. Drop-Down Financings

In a drop-down financing, the borrower identifies its valuable collateral that can be split from the rest of its business, such as intellectual property or a separate business line.\(^5^4\) Typically through a series of intermediaries, the borrower transfers the collateral to a pre-existing or newly-formed unrestricted subsidiary or an excluded non-guarantor restricted subsidiary.\(^5^5\) The borrower is careful to transfer the collateral to either an unrestricted or excluded subsidiary because that ensures the subsidiary will not be subject to the debt obligation or related covenants of the existing credit facility, freeing the subsidiary from limitations incurred by the borrower.\(^5^6\)

Once the transfer is complete, the lien that previously secured the transferred collateral is released since the collateral is no longer held by a restricted loan party.\(^5^7\) This allows the now unencumbered assets to be pledged to secure new money financing that the unrestricted subsidiary will issue to participating existing or new lenders.\(^5^8\) The new claims will enjoy a structurally senior position given their direct recourse to the valuable collateral and as a consequence will be secured by more valuable debt, subordinating lenders who were not invited to participate.

\(^5^4\) Kyrwood et al., supra note 19, at 1.
\(^5^5\) Id.
\(^5^6\) See id. at 1–2.
\(^5^7\) Id.
\(^5^8\) Id.
A drop-down financing may also include a “roll-up” component, in which participating existing lenders exchange the existing debt they hold in the borrower for new debt in the unrestricted subsidiary. By effectuating a roll-up, participating lenders effectively improve their priority position, subordinating other lenders who were not included. The roll-up feature is especially harmful to non-participating lenders when the assets are transferred to an unrestricted subsidiary since the subsidiary will not be subject to debt ceilings or other covenants in the existing credit facility which limited the borrower’s ability to issue further debt. Therefore, the subsidiary will have the freedom to incur large amounts of debt that leave the subordinated non-participating lenders with little or no chance of recovery from the valuable collateral. In addition to limiting non-participating lenders’ likelihood of meaningful recovery, the subordination makes the debt held by non-participating lenders less liquid due to its diminished value.

Including a roll-up feature may be key for a borrower to obtain the threshold number of lenders necessary to amend the existing loan documentation in furtherance of the transaction. If a roll-up is not included, the participating lenders will retain their existing claims that are subordinated by the new financing. Although the participating lenders will also hold structurally senior claims by virtue of participating in the drop-down, they will still hold additional claims pari-passu with non-participating lenders, absent a roll-up feature.

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59 Id. at 2.
60 See id. at 1–2.
61 See id. 2.
62 See id.
Therefore, a roll-up can be quite valuable to participating lenders and may be offered in exchange for beneficial terms to the borrower-subsidiary, such as loose covenants and other favorable terms.

The best known drop-down financing is the 2017 transaction in which J. Crew was the borrower. J. Crew had $540 million in outstanding payment-in-kind debt, the principal amount of which would have increased by $125 million on account of payment-in-kind interest through maturity, if left outstanding. J. Crew needed to address the maturing payment-in-kind debt but did not have additional valuable assets to pledge as collateral since all its assets were already securing over $1.5 billion in loans, precluding it from obtaining additional secured financing to address the payment-in-kind debt. To alleviate its indebtedness and prepare a path forward, J. Crew engaged in a drop-down financing in which it (1) transferred collateral outside the existing collateral structure, (2) pledged the transferred collateral to secure $300 million in new money financing, and (3) exchanged the payment-in-kind debt nearly in full for senior secured notes.

The first step in the J. Crew drop-down process was to transfer collateral outside the existing collateral structure. J. Crew transferred most of its pledged intellectual property outside of its existing collateral structure to a restricted subsidiary. The credit agreement provided that as a restricted subsidiary, it was subject to the covenants and other terms of the existing debt, including negative covenants preventing the incurrence of further debt. However, the restricted subsidiary “was not a guarantor of the existing debt.” This is particularly important because the credit agreement provided that a non-guarantor restricted subsidiary (i.e., the restricted subsidiary at issue here) could transfer assets to any unrestricted subsidiary. This element of a credit agreement is known as a “trap door.” It provides a restricted subsidiary holding collateral the ability to

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64 Id.
65 Id. (noting that 99.9% of the PIK notes participated in the exchange).
66 See id.
67 Id.
68 See id.
69 Id.
70 See id.
transfer assets outside the collateral structure to an unrestricted subsidiary.72 Absent a “trap door” provision, such a transfer is prohibited. As a result, the non-guarantor restricted subsidiary was free to transfer the intellectual property to an unrestricted subsidiary.73

With the intellectual property transferred to an unrestricted subsidiary, the next step was to pledge the intellectual property to secure new financing. J. Crew did so by obtaining $300 million in new money financing from a subset of pre-existing lenders, secured by the intellectual property.74

The final step in the drop-down was to exchange the payment-in-kind debt. During the resulting litigation brought by non-participating lenders contesting the drop-down financing, J. Crew negotiated to exchange the maturing and now subordinated payment-in-kind notes for new, senior secured notes issued by the unrestricted subsidiary and secured by the intellectual property, along with preferred and common equity in the unrestricted subsidiary.75

Ultimately, J. Crew was unable to avoid bankruptcy, filing for chapter 11 in 2020.76 Still, the company successfully reduced its indebtedness by $340 million and extended its maturity profile using the drop-down financing, delaying the need to seek bankruptcy relief by three years.77 Additionally, J. Crew’s bankruptcy filing was premised primarily on extraneous and unforeseen factors generated by COVID-19 that could not have been anticipated at the time of the transaction,78 indicating that the success of the drop-down should not be judged exclusively by the balance sheet pressures left unrelieved by the drop-down financing.

As illustrated above, drop-down financings and uptier transactions substantively differ. In an uptier transaction, non-participating lenders are contractually subordinated to newly issued, senior debt, secured by the same

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72 See id.
73 How Did They Do It? J. Crew & The Original Trap Door, supra note 63.
74 Id.
77 How Did They Do It? J. Crew & The Original Trap Door, supra note 63.
collateral as the non-participating lenders’ debt. By contrast, a drop-down removes valuable collateral from the existing collateral structure and the borrower pledges the same collateral to secure new, structurally senior debt. Another key difference is that in a drop-down financing, once the collateral transfer is complete, the lien securing the collateral is automatically released since the collateral is no longer held by a restricted loan party. By contrast, once an uptier transaction is complete, the non-participating lenders are not stripped of their liens and continue to hold first lien claims, albeit contractually subordinated to the superpriority liens generated by the uptier.

While all borrowers and lenders should be aware of both types of LMTs—drop-down financings and uptier transactions—the remainder of this Comment will focus on uptier transactions. On one hand, many borrowers do not have valuable intellectual property or other independently valuable assets to pledge as collateral, making a drop-down financing an unrealistic option. On the other hand, all borrowers with debt instruments containing the flexible and increasingly-prevalent terms discussed below may seek to incur new debt, regardless of the unique nature of their collateral. This suggests that uptier transactions may be more popular than drop-down financings in the future, absent judicial intervention or a trend toward less permissive loan documentation.

II. WHY PARTIES ENGAGE IN UPTIER TRANSACTIONS

Part II will focus on the motivations that lead loan parties to engage in an uptier transaction. Part II.A will focus on a borrower’s financial condition and Part II.B will consider lenders’ objectives.

A. Borrower’s Financial Condition

Borrowers engaging in uptier transactions are typically private-equity-owned businesses, experiencing balance sheet pressures and challenging

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79 Kyrwood et al., supra note 19, at 2.
80 Id. at 1–2.
81 Id.
82 See id. at 2.
83 See generally The Loan Market Response to Dropdown and Uptier Transactions, supra note 13 (establishing that Lien Subordination blockers used to thwart uptier transactions are becoming more common, and showing that Lien Subordination blockers were included in barely 10% of a pool of more than 600 leveraged loan credit agreements in 2017, but by 2021 were included in 60%).
Accordingly, their success in executing uptier transactions is due, at least in part, to their private equity owners. To protect their investments, private equity sponsors solve sophisticated problems that their portfolio companies are experiencing and prefer to make every possible effort out-of-court to delay or avoid bankruptcy. Therefore, sponsor-owners may exert external pressure on borrowers to restructure their debts through a creative transaction like an uptier.

In certain instances, the sponsor can benefit from the uptier. As owner of the company, the sponsor has a financial interest in its portfolio company improving its balance sheet, elevating the company’s valuation. Additionally, the sponsor often leads the financing efforts and therefore has the opportunity to participate in the new financing. In the Boardriders transaction, the sponsor was Oaktree Capital Management, a leading private equity firm. The borrower issued superpriority debt in three different tranches: Tranche A ($45 million in superpriority debt), Tranche B-1 (about $80 million in superpriority debt, consisting of $45 million in new money financing and a $35 million roll-up), and Tranche B-2 (about $286 million in superpriority debt). Oaktree was included in all three tranches, increasing its financial interest in its portfolio company.

