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Bankruptcy Court holds sacred right in an indenture is not an anti-lien subordination clause

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The Delaware Bankruptcy Court in *Bayside Capital Inc. v. TPC Group Inc.* offers a counterpoint to *TriMark* by holding that a "sacred right" provision in an indenture, which required the consent of each adversely affected noteholder to amend provisions dealing with the application of proceeds of collateral, cannot be read as an anti-lien subordination clause.

Introduction

On July 6, 2022, the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") became the latest court to weigh in on questions of contractual interpretation relating to out-of-court liability management transactions that have become more frequent in recent years, particularly with borrowers in distress or facing liquidity issues. In *Bayside Capital Inc. v. TPC Group Inc.* ("*TPC*"), Bankruptcy Judge Goldblatt held that a "sacred right" provision in an indenture, which required the consent of each adversely affected noteholder in order to amend provisions dealing with the application of proceeds of collateral, cannot be read as an anti-lien subordination clause. *Bayside Capital Inc. v. TPC Group Inc. (In re TPC Group Inc.)*, No. 22-50372 (CTG) (Bankr. D. Del. July 6, 2022) [ECF No. 72]. In reaching its decision, the Bankruptcy Court took a "greater includes the lesser" approach to interpreting the indenture. Specifically, it held (among other things) that, because the release of all or substantially all of the collateral from the liens securing the notes required the consent of holders of at least 66?% in aggregate principal amount of the notes (and not each adversely affected noteholder), it followed that the subordination of liens, which the Bankruptcy Court viewed as a less drastic measure, should not require a higher consent threshold in the absence of an express provision to the contrary.

The *TPC* decision is part of a growing body of caselaw considering the ability of companies and their creditors to execute "uptiering" transactions, in which a subset of creditors under a secured credit agreement or indenture agree to modify those documents to afford the participating creditors lien priority—higher status in the payments waterfall—over nonparticipating creditors. The courts reviewing these transactions have paid close attention to the specifics of the case: the nature of the transaction at issue and the particular words in the underlying documents. As an addition to this body of caselaw, the Bankruptcy Court's decision in *TPC* presents an interesting counterpoint to the New York State Supreme Court's recent decision in *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp.*, No. 565123/2020 (JMC), 150 N.Y.S.3d 894 (N.Y. Sup. Ct. 2021) ("*TriMark*"). In *TriMark,* a group of nonparticipating lenders under a credit agreement claimed that the company and a group of participating lenders breached a "sacred right" by engaging in a series of transactions that had the effect of altering the collateral proceeds waterfall without the consent of each directly and adversely affected lender. The *TriMark* court denied the defendants' motion to dismiss the claim, offering some support to non-consenting investors seeking to challenge lien subordination in the context of a new money superpriority financing transaction, at least on similar facts. The *TPC* decision, on the other hand, may be relied upon by distressed companies that decide to engage in liability management transactions to stave off a chapter 11 filing or otherwise manage their capital structure.

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Background

TPC Group (the "Company"), a petrochemical company headquartered in Houston, filed for chapter 11 protection in June 2022 after having executed a restructuring support agreement (RSA) with an ad hoc group of holders of the Company's 10.875% Senior Secured Notes due 2024 (the "Superpriority Notes") and 10.50% Senior Secured Notes due 2024 (the "First Lien Notes") and with the Company's sponsors. The RSA contemplated that the Company would enter into a new delayed draw debtor-in-possession term loan facility (the "Term DIP Facility") of up to $323 million to help fund the Company's operations and its chapter 11 cases. The Term DIP Facility would consist of $85 million of new money term loans and $238 million of outstanding obligations under the Superpriority Notes "rolled up" into DIP term loans. The Company sought – and the Bankruptcy Court granted – interim approval of the Term DIP Facility as part of its first day relief. *In re TPC Group Inc.*, No. 22-10493 (CTG) (Bankr. D. Del. June 3, 2022) [ECF No. 147].

