NY State Court Refuses to Enjoin Serta's Priming Credit Agreement Amendment

June 24, 2020

On June 20, 2020, the New York State Supreme Court in *North Star Debt Holdings L.P. v. Serta Simmons Bedding, LLC* denied plaintiffs' motion for a preliminary injunction enjoining Serta's de-leveraging recapitalization transaction. The court, ruling that it could not find a likelihood of success on the breach of contract claim, stated that the priming amendment to the credit agreement only required majority lender consent. The decision, as discussed below, raises some key considerations for private equity sponsors, corporate borrowers and investors considering liability management and liquidity enhancing transactions.

Background. Facing liquidity constraints during the COVID-19 crisis, in April 2020, Serta entered into discussions with the plaintiffs, who were minority lenders, to obtain additional funding secured mainly by its intellectual property and royalty streams after such intellectual property and other assets were transferred out of the existing collateral package. On June 5, 2020, Serta terminated its discussions with the plaintiffs and, on June 8, 2020, announced its intent to recapitalize the company by amending its first lien credit agreement. The amendment, which had the support of the majority of the existing first lien and second lien lenders, was to provide for three new facilities, all of which were to rank ahead of the plaintiffs' existing first lien term loans:

- **New Money First-Out Tranche**: $200 million of newly funded first-out debt provided by certain existing first lien and second lien lenders.
- **Discounted Exchange/Second-Out Tranche**: $875 million tranche of second-out debt into which holders providing the new money tranche could exchange their existing first lien and second lien term loans at specified discounts, thus reducing Serta's overall debt load.
- **Third-Out Tranche**: An unspecified amount of third-out debt to be used for future discounted exchanges of first lien and second lien term loans.

The Plaintiffs' Argument. The plaintiffs alleged that the proposed transaction required their consent under the credit agreement's amendment provision. They argued that the transaction would have the effect of amending the waterfall provision in a manner that would alter the pro rata sharing clause, the amendment of which requires the consent of all adversely affected lenders. Further, the plaintiffs insisted that the proposed transaction would have the effect of releasing substantially all of their collateral and guarantees since the transaction was "tantamount to transferring these First Lien Lenders into unsecured lenders," and that any such release requires the consent of 100% of the lenders. The plaintiffs also alleged a violation of the implied covenant of good faith and fair dealing. Stating that the transaction, if permitted, would "cause havoc in the corporate loan market," the plaintiffs asked to enjoin the transaction.

The Court's Opinion. The court rejected the plaintiffs' argument, accepting Serta's claim that the 100% consent rights in the amendment provision were not implicated by the proposed amendment, and finding that Serta effected the discounted exchanges through open market purchases of loans, which is one of the stated exceptions to the pro rata sharing clause. The court noted that the proposal also did not require a release of the plaintiffs' collateral or guarantees. Further, since the breach of implied covenant claim is identical to the breach of contract claim, it is also unlikely to succeed. The court, finding that the harm to defendants in delaying the deal exceeded that to the plaintiffs (since they could be compensated with monetary damages), refused to enjoin Serta's recapitalization transaction.

Key Takeaways. The decision presents a number of practical lessons:

- Borrowers, investors and their counsel should take special care with these boilerplate provisions in loan agreements.
- Serta's corporate process—evaluating multiple alternatives, obtaining independent director approval, clearly identifying strategic needs, announcing the transaction in advance—enhanced Serta's chances of success.
- The argument that the lack of an anti-subordination clause in the credit agreement made the transaction possible is likely to make such clauses more prevalent.
- Borrower consent rights to assignments and disqualified lender lists were a threshold hurdle to some of the plaintiffs' claims and will remain in focus.

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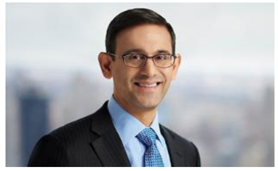

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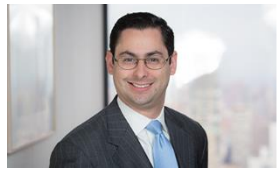

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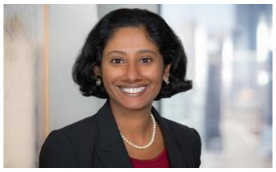

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