Proskauer

The Evolving New Normal 2024 Private Credit Restructuring Year in Review

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In many ways, 2024 continued existing trends in private credit: modest levels of M&A activity, competition among direct lenders to deploy capital, higher-for-longer interest rates, persistent inflation, elevated default rates, and restructurings frequently resolved out-of-court. However, several of those trends began to temper or reverse during the past year: M&A activity increased materially from 2023 levels, interest rate cuts finally took effect (resulting in a decrease in SOFR of approximately 100 basis points over the last few months of the year), inflation eased, and default rates ticked down. Nevertheless, corporate bankruptcy filings were up over the prior year and reached a fourteen-year high.

In the broadly syndicated loan ("BSL") market, a steady stream of liability management exercises ("LMEs") continued at a velocity built over the past several years, but market participants grew more sophisticated and their tactics more complex. Private credits were spared the creditor-on-creditor violence that has become a hallmark of the BSL market, where opportunistic credit investors mix, and often clash, with par holders. Yet, with the lines—whether demarcated by number of lenders or deal size—between direct lending and syndicated loans blurrier than ever, private credit lenders should keep a watchful eye on LME trends, discussed in detail below. Even if LMEs do not broadly penetrate the middle-market, we expect that because an LME can pose an existential threat to a creditor in individual positions, they will remain a key—perhaps *the key*—area of focus in the negotiation of both front-end deal documents and restructuring amendments.

Indeed, 2024 was particularly active with out-of-court debt exchanges negotiated by ad hoc groups of majority lenders to the detriment of minority lenders that are either excluded entirely or offered inferior terms as a condition to participation. As more LMEs end up in the spotlight of bankruptcy court, the Bankruptcy Code's safeguards against disparate treatment and opportunistic behavior might guide judges to provide protections to minority lenders, as the Fifth Circuit Court of Appeals did with its interpretation of "open market purchases" and the rejection of the majority's indemnity in its New Year's Eve decision in the *Serta* case.[1]

Private credit restructuring activity in the past year demonstrated the continued resilience of private credit lenders and their ability to navigate challenges with the flexibility needed to support a turnaround plan. As we look forward to 2025 and beyond, we expect that quickly moving and evolving conflicts between debt and equity investors, as well as intercreditor disputes, will persist, with potential implications for private credit.

Before we look ahead, let's look back at a couple of key court decisions from 2024.

The Latest on Make-Whole Treatment in Bankruptcy

In the much-anticipated *Hertz*[2] decision, the Third Circuit held that unsecured noteholder claims against a debtor for certain "Applicable Premiums" were the "economic equivalent" to unmatured interest and, therefore, not recoverable under section 502(b)(2) of the Bankruptcy Code. Nevertheless, because the debtor was solvent, the court held that the noteholders were entitled to recover more than $270 million in post-bankruptcy interest at the higher "contract rate" provided for under the notes, as well as redemption premiums and other fees.

This decision adopts the reasoning of the Fifth Circuit in *Ultra Petroleum*[3] and the Ninth Circuit in *PG&E*.[4] Like *Hertz*, *Ultra Petroleum* held that, while make-whole premiums for an unsecured creditor tied to future interest payments are the "functional equivalent of unmatured interest" and not recoverable under section 502(b)(2), in the case of solvent debtors, such claims are recoverable under the so-called "solvent debtor" exception, which is an equitable exception to section 502(b)(2)'s general prohibition on payment of unmatured interest. Because Hertz was solvent, the debtor was obligated to honor its make-whole obligation.

However, most bankruptcy cases do not involve solvent debtors (indeed, far from it). While the unsecured noteholders secured a victory in *Hertz*, this trio of decisions from the Fifth, Ninth, and Third Circuits has significant implications for unsecured lenders who extend credit with an expectation that make-whole claims are enforceable in bankruptcy.

If there is a silver lining for insolvent cases, it's that the *Hertz* court addressed only the rights of an unsecured creditor. As we said in our prior post on *Ultra Petroleum* (which you can read here)—we continue to believe that there is a legal basis for a secured creditor to recover a make-whole or prepayment premium based on the rights in section 506(b) of the Bankruptcy Code, which allows for the payment of "interest on such claim, and any reasonable fees, costs, or charges" when the creditor is oversecured (*i.e.*, the value of the collateral exceeds the claim amount).