Two holders of 10% in aggregate principal amount of the First Lien Notes (the "Non-Consenting Holders") immediately commenced an adversary proceeding in the Bankruptcy Court by filing a complaint against the Company along with a motion for summary judgment, alleging that the Company breached the indenture governing the First Lien Notes (the "Original Indenture") when it issued $153 million of Superpriority Notes in February 2021 (the "2021 Transaction"). The investors in the Superpriority Notes also held a majority in aggregate principal amount of the First Lien Notes, but notably did not "uptier" their First Lien Notes position into a super-senior tranche as similarly positioned creditors have done in other recent liability management transactions.

Also in connection with the 2021 Transaction, the Company entered into a supplemental indenture (the "Supplemental Indenture") that amended the Original Indenture to cause the First Lien Notes to be bound by a new intercreditor agreement (the "Superpriority Intercreditor Agreement"). Pursuant to the Superpriority Intercreditor Agreement, the liens securing the First Lien Notes were subordinated to the liens securing the Superpriority Notes. The Supplemental Indenture also amended the definition of "Permitted Liens" in the Original Indenture to carve out the Superpriority Notes from the requirement that such debt be subject to the existing intercreditor agreement (the "ABL Intercreditor Agreement") with the Company's asset-based revolving lenders. Approximately 67% of the holders of the First Lien Notes consented to the Supplemental Indenture and entry into the Superpriority Intercreditor Agreement.

In their motion for summary judgment, the Non-Consenting Holders claimed that their consent was required for the Company to enter into the Supplemental Indenture and subordinate the liens securing the First Lien Notes under the Superpriority Intercreditor Agreement. Specifically, Section 9.02(d)(10) of the Original Indenture provided that the consent of each affected holder of the First Lien Notes is required to "make any change in the provisions in the Intercreditor Agreement [i.e., the ABL Intercreditor Agreement] or this Indenture dealing with the application of proceeds of Collateral that would adversely affect the Holders … "

Section 9.02(d)(10) is known as a "sacred right": a consent right given to each individual holder in the amendment section of a credit document, under the notion that certain terms and provisions in credit documents are so fundamental to a holder's investment that they cannot be amended without the consent of each holder or each affected holder. Sacred rights are an exception to the general rule typically found in indentures and credit agreements that the consent of holders of a majority (and in some cases, a supermajority) in aggregate principal amount of the debt is required to amend or otherwise waive any provision in a credit document. Indeed, the Original Indenture contains a typical hierarchical scheme when it comes to the consents required to amend the Original Indenture and related note documents. Generally, the consent of holders of a majority in aggregate principal amount of the First Lien Notes is required to amend or otherwise waive the terms of the Original Indenture. Next, the consent of holders of 66?% in aggregate principal amount of the First Lien Notes is required to release all or substantially all of the collateral securing such notes. Finally, the consent of each affected holder is required, among other things, to reduce the principal amount or extend the maturity of the First Lien Notes, reduce the rate of interest or, as noted above, make any change to the ABL Intercreditor Agreement or the Original Indenture "dealing with the application of proceeds of Collateral that would adversely affect the Holders."

The Non-Consenting Holders claimed that Section 9.02(d)(10) was violated as a result of the execution of the Supplemental Indenture and the Superpriority Intercreditor Agreement because, when taken together, they changed the application of the proceeds of the collateral in a manner that adversely affected each holder by prioritizing the Superpriority Notes over the First Lien Notes with respect to such proceeds. The Non-Consenting Holders also asserted that Section 9.02(d)(10) was violated because the Superpriority Intercreditor Agreement effectively amended the ABL Intercreditor Agreement's waterfall (albeit indirectly) by giving the Superpriority Notes priority over the First Lien Notes when the waterfall in the ABL Intercreditor Agreement expressly provided that any parties entitled to payment out of collateral proceeds only get paid after payment of the First Lien Notes and the ABL obligations.

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As for the stakes of the Non-Consenting Holder's adversary proceeding, the Bankruptcy Court pointed out that, to the extent the 2021 Transaction was valid and the Superpriority Notes were truly senior to the First Lien Notes, the impact of the roll-up of $238 million of Superpriority Notes into the Term DIP Facility (and the administrative expense status granted as a result thereof) would be inconsequential to the other creditors in the capital structure, as the value of the collateral would have been first distributed to the Superpriority Notes to the extent there was sufficient collateral coverage.[1] However, if the transaction was invalid and the Superpriority Intercreditor Agreement was ineffective as to the First Lien Notes, the liens of the Superpriority Notes would be "second in time" to the liens of the First Lien Notes and therefore junior to the lien of the First Lien Notes. In that instance, if the value of the collateral were insufficient to cover the First Lien Notes, it would mean that unsecured claims were proposed to be "rolled up" ahead of secured claims.

