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Creditor-on-Creditor Violence: An Analysis of Uptier Exchange Transactions

Lance Fischer*

I. INTRODUCTION

In June 2020, Serta Simmons Bedding ("Serta"), one of the world's leading producers of mattresses, entered into an uptier exchange transaction in response to financial troubles.[1] In an uptier exchange transaction, the borrower offers senior liens to a majority of already-participating lenders.[2] The benefit offered to the existing lenders is typically a senior claim over collateral; thus, subordinating the lenders that had not participated in the transaction.[3] In *Serta Simmons Bedding*, the borrower negotiated a transaction in which Serta would issue around $1.075 billion worth of new, prioritized debt.[4] The new issuance of debt would create "a new money tranche comprising $200 million of new-money financing and[] an exchange tranche comprising $875 million[.]"[5]

In response to Serta's uptier exchange transaction, the lenders who had not participated ("minority lenders") filed suit.[6] The plaintiffs argued, among other things, that the uptier exchange transaction violated the implied covenant of good faith and fair dealing.[7] In support of this contention, plaintiffs asserted that the loan had been entered into without their consent.[8]

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[1] *See* LCM XXII Ltd. V. Serta Simmons Bedding, LLC, No. 21 Civ. 3987(KPF), 2022 U.S. Dist. LEXIS 57976, at *1 (S.D.N.Y., Mar. 29, 2022); Michael D. Messersmith et al., *Minority Lender Claims Against Serta Simmons Avoid Deep Sleep: Breach of Contract and Lack of Good Faith Claims Survive,* ARNOLD & PORTER, Apr. 11, 2020, https://www.arnoldporter.com/en/perspectives/advisories/2022/04/breach-of-contract-lack-of-good-faith-claims?utm_source=Mondaq&utm_medium=syndication&utm_campaign=LinkedIn-integration.

[2] Jason Kyrwood et al., *Lessons for the Loan Market from Recent Liability Management Transactions*, IFLR 2 (2020).

[3] *Id.*

[4] *See Serta*, 2022 U.S. Dist. LEXIS 57976, at *9.

[5] *Id.* at *8-9.

[6] *See id.* at *12.

[7] *See id.* at *44.

[8] *See id.* at *48. It is worth noting that on January 24, 2023, Serta Simmons filed for Chapter 11 bankruptcy. Jonathan Stempel, *U.S. Mattress Maker Serta Simmons Files for Bankruptcy Protection*, REUTERS (Jan. 24, 2023),

Essentially, the borrower had contracted this agreement with the participating lenders absent the minority lenders' knowledge.[9] In practice, minority lenders' typically are not afforded notice of an pending uptier exchange transaction.[10] Overall, the number of distressed businesses has continuously grown due to COVID-19; therefore, more companies have begun to utilize creative refinancing techniques.[11]

The uptier exchange transaction in *Serta* illustrates the numerous reasons people should be attentive to the ethics underlying uptier exchange transactions. First, it is crucial for those involved in the financial industry to understand the leveraged loan market. A borrower's ability to issue priming debt can have profound implications on the distressed financial industry, especially the bankruptcy landscape.[12] Further, uptier exchange transactions breed uncertainty within the leveraged loan market. This uncertainty is evident from the *pro rata* provisions that minority lenders seem to lean on so heavily during litigation.[13] Although courts have held that uptiering does not impede a lender's right to a proportionate share, minority lenders continuously argue that they do.[14] As a result of uncertainty, one can infer that the prospect of subordination disincentivizes many lenders from even participating in the market. Lastly, uptier exchange

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https://www.reuters.com/business/retail-consumer/us-mattress-maker-serta-simmons-files-bankruptcy-protection-2023-01-24.

[9] *See* Shana Elberg et al., *Uptier Exchange Transactions Remain in Vogue, Notwithstanding Litigation Risk*, SKADDEN (Feb. 2, 2021), https://www.skadden.com/insights/publications/2021/02/uptier-exchange-transactions; KING & SPALDING, *NYDJ, or Can You Really Prime 47% of Lenders Without Their Consent* 2 ("[m]inority [l]enders were not offered the ability to participate in the new money financing, nor were they provided with notice of . . . the related amendments").

[10] KING & SPALDING, *supra* note 9.

[11] *See, e.g.*, LCM XXII Ltd. V. Serta Simmons Bedding, LLC, No. 21 Civ. 3987(KPF), 2022 U.S. Dist. LEXIS 57976, at *1 (S.D.N.Y., Mar. 29, 2022).

[12] Vincent S.J. Buccola & Greg Nini, *The Loan Market Response to Dropdown and Uptier Transactions*, CREDITOR RTS. COALITION 4 (June 2022), https://creditorcoalition.org/wp-content/uploads/2022/06/article.loanmarketresponseBuccolaNini.pdf.

[13] *See* Julian Bulaon, *Covenant Trends: Expanded Sacred Rights Provisions in Recent Credit Agreements Provide Varying, Sometimes Circumventable Protections Against Lien Subordination Amendments*, REORG (Feb. 25, 2022) (illustrating that the lenders in Serta were subordinated even though they thought they had a sacred right to collect payments), https://reorg.com/covenant-trends-expanded-sacred-rights-provisions.

[14] *See Serta*, 2022 U.S. Dist. LEXIS 57976, at *15; Audax Credit Opps. Offshore v. Tmk Hawk Parent, No. 565123/2020, 2021 WL 3671541, at *41 (N.Y. Aug. 16, 2021).

transactions run the risk of creating a "creditor versus creditor" situation.[15] Such a scenario pushes for an "unfriendly" landscape in the lending market, thereby increasing the costs to account for the increased risk or even disincentivizing lenders from participating in the market at all.[16]

This Comment will examine the minority lenders' ability to protect against subordination. Specifically, I will argue that uptier exchange transactions often violate the borrower's implied covenant of good faith and fair dealing since they are often entered into without the minority lenders' consent. Part II of this Comment will discuss uptier exchange transactions in greater detail, explicitly outlining the arguments both in support and in opposition of them. In Part III, this Comment will provide a background of the leveraged loan market; namely, the surfacing of dropdown transactions. Court cases regarding uptier exchange transactions will be discussed in Part IV, and, in Part V, I will argue that uptier exchange transactions violate the borrower's implied covenant of good faith and fair dealing by outlining different interpretations of the covenant and why uptier exchange transactions breach the covenant under every interpretation. Since courts have yet to void an uptier exchange transaction, Part VI will discuss ways in which minority lenders can mitigate the potential for subordination, specifically focusing on the strength of the loan agreements.

Overall, this Comment will serve as a guide for courts' consideration of the implied covenant of good faith and fair dealing as applied to uptier exchange transactions. In essence, this Comment will argue that uptier exchange transactions ubiquitously breach the implied covenant of good faith and fair dealing.

II. WHAT IS AN UPTIER EXCHANGE TRANSACTION, EXACTLY?

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[15] *See* Stephan Lubben, *Holdout Panic*, 99 AM. BANKR. L. J. 1, 21 (2022).

[16] *See id.* ("we can expect that borrowers will pit lender groups against each other, so that in the end the real question will be 'who is willing to do more harm to your fellow lenders?'").

