RX INTERVIEWS

SERTA CASE STUDY AND TWO MAJOR RX TRENDS

RESTRUCTURINGINTERVIEWS.COM
NEW YORK, NEW YORK

Introduction

Alright, this is a rather long report and perhaps a bit more technical than the rest of the course. I'm going to try to keep things as high-level as possible, while also trying to keep all the essential details intact and (hopefully!) not confuse you.

What we're going to be discussing here is the recent case of Serta Simmon's restructuring.

There are a few reasons why I've put a reasonable amount of time into creating this report for you:

1. This was probably one of the hottest cases within the industry in 2020 (not because of Serta itself, but rather because the restructuring solution ultimately implemented by Serta was quite novel)

2. Serta's novel restructuring has paved the way for others to potentially emulate what they did (which means restructuring investment bankers will be making lots of pitches around "Serta-like" transactions for years to come)

3. Serta was presented with two different options – from two competing groups of creditors – that illustrate the two major trends we've seen in restructuring over the past five years (in my view)

You'll almost certainly never be asked in an interview directly about Serta or even the two types of distinct restructuring solutions present in this case study.

With that being said, you may be asked in an interview to discuss recent trends in restructuring.

The two major trends in restructuring solutions over the past five years are both present in Serta's case. So, a great way to answer the question about recent trends is via talking about Serta's restructuring and the two types of restructuring solutions that were involved.

Further, you'll almost always be asked – at some stage in the interview process – to talk about a recent deal.

While you may choose a different deal to talk about – because it's more recent or the bank you're interviewing at was involved with it – Serta is a great deal to have in your back pocket.

In other words, by talking at such length about Serta's restructuring we'll be killing a few birds with one stone. You'll have a great answer to both "Tell me about a recent restructuring trend?" and "Tell me about a recent deal?".

On top of that, you'll also (hopefully!) learn about some more complicated and less common types of restructuring solutions that have gained popularity in recent years.

Throughout this little report I've tried to take a broader lens by talking about the incentives of various parties, who wins and losses in certain outcomes, etc. to try to build up your broader understanding of what's going on here. Hopefully you find I've been reasonably successful and haven't ended up confusing you too badly.

I remember reading once that when Ben Bernanke – the former Fed Chairman – was a young economics graduate student at MIT he expressed an interest in monetary policy to a professor.

The professor quipped that Ben should read Milton Friedman's *A Monetary History of the United States, 1867-1960* and that if he was still interested in monetary policy – after getting through the nearly 900 pages of minutia contained in that book – then he was well suited toward further studying it. Obviously, that proved to be the case!

Likewise, this will be the most detailed piece of writing I've done on restructuring. If you still find restructuring interesting after reading this, then your most likely well suited toward it.

Two Quick Notes

At the outset, before we begin, I'll just say a few different things.

First, keep in mind that in an interview you should keep your answers – even to broad questions like, "Tell me about a restructuring trend?" – to no more than two or three minutes (since each interview round will be just 25-30 minutes).

Second, because so much content related to specific restructuring transactions is not entirely public or is gated off (behind expensive services like Reorg or DebtWire), no one expects you to understand all the ins and outs of what we'll be discussing here.

Another way to say all this is that in an interview, when discussing things like what we will be talking about here, it's incredibly impressive to just know about these topics *at all*.

…You won't have marks docked because you can't articulate a rationale behind why exactly the open-market purchasing language of credit docs were not violated in a non-pro rata uptier transaction, for example!

Anyway, let's get into it.

Two Major Trends in Restructuring

Most restructurings out-of-court don't look *that* different than they would've ten or twenty years ago. You have classic debt-for-debt exchanges, debt-for-equity exchanges, amend and extends, etc. Sure, there are changes around the margins on how credit docs are structured, who owns debt today versus who owned it twenty years ago, etc.

But the point is that when a RX banker is pitching a company on certain restructuring solutions (things they can do to alleviate their capital structure issues), what is done today largely wouldn't be entirely foreign or unrecognizable to folks who were in RX banking a decade or two ago.

Further, most restructurings in-court – given the strict process governing Chapter 11s – don't look that much different either (with the exception of pre-packs becoming ever more popular and some relatively minor changes to the bankruptcy law that are always occurring due to new precedents being set, etc.).

With all that being said, over the past five years there have been two major trends in restructuring *solutions* that are quite foreign to what has ever been done before. Both of these solutions have led to lots of litigation and has got some folks (mainly secured lenders / creditors) quite concerned about their potential implications.

