Proskauer

A Game of Survivor: Private Credit Restructuring Year in Review

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Private credit lenders started 2020 both with anticipation and trepidation. Activity levels were strong and default levels were at historic lows, but private credit lenders worried about the risk of economic headwinds – after all, we were then in the extra innings of the longest economic recovery on record.

At the time, we predicted the next wave of restructurings would be different because, unlike traditional lenders, private credit lenders have many more tools in the restructuring toolbox: strong relationships with sponsors, flexible capital that could be deployed in a downside scenario, the ability to operate at different levels of the capital structure, operational and financial experience, and, ultimately, the ability to own and operate a business, if necessary.

All of these tools were tested in 2020, as no one could have predicted COVID-19 and the impact it would have on the world, let alone the private credit restructuring market. According to Proskauer's Private Credit Default Index, default rates, which were under 2% pre-COVID, suddenly increased to over 8% as of the second quarter ended 2020, and threatened to continue to trend upwards. As most of the country began to work from home and Zoom became the virtual conference room, private credit lenders suddenly had to face difficult choices. In the extreme, they ranged from taking the keys of businesses with intensive capital needs and little prospects for short term revenue generation to rolling the "amend and extend" dice with sponsors and borrowers desperately trying to outrun a novel virus that showed no signs of regression. Collaboration among management teams, sponsors, and private credit lenders largely prevailed to solve liquidity issues and provided needed covenant relief.

But all was not smooth sailing. In some cases, the overnight decimation of pre-pandemic businesses caused seismic fulcrum shifts in valuation that intensified capital structure pressures and exacerbated the fault lines of intercreditor warfare that began to surface in 2019. Indeed, by early summer, the longevity of the virus and its attendant financial disruption fueled internecine battles among lenders trying to grab pieces of an ever shrinking pie. At the same time, borrowers and savvy sponsors also exploited flexibility in their credit agreements.

“Liability management” (we mean, shenanigans!) became the new watchword of the day. Despite borrower-friendly documentation wreaking havoc on numerous middle market credit deals (Serta, TriMark, and Boardriders), as we ended 2020 (good riddance!), the default rate settled back to a more modest 3.6% as of the fourth quarter 2020 according to Proskauer’s Credit Default Index and, private credit origination of borrower-friendly deals once again boomed, as vaccines became a reality, the presidential election (finally) arrived, and private equity and credit investors unleashed their pent up demand and capital for new investments.

Although we can see the proverbial light at the end of the tunnel, our view is that we are not out of the woods just yet. It still feels like we are watching one long game of Survivor. While federal stimulus and exuberant credit markets have thrown distressed borrowers an economic life preserver to weather the storm, no one really knows which businesses will survive unpredictable consumer behaviors and prolonged COVID-19 exposure this year.

The road to recovery remains challenging, and private credit lenders will still face troubled situations. So before we bid 2020 a final adieu, we look back and highlight those decisions that might keep private credit lenders up at night, as we expect tensions to flare up again in the coming year.

The Uptier Frontier – The Lender on Lender War

A series of cases starkly illustrated the “liability management” minefield. As companies faced with liquidity problems searched for sources of capital (often existing lenders or the sponsor), borrowers induced existing lenders to provide new financing by offering to exchange the existing lenders’ debt with new “super priority” priming facilities, a practice known as “uptiering.” In each case, the majority lenders agreed to amend the existing credit documents to permit the borrowers to issue new-money “super priority” debt and promptly traded in their existing debt for the super priority debt. Minority lenders were left with their existing debt now subordinated to the new super priority debt. Of course, these transactions led to legal challenges, and Serta, Trimark, and Boardriders became household names for private credit lenders overnight.

In Serta, the majority lenders under the first lien and second lien facilities exchanged their existing debt for new-money super priority debt – after the majority lenders voted in each case to approve the subordination of their respective existing tranches of debt to the new-money super priority debt. In each case, the minority holders were not offered the option to participate in the new-money issuance, and their existing debt became junior to the new superpriority debt. The minority lenders cried foul, arguing that the amendment violated the credit agreement’s restriction on amending the pro rata sharing provisions without each affected lender’s consent. The credit agreement, however, expressly permitted the non-pro rata “open market” Dutch auction repurchase of loans by the borrower, and the “waterfall” provisions were subject to change upon the consent of required lenders.

