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Avoiding Subordination Of Secured Debt After TPC Decision

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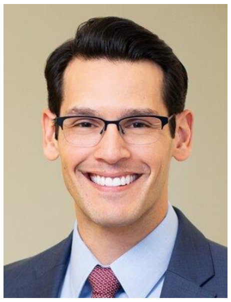
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Following a July 6 memorandum opinion from the U.S. Bankruptcy Court for the District of Delaware, lenders and noteholders risk subordination of their liens absent explicit language prohibiting such subordination in their respective debt documents.

U.S. Bankruptcy Judge Craig T. Goldblatt's decision in In re: TPC Group Inc. upheld a prepetition uptier transaction challenged by two leapfrogged minority noteholders in the context of TPC Group's proposed debtor-in-possession financing.

The bankruptcy court's decision highlights the importance of fortifying debt documents by explicitly delineating tiers of consent rights related to lien subordination.

Rather than apply the strict technical provisions of the operative loan documents in a vacuum as other courts have done, Judge Goldblatt considered the documents in the context of the broader lending market, and held that a 2019 indenture permitted the subordination of senior secured 10.50% notes in favor of a 2021 indenture for senior secured 10.875% notes issued by TPC Group.

The bankruptcy court based its decision on contractual interpretation of the relevant indentures and debt documents, holding that, absent any specific provision directly addressing subordination of liens, subordination was not one of the sacred rights in the 2019 indenture requiring consent of all holders of the 10.50% notes.

As Judge Goldblatt stated bluntly,

> [t]here is nothing in the law that requires holders of syndicated debt to behave as Musketeers. To the extent such holders want to be protected against self-interested actions by borrowers and other holders, they must include such protections in the terms of their agreements.[1]

In August 2019, TPC Group raised $930 million by issuing senior secured notes due in 2024 with an interest rate of 10.50%, and secured by a first lien on substantially all of the the debtors' assets. The minority holders of the 10.50% notes, the plaintiffs, held approximately 10% of the issued and outstanding 10.50% notes.

The 2019 indenture contained a hierarchy of consent rights governing the 10.50% notes, including:

- Sections requiring the consent of a simple majority of noteholders, such as "direct[ing] the time, place and method of conducting any proceeding for exercising any remedy available to the Trustee or exercising any trust or power conferred on it" or otherwise waiving an event of default under the 2019 indenture;[2]

- Actions requiring a two-thirds vote of holders of the 10.50% notes, including "releasing all or substantially all of the collateral from the Liens securing the Notes;"[3] and

- Certain "sacred rights" requiring the consent of each affected holder of the 10.5% notes, including any change "dealing with the application of proceeds of Collateral that would adversely affect the Holders."[4]

In February 2021, TPC issued separate tranches of $153 million and $51.5 million in new notes due 2024 each with an interest rate of 10.875%. Each tranche was secured by the same collateral securing the 10.50% notes, but with a lien senior to that securing the 10.50% notes.

Importantly, the holders of the 10.875% notes also held a supermajority — more than 67% — of the 10.50% notes and did not sell their share of the 10.50% notes back to TPC. The plaintiffs, however, were not issued any of the 10.875% notes.

The debtors filed for bankruptcy on June 1, and immediately sought approval of entry into a debtor-in-possession, or DIP, financing loan with the holders of the 10.875% notes.

The proposed DIP consists of $85 million in new money and a rollup of the $238 million outstanding under the 10.875% notes — such rollup being largely a belt-and-suspenders provision if the 10.875% notes were indeed already senior to the 10.50% notes.

The plaintiffs filed a complaint against TPC seeking a declaratory judgment that the 10.875% notes were junior to the 10.50% notes, and the bankruptcy court agreed to an expedited schedule to hear summary judgment motions prior to a scheduled July 15 final hearing on the DIP, which was subsequently adjourned.

The bankruptcy court heard oral argument from the parties on June 29, and the bankruptcy court issued its memorandum opinion on July 6.

In the opinion, the bankruptcy court made clear that the lien subordination dispute was a contractual issue governed by New York state law.[5] The bankruptcy court was also quick to distinguish the uptier financing at issue from other more "aggressive" transactions in which lenders or noteholders in the subsequent transaction sell their loans back to the debtors and exit their junior tranche.[6]

Ultimately, the bankruptcy court denied the plaintiffs' summary judgment motion and held the 10.50% notes could be subordinated to the 10.875% notes because the sacred rights that required unanimous consent of all affected holders of 10.50% notes did not expressly include lien subordination.

Specifically, the bankruptcy court found that the issuance of the 10.875% notes comported with the language of the 2019 indenture, and held that Section 9.02(d)(10) of the indenture prohibited neither subordination of the 10.50% notes nor the adoption of the supplemental indenture.

Key to the bankruptcy court's analysis was the language in Section 9.02(d)(10) requiring the consent of all affected noteholders on actions "dealing with the application of proceeds of collateral."