These are not solutions that can be done by *every* debtor. So, when talking about any of this in an interview, be sure not to make it sound like these kinds of transaction structures / solutions could potentially be done by any debtor. However, for those debtors who can enact these solutions, they can be both quite impactful for the debtor and cause quite a controversy among different creditors.

Fortunately for us, one of the most public deals (and conflicts!) in the world of restructuring in 2020 involves both of these trends. So that's what we'll discuss as a kind of case study that illustrates these two trends in restructuring solutions.

So, the two major trends in restructuring over the past five years – that would be unrecognizable to RX bankers from decades ago – are intellectual property (IP) transfers, which started in earnest around 2017, and non-pro rata uptiers, which began to gain popularity in 2020.

The way that I like to frame the difference between these two trends is that an IP transfer involves *stripping* collateral from secured lenders, sending it to an unrestricted subsidiary, having pre-existing secured lenders exchange their debt for new securities at the unrestricted sub, and then having those same pre-existing lenders put more money into that unrestricted sub as well.

Non pro-rata uptiers involve a group of creditors – that make up a simple majority of secured creditors - *priming* other existing term loan lenders by amending the credit docs

and creating new tranches of super priority debt above the existing term loans. This group of creditors then exchange their pre-existing secured debt into these super-priority tranches and likewise put in new money as well.

The way I would formulate it simply, so that you remember it, is that IP transfers involve *stripping* collateral from existing secured lenders, and non-pro rata uptiers involve *priming* existing secured lenders.

In an IP transfer the collateral moves away from existing secured lenders (to an unrestricted sub), but in a non pro-rata uptier the collateral stays put (but there are suddenly tranches of debt above the pre-existing secured lenders). So, pre-existing secured lenders will still have a claim on the same collateral, it will just be lower in priority.

The best (and most interesting!) way to flesh all of this out is by going through the saga of Serta, so let's do that.

The Case of Serta

Serta Simmons – the largest manufacturer and distributor of mattresses in North America – got in trouble in 2020. In particular, they needed to figure out a way to get some fresh cash and to try to reduce their debt load, which emanated primarily from their term loans.

Here are the two term loans and their size in June 2020 (~$2.3B in total).

Pre-Transaction Secured Cap Table		
1L TL	$	1,884
2L TL		424
Total Secured	**$**	**2,308**

Serta – being advised by Evercore – was quite smart about how they approached trying to rectify their capital structure.

They knew that there were a lot of funds holding both their 1L and 2L debt and so they sought proposals from these funds for potential restructuring transactions (out-of-court, obviously).

Note: I use the word "funds" here because while most holders of the term loans who got involved in this case are classic distressed hedge funds, some other key players were what I suppose you'd describe as rather robust mutual funds.

On one side you had a group of holders including Apollo and Angelo Gordon who held a minority position ($600M of the 1L). On the other side, you had a group of holders including Eaton Vance and Invesco who held a simple majority (50% +1) of both tranches of the term loans.

The first proposal came from Apollo, et al. and they proposed doing an IP transfer. An IP transfer – clearing away some more nuanced details - involves taking the intellectual property (IP) of a company and sending it to an unrestricted subsidiary. So, this strips the IP, which is valuable collateral, away from existing secured lenders and sends it to an unrestricted sub that is distinct from the rest of the company (meaning secured lenders no longer have a claim on this collateral directly like they did before).

How can this be done? How can you just stip collateral away from secured lenders? This can be done because credit docs have a series of "baskets" that permit the company to transfer assets including to an unrestricted sub (again, it gets a bit more complicated, but this is sufficient detail for our purposes).

These baskets are placed into credit docs – and are always heavily bargained for when the debt is issued – because as a secured lender you don't want to be too restrictive with the company. You want to ensure they have flexibility to move around assets and cash and make investments. Otherwise, you may prevent the company from doing what is in the best interest of growing the company or keeping it a going concern.

Basket sizing and what these baskets allow a company to do represents a kind of balancing act. On the one hand, a secured lender wants to make sure they are secured by lots of collateral and that too much is not stripped away from them. On the other hand, a secured lender doesn't want to cut off the oxygen supply to the company by not allowing them flexibility in moving assets around and making investments for worthwhile reasons.

So, what good does transferring assets to an unrestricted sub do for a company? Well, in a typical IP transfer folks are given the opportunity to exchange (usually at a heavy discount) their existing debt for new securities within this unrestricted sub. To entice the company to do this, the parties who exchange their debt down will often inject fresh cash as well for more of these securities.