Similarly, in Trimark and Boardriders, majority lenders also exchanged existing debt for new-money “super priority” debt, leaving minority lenders with junior paper. In addition, prior to swapping out of their holdings in the borrower’s existing debt, the majority lenders went further and authorized an amendment that stripped the existing documents of their covenants.

In August of 2019, Revlon made news when it "pulled a J. Crew," transferring valuable intellectual property away from the 2016 term loan lenders to a new unrestricted subsidiary, which subsidiary received a new $200 million loan with a first priority security interest in the transferred collateral. More recently, in May of 2020, Revlon proposed a priming transaction that would move additional intellectual property collateral away from the 2016 term lenders by issuing a new money facility with a first lien on the intellectual property and "roll-up" of a portion of the 2016 term loans with a second lien on the intellectual property.

After more than 50% of the 2016 term lenders would not consent to the transaction, the company utilized what some are calling a "sham revolver." To increase the voting power of the lenders willing to consent to the priming facilities, the consenting lenders issued new, unfunded revolver commitments that gave them a majority of the voting power to effectuate the financing. The new revolving commitments were then promptly exchanged into the new priming loans but not before the "majority" revolver lenders voted to amend the agreement to permit different lenders to take control over enforcement rights for the limited collateral remaining for the 2016 term loans.

Minority lenders in each of Serta, Trimark, Boardriders, and Revlon have brought suits contesting the propriety of the transactions. Minority lenders were denied requests for preliminary relief and the matters remain subject to pending litigation. While we await the outcome of these cases, we can anticipate future liability management battles and note that private credit lenders are keenly focused on credit agreement provisions that potentially permitted these transactions to occur.

Action in the DIP Financing Arena

During 2020, bankruptcy cases spiked compared to 2019, which naturally led to skirmishes over the terms of debtor-in-possession (or DIP) financing. DIP financing is a powerful tool for lenders to exert leverage in a chapter 11 proceeding. We witnessed a number of interesting matters worthy of note to private credit lenders.

DIP financing generally is provided by prepetition first lien lenders. As a condition of the DIP financing, these lenders will seek to have some, if not all, of their prepetition loan refinanced or “rolled-up” into the DIP financing. There are a host of benefits to a roll-up, so prepetition lenders seek to maximize the amount rolled-up, but it has the effect of “priming” any prepetition debt not subject to the roll-up. A 2:1 roll-up generally is considered to be the norm; that is, the prepetition lender can roll-up $2 of prepetition debt for every $1 of DIP financing. During 2020, we saw the roll-up ratio pushed and, in one notable case, True Religion, we saw a roll-up of 4:1.

The case also illustrated yet another liability management risk: the roll-up was not on a pro rata basis, as not all prepetition lenders participated in the DIP financing. Instead, a group of *minority* lenders provided the DIP financing and primed the *majority* prepetition lenders!

As a rule of thumb, priming DIP financing generally has been thought to require the existence of an equity cushion after giving effect to the DIP financing so the primed prepetition secured lenders are protected (a/k/a “adequately protected” in bankruptcy parlance). In the True Religion case and other cases, we saw priming DIP financing permitted *without* a showing of an equity cushion on the basis that a loan that helps a company avoid liquidation is adequate protection.

Two other cases during 2020 illustrate the flexibility and limits of DIP financing. In October 2020, a bankruptcy court in the Southern District of New York in the Grupo Aeromexico case approved a DIP financing in which the DIP lenders could elect to convert their DIP financing into reorganized equity. This type of provision risked the DIP financing being challenged as an improper *sub rosa* plan of reorganization (i.e. disguised or hidden plans of reorganization), which are prohibited under the Bankruptcy Code. The statutory creditors’ committee and other key creditors supported the financing, and the court approved it.

But in a similar situation, the bankruptcy court in Latam Airlines refused to approve the DIP financing with a similar conversion feature. In that case, the company initially sought approval of a multi-tranche $2.2 billion DIP financing. The DIP financing allowed the debtors to repay the junior most tranche, provided by the debtors' prepetition controlling shareholders, to be repaid, at the debtor's election, with equity in the reorganized debtor at a steep discount to plan value. In addition to the conversion feature favoring insiders, the financing was opposed by various creditor groups, including the statutory creditors' committee.