Contrary to the claims of non-participating lenders, borrowers and sponsors do not necessarily engage in uptier transactions out of a sense of animosity. Instead they are motivated by commercial considerations. Namely, they seek an alternative to chapter 11 bankruptcy since uptier transactions provide many of the same benefits of bankruptcy, without the drawbacks.

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87 See, e.g., id. at *3–5. Here, equity sponsors Centerbridge Partners and Blackstone participated in the uptier transaction.
89 Id. at *10.
90 Id. (participating lenders, including Oaktree, particularly benefited from the roll-up feature included in this exchange because the existing debt valued at 40–50% below par was exchanged at par).
91 See Unglesbee, supra note 85.
While uptier transactions are consummated out-of-court, they provide a similarly comprehensive debt restructuring to bankruptcy, producing cost-savings and maintaining or strengthening the borrower’s value as a going concern.\(^93\) Like bankruptcy, the resulting savings and liquidity produced by an uptier transaction can be allocated to reduce existing indebtedness, fund the borrower’s existing line of business, and expand the business if the borrower’s conditions turn around.\(^94\) Also similar to bankruptcy, the preservation of the business benefits more than just the parties to the transaction. By breathing new life into the business and carrying on operations, employees keep their jobs and suppliers and vendors continue working with the borrower.\(^95\) Additionally, customers receive the goods or services they need, and shareholders retain their equity.\(^96\)

Although uptier transactions have been labeled “coercive”\(^97\) and “hostile,”\(^98\) the borrower’s selection process for determining which lenders will be invited to participate is motivated by similar concerns that drive the classification scheme in bankruptcy and may produce similar benefits. In bankruptcy, classes are formed to vote on a plan of reorganization, with the debtor carefully sorting creditors into these classes with proposed recoveries that are fiscally manageable and provide the best path forward.\(^99\) In an uptier transaction, the borrower’s choice to include only some of the existing lenders in the exchange is likewise intended to enhance the borrower’s path forward. By inviting only a subset of existing lenders to participate, the borrower is able to win a “zero-sum game,”\(^100\) in which each invited lender fears if they do not participate, the borrower and other lenders will benefit from their non-participation, and as a consequence, subordination.\(^101\) This places invited lenders in a difficult situation, all but

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\(^93\) See Lourdes Dick, supra note 8, at 1340.
\(^94\) See id.
\(^95\) Id.
\(^96\) Id.
\(^97\) Raithel, supra note 7, at 34.
\(^98\) See generally Lourdes Dick, supra note 8.
\(^100\) Zero Sum Game (and Non Zero Sum), CORP. FIN. INST. https://corporatefinanceinstitute.com/resources/economics/zero-sum-game-non-zero-sum/ (last visited May 25, 2024) (“A zero sum game is a situation where losses incurred by a player in a transaction result in an equal increase in gains of the opposing player.”); see also Zero-Sum Game, GRAMMARIST, https://grammarist.com/usage/zero-sum-game/ (last visited May 25, 2024) (“A zero-sum game is a situation, especially a competitive one, in which there is no net gain among the participants. If one gains, it means others have to lose an equivalent amount.”).
\(^101\) In an uptier transaction, the zero-sum game is exploited in that if one party gains (the borrower and lenders who participate in the exchange), then, by definition, the other party has to lose (the non-consenting lenders who do not agree to the terms proposed by the borrower).
forcing them to consent to the exchange to prevent falling out of favor with the borrower and being replaced in the offering.

Additionally, each invited lender wants to prevent falling victim to a “prisoner’s dilemma,” in which no agreement is reached and the company fails. In that situation, both the borrower and all lenders are worse off since the company collapses, with each lender losing all or most of the value of their debt. By pressuring each invited lender to consent to the terms of the exchange, the borrower draws on the pressures of the zero-sum game and prisoner’s dilemma, forcing invited lenders to choose between consenting to terms favorable to the borrower or risk losing the value of their investment. Ultimately, this provides the best possible commercial terms for the borrower in the new credit facility, enhancing the borrower’s likelihood of success following the uptier transaction.

Uptier transactions also allow the borrower and participating lenders to avoid the negative aspects of bankruptcy. Bankruptcy may produce a public stigma that can be avoided by an out-of-court restructuring that is limited to private negotiations and non-publicly disclosed loan documentation. This is especially true in an uptier transaction in which the transaction is kept secret, even from a subset of existing lenders, until the negotiations are all but complete. Further, the public is typically only made aware of the commercial terms of the transactions upon the borrower issuing a carefully-crafted press release that positions the deal in the best possible light. That being said, because of the adverse nature of uptier transactions, several transactions have been litigated.

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102 Prisoner’s Dilemma, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/economics/prisoners-dilemma/ (last visited May 25, 2024) (“The prisoner’s dilemma . . . is an approach where individual parties seek their welfare at the expense of the other party.”).

103 In an uptier transaction, the prisoner’s dilemma is exploited in that if the borrower and invited lenders cannot reach an agreement to effectuate the exchange, then both risk the company failing. This is especially true because the impetus for the negotiation is the borrower’s state of distress.

104 As mentioned above, see supra notes 100–03, this is the culmination of the exploitation of the “zero-sum game” and “prisoner’s dilemma” in an uptier transaction.


106 Cf., e.g., TriMark Complaint, supra note 23, at *44.

after the closing, receiving some industry attention, but nowhere near the widespread public attention devoted to large-scale chapter 11 cases.  

The borrower and lenders may also consider commercial factors in electing an uptier transaction over bankruptcy. For example, all borrowers wish to limit business disruption, which they risk to a greater degree if they proceed in bankruptcy. Such disruption can include employees leaving, vendors ceasing to do business with the debtor, losing customers who fear worsening quality of goods or services as a result of bankruptcy, objection to operational relief from creditors and other parties in interest, and more. Additionally, creditors risk a potentially worse recovery in bankruptcy since they are subject to bankruptcy’s priority scheme, which requires equal treatment among creditors in the same class. By contrast, in an uptier transaction, lenders can contractually subordinate other lenders, avoiding bankruptcy’s priority scheme and prohibitions on disparate treatment among similarly situated lenders.

Finally, restructuring through bankruptcy mandates the bankruptcy court’s supervision and the involvement of third parties such as the United States Trustee and, potentially, equity and unsecured creditor committees, among others. Actions outside the borrower’s ordinary course of business will be subject to the court’s supervision and approval and may encounter scrutiny and even objection from third parties. This includes any debtor-in-possession financing the borrower seeks, which will likely include terms more onerous to the borrower than the terms in an uptier transaction and typically are challenged by parties in interest. By restructuring through an uptier transaction, borrowers avoid the involvement of the court, immediate challenge from third parties, and are free to seek financing without requiring court approval.

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111 Kyrwood et al., supra note 19, at 2.
115 See Lourdes Dick, supra note 8, at 1349–51.
B. Lenders’ Objectives

While negotiations surrounding uptier transactions are typically initiated by the borrower, each lender has an interest in proactively engaging with the borrower and other lenders to reach their financial goals. During the height of COVID-19, it was particularly difficult for opportunistic lenders to find new, lucrative investment opportunities given the relatively low cost of credit and tightened lending standards resulting from the increased investment risk. Uptier transactions provided a solution. Without expending resources to source new deals, existing lenders were able to use uptier transactions to allocate capital to maintain or increase their yield under existing investments. Although many companies struggled during the Pandemic, it may have been preferable to engage in a follow-on investment (e.g., an uptier transaction) rather than seeking new investments, given the lack of attractive alternative markets in light of the Pandemic and the macro-economic challenges it produced.

Uptier transactions are also attractive to lenders because of the existing borrower-lender relationship established during the initial investment. By the time discussions regarding an uptier transaction begin, lenders are already intimately familiar with the borrower, and their private equity sponsor if the borrower is sponsor-owned. Consequently, the lenders understand the borrower’s business so it may be more efficient to collaborate with them to turn around their business, rather than seek new and uncertain investment opportunities that may have a competitive bidding process, include borrower-friendly terms, produce a lower yield, and may be costly and time-consuming.

Since lenders do not owe fiduciary duties to other lenders in a consortium, they are free to address these issues without considering the impact to other lenders. Thus, lenders invited to participate in an uptier transaction can act in their best interest, disregarding any harm to the non-participating lenders caused


118 Maintaining an existing relationship can be especially important when the borrower is sponsor-owned. In those situations, lenders may prioritize cooperating with the sponsor, who spearheads the financing efforts, because the lender will want to be included in future financing consortiums with the borrower at issue and, potentially, other entities under common investment by the sponsor.

119 Lourdes Dick, supra note 8, at 1376.
by the exchange. While this contradicts the norms and customs of financing arrangements in which lenders are treated equally, the expediency it provides is another reason lenders may consent to uptier transactions, but should likewise be attentive when entering a syndicate.

