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MINORITY LENDERS BEWARE: HOW MAJORITY HOLDERS IN DISTRESSED FINANCINGS ARE LEVERAGING THEIR RIGHTS AT THE EXPENSE OF MINORITY HOLDERS

With increasing regularity, majority debtholders in distressed financings are attempting to leverage their rights under their loan documents to secure certain benefits and opportunities for themselves at the expense of the minority holders; and while minority holders have attempted to challenge such acts, they've largely been unsuccessful. This issue has garnered significant attention due to the recent proliferation of "up-tier transactions," and in this article the authors describe other scenarios where majority lender groups have taken such actions at the expense of minority holders and how courts in various jurisdictions have resolved challenges to such transactions.

By Elie Worenklein and Mitchell Carlson *

More than a century ago, both the Supreme Court and the Second Circuit took aim at transactions in which the holder of a majority of debt securities took action at the expense of minority holders, declaring that "[w]hen two or more persons have a common interest in a security, equity will not allow one to appropriate it exclusively to himself, or to impair its worth to the others. Community of interest involves mutual obligation."[1] Yet, with increasing regularity, groups of majority debtholders (both lenders and noteholders) of distressed companies are leveraging their ability to deliver consents of a tranche of debt in order to procure, for themselves, opportunities that are not being offered to all other similarly situated debtholders, or are otherwise taking actions that may be adverse to the interests of minority debtholders. In addition to the recent expansion of "up-tier transactions,"[2] these opportunities also often take the form of DIP financing or backstop arrangements that are only offered to select debt investors, who can appropriate for themselves fees and other benefits that would otherwise be shared by the entire class of debt holders. In other instances, a group of majority debtholders may seek to exercise remedies, such as credit bidding, that can have a disproportionate impact on minority debtholders who may be unable to accept the proceeds of such credit bid or may find themselves

[1] *Hackettstown Nat. Bank v. D.G. Yuengling Brewing Co*., 74 F. 110, 113 (2d Cir. 1896) quoting *Jackson v. Ludeling*, 88 U.S. 616, 616 (1874).

[2] One court recently described such transactions between a debtor and a majority (but not all) holders of a syndicated debt issuance as "tak[ing] advantage of technical constructions of loan documents in ways that some view as breaking with commercial norms." *In re TPC Group, Inc*., 2022 WL 2498751 at *1 (Bankr. D. Del. July 6, 2022).

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with illiquid equity that is subject to a significant minority discount.

This article discusses the proliferation of such transactions and their permissibility. As one court wryly observed, "if we have learned anything in the course of administering the Bankruptcy Code, it is that if we open a door by a crack in one case, the door gets pushed open ever wider in succeeding cases."[3] So, too, here.

EXCLUSION OF MINORITY DEBTHOLDERS FROM FINANCING OPPORTUNITIES

Debtholders who provide distressed companies with new financing are often in a position to extract favorable economics in exchange for such financing. For example, such debtholders may receive above-market interest rates, outsized commitment or private placement fees, senior priority in the capital structure, and backstop fees to fill any potential financing gaps if the financing opportunity is offered to similarly situated debtholders. Distressed companies frequently use the lure of such favorable terms not only to attract new financing, but also to obtain consent to existing debt documents that are necessary to permit the new financing or otherwise extend the runway of existing financing.

From the distressed company's perspective, if it can obtain any required consents from a subset of its debtholders (instead of all similarly situated debtholders), the aggregate amount of fees paid to obtain such consents can be reduced. Similarly, from the perspective of a group of debtholders that hold a majority but not all of the debt, if they can avoid sharing the economics with other debtholders, they can not only extract more for themselves but also enable the company to preserve cash and other value for the benefit of the company and its debtholders.

Not surprisingly, minority debtholders can be impaired by their inability to participate in favorable financing opportunities. Given this, minority debtholders have, with increasing frequency, sought to challenge their exclusion from financing opportunities by arguing, among other things, that such arrangements provide unfair priority or additional distributions that are not provided to all similarly situated creditors.