Technical Note: Unrestricted subs – unlike *restricted* subs – aren't subject to any of the existing credit docs restrictive or negative covenants, which more or less allows them to raise as much money as folks will give them (capped somewhere around the dollar value of assets in the sub, of course). Further, since an unrestricted sub doesn't guarantee the parent's debt then, in the event of default, those who lend to the sub have a higher priority claim on assets within the sub than the debt that remains at the parent.

So, from the debtor's perspective, a typical IP transfer allows for a possible reduction in total debt (since debt holders are exchanging their debt at below par for new securities in the unrestricted sub) and they will receive some fresh cash as well.

From the participating creditor's perspective, meaning those who exchange their debt down to the unrestricted sub, why would they do this? Well, they now have a sole direct claim on a valuable asset (intellectual property) that they may think, in the case of default, will return more than if they had just kept their prior position pre-transfer.

When folks think about IP transfers, they often think first of J. Crew. Indeed, in the lawsuits in the Serta case (which we'll get into later) Eaton, et al. called what Apollo wanted to do with this IP transfer a "J. Crew transaction".

While J. Crew's case was a bit distinct in how exactly they transferred IP – compared to how many are done now which are a bit more streamlined – the principle remains the same. You take the IP of a company, strip it from existing secured lenders, put it in an unrestricted sub, have some existing secured creditors swap their existing consideration (debt) for new consideration at the unrestricted sub (at a discount), and those who exchanged their debt also put in some fresh cash (or you go and raise some more).

As you can imagine, IP transfers are not something that every debtor can do. It depends on their credit docs (do they have the capacity to transfer their IP, or a large part of it) and whether their IP is worth much (which is why this is most often done by retail companies, since they have valuable brand names). Indeed, in the aforementioned lawsuit the IP of Serta was called the company's "crown jewel".

Note: I'm leaving out some more intricate details here, because an interviewer isn't going to ask you why J. Crew utilized a restricted sub to then go to an unrestricted sub (for reference, J. Crew used a two-step process).

So, this is what Apollo, et al. proposed to Serta. They basically said, "We've looked at your credit docs and you have the capacity to do an IP transfer. So, let's do an IP transfer just like lots of other retail companies have done over the past few years. We'll exchange our existing loans down (and let some other existing holders beyond ourselves do so as well) and give you some new money as well."

In many ways, what Apollo, et al. proposed is kind of boring! It's a script that has been played out many times before (often successfully), but there's nothing too special going on here.

Note: The exact details of this transaction aren't fully known, because (spoiler alert!), an IP transfer didn't really happen. However, remember before that I said in an idealized IP transfer the debtor will a) reduce overall debt meaningfully and b) get new money. The Apollo, et al. proposal appears to have offered to put in new money but from subsequent lawsuits it appears their proposal wouldn't have reduced overall debt by much at all.

So that's one side of the coin. Apollo, et al. wanted to do an IP transfer, which is a relatively novel form of restructuring, but has quite a bit of precedence over the past few years for large retail companies with valuable IP.

Technical Note: The total basket capacity – meaning the amount that could be sent to an unrestricted sub for the purposes of an IP transfer – was likely at least $675M if you add up capacity in the credit docs (which is a bit complex and well beyond the scope of what you need to know). Apollo's proposal – that came to light via lawsuits that were filed later on – involved sending between $465-$590M to an unrestricted sub. Given the fact that there was nearly $2.3B in secured debt that Serta had – between the 1L and 2L – this was a non-trivial amount to transfer away from existing secured creditors, obviously. However, at the same time, there would still be a lot of pre-existing 1L and 2L debt left over after an IP transfer (meaning it's not like everyone would have been able to participate in this transaction even if they wanted to).

Now, turning to the other side of the coin, we have Eaton, Invesco, and others. They weren't pleased with the notion of an IP transfer happening because that involved stripping collateral from themselves as existing secured lenders.

Further, because of their large holding size (over 50% of the total secured debt), and the *relatively* small amount that would be sent to an unrestricted sub, even if they could have participated in the IP transfer, they couldn't have gotten completely out of their existing 1L / 2L positions. In other words, they would have still been holding lots of their pre-existing position no matter what (which would no longer have the IP backing it, which they thought was very valuable).

So, they proposed something different and novel to Serta: a non-pro rata uptier transaction. What this involved was them amending the existing credit docs to allow for the creation of three new super-priority tranches of debt *ahead* of the existing 1L and 2L.

