LIABILITY MANAGEMENT WHACK-A-MOLE

Josh Feltman, Justin Forlenza, Jennifer Selendy, and Samuel Kwak

Liability management exercises and consequent objections to and redrafting around them have been compared by some commentators to a game of whack-a-mole. Just as one strategy arguably permitted by contract is accepted or rejected by the courts and/or the market, another strategy creatively designed by lawyers and bankers pops up.

The Creditor Rights Coalition, a thought-leadership advocacy organization, asked its expert Contributors to weigh in on the ongoing Incora trial in the Southern District of Texas. The SDTX, which in recent years has heard the plurality of nationwide large bankruptcy cases, is the first bankruptcy court to engage in an extensive weeks-long trial (no final decision as of this writing) after ruling against the company at the summary judgment stage. Will Incora be viewed as just another bump along the road, or does it indicate a more fundamental shift in terms of law, litigation strategy, or choice of venue? How closely are financial sponsors examining what's happening in Incora? Read on.

The views expressed are those of the authors only. Learn more at www.creditorcoalition.org.

Josh Feltman (*Wachtell Lipton)*:

Pre-*Incora* we had *Serta* as a lodestar, guiding debtors' wagons southwest from Yankee concerns about good faith and the need for further factual development to Cowboy certitude as to the completeness of the very same written contracts and the meaning of "open market." Post-*Incora* we face the Scylla of "good faith" (and the need for further factual development) in New York and the Charybdis of the "Integrated Transaction Doctrine" (and the need for further factual development) in Texas. The law-school version of me could write a 50-page article on the difference between those two, but the old-man version can synopsize it in three-words: *six of one* . . . Each is susceptible to application in a wide variety of circumstances and leaves substantial room for judicial discretion.

Or at least I hope that's the case. If Judge Isgur's summary judgement opinion stands for the proposition that any amendment to a debt document followed by a transaction that would not have been permitted but for that amendment should be "integrated," then this decision is vastly more radical than anyone believes. (Other than every single law-firm currently representing someone on the losing end of a transaction that required modification of pre-existing loan documents, perhaps.)

That said, *Incora* involves two circumstances constituting metaphorical "moles" particularly susceptible to whacking, the involvement of equity sponsors in the additional capacity of creditholder participants in the debt exchange and the issuance of new debt (itself then immediately exchanged) in order to obtain the requisite vote of an existing class. Without expressing a real opinion, one might allow that it is at least plausible that a judge would find those two circumstances indicative of (1) a breach of the implied covenant of good faith (though Judge Isgur declined to do so) *and/or* (2) transactions in respect of which the separate mechanical steps are simply too precious to credit as having independent legal significance (a notion Judge Isgur is willing to entertain).

One could also imagine a narrowly tailored decision emerging from the exhaustive trial, following which we all deem the whole case much ado about nothing, or at least that the creditor takeaway ought merely to be "don't let the sponsors get high on their own supply." A settlement could actually be the most impactful outcome from a market perspective, as we would be left with all of the Judge's very interesting questions and analysis but not very much in the way of guidance on application to particular facts.

In this light, I think the close watching may be coming more from leading creditor types than from sponsors. It is well documented that liability management transactions often do not "work," where "work" is defined as "avoid a short to medium term bankruptcy." Nonetheless, sponsors will always have an incentive to try to extend their runway—what do they have to lose given the company is footing the bill, even of the inevitable litigation? But if creditors come to believe that liability management is likely not to "work"—defined as "provide participating debtholders with a high probability of a meaningful non-ratable recovery"—then the benefits to the corporate enterprise of an earlier restructuring (less aggregate cash burn, earlier ability to reinvest in the business and/or shed burdensome contracts, quicker path to control, a cheaper, less litigious, less risky bankruptcy) may come to dominate the decision calculus. At the least we might conclude that *Incora* has already placed another stone on that side of the scales.

