ALERTS

Financial Titans Engage in Winner-Takes-All Battle: The Bankruptcy Court for the Southern District of Texas Upholds Serta's 2020 Uptiering Transaction

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"Sophisticated financial titans engaged in a winner-take-all battle. There was a winner and a loser. Such an outcome was not only foreseeable, it is the only correct result. The risk of loss is a check on unrestrained behavior."

On June 6, 2023, the Bankruptcy Court for the Southern District of Texas issued a highly anticipated decision permitting Serta Simmons' 2020 "uptiering" transaction under the terms of a 2016 credit agreement and determining that Serta Simmons entered into the transaction through good-faith, arm's-length negotiations. While there have been a handful of court rulings in recent years related to similar uptiering transactions, many have been at the motion to dismiss or summary judgment phase and, unlike this decision, not been issued following a full blown trial. Judge David Jones sided fully with the Debtors and the parties with whom they entered into the uptiering transaction — providing no support for the dissenting creditors. *See* Memorandum Opinion [ECF No. 1045], *In re Serta Simmons Bedding, LLC*, No. 23-90020 (Bankr. S.D. Tex. June 6, 2023). The ruling provides some new insight (but not much clarity) into how courts will view this type of controversial transaction gaining greater use. However, it is likely to further embolden certain favored creditors to push aggressively in conjunction with the borrower at the expense of other minority lenders.

Liability Management Transactions

Commercial borrowers have found themselves able to negotiate increasingly high degrees of flexibility in loan documentation in recent years. This looseness in credit documentation allows borrowers to manage their capital structures by enabling them to take advantage of creative liability management transactions.

These liability management transactions have often taken the form of "drop-down" and "uptiering" transactions. In a typical drop-down transaction, (1) the borrower forms or designates an unrestricted subsidiary,[1] (2) the borrower sells, contributes or transfers assets to the subsidiary in a manner that is permitted under the existing credit agreement's covenant baskets that causes a release of the liens of the existing lenders on the assets and (3) the subsidiary incurs new financing that is secured by a first priority lien on the transferred assets such that it is structurally senior to the existing debt.

In an uptiering transaction like the one engaged in by Serta, the borrower offers existing lenders the ability to participate in a new credit facility that is senior to the existing facility. These lenders also often negotiate to exchange at least a portion of their existing exposure into the new senior facility. These transactions require amendments to the applicable debt and lien baskets under the existing agreement, typically with the support of majority holders only, often without the opportunity for minority lenders to participate.

The Serta 2016 Credit Agreement

Serta entered into negotiations with a series of lenders in 2016, leading to credit facilities providing for $1.95 billion and $450 million in first and second lien term loans, respectively. The first lien credit agreement contained multiple provisions providing Serta with the flexibility it relied on in crafting its liability management transactions.

One provision, section 9.05(g) of the 2016 Credit Agreement, addresses the assignment of loans to Affiliated Lenders (defined to include the borrower), stating in relevant part that:

Notwithstanding anything to the contrary contained herein, 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 any Affiliated Lender on a

non-pro rata basis (A) through Dutch Auctions open to all Lenders holding the relevant Term on a pro rata basis or (B) through open market purchases, in each case with respect to clauses (A) and (B), without the consent of the Administrative Agent;

Another provision provided that the pro rata sharing provisions in the credit agreement did not apply to "any payment obtained by any Lender as consideration for the assignment of or sale of a participation in any of its Loans to any permitted assignee or participant, including any payment made or deemed made in connection with" a Dutch Auction or open market purchase described above. The 2016 Credit Agreement also allowed for modification by a simple majority of creditors when the amendment occurs in connection with a transaction entered into pursuant to a Dutch Auction or an open market purchase.

Serta Faces Financial Troubles

Facing an upcoming debt maturity, a souring consumer market and complications from the global pandemic, Serta began exploring ways to raise new capital and right-size its balance sheet in early 2020. Failing to address the company's liquidity needs likely would have led to a chapter 11 filing or liquidation. Serta's lenders, including lenders party to the 2016 Credit Agreement, formed two *ad hoc* groups. Each group, understanding the economic reality facing the company and recognizing that the 2016 Credit Agreement offered a great deal of flexibility, aimed to engage the company in a drop-down or uptiering transaction.

Anticipating engaging Serta in a drop-down transaction, the first group of lenders approached the company about their proposed refinancing strategy. The Bankruptcy Court found that these lenders "recognized that the 'looseness' of the 2016 Credit Agreement allowed for (i) a liability management solution; and (ii) the stripping of first lien lender protections."

The second group of lenders then proposed a competing uptiering transaction contemplating the creation of a new priority debt tranche consisting of $200 million of new money plus $875 million of exchanged first and second lien loans purchased at considerable discounts.

Serta accepted the second group's proposal and announced the transaction publicly shortly thereafter. The first group then filed suit in New York state court, arguing that the terms of the 2016 Credit Agreement did not allow Serta to issue superpriority loans to the second

group in exchange for existing loans and subordinate the first group. Serta and its affiliated debtors filed for chapter 11 protection on Jan. 23, 2023, three years after the transaction. Serta and certain of the new lenders then filed a complaint against, amongst others, the objecting lenders, seeking a determination that (i) the Transaction was permitted under the terms of the 2016 Credit Agreement and (ii) Serta and the new lenders did not violate the implied covenant of good faith and fair dealing.

The Decision

In March 2023, Judge David Jones held that, as a matter of law, the 2016 Credit Agreement allowed Serta to repurchase its debt on a non-pro rata basis pursuant to the plain language of the agreement. *See* Hearing Transcript [ECF No. 133], *Serta Simmons Bedding LLC v. AG Centre Street P'Ship (In re Serta Simmons Bedding, LLC)*, Adv. Pro. No. 23- 9001 (Bankr. S.D. Tex. Mar. 28, 2023). In his June opinion, Judge Jones finds that the transaction was both permitted by the terms of the 2016 Credit Agreement and the result of good-faith, arm's-length negotiations.

Judge Jones states that "[t]he parties were keenly aware that the 2016 Credit Agreement was a "loose document" and understood the implications of that looseness." New York law, which governs the 2016 Credit Agreement, implies a covenant of good faith and fair dealing in the performance of each contract and, in reviewing the actions of a contracting party, the court's inquiry must be objective and focus on the reasonable expectations of the plaintiff at the time of contracting. Judge Jones concludes that "[t]here is no evidence of a breach of the implied duty of good faith and fair dealing by either [Serta], the [participating lenders] or any of the other counter-defendants. There is no evidence of a breach of the 2016 Credit Agreement. The parties could have easily avoided this entire situation with the addition of a sentence or two to the 2016 Credit Agreement. They did not. And this litigation ends with each party receiving the bargain they struck — not the one they hoped to get."

Takeaways

1. Borrowers, lenders and distressed investors must understand the degree to which credit documents allow for liability management transactions. "While the result may be harsh," Judge Jones found that equity has no role where sophisticated parties negotiate, contract and

participate in credit agreements that include the potential for uptiering or drop-down transactions.

2. Courts have considered several similar transactions in recent years. They have issued an array of divergent opinions. While each case will hinge on the facts and particular language of the relevant credit agreements, Judge Jones has further cleared the way for Borrowers to rely on controversial transactions to the extent the transactions conform to the plain language of the credit agreements. This is likely to increase willingness by borrowers and selected lenders to push aggressively against minority lenders to ensure sufficient funding.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] A non-guarantor subsidiary could also potentially be used, although being restricted it would still be subject to covenants in the existing credit agreement.

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