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Locke Lord QuickStudy: Not Cool, Dude: Surf and Skate Company Primes Lenders with "Uptiering" Transaction

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On October 9, 2020, a group of first lien lenders filed a lawsuit in the New York Supreme Court against Boardriders, Inc., a California-based surfing and skateboarding apparel company and its equity sponsor, challenging a series of transactions that effectively subordinated the aggrieved lenders to $431 million in new super-priority debt. These transactions also had the effect of stripping away substantial affirmative and negative covenants protecting the aggrieved lenders' rights under the first lien facility. The transaction at issue presents another example of a borrower utilizing permissive provisions under its credit agreement to rearrange its capital structure in a novel and material way, thereby accessing additional liquidity at the expense of non-participating lenders.

Boardriders, the surf and skate company behind popular brands such as Quicksilver and Billabong, entered into a $450 million term loan facility on April 6, 2018. The plaintiffs allege that, in August 2020, the company consummated a "covert recapitalization transaction" that unfairly favored a subset of lenders "handpicked" by the company's private equity sponsor.

The Boardriders case comes on the heels of the well-publicized dispute between Serta Simmons Bedding, LLC and its lenders. In the Serta case, a group of lenders alleged that the company consummated a similar "uptiering" recapitalization that resulted in those lenders being primed for the benefit of a different subset of lenders under the credit facility.[1]

The Boardriders 2018 credit agreement requires, like most syndicated credit facilities, that any repayments or prepayments of the loans by the borrower be shared by the lenders on a *pro rata* basis. This pro rata treatment is typically considered a "sacred right" that cannot be amended without the consent of all lenders under the credit facility. A common exception to this requirement for pro rata treatment is that the borrower is often permitted to repurchase its loan through open market purchases on a non-pro rata basis.

By utilizing this open market purchase exception, the complaint alleges that Boardriders' equity sponsor "handpicked a preferred group of lenders" (including certain affiliates of the equity sponsor) to exchange $321 million of their existing debt at par, with such debt being rolled-up into a new super-priority credit facility that would rank ahead of the remaining debt outstanding under the 2018 credit agreement. In addition to the rollup of existing debt, Boardriders also borrowed an additional $110 million in new money under the super-priority facility. The open market purchase exception is the same mechanism used in the aforementioned Serta transaction. The

aggrieved lenders in Boardriders allege that the exchange at issue was a private transaction with selected lenders, was not priced at market, and therefore did not satisfy the common understanding of an "open market" exchange.

The complaint further alleges that substantially simultaneously with the exchange, the exchanging lenders "added insult to injury by abusing the amendment and waiver provisions" of the 2018 credit agreement by effectuating a series of amendments that eliminated all of the affirmative and negative covenants in the 2018 credit agreement. According to the complaint, the exchanging lenders then inserted all (or substantially all) of these covenants into their new credit agreement governing the super-priority debt: "[i]n other words, the Roll-Up Lenders were apparently unwilling to enter into the Super-Priority Credit Agreement without preserving these critical affirmative and negative covenant protections for themselves, yet they had no issue removing such covenant provisions from the Credit Agreement—an agreement to which they would no longer be parties following the Private Roll-Up Transaction." The complaint alleges that the agent for the first lien lenders resigned prior to the consummation of these transactions, but the successor agent signed off on the amendments implementing the elimination of these covenant protections.

Lenders seeking to avoid a similar fate should consider negotiating for greater protections in their loan documents. The following would prohibit or limit the borrower's ability to "uptier" a subset of its lenders:

1. **Requiring that entry into a subordination or intercreditor agreement only be permitted with the consent of all lenders (i.e., making lien priority a sacred right).** Such a requirement would explicitly prohibit uptiering transactions of the type consummated in Serta and Boardriders. As mentioned in our previous QuickStudy discussing the Serta case, such protections exist in a minority of middle market credit agreements, but are relatively uncommon.
2. **Narrowing and more precisely defining the open market purchase exception to the pro rata sharing provisions.** In particular, the exception could be restricted to situations where the debt exchange occurs at a market price, and in a non-collusive manner. By way of contrast, the "open market" exchange in Boardriders was priced at par, at a time when the relevant debt was trading at the 50-60% level. In the same vein, additional restrictions could be placed upon "open market" exchanges with affiliates of the borrower or its equity sponsor.
3. **Requiring that open market purchases be made solely for cash consideration.** In both Serta and Boardriders, the open market "purchase" took the form of a debt exchange whereby a subset of lenders "sold" their debt back to the borrower in exchange for new, more senior debt. In Boardriders, the new cash provided under the super-priority facility totaled $110 million, while another $321 million of existing first lien debt was rolled up into the new facility. By prohibiting the use of roll-ups in connection with open market purchases, the potential for gamesmanship with respect to such provisions would be reduced (albeit not eliminated).
4. **Prohibiting indirect amendments to pro rata sharing provisions.** Credit agreement pro rata sharing provisions typically cannot be amended without the consent of all lenders. In both Serta and Boardriders, the aggrieved lenders argued that pro rata protections were *indirectly* amended by transactions that had the effect of modifying the pro rata treatment without explicitly amending those sections of the credit agreement. Prohibiting such indirect modifications would provideadditional protection to lenders, although determining what constitutes such an "indirect" amendment can be a subjective matter that leads to a dispute.

With the economy strained by the continuing global pandemic, borrowers are facing increased financial pressure and liquidity constraints. That such borrowers are seeking creative ways to alleviate this pressure is no surprise. It remains to be seen whether uptiering is the "new normal" or whether Serta, Boardriders and a handful of similar situations are one-off in nature. It also remains to be seen how some of these creative recapitalizations will be viewed and treated in subsequent bankruptcy proceedings. In particular, where similarly situated lenders have been treated in a disparate and prejudicial fashion, we may expect to see, among other remedies and strategies, the aggrieved lenders making requests for equitable subordination under the Bankruptcy Code—so as to restore

the original priority for which they bargained. For lenders seeking additional contractual protection under their applicable credit agreements, implementing safeguards of the type described above is easier said than done – particularly for a credit agreement that has already been executed. With the credit markets remaining relatively robust, and oversubscribed syndicated deals continuing to be placed in the market, lenders demanding such protections may find themselves sitting on the sidelines while other more aggressive lenders deploy capital. Such is life in the surf and skate world: no waves, no glory.

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1. See **Enter Sandman: Serta Sends Senior Lenders Off to Never-Never Land**.

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