KING & SPALDING

HOW DID THEY DO IT?

Serta Simmons Transaction

King & Spalding Private Credit & Special Situations Investing

Case Overview

On June 8, 2020, Serta Simmons ("Serta") announced it had entered into an agreement with a majority of its First Lien and Second Lien Term Lenders (the "Consenting Lenders") to amend the existing credit agreements to permit Serta to enter into a new credit facility with new documentation providing for (i) $200 million of new-money superpriority "first out" debt and (ii) $875 million of superpriority "second out" debt through an exchange of a portion of Serta's outstanding first and second lien term loans (at an expected exchange rate of $74 and $39 for every $100, respectively). The proposed amendment would also permit the future incurrence of an unspecified amount of "third out" superpriority debt.

- The Proposed Transaction was expected to provide Serta with $200 million of liquidity while reducing its outstanding debt by $400 million.
- The opportunity to participate in the new facility was limited to the Consenting Lenders.
- A group of minority lenders (who, notably, had proposed their own J.Crew-style transaction coupled with an exchange which Serta declined in favor of the Proposed Transaction) filed a complaint in the Supreme Court of the State of New York seeking an injunction and temporary restraining order prohibiting Serta from proceeding with the transaction (originally expected to close June 23, 2020).

Case Overview (cont'd)

THE PLAINTIFFS ARGUED, AMONG OTHER THINGS:

- both the creation of a new superpriority class of loans and the exchange violate the pro rata sharing provisions of the existing facilities;
- incurring the liens securing the super-senior debt under the new credit facility essentially acts as a release of such liens and guarantees by effectively rendering them worthless;
- the Proposed Transaction violates the "sacred rights" of the minority lenders, whose consent is expressly required for changes to pro rata sharing provisions, or for any release of all or substantially all collateral or guarantors; and
- the Proposed Transaction violates the implied covenant of good faith and fair dealing (evoking the NYDJ case which ultimately settled, but where the judge questioned the fairness of the priming transaction in dicta). How did they do it? NYDJ, or Can You Really Prime 47% of Lenders Without Their Consent?

SERTA AND THE CONSENTING LENDERS ARGUED:

- the proposed amendments do not include any changes to pro rata sharing provisions – instead, the new facilities are permitted, will be governed by a separate set documents, and the existing Agent is being directed by "Required Lenders" (i.e. the Consenting Lenders) to consent to the subordination;
- the exchange, though non-pro rata, is permitted because the Borrower may make "open market purchases" of loans and such purchases are expressly carved out of the pro rata sharing sacred voting rights; and
- there is no release of guarantees or collateral – instead, there is permitted subordination, which is not an all-lender vote because the existing credit agreements do not contain an express anti-subordination sacred right (sometimes seen in other deals).

Case Overview (cont'd)

SERTA AND THE CONSENTING LENDERS ALSO ARGUED THAT THE PLAINTIFFS LACK "STANDING" TO EVEN BRING THE ACTION BECAUSE OF A "NO-ACTION CLAUSE" IN THE CREDIT AGREEMENT:

- The Consenting Lenders' brief asserted that the Credit Agreement's no-action clause provides that "no Secured Party shall have any right individually to realize upon any of the Collateral or to enforce the Loan Guaranty . . . [that right] may be exercised solely by the [1L] Agent on behalf of the Secured Parties."

Though the court in Serta did not address the standing argument in its decision (as discussed on the next slide), other New York courts that have decided the issue have held that "no-action" clauses specifically preclude enforcement of contractual claims arising under credit agreements and indentures but do not bar independent common-law or statutory claims. See *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 23 N.Y.3d 549, 561 (2014).

An example of a standard no-action clause from a credit agreement is included in the appendix.

Court Decision

Ultimately, the Court refused to grant the injunction based on the following standard: "Before a court may issue a preliminary injunction, the movant must establish **(1) a likelihood of success on the merits of the action**, (2) the danger of irreparable harm in the absence of a preliminary injunction, and (3) a balance of equities in favor of the moving party."