Headlines sounding the death knell for make-whole premiums in bankruptcy are misleading. While unsecured creditors of an insolvent debtor face an uphill battle, secured creditors have a different set of rights under the Bankruptcy Code and their path to recover a make-whole premium has not been addressed by *Hertz*, *Ultra Petroleum*, or *PG&E*.

See here for additional discussion on this topic.

Not Equitably Moot! A Boost for Appeals Following Plan Approval

Minority lenders who unsuccessfully challenge an LME in bankruptcy court are faced with the specter of "equitable mootness." Appellate courts that embrace equitable mootness apply the doctrine to avoid upsetting the finality of a reorganization that has been substantially consummated, for the reason that doing otherwise would be an attempt to "unscramble the egg" after parties have justifiably relied on the transactions implemented by the confirmed reorganization plan. The doctrine effectively cuts off any appeal rights if certain requirements are met.

In *Serta*, the consenting majority lenders obtained an indemnity from the borrower in the initial 2020 LME. Recognizing that the prebankruptcy promise of an indemnity would be disallowed in bankruptcy, Serta granted the same consenting majority lenders a substantially similar indemnity through its chapter 11 plan. The indemnity was framed as a settlement between Serta and the consenting majority lenders. The bankruptcy court approved the indemnity when confirming Serta's chapter 11 plan, and Serta consummated the plan.

The minority lenders appealed the validity of the LME and the indemnity in the plan. Serta and the consenting majority lenders argued that the appeal was equitably moot because Serta had already consummated its plan, which the consenting majority lenders agreed to support because of the indemnity. Thus, it would be unfair to excise the indemnity on appeal.

The Fifth Circuit held that the appeal was not equitably moot, and that the indemnity was an impermissible attempt to circumvent applicable provisions of the Bankruptcy Code.

The Fifth Circuit expressed general skepticism about the doctrine of equitable mootness because all parties that would be impacted by the court's decision on appeal were present before the court. The Fifth Circuit also noted Serta's and the consenting majority lenders' position would effectively abolish appellate review if parties supporting an unlawful plan provision could simply cite reliance on that provision to shield it.

Similarly, in *ConvergeOne*, the District Court in Houston declined to find an appeal equitably moot where the court "can fashion a remedy without upsetting the reorganization." There, the bankruptcy court confirmed a plan where certain majority lenders were provided an opportunity to backstop an equity rights offering. The minority lenders who were not provided the same opportunity objected to the plan. The District Court found that the appeal was not equitably moot because "either a monetary award or a redistribution of the equity allocation . . . would not require an unwinding of the plan that would affect the debtor."

Both courts ruled that the task presented to them was practically achievable, more akin to picking out a piece of eggshell than unscrambling the egg.

These results mitigate the concern that equitable mootness will cut off the viability of appeals after plan confirmation. Eyes are on other circuits and whether they will take similar positions. Notably, while never directly addressing equitable mootness, the U.S. Supreme Court has hinted at its disfavor over the principle in *MOAC Mall Holdings LLC v. Transform Holdco LLC*, *Mission Product Holdings v. Tempnology LLC*, and *Truck Insurance Exchange v. Kaiser Gypsum*.

Wesco Ruling Has “The Effect Of” Providing Hope to Excluded Minority Lenders

In March 2022, Wesco Aircraft Holdings, Inc. consummated an uptier exchange LME that involved, as a crucial step, the release of all liens securing its 2026 notes. Pursuant to the applicable sacred right in the indenture governing Wesco’s 2026 notes, this release required the consent of holders of two-thirds of the 2026 notes. The holders willing to participate in the LME, though constituting a majority-in-interest, held less than the two-thirds threshold. To solve for this, Wesco issued additional notes to the participating lenders sufficient to cause them to exceed the two-thirds threshold, and then immediately—but via a separate amendment—consummated the lien release and other transactions comprising the LME.

In 2024, Wesco filed for bankruptcy and found itself in front of Judge Isgur in the Southern District of Texas, who scrutinized the 2022 LME in analyzing claims brought by minority excluded lenders.

