Turnarounds & Workouts

OCTOBER 2023

VOLUME 37, NUMBER 10

News for People Tracking Distressed Businesses

www.TurnaroundsWorkouts.com

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Lessons from Recent Uptier Transaction Litigation

By Evan Hill and Mason Walther

The U.S. leveraged loan and high-yield bond markets recently exited a decade-long period of low interest rates in which loan volumes more than doubled and high-yield bond volumes grew steadily. By some measures, leveraged loan volumes now stand at $1.7 trillion, while the high-yield bond market has reached $1.4 trillion. During this period, lenders competed to provide financing, executing credit documents that contained fewer financial maintenance covenants, larger carve-outs from incurrence covenants, and looser (if any) operating covenants. Billions of dollars of outstanding debt governed by these "covenant-lite" credit documents may be susceptible to certain types of liability management transactions that some have labeled "position enhancing transactions."

Superpriority uptiering transactions are one popular liability management

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Vesttoo: The Madoff of Insurance

By Christopher Patalinghug

Creditors of Vesttoo, Ltd., a failed financial technology company focused in the insurance and reinsurance sectors, and the United States Trustee are seeking the company's liquidation. The official committee of unsecured creditors appointed in Vesttoo's Chapter 11 cases is looking to wrest control of the fintech's reorganization proceedings from the debtors, asking the United States Bankruptcy Court for the District of Delaware to terminate the periods within which Vesttoo has the exclusive rights to propose and solicit acceptances of an exit plan. The Committee says it is prepared to file a liquidation plan that will allow the cases to "advance quickly to a fair and equitable resolution for all parties-in-interest."

Meanwhile, the U.S. Trustee has asked the Court to convert the cases to an outright liquidation under Chapter 7 "to spare the Court and the estates the cost of a lengthy contest" between the debtors and the Committee. The U.S. Trustee says

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technique that allows a distressed borrower to raise liquidity and create a runway to avoid a bankruptcy or restructuring when credit markets are otherwise unavailable. In short, such uptiering transactions allow borrowers to raise money by providing certain existing lenders priority over others.

Until recently, it was unclear whether courts would countenance the contested aspects of superpriority uptier transactions. However, now that litigation in several such transactions is winding through the courts, borrowers and lenders alike stand to gain a clearer understanding of the long-term benefits and costs that accompany superpriority uptier transactions. As the federal funds effective rate has risen from near zero to over five percent for the first time since the financial crisis, uptiering and similar transactions will likely remain an attractive option that generates liquidity and litigation alike.

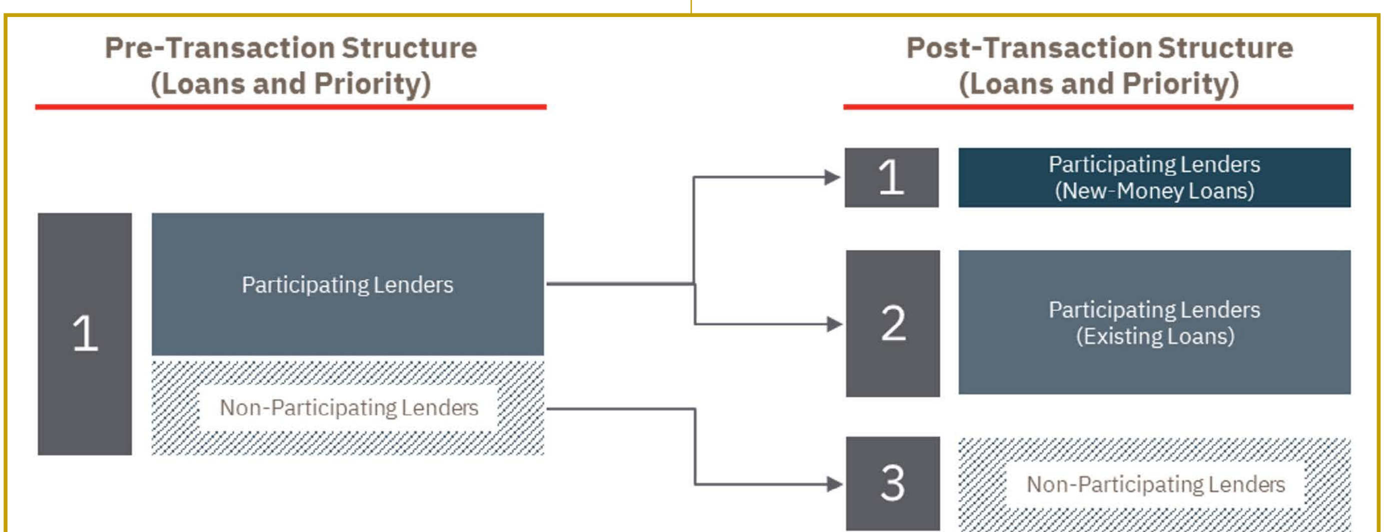
Key elements of uptier transactions

In an uptier transaction, a borrower incurs new superpriority secured debt ranking senior to the borrower's preexisting first-lien secured debt. Incurring superpriority debt is typically not possible under the terms of leveraged loan documents absent modification. Therefore, a borrower, with the consent of a majority of its lenders, will amend its loan documents to permit the incurrence of superpriority debt and to remove any provisions prohibiting the subordination of existing loans. The borrower will also likely need the amendment to allow the borrower to enter into a new intercreditor agreement to govern the relative priorities of the post-transaction tranches of debt.