Uptier exchange transactions emerged partly due to the waning power of lenders.[17] While lenders' power has slowly declined, borrowers have continually gained more power and leverage within the loan context since the Great Recession.[18] Specifically, the period after the Great Recession saw term loans being increasingly sold to non-bank entities, like private credit funds.[19] The widening of the pool of loan holders led to increased negotiation costs; thus, traditional restrictions imposed on borrowers began to loosen.[20] According to Vince Buccola, the loosening of borrower restrictions can be generally attributed to two changes in the lending market: (1) the loosening of non-price loan terms for leveraged borrowers and (2) private equity sponsors becoming the "key strategic decisionmakers in large, distressed businesses."[21] Since private equity sponsors have become the key decisionmakers, they tend to lean towards avoiding bankruptcy-like proceedings.[22]

Beginning around 2016, borrowers began to use two transaction forms—the dropdown transaction and the uptier transaction—to gain access to much-needed capital.[23] An uptier exchange transaction, as stated above, is the offering of senior liens by the borrower to the majority of lenders.[24] To successfully uptier, the majority of lenders must first amend the loan agreements.[25] Typically, a loan agreement contains provisions that limit the incurrence of new debt and prohibit

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[17] *See* Vince Buccola, *How the Balance of Power Is Changing in the Resolution of Corporate Financial Distress*, COLUM. L. SCH. (Aug. 3, 2022) (stating that lender interests have seemingly become irrelevant in the face of their waning powers), https://clsbluesky.law.columbia.edu/2022/08/03/how-the-balance-of-power-is-changing-in-the-resolution-of-corporate-financial-distress.
[18] *See* Thomas Griffin et al., *Losing Control? The 20-Year Decline in Loan Covenant Violations*, SSRN, Nov. 27, 2018, at 2.
[19] *Bank and Nonbank Lending Over the Past 70 Year*, 13 FDIC Q. 1 (2019).
[20] Buccola, *supra* note 12, at 9.
[21] *See* Buccola, *supra* note 17.
[22] *See* Stephen J. Lubben, *Protecting Ma and P: Bond Workouts and the Trust Indenture Act in the 21st Century*, 82 CARDOZO L. REV. 81, 93 (2022).
[23] Buccola, *supra* note 12, at 4.
[24] Jason Kyrwood et al., *Lessons for the Loan Market from Recent Liability Management Transactions*, IFLR 2 (2020).
[25] Buccola, *supra* note 12, at 18.

the subordination of already-existing loans.[26] The only way, therefore, that a borrower can enter into an uptier exchange transaction is by amending these provisions to allow for the subordination of existing loans and the incurrence of new debt.[27] To do this, a bare majority—a mere 50.1 percent—must approve the amendment.[28]

After garnering the support of a bare majority of lenders for the amendments, the borrower must address the *pro rata* sharing provisions in the loan agreement.[29] A *pro rata* sharing provision is a sacred right that "prevent[s] one lender from receiving a greater benefit than another, similarly situated lender."[30] Since *pro rata* provisions are considered a sacred right, they typically require the consent of each affected lender for amendment.[31] To get past this hurdle, borrowers usually seek to repurchase the existing debt in the "open-market," which many loan agreements allow.[32] An open-market repurchase enable the borrower to repurchase some, but not all, debt at privately negotiated prices.[33] For example, in *Serta Simmons*, the borrower bought back the majority lenders' debt for $875 million using some of the newly obtained capital.[34] This allowed Serta to essentially bypass the *pro rata* sharing requirements since the only lenders who remained in this tranche were the minority lenders.[35] Thus, after amending the relevant provisions limiting the incurrence of debt, prohibiting subordination, and repurchasing the majority lenders' debt in the open-market, the borrower can successfully enter into an uptier exchange transaction.

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[26] *See* Elberg, *supra* note 9.
[27] *See id*.
[28] Lubben, *supra* note 15, at 20 ("amendments to debt and lien covenants are permitted, provided at least 50% of lenders consent.").
[29] *Id*.
[30] Nicholas A. Whitney & Marina Zelinsky, *Pro Rata Sharing Provisions in Credit Agreements: What Lenders and Loan Investors Need to Know*, 13 PRATT'S J. OF BANKR. L. 385, 386 (2017).
[31] *Id.*
[32] Lubben, *supra* note 15, at 20.
[33] Gareth Deiner et al., *Liability Management in Volatile Markets: To Tender or Repurchase in the Open Market*, CLIFFORD CHANCE 1 (2020).
[34] *See* LCM XXII Ltd. V. Serta Simmons Bedding, LLC, No. 21 Civ. 3987(KPF), 2022 U.S. Dist. LEXIS 57976, at *8-9 (S.D.N.Y., Mar. 29, 2022)
[35] *See id.* at *12.

Uptier exchange transactions provide myriad benefits to both majority lenders and borrowers. With the super-priority liens afforded to the new money lenders, the new tranche obtains the first claim over collateral in the event of bankruptcy.[36] Further, majority lenders gain "favorable economics in the form of fees, high interest rates, enhanced priority, and sometimes premiums on exchanged loans."[37] Thus, majority lenders gain a more favorable position for future financing and restructuring proceedings since the uptier exchange transaction reduces the risk of total loss.[38]

Borrowers likewise avoid comprehensive restructuring proceedings and bankruptcy.[39] By entering into an uptier exchange transaction, a distressed borrower gains access to much-needed capital without needing to encumber more assets.[40] This newly obtained liquidity can be utilized for several things, like paying off outstanding debt. Further, the opportunity to encumber the assets to obtain new capital is not foregone due to the uptier exchange transaction.

While uptier exchange transactions can provide numerous benefits for majority lenders and borrowers, they can be severely detrimental for minority lenders. The subordination of debt may lead to credit rating downgrades.[41] The effects of credit rating downgrades are numerous; for instance, credit rating downgrades during the COVID-19 pandemic reflected the overall riskiness of the of the assets.[42] Further, subordination may result in harsh discounts on the value of loans

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[36] Buccola, *supra* note 12, at 18.
[37] *See* Elberg, *supra* note 9.
[38] *See id*.
[39] *See id.*
[40] *See, e.g.,* LCM XXII Ltd. V. Serta Simmons Bedding, LLC, No. 21 Civ. 3987(KPF), 2022 U.S. Dist. LEXIS 57976, at *8-9 (S.D.N.Y., Mar. 29, 2022). It is worth noting that if the borrower does end up in bankruptcy, the uptiered lenders are better positioned since they have first right to collateral.
[41] *See* Kose John et al., *The Notching Rule for Subordinated Debt and the Information Content of Debt Rating*, FIN. MGMT. 491 (2010) ("The S&P approach is to notch up secured debt from the company credit rating and notch down subordinated debt.")
[42] Yoruk Bahceli, *U.S. Leveraged Loan Downgrade Ratio Five Times Worse than 2008-09*, REUTERS (June 4th, 2020), https://www.reuters.com/article/us-health-coronavirus-leveraged-loans-gr/u-s-leveraged-loan-downgrade-ratio-five-times-worse-than-2008-09-idUSKBN23B2H8.

due to the risk that the loans will be under-secured in the event of a future restructuring.[43] Also, when uptier exchange transactions are entered, many subordinated lenders lose their covenants because of the amendment process, where the majority lenders had opted to completely strip them rather than only address the *pro rata* and subordination provisions.[44]

In light of these detriments, minority lenders have opted to challenge the usage of uptiering in many ways. Many minority lenders argue that amending the loan documents negatively impacts the likelihood that every lender will receive their *pro rata* share of collateral proceedings.[45] As stated above, *pro rata* provisions guarantee that each lender receives their proportional share of the borrower's payments or collateral.[46] Uptier exchange transactions seemingly remove the likelihood that a lender will receive their fair share due to the new super-priority afforded to majority lenders. Similarly, minority lenders argue that uptier exchange transactions result in the release of all of the collateral secured to their loans because the subordination leaves the "loans in an unsecured position with worthless guarantees."[47]

Minority lenders also argue that the uptier exchange transactions cannot be categorized as an open-market purchase.[48] Minority lenders reason that these uptier exchange transactions are merely prepayments of debt, which is "required to be executed pro rata under the [o]riginal [a]greement.[49] Essentially, minority lenders argue that it must be offered to all lenders.[50] In the

