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Locke Lord QuickStudy: Enter Sandman: Serta Sends Senior Lenders Off to Never-Never Land

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Serta Simmons Bedding, LLC ("Serta") offers one of the latest examples of a creative borrower utilizing flexibility in its credit agreement terms to access new liquidity at the expense of its existing senior lenders. Serta is one of the largest manufacturers and distributors of mattresses in North America. With the agreement of a subset of its senior lenders, Serta accomplished a debt-for-debt exchange that provided for the redemption of a portion of its existing senior debt at a discount, and the issuance of new super-priority debt for those lenders choosing to participate—thereby priming the non-participating lenders. Recognizing that this recapitalization would substantially erode their senior rights, the non-participating lenders sought to enjoin the closing of the transaction. The New York State Supreme Court denied the request for an injunction and the transaction closed.

Serta is the latest installment in a series of high-profile lender/borrower disputes that have included J. Crew, Petsmart and Travelport, among others. These disputes have generally involved borrowers taking advantage of flexible terms in their credit agreements to transfer valuable collateral beyond the reach of their secured creditors. The Serta situation is unique in that it did not involve a transfer of the lenders' collateral, but rather the subordination of the lenders' right to repayment (without the consent of all lenders whose obligations were being subordinated).

Background

In November 2016, Serta entered into certain credit facilities that provided for, among other things, the issuance of $1.95 billion in first lien term debt. As part of the recapitalization transaction at issue, Serta consummated a debt-for-debt exchange pursuant to which certain lenders under the 2016 credit agreement exchanged their 2016 debt (at a discount) for new debt documented under a separate credit facility. In consideration for exchanging their debt at a discount, the exchanging lenders were given payment priority over those 2016 lenders that did not participate in the exchange.[1]

The exchanging lenders, who held just over 50% of the outstanding principal balance of the Serta loans, effectuated this recapitalization without the consent of the non-exchanging lenders. Instead of soliciting such consent, the exchanging lenders (who constituted the "Required Lenders" under the credit agreement) approved an amendment to the 2016 credit agreement, and thereby authorized the incurrence of the new debt to be issued in exchange for the 2016 debt. The credit agreement authorized the administrative agent to enter into any subordination or intercreditor agreement with respect to any debt that is permitted to be subordinated under such credit agreement. Upon the approval of the amendment to the credit agreement and the issuance of the new debt,

the administrative agent was automatically authorized to subordinate the 2016 loan obligations to those obligations incurred under the new credit agreement.[2] In effect, the exchanging lenders authorized the priming of the existing 2016 debt in favor of the new debt to be issued to them as part of the exchange. Practically speaking, this structure caused the non-exchanging lenders to be primed.

In the litigation, the plaintiffs argued that the recapitalization transaction violated the "sacred rights" of the non-exchanging lenders, i.e., those rights that cannot be waived or amended without the consent of 100% of the lender group. The sacred rights in question fall into two categories: the *pro rata* sharing provisions and the prohibition against releasing all of the lenders' collateral.

Pro Rata Sharing

Credit agreements typically have a "waterfall" provision specifying how proceeds from any liquidation of collateral must be distributed and applied. In the Serta 2016 credit agreement, the waterfall required that collateral liquidation proceeds would be shared *pro rata* amongst the first lien lenders (after paying certain priority expenses). The plaintiffs argued that the recapitalization transaction resulted in a *de facto* amendment of this waterfall provision, since the exchanging lenders would be given payment priority over the non-exchanging lenders.

The court disagreed, finding that Serta's recapitalization did not require an amendment to this section of the credit agreement. By its terms, the 2016 waterfall provision only governs the application of proceeds amongst the lenders *under such 2016 credit agreement*. This provision does not apply to a new class of secured lenders seeking payment independently of the terms of the 2016 credit agreement. Following the issuance of the new class of debt, the application of proceeds between the 2016 obligations and the 2020 obligations would be governed by the intercreditor agreement approved in conjunction with the recapitalization. The 2016 credit agreement explicitly provides that the waterfall provisions are subject in all respects to any intercreditor agreement. Accordingly, the court did not find the recapitalization transaction to be in contravention of the waterfall.

The *pro rata* sharing provisions also provide that, to the extent any lender receives a voluntary prepayment on account of its loans that is of a greater proportion than that received by the other lenders, such excess amount is required to be shared ratably amongst all lenders. This provision would seemingly prohibit the debt-for-debt exchange since such transaction involved a non-*pro rata* exchange of loans.