They could do this – although it's controversial, as we'll discuss later – because Eaton, et al. owned over 50% of the 1L and 2L and thus could amend the credit docs to allow for these new tranches of debt to be placed above them (because it only required 50%+1 consent to subordinate the existing term loans).

The super-priority "first out" tranche would have Eaton, et al. invest $200M of new money in exchange for securities. The "second out" tranche would be $875M in size and involve a pure debt-for-debt exchange – at well below par – of this group's existing 1L and 2L securities. The existing 1L would exchange for 74 cents on the dollar and the 2L would exchange for 39 cents on the dollar. A "third out" tranche was also created for future use, although it hasn't been utilized.

Here's what the new capital structure would look like, under the non-pro rata uptier proposal:

Pro Forma Cap Table		
First Out (New Money)	$	200
Second Out (Debt Exchange)		875
Third Out (Not Filled)		-
1L TL (Pre-Existing)		814
2L TL (Pre-Existing)		211
Total Secured	**$**	**2,100**

So, from the debtor's perspective, this is great. They get $200M of new money and, when it's all said and done, would reduce their net debt by $408M (since the exchanges are happening at such steep discounts).

Let's break this down a little bit more.

So, for the new "first out" tranche it's simple enough. Eaton, et al. proposed putting in $200M in return for some new securities.

For the second out tranche, it was a pure debt-for-debt exchange. So, no cash was exchanged in any direction. Eaton, et al. exchanged $1.070B of their pre-existing 1L term loan, at 74 cents on the dollar, in return for $792M in new "second out" securities. Likewise, they exchanged $213M of their 2L position, at 39 cents on the dollar, for $83M of the same "second out" securities.

Note: Below I show the percent of the 1L and 2L that was exchanged. Meaning, the percent of the 1L and 2L that Eaton, et al. owned and then exchanged into the "second out" tranche. See how both are slightly above 50%, as you'd expect given that 50%+1 were needed to vote to allow for the creation of these new priority tranches to begin with.

Second Out Debt Exchange		
1L Exchange Rate		74%
1L $ Exchanged		1070
1L Second Out Debt	**$**	**792**
% of 1L Exchanged		*57%*
2L Exchange Rate		39%
2L $ Exchanged		213
2L Second Out Debt	**$**	**83**
% of 2L Exchanged		*50%*
Total Second Out Debt	**$**	**875**

In total, this new "second out" tranche contained $875M in new securities but resulted in the debtor not receiving any cash. Instead, they reduced the amount of debt outstanding, after the exchange was done, by around $408M (due to the exchange discount).

Discount Capture		
1L Discount %		26%
1L $ Exchanged		1070
1L Discount Capture	**$**	**278**
2L Discount %		61%
2L $ Exchanged		213
2L Discount Capture	**$**	**130**
Total Discount Capture	**$**	**408**

Of course, this discount capture purely relates to the debt reduction via the exchange. Serta also incurred $200M in new debt – within the "first out" tranche – but also received $200M in cash as well as a result.

Ok, so we've covered Serta's perspective. They get $200M of cash by raising $200M of new debt and extinguish $408M in debt via an exchange. Seems like a pretty good deal.

From the creditor's perspective, it gets a bit thornier. The proposed transaction was non-pro rata, meaning that only a certain group of lenders (that had a simple majority of the 1L and 2L and amended the docs to create these super priority tranches) were going to be able to participate in this. Folks like Apollo and Angelo wouldn't be able to invest new money in the "first out" tranche or exchange their loans into the "second out" tranche even if they wanted to.

What this means is that those who *could* participate (Eaton, et al.) have to invest new money and exchange their debt at a discount, but they are now solely in smaller super priority tranches at the very top of the capital structure. For those who *could not* participate (Apollo, et al.) their prior 1L and 2L positions effectively became 3L and 4L positions! In fact, if the newly created "third out" tranche were to ever be utilized by the debtor then the prior 1L and 2L would become effectively a 4L and 5L position.

Needless to say, in the event of a Chapter 11 the recovery values of the pre-existing 1L and 2L are going to be much lower if there are two or three super-priority tranches of debt above them!

So, for Eaton, et al. who are exchanging their debt at a large discount and putting in new money, it's not entirely clear how profitable this will or will not be for them. They're at the top of the capital structure, sure, but if the company falls into heavy distress maybe when

all is said and done it'll end up being unprofitable or their return will be rather low and stretched out. It's murky, since they've already taken a hit by exchanging their pre-existing debt at such a discount, but they clearly think it has a good shot of paying off.