- With respect to prong 1, the Court noted: "Since the amendments do not affect Plaintiffs so-called 'sacred rights' under the Credit Agreement, Plaintiffs' consent does not appear to be required. Rather, the Credit Agreement requires only the consent of a simple majority of the First Lien Term Lenders to amend the Credit Agreement."
  - The Court did not find that this transaction would require a release of all or substantially all liens (which would be a sacred right).
  - The Court stated that "The Credit Agreement seems to permits the debt-to-debt exchange on a non-pro rata basis as part of an open market transaction."
- ***The court did not address the standing "no-action" clause argument and, instead, presumed for purposes of the opinion that the Plaintiff has standing.***
- Though the court did not decide whether the transaction is permitted, it did not grant the injunction because stopping the transaction would result in more harm to Serta than it would to the defendants ***who are still free to seek damages/sue for breach of contract.***

Key Takeaways/Observations

WHAT THE RULING DID

- Rule in favor of Serta and the defendant lenders in refusing to grant an injunction to stop a proposed de-levering and exchange transaction.
- Determine whether to grant an injunction is subject to its own stringent standards and a court could still later find that the transaction at issue here breaches the existing Serta credit agreements.
- Note (multiple times) that the Plaintiffs are free to continue to pursue remedies and breach of contract claims and seek damages (which the Plaintiffs have stated they intend to do). This was one of several facts relied on in considering whether the harm to defendants in delaying the deal would exceed the harm to the Plaintiffs.
- Suggest, albeit in non-binding dicta, that subordination is not the same thing as lien release.
- Suggest, albeit in non-binding dicta, that, relying on advisor interpretation of the documents, the non-pro rata exchange was an open market purchase and since open market purchases are carved out of the sacred voting rights (i.e. rights requiring consent of all affected lenders) regarding pro rata sharing, the exchange could likely be effectuated with simple majority consent.

WHAT THE RULING DIDN'T DO

- Decide whether the transaction in question ultimately would breach (in whole or in part) any provisions of the Credit Agreement.
- Decide that the transaction in question (or any part of it) is permitted.
- Address whether a "no-action" clause (which requires lawsuits be brought by the Agent rather than the individual lenders) could prevent a group of lenders acting on their own from having standing/legal authority to challenge the transaction in court (i.e., were the lenders here even allowed to sue or would the suit have needed to be brought by the Agent).

Appendices

A. Priming Transactions Overview

Bifurcation Through Amendment

- In many credit agreements the “all-lender” or “affected Lender” issues will not include the waterfall provisions, subordination of the obligations or may contain exceptions such as, "except as otherwise provided herein”.
- Required Lenders may be able to amend the waterfall to subordinate liens to a new tranche of funded debt and can also execute long-term forbearance on account of any anticipated defaults relating to payment, interest or maturity.
- While extension of Maturity Date or similar payment features may be an "all-lender" issue, it is often possible to amend the credit agreement so that Non-consenting Lenders receive **no** benefit by failing to consent while missing out on the upside of participation.

Example: Bifurcation Through Amendment

- Extend the Maturity Date with respect to the Consenting Lenders only.
- Add an exclusive action provision vesting the authority to enforce rights and remedies exclusively in the Agent on behalf of the Lenders.
- Modify the language of the waterfall section to provide:
  - If any Lender receives a payment inconsistent with the terms of the waterfall, the Agent will redistribute such payment in accordance with the provisions of the amended waterfall, including towards any outstanding priming portion.
  - Any Lender whose payment is redistributed per the above will be deemed to have purchased a silent, non-voting senior participation interest in such distribution.
- Exclude any non-consenting Lender from receiving costs and expenses and indemnity; add additional indemnity by only non-consenting Lenders for breach of collective action provision and unsuccessful challenge to amendment by Non-consenting Lenders.
- Company can then repay in full the obligations owing to any non-consenting Lender on the existing Maturity Date for that Lender in accordance with the Credit Agreement, but Agent will redistribute such funds to the other Lenders in accordance with the amended credit agreement. Non-consenting Lender would then have a silent, non-voting, senior participation interest in the loans of such other Lenders.

Bifurcation Through Exchange

STEP 1	**Create new loan with attractive terms (including longer maturity, if desired):** • "Clean slate" to determine terms.
STEP 2	**Offer all Lenders the right to exchange their current loans for the new loan:** • Typically done through consent solicitation (e.g., debt for debt exchange).
STEP 3	**"Required [Exchanging] Lenders" do the following prior to exchanging their existing loans:** • Agree to subordinate the liens securing the existing loan obligations to the new loan obligations. • Strip covenants from existing loan agreement. • Enter into long-term forbearance agreement with company with respect to Maturity Date and other events of default. • Consider impact on borrower/business with respect to operating in "default" (e.g., clean audit, cross defaults, supplier issues, regulatory issues, etc.).

Bifurcation Through Exchange

VARIATIONS ON THE "EXCHANGE" STRATEGY:

- Attractive terms of new loan can be better collateral package, including, if permitted by the Credit Agreement, transferring good collateral to unrestricted affiliate or subsidiary.
    - Utilization of baskets for investments in and restricted payments to Unrestricted Subsidiaries or Non-Loan Parties.
- Increased interest rate for exchanged loans, backstop fee, consent fee and other fees to incentivize cooperation.
- "Required Lenders" can amend existing loan agreement to (i) remove accrual and payment of default interest, payment of attorneys fees, indemnity and other protections of any lender challenging the transaction and (ii) expressly provide exclusive action provision limiting enforcement rights only with the Agent and not individual lenders.