The specific language in the indenture’s applicable sacred right, in relevant part, read: “without the consent of the Holders of at least 66 2/3% in aggregate principal amount of the 2026 Secured Notes then outstanding…no amendment, supplement or waiver may (1) ***have the effect of*** releasing all or substantially all of the Collateral from the Liens created pursuant to the Security Documents” [emphasis added]. The excluded lenders’ breach claims turned on whether the initial supplemental indenture in the sequence—the one that issued additional notes to the participating lenders—had “the effect of” releasing the liens, because the lien release would immediately and inevitably follow it. The court ruled that it did.

The court determined that the facts of the 2022 LME made it clear that once the supplemental indenture issuing the additional notes to the participating lenders went effective, the effectiveness of the lien release and balance of the LME—though documented separately— "became irrevocable" and was "an inevitable result". Relevant facts included that all documentation, for both the notes issuance, lien release and other LME transactions were delivered to all parties the night before closing in escrow, and were simultaneously released on the closing call on the day of closing. Accordingly, the issuance of the notes itself had "the effect of" releasing the liens, and the supplemental indenture that authorized such issuance was not executed or supported by holders of the necessary two-thirds supermajority. As a result, the notes issuance breached the indenture and all supplemental steps were ineffective.

While this decision turned on the interpretation of a specific indenture provision—and one that does not appear in the same context in most direct lending or BSL credit documentation—the court was apparently bothered by the actions of the majority lenders and their impacts on the property rights of the minority lender. We thus view the result as having limited direct impact on private credit and BSL restructurings, but providing general support for minority lenders' prospects in prosecuting LME-related claims in subsequent bankruptcy cases.

Liability Management – What Next in 2025?

LMEs surged in 2024. Their structures vary, but their objectives are broadly the same, and laudable: allow stressed companies to stabilize and turnaround by increasing liquidity, reducing leverage, extending maturities, and/or reducing debt service. The tactics typically employed in pursuit of those objectives—disparate treatment of similarly situated lenders, coercive and opaque processes, and aggressive contract interpretation—are what draw criticism. As does the fact that LMEs often fail to achieve their ultimate objective, and instead merely forestall a chapter 11 filing. Let's look at some of the latest trends in LMEs and consider how they may continue or change this year.

Pro Rata Offers Without Pro Rata Economics

One of the most important developments in the maturing LME market is the movement away from deals struck by a group of majority lenders and the borrower that completely exclude all other lenders (*e.g.*, *Serta*), and toward transactions that are offered to all lenders at least nominally on a pro rata basis. This approach improves the treatment of minority lenders while being somewhat less advantageous to majority lenders, and offers significant potential benefits to borrowers, most notably maximizing debt discount and minimizing litigation risk.

In this context, though, market participants must be aware that pro rata does not mean equal in all respects. Rather, these transactions often have various tiers that ascribe different treatment—which may include fees and other economics, exchange rates and priorities—to different groups. It is common for steering committee members to receive the most favorable treatment, followed by other ad hoc group members, and then non-AHG participating lenders, with non-participating lenders receiving only the stick and no carrot.

Of course, any deal regarding differing treatment can be struck on a consensual basis where the credit documents permit the underlying transactions, but in cases where the LME is premised upon complying with a “pro rata offer” exception to a Serta (or similar) sacred right, the question arises as to how differently these classes can be treated before the offer is outside the bounds of the pro rata exception. The “pro rata offer” provision will often include an “ancillary fees” concept that delineates what can be paid to one group but not all others. It varies widely in construction, from being limited to relatively minor consideration like reimbursing legal fees and paying customary administrative agency fees, to expansively allowing only the favored lenders to receive backstop, arrangement, structuring and other fees. Often, the provision will include some loosely market-based qualification, such as that the fees are “customary” or “bona fide,” but given the level of these fees in various LMEs that have been completed in the market, those qualifications likely still allow for materially disparate treatment.

We will be closely monitoring the spreads between these groups and are curious to see whether they still have room to expand, or rather will be pulled back by the market and/or legal challenges.

Increased Cooperation? Or Will Cooperation Be Banned?