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[43] *See* Elberg, *supra* note 9.
[44] *See* Peter Antoszyk et al., *A Game of Survivor: Private Credit Restructuring Year in Review*, PROSKAUER (Feb. 23, 2021), https://www.proskauer.com/report/a-game-of-survivor-private-credit-restructuring-year-in-review.
[45] *See* Audax Credit Opportunities Offshore Ltd. v. Tmk Hawk Parent, No. 565123/2020, 2021 WL 3671541, at *41 (N.Y. Aug. 16, 2021); *Serta*, 2022 U.S. Dist. LEXIS 57976, at *15.
[46] Nicholas A. Whitney & Marina Zelinsky, *Pro Rata Sharing Provisions in Credit Agreements: What Lenders and Loan Investors Need to Know*, 13 PRATT'S J. OF BANKR. L. 386 (2017).
[47] *See* Elberg, *supra* note 9.
[48] *See* LCM XXII Ltd. V. Serta Simmons Bedding, LLC, No. 21 Civ. 3987(KPF), 2022 U.S. Dist. LEXIS 57976, at *15 (S.D.N.Y., Mar. 29, 2022); Complaint at 4–7, ICG Glob. Fund 1 DAC v. Boardriders, Inc., No. 655175/2020 (N.Y. Sup. Ct. filed Oct. 9, 2020); Complaint at 65, Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp., No. 565123/2020, 2021 WL 3671541 (N.Y. Sup. Ct. filed Nov. 7, 2020).
[49] Complaint at 65, *Audax*, 2021 WL 3671541.
[50] *See* Elberg, *supra* note 9.

absence of such an offering, the minority lenders argue that the "open-market" purchases do not result in an uptier exchange transaction since they do not adequately address *pro rata* provisions.[51]

In the alternative, minority lenders argue that uptier exchange transactions breach the implied covenant of good faith and fair dealing.[52] The implied covenant of good faith and fair dealing ensures that a party proceeds with honesty and conforms to the *justified expectations* of the opposing party.[53] Under Section 205 of the Restatement (Second) of Contracts ("Restatement"), each "contract imposes upon [every] party a duty of good faith and fair dealing in its performance."[54] The Uniform Commercial Code propounds a similar definition.[55] Minority lenders argue that since these agreements are typically made in secret, they breach the implied covenant of good faith and fair dealing.[56] Historically, this claim has been dismissed by the courts.[57] Recently, the claim for a breach of the implied covenant of good faith and fair dealing has been survived a motion to dismiss in *Serta*.[58]

The unique nature of uptier exchange transactions has posed a problem for courts as they seek to analyze whether or not they constitute a breach of the implied covenant of good faith and fair dealing.[59]

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[51] Complaint at 65, *Audax*, 2021 WL 3671541.
[52] *Serta*, 2022 U.S. Dist. LEXIS 57976, at *44.
[53] RESTATEMENT (SECOND) OF CONTRACTS § 205 CMT. A (1981).
[54] *Id.* at § 205; *see also* Uniform Commercial Code § 1-304 (requiring good faith in every contract under the UCC).
[55] *See* U.C.C. § 1-304 (requiring good faith in every contract under the UCC).
[56] *See* KING & SPALDING, *NYDJ, or Can You Really Prime 47% of Lenders Without Their Consent* 2 (last visited Oct. 26, 2022) ("[m]inority [l]enders were not offered the ability to participate in the new money financing, nor were they provided with notice of . . . the related amendments").
[57] *See* Audax Credit Opps. Offshore v. Tmk Hawk Parent, No. 565123/2020, 2021 WL 3671541, at *37 (N.Y. Aug. 16, 2021) (dismissing the plaintiff's claim of breach of the implied covenant of good faith and fair dealing).
[58] *See* LCM XXII Ltd. V. Serta Simmons Bedding, LLC, No. 21 Civ. 3987(KPF), 2022 U.S. Dist. LEXIS 57976, at *44 (S.D.N.Y., Mar. 29, 2022).
[59] This difficulty has been illustrated in the inconsistency by the courts in applying the standard for a breach of the implied covenant of good faith and fair dealing to cases that involve uptier exchange transactions. *Trimark* and *Serta* illustrate this inconsistency. *See* Audax Credit Opps. Offshore v. Tmk Hawk Parent, No. 565123/2020, 2021 WL 3671541, at *37 (N.Y. Aug. 16, 2021) (dismissing the plaintiff's claim of breach of the implied covenant of good faith and fair dealing); *Serta*, 2022 U.S. Dist. LEXIS 57976, at *44.

III. HOW DID WE GET HERE?: ANALYZING *J. CREW* AND DROPDOWN TRANSACTIONS

As stated above, the Great Recession led to the weakening of traditional lender power; thus, leading to the loosening of the restrictions on borrower activity.[60] While covenants that restrict lien creation and issuance of debt have remained a necessity for every leveraged loan, the changes that accompanied the Great Recession have allowed borrowers to sidestep the covenants.[61] The first wave of creative financial techniques came to light in 2017.[62] Distressed borrowers began using "trap doors" to move collateral out of the reach of existing creditors.[63] Simply put, the distressed borrower would invest capital downstream to an unrestricted subsidiary.[64] The unrestricted subsidiary, which is free from the loan agreement's covenants and restrictions,[65] is able to "incur debt, grant liens, sell assets, pay dividends and make investments without limitation."[66] Thus, the investment of assets downstream allows the unrestricted entity to borrow against the assets.[67] This newly acquired capital allows the original subsidiary to relieve its capital needs.[68] On the flip side, re-encumbering assets subordinates the lenders of the borrowing, or restricted, subsidiary.[69] These transactions became known as "drop-down" transactions and were the subject of litigation in J. Crew's transaction in 2017.[70]

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[60] Thomas Griffin et al., *Losing Control?: The 20-Year Decline in Loan Covenant Violations* 1 (Dec. 8, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3277570.
[61] Buccola, *supra* note 12, at 1.
[62] *See* Complaint at 18, Eaton Vance Mgmt. v. Wilmington Sav. Fund Soc'y, No. 654397/2017, 2018 WL 1947405 (N.Y. Sup. Ct. 2017)
[63] *See* Elberg, *supra* note 9.
[64] Lee Federman et al., *Jumping the Line: Priming Restructuring Transactions During the COVID-19 Crisis*, BUTTERSWORTHS J. OF INT'L BANKING AND FIN. L. 100 (2021).
[65] Michael Friedman, *What You Need to Know About "Unrestricted Subsidiaries*, CHAPMAN (Feb. 14, 2017), https://www.chapman.com/publication-Investment-Covenants-Unrestricted-Subsidiaries#:~:text=What%20is%20an%20%E2%80%9CUnrestricted%20Subsidiary,financing%20agreement's%20covenants%20and%20restrictions.
[66] Federman, *supra* note 64, at 100.
[67] *See* Emin Guseynov, *A "Trap Door" Intact: Fixing the J.Crew Blocker*, ORRICK (July 1, 2020), https://www.orrick.com/en/Insights/2020/07/A-Trap-Door-Intact-Fixing-the-J-Crew-Blocker.
[68] Buccola, *supra* note 12, at 10.
[69] *Id.*
[70] Federman, *supra* note 64, at 100; *see also* Complaint at 18, Eaton Vance Mgmt. v. Wilmington Sav. Fund Soc'y, No. 654397/2017, 2018 WL 1947405 (N.Y. Sup. Ct. 2017).