To date, challenges in bankruptcy court to exclusions of minority debtholders from financing opportunities have generally not been successful. In bankruptcy cases, minority debtholders have largely relied upon section 1123(a)(4) of the Bankruptcy Code, which requires that a plan "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest."[4] Citing that statute, minority creditors have argued that providing other debtholders the exclusive opportunity to finance the debtor and then receive either backstop fees, private placement, fees to support the RSA, or other fees violates section 1123(a)(4) to the extent that all similarly situated debtholders in the same class do not receive those same benefits. Courts, however, have interpreted section 1123(a)(4) to only require equal treatment on account of similar situated *claims*, but not *creditors*, and have regarded the opportunity or request to provide new financing as separate from the treatment of existing claims.[5]

The Eighth Circuit in *In re Peabody Energy Corp*.[6] is the most recent circuit court to directly address this issue in connection with a plan that provided some, but not all, debtholders with the opportunity to participate in a private placement in accordance with a plan support agreement. More specifically, in *Peabody* the private placement agreement contemplated raising $750 million through the private placement of preferred equity, which would be sold at a 35% discount to the plan equity value. To participate in the private placement, a noteholder had to commit to supporting the plan through the Plan

[3] *In re SAS AB*, 644 B.R. 267, 272 (Bankr. S.D.N.Y. 2022).

[4] 11 U.S.C. § 1123(a)(4).

[5] *See, e.g., In re Financial Oversight and Management Board for Puerto Rico*, 637 B.R. 223, 269 (D.P.R. 2022) ("While it is true that all claims must be treated equally, the same is not true for all claimants" under section 1123(a)(4)); *In re UNR Indus., Inc.*, 143 B.R. 506, 523 (Bankr. N.D. Ill. 1992), *rev'd on other grounds*, 173 B.R. 149 (N.D. Ill. 1994) (noting that creditors should not confuse "equal treatment of *claims* with equal treatment of *claimants*.").

[6] 933 F.3d 918 (8th Cir. 2019).

Support Agreement. In addition, the sooner that a party joined, the greater the proportion of preferred equity made available to that holder. As a result of negotiations, certain noteholders who held a little over one-third of the relevant claims obtained over two-thirds of the preferred equity. The ad hoc committee of nonconsenting noteholders argued that the private placement violated section 1123(a)(4), which they described as the sale of almost half of the debtor's equity to a specific group of creditors at a significant discount to the value of that equity. They argued that the value from the private placement that was given to the select consenting noteholders was $160 million more than what was retained by all other creditors in the case.

The Eighth Circuit affirmed the lower court's approval of the plan. In particular, the court found that "the right to participate in the Private Placement was not 'treatment for' a claim. 11 U.S.C. § 1123(a)(4). The right to participate in the Private Placement was consideration for valuable new commitments. Consequently, the plan did not violate the equal-treatment rule of § 1123(a)(4)."[7]

Most recently, the district court in *In re LATAM Airlines Group S.A.* affirmed a plan that overruled a section 1123(a)(4) objection filed by an ad hoc group of creditors.[8] In *LATAM*, creditors opposed the plan arguing, among other things, that "while the Non-Commitment Creditors and the Commitment Creditors are classified together in Class 5, the Commitment Creditors will receive a far superior opportunity for recovery compared to the Non-Commitment Creditors" on account of backstop agreement fees.[9] According to the objectors, the Commitment Creditors in Class 5 will receive a 43.4% recovery while the Non-Commitment Creditors in the same class will only receive a 19.3% recovery.[10] The bankruptcy court overruled the objection by noting that "[t]he requirements of section 1123(a)(4) apply only to a plan's treatment *on account of particular claims* or interests in a specific class — not the treatment that members of the class may separately receive under a plan on account of the class members' other rights or contributions."[11] Applying that standard, the court found that "[t]he treatment that the Commitment Creditors are receiving in their capacity as Holders of Allowed General Unsecured Class 5 Claims of LATAM Parent is the same as the Non-Commitment Creditors in Class 5. . . The additional compensation that the Commitment Creditors will receive under the Plan is not based on their status as Holders of Allowed General Unsecured Class 5 Claims; it is in consideration for their commitments described in the Commitment Creditors Backstop Agreement."[12] The district court affirmed, noting that "[c]ourts often approve reorganization plans that provide certain claimants additional benefits — including backstop fees and additional opportunities to invest in preferred equity — in exchange for their agreement to backstop certain offerings."[13] The district court likewise commented that other sections of the Bankruptcy Code "allay concerns that parties may use backstop agreements as a pretext for unjustifiable unequal treatment of creditors."[14]

Courts in other jurisdictions have reached similar conclusions.[15]

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[7] *Id.* at 927.