Lenders must also consider their entity structure and investment profile when engaging in uptier transactions. Lenders may consist of Collateralized Loan Obligation (“CLO”) funds or Business Development Companies (“BDCs”) that are limited in the assets they can hold or receive in connection with an in- or out-of-court restructuring. CLO funds generally manage a portfolio of leveraged loans, typically senior-secured loans rated below investment grade. Likewise, CLO funds may have restrictions on industry- and issue-concentration limits which prevent specific types of holdings beyond a certain threshold, and coverage ratio thresholds that assess the borrower’s ability to service its debt.

A BDC is a closed-end fund that typically invests in smaller distressed companies—notably, the typical borrower in an uptier transaction. A limitation of BDCs is that they must invest at least 70% of their assets under management in private companies or low-volume public companies with market values of less than $250 million. While distressed borrowers engaging in uptier transactions may fall below the market value maximum based on market capitalization, it is possible for such a business to sit well above the $250 million maximum based on their amount of indebtedness. Thus, if a borrower’s indebtedness places it above the maximum, BDCs will be precluded from holding equity in the borrower, which is the typical recovery for secured creditors in bankruptcy.

A key limitation of CLO funds and BDCs is that both are limited in the degree of high-risk loans they can hold. The risk of the loans are determined by

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120 See id.
121 See Raithel, supra note 7, at 34–35.
123 Id.
126 Although this scenario is possible, it is unlikely that a private-equity-backed borrower and the sponsor will expend the time and resources necessary to execute an uptier transaction when the borrower’s equity value is below the market capitalization maximum of $250 million but its indebtedness is greater than $250 million, as it is simply not worth it.
their investment rating. In the case of loans held by CLO funds, the portfolio typically cannot be composed of more than 7.5% CCC-rated debt or its equivalent. The loans that are CCC-rated or similarly lower-rated are often reserved for exchanges (e.g., an uptier transaction). While loans held by CLO funds and BDCs may initially receive a rating that the entities can support, the rating can be downgraded if the lenders are subordinated or their loans are otherwise worse off due to the uptier transaction. As a result, if the loan is downgraded to the point that it can no longer be held by the CLO fund or BDC lenders, they must divest the loan, often incurring a loss on the investment, which may harm their overall portfolio returns. For that reason, CLO funds and BDCs must be especially proactive when entering lender syndicates.

The most meaningful restriction on CLO funds and BDCs is the complete prohibition on holding equity, making it difficult for them to engage in the full suite of options available under traditional restructurings. The form of recovery for senior secured creditors in a reorganization or other equitization transaction may include equity in the reorganized borrower. Thus, a debt-for-equity exchange is not a viable route to addressing CLO fund and BDC lenders.

It may be possible to work around this issue by proceeding with bankruptcy and providing the CLO fund and BDC creditors with either cash or new debt that fits their investment guidelines, while other similarly-situated creditors receive equity. However, that can be difficult to coordinate, may extend the plan negotiations and complexity, and will require the court’s consent due to the

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128 See Norton et al., supra note 122.
129 CCC-rated debt refers to the rating set by S&P Global Ratings. The equivalent rating is CCC by Fitch Ratings and Caa by Moody’s Investors Service. Santos, supra note 127.
130 See Norton et al., supra note 122.
132 See Norton et al., supra note 122.
133 See id.
135 But see Norton et al., supra note 122. This article describes the bankruptcy proceedings of Deluxe Entertainment, and is a depiction of the challenges of a new debt issuance to CLO-fund creditors. These CLO-fund creditors consented to an expedited prepackaged plan of reorganization in which they would receive new debt. However, during the life of the plan, the ratings of the loans held by the CLO-fund creditors were downgraded to CCC, placing the CLO funds above their cap for CCC-rated debt. The issue was ultimately resolved by forcing the debtor into an extended chapter 11 process, increasing the time and costs necessary to effectuate the reorganization.
disparate treatment to creditors within the same chapter 11 plan class.\(^{136}\) Additionally, debt and or cash recoveries to CLO fund and BDC creditors may not be feasible depending on the debtor’s capital structure and post-reorganization business plan (i.e., debtor does not have enough cash emerging from bankruptcy). As a result, a non-traditional workout such as an uptier transaction that will provide these lenders with recoveries in the form of debt that fits their investment guidelines may be more attractive to CLO funds and BDCs so long as they comply with the other limitations addressed above.

### III. Key Issues in Uptier Transactions and Their Treatment by Courts

Once the necessary amendments to the existing credit facility are complete, the borrower and participating lenders can execute the uptier exchange purportedly without violating the existing loan documentation. Notwithstanding superficial compliance with the existing documentation, the non-participating lenders may allege violations and bring suit.\(^{137}\) At this point, there have not yet been any decisions on the merits. Still, the few opinions published on motions to dismiss are insightful. Part III will analyze (1) the legal and equitable arguments non-participating lenders have raised in contesting uptier transactions; (2) the defenses used by borrowers and participating lenders; and (3) the preliminary decisions different courts have reached on each cause of action.

Underlying each complaint is the proposition that uptier transactions are coercive and made in bad faith.\(^{138}\) Non-participating lenders depict the exchange process as “lender-on-lender violence,”\(^{139}\) in an effort to undermine the legitimacy of the transaction.\(^{140}\) In furtherance of their argument, non-participating lenders characterize the practice as a secretive negotiation process executed behind their backs, without those lenders’ knowledge or consent or even an offer to participate.\(^{141}\) Borrowers and participating lenders can,

\(^{136}\) 11 U.S.C. § 1123(a)(4) (requiring that creditors within the same class receive equal treatment); Ad Hoc Comm. of Non-Consenting Creditors v. Peabody Energy Corp. (In re Peabody Energy Corp.), 933 F.3d 918, 925 (8th Cir. 2019) (holding that disparate treatment is acceptable when a reorganization plan “treat[s] one set of claim holders more favorably than another so long as the treatment is not for the claim but for distinct, legitimate rights or contributions from the favored group separate from the claim”).

\(^{137}\) 11 U.S.C. § 1123(a)(4) (requiring that creditors within the same class receive equal treatment); Ad Hoc Comm. of Non-Consenting Creditors v. Peabody Energy Corp. (In re Peabody Energy Corp.), 933 F.3d 918, 925 (8th Cir. 2019) (holding that disparate treatment is acceptable when a reorganization plan “treat[s] one set of claim holders more favorably than another so long as the treatment is not for the claim but for distinct, legitimate rights or contributions from the favored group separate from the claim”).

\(^{138}\) Lourdes Dick, supra note 8, at 1370–71.

\(^{139}\) See TriMark Complaint, supra note 23, at *5, *37, *50; Boardriders Complaint, supra note 23, at *32, *50.

\(^{140}\) See McElhaney, supra note 9 (using the term “creditor-on-creditor violence.” This Comment uses the term “lender-on-lender violence” since the exchange occurs outside of bankruptcy).

\(^{141}\) See TriMark Complaint, supra note 23, at *44.
however, justify their surreptitious engagement because both fear suit and a
court order of injunctive relief that would prohibit the transaction. Such a result
could jeopardize the borrower’s financial health and viability as a going concern.

To determine whether the borrower’s and participating lenders’ actions are
permitted by the loan documentation, some courts have relied heavily on the
express language of the documents. Those documents contain consent
thresholds necessary to produce the amendments required to execute the
transaction. The loan documentation may require unanimous lender consent to
amend specific provisions, referred to as “sacred rights.” These are typically
the fundamental concerns in a credit agreement that govern the economics of the
transaction, such as maturity date, principal, interest rate, interest payment
periods, pro rata sharing, and more. If not expressly set forth, it is often
unclear whether an issue falls within the sacred rights such that it requires
unanimous consent. In situations requiring unanimous consent, the borrower and
majority lenders are unable to make amendments without violating the
agreement. By contrast, the loan documentation may provide that only a simple
majority or supermajority (e.g., two-thirds) of lenders are necessary to amend
any or specific provisions in the agreement.

