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Liability Management Exercises and the Litigation Quagmire

By H. Peter Haveles Jr. [*]

Distressed borrowers are burdened with substantial indebtedness, subject to numerous covenants and restrictions. As the credit markets have become more difficult and have impaired the ability to restructure and refinance that debt, borrowers have employed numerous strategies, particularly liability management exercises, to restructure that debt. In this article, the author examines the difficulties lenders face in the courts when a lender class is not unanimous and disputes arise regarding the treatment of the nonparticipating lenders. The author also reviews how the courts have been inconsistent in resolving these disputes and concludes by identifying a path to reduce the litigation risks in those circumstances.

For too long, many businesses have struggled with more debt than they can bear, lulled into carrying a substantial debt load by an unduly prolonged 15 years of nominal interest rates. As a result, as businesses have struggled with that debt load and sought to restructure that debt to avoid seeking relief under the U.S. Bankruptcy Code, those businesses have attempted to confront that dire problem by engaging in liability management exercises (LMEs) in order overcome the restrictive covenants in the existing agreements for senior term debt (be it secured or unsecured).[1]

At the same time, the creditors to whom that debt is owed have had to confront those businesses' efforts to evade those restrictions while restructuring their debt. Too frequently, the borrowers have pursued LMEs with the participation of only some of its senior creditors, ignoring and thereby prejudicing the rights of other senior creditors in the process. The result has been a steady stream of creditor/intercreditor/borrower litigation regarding the validity of debt restructured with the support of only some of the senior lenders.

APPELLATE RULINGS

That struggle is highlighted by two appellate decisions issued at the last days of 2024 regarding "uptier" restructuring transactions that, for all intents and purposes, undermined the "sacred right" of ratable treatment of lenders. Yet, while one court said yes, the scheme was invalid, the other court said no. In *In*

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[1] Much has been written about the inequities of LMEs, and LMEs have been described as "lender on lender violence" nonparticipating lenders are losers. See, e.g., Note, Uptier Exchange Transactions: Lawful Innovation or Lender-on-Lender Violence?, 40 Yale J. on Reg. 408 (2023).

re Serta Simmons Bedding, LLC,[2] the U.S. Court of Appeals for the Fifth Circuit invalidated an uptier restructuring as a breach of the loan agreement, reversing the bankruptcy court's judgment. In elevating form over substance in *Ocean Trails CLO VII v. MLN Topco Ltd.*,[3] the First Department of the New York Appellate Division upheld the uptier restructuring as a matter of law.

Such restructuring solutions that benefit only some but not all of a senior creditor class have given rise to litigation because the transactions expose the nonparticipating creditors to meaningful economic risk. Much of that risk arises from inconsistent decisions by different courts because of the lack of precision (i.e., the ambiguity) in the restrictive covenants and the terms protecting the senior lenders' rights. In the long run, these inconsistent judicial outcomes create uncertainty and prejudice for both creditors and borrowers, as neither can be sure how the courts will assess the validity of the restructuring supported by only a portion of the senior creditor class. Although little can be done to minimize or eliminate that risk for existing loan agreements, sharper, clearer and more comprehensive drafting of the restrictive covenants is the only long-term solution.

These two decisions do not address the only disputes that the courts have confronted regarding borrowers' attempts to restructure with the participation of only some senior creditors. Case law from the last decade illustrate the erratic treatment that these efforts have received. In some cases, the courts grant summary judgment in favor of the excluded creditors; in other cases, the courts rule in favor of the borrower/participating creditors; and in other cases, the courts deny dispositive motions and a trial must occur, with a resolution years after the restructuring process began.

It is common for senior term debt loan agreements to include a provision, commonly referred to as a "sacred right," that provides that all holders of the debt are to be paid ratably, *i.e.,* that no member of that lender class can be paid more than its ratable share. It is also common that there are narrow exceptions to the restrictive covenants that would permit the borrower to reduce the debt load, such as permitting the debt to be purchased either in the open market or by some version of a Dutch Auction in the uptier scenario. There have been a number of instances when, in an effort to restructure their debt burden, borrowers have attempted to contort transaction to avoid breaching the loan

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[2] In re Serta Simmons Bedding, LLC, 125 F.4th 555 (5th Cir. 2024), revised and superseded, 2024 U.S. App. LEXIS 33815 (5th Cir. Feb. 14, 2025), reh'g denied, 2025 U.S. App. LEXIS 3694 (5th Cir. Feb. 18, 2025).