While the bankruptcy court concluded that the debtors had demonstrated that the DIP financing was necessary, fair, and in "good faith," it would not approve the proposed DIP financing, finding that it constituted a *sub rosa* plan. Ultimately, the conversion feature was removed and the financing approved.

Tribune: Intercreditor Subordination Agreements

Subordination agreements generally are enforceable under the Bankruptcy Code. So typically, senior lenders enter a bankruptcy case with the comfort that distributions otherwise payable to a subordinated creditor are going to be subject to turnover to the senior lender. The Third Circuit Court of Appeals in the Tribune Company case threw a curveball to the senior lender when it held that debt subordination agreements need not be "strictly enforced" when confirming a non-consensual chapter 11 plan, or "cramdown."

In that case, the debtor filed a plan of reorganization that provided all but a small portion ($30 million!) of the distribution payable to the subordinated noteholders were to be distributed to the senior noteholders in accordance with the terms of the subordination provisions of the subordinated notes. (For context, the senior noteholders recovery would have increased by 2.3%). The plan provided that the $30 million that otherwise was subject to turnover to the senior noteholders was to be paid to other creditors in the case. The senior noteholders asserted that the plan could not be confirmed unless the distributions were made in strict accordance with the subordination provisions of the notes. Seemed like a pretty open and shut case.

The bankruptcy court saw it differently. In a results oriented decision, it overruled the objection of the senior noteholders and confirmed the plan on the grounds that the difference (which amounted to a mere 0.9% in recovery and was “immaterial” and fair, and, ultimately, on appeal, the Third Circuit agreed with the bankruptcy court.

Our view is that private credit lenders can rest easy, as the Tribune ruling does not serve to undermine the integrity of subordination agreements. More than anything, this case serves as a reminder that often around the edges there is bias in bankruptcy for decisions that encourage reorganization.

Ultra Petroleum: The Make-Whole Battle Carries On

It seems that every year brings litigation over the enforceability of make-wholes, and 2020 proved no exception. The battle lines in Ultra Petroleum stem from whether or not makes-wholes are treated as unmatured interest, which the Bankruptcy Code disallows.

In that case, the Fifth Circuit previously ruled that a make-whole could be construed as a proxy for unmatured interest. As a result, the case was sent back to the bankruptcy court to determine the nature of the make-whole claim. The bankruptcy court found the make-whole was not “unmatured interest” (nor the economic equivalent thereof) because the make-whole payments compensated the claimants for Ultra’s decision <u>not</u> to use their money, rather than interest. The bankruptcy court further distinguished make-whole payments from interest, noting that interest accrues over time, whereas the make-whole payment was a fixed amount.

While the bankruptcy court held the make-whole was enforceable, it observed that each case is a fact-specific inquiry, ensuring that the make-whole battles will carry on. The impact of this decision remains to be seen, as it will likely make its way back to the Fifth Circuit Court of Appeals (again).

Golden Shares: Real or Fool’s Gold

Private credit lenders may seek the issuance of a “golden share” (a share that is issued to the lender, the consent from which is required for the company to voluntarily file bankruptcy) in connection with a substantial restructuring. It is the trade-off granted by the company for concessions offered by the lender to effectuate an out-of-court workout. There has always been some debate as to enforceability of these consent rights. In 2020, the efficacy of the “golden share” was again tested in a Delaware bankruptcy filing by Pace Industries.

In connection with its roughly $37 million preferred equity investment, the preferred shareholder obtained various rights and protections, including an amendment to the company’s corporate charter to include a “golden share” provision. Following the COVID-19 pandemic, Pace Industries found itself in dire financial straits, unable to pay hundreds of millions of dollars of debt, closing many of its manufacturing facilities, and laying off the majority of its employees. The company, however, successfully negotiated a restructuring and filed a chapter 11 petition to implement the restructuring, which was supported by the company’s secured creditors and which proposed to pay unsecured creditors in full. The preferred shareholder did not consent to the petition and moved to dismiss the case.