But the court concluded otherwise, finding that the debt-for-debt exchange was consummated under Section 9.05(g) of the 2016 credit agreement, which provides that: "*any Lender may, at any time assign all or a portion of its rights and obligations under this Agreement in respect of its Term Loans to [Serta] on a non-pro rata basis…through open market purchases…without the consent of the Administrative Agent*." This is often referred to as an open market purchase provision, and is commonly found in upper middle market and large cap credit facilities. The *pro rata* sharing provision explicitly excludes payments received by lenders in connection with open market purchases by the borrower. Because the recapitalization was accomplished through this open market purchase mechanism, the court did not find the transaction to be in contravention of the *pro rata* sharing requirement.

Release of Collateral

The release of all or substantially all of the lenders' collateral is another sacred right that typically could not be modified or waived without the consent of all lenders. The plaintiffs argued that the subordination contemplated by the recapitalization constituted a "release" of the 2016 lenders' collateral. The court was not convinced by this argument either. In so ruling, the court noted that no collateral was actually released as part of the recapitalization (the 2016 lenders retained their liens, albeit on a subordinated basis) and the plain language of the 2016 credit agreement did not include anti-subordination language as part of the sacred rights.

Conclusion

The Serta situation demonstrates that borrowers seeking liquidity are combing their balance sheets and credit agreements to identify ways in which additional availability can be identified and leveraged. In this context, secured lenders are well served to review their credit agreements carefully, to consider the interplay of restrictions, covenants and sacred rights, and to make sure that their lien rights cannot be modified, primed or eroded through strategic negotiations with a subset of the lender group, or with a new lender group.

While a prohibition against releasing all or substantially all of the lenders' collateral is a well-established sacred right, the Serta case suggests that lenders may be well served to insist upon anti-subordination protection as an additional sacred right. Such anti-subordination sacred right provisions are not common in middle market or large cap loan transactions (although such provisions do exist in a minority of deals). Likewise, while *pro rata* sharing provisions in credit agreements are longstanding fundamental sacred rights, the Serta situation may lead secured lenders to provide explicitly that such provisions may not be indirectly amended or altered (even if such alteration is effectuated pursuant to a separately documented credit facility).

We note that the court's decision in the Serta case was delivered in the context of adjudicating and denying a request to enjoin the closing of the recapitalization. The judicial standard applicable to such an order is different than that which would apply to full-blown litigation of the issues at hand. The plaintiffs failed to satisfy the burden for injunctive relief, including the requirement to show a likelihood of success on the merits. That failure does not decide the ultimate case, and it remains to be seen whether the plaintiffs will ultimately fail in their challenge to the recapitalization. However, the Serta transaction does highlight the need for secured lenders to consider carefully the sacred right protections found in their credit agreements, and to push back on those portions of the agreements that could undo or end run those protections. The Serta case offers a dramatic illustration of the dire economic consequences of such an end run. Had Serta filed for Chapter 11 bankruptcy protection and sought to issue the new superpriority debt through a debtor-in-possession facility, Serta would have been obliged to demonstrate that the non-exchanging lenders were receiving adequate protection. By contrast, and under the recapitalization completed by Serta, the non-exchanging lenders ended up getting primed with no replacement liens or adequate protection of any kind.

Given the unprecedented impact of the global pandemic, secured lenders may increasingly find themselves navigating the complexities of out-of-court debt exchanges, and the risk that those exchanges may reorder rights and priorities under the facility in highly prejudicial ways.Indeed, secured lenders should heed the admonition of Metallica's *Enter Sandman*: "Sleep with one eye open, gripping your pillow tight." As the Serta recapitalization demonstrates, a borrower may utilize flexibility under the credit agreement to find new sources of liquidity, and,

with the consent of a bare majority of Required Lenders, to prefer some portions of the lender group over others in unexpected ways. Those lenders sitting outside the Required Lender group may find themselves sent “off to never-never land” without remedy or recourse.

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1. We note that Serta’s 2016 loan obligations consisted of both a first lien and second lien credit facility (each of which was documented separately). For ease of discussion, we refer generically to the 2016 credit agreement.
2. The amendment to the 2016 credit agreement permitted three new tranches of “super-priority debt”, all of which would rank ahead of the 2016 obligations: (1) the debt issued in exchange for the 2016 debt (which is the subject of this article); (2) an additional $200 million of new-money debt to be provided by the exchanging lenders; and (3) an additional debt basket that can be used to accommodate future debt exchanges.

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