LANGUAGE OF LOAN DOCUMENTS MATTERS GREATLY.

- Ability to make non pro rata exchange.
- Subordination not implicating all affected lender vote.

Required Lenders

"**Required Lenders**" means at any time (a) Lenders then holding more than fifty percent (50%) of the sum of the Aggregate Revolving Loan Commitment then in effect, [**the Aggregate DDTL Commitment then in effect, if any**] plus the aggregate unpaid principal balance of the Term Loans then outstanding, or (b) if the Aggregate Revolving Loan Commitments and [**and Aggregate DDTL Commitments**] have terminated, Lenders then holding more than fifty percent (50%) of the sum of the aggregate unpaid principal amount of Loans (other than Swing Loans) then outstanding Letter of Credit Obligations, amounts of participations in Swing Loans and the principal amount of unparticipated portions of Swing Loans. Such portion of the Aggregate Revolving Loan Commitment (or Revolving Loans, as applicable) **[and Aggregate DDTL Commitment]** and the sum of the aggregate unpaid principal amount of the Term Loans then outstanding, as applicable, held or deemed held by a Defaulting Lender shall be excluded for purposes of making a determination of Required Lenders at any time.

Voting Section

(a) Amendments Generally. Subject to the provisions of Section 10.1(e), (f), (g) [, (h) and (i)] hereof, no amendment or waiver of, or supplement or other modification (which shall include any direction to Agent pursuant) to, any Loan Document (other than the Fee Letter, any Control Agreement, any Mortgage, or any letter of credit reimbursement or similar agreement or any landlord, bailee or mortgagee agreement) or any provision thereof, and no consent with respect to any departure by any Credit Party from any such Loan Documents, shall be effective unless the same shall be in writing and signed by the Required Lenders (or by Agent with the consent of the Required Lenders (subject to Section 9.1(d)(iii))), and the Borrower Representative and then such waiver shall be effective only in the specific instance and for the specific purpose for which given; provided, however, that no such waiver, amendment, supplement (including any additional Loan Document) or consent shall, unless in writing and signed by all the Lenders directly and adversely affected thereby (or by Agent with the consent of all the Lenders directly and adversely affected thereby (subject to Section 9.1(d)(iii))), in addition to the Required Lenders (or by Agent with the consent of the Required Lenders (subject to Section 9.1(d)(iii))) and the Borrowers, do any of the following:

(i) increase or extend the Commitment of such Lender (or reinstate any Commitment terminated pursuant to Section 8.2(a));

(ii) postpone or delay any date fixed for, or reduce or waive, any scheduled installment of principal or any payment of interest, fees or other amounts (other than principal) due to the Lenders (or any of them) or L/C Issuer hereunder or under any other Loan Document (for the avoidance of doubt, mandatory prepayments pursuant to Section 2.8 (other than scheduled installments under Section 2.8(a)) may be postponed, delayed, reduced, waived or modified with the consent of Required Lenders);

(iii) reduce the principal of, or the rate of interest specified herein (it being agreed that waiver of the default interest margin shall only require the consent of Required Lenders) or the amount of interest payable in cash specified herein on any Loan, or of any fees or other amounts payable hereunder or under any other Loan Document, including L/C Reimbursement Obligations;

(iv) (A) change or have the effect of changing the priority or pro rata treatment of any payments (including voluntary and mandatory prepayments), Liens, proceeds of Collateral or reductions in Commitments (including as a result in whole or in part of allowing the issuance or incurrence, pursuant to this Agreement or otherwise, of new loans or other Indebtedness having any priority over any of the Obligations in respect of payments, Liens, Collateral or proceeds of Collateral, in exchange for any Obligations or otherwise), or (B) advance the date fixed for, or increase, any scheduled installment of principal due to any of the Lenders under any Loan Document;

(v) change the percentage of the Commitments or of the aggregate unpaid principal amount of the Loans which shall be required for the Lenders or any of them to take any action hereunder;

(vi) amend this Section 10.1 (other than Section 10.1(c) [or Section 10.1(h)]) or, subject to the terms of this Agreement, the definition of Required Lenders, [the definition of Required Revolving Lenders] or any provision providing for consent or other action by all Lenders; or

(vii) discharge any Credit Party from its respective payment Obligations under the Loan Documents, or release all or substantially all of the Collateral, except as otherwise may be provided in this Agreement or the other Loan Documents;

it being agreed that (X) all Lenders shall be deemed to be directly and adversely affected by an amendment, waiver or supplement described in the preceding clauses (iv)(B), (v), (vi) or (vii) and (Y) notwithstanding the preceding clause (X), only those Lenders that have not been provided a reasonable opportunity, as determined in the good faith judgment of Agent, to receive the most-favorable treatment under or in connection with the applicable amendment, waiver or supplement described in the preceding clause (iv) (other than the right to receive customary administrative agency, arranging, underwriting and other similar fees) that is provided to any other Person, including the opportunity to participate on a pro rata basis on the same terms in any new loans or other Indebtedness permitted to be issued as a result of such amendment, waiver or supplement, shall be deemed to be directly and adversely affected by such amendment, waiver or supplement.

