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Debt buybacks, Serta case and market reactions

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Introduction

The Federal Bankruptcy Court overseeing the Chapter 11 proceedings of *In re: Serta Simmons Bedding, LLC, et al*, issued a bench ruling on 28 March 2023 followed by a 6 June 2023 opinion interpreting that "open market purchases" conducted by the eponymous company were permissible under its loan agreements. Open market purchases, or loan buyback provisions, are commonly included in broadly syndicated loan agreements and news of the Court's ruling in *Serta* has been widely followed by the loan market. As of 17 July, the decision remains on appeal with the Court of Appeals for the Fifth Circuit. Thus, it bears looking into in the context of the history of these provisions.

Loan buyback provisions create a means for a borrower or its affiliates to repay (or exchange for value) debt of an individual lender on a non-pro rata basis. These provisions have gained attention as certain borrowers[(1)] have used buybacks to accomplish liability management transactions, through which a borrower may obtain additional capital from a subset of lenders that is (often) supported by a superior lien in the same collateral that secured the original debt (or, in some cases, other assets that are outside of the collateral pool). As part of these transactions, a company can purchase (or exchange for value) the original debt of participating lenders (ie, those providing the new capital) with the proceeds of a new "priming" tranche of debt, leaving behind a group of non-participating lenders that are effectively junior on collateral assets to the new and exchanged-for lenders. Some of these transactions have resulted in litigation, leaving courts to rule on the permissibility of the contractual provisions utilised in the underlying loan agreements.

This article discusses the history of loan buybacks, the recent *Serta* decision and the meaning of "open market" repurchases.

Background

Debt buybacks involve a borrower purchasing the borrower's debt through a so-called "Dutch auction" or in the open market, at a discount to its face value. By doing so, the company can reduce its outstanding debt at a cheaper cost than a traditional voluntary prepayment, which would be required to be prepaid at par (or possibly with call premium) and lower its interest expense.

There are several reasons why a company might choose to engage in a debt buyback, but mainly it confers two principal advantages over the regular-way prepayment provisions of a loan agreement. It allows a loan borrower to:

- reduce its debt and debt service obligations more cheaply than a prepayment at par by taking advantage of a loan trading below its par value; and
- negotiate a bilateral arrangement with an individual lender (or group of lenders) and repay or exchange that lender or lenders' loans outside of the general obligation to treat all lenders ratably in making any payments under the loan agreement.

While a company's debt trading below par may be a sign of distress, it is often the case that a loan trades below its face value for reasons outside of a company's control (eg, due to changes in the syndicated loan market, the particular industry of that company or other macro-economic forces). If a company has excess cash on hand and believes its debt is undervalued, it can make good corporate sense to buy back debt and reduce its debt service obligations at the cheapest possible cost. It is also a means for a company to maintain or improve its creditworthiness or rating.

Borrowers have long sought the ability to pay lenders in a syndicated loan facility on a non-ratable basis. These were historically prohibited by loan documentation on the basis that among the first principles of a syndicated loan was that all lenders are treated equally and ratably.

During the financial crisis between 2008 and 2009, secondary prices of bank loans were negatively impacted for distressed and strong borrowers alike. This created opportunities for well-capitalised companies (and their financial sponsors) to repurchase loans at significant discounts. Market pressures, together with the virtuous benefits for both lenders and borrowers created by buybacks (in the form of de-leveraging and credit improvements) began to outweigh the market's general adherence to the rule of pro rata treatment of lenders. As a result, buyback provisions began to appear in credit agreements in the form of amendments to existing documentation. These were initially to include Dutch auctions giving all lenders an opportunity to participate in the buyback and where all lenders were given an opportunity to participate in a potential paydown.

In their initial form, buybacks were permitted as long as they were offered on a pro rata basis to all lenders to maintain equal opportunity among lenders to participate (if not equal outcomes): that is, Dutch auctions or pro rata-offered buybacks (although the equality of prepayment and price, depending on the time of the Dutch auction, was not guaranteed). In some formulations, lenders were given an opportunity to be repaid at the clearing price of an auction. New issue loans also started to include provisions relating to "open market" buybacks that were differentiated from the Dutch auction procedures to allow for bilateral assignments between parties and that pointedly did not include a requirement for offers to be made to all lenders or for price parity. The more flexible "open market" buyback feature allowed borrowers to find opportunistic bilateral debt purchases via individually negotiated prices. Market participants were comfortable with these provisions on the basis that it allowed lenders to maintain control over whether to sell their loans and at what price. These provisions became prevalent as early as 2011 and 2012 in newly executed documentation (and indeed, the Loan Syndication and Trade Association (LTSA) also promulgated form of buyback language in their LSTA Model Credit Agreement in 2017).

Loan buyback provisions are now ubiquitous and standardised in the syndicated loan market. The terms in syndicated credit agreements are substantively consistent with those analysed in the *Serta* litigation. These open market purchases are commonly viewed as express exceptions to the pro rata sharing provisions in a loan agreement and set apart from a Dutch auction or pro rata-offered buyback options in those contracts.

Serta Simmons case

The transactions at issue in the recent *Serta* bankruptcy ruling occurred at the height of the covid-19 pandemic in the summer of 2020 (the 2020 transactions). Forced lockdowns and severe drop-offs in revenue compelled the company to seek out options to recapitalise its debt obligations and find a fresh capital injection. At the time, the company was party to a first lien term loan (in an original principal amount of $1.95 billion) and a second lien term loan (in an original principal amount of $450 million).