Another way in which the LME market has become more sophisticated is in borrowers' management (or perhaps control) of the processes by which they are implemented. Expansive, restrictive non-disclosure agreements ("NDAs") are now often the base price for admission to the LME tent. These NDAs commonly prohibit each lender from talking to any other lender, even when both lenders are subject to substantially similar NDAs. NDAs with these and similar provisions severely curtail the negotiating power and ability of lenders to organize. In a countermeasure, lenders have increasingly entered into cooperation agreements upon early signs of distress to ensure that what is offered to one is offered to all, and approved by a majority, or otherwise prohibit signatory lenders from participating in an LME.

Recently, there has even been discussions among lenders to enter into cooperation agreements or similar voting agreements at the origination stage as a preemptive protection, in situations where lenders are concerned by the flexibilities in the credit documents and their non-controlling positions.

Borrowers and their counsel loathe these agreements, even suggesting that they are improper and anti-competitive, and have begun seeking to include prohibitions on such agreements in credit documents. So far, the market seems to be resisting these anti-coop provisions, but we are interested to see if the dam will break and wash away co-ops in 2025.

The Serta Response

The most headline-grabbing LME decision of 2024 came down on New Year's Eve, when the Fifth Circuit Court of Appeals held that the debt exchange completed in Serta's 2020 LME was not an "open market purchase". An open market purchase is a common exception to the general rule that prepayments and repurchases of loans must be done either on a pro rata basis or through a process that provides a pro rata offer to all lenders, and it has been relied upon in many uptier, drop-down and double-dip debt exchanges in the past four or five years. Now that the Fifth Circuit has held that an open market purchase of a BSL must be completed on the secondaries market, we expect changes to both new documentation and tactics for LMEs under existing documentation.

Many borrowers in new credits will respond by advocating directly for the right to make non-ratable, directly and privately negotiated repurchases (including as part of an exchange), which will replace or supplement the open market purchase right.

In existing loans with sacred rights that do not broadly protect pro rata offers and/or repurchases, rather than utilize the open market purchase provision, borrowers will likely opt to team up with participating majority lenders to amend documentation to allow for non-ratable exchanges either without a pro rata offer to all lenders, or with a pro rata offer that includes differing treatment to various groups of lenders (as previously discussed). Of course, documents vary widely and we expect no shortage of creativity in utilizing various other provisions that exist in the market, as well.

Structural Subordination Set to Rise?

Several years ago, credit documents often lacked sacred rights protecting against non-consensual modifications to the payment waterfall and pro rata sharing provisions. After NYDJ's majority lenders used the absence of these protections to re-tranche its credit facility by changing the waterfall to create a new money first-out tranche and rolling up the loans held by participating into a second-out tranche ranking senior to the excluded/non-participating lenders, the credit markets took notice. Similarly, after Serta's 2020 LME that took a similar approach but subordinated the existing credit facilities to new separate credit facilities pursuant to an intercreditor agreement, the Serta sacred right took hold in the market. Today, both are ubiquitous. And though they vary substantially in their strength and scope, these sacred rights rarely protect against structural subordination, but instead typically only cover contractual subordination.

Now that contractual uptiers are more likely than ever to require all adversely affected lenders' consent, but Borrowers and opportunistic lenders are no less eager to consummate priming and uptier transactions, a third strategy seems poised to break through. That is because another sacred right—lacking the name-recognition and urgency that comes with a high-profile branded LME—has barely changed in the era of lender-on-lender violence. This sacred right is one of the most common and uniformly formulated in the credit markets, and requires the consent of all lenders (or sometimes, all affected lenders) to release liens on assets representing "all or substantially all" of the collateral, or to release guarantees representing "all or substantially all" of the value of all guarantees.

This phrase, “all or substantially all”, is currently receiving so much attention from restructuring professionals that we see it abbreviated as AOSA and pronounced as “*ay-osa*” in the interest of efficiency. But what does it mean? As it is customarily not a defined term and there is no conclusive New York caselaw providing a bright-line rule in this context, there is room for interpretation and debate, but for the purpose of conceptualizing this strategy at a high level, at least two-thirds is likely a fair baseline for “substantially all.”