[3] Ocean Trails CLO VII v. MLN Topco Ltd., 233 A.D.3d 614, 2024 N.Y. App. Div. LEXIS 7034 (1st Dep't Dec. 31, 2024).

agreement by seemingly employing one of the exceptions noted above or through other exceptions in the loan agreement.[4]

In Serta, the Fifth Circuit confronted a situation in which the borrower purchased the debt of certain members of the lender class and issued new super-priority debt to those participating lenders in exchange for new financing of $200 million. The borrower and the participating lenders attempted to characterize the purchase of the existing debt held by the participating lenders as an "open market purchase" transaction and thus permissible under the loan agreement.

The Fifth Circuit rejected that characterization, after reviewing the terms of the loan agreement and defining what an "open market" transaction constitutes.[5] The court construed that provision as a matter of law, without finding an ambiguity. The court held that an "open market purchase" occurs in a market that is generally open to participation by various buyers and sellers and that the market is an unrestricted market in which buyers and sellers may trade freely.[6] Here, the transaction with the participating lenders did not occur in such a market, but was privately negotiated, excluding the nonparticipating lenders as well as any other parties.

The court rejected the borrower's argument that an "open market purchase" means to acquire something for value and competition among private parties.[7] In the court's view, the borrower and the participating lenders struck the word "market" from that requirement and that the expansive definition proffered by the borrower and the participating lenders would "swallow" the Dutch auction exception, permitting a borrower to label any arms-length transaction as an open market purchase.[8]

In *Ocean Trails*, the court was confronted with a different transaction to overcome the sacred right provision. The borrower engaged in a transaction with the participating lenders that the borrower characterized as an "assignment" because the participating lenders assigned their loans back to the borrower, which the borrower then cancelled and replaced with new super priority loans. The transaction's structure effectively subordinated the rights of the nonparticipating lenders.

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[4] In addition to uptier transactions, borrower attempt "drop down" transactions, tender offers and purported open market exchanges to evade the restrictive covenants.

[5] 125 F.4th at 578-82.

[6] Id. at 579-80.

[7] Id. at 580.

[8] Id. at 581.

However, elevating form over substance, the Appellate Division held that the transaction was not a breach because, even though the transaction was a pure restructuring, the borrower purchased the debt via a technical assignment (which was permissible) from the participating lenders.[9]

Further, the court rejected the contention that the nonparticipating lenders were adversely affected in violation of the loan agreement, holding that the subordination only indirectly affected the nonparticipating lenders rights and therefore was not prohibited.[10] With respect to each contractual provision advanced by the nonparticipating borrowers, the court observed that, had those lenders wanted to be protected, they could have included additional language and could have included more restrictive covenants as sacred rights.[11] For a court that typically enforces creditor rights, the Appellate Division loosely interpreted the terms of the loan agreement in order to override the restrictive covenants that should have prevented an uptier transaction that unquestionably prejudiced the nonparticipating lenders.

These two decisions are instances when the courts have found the answer to be black and white and have ruled as a matter of law. However, the courts often have found the restrictive covenants to be ambiguous, thereby denying dispositive motions either to dismiss the complaint or to grant summary judgment and requiring a trial on the merits.

OTHER COURT DECISIONS

In an earlier action brought by a group of lenders in the Southern District of New York regarding Serta's attempted refinancing, the court denied the motion to dismiss.[12] Unlike the Fifth Circuit ultimately did, the district court found that the term "open market purchase" was ambiguous and noted that the interpretation proffered by Serta and the participating lenders that an "open market" could mean just a willing buyer and a willing seller in an arms-length negotiation was a possible meaning.[13] The court concluded that there was no definitive meaning that permitted the court to rule as a matter of law.[14] As a

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[9] 2024 N.Y. App. Div. LEXIS 7034, at *3-4.

[10] Id. at *2.

[11] Id. at *3.

[12] See LCM XXXII Ltd. v. Serta Simmons Bedding, LLC, 2022 U.S. Dist. LEXIS 57976 (S.D.N.Y. Mar. 29, 2022).

[13] Id. at *18-20.