The new superpriority debt often includes at least two tranches — one tranche on account of new money loaned to the borrower, and a second tranche on account of preexisting debt held by participating lenders that is "rolled up." The roll-up tranche becomes senior to the preexisting debt but junior to the new money tranche. A borrower will typically utilize the "open market purchase" provisions of its existing debt documents to implement a roll-up.

For incumbent lenders who are not offered an opportunity to participate in the new facility, their previously first lien secured loan is reduced, in essence, to a third lien position in the capital structure (or even fourth lien, depending on how the uptier is structured). The impact of an uptier transaction on such nonparticipating lenders can be significant. For example, the market value of the $261.5 million of first-lien debt subordinated in TriMark's uptier transaction fell from 78 to 50 cents on the dollar.

As a result of a superpriority uptier transaction, the nonparticipating lenders—who formerly held first-priority secured obligations—are subordinated not only to any new money, but also to a significant portion of previously pari passu (and sometimes junior) debt, as depicted in the illustrative structure below.



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Benefits and risks of uptier transactions

The primary benefit for a borrower to completing an uptier transaction is clear—it facilitates a liquidity infusion that otherwise is unavailable. Uptier transactions also can result in a deleveraged balance sheet if they are structured to include a discounted roll-up. With new money from participating lenders and potentially a reduced debt load, a borrower can attempt to avoid chapter 11 or a restructuring by extending its runway. During this period, the borrower can seek to turn its business around, pursue a sale, or seek to bridge through a change in market conditions.

A secondary benefit to an uptier transaction is that it creates a coalition of lenders that may be called upon to facilitate a future reorganization in bankruptcy. This benefit becomes more valuable as a restructuring becomes more likely. In that event, participating lenders may be predisposed to support an RSA or provide DIP financing, increasing the value of uptiering as a hedge against freefall bankruptcy.

However, uptier transactions come with a notable downside—the likelihood of protracted litigation with nonparticipating lenders. In light of the negative impact on nonparticipating lenders' loans, nonparticipating lenders are incentivized to challenge uptier transactions in state or federal courts. Nonparticipating lenders may seek to challenge uptier transactions on numerous grounds, such as that (1) the transaction violates the "sacred rights" provisions of existing debt documents that mandate pro rata distribution of collateral proceeds, (2) the open market purchase provision cannot be utilized to roll up the loans of participating lenders, (3) the transaction improperly releases all or substantially all collateral and the value of guarantees, and (4) the transaction results in the breach of the implied covenant of good faith and fair dealing.

Lessons learned from recent uptier transaction litigation

The outcomes of recent litigation in several uptier transactions illustrate the potential benefits to borrowers to pursuing uptier transactions, even in the face of litigation. In two cases, Boardriders and TriMark, the uptier transaction provided the liquidity needed to avoid near term restructurings and bridged the borrowers to improved business conditions. In both cases, the borrowers ultimately settled with (or otherwise paid in full) the nonparticipating lenders while avoiding a restructuring or bankruptcy filing. The Serta Simmons case illustrates a scenario where the borrower is unable to avoid a restructuring but reorganizes in bankruptcy with the support of a lender coalition that participated in a prepetition uptier transaction.

Settling with nonparticipating lenders —TriMark and Boardriders

In September 2020, TriMark, a restaurant supply business struggling in the aftermath of COVID and a previous leveraged buyout, executed an uptier transaction that raised $120 million in new liquidity and rolled up $307.5 million of preexisting debt. Both tranches of debt were senior to the company's preexisting first lien debt. The nonparticipating lenders commenced litigation in New York state court, seeking a declaratory judgment that the amended credit agreement was void and alleging breach of contract for altering their sacred rights without consent, breach of the implied covenant of good faith and fair dealing for subordinating their loans in secret, tortious interference with contract against equity sponsors, and violation of the New York Uniform Voidable Transactions Act for enacting the uptier with intent to hinder, delay, or defraud nonparticipating lenders. TriMark moved to dismiss the nonparticipating lenders' complaint. In August 2021, the court denied TriMark's motion to dismiss regarding the declaratory judgment claim, leading to the prospect of a

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protracted litigation process. However, in January of 2022, after two quarters of 54% and 30% revenue growth that saw TriMark's earnings swing from negative to positive, TriMark settled with the nonparticipating lenders by exchanging their subordinated debt into the supersenior roll-up tranche on a dollar-for-dollar basis.