J. Crew is the most well-known illustration of a drop-down transaction.[71] In 2011, J. Crew was acquired by TPG Capital and Leonard Green & Partners because of a $3.1 billion leveraged buyout.[72] J. Crew, to fund the transaction, shouldered around $1.6 billion worth of new debt.[73] In 2016, the distressed J. Crew foresaw the possibility of default and opted to utilize a "trapdoor" to avoid a comprehensive restructuring.[74] To successfully use a "trapdoor," J. Crew formed a number of new, unrestricted subsidiaries to which it transferred trademark collateral valued at $250 million.[75] The immediate ramification of this transfer was that many lenders lost their pledge of the transferred capital.[76] In spite of J. Crew's creative transaction, it nonetheless filed for chapter 11 bankruptcy in May of 2020.[77]

The critical language that allowed this transfer was Section 7.02(t) of the loan agreement.[78] Under its interpretation of Section 7.02(t), J. Crew was allowed to invest its assets into an unrestricted subsidiary where they could be used for any purpose.[79] J. Crew, in light of this interpretation, soon enticed junior, unsecured bondholders to exchange their debt for new bonds that were secured and had longer maturities.[80] Further, the company sought the senior lenders'

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[71] *See* Peter Coy, *In Finance, 'J. Crew' Is a Verb. It Means to Stick it to a Lender*, BLOOMBERG BUSINESSWEEK (June 17, 2019), https://www.bloomberg.com/news/articles/2019-06-17/in-finance-j-crew-is-a-verb-it-means-to-stick-it-to-a-lender.
[72] Complaint at 39, Eaton Vance Mgmt. v. Wilmington Sav. Fund Soc'y, No. 654397/2017, 2018 WL 1947405 (N.Y. Sup. Ct. 2017).
[73] *Id.*
[74] *See id*. at ¶ 49.
[75] *See id*. at ¶ 60.
[76] *See id.*
[77] *See* Vanessa Friedman et al., *J. Crew Files for Bankruptcy in Virus's First Big Retail Casualty*, N.Y. TIMES (May 3, 2020), https://www.nytimes.com/2020/05/03/business/j-crew-bankruptcy-coronavirus.html.
[78] 7.02(t) specifically allowed "[i]nvestments made by any Restricted Subsidiary that is not a Loan Party to the extent such Investments are financed with the proceeds received by such Restricted Subsidiary from an Investment in such Restricted Subsidiary made pursuant to Sections 7.02(c)(iv), (i)(B) or (n)." *See* J. Crew Grp., Inc., Amendment No. 1 to Amended and Restated Credit Agreement (July 13, 2017), https://www.sec.gov/Archives/edgar/data/0001051251/000156459017013589/jcg-ex101_11.html; *see also* Christine Dreyer McCay, *J. Crew Group, Inc.: Use of Credit Facility Baskets Eviscerates Value of Term Loan Collateral*, JDSUPRA (Oct. 5, 2017), https://www.jdsupra.com/legalnews/j-crew-group-inc-use-of-credit-facility-48821.
[79] See David W. Morse, *Where Did My Collateral Go?*, THE SECURED LENDER (July 15, 2017), https://www.martindale.com/matter/asr-2500841.Otterbourg_TSL.pdf.
[80] *See* Diane L. Dick, *Hostile Restructuring*, 96 WASH. L. REV. 1333, 1365 (2021)

consent to the transaction by offering to purchase around $150 million of debt at par. Approximately 88 percent of lenders approved the terms of the restructuring, leading the other 12 percent to sue to enjoin the transaction.[81] However, the court denied the preliminary injunction and reasoned that it was persuaded by the sheer support the transaction had received.[82]

Following the coverage of *J. Crew* and similar cases, creditors have focused on crafting more robust credit agreements, specifically focusing on blocking (1) transfers to unrestricted subsidiaries[83] and (2) reduction in the amount the restricted subsidiary can invest.[84] Drop-down transactions remain an issue, however, for many creditors.[85] Many distressed companies continue to utilize trapdoor provisions within their loan agreements.[86] While an in-depth discussion of drop-down transactions is outside the scope of this Comment, it is important to know the history of so-called "creative" borrower techniques. While drop-downs and uptiers are conceptually different in their operation, they are very similar because they are products of loosening lender power.[87] Drop-downs help illustrate the loosening of lender protections and lender power. With the utilization of drop-downs and their subsequent litigation, distressed borrowers began looking for

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[81] J. Crew's Memorandum of Law in Opposition to Plaintiffs' Order to Show Cause for Entry of a Temporary Restraining Order and for a Preliminary Injunction at 21–22, Eaton Vance Mgmt. v. Wilmington Sav. Fund Soc'y, No. 654397/2017, 2018 WL 1947405 (N.Y. Sup. Ct. 2017); Transcript at 46-49, Eaton Vance Mgmt. v. Wilmington Sav. Fund Soc'y, No. 654397/2017, 2018 WL 1947405 (N.Y. Sup. Ct. 2017).
[82] Transcript at 46-49, Eaton Vance Mgmt. v. Wilmington Sav. Fund Soc'y, No. 654397/2017, 2018 WL 1947405 (N.Y. Sup. Ct. 2017).
[83] Federman, *supra* note 64, at 100.
[84] Buccola, *supra* note 12, at 16.
[85] *See* Nick Williams, *Waterfall Model: Structure of Revlon's Brandco Loan May Advantage BrandCo 2L Recoveries on RemainCo Collateral at the Expense of 2016 Term Lenders*, REORG (Sep. 23, 2021) (Illustrating the dropdown utilized by Revlon), https://reorg.com/revlon-refinancing/; Sean Scott et al., *Cirque Du Soleil and Travelport Transactions Create Controversy*, MAYER BROWN (June 12, 2020) (analyzing the dropdown transactions utilized by both Cirque du Soleil and Travelport), https://www.realbankruptcyintel.com/2020/06/cirque-du-soleil-and-travelport-transactions-create-controversy.
[86] *See* Williams, *supra* note 85 (Illustrating the dropdown utilized by Revlon); Sean Scott et al., *Cirque Du Soleil and Travelport Transactions Create Controversy*, MAYER BROWN (June 12, 2020) (analyzing the dropdown transactions utilized by both Cirque du Soleil and Travelport), https://www.realbankruptcyintel.com/2020/06/cirque-du-soleil-and-travelport-transactions-create-controversy.
[87] Buccola, *supra* note 12, at 9.

other creative ways to obtain capital. Soon, uptier exchange transactions began to find their way into courts.[88]

IV. The Litigation of Uptier Exchange Transactions: *Murray Energy Holdings, Trimark, TPC, and Serta*

As stated above, an uptier exchange transaction occurs when the borrower persuades the majority of syndicated investors—which could be a mere .1 percent majority—to amend the loan agreement so that it permits the borrower to create prioritized debt.[89] Recently, there has been a surge in litigation regarding uptier exchange transactions. As you will see below, minority lenders have not been successful in most of these cases. Typically, most claims get dismissed during the pre-trial proceedings.

The first noteworthy case was *Black Diamond Commercial Finance v. Murray Energy Corporation*.[90] This case was brought to court after Murray Energy Corporation ("Murray") had amended its $2 billion credit facility in 2018, which (1) allowed it to remove the limitations on lien grants and (2) allowed the majority of lenders to sell their existing loans in exchange for new loans.[91] Because of the amendment, the 2018 loans were given priority over the original 2015 loans.[92] Subsequently, when Murray filed for bankruptcy, the minority lenders sued to rescind the transaction, arguing that the 2018 loan agreement amendment occurred without their consent.[93]

In their argument, plaintiffs sought relief based on three premises; but I will focus on the second and third claims.[94] The second claim contended that the loan agreement amendments and,

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[88] *See, e.g.*, Octagon Credit Invs., LLC v. NYDJ Apparel, LLC, No. 656677/2017 (N.Y. Sup. Ct. filed Nov. 1, 2018).
[89] Buccola, *supra* note 12, at 18. For a simplified version of an uptier exchange transaction see *Holdout Panic*. *See* Lubben, *supra* note 15, at 21.
[90] 634 B.R. 951 (Nov. 8, 2021).
[91] *See* Jeff Norton et al., *COVID-19: Prime Time for Priming*, O'Melveny (Jul. 15, 2020), https://www.omm.com/resources/alerts-and-publications/alerts/covid-19-prime-time-for-priming.
[92] *See Murray Energy Corp.,* 634 B.R. at 961.
[93] *See id.*
[94] *See* Black Diamond Com. Fin. v. Murray Energy Corp., 616 B.R. 84, 97 (May 4, 2020).