[8] *In re LATAM Airlines Group S.A.*, 2022 WL 2206829 (Bankr. S.D.N.Y. June 18, 2022), as corrected by 2022 WL 2541298 (Bankr. S.D.N.Y. July 7, 2022), *aff'd* 643 B.R. 756 (S.D.N.Y. 2022).

[9] 2022 WL 2541298 at *35.

[10] *Id.*

[11] *Id*. at *35 (emphasis in original).

[12] *Id*. at *36.

[13] 643 B.R. at 767.

[14] *Id.* at 768.

[15] *In re Financial Oversight and Management Board for Puerto Rico,* 637 B.R. 223, 269 (D.P.R 2022) (confirming a plan that provided up to $801 million of consummation costs, restriction fees, and support fees to bondholders who were parties to the plan support agreement noting that "While it is true that all *claims* must be treated equally, the same is not true for all *claimants*" under section 1123(a)(4)); *In re CHC Grp. Ltd*, No. 16-31854 (BJH), 2017 WL 11093971 (Bankr. N.D. Tex. Mar. 3, 2017) (confirming a plan with a financing premium (which was paid with equity) to the PSA noteholders by noting that "the payment of the Put Option Premium to the Plan Sponsors does not constitute impermissible disparate treatment in violation of section 1123(a)(4) of the Bankruptcy Code, but is instead consideration paid in return for the Plan Sponsors' agreement to backstop the Rights Offering."); *In re SunEdison Inc*., No. 16-10992 (SMB), Dkt. No. 3725 (Bankr. S.D.N.Y. July 25, 2017) (confirming chapter 11 plan over objection of unsecured noteholders to the backstop commitment provided by holders of second-lien notes in relation to a $300M rights offering by finding that "debtors are free to offer to anyone on a preferential basis, the opportunity to provide exit financing"); *In re TCI 2 Holdings, LLC*, 428 B.R. 117 (Bankr. D.N.J. 2010) (approving a plan that provided for a group of second-lien noteholders to receive 20% of the equity in the reorganized debtors in consideration for their agreement to backstop the rights offering contained in the plan, finding the plan did not violate section 1123(a)(4) because "the Backstop Fee is offered

Not every judge has accepted the argument that section 1123(a)(4) does not apply to fees and related benefits obtained in connection with providing new financing. In particular, Judge Wiles, in *In re Pacific Drilling*,[16] citing potential unequal treatment concerns, *sua sponte* questioned debtors' proposed chapter 11 plan funding of (1) $400M rights offering (at a 47% discount), (2) $100M private placement exclusively for an ad hoc creditor group, and (3) backstop fees payable to the ad hoc group equal to 8% of the $500M capital raise. The court raised concerns in connection with a backstop agreement motion that there was an equal treatment problem and that in order to address it, the fee offered to the ad hoc group should be offered to anyone who was excluded but who wanted to become a reserve party. In analyzing the issue, Judge Wiles explained the policy behind section 1123(a)(4) by stating "[t]he theory of the Bankruptcy Code is that when the big creditors sit in a room and negotiate a deal, the little creditors who are in the same boat get the same deal. The Bankruptcy Code does not permit the unequal treatment of creditors in the same class; it also does not permit the payment of extra compensation to large creditors in exchange for their commitment to vote for a plan."[17]

The court then went on to analyze the benefit that the creditor was providing in exchange for the fee and reiterated "[t]he Code allows for reasonable financing terms but they must be reasonable, and they *cannot just be a disguised means of giving bigger creditors a preferential recovery*."[18] In addition, he explained that a backstop fee can be appropriate "when real risks are taken and when the fees are proportionate to those risks," but here the fees were "really just an extra payment and an extra recovery rather than a reasonable, stand-alone financing term."[19] Accordingly, the court warned that these fees should not be limited to the bigger creditors and should be offered to all creditors in the same class.