In August 2020, Boardriders, a surfing and skateboard apparel maker that had borrowed heavily to acquire a competitor, executed an uptier transaction that raised $110 million in new liquidity and rolled up $321 million of preexisting debt, all senior to the company's preexisting first lien debt. The nonparticipating lenders sued in New York state court in October 2020, alleging breach of contract for making voluntary prepayments on a non–pro rata basis and conducting a roll-up that was not an open market purchase, as well as alleging breach of the implied covenant of good faith and fair dealing. The nonparticipating lenders also alleged that the equity sponsor tortiously interfered with the credit agreement and that the roll-up transferred rights with intent to hinder, delay, or defraud the nonparticipating lenders in violation of the New York Uniform Voidable Transactions Act. In December 2020, Boardriders moved to dismiss the nonparticipating lenders' complaint. The court denied the motion to dismiss regarding the breach of contract claim and the good faith and fair dealing claim in October 2022. In November 2022, Boardriders appealed the decision. However, in August 2023, the parties announced a pending settlement in connection with Boardriders' purchase by Authentic Brands that would involve repayment in full of nonparticipating lenders' debt. In September 2023, the parties filed a stipulation of dismissal with prejudice, ending their uptier litigation.

The TriMark and Boardriders cases illustrate how uptier transactions may provide a sufficient liquidity runway to allow a borrower to bridge to a longer term solution, notwithstanding litigation from nonparticipating lenders.

Restructuring with the participating lender coalition—Serta Simmons

In June 2020, Serta Simmons Bedding, a bedding company hurt by COVID lockdowns and a high debt load after a 2012 leveraged buyout, uptiered to raise $200 million in new liquidity and exchanged up to $875 million of new second-out debt for $1.3 billion of preexisting debt. Both new tranches of debt were senior to the company's preexisting first lien debt.

Nonparticipating lenders unsuccessfully sought to enjoin the transaction in New York state court in June 2020 and then sued in the Southern District of New York in May 2021, alleging the uptier transaction violated the terms of the 2016 credit agreement's collateral-release provision, altered its pro rata sharing provision without unanimous consent, and created an exchange of loans that was not an open market purchase. They also alleged breach of the implied covenant of good faith and fair dealing for executing the uptier in secret and without giving nonparticipating lenders an opportunity to join. Serta moved to dismiss the nonparticipating lenders' complaint in July 2021, and in March 2022 the court denied Serta's motion to dismiss regarding the breach of contract claim and good faith and fair dealing claim.

In January 2023, Serta filed for chapter 11 with more than 75% of participating lenders supporting Serta's RSA. Serta's final plan included 100% recoveries for first-out participating lenders and roughly 75% recoveries for second-out participating lenders, with 0.6-2.4% recoveries for nonparticipating lenders. Participating lenders agreed to equitize their debt and provide exit financing, receiving an indemnity from the reorganized debtor against liability associated with the uptier transaction. Serta and its participating lenders crammed down the plan on nonparticipating lenders, cancelling their claims and giving the class a 1% equity stake in the reorganized company.

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Where the District Court had found enough ambiguity on whether the uptier exchange was an "open market purchase" to deny Serta's motion to dismiss, the Bankruptcy Court granted partial summary judgment for Serta in March 2023, finding that the uptier was an open market purchase allowed by Serta's 2016 credit agreement. In June 2023, the Bankruptcy Court went further and found the uptier was not a breach of contract nor of the implied covenant of good faith and fair dealing, confirming a plan of reorganization supported by Serta's participating lenders. Nonparticipating lenders appealed both the March and June decisions, which were certified to the Fifth Circuit. The Bankruptcy, District, and Fifth Circuit Courts declined to stay plan confirmation pending appeal. As a result, Serta was able to consummate its plan of reorganization, thereby crystallizing the disparate recoveries afforded to participating lenders as compared to nonparticipating lenders.

The Serta case illustrates how a borrower and a coalition of participating lenders can have significant leverage in an ensuing restructuring, notwithstanding the litigation risk attendant to uptier transactions. It also serves as an example of how bankruptcy courts, where the success of a debtor's reorganization is a paramount consideration, may serve as the more favorable forum for borrowers to litigate the propriety of uptier transactions.

Conclusion

Uptier transactions can provide a lifeline to distressed companies that do not otherwise have access to the capital markets. Recent trends demonstrate that, when uptier transactions work, they can serve as a potent tool to bridge a borrower to profitability, notwithstanding related litigation. Once on sounder financial footing, a borrower may have the opportunity to close out its hedge by settling uptier litigation and making nonparticipating lenders whole. If a borrower is unable to bridge to a turnaround, a borrower may enter a restructuring with the support of a lender coalition that is willing to fund and spearhead a bankruptcy reorganization premised on the priorities implemented through a prepetition uptier transaction. Borrowers and other market participants should consider the costs, risks and potential benefits associated with using uptier transactions (or similar liability management transactions) as a tool to bridge through near-term business disruption or liquidity challenges. ¤

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About This Publication:

Turnarounds & Workouts is a newsletter for people tracking distressed businesses in the United States and Canada. *Turnarounds & Workouts* is published by Beard Group, Inc., Telephone: (240) 629-3300. ISSN 0889-1699. Editor: Christopher Patalinghug (tope@beardgroup.com). Assistant Editors: Psyche Maricon Castillon, and Peter A. Chapman. Subscription Rate: $447 per year per firm for one recipient plus $25 per year for each additional recipient. Contact tope@beardgroup.com for comments and coverage suggestions.