In sum, under the vast majority of credit documents, required lenders can authorize the release of most of the value of liens and guarantees, making those assets and entities available to support new and/or exchanged debt also authorized and provided by required lenders—a classic example of structural subordination. We are interested to see whether there will be material movement of this term before there is a well-known release-and-encumber transaction named for it.

Boundless Creativity…

While the express flexibilities set forth in credit documents have expanded materially during this cycle, another trend in LMEs has been the increasingly novel interpretation of longstanding credit provisions. For example, with respect to sacred rights, borrowers and majority lenders have asserted in various cases that:

- decreasing the cash rate of interest (and allowing all or a portion of previously cash interest to be paid in-kind) is neither a decrease in the rate of interest nor an extension of a scheduled date of payment,
- extending the “grace period” (*e.*, the period before a payment default becomes an event of default) for payment of interest from a few business days to a period of years—to be coterminous with the maturity date of the applicable loan—is not an extension of a scheduled date of payment, and
- adding a provision that permits the borrower, at its option, to extend the grace period for an interest payment is not the extension of a scheduled date of payment.

LME protections continue to be top of mind for lenders, but are generally backward-looking and prohibit types of transactions already consummated and publicized. We expect borrowers to continue to innovate, both by utilizing new and overlooked provisions and by finding novel but defensible interpretations of common terms.

…And Tools Hiding in Plain Sight

Not all borrower actions that rankled lenders over the past year were complex, highly-structured LMEs or relied on aggressive interpretations of their credit documents. In fact, we have seen many borrowers address liquidity needs, make debt service payments, satisfy financial covenants or otherwise create runway or bargaining power by simply pulling the levers for which they expressly negotiated at origination. These are not comprehensive transactions that address an unsustainable capital structure, but temporary solutions to discrete triggers that often frustrate lenders as they seek to gain control over a foundering credit. Baskets we've seen used for liquidity include pari passu free-and-clear baskets (incremental, equivalent debt, etc.), debt baskets for structurally senior loans to non-guarantor subsidiaries (as in *Pluralsight*), receivables or inventory financing baskets that allow first lien debt incurred against those specific assets, and structurally senior financings to unrestricted subsidiaries that hold assets dropped down using baskets dedicated for such purpose. Similarly, financial covenants are sometimes managed through methods such as preemptively "curing" an anticipated breach by making either an equity contribution before the end of the relevant period—so that the cash proceeds are netted in the determination of a net leverage ratio but can later be taken out of the business—or by upstreaming cash or other assets from an unrestricted subsidiary to be added to EBITDA.

The circumstances in which these flexibilities are tapped make them unwelcome to lenders, but if properly executed they should adhere to the express terms of the credit documentation. We say "should adhere", because borrowers sometimes fail to properly execute these strategies and end up afoul of their covenants, and lenders would be well-served to always check the borrower's work. We expect borrowers to continue to wring out any benefits they can from not only the large-scale LME strategies discussed above, but also these more limited and direct tactics.

A Look Ahead

We do not expect a sea change in private credit and BSL restructurings in 2025. Out-of-court solutions will continue to be the norm, with a mix of fully consensual amend and extends, coercive but consensual modifications negotiated against the threat of a deal-away LME. LMEs will continue to be innovated and refined. Differentiation between groups of lenders will certainly continue, and we will be closely monitoring whether there is yet room to increase spreads between favored and disfavored groups of creditors, or if those spreads have peaked and will start to pull back. Many LME participants that have failed to permanently right the ship will avail themselves of bankruptcy protection, and courts will have new caselaw with which to evaluate their prior actions. In short, the Proskauer Private Credit and Restructuring teams expect a busy year on all fronts, with many interesting and important developments to come. We look forward to keeping you updated.

[1] Read our coverage on *Serta* here.

[2] *In re Hertz Corp.*, 120 F.4th 1181 (3d Cir. 2024).

[3] *In re Ultra Petroleum Corp.*, 51 F.4th 138 (5th Cir. 2022).

[4] *In re PG&E Corp.*, 46 F. 4th 1047 (9th Cir. 2022), *cert. denied*, 143 S. Ct. 2492 (2023).

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