The company agreed to a proposal resulting in the following:

- The company incurred $200 million of new money in a new tranche of debt in the form of first lien first out term loans and exchanged approximately $1.2 billion of existing first lien and second lien debt (at an exchange ratio of 0.74 cents on the dollar for existing first lien term loans and 0.39 cents on the dollar for existing second lien term loans) for approximately $875 million of new term loans that were "second-out" to the first lien first out term loans. The first lien first out term loans and first lien second out term loans were established under a new credit agreement.
- The exchange was effected through an assignment made via "open market" purchases and the participating lenders were able to amend the existing loan documents with a vote by a majority of the holders of existing debt (50.1%).

The company's resulting capital structure was "re-set" as follows:

- $200 million first lien first out term loans;
- $875 million first lien second out term loans; and
- $862 million of first lien and second lien debt remaining from the existing non-participating term loans.[2]

Once the 2020 transaction was publicly announced, the non-participating lenders sued the company, first in New York state courts and later in New York Federal Court to unwind the transactions. The non-participating lenders argued, in part, that the exchange made by the company with the participating lenders violated the so-called "sacred" rights of lenders, which would usually require unanimous lender consent in circumstances that disadvantage once set of lenders in favour of another set of lenders.

An exception to these "sacred" rights under the credit agreement in question was the ability to assign loans to the company pursuant to an "open market" purchase. The non-participating lenders claimed, however, because the exchange was negotiated in private between the company and the participating lenders, it could not be considered an "open market" purchase that met the exception under the existing loan agreements. The non-participating lenders took the position that a true "open market" should require a "market in which any buyer or seller may trade and in which prices and product availability are determined by free competition". The company and participating lenders argued that an "open market" purchase is simply the price that a willing buyer and a willing seller can obtain in an arm's length negotiation between two parties.

In March 2022, a federal judge in the Southern District of New York denied a motion by Serta to dismiss the claims of the non-participating lenders, holding that she could not rule on the the motion's interpretation definition of an "open market" and there was ambiguity in the meaning of that phrase in the loan documentation.

In January 2023, Serta filed for bankruptcy protection in the Southern District of Texas, citing among other things, the overhang of the New York District Court litigation brought by the non-participating lenders. The Bankruptcy Court determined that the disputes over the 2020 transactions were better determined in Serta's bankruptcy case than in the civil court system and the claims brought in New York courts by the non-participating lenders were stayed.

In March 2023, Judge David R Jones of the Bankruptcy Court in the Southern District of Texas ruled in favour of the participating lenders, finding "there was no ambiguity regarding the meaning of 'open market purchase' and that it was 'very clear' that the transaction fit within the definition of an 'open market purchase'".

It should be noted that other similar cases have been brought by disadvantaged creditors – including lawsuits brought against borrowers Boardriders and Trimark – which considered similar contractual provisions and questions of law. In the *Boardriders* case, the Supreme Court of New York rejected the borrower's motion to dismiss such claims, stating that the language "open market" was "reasonably susceptible to more than one interpretation" and an ambiguity exists in the contractual language. The *Boardriders* decision remains stayed on appeal in New York State Court and the *Trimark* litigation (on the issue of a similar exchange in an uptier transaction) was ultimately settled by the litigants.

Market reaction

While the proceedings described above have made their way through the state, federal and bankruptcy courts, lenders have sought to strengthen a lender's "sacred" rights by blocking a borrower's ability to subordinate the payment obligations and liens securing a credit facility – referred to colloquially as "*Serta* protection". Current formulations of "*Serta* protection" in loan agreements enhance voting rights of lenders to prohibit subordination of their claims (or guarantee all lenders an opportunity to participate in any such transaction).

Conversely, there is little evidence that lenders are seeking to modify or remove the loan buyback provisions wholesale or clarify a different meaning of "open market" repurchases to either permit or block the exchange mechanics scrutinised by the 2020 transactions. Indeed, there have been no real amendments to the substance of the language that would support the interpretation offered by the non-participating lenders in the *Serta* case.

It can be extrapolated from the fact that the documentation has evolved on the substantive question of subordination rather than the buyback mechanics that market participants understood the original intent of open market buyback technology – meaning, it remains a market norm to allow non-pro rata buybacks by loan borrowers at a discount to par if a borrower can negotiate an acceptable price with individual lenders. If anything, the litigation and market trends have shown that this remains an acceptable feature of loan agreements, with the added position that it is not used to violate another important norm for lenders (ie, subordinating a lender's claim without their consent (or opportunity to consent)).

Comment

Investors, lenders and lawyers await the Fifth Circuit Court of Appeals' decision ruling on the appeal on these issues with interest. It is expected that, in the event a New York court or the Fifth Circuit takes the view that open market repurchases require something more than a bilateral or privately negotiated agreement, these provisions in loan agreements will be modified to reflect that open market repurchases were established to allow for non-pro rata and private transactions. In the meantime, lenders seem to agree that the benefits of open-market buyback technology are an important feature for borrowers and lenders alike, particularly for a mature market that allows and, in some cases, expects, wide distribution of loans within a highly liquid market place.

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Endnotes

(1) Buybacks can be accomplished by a loan borrower (often called a "borrower buyback") or an affiliate of the borrower, often times a private equity firm (called a "sponsor buyback" or "affiliated lender buyback"). While these have slightly different treatment under most loan agreements, for simplicity, this article refers to buybacks being accomplished by a borrower, but it should be interpreted to refer to affiliated lender buybacks as well.

(2) According to the company, the transaction raised the company's liquidity to $300 million, reduced debt by some $400 million, and staved off an imminent bankruptcy filing.