To be sure, it is generally true that majority debtholders who advance new financing provide a material benefit to distressed companies or debtors distinct from the treatment of their claims. For example, obtaining a backstop commitment to fully subscribe a rights offering better ensures full subscription, and thus provides a debtor with a more certain path to confirmation. Similarly, having debtholders commit early to participate in a private placement likewise provides a debtor with the assurance up front that the substantial funds required to demonstrate feasibility of the plan were in fact committed — irrespective of what might happen to the company's business and operations before confirmation. However, in situations where the debtholders receive fees for both (1) a financing commitment and (2) an agreement to vote their existing claim in favor of a chapter 11 plan, it can be difficult to determine what portion of the fees are attributable to the value of the financing commitment itself versus the commitment to support the debtor's treatment of the existing claim under the plan.

From a legal standpoint, the optimal solution would be to require debtors to offer all debtholders of a given class the opportunity to participate in the backstop or financing opportunity. Courts have described section 1123(a)(4) as simply requiring the same opportunity for all similarly situated creditors.[20]

Creditors are of course free to accept different settlements, which does not run afoul of section 1123(a)(4).[21]

Courts have similarly analyzed a transaction's exit consents under the same lens of whether all similarly situated lenders are provided the same opportunity. For example, the Court of Chancery of Delaware denied a request to enjoin the consummation of an exchange offer and consent solicitation by finding that all holders were

as consideration for the $225 million commitment made by the Backstop Parties, which will be paid only if the $225 million is funded.").

[16] 2018 WL 11435661 (MEW)(Bankr. S.D.N.Y. Oct. 1, 2018).

[17] *Id.* at *2.

[18] *Id.* (emphasis added).

[19] *Id.* at *5.

[20] *In re W.R. Grace & Co.,* 729 F.3d 311, 327 (3d Cir. 2013) ("[C]ourts have interpreted the 'same treatment' requirement [of section 1123(a)(4)] to mean that all claimants in a class must have 'the same opportunity' for recovery."); *In re Dana Corporation*, 412 B.R. 53, 62 (S.D.N.Y. 2008) ("The key inquiry under § 1123(a)(4) is not whether all of the claimants in a class obtain the same thing, but whether they have the same opportunity.").

[21] *In re Energy Future Holding Corp*., 527 B.R. 157 (Bankr. D. Del. 2015) ("Providing different treatment to a creditor who agrees to settle instead of litigating is permitted by section 1123. Though Debtors' offer may have treated the make-whole claims for the 10% noteholders and the 6 7/8% noteholders differently, each noteholder had the opportunity to decline the settlement offer and litigate for the full value of the claim.").

offered the same opportunity to vote on the exit consents.[22]

Imposing that requirement, however, may diminish the appetite of larger creditors to provide any upfront backstop commitment, thereby depriving the debtor of an important and valuable restructuring tool. Given that reality, another theoretical solution would be to use the market test requirement imposed by *Bank of Am. Nat. Trust v. 203 N. LaSalle St. P'ship*, 526 U.S. 434 (1999), as a guide to isolating the "new value" attributable to the backstop or financing alone. This would involve requiring a debtor to shop the financing opportunity to third parties who are not creditors and thus indifferent to treatment of their claim under a plan. Running such a process, however, may not be practicable for a variety of reasons, including timing concerns, securities law compliance, and the risk that non-creditors will attribute lower value to the new securities than creditors who have skin in the game.

Perhaps a more suitable approach would be to follow Judge Wiles' approach from *Pacific Drilling* and focus on substance over form, by conducting an independent determination of what the fees are being provided for.[23] Bankruptcy courts conduct similar exercises when they need to recharacterize debt as equity,[24] or leases as disguised financing.[25] Such an approach would enable a bankruptcy court to determine whether the debtor is providing "reasonable financing terms" or "a disguised means of giving bigger creditors a preferential recovery." As parties continue to push the limits where only certain creditors receive an additional benefit, courts are more likely to further scrutinize such transactions.