Pro Rata Payments

Sharing of Payments, Etc. If any Lender, directly or through an Affiliate or branch office thereof, obtains any payment of any Obligation of any Credit Party (whether voluntary, involuntary or through the exercise of any right of setoff or the receipt of any Collateral or "proceeds" (as defined under the applicable UCC) of Collateral) (and other than pursuant to Section 10.9, Section 10.20, Article XI **[or a Discounted Buyback] [any purchase option pursuant to any intercreditor agreement or any subordination agreement to which Agent is a party]** or any payment to a Lender that has not accepted an Extension Offer in respect of the original terms of those of its Loan and Commitments that, as to Lenders that accepted such Extension Offer, were extended as to such Lenders) and such payment exceeds the amount such Lender would have been entitled to receive if all payments had gone to, and been distributed by, Agent in accordance with the provisions of the Loan Documents, such Lender shall purchase for cash from other Lenders such participations in their Obligations as necessary for such Lender to share such excess payment with such Lenders to ensure such payment is applied as though it had been received by Agent and applied in accordance with this Agreement (or, if such application would then be at the discretion of the Borrowers, applied to repay the Obligations in accordance herewith); provided, however, that (i) if such payment is rescinded or otherwise recovered from such Lender or L/C Issuer in whole or in part, such purchase shall be rescinded and the purchase price therefor shall be returned to such Lender or L/C Issuer without interest and (ii) such Lender shall, to the fullest extent permitted by applicable Requirements of Law, be able to exercise all its rights of payment (including the right of setoff) with respect to such participation as fully as if such Lender were the direct creditor of the applicable Credit Party in the amount of such participation. If a Defaulting Lender receives any such payment as described in the previous sentence, such Lender shall turn over such payments to Agent in an amount that would satisfy the cash collateral requirements set forth in Section 2.11(e). **[Notwithstanding anything to the contrary set forth in the foregoing or in any other Loan Document, in the event any payment to a Sponsor Controlled Affiliated Lender [or Independent Debt Fund Affiliate] is invalidated, avoided, declared to be fraudulent or preferential, set aside or otherwise required to be transferred to a trustee, receiver, Credit Party or estate of a Credit Party in connection with any Insolvency Proceeding as a result of such Sponsor Controlled Affiliated Lender [or Independent Debt Fund Affiliate] being an Affiliate of a Credit Party or otherwise required to be transferred to any other Person, such Sponsor Controlled Affiliated Lender [or Independent Debt Fund Affiliate] shall have no right, in respect of such payment, of contribution or payment (including by way of participation) from any Lender or Agent under this Section 10.11(b) or any other term or provision of any Loan Document providing for the pro rata treatment of Lenders.]**

B. No Action Clause Example

Collective Active Provision

Exclusive Right to Enforce Rights and Remedies. Notwithstanding anything to the contrary contained herein or in any other Loan Document, the authority to enforce rights and remedies hereunder and under the other Loan Documents against the Credit Parties or any of them shall be vested exclusively in, and all actions and proceedings at law in connection with such enforcement shall be instituted and maintained exclusively by, Agent in accordance with the Loan Documents for the benefit of all the Secured Parties; provided that the foregoing shall not prohibit (i) Agent from exercising on its own behalf the rights and remedies that inure to its benefit (solely in its capacity as Agent) hereunder and under the other Loan Documents, (ii) each of the L/C Issuer and the Swing Lender from exercising the rights and remedies that inure to its benefit (solely in its capacity as L/C Issuer or Swing Lender, as the case may be) hereunder and under the other Loan Documents, (iii) any Lender from exercising setoff rights in accordance with Section 10.11 and this Section 9.3 or (iv) any Secured Party from filing proofs of claim (and thereafter appearing and filing pleadings on its own behalf during the pendency of a proceeding relative to any Credit Party under any bankruptcy or other debtor relief law), but in the case of this clause (iv) if, and solely if, Agent has not filed such proof of claim or other instrument of similar character in respect of the Obligations within five (5) days before the expiration of the time to file the same.