The Credit Suisse Leveraged Loan Index tracks leveraged loans issued by
lenders overall and loans issued specifically by private-equity-owned
borrowers. As of September 2023, 62.4% of those loans overall and 63.4% of
the leveraged loans issued by private equity-owned borrowers permitted
majority voting, rather than requiring unanimous consent, with respect to
subordination of liens securing such loans. Not surprisingly, lower-grade
loans are even more permissive, with CCC-rated loans or its equivalent
permitting majority voting to make such amendments in 67.3% of the credit
agreements surveyed overall and 66.7% for those issued by private equity-

142 See, e.g., Bayside Cap. Inc. v. TPC Grp. Inc. (In re TPC Grp. Inc.), No. 22-10493 (CTG), AP 22-50372
143 The Cramdown, Lender on Lender Priming, O’MELVENY, at 04:03 (Nov. 29, 2020) (downloaded using
Overcast).
144 Id. at 05:20.
146 See generally Lens on Loopholes Q3 2023 Update: Share of Index Loans with J. Crew / Serta / Chewy /
Envision Loopholes Across the Index and a Breakdown by Sponsor Group, CREDITSIGHTS (Dec. 13, 2023),
https://know.creditsights.com/lens-on-loopholes-q3-2023-update/.
147 Id.
owned borrowers.\textsuperscript{148} Uptier transactions have become more pervasive because of this increased trend in majority consent voting.\textsuperscript{149}

\textit{Figure 3: Pervasiveness of the “Serta Loophole”}\textsuperscript{150}

Not all courts have agreed that the express language of the loan documentation is determinative.\textsuperscript{151} Those courts have also considered the “spirit of the agreement” in determining whether uptier transactions should be valid, disregarding to a degree the supposed permissiveness of the express language of the loan documentation in favor of the spirit of the original deal and notions of fair play.\textsuperscript{152} The spirit of the agreement may be extended to characterize specific provisions as sacred rights, requiring unanimous consent because those terms are integral to the credit agreement notwithstanding the lack of supporting express contractual language.\textsuperscript{153}

\begin{itemize}
\item \textsuperscript{148} \textit{Id.}
\item \textsuperscript{149} Note that majority consent voting in this context refers strictly to permitting subordination or release of liens through amendment by majority consent voting, rather than amendment to the credit agreement in its entirety.
\item \textsuperscript{150} \textit{Lens on Loopholes Q3 2023 Update, supra note 146.}
\item \textsuperscript{152} See, e.g., \textit{id.}
\item \textsuperscript{153} See \textit{id. at *20–21, *24.} 
\end{itemize}
Even if non-participating lenders fear the plain language of the existing loan documentation may be interpreted to permit an uptier transaction, it is practically necessary for non-participating lenders to initiate suit and rely, at least in part, on the “spirit of the agreement” to frustrate the transaction. The seeming permissibility of an uptier transaction based on the express terms of the documents does not lend support to the non-participating lenders. Therefore, they must appeal to something beyond the plain language of the agreement to sway the court.

Further, if non-participating lenders rely solely on the plain language in such situations, they are certain to have their debt substantially diminished in value to pennies on the dollar or to no value at all given the potential for the court to dismiss their arguments that are premised wholly on unsupportive contractual language. While the language of each credit agreement varies, so do courts’ interpretations, presenting the possibility that a court may sympathize with the non-participating lenders based on arguments rooted in the spirit of the agreement.

Additionally, litigation provides extra-contractual recourse to slow down, prevent, or even unwind the transaction. In litigation, the non-participating lenders have outsized negotiating leverage that they did not have earlier during the formulation of the uptier. The newfound negotiating leverage could present the opportunity for non-participating lenders to settle for more than they would receive through a judgment. Likewise, it might offer the possibility to participate in the transaction, either as a settlement or by judicial ruling.

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157 See, e.g., Press Release, TriMark USA, TriMark USA Announces Resolution of Litigation with Its Lenders, PR Newswire (Jan. 7, 2022, 4:40 PM), https://www.prnewswire.com/news-releases/trimark-usa-announces-resolution-of-litigation-with-its-lenders-301456561.html. Here, the borrower and non-participating lenders settled, resulting in a dollar-for-dollar exchange of all outstanding first lien term debt for Tranche B Loans, subject to the borrower’s Super Senior Credit Agreement. Note that, despite the non-participating lenders’ inclusion through the settlement, the superpriority Tranche A Loans issued to participating lenders retained their position in the borrower’s capital structure, maintaining priority over the Tranche B Loans now provided by the non-participating lenders.

158 See, e.g., id.
A. No-Action Clause

The amended “No-Action” clause is often the first hurdle for non-participating lenders in contesting uptier transactions. Typically, a No-Action clause provides the manner in which a lender can bring suit or exercise remedies against the borrower under a credit agreement. It is intended to protect borrowers from frivolous, unfounded, or duplicative claims brought by lenders acting in favor of their own interests at the expense of the majority. Additionally, the No-Action clause is intended to represent an “ex ante agreement” by lenders to sacrifice individual rights to benefit the transaction overall. Key to the No-Action clause is that it generally requires the creditors to direct an administrative agent to bring suit to avoid a conflict of interest. While the opposing participants in these situations are coupled financially as members of a syndicate, they also have conflicting interests given the subordination of a subset by way of the uptier. Thus, there are both practical and policy reasons to prevent a lender or group of lenders from individually bringing suit on its own behalf in these situations.

During the amendment process, the borrower and majority lenders may amend the No-Action clause to preemptively thwart post-closing litigation by ensuring the administrative agent requirement is in place, including a cash indemnity requirement, and prohibiting specific lender action. If suit is commenced, they will rely on the amended No-Action clause as grounds for a procedural defense, claiming the minority lenders do not have standing to sue because they acted in violation of the No-Action clause. Three key issues have arisen in the context of the No-Action clause: (1) the role of the administrative agent, (2) the cash indemnity requirement, and (3) what lender actions are prohibited.

160 See Quadrant Structured Products Co., Ltd. v. Vertin, 23 N.Y.3d 549, 565–66 (2014); see also Moss, supra note 159.
162 Moss, supra note 159.
163 See, e.g., TriMark, 2021 N.Y. Misc. LEXIS 4475, at *20–21.
First, loan documentation generally restricts lenders from commencing suit directly, instead requiring an administrative agent to bring suit. In several contested uptier transactions, the minority lenders have initiated suit directly without directing an administrative agent to do so to ensure their interests are adequately represented and to maintain control over the case, rather than cede control to an administrative agent that is paid by the borrower.

In *TriMark*, the borrower and majority lenders asserted that the minority lenders lacked standing because they brought suit themselves, instead of directing the administrative agent. While the language of the amended No-Action clause required minority lenders to direct the administrative agent to commence suit rather than do so directly on their own behalf, the New York Supreme Court rejected the defense. The court noted that the amendments to the No-Action clause were made “to prevent these Plaintiffs from suing these Defendants in connection with this transaction—a preemptive self-pardon, of sorts.” The court reasoned that the secretive and coercive nature of the amendment and entire transaction cut against the essence of a No-Action clause in which the parties voluntarily sacrifice some rights to produce a “salutary benefit” to all parties. Because the minority lenders’ rights were involuntarily stripped by way of the amendment, the court rejected the defendants’ motion to dismiss on the grounds of the No-Action clause. This is a notable example of the court using its equitable power to embrace the “spirit of the agreement,” as opposed to relying on the plain meaning of the contractual text.

The second issue that arises with respect to the No-Action clause is a cash indemnity requirement. The amendment often adds a condition to suit that any lenders seeking to bring suit provide a cash indemnity. In *Boardriders*, the minority lenders did not provide a cash indemnity when they directly brought suit, despite the requirement in the amended No-Action clause. For the same reason the court rejected the enforceability of the administrative agent requirement in *TriMark*, the court in *Boardriders* disregarded the cash indemnity

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165 See Moss, supra note 159.
166 See, e.g., *TriMark* Complaint, supra note 23.
167 See *TriMark*, 2021 N.Y. Misc. LEXIS 4475, at *19.
168 See *TriMark*, 2021 N.Y. Misc. LEXIS 4475.
169 Id. at *20–21 (emphasis in original).
170 Id. at *21–23.
171 See id. at *19–25.
Again employing its equitable power, the court based its ruling on the premise that the No-Action clause is meant to provide a benefit to the business relationship between the lenders and deal overall, while here there was no such benefit as the amendment actually had the effect of harming a subset of lenders without their consent.174

The final issue that has arisen in the context of the No-Action clause is the scope of lender acts it prohibits. In the Serta uptier transaction, involving a bedding company owned by a leading private equity firm, the No-Action clause restricted secured lenders from realizing on any collateral or enforcing a loan guaranty, leaving those rights solely to the administrative agent.175 The borrower and majority lenders argued that by seeking a remedy as secured lenders, the minority lenders sought a realization of collateral or enforcement of a loan guaranty, in violation of the No-Action clause, and therefore lacked standing to sue.176 Based solely on the scope of contractual language at issue, rather than any notion of equity, the court distinguished the minority lenders’ asserted claims from those remedies that would otherwise be subject to the No-Action clause.177 Since the minority lenders sought independent common law and statutory remedies in the form of an injunction and damages, not realization of collateral or enforcement of a loan guaranty, the minority lenders’ action did not fall within the scope of the prohibited action of the No-Action clause.178

Based on the foregoing analysis, borrowers and majority lenders are unlikely to succeed in alleging lack of standing by minority lenders in contesting uptier transactions.