SELECTIVE DIP ROLL-UP

Another example of a majority group of debtholders acting to the detriment of minority debtholders can arise in the context of the "roll-up" of DIP financing. A roll-up is a provision in a DIP financing facility that permits the debtor to apply the proceeds of the DIP financing to satisfy, in whole or in part, pre-petition indebtedness, with the effect of transforming funds lent pre-petition into funds lent under the DIP, which constitute administrative expenses payable upon confirmation and secured by the post-petition priming lien.[26] In such instances, only certain lenders are given the opportunity to provide DIP financing and obtain a roll-up, and minority lenders holding the same debt may find their pre-petition debt subordinated to the newly rolled-up priming debt.[27]

This is exactly what occurred in connection with J.C. Penney's DIP loan during its chapter 11 case in 2020. At the time of its bankruptcy filing, J.C. Penney Corporation, Inc. had approximately $1.5 billion of first-lien term loans outstanding as well as $500 million of first-lien notes and $400 million of second-lien notes, along with $1.3 billion of unsecured debt. The holders of the first-lien term loans and the holders of the first-lien notes had entered into a *pari passu* intercreditor agreement.

On the same day the company filed its bankruptcy petition, the debtor sought approval of a DIP financing package to be provided by an ad hoc group of first- and second-lien debt holders that collectively held approximately 81% of the first-lien term loans and 63% of the first-lien notes. The proposed DIP was a $900 million facility made up of $450 million of new money provided by the majority group of existing secured lenders and $450 million of rolled-up pre-petition first-

[22] *Katz v. Oak Industries, Inc*., 508 A.2d 873, 881 (Del. Ch. 1986) (noting that "the incentive to consent is equally available to all members of each of bondholders"). Notably, in *Katz*, the Court expressly relied on the fact that the offer to purchase debt was made available to all bondholders in finding that no breach of the duty of good faith and fair dealing had occurred. *Id.*

[23] *Pepper v. Litton*, 308 U.S. 295, 305 (1939) (noting that bankruptcy courts should use "equitable powers" to ensure that "substance will not give way to form, that technical considerations will not prevent substantial justice from being done.").

[24] *In re SubMicron Sys. Corp*., 432 F.3d 448 (3d Cir. 2006).

[25] *In re Pillowtex, Inc*., 349 F.3d 711 (3d Cir. 2003).

[26] *See, e.g., In re Energy Future Holding Corp.,* 527 BR 157, 166 (Bankr. D. Del. 2015) ("Roll-ups most commonly arise where a pre-petition secured creditor is also providing a post-petition DIP loan under section 364(c) and/or (d) of the Bankruptcy Code. The proceeds of the DIP loan are used to pay off or replace the pre-petition debt, resulting in a post-petition debt equal to the pre-petition debt plus any new money being lent to the debtor.").

[27] Because rolling-up pre-petition indebtedness into post-petition debt can have a material economic impact, such provisions often receive a lot of scrutiny. However, as one court noted, roll-up provisions are "not impermissible as matter of law" and, despite being generally perceived as "distasteful," such provisions should be analyzed as another "economic arrangement in order to obtain the financing" that need to be evaluated based upon the totality of the circumstances surrounding the debtor and proposed financing. *In re Bruin E&P Partners, LLC*, No. 20-33605, Dkt. 79 at 67-68 (Bankr. S.D. Tex. Jul. 21, 2020).

lien debt held by the majority group. A minority group of debtholders holding roughly 11% of the first-lien loans and 28% of the first-lien notes objected to the DIP facility on a variety of grounds. Among these objections was the assertion that approval of the proposed DIP order "would be sanctioning breaches of contract by the DIP Lenders."[28]

First, the minority group argued that permitting the proposed DIP financing would sanction a breach of the Term Loan Credit Agreement. Specifically, they asserted that "[t]he Term Loan Credit Agreement contains a 'Ratable Sharing' provision that requires any Term Loan lender to ratably share any amount it receives in payment of obligations due under the Term Loan with other term loan lenders who may not receive the same proportional amount."[29] Under the "Ratable Sharing" provision, any lender who received a payment, "whether by voluntary payment . . . or otherwise," that provided that lender with disproportionate recovery in relation to the other lenders would be required to share that payment "so that all such recoveries . . . shall be shared by all Lenders in proportions to the Aggregate Amounts Due to them."[30]

The majority group responded with a technical argument that the ratable sharing provision in the Term Loan Credit Agreement only applied to "receiv[ing] payments or reduction of a proportion of the aggregate amount of principal, interest, fees, and other amounts then due and owing to such Lender."[31] Thus, the majority group argued, the 'Ratable Sharing' provision was not applicable to the roll-up, which involved neither the receipt of payment nor the reduction in the aggregate amount owed to such lenders.[32]