therefore, the 2018 transactions were ineffective since the amendment took place without the required consent.[95] Plaintiff further claimed that the super-priority lenders lacked the authority to amend the loan agreements since they had committed to sell their loans back to Murray.[96] Essentially, the court dismissed this claim and reasoned that although the lenders had agreed to sell their 2015 loans back to Murry before the amendment, they had remained lenders when the 2018 amendment was enacted.[97]

Plaintiff further argued that the amendments effectively resulted in a release of collateral, which accordingly required unanimous lender consent to do.[98] The court, likewise, rejected this argument and reasoned that subordination and release are two completely different concepts.[99] Although the court acknowledged that the actual impact might nonetheless have the same effect as release, it declined to treat subordination on similar grounds as release.[100] The dismissal of the claims in this case ultimately reflects the proposition that subordination does not require the full consent of the lenders; basically, subordination does not amount to a breach of a sacred right like release does.[101] Thus, courts have allowed uptier exchange transactions to continue even though they may unduly burden minority lenders.

A similar result was reached in *Audax Credit Opportunities Offshore Limited vs. Tmk Hawk Parent Corporation* (“*Trimark*”).[102] In 2017, two private equity firms acquired around 87 percent equity interest in Trimark via a $1.265 billion leveraged buyout.[103] Around two-thirds of the

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[95] *See id.*
[96] Black Diamond essentially argued, and the court agreed, that once a loan is repurchased, the holder does not have a right to vote. *See id.*
[97] *See id.*
[98] *See id.* at 98 (“ The Credit Agreement provides that ‘[w]ithout the written consent of each Lender . . . that would be directly adversely affected thereby . . . no amendment . . . shall be effective if the effect thereof would release all or substantially all of Collateral[.]’”).
[99] *See id.*
[100] *See Murray Energy Corp.,* 616 B.R. at 98.
[101] See *id.*
[102] No. 565123/2020, 2021 N.Y. Misc. LEXIS 4475 (N.Y. Aug. 16, 2021).
[103] *Id.* at *5.

purchase price was financed by a syndicated loan, which is essentially an offering by a group of lenders.[104] The loan had two tranches: the first lien and the second lien.[105] The same collateral secured both tranches, but the first lien had priority over the second lien regarding the collateral claim.[106] Due to the substantial hardship brought by COVID-19, Trimark announced that it would enter into a new transaction.[107] This new transaction, which entailed an agreement between the borrower and existing lenders, would provide the distressed Trimark with much capital.[108] Specifically, Trimark would (1) enter into a "Super Senior Credit Agreement," which would subordinate existing tranches, and (2) issue $307.5 million to the participating lenders through a dollar-for-dollar exchange.[109] Lenders that had not participated were not even notified about the pending uptier exchange transaction.[110]

Under this new agreement, Trimark eased the restrictions regarding the issuance of super-senior debt while restricting the plaintiffs' right to litigate the transactions.[111] Plaintiffs subsequently filed suit and argued, among other things, that Trimark had breached their implied covenant of good faith and fair dealing.[112] The court rejected this claim because the plaintiff failed to show how it differed from their breach of contract claim.[113]

The *Trimark* case illustrates that litigators should make a claim for the breach of the implied covenant of good faith and fair dealing that stands independently of a breach of contract claim.[114]

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[104] *See id.* at *6; *see also* Blaise Gadanecz, *The Syndicated Loan Market: Structure, Development and Implications*, BIS Q. REV. 75 (Dec. 2004) ("Syndicated loans are credits granted by a group of banks to a borrower").
[105] *Audax*, 2021 N.Y. Misc. LEXIS 4475, at *6.
[106] *Id.*
[107] *Id.* at *9.
[108] *Id.*
[109] *Id.*
[110] *Id.* at *3.
[111] *Audax*, 2021 N.Y. Misc. LEXIS 4475, at *9.
[112] *Id.* at *37.
[113] *See id.*; *see also* Gerard S. Catalanello et al., *Financial Restructuring & Reorganization Advisory: Trimark: Are "Sacred Rights" Still Sacrosant?*, ALSTON & BIRD (Sep. 10, 2021)
[114] *See Audax*, 2021 N.Y. Misc. LEXIS 4475, at *9 ("cannot be used to impose obligations or restrictions going beyond what is set forth in the contract").

It is noteworthy that the court embraced the notion that an amendment within the defendant's contractual right is not a breach of the implied covenant of good faith and fair dealing.[115] This means that uptier exchange transactions do not breach the implied covenant of good faith and fair dealing even if the borrower neglects to notify the minority lenders of their intent to enter into such a transaction.

Like *Trimark* and *Murray*, *In re TPC Group* ("*TPC*") came to a similar conclusion. In *TPC*, the borrower had issued senior secured notes with an interest rate of 10.5 percent.[116] A first lien secured these notes to essentially all of TPC's unencumbered assets, and a second lien on the encumbered assets.[117] To address its need for liquidity, TPC issued around $153 million in new notes that had an interest rate of 10.875 percent.[118] Subsequently, TPC issued an additional tranche which was intended to be secured by the same collateral as the 10.5 percent notes; thus, the new notes would become senior over the 10.5 percent notes.[119]

To prioritize the new notes, TPC needed to amend various provisions of the loan agreement, but, since the holders of the new notes had also held a majority of the 10.5 percent notes, they could amend the agreement such that the amendment did not interfere with the creditors' sacred rights.[120] In interpreting the plain meaning of the loan agreement regarding the 10.5 percent notes, the bankruptcy court explained that the amendment to the 10.5 percent notes did not require unanimous consent.[121] The minority lenders' subsequently filed a motion to stay

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[115] *See id.* at *37 ("[t]he defendants were within their contractual rights to amend the Original Credit Agreement without Plaintiffs' consent, that is the end of the story.").
[116] *In re* TPC Grp. Inc., No. 22-10493 (CTG), 2022 WL 2498751, at * 1 (Bankr. D. Del. July 6, 2022).
[117] *Id.* at *1.
[118] *Id.* at *9.
[119] *Id.*
[120] *Id.*
[121] *Id.* at *26 ("Reading § 9.02(d)(10) to treat any subordination as violating a "sacred right," however, would be inconsistent with this hierarchy. Subordination of a lien to that of another lender is a less drastic intrusion . . .").

the bankruptcy court's opinion.[122] Relying on the plain language of the loan agreement, the district court denied the minority lenders' motion and found that the minority noteholders could not exhibit a "better than negligible" likelihood of success since there was "little support for Appellants' interpretation of section 9.02(d)(10) as an anti-subordination provision."[123]

In *TPC*, the court seemingly agreed with the court in *Murray*. Both found that anti-subordination provisions must be construed as a sacred right for the subordination of a lender's rights to require unanimous consent.[124] Both cases' reasoning seemed to stress the importance of the text's plain meaning.[125] Further, both courts seemed sympathetic to the distressed borrower who had faced issues regarding liquidity.[126]

In March 2022, the court finally took a turn in recognizing the claims of the minority lenders. In 2016, Serta Simmons entered into a first-lien term loan agreement providing $1.95 billion with various lenders.[127] The loan established that the lenders were entitled to payments on a *pro rata* basis; specifically, they would be paid based on their percentage ownership of the loan.[128] On June 8, 2020, Serta Simmons announced a subsequent transaction involving a majority of first- and second-lien lenders to provide capital, enhancing overall liquidity.[129] Specifically, this new transaction created two tranches of debt that would rank ahead of the already existing first-lien loans: (1) a new-money tranche that would contain around $200 million of free capital