Bankruptcy Court decision

On July 6, 2022, the Bankruptcy Court issued an opinion resolving the parties' summary judgment motions, ruling in favor of the Company (and an ad hoc group of noteholders party to the RSA, who intervened as a defendant). The Bankruptcy Court held that because the Original Indenture required a two-thirds majority vote for the release all or substantially all of the liens securing the First Lien Notes, it followed that the subordination of such liens, which the Bankruptcy Court viewed as a less drastic measure, should not require a higher consent threshold in the absence of express language to the contrary.

In reaching its decision, the Bankruptcy Court pointed out that, when viewing Section 9.02(d)(10) in isolation, reasonable arguments could be made on both sides as to whether the subordination of the First Lien Notes' liens in the 2021 Transaction resulted in a change to the "application of the proceeds of the Collateral in a manner adverse to the Holders." On the one hand, a change to the Original Indenture or ABL Intercreditor Agreement that affects the amount that the trustee under the Original Indenture ultimately receives to distribute to the holders of First Lien Notes could be viewed as adversely impacting the application of proceeds of collateral. On the other hand, as the defendants argued, Section 9.02(d)(10) could be read as only applying to the trustee's application of proceeds pursuant to the existing waterfall provision in the Original Indenture, which required such application to be ratable to the noteholders following the payment of the trustee's fees and expenses. So long as the Supplemental Indenture did not change that ratable distribution (which it did not), Section 9.02(d)(10) would not be violated.

The Bankruptcy Court next turned to the *TriMark* decision. *TriMark* involved a credit agreement under which participating lenders holding a majority of the loans voted to subordinate the liens of nonparticipating lenders in a superpriority financing and uptier exchange transaction, despite language in the amendment section stating that the consent of each directly and adversely affected lender was required to amend the collateral proceeds waterfall in the security agreement "in a manner that would alter the application of the proceeds" of the collateral. Also, similar to the Original Indenture and the 2021 Transaction, (1) the credit agreement in *TriMark* did not expressly require the consent of each affected lender or all lenders to subordinate the liens securing the loans thereunder and (2) the definition of "Intercreditor Agreements" in the credit agreement was changed to include the new superpriority intercreditor agreement (thereby making the collateral proceeds waterfall expressly subject to the superpriority intercreditor agreement). But the court in *TriMark* denied the defendants' motions to dismiss and allowed the plaintiffs' breach of contract claim to proceed, holding that it was reasonable to interpret the sacred right at issue as preventing a tranche of debt from being placed above the existing debt, notwithstanding the fact that the order of distribution within the security agreement remained facially unchanged. The parties eventually settled the lawsuit, but *TriMark* called into question what many had understood to be a valid interpretation of a credit agreement or indenture, supported by several judicial decisions: absent express language to the contrary, the company and majority lenders could direct the applicable agent or trustee to subordinate the liens of nonparticipating lenders in a superpriority financing transaction.[2]

The Bankruptcy Court agreed with the court's decision in *TriMark* to allow the case to proceed past the company's motion to dismiss. But the Bankruptcy Court in *TPC* had before it motions for summary judgment with facts that the parties agreed were undisputed, as opposed to motions to dismiss and requests for declaratory relief. To that end, the Bankruptcy Court turned to "other tools of construction, beyond the words themselves," to reach the conclusion that the Supplemental Indenture and Superpriority Intercreditor Agreement did not violate Section 9.02(d)(10) of the Original Indenture.

The Bankruptcy Court observed that anti-subordination language in indentures is commonplace such that in the absence of an express anti-subordination clause, "a provision providing for ratable distribution … would more naturally apply to distributions *within* a class, and not prohibit subordination of an entire class to another … ." Indeed, it highlighted that the indenture for the Superpriority Notes expressly required a two-thirds majority vote for lien subordination.