The minority group further argued that permitting the proposed DIP facility would violate Section 2.01 of the intercreditor agreement, which provided for the application of proceeds *first* to the Collateral Agent for all amounts owed thereto and *second* "to the payment in full of the Term Loan/Notes Secured Obligations of each Series **on a ratable basis** in accordance with the terms of the applicable Term Loan/Notes Documents (emphasis added)." The roll-up, the minority group argued, violated this ratable sharing requirement. Although the intercreditor agreement provided that if J.C. Penney entered bankruptcy, the parties thereto would not object to a proposed DIP financing, section 2.05(b)(C) provided that the enforceability of that consent was conditioned upon the following requirement: "if any amount of such DIP Financing and/or cash collateral is applied to repay any of the Term Loans/Notes Secured Obligations, such amount is applied pursuant to [the ratable sharing provisions in] Section 2.01 of this Agreement." Claiming that the proceeds of the roll-up would not be so applied, the minority group argued that they were not barred from objecting to the DIP financing and, specifically, the disproportionate roll-up.

In rebuttal, the debtor and the majority group argued that the minority lenders *were* barred from objecting to the proposed DIP under the intercreditor agreement. They argued that the minority group's reliance on Section 2.05(b)(C) as their justification for not being barred from objecting was misplaced, as the roll-up in the DIP facility was not a *repayment* as Section 2.05(b)(C) required, but instead was, at best, a *refinancing*. The debtor argued that the intercreditor agreement "expressly governs the terms of permissible refinancing" and that "there are no prohibitions in the [intercreditor agreement] on the contemplated refinancing."[33]

Ultimately, the court never had to decide the issue as the parties entered into a settlement that allowed the minority group to participate in the roll-up portion of the DIP on the same terms as the majority group, except that instead of voting rights in the roll-up portion of the DIP, the minority group received unanimous consent rights over amending the section of the DIP credit agreement that ensures all lenders are treated on a *pro rata* basis. Notably, the minority group was not required to participate in the new money component of the DIP facility.

While the issue was ultimately settled in J.C. Penney, the case is a reminder for minority lenders to pay particular attention to DIP facilities containing a roll-up provision that may not comply with the applicable debt

[28] *In re J.C. Penney Company, Inc.*, No. 20-20182, Dkt. 469 (Bankr. S.D. Tex. Jun. 2, 2022).

[29] *Id.*

[30] Term Loan Credit Agreement § 2.17.

[31] *In re J.C. Penney Company, Inc.*, No. 20-20182, Dkt. 512 (Bankr. S.D. Tex. Jun. 4, 2022).

[32] In any event, the DIP lenders argued that they consisted of "more than 75% of the holders of the Term Loan Credit Agreement, [and therefore had] the authority to amend the pro rata sharing provision of the Agreement to make clear that the DIP Facility does not violate the Agreement's terms." *Id.*

[33] *In re J.C. Penney Company, Inc.*, No. 20-20182, Dkt. 512 (Bankr. S.D. Tex. Jun. 4, 2022).

documents, and to pay specific attention to the definitions of "repayment" and "refinancing" that would likely be relevant to this type of analysis. It is unclear whether a court would be receptive to the majority group and debtor's argument that the roll-up was not a "repayment" of the existing debt. A judge adopting a "substance over form" approach may quickly dismiss that argument as splitting hairs and inconsistent with the spirit of the agreements. On the other hand, when a debtor is seeking financing at the outset of the case that is often critical to preserving the going concern value of the business, some courts may be more willing to overlook objections that would interfere with the debtor's ability to obtain financing, especially if the terms are more favorable than would be the case in the absence of any roll-up.

CREDIT BIDDING

A somewhat different scenario under which minority lenders may be prejudiced by majority lenders involves "credit bidding" in a bankruptcy sale. Credit bidding under section 363(k) of the Bankruptcy Code authorizes secured creditors to "bid for the property using the debt it is owed to offset the purchase price."[34] "The ability to credit bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price. It enables the creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan."[35]

With respect to the debt held by a group of lenders that is secured by a single lien held by an agent or trustee, a requisite majority of the lenders can instruct the agent or trustee to bid for the assets in accordance with the applicable debt documents. As a result, minority lenders may be required to acquiesce to the credit-bid purchase instead of seeking other forms of recovery for their outstanding debt. Critically, the threshold to direct an agent or trustee to pursue a credit-bid purchase to satisfy the existing debt may be as low as 50.1% — less than the 66.67% voting threshold contemplated by section 1126 of the Bankruptcy Code.