[14] In contrast to the ruling, the same district court granted summary judgment, holding that a loan restructuring whereunder the loans held by junior unsecured noteholders would be exchanged for new secured indebtedness that would share pari passu in the first priority liens held

result, the litigation continued for another ten months until Serta filed its petition for relief under Chapter 11 of the Bankruptcy Code in January 2023, and this dispute was consequently resolved by the Fifth Circuit's decision.[15]

Likewise, the bankruptcy court in *Black Diamond Commercial Finance, L.L.C. v. Murray Energy Corp.*,[16] denied cross-motions for summary judgment after initially denying in part a motion to dismiss with respect to the nonparticipating lenders' claim that the transaction violated the loan agreement. Having failed to obtain consent from all the lenders to extend the maturity date of the loan, the borrower and certain of the lenders entered into an agreement whereby they:

(i) Amended the loan agreement to eliminate the right of nonparticipating lenders to participate in the transaction;

(ii) Used a purported "modified Dutch auction" to repurchase the term loans on a non pro rata basis from the participating lenders; and

(iii) Entered into a super priority credit agreement with the participating lenders that subordinated the nonparticipating lenders. [17]

The court had to address whether the borrower's auction complied with the loan agreement. In an earlier motion to dismiss decision, the court had rejected the borrower's arguments that the auction did not have to comply with the detailed procedures set forth in Exhibit M to the loan agreement and that it would be sufficient if the auction merely satisfied other acceptable procedures.[18] Despite that ruling, the nature of the borrower's auction and whether it complied with the exhibit's procedures were hotly disputed by dueling experts on industry standards.[19] As a result, the court could not resolve the issue as to how the term modified Dutch auction was understood in the finance industry and therefore denied summary judgment.[20]

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by the term lenders was barred by the term loan agreement. See Cumulus Media Holdings Inc. v. JPMorgan Chase Bank, N.A., 2017 U.S. Dist. LEXIS 66110 (S.D.N.Y. Mar. 31, 2017) (the court's opinion is set forth on the record at a February 24, 2017 hearing – No. 16 Civ. 9591 (KPF), Dkt. 118).

[15] Id. at *19, 22-23.

[16] Black Diamond Commercial Finance, L.L.C. v. Murray Energy Corp., 634 B.R. 951 (S.D. Ohio 2021).

[17] Id. at 961.

[18] Id. at 962.

[19] Id. at 963-67.

[20] Id. at 973-74.

In *Bank of New York Mellon v. Realogy Corp.*,[21] the court had to address the borrower's attempt to conduct a debt exchange entailing the issuance of new notes to the participating lenders that would be pari passu with the senior notes under the initial loan agreement, but would have security unlike the unsecured senior debt held by the nonparticipating lenders. The indenture trustee contended that the transaction violated the loan agreement's negative covenants that, among other things, prohibited the granting of greater security to a new noteholder.[22] The court rejected the borrower's reliance on more general provisions in the loan agreement to override that restriction, and it held:

> There is no right in the senior notes to additional security, nor is there any provision in Section 6.02 that would permit it. As a result, the refinancing of the senior notes with second lien term loans does not qualify as permitted refinancing indebtedness.[23]

In *U.S. Bank National Association v. Windstream Services, LLC*,[24] the court held a trial to resolve a dispute under a different set of restrictions that the borrower sought to evade. The loan agreement barred the borrower from incurring any new indebtedness if it would cause the borrower to exceed a "consolidated leverage ratio."[25] To evade that requirement, the borrower restructured its business by spinning off an entity that the borrower organized as an REIT and then entered into a sale leaseback agreement with that REIT with respect to the borrower subsidiaries' assets.[26] The indenture trustee promptly challenged that transaction on the ground that the sale leaseback transaction did not comply with the conditions for related party transaction set forth in the loan agreement.

In response, the borrower made an offer to noteholders in other bond tranches to exchange their notes for newly issued senior notes in order to dilute the percentage of senior notes held by the nonparticipating noteholder and to obtain consent from the new and participating noteholders to waive any default arising from the invalid sale leaseback transaction.[27] Upon the sale of the new senior notes, the borrower consequently amended the indenture to waive the

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[21] Bank of New York Mellon v. Realogy Corp., 979 A.2d 1113 (Del. Ch. 2008).

[22] Id. at 1127.

[23] Id. at 1128.

[24] U.S. Bank National Association v. Windstream Services, LLC, 2019 U.S. Dist. LEXIS 26129 (S.D.N.Y. Feb. 15, 2019).