In denying the motion to dismiss, the bankruptcy court was keenly focused on the harsh reality facing Pace Industries, and ultimately persuaded both by the fact that the COVID-19 outbreak had forced the company to shut down most of its operations and the proposed DIP financing was the company’s only source of liquidity in the midst of a global pandemic. Furthermore, the bankruptcy court observed that the preferred shareholder had not offered any viable alternatives. As a result, the bankruptcy court refused to enforce the “golden share” and concluded that permitting the bankruptcy filing likely would benefit the greatest number of stakeholders, while dismissing the bankruptcy case would violate federal public policy by taking away a debtor’s constitutional right to bankruptcy relief.

We note that the Fifth Circuit Court of Appeals, however, reached a different conclusion in the 2018 case of Franchise Services, where a preferred shareholder agreed to make a $15 million investment in a company so long as the company reincorporated in Delaware and amended its corporate charter to include a “golden share” provision. When the company filed for chapter 11, the preferred shareholder sought to dismiss the case, arguing that the petition could not be authorized without a shareholder vote. The company responded by asserting that the shareholder’s argument was a pretense for its true motivation – to secure undue leverage for repayment of its $3 million claim for unpaid consulting fees. In affirming the dismissal of the bankruptcy case, the Fifth Circuit agreed with the preferred shareholder and upheld the right of a bona fide preferred shareholder to exercise its “golden share.”

Given the split in legal authority, this issue remains ripe for challenge in the years to come.

Foreclose Away: No Shareholder Vote Required for Lenders Exercising Remedies

Stream TV Networks was an important case that should help private credit lenders more effectively achieve out-of-court restructurings. Under the Uniform Commercial Code, there are provisions (called “strict foreclosure” provisions) that allow a company to transfer to its lender the lender’s collateral in full or partial satisfaction of the debt owed by the company. Private credit lenders holding all asset liens might look to use this provision, as it offers an efficient means to effectuate an out-of-court, consensual restructuring without the time and expense of a bankruptcy case. The question has been whether shareholder approval was required for a strict foreclosure.

In the Stream TV Networks case, following payment defaults and ongoing financial difficulties, Stream TV Networks’ independent directors negotiated an agreement that provided for a voluntary transfer of Stream’s assets to SeeCubic, Inc., a newly formed entity owned by Stream’s secured creditors. Stream’s interested directors, who opposed the transaction and who were looking to exercise leverage, sought to stop the foreclosure, arguing that stockholder consent was required under Delaware law before the corporation could transfer its assets to the secured lenders.

The Chancery Court found that Delaware law did not require the company to obtain shareholder approval to transfer its assets to its secured creditors in a consensual foreclosure. This decision will help clear the path for more consensual restructurings without interference from out-of-the money shareholders.

Mothballing Bankruptcy Case: Pushing The Boundaries

This past year brought many novel restructuring challenges. In the retail area, the impact of COVID and governmental imposed closures or restrictions on gatherings were particularly consequential and resulted in a series of bankruptcy filings. Normally, debtors have to keep moving the case along and pay certain postpetition obligations (including, for instance, rent) while they pursue their restructuring efforts. In some of those cases, bankruptcy courts were faced with requests by debtors to suspend or mothball cases relying upon a seldom used provision of the Bankruptcy Code while they waited out the effects of the pandemic.

Bankruptcy courts in the chapter 11 cases of Modell's Sporting Goods, CraftWorks (a restaurant chain), and Pier 1 all granted temporary pause in their bankruptcy cases (over the objection of various creditors and landlords who were not being paid during the suspension period) to give them an opportunity to husband their resources to later pursue their restructuring strategies. Other debtors, like CEC Entertainment (operators of Chuck E. Cheese) and Art Van Furniture were not so lucky, as the courts in those cases denied similar requests. As the pandemic abates, we expect these types of novel arguments will gain less and less traction.

Conclusion and A Look Forward

As we look forward, we believe that the private credit restructuring trends of 2020 will continue through 2021. While parties collaborated in 2020 to ride out the effects of COVID, there will be companies that struggle as we begin to emerge in the latter half of 2021. We continue to believe that the commercial impulses of sponsors, borrowers and private credit lenders will more often than not result in solutions reached in the virtual conference room, and not the courtroom. However, there inevitably will be those cases where the limits of liability management continue to be tested or otherwise end up having to be decided by a judge. We will continue to monitor the courtroom action, as it plays out.

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