B. Breach of the Implied Covenant of Good Faith and Fair Dealing

A fundamental theme of each complaint is that uptier transactions are coercive and made in bad faith. For that reason, minority lenders have consistently asserted a cause of action for breach of the implied covenant of good

173 See id. at *15–17.
174 Id. at *17; Sung Pak et al., New York Court’s Ruling Could Have Broader Implications for No-Action Clauses, OMM (Aug. 6, 2021), https://www.omm.com/resources/alerts-and-publications/alerts/new-your-courts-ruling-could-have-broader-implications-for-no-actions-clauses/.
175 LCM XXII Ltd. v. Serta Simmons Bedding, LLC, No. 21 Civ. 3987 (KPF), 2022 WL 953109, at *43 (S.D.N.Y. Mar. 29, 2022); Petition of Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. Jan. 23, 2023), ECF No. 1 (the borrower’s bankruptcy filing indicates that the uptier transaction ultimately could not prevent bankruptcy).
176 Serta, 2022 WL 953109, at *43.
177 Id. at *15–16.
178 Id. at *43.
faith and fair dealing. The Restatement (Second) of Contracts defines the implied covenant of good faith and fair dealing as “faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.” The covenant is intended to protect contractual parties from attempts by counterparties who may seek to intentionally frustrate such parties’ rights and benefits under the governing contract. In New York, where most contested uptier transactions have been litigated, all contracts are deemed to imply the covenant of good faith and fair dealing to ensure that no party will act to undermine the contract.

Despite this implied covenant, it may be difficult for a minority lender asserting this claim to prevail because courts in the United States primarily rely on the plain language of the contract on the basis that it reflects the parties’ intent. Courts have historically been hesitant to interfere with that intent, favoring the notion of freedom to contract. Thus, if an agreement is unambiguous, the court will typically accept the plain language of the contract as controlling and will be reluctant to intervene to the contrary.

In Boardriders, the court considered evidence that it determined was proof of bad faith by the borrower and participating lenders. Prior to the consummation of the uptier transaction, the non-participating lenders made several attempts to speak with the borrower’s managers, repeatedly trying to determine whether the borrower needed additional financing in light of the burden COVID-19 placed on the borrower’s business. However, the non-participating lenders “received conflicting responses or could not reach anyone” regarding the borrower’s financial condition.

Further, the court considered the substance of the amendments. The borrower and participating lenders amended the existing credit agreement to strip the non-participating lenders of protective covenants in furtherance of the uptier transaction, materially depleting the value of the non-participating lenders’ debt. The amending parties achieved this by deleting entire material sections

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179 See TriMark Complaint, supra note 23, at *47; Boardriders Complaint, supra note 23, at *48.
181 Id. § 205 cmt. d.
185 Id. at *7.
186 Id. at *8.
187 See id.
of the credit agreement, removing many of the affirmative and negative covenants intended to preserve the credit quality of the remaining debt.\textsuperscript{188} For example, specific affirmative covenants required the borrower to provide all lenders with quarterly and annual financial reports and preserve its corporate rating.\textsuperscript{189} The negative covenants prohibited the borrower from granting additional liens on its property, subject to certain carveouts.\textsuperscript{190} Its removal allowed the borrower to issue new secured debt to the participating lenders.

Based on the reticent nature of the amendments and transaction, and the outright removal of lender protections, “carried out in secret”\textsuperscript{191} by way of “secret discussions,”\textsuperscript{192} the court determined the evidence was sufficient to allow the non-participating lenders’ claims to survive the motion to dismiss based on the applicable standard.\textsuperscript{193}

Notably, \textit{TriMark}, also decided by a New York supreme court, came out the opposite way on this issue based on technical grounds.\textsuperscript{194} In New York, a claim for breach of the implied covenant of good faith and fair dealing cannot rely “on the same facts that form the basis for the breach of contract claim and seek the exact same damages.”\textsuperscript{195} The non-participating lenders in \textit{TriMark} alleged similar facts to the non-participating lenders in \textit{Boardriders}.\textsuperscript{196} Nevertheless, the court in \textit{TriMark} dismissed this cause of action, reasoning that the non-participating lenders’ claim was rooted in breach of contract of the existing loan documentation.\textsuperscript{197} As a result, the non-participating lenders’ claim was

\textsuperscript{188} Id. at *8–9.
\textsuperscript{189} Id. at *9.
\textsuperscript{190} Id. at *8–9.
\textsuperscript{191} Id. at *24.
\textsuperscript{192} Id. at *8.
\textsuperscript{193} Id. at *24. In New York (where much of the uptier litigation has occurred), a motion to dismiss may be brought under CPLR 3211(a). In this case, the borrower and participating lenders relied on CPLR 3211(a)(1) (a defense is founded upon documentary evidence), (3) (the party asserting the cause of action has no legal capacity to sue), and (7) (the pleading fails to state a cause of action). N.Y. C.P.L.R. 3211 (Consol. 2022).
\textsuperscript{196} \textit{TriMark}, 2021 N.Y. Misc. LEXIS 4475, at *9. Months before the uptier transaction was announced, the non-participating lenders “formed a committee to engage with TriMark to try to understand whether the company needed additional liquidity to weather the stress caused by the pandemic and, if needed, to explore potential pro rata financing options.” \textit{Id}. The borrower ensured the non-participating lenders that it had no “near-term cash issue,” did not need “additional liquidity,” and had not “spoken to outside financing sources.” \textit{Id}. All the while, the borrower was acting in concert with the participating lenders to make the necessary amendments to effectuate the uptier transaction, removing protective covenants.
\textsuperscript{197} Id. at *25.
“duplicative of [their] breach of contract claims, in that they arise from the same operative facts and seek essentially the same relief.”

While the court in TriMark acknowledged the implied covenant of good faith and fair dealing and recognized its applicability, it dismissed the cause of action on technical grounds. That, however, does not indicate that the court would have rejected the premise that the uptier transaction was made in bad faith and in violation of the covenant of good faith and fair dealing.

Minority lenders challenging uptier transactions may bolster the survivability of claims for breach of the implied covenant of good faith and fair dealing by pleading different facts and seeking different damages as compared to their breach of contract claims. At the least, this may permit such claims to survive dismissal on technical grounds. However, that may not always be an option because of the limited facts in cases of contested uptier transactions. Therefore, even though some underlying facts may overlap between breach of contract and breach of the implied covenant of good faith and fair dealing claims, non-participating lenders should ensure that they adequately plead at least one of these claims.

C. Waterfall and Pro Rata Sharing

As discussed earlier, since uptier transactions occur outside of bankruptcy, the priority arrangement prescribed by bankruptcy does not govern. Instead, the contractual ordering of the waterfall provision in the credit documentation governs, dictated by the borrower and majority lenders alone, post-amendment, and without minority consent. Credit agreements may contain a “Pro Rata Sharing” provision that requires payments received by lenders under a credit agreement to be shared ratably between lenders, based on each lender’s relative

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198 Id. at *37.
199 It is not surprising that the facts pled for a claim for breach of the implied covenant of good faith and fair dealing and a claim for breach of contract rely on similar facts since the facts relevant to each claim arise out of manipulation of the existing loan documentation.
200 It is worth noting that European advisors are beginning to think about uptier transactions and LMTs more generally. They anticipate that European courts will treat LMTs differently, sympathizing with non-participating lenders more than New York courts, specifically for claims involving breach of the implied covenant of good faith and fair dealing. If similar transactions are litigated in European courts and the rulings are not favorable to borrowers and participating lenders, it may shape European loan issuance into a market rife with protective provisions and little flexibility for creative out-of-court restructurings. For expanded discussion see Federman et al., supra note 71, at 100.
201 See supra Part I.A.
ownership percentage of the outstanding debt. This requirement protects lenders from having their share of the principal and interest payments taken by other lenders, ensuring the adequate compensation of lenders for their share of exposure to the debt.

As one commentator noted, lenders might wish, and even expect the Pro Rata Sharing provision to be protected from adverse amendment as a sacred right, but that is not guaranteed as the express terms of credit agreements may vary. If the Pro Rata Sharing provision is successfully neutralized via amendment by the borrower and participating lenders, the amendment will permit the uptier transaction to occur on a non-pro rata basis, excluding the non-participating lenders. Effectively, the new debt issuance does not follow the pro rata requirements bargained for in the existing credit facility. Further, the newly issued debt often provides the participating lenders with advantageous non-pro rata treatment in the form of increased protections and benefits that the existing credit facility did not provide. Most significant of those privileges are higher payment and collateral priority, improved pricing, and stricter covenants.

In TriMark, the court addressed three examples of non-pro rata treatment permitted by amendments to the existing loan documentation: (1) prepayment, (2) lien priority, and (3) exchanges. Each was utilized to disadvantage the non-participating lenders.

The existing first lien loan documentation provided that any prepayments made by the borrower before the maturity date must occur on a pro rata basis. This was amended to allow the borrower to prepay first lien debt “at, below, and/or above par at its sole discretion[] on a non-pro rata basis,” thereby authorizing non-pro rata prepayments to certain first lien lenders.