Justin Forlenza *(Covenant Review)*:

The term "Whack-A-Mole" is a fair way to describe what has been going on in the liability management market since its inception. For every contractual provision that lenders attempt to strike down by adding a "blocker" or another type of protective provision, it seems that two more potential moles will spring forth, either hidden in old agreements (waiting to be unearthed by crafty lawyers and financial professionals) or developed *de novo* by clever lawyers. When credit agreements now consistently run upwards of 300 pages and ever increasing in complexity, there are always more potential loopholes that borrowers or their sponsors may exploit in a liability management scenario.

Consider the Serta blocker: although *Covenant Review* has seen Serta blocker provisions increasingly included in broadly syndicated loans since 2020, their drafting leaves potential holes large enough to drive a double-length NYC bus through. Several recent uptier liability management transactions have been structured as two-step transactions: first, the majority lender group that is steering the transaction amends the credit agreement to allow for a priming debt incurrence and exchange transaction and also to strip most of the existing covenant and default protections. Step two is the "ratable offer" made to the existing minority lender group, which is often required by the Serta blocker provisions.

However, even *if* a protective provision is included, there is no guarantee that it will work to actually protect a minority lender group. Serta blockers often only vaguely require the priming debt to be offered to all lenders on the "same" terms; often backstop, commitment, and similar fees are explicitly *excluded*. As such, the majority "steering" lender group could receive significantly better economic terms than the other lenders and still comply with the Serta blocker. Further, the terms of the priming debt can sometimes be explicitly *adverse* to the existing lenders—the currency may be different, or there could be a PIK interest component included.

One complicating factor in the *Incora* transaction was the "vote rigging" element. Because it could not initially garner sufficient bondholder support, *Incora* first amended its existing indenture to permit the issuance of additional notes, which then voted to meet the two-thirds threshold for collateral releases required by the original indenture. Judges appear to view this tactic (used several times including in *Revlon*, *Bombardier*, and *iHeart*), with some distaste, which perhaps provides them with an incentive to allow litigation to proceed. And although the opinions seemed to throw cold water on good faith and fair dealing arguments, the reasoning under the "integrated transaction" or "step-transaction" doctrine (which states that when different components of a transaction are sufficiently related, the court can consider them as part of the same overall transaction) is similar. In each case, it seems that the judges are, at least implicitly, looking through the form of these transactions to analyze the overall substance. In both cases, the courts found that whether the step-transaction doctrine should be applied to collapse the various transaction steps to a single set of related transactions was a factual issue of intent, and therefore could not be dismissed before a trial.

This doctrine might be a viable alternative to the good faith and fair dealing doctrine when assessing the viability of an uptier liability management transaction. Practically speaking, everyone involved in these transactions understands that even if they are technically structured as multi-step amendments and exchange offers, they are all interrelated. The step-transaction doctrine is especially important in the vote rigging context, because in those transactions it is pretty clear that without the additional notes issuance, the issuer would not have received sufficient consents to allow for the collateral release / subordination element of the transaction.

Regardless, even if courts begin to more creatively apply transactional doctrines in these contexts, there are still many other credit agreement provisions that issuers can take advantage of in order to structure a liability management transaction. As such, the game of whack-a-mole is likely to continue indefinitely.

Jennifer Selendy and Samuel Kwak *(Selendy Gay)*:

Although the first of its kind in some respects, the ongoing drama in the *Incora* case should not have come as a surprise to anyone following the litigation of liability management transactions or, as some call it, lender-on-lender violence.

Like previous uptiering decisions denying motions to dismiss, the court's summary judgment ruling highlights a common feature of these recurring contract claims—whether the transaction constituted a breach often hinges on crucial, yet undefined, terms: "redemption" and "right of payment" in *Incora*; "open market purchase" in *Serta*; and "purchase" in *Mitel*, to name just a few. The ambiguity of such terms both opens the door to these transactions in the first place and prolongs the resolution of the inevitable disputes that ensue as we see playing out now. The company and participating lenders argue that without a specific anti-subordination sacred right, uptiering is permitted. Excluded lenders protest that credit agreements were drafted to protect against subordination and indecorous exits whether or not such agreements used the magic "s" word.

