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Restructuring Lessons Learned Alert – Coercive Rollup Transactions

This memorandum was prepared as part of our continuing focus to facilitate the collective sharing of best practices and lessons learned in the financial restructuring and documentation areas. If you have any questions or comments regarding this alert, or would like to discuss the issues raised in this alert, please contact us at Noble Law PLLC.

Out-of-court rollup transactions providing for the creation of priming facilities that have priority over the existing senior secured facility, and are used to elevate the existing loans held by certain lenders on a non-pro rata basis, have recently been announced and consummated by Serta Simmons, Boardriders and TriMark. These transactions each provided for the required lenders to approve: (i) subordination of the existing senior secured facility to a new first-lien facility, (ii) commitment of a new first-lien facility that is sized to (a) fund the borrower's buyback of existing loans from the participating lenders and (b) provide new, incremental liquidity to the borrower and (iii) amend the existing senior secured facility to eliminate the covenant protections available to the remaining, non-participating lenders and, potentially, forbear with respect to the enforcement of payment obligations owed to the non-participating lenders.

Importantly, the opportunity to participate in these transactions was not offered to each of the existing lenders, and each of these transactions is currently, or likely to become, the subject of pending litigation. This alert does not express a view on the merits of this litigation or likely outcomes, but is instead intended to review and summarize certain documentation issues relating to these transactions. Moreover, this alert does not focus on the reputational risks that may arise from arranging or participating in such rollup transactions.

Following is a review of the specific provisions of the credit agreement applicable to the foregoing transactions and potential amendments that lenders may want to consider to avoid a coercive rollup occurring in which they do not consent (or were not even offered the ability to participate). We note the an amendment to either the subordination or the borrower buyback

provisions, as discussed below, would be sufficient to protect an individual lender from such coercive rollup transactions.

1. Existing Credit Agreement Provisions.

The foregoing rollup transactions were nominally structured to utilize provisions under the applicable credit agreements relating to (A) subordination and (B) borrower loan buybacks.

A. Subordination Provisions. Credit agreements commonly require the consent of all lenders to release liens on all or substantially all of the collateral, but do not require the consent of all lenders to subordinate those liens.[1] Justification for this market convention includes, in part, the need for flexibility in a workout scenario in order to provide necessary incremental liquidity on a first-priority basis. Use of this subordination convention in connection with a workout is not a recent development, and does not impact other provisions of the credit agreement that require the consent of all lenders to amend, for example, the applicable waterfall and ratable sharing provisions.

B. Borrower Loan Buybacks. Credit agreements often permit borrower buybacks of outstanding term loans at or below par, subject to certain restrictions, pursuant either to (i) a Dutch auction or (ii) an open-market transaction. Dutch auction provisions generally require that the purchase offer be made available to all term loan lenders on a pro rata basis, subject to extensive procedures set forth in an annex to the credit agreement, although the actual purchases can be made on a non-pro rata basis depending on which lenders have submitted the lowest prices at which they would sell their loans. Conversely, open-market purchases are generally not subject to express procedural requirements and do not need to be made available to all lenders on a pro rata basis. Each of the rollup transactions referenced above was structured as an open-market purchase. Although the inclusion of borrower buyback provisions is not a recent development, its use in connection with the subordination provisions discussed above to execute a coercive rollup transaction is a new development.

In addition to utilizing the foregoing subordination and borrower buyback provisions, these rollup transactions also provided for the required lender to amend or eliminate certain financial and other covenants, which are not generally not viewed as "sacred rights." These rollups may also contain forbearance provisions that preclude or defer enforcement based on events of default resulting from the borrower's failure to comply with payment obligations owed to the remaining lenders.

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[1] Reorg Covenant Review recently reviewed over 200 private sponsored credit agreement from 2017-19 and determined that only 5 (less than 2.5%) required 100% lender consent to amend lien priorities.

2. Potential Protective Amendments to Credit Agreement.

A. Subordination Provisions. The amendment provisions of the credit agreement may be amended to include subordination as a sacred right that requires the consent of each lender in order to subordinate the existing facility.

Sample Amendment. Following is a sample protective provision:

> Subordinate or have the effect of subordinating the Obligations hereunder, or the Liens granted hereunder or under the other Loan Documents, to any other Indebtedness or Lien, as the case may be, without the written consent of each Lender.

We note, however, that such an amendment to the amendment provisions of the credit agreement will itself require the consent of each lender. As a result, any such amendment should be sought either at (i) the time of origination or (ii) prior to the occurrence of a default or event of default, when full lender approval is more readily obtained, and required lender subordination is not viewed as a strategic option.

We also note that the inclusion of both subordination and waterfall provisions as sacred rights that can only be amended with the consent of each lender may unduly limit the ability of the lenders to provide necessary incremental liquidity during a workout scenario. As a result, it may be appropriate to further amend the amendment provisions to provide that the subordination and waterfall provisions can be amended based on the consent of all "affected lenders" (i.e., fewer than all lenders), provided that the opportunity to participate in any new facility is offered to each of the lenders on a pro rata basis.

Sample Amendment. Following is a sample protective provision:

> Only Lenders that have not been provided a reasonable opportunity to receive the most-favorable treatment under or in connection with the applicable amendment, waiver or supplement described in the preceding clause [relating to changes to the waterfall or subordination provisions] (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.

This provision seeks to balance the need for flexibility in providing liquidity during a workout scenario while protecting each individual lender from a potentially coercive rollup or transaction of similar effect.

B. Borrower Buyback Provisions. The assignment provisions of the credit agreement may be amended by required lenders to provide that any borrower buyback shall be made pursuant to a standard Dutch auction provisions or, if made as an open-market transaction, that such purchase offer must be made available to all term loan lenders on a pro rata basis.

Sample Amendment. Following is a sample protective amendment:

> 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 the Borrower on a non-pro rata basis ~~(A)~~ through Dutch Actions or open market transactions, that are in each case open to all Lenders holding the relevant Term Loans on a pro rata basis ~~or (B) through open market purchases~~.

We note that although the assignment provisions of the credit agreement are generally not included as a "sacred right," the ratable sharing provisions of the credit agreement may prohibit any future amendment to undo the foregoing sample amendment, and permit borrower buybacks that are not offered to all lenders on a pro rata, absent the consent of each lender.

Alternatively, the lenders may want to consider adding the assignment provisions as a sacred right so that any future amendment expressly requires the consent of all lenders. Such inclusion should be made either at (i) the time of origination or (ii) prior to the occurrence of a default or event of default when full lender approval is more readily obtained, and non-pro rata purchase offers are not viewed by required lenders as a strategic option.

If you have any questions or comments regarding this alert, or would like to discuss the issues raise in this alert, please feel free to contact us at Noble Law PLLC.

Kenneth Noble

Noble Law PLLC
1185 Avenue of the Americas, 3rd Floor
New York, New York 10036-6805
M: +1 917 689 5897
E: knoble@noblepllc.com