For Apollo, et al. this non-pro rata uptier is a disaster. There's no getting around the fact that they've been heavily primed – with over a billion dollars ("first out" and "second out" tranches) now in front of them, which heavily reduces their existing secured debt value. Further, there's the hanging dagger of the "third out" tranche that is not yet filled but could be in the future.

I guess I'll spoil the story here and let you know that ultimately the debtor went with the non-pro rata uptier and it did end up happening (on June 22nd, 2020). Of course, for the debtor this was a much better deal than the IP transfer! They reduced down their debt significantly, got new money, and really the transaction seems much simpler to the debtor than an IP transfer (no wrangling over baskets and transfers to unrestricted subs, etc.). Predictably, the pre-existing 1L and 2L traded down heavily through all of this as people recalibrated their view on the worth of these positions (reflecting the fact they are now, for practical purposes, 3L and 4L positions).

How Was Any of This Possible?

So, how on earth can this kind of transaction happen? How is this legal? Surely when secured lenders initially lent money into the 1L and 2L they weren't anticipating that one day they'd wake up and their positions would be effectively 3L and 4L because a simple majority of *other* lenders agreed to prime them!

Doesn't it seem a bit odd that a group of slightly over 50% of secured lenders decided to place tranches of debt above themselves, then just exchange their pre-existing debt into these new super priority tranches (effectively leaving everyone who wasn't in this favored 50% behind with far less valuable debt)?

Apollo, et al. certainly thought so and immediately filed a lawsuit over it.

You can read Apollo's lawsuit here:
https://assets.bwbx.io/documents/users/iqjWHBFdfxIU/r1.MTvi5PBzE/v0

And the response, by Eaton, et al. here:
https://assets.bwbx.io/documents/users/iqjWHBFdfxIU/rNbLXCG_YI2I/v0

Just to set the stage, here's what Apollo had to say in the first three paragraphs on the lawsuit:

> 1. This Action challenges Defendants' unlawful scheme to rob certain of Serta's lenders, including Plaintiffs, of their bargained-for rights to security for their loans

> under a credit agreement while protecting and providing special benefits to a group of favored lenders who agreed to participate in the scheme.
>
> 2. Plaintiffs are First Lien Lenders who collectively own approximately $600 million in loans under a First Lien Term Loan Agreement with Serta. Under that agreement, "First Lien" means what it says: the lenders thereunder, including Plaintiffs, have rights to collateral that are contractually superior to all others and, as is routinely provided for, cannot be weakened without their consent. Defendants' unlawful scheme proposes to strip Plaintiffs of those first lien rights without even seeking—much less obtaining—their approval, by subordinating their loans beneath more than $1 billion in new loans from a favored group of lenders who will be given "super-priority" rights.
>
> 3. Such a brazen violation of standard contractual protections afforded to first lien lenders is unprecedented. If permitted to stand, it will not only strip Plaintiffs of the collateral protecting their loans, but will cause havoc in the corporate loan market. If majority lenders can conspire with borrowers to subordinate the minority, there are billions of dollars of loans that are at risk of having value stripped away in an instant. It should be enjoined.

It's fair to say Apollo, et al. weren't overly pleased. And on first blush, who could blame them! They're getting primed by more than a billion of super priority debt and can seemingly do nothing about it, because they weren't in the 50%+1 that voted to allow this to happen to them.

However, the judge in the case quite quickly denied Apollo's claim, thus the non-pro rata uptier was approved on June 22nd.

So, again, how is any of this possible? Well, it all gets a bit thornier and legal-ish, but let's go over a few things (some of which Apollo, et al. have argued and some that others have argued regarding other non-pro rata uptiers that have happened since Serta).

Apollo said that:

> [T]he Proposed Transaction would have the effect of effectively releasing **all or substantially all of the First Lien collateral** from the current first-priority ranking lien that benefits the First Lien Lenders by modifying the ranking of the loans. It would further have the effect of releasing all or substantially all of the value of the guarantees that protect the First Lien Lenders, because the guarantees of the existing loans, which would now be subordinated, would be worthless. In each case, this violates Sections 9.02(b)(B)(2) and 9.02(b)(B)(3) because the consent of the Plaintiffs have not been provided (or requested). An agreement to release all or substantially all of the Collateral (except under limited circumstances that do not apply in this context) requires the prior written

consent of each Lender, as does an agreement to release all or substantially of the value of the guarantees of the borrower's obligations under the Credit Agreement under Section 9.02(b)(B)(3).