Any trial court tasked with resolving these ambiguities faces a number of complexities. While bankruptcy courts could sometimes be viewed as expedient to meet the deadlines imposed by debtors looking to a shotgun bankruptcy proceeding, it is heartening to see Judge Isgur prioritize the trial's timeline over that of the debtor's unrealistic confirmation schedule.

We are watching a real-time battle of experts. In *Incora*, each side has retained a Columbia law professor to endorse the party's desired reading of the contract in light of the purported industry standard. Dueling experts on the meaning of central and disputed contract provisions will almost always preclude summary judgment.

Contractual ambiguity also necessitates a factual inquiry into the intent of the drafting parties as well as the circumstances surrounding the execution of the transaction at issue. We have seen substantial testimony from a substantial number of participating lenders, company witnesses, financial advisors, and the equity sponsor. According to Judge Isgur, the debtor and participating lenders' intent will inform whether there was an "integrated transaction." While it is well-settled in many jurisdictions that multiple agreements executed at the same time may constitute a single transaction, this issue has not been ruled upon decisively in the context of liability management transactions. Further, because Judge Isgur allowed the tortious interference claim against the equity sponsor to proceed, the equity sponsor is not off the hook, and the nature of the trial has covered the actions of the sponsors.

Recent developments in *Incora* suggest an expeditious resolution will be difficult. In fact, the mediation that took place in the middle of the trial was not successful, and the trial has resumed. As a result, *Incora* has pushed back the plan confirmation hearing by another month, delaying the hearing that was initially scheduled for February 27 to May 16. Given how expensive each additional day in bankruptcy is, the delay caused by the protracted dispute over a liability management transaction—

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which was purportedly executed for the benefit of the debtor—undermines the prospect of *Incora*'s emergence from bankruptcy in a strong financial position.

Incora is also the first uptiering case to find the excluded lenders' contract and tort claims to be non-core claims under the bankruptcy code. While the bankruptcy court may "submit proposed findings of fact and conclusions of law to the district court," only the district court may enter a final judgment as to the claims and may review *de novo* the bankruptcy court's findings and parties' objections absent the parties' consent to entry of a final judgment by the bankruptcy court. Under federal law, there is also a chance that the district court is required to or chooses to remand the case to the state court. This means a bankruptcy court's *non-final* ruling may be subject to an early challenge. Indeed, 15 days after Judge Isgur's order, one of the excluded lenders sought clarification on whether the court's order constituted "proposed findings of fact and conclusions of law"—so that it may seek a potential "do-over" before the district court.

In this regard, *Incora* may change market participants' calculus in considering a non-pro rata liability management transaction where the expectation is that any dispute regarding the transaction will be quickly litigated in the bankruptcy court.

First, protracted litigation, combined with a potential do-over in the district or state court, takes a toll on the debtor, equity sponsor, and participating lenders' resources.

Second, it is unclear whether a bankruptcy court, especially the Bankruptcy Court for the Southern District of Texas, will continue to be viewed as a favorable venue for non-pro rata liability management transactions in light of *Incora*'s more creditor-friendly outcome (as opposed to *TPC* and *Serta*) at the summary judgment stage.

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Jennifer Selendy is a founding partner of Selendy Gay. Ms. Selendy represents both plaintiffs and defendants in high-stakes disputes. In her plaintiffs practice, she is increasingly called on to help clients in disputes related to so-called liability management transactions, such as uptiering transactions. Ms. Selendy's leadership has been recognized by Corporate Counsel, which named her 2020's "Managing Partner of the Year," and the New York Law Journal, which lists her among 2020's "Distinguished Leaders." National Law Journal named Jennifer one of 2022's Elite Women of the Plaintiffs Bar.

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