[122] *In re TPC*, 2022 WL 2952518, at *14.
[123] *Id.*
[124] *Id.* at *26; *see* Black Diamond Com. Fin. v. Murray Energy Corp., 616 B.R. 84, 98 (May 4, 2020).
[125] *In re TPC*, 2022 WL 2952518, at *14.; *Murray Energy Corp.,* 616 B.R. at 98.
[126] *See* Andrew Cheng et al., *TPC Bankruptcy and District Court Opinions Uphold Uptiering Transaction and Teach an Important Lesson on the Need for Express Lender Protections in Debt Documents*, JDSUPRA (Aug. 17, 2022).
[127] LCM XXII Ltd. v. Serta Simmons Bedding, LLC, No. 21-CV-3987, 2022 WL 953109, at *2 (S.D.N.Y. Mar. 29, 2022).
[128] *Id.* at *2.
[129] *Id.* at *8.

and (2) an exchange tranche which would contain $875 million of loans that were created "through an exchange of the Participating Lenders' first- and second-lien loans."[130]

How was Serta able to achieve all this? Well, Serta obtained the approval of the participating lenders—the majority—to amend the agreement so that Serta could incur priority term loans, thus allowing Serta to issue new, senior debt.[131] The new senior debt that the participating lenders held was around $1.075 billion.

Subsequently, the plaintiffs sued Serta and argued that Serta had breached the loan agreement by breaching the implied covenant of good faith and fair dealing.[132] The court, in its decision, denied Serta's motion to dismiss the claim.[133] The court noted that a claim for breach of the implied covenant of good faith and fair dealing might be brought where one party's conduct, although not technically a breach of the contract, deprives the other party of the benefit of the bargain.[134]

Why did Serta elect to enter into an uptier exchange transaction rather than typical refinancing methods? Serta opted to utilize an uptier exchange transaction to avoid the incurrence of new indebtedness secured to currently unencumbered assets.[135] By giving the participating lenders a super-priority over existing collateral, Serta was able to obtain new capital without the setback of securing it to unencumbered assets.[136] Another reason Serta entered into an uptier

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[130] *Id.*
[131] *Id.*
[132] *Id.* at 44.
[133] *Serta*, 2022 WL 953109, at *44.
[134] *Id.*; it is worth noting that, as of March 28, 2023, United States Bankruptcy Court for the Southern District of Texas dismissed arguments that the plaintiffs had been unfairly frozen out of the transaction between Serta and the majority lenders; but the claim regarding a breach of the implied covenant of good faith and fair dealing lives on. Sujeet Indap and Eric Platt, *Big Debt Investors Dealt Blow in Mattress Maker Bankruptcy Ruling*, FIN. TIMES (Mar. 28, 2023), https://www.ft.com/content/3364f0ab-0073-41a0-ad5b-f13cd02ff524?accessToken=zwAF-4J4JBxQkc8zZPCrAHNBoNOtW_E80C_1JA.MEQCIHSd6oNyekZMfJUqmCyjL4ZAJ2TRzzUYy397Mmdb11GBAiBtRvtqMo5Gr2lITRYsxP2P_8luZijoPvfNL_vaPZFx2Q&sharetype=gift&token=3582ac49-c409-453e-84dc-e9b76d3b653e.
[135] *See* Elberg, *supra* note 9.
[136] *See Serta*, 2022 U.S. Dist. LEXIS 57976, at *8-9.

exchange transaction was that it allowed Serta to avoid a comprehensive restructuring proceeding or bankruptcy filing.[137] Bankruptcy proceedings are typically expensive and have long-term financial impacts, so it is typically in an entity's best interest to avoid it.[138]

In *Serta*, the court departed from past cases and allowed for the claim for breach of the implied covenant of good faith and fair dealing.[139] In reaching this decision, the court focused on how Serta affected the transaction, not merely the existence of such rights.[140] The court also noted that Serta's "combing through the agreement" in an effort to morph a "previously impermissible transaction into a permissible one" could show bad faith since the minority lenders were seemingly left out of the negotiations.[141] While the court's denial of Serta's motion to dismiss is a step in the right direction, it falls short of acknowledging the outright breach of the implied covenant of good faith and fair dealing that persists in most uptier exchange transactions.

V. Bad Faith Borrowers: Why Uptier Exchange Transactions Often Breach the Implied Covenant of Good Faith and Fair Dealing

As stated above, uptier exchange transactions often breach the implied covenant of good faith and fair dealing because they are usually made without the consent of the minority lenders. Accordingly, courts should have no hesitation in holding that many uptier exchange transactions are void. Admittedly, courts have yet to do so because courts often have great difficulty applying the standards of good faith and fair dealing to not only uptier exchange transactions, but a myriad

[137] *See* Lynn Lopucki, *A Team Production Theory of Bankruptcy Reorganization*, 57 VAND. L. REV. 741, 742 (2004) ("United Airlines filed for bankruptcy reorganization, the firm lost $3.2 billion.)
[138] TJ Porter, *Considering Bankrupcy? It Could Cost More Than You Think*, BANKRATE (May 12, 2022), https://www.bankrate.com/personal-finance/debt/how-much-does-it-cost-to-file-bankruptcy/#:~:text=However%2C%20bankruptcy%20isn't%20free,ll%20want%20to%20prepare%20for.
[139] *Serta*, 2022 U.S. Dist. LEXIS 57976, at *44.
[140] *Id.* at *46
[141] *Id.* at *49.

of different cases.[142] Accordingly, Part A will explain the implied covenant of good faith and fair dealing generally. Part B will provide the different interpretations of how a court should apply the implied covenant of good faith and fair dealing. Part C will argue that the outcome remains the same under either interpretation.

A. The Implied Covenant of Good Faith and Fair Dealing

The Restatement provides that "every contract imposes upon each party a duty of good faith and fair dealing in its performance."[143] The Restatement breaks this implied covenant into two parts: (1) good faith and (2) fair dealing.[144] The description of good faith is "faithfulness to an agreed common purpose and consistency with the justified expectations of the other party."[145] Further, good faith is typically defined based in opposition to "bad faith."[146] Similarly to the Restatement, the Uniform Commercial Code (UCC) defines good faith as "*honesty in fact* and the observance of *reasonable* commercial standards in faith dealing."[147] This definition contains both a subjective and an objective element.[148]

The American Bar Association (ABA) provides another interpretation of the implied covenant of good faith and fair dealing. The ABA defines good faith as "honesty in a person's conduct during the agreement"[149] The ABA further states that the standard for fair dealing is

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[142] *See* Paul MacMahon, *Good Faith and Fair Dealing as an Underenforced Legal Norm*, 99 MINN. L. REV. 2051, 2052 (2015)
[143] RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); *see also* Uniform Commercial Code § 1-304 (requiring good faith in every contract under the UCC).
[144] *See* RESTATEMENT (SECOND) OF CONTRACTS § 205.
[145] RESTATEMENT (SECOND) OF CONTRACTS § 205 CMT. A (1981).
[146] RESTATEMENT (SECOND) OF CONTRACTS § 205 CMT. A (1981).
[147] Uniform Commercial Code § 1-201(20) (emphasis added).
[148] *See* BAKER DONELSON, *Good Faith, Fair Dealing and Moral What? Beyond the Four Corners of Your Documents* (July 1, 2013), https://www.bakerdonelson.com/Good-Faith-Fair-Dealing-and-Moral-What-Beyond-the-Four-Corners-of-Your-Documents-07-01-2013.
[149] *See* Catherine Patrikos Kelly, *What You Should Know About the Implied Duty of Good Faith and Fair Dealing*, AM. BAR ASS'N (July 16, 2016).

higher than that of good faith.[150] Fair dealing "generally requires that a party cannot act contrary to the '*spirit*' of the contract."[151]

The multitudinous number of competing definitions of good faith and fair dealing illustrates the proposition that there has yet to be an established definition of said covenant. According to Professor Robert S. Summers, an important figure within the contractual landscape, good faith is "a phrase which has no general meaning or [any] meaning on its own."[152] While absent a general definition, the overall theme is fairness.[153] Boiled down, the implied covenant of good faith and fair dealing is a tool that is utilized to ensure that a party's reasonable expectations are not ignored.[154]

When does the implied covenant of good faith and fair dealing typically apply? The implied covenant of good faith and fair dealing only applies to situations when conduct is not expressly resolved by the terms of the contract or by another default rule.[155] Put simply, unless an express term within the contract is on point, the covenant will apply, and vice versa. So, the implied covenant is ordinarily used by courts in situations where the contract is silent about the conduct performed or when the conduct is discretionary.[156] Within the context of uptier exchange transactions, the contracts are usually silent on the borrower's conduct.