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More fundamentally, the Bankruptcy Court found relevant the hierarchical nature of the voting rights under the Original Indenture. The Bankruptcy Court reasoned that "[t]he logic of that hierarchy would suggest that the matters included among the ten sacred rights would be actions that – at least from the perspective of an individual holder – would be more problematic or potentially prejudicial than the kinds of actions that can be taken simply with the approval of a simple or two-thirds majority." The Bankruptcy Court went on to explain that reading Section 9.02(d)(10) as protecting an individual noteholder's right to pro rata distributions vis-à-vis other noteholders, as opposed to protection more generally from the subordination of liens securing the First Lien Notes, is consistent with this structure. The Bankruptcy Court also noted that lien subordination is a less drastic intrusion on the rights of individual holders than the release of all of the collateral. Therefore, the Bankruptcy Court reasoned, if the release of all or substantially all of the liens requires a two-thirds majority vote, it would not make sense to require the consent of every noteholder to subordinate liens under the hierarchical voting structure.[3]

In addition, in support of its view that lien subordination is a less drastic measure than a release of all liens, the Bankruptcy Court considered such a transaction from a commercial perspective, noting that "the need to infuse a borrower with new money in order to protect the value of existing collateral might well provide a sound reason why lenders would agree that a majority (or, in the case of the Supplemental Indenture, a super-majority) may bind a class of holders to a decision to subordinate their lien."[4] The Bankruptcy Court also pointed out that "[a]s far as commercial norms go, to the extent objecting noteholders have anything to complain about from the 2021 transaction, that complaint is more with the fact that the objecting noteholders were not offered the opportunity to participate in the new loan than it is with the treatment of their old debt." It further added that there was nothing in the Original Indenture that gave the Non-Consenting Holders the right to participate and explained that:

> [W]hile the various 2021 transactions may have violated what the *TriMark* court (perhaps aspirationally) called the 'all for one, one for all' spirit of a syndicated loan, the transactions did not violate the letter of the applicable agreements … . 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.

Two other aspects of the Bankruptcy Court's decision in *TPC* are worth noting.

First, the Bankruptcy Court held that under New York law, the Original Indenture's no-action provision, which required noteholders holding 25% or more of the First Lien Notes to cause the trustee to pursue remedies under the Original Indenture and the First Lien Notes, did not preclude an individual noteholder from enforcing its individual consent right under Section 9.02(d)(10). The Bankruptcy Court's ruling on this point reaffirms the prevailing view that no-action clauses requiring collective action cannot bar holders from enforcing their individual consent rights under a credit document.

Second, the Bankruptcy Court disregarded assertions that the Non-Consenting Holders could not validly challenge the 2021 Transaction because they acquired their interests in the First Lien Notes after the 2021 Transaction, stating that New York law is clear that the Non-Consenting Holders have the same legal rights as the original holders. The Bankruptcy Court noted in this context that "the robust secondary market for distressed syndicated debt, one that benefits buyers and sellers alike, depends on courts respecting the fact that the buyer of such debt acquires the same bundle of legal rights as were held by its predecessor."

Conclusion

The *TPC* decision (assuming it survives appeal)[5] provides an incrementally more favorable precedent to the proponents of liability management transactions, but would not foreclose non-consenting parties seeking to challenge them. In the context of an indenture, absent an express anti-subordination clause, the Bankruptcy Court's hierarchical approach to resolving the issue should be kept in mind – if the release of all or substantially all liens requires a two-thirds majority vote (a threshold that is quite common in indentures), it stands to reason that lien subordination is not itself entitled to greater protection as a sacred right. But this reasoning assumes that lien subordination is in fact a less drastic measure. A court may be persuaded to take a different view of the level of severity of lien subordination, particularly in the context of a credit agreement that, as the court in *TriMark* observed, more traditionally embodies an "all for one, one for all" approach when it comes to a syndicate of lenders.[6] In addition, had the new money noteholders in the 2021 Transaction uptiered their First Lien Notes ahead of the nonparticipating noteholders, the resulting decision may have differed. Any or all of these facts could outweigh the consent threshold for releasing substantially all collateral on a determination of whether lien subordination is captured by an "application of proceeds" or similar sacred right. What the *TPC* decision makes clear (once again) is that the words on the page matter, and if an indenture or credit agreement does not expressly address lien subordination, investors may be vulnerable to a transaction that does just that.

