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In The Know

Leveraged Finance Newsletter

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Uptiering in European leveraged finance — does the Serta decision move the needle?

On 6 June 2023, the US Bankruptcy Court for the Southern District of Texas (the "**Court**") ruled in favour of Serta Simmons Bedding LLC's ("**Serta**") Chapter 11 reorganisation plan. Judge David R. Jones' decision confirmed the reorganisation plan and validated Serta's 2020 non-pro rata uptiering exchange offer (the "**Uptiering Transaction**").

Whilst the judgment appears to give the green light to certain uptiering transactions in the US (if the documentation — as with the debt buyback provisions in Serta's case — so permits), several obstacles / protections (depending on your point of view) remain in the European market. Regardless of geography, it is clear now more than ever that careful drafting is required to preserve or deny the flexibility required for these transactions. Or to put it in more neutral terms, to ensure that the parties' collective understanding of the terms of the transaction is reflected. The importance of knowing and understanding your terms cannot be overstated.

Background

In 2020, following negotiations with its lenders, Serta and a subset of its lenders (the "**Majority Lenders**") approved amendments to the indebtedness and liens provisions of its November 2016 first lien term loan credit agreement (the "**Credit Agreement**"), enabling Serta to incur new super-priority priming debt. The Majority Lenders were then offered the chance to exchange their existing debt at a discount for the new super-priority debt (and new first-out term loans). Certain lenders who were not offered the chance to participate in the exchange (the "**Minority Lenders**") were left lower in the order of priority than they had been before the Uptiering Transaction. See figure (a) for an indicative example of a plain vanilla uptiering transaction structure.

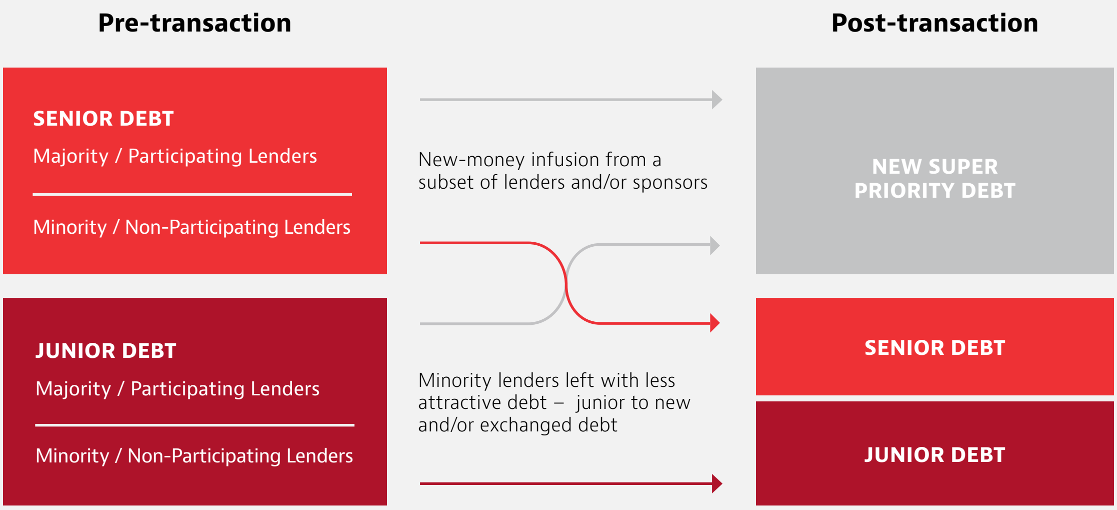
This, and other similar transactions, have proved controversial due to the potential conflict between, on the one hand, the necessary amendments to provisions of a credit agreement and the involvement of only a subset of lenders and, on the other hand, the pro rata sharing and consent requirements. Normally, in both New York law and English law loan agreements, pro rata sharing requires payments to the lenders to be made rateably and, as a "sacred right", requires unanimous lender consent to amend.

Decision

In Serta, the Minority Lenders challenged the Uptiering Transaction on the basis that it (i) was not permitted under the Credit Agreement and (ii) constituted a breach by Serta and the Majority Lenders of the implied covenant of good faith. After filing for Chapter 11, Serta sought a declaratory judgment on the two issues. Following the decision on 6 June 2023, and an earlier summary judgment of the same court on 28 March 2023, both issues have now been decided in favour of Serta, with the Uptiering Transaction held to be "binding and enforceable in all respects".