B. Competing Interpretations of the Implied Covenant of Good Faith and Fair Dealing

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[150] *See id.*
[151] *See id.*
[152] *See* Robert S. Sumers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 196 (1968).
[153] LUBIN AUSTERMUEHLE, *Difference Between Implied Covenant of Good Faith and Fair Dealing and the Fiduciary Duty of Good Faith*, https://www.thebusinesslitigators.com/difference-between-implied-covenant-of-good-faith-and-fair-deali.html.
[154] *Id.*
[155] *See* Gen. Aviation, Inc v. Cessna Aircraft Co., 915 F.2d 1038, 1041 (6th Cir. 1990) (stating that the covenant cannot be used to override express contractual terms).
[156] *See*, *e.g.*, Hubbard Chevrolet Co. v. Gen. Motors Corp., 873 F.2d 873, 876–77 (5th Cir. 1989), *cert. denied*, 493 U.S. 978 (1989); Chrysler Credit Corp. v, Marino, 63 F.3d 547, 579 (7th Cir. 1995).

To date, courts have been inconsistent in their application of the implied covenant of good faith and fair dealing. This is primarily due to the overall absence of a uniform standard for courts to utilize.[157] Historically, there have been numerous prevailing interpretations of the implied covenant of good faith and fair dealing. This section will examine two of the most prominent interpretations, which are essentially opposite interpretations, and argue why one interpretation should prevail over the other.

In 1983, Kham & Nate's Shoes No.2, Inc. ("Kham") obtained a line of credit for $300,000.[158] The lender advanced the funds until March 7, 1984, when it stopped at a point where the debtor had taken on about $75,000 worth of credit.[159] Kham filed for chapter 11 bankruptcy, and the court found that the lender had breached the implied covenant of good faith and fair dealing.[160] The Seventh Circuit Court of Appeals overturned the trial court's decision.[161] In a famous opinion, Judge Easterbrook argued that good faith is not used to block terms within the contract; thus, it should only be utilized when the contract is silent.[162] Judge Easterbrook's determination rested on his decision to concentrate on the literal meaning of the contract. It shows his inherent hesitation to allow implied terms into the contract.

Judge Easterbrook's view mirrors one of the two significant articulations of good faith and fair dealing: the foregone opportunities view. While the intricacies of this view are outside of the scope of this article, it basically focuses narrowly on the contract itself.[163] The foregone opportunities approach defines bad faith as an attempt to recapture the opportunities foregone.[164]

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[157] *See generally* Jay. M. Feinman, *Good Faith and Reasonable Expectations*, 67 ARK. L. REV. 525 (2014).
[158] Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1353 (7th Cir. 1990)
[159] *Id.*
[160] *Id.*
[161] *Id.* at 1363.
[162] *Id.* at 1357 ("[P]rinciples of good faith . . . do not block use of terms that actually appear in the contract).
[163] *See* Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 374 (1980).
[164] Feinman, *supra* note 157, at 527–28.

Overall, Judge Easterbrook's interpretation falls short because it neglects the standard rules of contractual interpretation. Specifically, Judge Easterbrook fails to note that the standard rules of interpretation require the protection of the justified expectations of the opposite party.[165] Since the beginning of contemporary contract law, many contract treatises have stressed the interplay between reasonable expectations and good faith.[166] Ultimately, the foregone opportunities approach provides a stringent framework that seemingly drops the "reasonable expectations" piece of good faith.

The opposing view is what is known as the "excluder" approach.[167] Essentially, the excluder approach argues that good faith "is a phrase without general meaning (or meanings) of its own and serves instead to exclude a wide range of heterogeneous forms of bad faith."[168] Overall, the excluder framework has been applied to numerous court decisions.[169] Some judicially recognized forms of bad faith include, but are not limited to:

> (1) evading the spirit of the deal—namely, its underlying rational, not necessarily manifested in the contract language; (2) lack of diligence and slacking off; (3) willfully rendering only "substantial performance"—that is, imperfect performance that cannot be attributed to mere mistake or inadvertence . . . (6) interfere with or failure to cooperate in the other party's performance.[170]

The first and third judicially recognized forms of bad faith are particularly noteworthy as applied to uptier exchange transactions. As discussed in the next section, uptier exchange transactions arguably amount to both.

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[165] *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 CMT. A ("[C]onsistency with the *justified expectations* of the other party") (emphasis added).
[166] *See* ARTHUR LINTIN CORBIN, CORBIN ON CONTRACTS § 1.1 (one vol. ed. 1952) ("The Main Purpose of Contract Law Is the Realization of Reasonable Expectations Induced by Promises").
[167] *See* Feinman, *supra* note 157, at 526 n. 4 (*citing* Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 196 (1968)).
[168] Sumers, *supra* note 152, at 262.
[169] *See, e.g.*, Fremont v. E.I. DuPont DeNemours & Co., 988 F. Supp. 870, 877 (E.D. Pa. 1997); Garrett v. BankWest, Inc., 459 N.W.2d 833, 841 (S.D. 1990).
[170] *See* Alan D. Miller & Ronen Perry, *Good Faith Performance*, 98 IOWA L. REV. 689, 699 (2012).

Since most uptier exchange transactions cases are brought under New York law, it is worth specifically analyzing the obligation of good faith and fair dealing under New York law. In *Howard v. Pooler*, for example, the parties formed a limited liability company (LLC) to develop residential subdivisions.[171] The LLC agreement stated that the plaintiff would be the exclusive agent for the sales of lots in the subdivision.[172] After around five years, the defendant removed the plaintiff's role under the operating agreement, essentially depriving the plaintiff as exclusive agent.[173] The court affirmed the lower court's finding that this action constituted a breach of the duty of good faith and fair dealing because, although the conduct was not "expressly forbidden," it nonetheless deprived plaintiff of the benefits of the contract.[174] Here, it is unclear whether the court embraced the excluder approach or the foregone opportunities approach. While there is an argument that the defendant was attempting to recapture the "foregone opportunity" of hiring their own listing agent, there is an equally strong argument that the action constituted bad faith. Thus, it is unclear what approach New York embraces.

The excluder framework is the correct interpretation of the implied covenant of good faith and fair dealing for several reasons. First, it has been used successfully in a number of cases.[175] This illustrates the "usability" of the framework within litigation. Second, it has been adopted by the Restatement.[176] For purposes of uniformity, courts would be naïve to elect to utilize a different standard. Lastly, the excluder framework is easy to apply. Courts generally have an easy time

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[171] 126 N.Y.S.3d 824, 827 (4th Dept. 2020).
[172] *Id.*
[173] *Id.*
[174] *Id.* at 849
[175] *See, e.g.*, Fremont v. E.I. DuPont DeNemours & Co., 988 F. Supp. 870, 877 (E.D. Pa. 1997); Garrett v. BankWest, Inc., 459 N.W.2d 833, 841 (S.D. 1990).
[176] *See* Teri J. Dobbins, *Losing Faith: Extracting the Implied Covenant of Good Faith from (Some) Contracts*, 84 OR. L. REV. 227, 271 (2005).

determining what constitutes bad faith rather than defining what constitutes good faith.[177] The excluder framework is entirely based on bad faith; therefore, it is easy to apply.