The borrower and participating lenders further amended the Pro Rata Sharing provision to permit an adjustment to lien priority. The existing loan

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203 Id.
204 Lender on Lender Priming, supra note 143.
205 Id.
207 See id. at *13.
208 Id. at *14.
209 Id.
documentation provided negative covenants that prohibited the borrower from granting new liens (e.g., superpriority liens) on collateral that would be senior to the first lien lenders’ claims. That limitation was removed by the amendment, supplanted by a separate Collateral Agreement that designated a priority waterfall in which superpriority liens would take priority over claims held by first lien (i.e., non-participating) lenders.

The TriMark court considered one final amendment to the Pro Rata Sharing provision, which related to debt exchanges. The existing loan documentation limited debt exchange offerings to be made pro rata to “all” first lien lenders. In contrast, the amended section permitted non-pro rata debt arrangements to “one or more” first lien lenders, in effect authorizing a non-pro rata exchange.

The principal consequence of such amendments to a Pro Rata Sharing provision is that non-participating lenders will not receive the same pro rata protections they initially bargained for when negotiating the existing credit facility. For instance, in TriMark, the non-participating lenders expected to be paid ratably with all other lenders in the syndicate. However, once the exchange was complete, those non-participating lenders’ claims were subordinate to the uptier loans, leaving them no longer entitled to ratable distribution based on the plain language of the loan documentation and junior to $427.5 million in superpriority financing.

D. Open Market Purchase

An open market purchase provision generally allows a borrower to purchase debt held by a subset of lenders, often at a discount to par. This contract term expanded in use during the 2007–2008 Financial Crisis since it enabled borrowers to purchase their debt on a non-pro rata basis if certain conditions were met. Today, borrowers seeking to engage in an uptier transaction may

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210 Id.
211 Id. at *14–15.
212 Id. at *14.
213 Id.
214 Id. at *14.
215 See id. at *13.
utilize an open market purchase provision since it arguably authorizes the borrower to negotiate with a subset of lenders to effectuate the transaction.\textsuperscript{218}

Thus, even if a credit agreement provides additional pro rata sharing protections, borrowers may exploit the vagaries of open market purchase provisions to engage in a non-pro rata roll-up in furtherance of an uptier transaction.\textsuperscript{219} Likewise, because of the open-ended nature of open market purchase provisions given the lack of a clear definition, such action may be authorized even absent amendments to the loan documentation, depending on the facts and circumstances.\textsuperscript{220}

In the \textit{Boardriders} transaction, the existing loan documentation permitted the borrower to engage in a non-pro rata debt-for-debt exchange.\textsuperscript{221} The borrower rolled-up two tranches of first lien debt with a subset of lenders on a non-pro rata basis.\textsuperscript{222} The roll-up included an agreement by the borrower to satisfy its $321 million payment obligation at par in exchange for new superpriority debt of the same value, effectively swapping significant indebtedness for new debt with a later maturity date.\textsuperscript{223} The result of such an exchange was that the participating lenders were able to avoid subordination and hold contractually senior debt by providing new financing.\textsuperscript{224} Meanwhile, the borrower was able to reduce its existing debt obligation, using in part the new money financing, and devoting the remainder of the financing toward its business.\textsuperscript{225}

Although the financing documents were titled “Open Market Purchase Agreements,” non-participating lenders in \textit{Boardriders} argued that the roll-up was not an open market purchase because it was not offered to all lenders.\textsuperscript{226} The “Loan Repurchases” section of the original credit agreement provided that the borrower “may from time to time purchase Loans on the open market (each, an ‘Open Market Purchase Offer . . . ’).”\textsuperscript{227} While the

\begin{flushleft}
\textsuperscript{218} See Fuller, III et al., supra note 216.
\textsuperscript{219} See Lourdes Dick, supra note 8, at 1353–54.
\textsuperscript{220} See Filardi, supra note 217.
\textsuperscript{222} Id. at *13.
\textsuperscript{223} Id.
\textsuperscript{224} See id. at *14.
\textsuperscript{225} See id. at *13–15.
\textsuperscript{226} See id. at *27.
\textsuperscript{227} Id. at *28.
\end{flushleft}
section provided for an open market debt exchange, it did not define open market exchange, leading to two alternative interpretations.\footnote{228 Id. at *29.}

The borrower argued that because the credit agreement explicitly required a different type of debt exchange (a “Dutch Auction Purchase Offer”) to be “open and offered to all Lenders,” the omission of that requirement from the “Open Market Purchase Offer” provision indicated that any open market purchase did not need to be offered to all lenders and could be presented only to a subset thereof.\footnote{229 Id.} By contrast, the non-participating lenders maintained that any open market purchase was required to be offered to all lenders based on the plain meaning of “open market,” which typically means “open and offered to all Lenders.”\footnote{230 Id.} The court found both interpretations reasonable, and since a contractual ambiguity existed, the non-participating lenders’ claim survived the motion to dismiss.\footnote{231 Id. at *29–30.}

The focus of litigation surrounding open market purchases in contested uptier transactions indicates that there may not be a market standard for interpreting the term’s meaning. Given this, including a carefully-crafted definition may provide greater clarity to all parties. Additionally, open market purchases consummated in connection with uptier transactions have involved debt-for-debt exchanges, as seen in the \textit{Boardriders} transaction.\footnote{232 E.g., \textit{Boardriders}, 2022 N.Y. Misc. LEXIS 10375.} Lenders can protect themselves against this usage by pushing for “open market purchase” to permit only cash or cash-equivalent payment, instead of debt. Such a definition would effectively frustrate the mechanism to effectuate a roll-up. This is so because borrowers in uptier transactions are typically distressed and unable to afford a debt-for-cash exchange, which also reduces the risk that a subset of lenders will be cashed out on a non-pro rata basis. Such a definition may stunt uptier transactions, or at least prevent exchanges that layer on superpriority debt above lenders’ existing first lien holdings.

Ultimately, since the lack of a definition of “open market purchase” is a mechanism by which uptier transactions may be authorized, it is one of the most important issues to be considered by stakeholders in the leveraged loan market. With a narrow definition, the permissibility of an uptier transaction (that by definition does not invite all lenders to participate) is instantly called
into question. However, if left undefined, there is no guarantee that a court will frustrate the transaction.

E. Fraudulent Transfer Considerations

The Code and state law contain fraudulent transfer protections that allow a creditor to unwind certain transfers between a debtor and a third-party that would prevent a creditor from realizing the full value of its claim. Typically, contested uptier actions are brought outside of bankruptcy, under state law, and in New York for a few reasons. First, although the borrower may maintain its headquarters elsewhere, its private equity sponsor-owner generally operates in New York, where it oversees the transaction. As such, sponsors are typically more comfortable using New York law. Therefore, the debt and claims under the loan documentation are often governed by New York law, and there may similarly be a forum selection clause providing New York as the exclusive forum with parties waiving arguments as to forum non conveniens (if another forum would be more appropriate given the borrower’s operations or headquarters). Finally, since the litigation occurs outside of bankruptcy, the Code is inapplicable and state law is the de facto applicable law. Therefore, fraudulent transfer law under the Code is rarely implicated in contested uptier transactions and New York fraudulent transfer law typically governs.

The New York Uniform Voidable Transactions Act (“NYUVTA”) governs fraudulent transfers in New York. It protects creditors and lenders from actual fraud, in which the debtor acts with “intent to hinder, delay or defraud,” and constructive fraud, in which the debtor does not receive “a reasonably equivalent value in exchange for the transfer or obligation.” In the event that actual fraud

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233 Fraudulent transfer and preference law are often lumped together because both enable a transaction to be clawed back. Despite that, preference actions have not been brought in the context of uptier transactions because uptier transactions occur outside of bankruptcy and preference actions are not available under state law, provided for only within bankruptcy proceedings. For further explanation, see John D. Ayer et al., Overview of Avoidance Actions, AM. BANKR. INST. J., Mar. 2004.


236 See, e.g., LCM XXII Ltd. v. Serta Simmons Bedding, LLC, No. 21 Civ. 3987 (KPF), 2022 WL 953109, at *6 n.10 (S.D.N.Y. Mar. 29, 2022).