This scenario arose in *Empire Generating,* where a minority group of lenders holding 45% of the secured debt under a credit facility objected to the proposed credit bid from the majority lenders.[36] The debtors entered into an asset purchase agreement pursuant to which the collateral agent would credit bid all outstanding secured obligations in exchange for the equity in the reorganized debtor. Holders of 55% of the secured debt supported the sale and provided formal instructions to the agent. Minority lenders holding 45% of the secured debt opposed the sale and the associated bidding procedures motion arguing, among other things, that the secured debt exceeded the value of the purchased assets and therefore the collateral agent was in violation of the intercreditor creditor agreement by "stripping" minority lenders of their ability to have a deficiency claim to vote in the chapter 11 case. Notably, the inability to assert a deficiency claim to vote on the chapter 11 plan was critical, because the minority lenders would have held a blocking position for the class of claims under section 1126 of the Bankruptcy Code. According to the minority lenders, "the core of [their] objection is simple: a 51% holder cannot buy off a sponsor with releases and assumption of insider-benefiting contracts in exchange for an inflated credit bid designed to deprive the Minority Lenders of the protections afforded them by their contracts and the Bankruptcy Code."

The bankruptcy court overruled the minority lenders' objection, finding that any limitation on the minority lenders' rights to challenge the sale arose out of their own agreement, not the applicable court orders. On appeal, the district court affirmed that the intercreditor agreement "allowed the Majority Lenders to direct the Collateral Agent to credit bid the full amount of the secured loans, rendering Appellants' interests unimpaired (at least as a technical matter) and thus stripping them of their right to vote on the reorganization plan . . . [and] Courts have generally refused to rewrite agreements to provide minority lenders with any rights . . . which are not expressly set forth in the agreements."[37] Moreover, the court found that "The unambiguous terms of the [intercreditor] agreement, for which Appellants bargained, show that the Collateral Agent had no discretion not to credit bid when directed to do so."[38] Thus, the court overruled the minority lenders' challenge to the proposed credit-bid purchase and the related court orders. As a result, the majority lenders were able to drag along the minority lenders due to the consent requirements of the intercreditor

[34] *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S.Ct. 2065, 2069 (2012).

[35] *Id.* at 2070 n.2.

[36] *In re Empire Generating Co, LLC*, 2020 WL 1330285 (S.D.N.Y. March 23, 2020).

[37] *Id*. at *9 (internal citations omitted).

[38] *Id.* at *13.

agreement, even though the majority lenders did not hold over 2/3 of the claims in the applicable class.[39]

Other courts have likewise focused on the underlying debt documents when approving credit bids under section 363(k) of the Bankruptcy Code over the objections of minority lenders.[40]

More recently, in the *Town Sports* chapter 11 case, a minority lender argued that the majority lenders used their combined status as "Required Lenders" under the applicable credit agreement to push through a chapter 11 credit-bid purchase in violation of the credit agreement.[41] The debtors in *Town Sports* commenced a sale process pursuant to section 363 of the Bankruptcy Code. Thereafter, the debtors negotiated a sale of substantially all of the debtors' assets to a new entity that was to be owned jointly by the secured lenders that would contribute $80 million of their loans and Tacit Capital, a private equity firm that was to capitalize the new entity with $47.5 million in cash.[42] Shortly after the bankruptcy court approved the sale, the majority lenders filed an emergency motion notifying the court that Tacit Capital did not satisfy its funding obligations and that the majority lenders never instructed the agent to credit bid or otherwise contribute the $80 million of debt. The majority lenders sought to refrain from closing the sale, acknowledging that the sale would essentially be "an exchange of their entire pre-petition loan in exchange for zero recovery" in light of the changed circumstances.

The debtors argued in response that the sale order provided that the majority lenders already instructed the agent and therefore the credit bid was already contributed to the buyer. The Delaware bankruptcy court denied the emergency request and the sale thereafter closed in November 2020. Town Sports emerged from bankruptcy on December 22, 2020.