C. The Excluder framework and the Foregone Opportunities Standard in the context of Uptier Exchange Transactions

As stated above, uptier exchange transactions typically entail the outright exclusion of minority lenders.[178] Under the excluder framework, this likely illustrates bad faith as the borrower is (1) evading the spirit of the deal, namely the fact that most plaintiffs expressly bargain for first lien priority and *pro rata* rights, and (2) willfully rendering only "substantial performance."[179] While on its face, it may not seem like there is merely "substantial performance," the reality is that these transactions typically occur when a company is distressed—it is the last resort before bankruptcy or a comprehensive restructuring.[180] This fact, coupled with the super-priority granted to the majority lenders, logically means that the minority lenders cannot expect to receive their fair share of collateral. I argue this amounts to merely substantial performance because the borrower exhibits no intent to pay based on the lenders' original *pro rata* right.

Furthermore, uptier exchange transactions blatantly evade the spirit of the deal. Entering into an uptier exchange transaction goes against the grain of the original deal. Minority lenders agreed to the original loan agreement, which laid out their priority over collateral and *pro rata* rights. Entering into uptier exchange transactions ignores the original intent for entering into the loan agreement in the first place.

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[177] *See* Saul Litvinoff, *Good Faith*, 71 TUL. L. REV. 1645, 1665 (1997).
[178] *See* LCM XXII Ltd. v. Serta Simmons Bedding, LLC, No. 21 Civ. 3987(KPF), 2022 U.S. Dist. LEXIS 57976 (S.D.N.Y., Mar. 29, 2022).
[179] *See* Alan D. Miller & Ronen Perry, *Good Faith Performance*, 98 IOWA L. REV. 689, 699 (2012).
[180] *See* Elberg, *supra* note 9.

The failure to include minority lenders in the uptier exchange transaction also implies an intent to harm. The fact that the borrower typically makes these transactions behind curtains illustrates their knowledge that it would likely indirectly harm the minority lenders. Overall, entering an uptier exchange transaction goes against the minority lenders' *justified expectations*, a foundational element of contract law.

Under the foregone opportunities framework, uptier exchange transactions likewise breach the implied covenant of good faith and fair dealing. The court in *Serta* recognized that even an explicitly discretionary contractual right may be exercised in a manner that constitutes bad faith.[181] The borrower's exercise of their discretion, which frustrates the minority lenders' contractual benefit, illustrates their attempt to claim a foregone opportunity. Under this framework, bad faith is typically found where "contractual discretion is used to recapture opportunities foregone at formation."[182]

Uptier exchange transactions essentially amount to an amendment of the *pro rata* sharing provisions, which are a sacred right.[183] When the borrower enters a loan agreement, they impliedly forego the opportunity to amend pro rata sharing provisions unless they receive unanimous consent. Uptier exchange transactions essentially constitute an amendment to *pro rata* provisions since the minority lenders lose their original proportional fair share of collateral. When borrowers amend to allow for uptiering, they are essentially attempting to capture an opportunity foregone; thus, the borrower illustrates bad faith under both the excluder framework and the foregone opportunities approach. As such, a court should routinely hold that uptier exchange transactions breach the implied covenant of good faith and fair dealing.

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[181] *Serta*, 2022 U.S. Dist. LEXIS 57976, at *49.
[182] *See* Alan D. Miller & Ronen Perry, *Good Faith Performance*, 98 IOWA L. REV. 689, 706 (2012).
[183] Seth E. Jacobson, *Unhappy Lenders Challenge Aggressive Debt Exchanges*, SKADDEN (Jan. 19, 2022) ("credit agreements often treat the pro rata sharing of payments as a 'sacred right'").

VI. FOR NOW . . .

Courts have yet to find a breach of the implied covenant of good faith and fair dealing in the context of uptier exchange transactions.[184] To avoid being subordinated by an uptier exchange transaction, lenders should do the following: (1) adopt stronger loan agreements, and (2) utilize the collateral coverage test in their loan agreements.

Lenders should strive to form rigid credit agreements.[185] Lenders should start by expanding the sacred right on release to cover subordination. As was seen in *Serta* and *Murray*, the courts held that the sacred right of release did not extend to subordination.[186] Courts prioritize express language, so lenders can ensure that their liens do not become subordinated by expressly expanding the sacred right of release.

Lenders can also increase the voter threshold needed to amend. Currently, most loan agreements only require the consent of a bare majority of lenders to amend.[187] Lenders requiring a higher voting threshold for amendment can make it more difficult for borrowers to obtain the consent needed to amend subordination provisions.[188] While this would not outright stop the amendment of the loan agreement, it would make it more difficult in cases with many lenders. Further, lenders could seek to expand the *pro rata* sharing provisions to prevent one lender from receiving a greater benefit than another.[189] If crafted correctly, this could keep certain lenders from receiving the right to prioritize their liens.

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[184] *See, e.g.*, *Serta*, 2022 U.S. Dist. LEXIS 57976.
[185] For examples of credit agreements that protect against lien subordination look at HanesBrands and Gannett Co. credit agreements. *See* Bulaon, *supra* note 13.
[186] *See* Black Diamond Com. Fin. v. Murray Energy Corp., 616 B.R. 84, 98 (May 4, 2020); In re TPC Grp. Inc., No. 22-10493 (CTG), 2022 WL 2498751, at *26 (Bankr. D. Del. July 6, 2022).
[187] *See* Lubben, *supra* note 15, at 18.
[188] Norton, *supra* note 91.
[189] *Id.*

Another way in which lenders can avoid being subordinated is by utilizing the collateral coverage ratio test.[190] The collateral coverage ratio would be a test that requires the debtor to show that the value of the collateral is pegged to an agreed-upon multiple of debt or first-lien debt at the time another transaction is entered.[191] This ratio ensures that there is enough collateral to cover the loan in case of default.[192] This would provide yet another obstacle for borrowers looking to enter priming transactions. One potential pitfall, however, could lie in the debtor's ability to inflate the values in a priming move.[193]

While the above recommendations do not outright halt uptiering, they make it significantly more difficult. Further, they provide an additional foothold upon which the minority lenders can challenge the validity of an uptier exchange transaction.

VII. Conclusion

The utilization of uptier exchange transactions poses a unique issue for courts to grapple with. While uptier exchange transactions provide much-needed capital for distressed borrowers, they simultaneously raise the question of whether entering these transactions is equitable for minority lenders. Given the nature of these transactions—i.e., the failure to notify minority lenders—courts should easily find that these transactions often breach the implied covenant of good faith and fair dealing, yet they have not. Thus, this Comment should serve as a tool as cases continue to be brought before the courts. While *Serta* is a step in the right direction, this issue ultimately lies in the hands of the judiciary.

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[190] *Id.*
[191] *See* Meredith Wood, *Collateral Coverage Ratio: Formula, Definition, and Examples*, FUNDERA (Sep. 29, 2020), https://www.fundera.com/blog/collateral-coverage-ratio-definition#:~:text=What%20Is%20the%20Collateral%20Coverage,by%20the%20total%20loan%20amount.
[192] *See* Tom Thunstrom, *Collateral Coverage Ration: What it Is & How to Calculate it*, FIT SMALL BUS. (Dec. 21, 2021), https://fitsmallbusiness.com/what-is-collateral-coverage-ratio/.
[193] Jeff Norton, *supra* note 91.