As discussed in the course, there are a few elements of a credit doc that require the unanimous – or virtually unanimous – consent of lenders in order to change. Almost all other elements of a credit doc – for instance surrounding negative covenants - just require a simple majority (50% +1) in order to change.

The kinds of things that require unanimous consent are the so-called "sacred rights" around reducing the principal amount of the debt, decreasing the interest rate, etc. There's also almost always an element – contained within this section of the credit docs – related to needing unanimous consent in order to release all collateral as well (which Apollo noted).

This is all for good reason! If you're a secured 1L lender you don't want to wake up and then have all your collateral stripped away from you due to a simple majority of holders agreeing to do so.

Note: Look at the part I bolded above in the suit. They're arguing *effectively* – or for practical purposes - all collateral is released due to how heavily they've been primed. The reason why an IP transfer can work is that, yes, you're releasing *some* collateral, but that's the amount you're allowed to under the credit docs, not all of it.

Now, this argument from Apollo, et al. really went nowhere with the judge. Of course, the pre-existing 1L and 2L still have a claim on the same collateral. No collateral has been released or moved! It's just that the pre-existing debt is now behind a few new tranches of debt that, yes, are large, but remember as well that the amount of debt outstanding in the secured part of the capital structure has been *reduced* by over $400M as a result of this transaction (because Eaton, et al. exchanged at a heavy discount). So, the collateral amount is the same, the amount of secured debt outstanding is reduced, but the number of tranches of secured debt has just increased.

In reality, if the credit docs had said, "You can't subordinate existing term loans without the unanimous consent of holders" then this transaction could *not* have happened. The credit docs just don't say this, and credit docs are generally interpreted by the courts in a textualist manner (meaning, the docs say what they say, you don't read into the "spirit" of what they perhaps were intending to say or mean).

The credit docs say things like you can't decrease the interest rate, reduce the principal amount of the debt, etc. without 100% consent of lenders. But there's no anti-subordination provision – saying you need 100% consent to subordinate existing term loans - and because they don't say this, it's assumed that one just needs a simple majority to vote to allow for subordination to occur.

Another argument that Apollo, et al. sort of made – they really threw the kitchen sink at Serta hoping the judge would agree with them on at least one point – surrounds pro rata sharing and the open-market purchasing language that exists in all term loan docs.

Note: We'll ignore some of Apollo's other arguments since they get a bit convoluted and are really stretching credit doc language to the point it may end up being more confusing to discuss than educational.

Personally, I find the "pro rata sharing / open-market purchasing language" argument most persuasive, but not ultimately compelling in the case of Serta.

So, pro rata sharing provisions refer simply to provisions within credit docs – that almost always require unanimous consent to amend – that basically say, "If the company is going to pay down one term loan, it has to pay down every term loan holder by an equal amount." It's obvious why this is something all lenders would need to consent to ever change. You don't want to end up in a scenario where 50%+1 decide to allow themselves to be paid back in full or in part, and leave everyone else in the cold.

Now, like everything in RX, it gets a bit nuanced. Let's say you, as a company, want to buy back some of your debt because you have extra cash laying around and the debt is trading well below par. So, you go and buy back some debt and retire it. Haven't you just done what the pro rata sharing provision prohibits? You've paid back some, but not all, term loan holders (or partly done so, depending on how much they hold of your term loans).

This clearly can't be the way things work in practice. If a company wants to buy back debt, surely you can't expect them to *always* go buy an exactly equal amount from every single holder in order to comply with the pro rata sharing provision.

The answer to this is that there exists open-market purchasing language. This is a kind of carve out or exemption from pro rata sharing. Basically, what this means is that you need to distribute cash equally among all term loan holders if you're paying some holders back early, not just advantage certain ones, *unless* you're doing open-market purchases.

Note: As a debtor, if you want you can also buy back debt through an auction process whereby you make an offer to all lenders to buy back debt and do so (for those who say they want to sell) on a pro rata basis. So, in a more macro sense this auction process is non-pro rata as you are only paying back certain creditors who want to sell. The exact auction process is normally outlined in the credit docs. So, both the auction process and open-market purchases are carve outs or exemptions from pro rata sharing that allow for a debtor to buy back their debt (which usually they'll look to do when it's below par).