A minority lender filed suit in New York arguing that the majority group "took unauthorized actions in the debtors' bankruptcy case," including credit bidding $80 million of secured debt into a "worthless" 20% equity share in "a severely undercapitalized health club operator."

On January 6, 2023, after the matter was transferred to the Delaware bankruptcy court, the court issued an opinion finding that it lacked jurisdiction over the breach of contract claims between the nondebtor lenders, but that it did have jurisdiction to determine whether its prior orders precluded the pending complaint. In particular, the court found that the bankruptcy court had already rejected these same arguments and found that "the sale order makes it clear that the preliminaries, *i.e.,* the transfer of the right to credit bid, have already occurred and we're not awaiting that happening."[43] Accordingly, "at the time the sale order was entered, the agent would reasonably know and understand that majority lenders intended to give the buyer the authority to credit bid, and that under the circumstances there was no need to honor the formalities of the issuance of an 'instruction' per se. Rather, as the maxim goes, the Court would regard as being given those instructions that ought to have been given."[44] Accordingly, the court ruled that "[o]ne cannot bring a collateral attack on the Court's prior ruling in the guise of a breach of contract action," and the minority lender was precluded from pursuing the complaint.[45]

It is worth noting that the *Town Sports* decision focused on whether the minority lender was precluded from pursuing this post-bankruptcy litigation after the bankruptcy court had approved the sale by overruling the same arguments that were raised by other parties. The outcome may have been different if the minority lender had challenged the credit bid prior to the entry of the sale order. But as occurred in *Empire Generating*, the bankruptcy court might well have focused on the underlying debt documents and "refuse[] to rewrite

[39] Similarly, in *In re WestPoint Stevens, Inc*., 600 F.3d 231 (2d Cir. 2010), the bankruptcy court in dicta approved a credit bid by holders of 54% of the debt over the minority lender's objection despite not holding 66.67% of the claim. However, the credit bid was ultimately not the prevailing bid at the auction and the debtors instead selected the minority lender's bid. *Id*. at 237.

[40] *See, e.g., In re Metaldyne Corp*., 409 B.R. 671, 677–79 (Bankr. S.D.N.Y.), *aff'd*, 421 B.R. 620 (S.D.N.Y. 2009) (overruling minority lender objection and finding that "the Agent properly credit bid 100% of the term debt to purchase substantially all of the Debtors' assets in the auction and released the lien with respect to the remaining collateral that the Debtors will retain."); *In re GWLS Holdings, Inc.,* No. 08-12430 (PJW), 2009 WL 453110, at *6 (Bankr. D. Del. Feb. 23, 2009) (overruling minority lender objection to sale by finding that the collateral agreement authorized the agent to exercise "all rights and remedies" under "applicable law," which includes a bankruptcy credit bid.).

[41] *In re Town Sports International, LLC*, 2023 WL 124860 (Bankr. D. Del. Jan. 6, 2023).

[42] *Id.* at *3.

[43] *Id.* at *14.

[44] *Id.* at *15.

[45] *Id.* at *16.

agreements to provide minority lenders with any rights, . . . which are not expressly set forth in the agreements."

CONCLUSION

In sum, there has been a large increase in transactions where the majority lenders take certain actions to the detriment of minority lenders. As parties take more aggressive positions, courts may begin pushing back against such efforts. In the context of adjudicating the validity of up-tier transactions — another example of oppression of minority debtholders — some courts have found that the implied duty of good faith and fair dealing may have been breached by virtue of such transactions, even if the majority lenders have complied with the technical reading of the underlying agreements.[46] Given the negative reaction of the Supreme Court and the Second Circuit to such oppression — albeit expressed more than a century ago — one cannot dismiss the possibility of a more hostile judicial reception to such transactions if debtors and majority groups continue to push the envelope aggressively. ■

[46] *See, e.g., ICG Global Loan Fund 1 DAC v. Boardriders, Inc.*, 2022 WL 10085886 (N.Y. Sup. Oct. 17, 2022); *LCM XXII Ltd. v. Serta Simmons Bedding, LLC*, 2022 WL 953109 (S.D.N.Y. March 29, 2022).