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If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Jon Finelli
+1 212 450 3817
jon.finelli@davispolk.com

James A. Florack
+1 212 450 4165
james.florack@davispolk.com

Marshall S. Huebner
+1 212 450 4099
marshall.huebner@davispolk.com

Jason Kyrwood
+1 212 450 4653
jason.kyrwood@davispolk.com

Elliot Moskowitz
+1 212 450 4241
elliot.moskowitz@davispolk.com

Brian M. Resnick
+1 212 450 4213
brian.resnick@davispolk.com

Damian S. Schaible
+1 212 450 4580
damian.schaible@davispolk.com

Adam L. Shpeen
+1 212 450 4169
adam.shpeen@davispolk.com

Kenneth J. Steinberg
+1 212 450 4566
kenneth.steinberg@davispolk.com

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[1] Note that the Bankruptcy Court did not further address whether there was sufficient collateral coverage, as that question was not before the court.

[2] While the parties ultimately settled in *TriMark*, there is a proceeding pending against Serta Simmons, the mattress manufacturer, in the United States District Court for the Southern District of New York (the "District Court") in connection with a superpriority financing and uptier exchange transaction similar to the one in *TriMark*. This action was brought by a minority group of lenders seeking to challenge such transaction following the settlement of a dispute with a group of non-consenting lenders in the New York State Supreme Court, which denied a request for preliminary injunction in connection with the transaction. The minority lenders in the federal case alleged, among other things, that the financing transaction violated the covenant of good faith and fair dealing, and that an "open market purchase provision" in Serta's credit agreement – an exception to the general rule requiring pro rata prepayments of all lenders – did not permit Serta's non-pro rata purchase of loans of consenting lenders. The District Court in *LCM XXII Ltd. v. Serta Simmons Bedding, LLC*, No. 21 CIV. 3987 (KPF), 2022 WL953109 (S.D.N.Y. Mar. 29, 2022) ("*Serta II*"), denied the company's motion to dismiss and allowed the case to proceed to trial on those two questions. And while the ultimate outcome of *Serta II* could have significant implications for superpriority financing and uptiering transactions, the case is distinguishable from *TPC* for two reasons. First, the breach of contract claim that survived the motion to dismiss in *Serta II* centered on whether the company properly conducted open market purchases of the participating lenders' term loans, while the issue in *TPC* was whether the issuance of the Superpriority Notes violated one of the Original Indenture's sacred rights. Second, the plaintiffs in *Serta II* argued that the transaction violated the covenant of good faith and fair dealing in the context of a credit agreement, which traditionally embodies the principle that lenders in a syndicate share pro rata in payments by and recoveries from the borrower. In *TPC*, the plaintiffs made no such argument.

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[3] The Bankruptcy Court also briefly addressed the Non-Consenting Holders' argument that the Supplemental Indenture and the Superpriority Intercreditor Agreement effectively amended the ABL Intercreditor Agreement, stating that, while the 2021 Transaction placed the Superpriority Notes ahead of both the First Lien Notes and the ABL credit facility, nothing in the 2021 Transaction changed the rights of the holders of such debt vis-à-vis each other (and therefore was not a change that dealt with the application of the proceeds of collateral).

[4] It's worth highlighting that in previous liability management transaction cases, the objecting investors claimed that the subordination of liens on the entire collateral is effectively a release of all of the collateral (and therefore should be subject to the same consent threshold, which in those cases required the consent of all lenders). This argument was rejected by the courts in those cases, and the *TPC* decision reinforces the notion that they are two separate actions.

[5] The objecting noteholders' appeal of the decision is currently pending.

[6] Indeed, during the hearing in *TPC*, plaintiffs' counsel attempted to distinguish lien subordination as a measure that is inflicted on a minority group of holders by a majority group of holders, while the release of all liens is a measure that affects all of the parties equally with different consequences (the implication being that a release of liens harms the investment for everyone, while lien subordination may allow participating investors to have their cake and eat it too, all to the detriment of the minority group). In this regard, the plaintiffs argued that protection against lien subordination is an individual right that should be covered by Section 9.02(d)(10).

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