Naively, you may think that open-market purchasing just means that the company is allowed to go into the open market and buy back their debt, because that's a) the current market clearing price and b) you aren't buying it from a favored party, you're just buying it from whoever happens to be selling at that time in the open market.

However, once again, you have to be careful to look at how things are defined.

Here's how Serta's credit docs, in part, define open-market purchases:

> "… to the extent … replacement, renewal or refinancing is effected by means of a 'cashless roll' by such Lender, such … replacement, renewal or refinancing shall be deemed to comply with any requirement hereunder or any other Loan Document that such payment be made 'in Dollars', 'in immediately available funds', 'in Cash' or any other similar requirement."

So here we see a "cashless roll" – which just means a debt-for-debt exchange into new securities – can be considered an open-market purchase.

I mean, obviously, a private debt-exchange, only done by certain parties not all holders, doesn't *sound* like an open-market purchase. But remember that things like "open-market purchases" are just descriptors or labels in credit docs. They don't always mean what you *think* they reasonably should mean; they mean what they are *defined* to mean in the docs.

So, to be clear, the argument folks make is that: we have pro rata sharing provisions a simple majority can't amend (you need unanimous consent to amend them). Yes, open-market purchases are exempt from pro rata sharing. However, these debt-for-debt exchanges, only available to certain term loan holders, clearly violate the spirit of what open-market purchases should be! No one, until this happened, really thought open-market purchases could lead to this kind of transaction (where 1L lenders suddenly become a 3L or 4L without even being able to participate in the new super priority tranches of debt). Therefore, these debt-for-debt exchanges aren't open-market purchases, therefore they aren't exempt from the pro rata sharing provision, therefore they should not have occurred as they did (with a favored group being able to exchange, but no one else) without unanimous consent.

Like I said, I personally find this the most compelling angle to argue. However, it's only compelling when credit docs are more ambiguous than Serta's as to defining what open-market purchases mean (sometimes they don't speak directly to cashless exchanges).

Ultimately, in the case of Serta, what has been done with the non-pro rata uptier *seems* to many people as wrong. It just somehow seems unfair because surely no initial lenders into the 1L or 2L position ever dreamt that one day they'd be made a 3L or 4L without even having a say in the matter. However, as hopefully you've been able to see, when you go through the major arguments leveled against Serta (and Eaton, et al.) they begin to fall apart because the credit docs make it quite clear that this is allowed.

What's important to also note is that judges are a bit remiss to get involved with "fairness" issues around these kinds of cases, because these kinds of scenarios could be so easily prevented. In the next section we'll go over how easily it could be to stop non-pro rata uptiers, but how perhaps surprisingly I doubt we'll see them stop.

The Aftermath

So, there you have it. I'm going to recap the deal in a shorter, more interview friendly way in the final section of this report, but hopefully you get the gist of what's gone on here.

There are a few interesting things that happened in the last half of 2020 and into 2021 we should discuss.

First of all, like what happened after J. Crew did their IP transfer years ago, it opened people's eyes to the fact that they may be able to do this kind of transaction too.

As a result, we saw a few debtors – including Boardriders and TriMark – do a non-pro rata uptier after Serta successfully completed theirs.

What's important to realize, as I mentioned in the introduction, is that both IP transfers and non-pro rata uptiers aren't going to be something the vast majority of debtors can do.

Roughly speaking, the constraints on an IP transfer are:

- Whether there is sufficient basket capacity (meaning, can the debtor transfer enough IP down to an unrestricted sub for this transaction to make a significant difference?)

- Whether there are creditors, in sufficient size, who are willing to exchange their existing debt at a discount and put new money into the unrestricted sub.

- Whether the IP itself is actually worth enough to make a difference. This is why retailers are the main ones who do IP transfers, since their IP is such a large asset relatively speaking.

Roughly speaking, the constraints on a non-pro rata uptier are:

- Whether there's a concentrated group of creditors who own a simple majority of the debtor's secured debt (given how widely held secured debt often is, this can be a big hurdle).

- Whether or not these secured lenders are willing to exchange their debt at a heavy discount (usually) and place new money into the company as well.

- Whether the company's credit docs allow for this to occur. Remember that a 100% consent requirement for amending subordination provisions (allowing for new debt to be placed above current secured holders) would prevent a non-pro rata uptier. Likewise, more narrowly defining what open-market purchases are would also likely prevent these kinds of transactions.

One thing you shouldn't lose sight of is that while Apollo, et al. are obvious losers in the case of Serta, it's not a foregone conclusion that those who did participate in this are winners.

