<u>Legal Opinion Issues in the Context of Up-tiering Transactions: ABA LOC September 24, 2020 discussion item by Arthur Cohen, LOC vice-chair</u>

Clean opinions on up-tiering transactions appear to be a new thing, and it raises issues both for firms that may be asked to give such an opinion and for firms which receive such a clean opinion and may feel that it is not well and appropriately grounded. There is a potential issue about whether parties involved are acting in good faith, and despite the unstated assumption to that effect, it is not available if it appears that the assumption is unreliable. The purpose of this inquiry is not to tell any firm what opinions should and should not be given. Rather the purpose of this inquiry is to help opinion recipients understand how to deal with this issue if they have concerns of the type raised here.

In an up-tiering transaction the borrower and a group of existing secured noteholders sufficient in size to approve amendments that do not require unanimity (the "***Required Lenders")*** (either bond noteholders or credit agreement lenders) enter into an amendment to the governing debt document that permits the borrower to incur an additional tranche of debt (the "***Incremental Debt***") funded by the same group of Required Lenders. In most cases the new debt is completely new money. In other cases, the new debt is exchanged for old debt with the old debt being exchanged at a discount. The amendment also amends the credit agreement or indenture, as applicable, together with any intercreditor agreements, to provide that the Incremental Debt is secured by a lien on the Borrower's assets **<u>senior to the liens securing the existing debt</u>** and specifically provides that the liens securing the existing debt are now subordinate to the liens securing the Incremental Debt.

The legal question this type of transaction presents is whether such amendments require 100% of the existing lenders/noteholders to consent to the amendments or whether the amendments can be effected with only "Required Lender" consent (typically 51%). The opinion issue arises because several firms are giving flat opinions that only Required Lender approval is needed and the basis for such a flat opinion is not clear.

In one recent typical case, the borrower had both a senior bank credit agreement and secured senior notes (governed by an indenture). There was a typical split collateral arrangement with the Banks having a first lien in ABL collateral and a second lien in all other assets and the bondholders having a first lien in all assets other than the ABL collateral and a second lien in the ABL collateral. The indenture provisions stated:

> no amendment, supplement or waiver shall, without the consent of the Holder of each outstanding Note affected thereby (with respect to any Notes held by a non-consenting Holder) ***make any change in the ranking or priority of any Note that would adversely affect the Holders;***

This raises the question of how to interpret the phrase "ranking or priority of any Note". At least one unnamed major law firm (and perhaps others) take the view that this language only prevents amendments which affect the "***payment***" priority and therefore 51% of the noteholders are entitled to subordinate the liens. The counter to this argument is:

- The language doesn't specifically refer to payment priority
- To the extent that all the assets are pledged to secure existing debt the only way the existing notes get paid is out of proceeds of the collateral.

  - If the value of the collateral is less than the aggregate amount of the secured debt (existing debt plus Incremental Debt), any action taken to subordinate the liens securing the existing debt will clearly affect the likelihood of the existing debt being repaid.
- Even without valuing the collateral, where all of the assets are pledged as collateral, layering in new debt secured by the same assets above the existing debt is the essential equivalent of altering the "ranking or priority" of the existing debt in an adverse manner.

In a Credit Agreement context, the language is not as clear and perhaps there is more room to argue in favor of up-tiering. The two 100% voting amendments in most credit agreements are

- amendments to the pro-rata sharing provision and
- releasing all or substantially all of the liens in the collateral. Typical language in a syndicated credit agreement requires 100% vote to release liens in all or substantially all of the Collateral, and in many cases this requirement of 100% vote relates to release of "any substantial part of the Collateral."

In the Credit Agreement context, the issue becomes whether the issuance of new debt and subordination of the existing liens is the equivalent of releasing the liens. In certain factual situations (which often correspond to exactly the type of situations where up-tiering is used) it has been argued that up-tiering is in some ways similar to releasing the liens. Such a situation would be as follows: There is a $100 million secured credit facility, and the value of the collateral is uncertain, probably $120-160 million, with a wide range of uncertainties if the company ceases operations. There is an up-tiering transaction in which the Required Lenders (51%) provide $50 million of new funds on a secured basis, and sign amendments to expressly subordinate the old credit facility. In this scenario, the new financing, taking a senior position, exposes the old financing to increased uncertainty of collateral coverage – they may be covered 100%, but their degree of uncertainty is much greater. The new money collateral has no risk because they are greatly over-collateralized and are earning very-high interest and fees for this work. They argue that they are also protecting the collateral value for their other position, but it is hard to separate their incentives.

The key is the distinction between payment subordination and lien subordination. The question is whether those two are interrelated such that in some cases, such as where the only source of repayment is from collateral, layering in a tier of debt with higher lien priority impacts the "ranking" of the notes such that the practical effect to the lenders which have had their liens subordinated is that they don't get paid until the new tranche has been paid, which somehow creates payment subordination. And related to that is this question: Should there be sufficient concern that a court might rule this way that an unqualified opinion is one that can reasonably be treated by a recipient with skepticism?

Overall, the question is how it is possible for a firm to deliver a flat opinion that transactions of this type are permitted under the existing documentation. In a bond indenture or loan credit agreement context, can you layer in priming lien debt ahead of existing secured (or unsecured debt) without the consent of all existing lenders/noteholders, and do so in a way that is so clearly permitted as to be able to give a clean opinion thereon? This seems like a question that is important to consider.

Of course, the overarching policy question in all of these transactions is whether the existing language in most credit agreements and indentures would permit this out of court restructuring of lien priorities without the unanimous consent of the lenders. Historically this was achieved only through a bankruptcy and court orders binding on all creditors. These up-tiering transactions are now leading to out-of-court restructurings and there may be compelling policy reasons to support such restructurings, but many

minority investors/noteholders/lenders will be surprised to find themselves not being invited to participate in the up-tiering transaction. The question I propose to discuss is to what extent law firms can appropriately give the legal opinions on which these transactions rely.