The bankruptcy court eschewed the plaintiffs' broad interpretation — that any change that would put new debt ahead of the 10.50% notes with respect to the right to recover out of their collateral would implicate this section — in favor of the debtors' narrow interpretation, that the only provision of the 2019 indenture "dealing with the application of proceeds of collateral" was Section 6.10, addressing the waterfall for how the trustee under the 2019 indenture should ratably distribute the proceeds it receives.

Diverging from the Supreme Court of the State of New York's approach in Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent Corp. in August 2021,[7] in which the court denied a motion to dismiss a similar action after looking solely at contractual language without reference to commercial norms, the bankruptcy court noted that

> [i]n the context of an indenture, the Court believes that the inclusion of express anti-subordination clauses are sufficiently commonplace that, under the customs and usages that are common in the trade, a provision providing for ratable distribution (in the absence of an express anti-subordination clause) would more naturally apply to distributions within a class, and not prohibit subordination of an entire class to another, different class.[8]

Further, the bankruptcy court found that the hierarchy of consents laid out in the 2019 indenture to be instructive, pointing out the absurdity of elevating subordination to a sacred right while the release of all collateral securing the 10.50% notes — a more drastic action in the bankruptcy court's view — merely required a two-thirds vote under Section 9.02(e) of the 2019 indenture.[9]

On July 8, the plaintiffs appealed the bankruptcy court's order[10] and filed an emergency motion for stay pending appeal,[11] arguing that the plaintiffs would be irrevocably harmed absent a suspension of the DIP proceedings. On July 11, the bankruptcy court entered an order and opinion denying the plaintiffs' requests for the stay, with the bankruptcy court reiterating its analysis from the opinion and inviting the plaintiffs to seek and obtain a stay from the U.S. District Court for the District of Delaware.[12]

The Delaware district court subsequently issued a temporary stay through July 25, when it will rule on whether a more substantive stay is warranted. If the district court determines that no further stay is necessary, a final hearing on the DIP will take place on July 29.

Considerations

The bankruptcy court's opinion creates several considerations for lenders and noteholders seeking to maintain the priority of their liens due to an uptier transaction.

First and foremost, these parties should include specific provisions in their debt documents that elevate subordination to a sacred right requiring the affirmative vote of every lender or noteholder affected.

Without it, minority noteholders or lenders may find themselves subordinated to a subgroup of noteholders or lenders with whom they were previously pari passu, as the bankruptcy court's ruling makes clear that similarly situated lenders or noteholders have no implied duty of allegiance that prohibits subordination via uptier transactions and can rely on the contract governing subordination.

Even though inclusion of subordination as a sacred right may create a situation where more drastic"actions such as the release of collateral are subject to a lower hierarchy of consent rights, any court following the guidance in In re: TPC Group would likely give substantial weight to clear and unambiguous language delineating the consent rights surrounding subordination of liens.

Second, the bankruptcy court's denial of the stay demonstrates that challenging an uptier transaction may be neither necessary nor sufficient to defeat a debtor-in-possession financing from the uptier parties.

As the bankruptcy court explained in its opinion denying the stay pending appeal,

> there are potential bases for objecting to the loan that do not depend on the declaratory judgment ruling. And on the flip side, while the objection to the DIP loan would be undoubtedly stronger if the 10.5% Notes were senior to the debt that is proposed to be rolled up, a ruling in the declaratory judgment action in favor of the objecting noteholders would not necessarily mean that the DIP loan could not be approved.[13]

Given these lessons, the bankruptcy court's opinion is a reminder that lenders and noteholders must remain vigilant in drafting protective provisions in their respective debt documents, particularly where market cycles may give way to periods of covenant light drafting.

Such rights that may have previously been considered implicit can be quickly discarded in a bankruptcy setting where the Three Musketeers motto of "all for one and one for all" quickly becomes "everyone for him or herself."

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[1] Bayside Cap. Inc. and Cerberus Cap. Mgmt., L.P. v. TPC Group Inc. (In re TPC Group Inc.), Adv. Case No. 22-50372 (CTG) Dkt. 72 at * 28 (Bankr. D. Del. July 6, 2022).

[2] 2019 Indenture §§ 6.05 and 9.02(a).

[3] Id. at § 9.02(e).

[4] Id. at 9.02(d)(10).

[5] Opinion at 16-17 ("The current dispute [] does not turn at all on whether one or another party might be cast as sympathetic or opportunistic. It simply calls for the Court to read and enforce the parties' agreements in accordance with their terms.").

[6] Id. at 2.

[7] Trimark (Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp., No. 565123/2020 (JMC), 2021 WL 3671541 (N.Y. Sup. Ct. Aug. 16, 2021)

[8] Opinion at 24-25 (emphasis in original). The Court further found it further compelling that the Supplemental Indenture indeed contained such an express subordination prohibition. Id.

[9] Id. at 26.

[10] Adv. Dkt. 76.

[11] Adv. Dkt. 79.

[12] Adv. Dkt. 87.

[13] Id. at 12-13. Note, however, that the Bankruptcy Court did not go so far as to hold that no irreparable injury could be shown on this basis until the DIP was approved. Id.