238 Id. § 273(a)(1).

239 Id. § 273(a)(2).
is not express, the NYUVTA outlines “badges of fraud” that constructively indicate actual fraud.\textsuperscript{240} The two badges cited in challenging uptier transactions as fraudulent transfers are (1) “the transfer or obligation was to an insider,”\textsuperscript{241} and (2) “the transfer or obligation was disclosed or concealed.”\textsuperscript{242} With respect to the first badge, the new liens issued in an uptier transaction may include liens granted to the sponsor-owner, who is an insider given their working relationship and control over the borrower.\textsuperscript{243} As for the second badge, the negotiation and effectuation of these transactions is often kept concealed until complete.\textsuperscript{244}

In \textit{TriMark}, the non-participating lenders alleged that the borrower’s incurrence of senior liens met the standard for actual intent in which TriMark, the borrower, acted with “intent to hinder, delay or defraud” non-participating lenders.\textsuperscript{245} Therefore, “all transfers made and obligations incurred by TriMark to the benefit of the [participating lenders] are voidable and should be unwound.”\textsuperscript{246} Similar to the non-participating lenders’ claim for breach of the implied covenant of good faith and fair dealing, the court was again unable to rule on the merits of the legal issue—whether the uptier transaction constituted a fraudulent transfer—because the court was forced to make a decision based solely on technical grounds.\textsuperscript{247}

While New York fraudulent transfer law relies on the NYUVTA, it provides that fraudulent transfers are not exclusively governed by New York law. The NYUVTA says that a fraudulent transfer claim “is governed by the local law of the jurisdiction in which the debtor is located when the transfer is made or the obligation is incurred.”\textsuperscript{248} For purposes of determining where a debtor is located, “[a] debtor that is an organization and has more than one place of business is located at its chief executive office.”\textsuperscript{249} TriMark’s chief executive office was in Massachusetts.\textsuperscript{250} Therefore, the non-participating lenders did not have standing

\textsuperscript{240} Id. § 273(b).
\textsuperscript{241} Id. § 273(b)(1); see also TriMark Complaint, supra note 23, at *51; Boardriders Complaint, supra note 23, at *54–55.
\textsuperscript{242} N.Y. DEBTOR & CREDITOR LAW § 273(b)(3); see also TriMark Complaint, supra note 23, at *51; Boardriders Complaint, supra note 23, at *54–55.
\textsuperscript{244} See supra Part I.A.
\textsuperscript{246} TriMark, 2021 N.Y. Misc. LEXIS 4475, at *44.
\textsuperscript{247} Id. at *52 n.8.
\textsuperscript{248} N.Y. DEBTOR & CREDITOR LAW § 279(a).
\textsuperscript{249} Id. § 279(a)(3).
\textsuperscript{250} TriMark, 2021 N.Y. Misc. LEXIS 4475, at *44.
in New York to bring their fraudulent transfer claim. Accordingly, to bring such a claim, the non-participating lenders should have sued under Massachusetts fraudulent transfer law.

The non-participating lenders further argued that the debtor’s location was irrelevant because the credit agreement included a choice-of-law provision specifying that New York law governed. The court rejected this argument because state fraudulent transfer claims sound in tort. New York law provides that tort claims fall outside the scope of a choice-of-law provision that does not specifically include actions sounding in tort. Since the choice-of-law provision in the credit agreement did not include torts, it did not control where the fraudulent transfer claims could be brought, and, therefore, the non-participating lenders lacked standing to bring such claims in New York given the facts.

A fraudulent transfer judgment under the NYUVTA can result in an avoidance of the transfer or obligation, an attachment of the transferred assets, or “subject to applicable principles of equity . . . any other relief the circumstances may require.” Such a decision can totally unwind an uptier transaction, making the non-participating lenders once again pari-passu with the participating lenders. Given the significance of a successful fraudulent transfer claim in unwinding a challenged uptier transaction, lenders may seek to protect their interests by pushing for broader choice-of-law provisions that do not limit forum selection to New York and include actions sounding in tort to ensure they have standing to bring such a claim in their preferred forum.

IV. THE EFFECTS OF UPTIER TRANSACTIONS ON THE LEVERAGED LOAN MARKET

Up to now, courts have been unwilling or unable to definitively rule in favor of non-participating lenders in contested uptier transactions based on the merits

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251 Id. at *45.
254 See TriMark, 2021 N.Y. Misc. LEXIS 4475, at *45.
256 Id. § 276(a)(2).
257 Id. § 276(a)(3), (a)(3)(iii).
of the legal issues implicated in each case. Absent different treatment by future courts, those decisions may lead lenders to negotiate for increasingly protective provisions in their credit agreements. Some lenders have already started seeking the inclusion of “blocker” provisions that prohibit the actions taken to effectuate an uptier transaction.\textsuperscript{258} Additionally, some lenders may push for making pro rata sharing a “sacred right,”\textsuperscript{259} defining “open market purchases” so new offerings must be presented to all lenders and require a debt-for-cash exchange,\textsuperscript{260} and more expansive choice-of-law provisions that encompass all conceivable types of claims, including tort.\textsuperscript{261} Perhaps most importantly, lenders may push for protection against majority consent voting to amendments. Lenders may instead seek to require unanimous consent for all provisions, or at least for any amendment that would adversely affect one or more lenders,\textsuperscript{262} specifically amendments related to release of liens or guarantees, subordination or layering of senior debt, transfer of collateral, and other credit aspects underlying LMTs.

While lenders may proactively seek to be assertive to protect their interests in a potential distressed scenario, they should be careful not to negotiate to the point of their exclusion from the lender base of future credit facilities. Lenders pushing for market-changing terms to prevent the possibility of an uptier transaction may inadvertently reduce their attractiveness as potential investors given that borrowers and sponsors want to ensure flexibility from their lenders. As such, they may be less likely to seek investment from lenders perceived as aggressive since they want to deal freely, without fear of litigation or resistance should an uptier transaction be necessary.

Sponsors, in particular, value lender flexibility because they manage many portfolio companies and do not want to be forced to dedicate excessive resources to a particular investment because there are disagreeable lenders in a syndicate. Therefore, if a lender is overly ambitious and seeks total protection from uptier or similar transactions, borrowers and their sponsor-owners may simply seek

\begin{itemize}
  \item \textsuperscript{258} \textit{Lens on Loopholes Q3 2023 Update}, supra note 146 (exhibiting that the “J. Crew Trapdoor” Pass-Through Investment Basket provision allowing the transfer of collateral to an unrestricted subsidiary was included in less than 10% of all leveraged loans and CCC-rated loans in the Credit Suisse Leveraged Loan Index as of September 30, 2023, as a result of lender negotiation efforts to block their inclusion).
  \item \textsuperscript{259} \textit{See TriMark}, 2021 N.Y. Misc. LEXIS 4475, at *7–8.
  \item \textsuperscript{261} \textit{See TriMark}, 2021 N.Y. Misc. LEXIS 4475, at *44–45.
  \item \textsuperscript{262} Referred to as the “Serta Loophole” in \textit{Lens on Loopholes Q3 2023 Update}, supra note 146 (displaying that majority consent voting appeared in just 62.4% of leveraged loans overall and 67.3% of CCC-rated loans in the Credit Suisse Leveraged Loan Index as of September 30, 2023, due to lender pushback).
\end{itemize}
investment from other lenders who are more flexible and willing to take on the risk of looser terms, particularly as these looser terms have been and continue to be the market norm.\footnote{Id. (such terms include the Phantom Guarantee ("PetSmart/Chewy Loophole") and Envision Loophole).}

More compliant lenders themselves may also be the cause of the exclusion of aggressive lenders. Such lenders may not want to enter into a syndicate or sell a portion of the debt to aggressive lenders who have a reputation for creating unending negotiation for the same reasons as borrowers and their sponsors.\footnote{See generally Jeswald Salacuse, The Importance of a Relationship in Negotiation, HARV. L. SCH. PROGRAM ON NEGOT., DAILY BLOG (Dec. 12, 2023), https://www.pon.harvard.edu/daily/negotiation-training-daily/negotiate-relationships/.
} Thus, overly combative lenders jeopardize being ostracized from the leveraged loan market at origination and in the secondary market. Despite that, if an aggressive lender can manage to successfully include protections in the loan terms, that may make their debt more attractive to secondary lenders who wish to purchase the debt post-issuance given the value produced by such protections.

} However, smaller and more closely-held loans could be provided by just a single lender or a small group of lenders. Such a group may have an interest in not participating in a “coercive” restructuring (i.e., an uptier transaction) to the detriment of the rest of the intimate lender base, due to commercial and reputational considerations. These considerations could include a desire for repeated participation in future loan issuances and awareness that disrupting the smooth administration of one loan could have a spillover effect that disrupts the group’s business relationship on one or more existing loans.\footnote{See Hannah Zhang, Private Credit Boomed Amid Low Yields—and Now It’s Set To Flourish, INST. INV. (May 11, 2022), https://www.institutionalinvestor.com/article/b1xzvkq9dnw79g/ (indicating private credit has grown at a record rate, suggesting lenders’ desire to be included in future opportunities).}

Further, both lenders and borrowers may prefer loans originated by smaller groups for practical reasons. Absent other circumstances, a smaller group generally means quicker execution and greater certainty that the deal will close
because there are fewer parties vying for bespoke terms. Additionally, a smaller lender base may generate smaller fees for legal and financial advisors since the process for arranging and syndicating the loan will be expedited and involve less parties.