[25] Id. at *7.

[26] Id. at *16-19.

[27] Id. at *26-27.

borrower's default.[28] The court denied the borrower's motion to dismiss, and the court held a trial after extensive discovery.

At trial, the borrower attempted to recharacterize the transaction as not being an impermissible sale leaseback, but the trial court rejected that contention, pointing to the substance as opposed to the form of the transaction.[29] The trial court also held that the amount of the new notes exceeded the amount of additional indebtedness permitted under the loan agreement.[30] Thus, the trial court held that the new notes could not be used to amend the loan agreement and to waive the breach of the sale leaseback restrictions.[31] Even though the trial court concluded that the terms of the loan agreement were plain and unambiguous, because the nature of the borrowers' sale leaseback transaction was factually disputed, the trial court was not able to enter judgment in favor of the nonparticipating lender until 16 months after the litigation was commenced.[32]

The recent history of frequent challenges to borrowers' attempts to evade restrictive covenants does not paint a reassuring picture for lenders. These disputes end up in the courts because of both the financial prejudice to nonparticipating lenders as well as poorly drafted or inadequate restrictive covenants. As a result, the courts are just as likely to postpone resolution of the challenge on the ground that there are contractual ambiguities or factual disputes that cannot be resolved immediately. Thus, senior lenders seeking to protect their rights under the loan agreements run a meaningful risk of incurring both substantial delay and expense. The litigation over eight years regarding Serta's exchange plan is a telling example of such costs. The risks to lenders are best exemplified by a seemingly favorable 2016 decision.

In *Citibank, N.A. v. Norske Skogindustrier ASA*,[33] the district court ruled that the plaintiff established that it was likely to succeed in establishing that the borrower's restructuring via an exchange offer violated the loan agreement's

[28] Id. at *27-28.

[29] Id. at *45-51.

[30] Id. at *76-80.

[31] Id. at *80.

[32] The litigation was all for naught. A week after the district court issued its ruling invalidating the attempted restructuring, the borrower filed a petition for relief under Chapter 11 of the Bankruptcy Code.

[33] Citibank, N.A. v. Norske Skogindustrier ASA, 2016 U.S. Dist. LEXIS 35784 (S.D.N.Y. Mar. 8, 2016).

prohibitions about refinancing parent notes.[34] Yet, the court denied the motion for a preliminary injunction because the objecting noteholder could not establish irreparable injury and left the issue of injury for discovery and a later adjudication.[35]

LESSONS AND OBSERVATIONS

Several lessons and observations can be drawn from these disputes.

- First, financially distressed borrowers will persistently seek to exploit weaknesses or ambiguities in a loan agreement to effect a restructuring whenever there are senior noteholders who object and decline to participate in a restructuring of the borrower's debt stack.
- Second, vague and undefined or incomplete terms in the loan agreements are lenders' Achilles heel. Such terms enable the borrower to undertake its seemingly invalid restructuring scheme, and courts will often decline to construe such terms as a matter of law.
- Third, the objecting noteholder will have to resort to litigation to protect its rights, which will entail substantial cost and possibly a lengthy delay before the dispute is resolved, with the attendant risk of the borrower ultimately seeking relief under the Bankruptcy Code.
- Fourth, the only protection for lenders is more rigorous drafting of the restrictive covenants with borrowers that do not have AAA credit. Light covenants in less than pristine credit situations transfer risk to the lender. For new financing, lenders need to require restrictions concerning restructuring or refinancing that are not susceptible to being found ambiguous. The recent trend has been with at least some new lenders to strengthen the covenants to prevent borrowers from engaging in LMEs. But more vigilance is necessary. The history of litigation over terms such as "open Market" and "Dutch auction" (which enable borrowers to argue that industry practice supports their actions) will invariably weaken the ability to seek relief in the courts. The same is true with the new "LME blockers" that lenders are employing – they must be scrubbed to eliminate any ambiguities or loopholes. Such terms must be accompanied by precise definitions that expressly state what is permissible and what is not permissible. And if borrowers say no to tougher restrictive covenants, then the lenders are in a quintessential caveat emptor situation and must ask if the future risks are

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[34] Id. at *11-12.

[35] Id. at *13.

worth the short-term benefit of extending the loan and obtaining new business.