Whilst the Credit Agreement contained the usual pro rata provisions, there was an exception that permitted Serta to buy back its debt on a non-pro rata basis using "open market purchases" that did not refer to needing to be made to all lenders. As such, open market purchases could be agreed with a subset of lenders and payments to such lenders could be on a non-pro rata basis. The Court ruled that the exchange offer was a "quintessential" Wall Street open market purchase, that it did not need to comply with the pro rata provisions, and that it was therefore valid. The Court further ruled that the Uptiering Transaction was the result of "arm's-length negotiations" and emphasised

Figure (a)



the "undeniable" evidence that the parties were "keenly aware" that the Credit Agreement was "loose" and "understood the implications" of this. The fact that one party was unhappy with the result of such negotiations did not violate the implied duty of good faith.

The decision confirms that it is possible for transactions that favour a certain group of lenders to pass judicial muster, at least in the US courts. This could go some way to mitigating litigation risk and might encourage more borrowers to consider similar transactions. For lenders, the Court was clear on the best way to avoid this: with "careful drafting of lending documents". To avoid uncertainty, parties should define key terms and express their intent in full in the drafting, rather than relying on the court's or the market's interpretation. This is particularly important in European deals, as the lack of litigation means even less certainty around interpretation.

That said, there has been minimal investor pushback on the open market purchase provisions in credit agreements. In fact, sponsors have been pushing to crystalise their greater flexibility with the addition of "privately negotiated transactions" to the definition of an "open market purchase". Alternatively, lenders can seek to add more robust "sacred rights" voting protections, such as provisions that require unanimous consent to subordinate (as well as release) obligations or liens. This is the approach that tends to be taken in the European market.

European leveraged finance

Although the decision in the US to approve the Uptiering Transaction, and the continuing loosening of terms, have led to concerns that similar transactions could become a feature in Europe, certain factors continue to present a barrier to similar transactions in Europe. From a practical point of view, the leveraged finance community in Europe is smaller and generally more collaborative than in the US. This has historically meant that there is less inclination for borrowers to pursue Serta-like transactions, and that creditors are more likely to remain aligned. However, as the market becomes increasingly challenging and terms become increasingly flexible, this unity might be tested.

The main impediment to uptiering in Europe is that English law or LMA-style facilities agreements in Europe (**"SFAs"**) typically prohibit (i) loans ranking senior to the facilities (with some exceptions) and (ii) changes in the order of priority. Although some large-cap SFAs now permit item (i) subject to a cap on size, changes to the order of priority remains an all lender matter.

In the current market, it seems almost inevitable that European borrowers will at least start to consider the full range of options potentially available to them, even if only as a bargaining chip. Their ultimate use will remain highly fact- and document-dependent, and particular attention should be paid to the "amendments and waivers" provisions to determine whether lenders are protected from the introduction of a super-priority debt without all lender consent. The potential use of "hollow tranches" and incremental facility provisions, and their interplay with the conditions for amendments and waivers, could also be a route to be tested.

Even if the flexibility to change the order of priority does not exist in a certain SFA, there can be other ways of achieving the same end. SFAs tend to disapply pro rata provisions subject to certain conditions — for example, requiring a Dutch auction or some form of pro rata solicitation before attempting non-pro rata repurchases. If certain procedural requirements are followed first, non-pro rata debt buybacks are permitted. Further, SFAs generally do not require all lender consent for "covenant stripping" (typically majority lender consent only), or release of all or substantially all security (super majority lender consent), so covenant strips could also potentially be effected. As a result, an Amend & Extend ("**A&E**") process, combined with a covenant strip, could result in minority lenders being left with unsecured (though temporally senior) debt and majority lenders holding secured debt. This means that the majority lenders (and not the minority lenders) would have a claim on the proceeds of enforcement. Unlike a traditional uptiering transaction, however, all lenders are involved in A&E processes and can 'choose' whether to roll into the new debt or remain in the existing structure. Parties should be mindful, though, of English law principles of minority lender protection. In particular, the decision in *Assénagon* introduced the idea that a majority is not necessarily free to bind a minority, and must exercise this power in the bona fide interests of the lenders as a whole. However, a disadvantageous amendment will not by itself be deemed in bad faith and any determination on the bona fide exercise will be fact driven (and the circumstances in *Assénagon* were particularly extreme).

With European leveraged finance poised to enter a prolonged period of uncertainty, borrowers, lenders, investors and sponsors need to be acutely aware of what they are, and are not, permitted to do under their documents. Likewise, the wider context of, and historical relationship between the parties involved in, a particular transaction will continue to play a key role.

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