Loans originated by a smaller lender base may also give rise to involvement by different lenders. The typical originators of widely-syndicated loans are banks, while hedge funds and credit funds are often relegated to secondary holders who purchase a portion of the debt post-issuance. However, corporate loans could be issued where fewer or even no banks serve as lenders, originated instead by the typical secondary holders. Lenders in those smaller lender bases may also include CLO funds and BDCs, who have already become increasingly active in LMTs due to their investment constraints. This could potentially create a self-reinforcing cycle in which CLO funds and BDCs are active in uptier transactions not only because of their investment constraints that are well-suited toward follow-on financings rather than traditional restructurings, but also because they are individual lenders that fit the mold of other typical secondary holders.

V. SOLUTIONS

Since contested uptier transactions have not yet proceeded past the motion to dismiss stage, courts have not had occasion to fashion final judgments. In light of this uncertainty, there are three possible avenues to preventing the issues presented by uptier transactions: (A) congressional intervention, (B) judicial intervention, and (C) self-regulation.

272 See Norton et al., supra note 122.
273 As of March 2024, there have been settlements and decisions on motions to dismiss, but no judgments.
A. Congressional Intervention Is a Limited Solution Since It Is Based in Bankruptcy

Congress could amend the Code to provide that any creditors made senior by a coercive transaction (i.e., an uptier transaction) are subordinated back down to equal status with all lenders of the first lien lender base, thereby losing their superpriority status. The justification for such an addition to the Code would be that absent the coercive transaction, the subordinated creditors would have remained pari-passu with their now senior counterparts. Accordingly, this treatment would restore the pre-transaction status quo, placing the subordinated creditors on equal legal footing as the participating creditors.

Ultimately, amendment to the Code is a limited solution because congressional intervention is predicated on seeking relief during the debtor’s bankruptcy. Uptier transactions occur outside of bankruptcy, with the intent of avoiding bankruptcy relief. Therefore, congressional intervention may only help subordinated creditors if the debtor later files bankruptcy and is subject to the bankruptcy court’s oversight and the Code. Further, the same variability regarding key issues in contested uptier transactions in the pre-petition litigation context may arise in bankruptcy courts. Finally, uptier transactions may delay bankruptcy for years, placing the bankruptcy filing well beyond the statute of limitations for fraudulent transfer and preference claims in bankruptcy, which

274 Governmental intervention by means of agency action is also likely inapplicable. For example, a public bond offering requires compliance with section 5 of the Securities Act of 1933 (the “Securities Act”). The requirements include filing a registration statement with the Securities and Exchange Commission (“SEC”) to be permitted to market the security, and waiting until the SEC deems the registration statement effective to be able to sell the security. Additionally, in a public offering, the issuer does not have discretion to limit the offerees. Uptier transactions cannot be considered a public offering since they are offered only to a subset of existing or new lenders. Therefore, section 5 is inapplicable. Further, if federal securities regulation covered the type of offering at issue in an uptier transaction (a private placement), which is generally exempt from the requirements of section 5, it is not clear that the debt issued is a “security” as defined in section 2(a)(1) of the Securities Act and section 3(a)(10) of the Securities Exchange Act of 1934 (the “Exchange Act”). In both sections, “note” is included in the definition of “security” and notes may be the type of debt instrument used in an uptier transaction. Despite that, not all investments with the characteristics of a “note” are considered a security. For example, where an investor purchases a note purely for investment purposes, and common trading in the note is not available (both of which are present in an uptier transaction), the presumption that a note is a security is defeated, rendering securities laws inapplicable. See Reves v. Ernst & Young, 494 U.S. 56, 67–69 (1990).

275 As explored below, such a cause of action could be supported by the notion of equitable subordination provided in 11 U.S.C. § 510(c)(1).

may limit the usefulness of any such congressional amendments implemented in connection with the fraudulent transfer or preference provisions of the Code.277

B. Judicial Intervention Is an Overreach

As mentioned above, the applicability of the bankruptcy system is predicated on the debtor’s bankruptcy. In the event that a debtor files bankruptcy following an uptier transaction, the bankruptcy court may consider the doctrine of equitable subordination, in which the court subordinates one or more creditors’ claims on grounds of fairness, typically for inequitable conduct.278 As such, the bankruptcy court could consider equitably subordinating superpriority creditors based on their prepetition conduct in connection with the uptier transaction, and congressional intervention in the form of amendments to the Code providing for such treatment would support such action. However, given the occurrence of uptier transactions outside of bankruptcy, the likelihood of such amendments to the Code are unlikely.

Certain non-bankruptcy courts addressing contested uptier transactions have acknowledged the “spirit of the agreement,” embracing notions of equity in limited circumstances.279 In doing so, those courts have de-emphasized the plain language of the loan documentation permitting the constituent components of uptier transactions because of the transaction’s coercive nature. While the TriMark and Boardriders courts employed their equitable power to disregard the restrictions imposed by the amended “No-Action” clauses,280 courts have been reluctant to apply similar equitable considerations to other key issues in litigated uptier actions.

While equitable consideration to the “No-Action” clause is reasonable since it permits the non-participating lenders’ claim to survive past the initial motion to dismiss stage (before discovery which might produce evidence of some lack of good faith or other impermissibility), such treatment to other key issues would be an overreach by courts. Freedom to contract is a bedrock of commercial law

in the United States, and substantive terms that have material effects on the economics of a contract (i.e., open market purchase, waterfall, and pro rata sharing) are best left to the parties to negotiate, without interference from the courts.

C. Self-Regulation Is the Realpolitik Solution

The notion of freedom to contract, which is widely accepted in the United States, as well as reliance on the express language of the loan documentation, suggests leaving the loan parties alone to deal freely, without intervention by Congress or the courts. The logic of self-regulation is that as lenders become more familiar with the potential risk posed by uptier transactions, they will seek to proactively protect themselves. While self-regulation does not guarantee protection to all lenders in all uptier transactions, the risk of total exclusion from a lender group or being pitted against other lenders to accept less agreeable terms drives borrowers and lenders to negotiate for more favorable terms, which enhances the opportunities for stakeholders in the leveraged loan market.

The crux of the conflict surrounding uptier transactions lies in the definition, or lack thereof, of “open market purchase.” Self-regulation is most effective as the solution to the risks of uptier transactions when stakeholders push for a defined standard. Recently, the Serta court reasoned that absent a definition, “open market purchase” will be read broadly by courts (and therefore by borrowers and participating lenders). The court explained:

> The process utilized . . . to solicit interest from these existing lenders, the receipt and negotiation of multiple offers by the Debtors to achieve the greatest benefit for the Debtors, the attempts by various lenders to “outmaneuver” one other [sic] with an ultimate winner announced, and the Objecting Lenders subsequent attempts to undermine the announced winning deal is the quintessential “Wall Street” open market purchase.

By defining “open market purchase,” lenders will ensure they are aware of the parameters they operate in as parties to the credit agreement. Likewise, borrowers and proactive lenders need not fear their actions will be seen as taken in bad faith if an offering as part of an uptier transaction is made within the

282 See id.  
283 See supra notes 98–100.
confines of the “open market purchase” as defined by the governing credit agreement.285

Given the absence of a legal standard as to the permissibility of uptier transactions, there is little reason to believe borrowers and participating lenders will change their tactics—particularly in the absence of congressional intervention or definitive, adverse court decisions. Additionally, the increasing prevalence of “blocker” provisions and cooperation agreements suggests that stakeholders have already started to self-manage the process for new loans and amend existing loans that are rife with holes enabling uptier transactions.286 Consequently, relying on self-regulation is the most practical solution that leaves the power to make decisions with the stakeholders of the leveraged loan market.

CONCLUSION

Looking forward, as the market remains borrower-friendly in terms of documentation and willingness to extend capital to non-investment grade borrowers, and equity markets remain in turmoil, debt markets may be a preferable way for investors to receive returns.

Given this, lenders, sponsors, and borrowers must remain vigilant as to the market changes resulting from varying court treatment and usage of terms in connection with uptier transactions. In particular, existing and prospective lenders seeking new investment opportunities should understand the risks associated with debt investing. This includes awareness of the tactics employed by crafty borrowers and their sponsors as well as protections lenders can seek to defend their interests both during the credit negotiation process and post-issuance.

At the same time, despite heightened interest rates, corporate borrowers will continue to take on debt to finance new projects, obtain working capital, and fund their acquisitions, particularly in light of the turmoil in the equity markets. While some ventures may fail outright, others will result in excessive, but resolvable, indebtedness, which borrowers may attempt to address through an uptier transaction. Additionally, sponsors may continue to use uptier

285 The court in Serta noted that since the transaction fell within the scope of an open market purchase, the “[t]ransaction was the result of good-faith, arm’s length negotiations.” Id. at *12.

transactions to extend the financial runway for their distressed portfolio companies to avoid the loss of their equity investments that would result in bankruptcy.

Ultimately, uptier transactions are here to stay and continue to be on the rise.

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