There are certainly situations that arise where a debtor could do an IP transfer or a non-pro rata uptier, but creditors simply aren't interested because they don't think it will allow the company to survive that much longer. Further, creditors may think their new consideration, and new money placed, will provide an inferior return to what they hold now if nothing else changes.

Remember that Eaton, et al. only made their proposal after seeing the IP transfer proposal from Apollo, et al. and clearly felt like they needed to offer an alternative. Maybe if the choice was between the status quo or the non-pro rata uptier, Eaton, et al. would have picked the status quo and avoided needing to put $200M into Serta (I doubt this, as I really like this transaction personally, but it's something to keep in mind – this deal is not a guaranteed home run for Eaton, et al).

As mentioned earlier as well, if you're a secured creditor and you want to make sure you can't suddenly be primed by hundreds of millions (or billions) of debt then there's a simple solution. When you draft the credit docs, just put in an anti-subordination clause requiring unanimous consent to amend! It's really that simple – one or two lines in the right place of a credit doc would have stopped this from ever happening.

Alternatively, you could have more narrowly defined open-market purchases – saying they need to involve cash exchanges, not just debt-for-debt exchanges – and that would've put a wrench in this transaction style (although there are likely ways to get around that). The anti-subordination provision is really what would stop non-pro rata uptiers in their tracks.

What you may find interesting is that when J. Crew famously did their IP transfer there were similar ways to foreclose another retailer from doing a transaction like that in the future (assuming, of course, we're talking about newly issued debt where you're negotiating fresh credit docs). However, the majority of new credit docs post-J. Crew don't *really* foreclose the capacity for debtors to do an IP transfer in the future.

In the aftermath of Serta, the folks over at Reorg have done a great job going through some newly issued secured credit docs. You would think that because a non-pro rata uptier is so simple to prevent – by just inserting a few lines about any subordination requiring unanimous consent – that you would see all new secured credit docs have some kind of language to this effect.

Put another way, you would think that what happened with the case of Serta is that they exploited a loophole and that such a loophole couldn't be exploited again in the future.

In reality, it appears very few new credit docs actually inserted any new anti-subordination language. This may come as a bit of a surprise given that if you're a new 1L or 2L lender,

surely you want to make sure that a few years down the line you don't end up becoming a 3L or 4L without having any say in the matter.

The answer to why we haven't seen any real changes in how credit docs are drafted (in my view) is because beggars can't be choosers. There's so much cash parked in direct lending and private credit funds that if you were to try to argue for this language you'd likely just be left on the sidelines. In other words, there are more than enough people to lend who don't care *that much* about this language, so the company (naturally) goes with them not those who want more stringent language in the credit docs.

If a debtor can get away with raising the amount of money they want without language that would preclude – or make it tricky – to do an IP transfer or a non-pro rata uptier in the future then they will (since they want full optionality in the event of a restructuring in the future).

If credit markets were much more sluggish then lenders would have the capacity to dictate terms more, but that's not the world we've been in really since the great financial crisis (with a slight blip during March / April of 2020).

If you're a lender then you need to prioritize what you want to fight for and if you assign a very low probability to an IP transfer or non-pro rata uptier occurring in the future (and they are rare forms of restructuring, relatively speaking) then it won't be high on your priority list.

Likewise, many folks lending new money to firms that are quite levered, but nowhere near distress, will try to get out of their position if it falls modestly anyway.

In other words, these lenders won't be around when complicated restructurings occur because they don't have the investment mandate or expertise to deal with it. So, their view is more or less, "Well if the company gets in a tough spot, we'll probably just sell out of our position to some distressed fund anyway, so it doesn't matter to us what the debtor ultimately does when it's term loans get truly distressed."

So, because some original lenders are unlikely to hang around if a company is clearly trending toward distress, what's their incentive to put in language that precludes some forms of controversial restructurings (especially if they need to negotiate heavily for that language)?

I haven't talked too much about the competing buy-side incentive structures that exist in the distressed world – since that's not the aim of this course! – but remember that you have many different players who come into situations at different times with entirely different motives.

For instance, Apollo wasn't an original lender in the Serta 1L. They came in after it fell into distress when they thought they could clip some profit by implementing an IP transfer.

For many initial term loan lenders – who are arguing over credit doc language with the debtor – they will often care less about these kinds of loopholes (if you want to call them that) since at the point at which they'd be used, they'll likely have already sold off their stake anyway (or perhaps hold enough of it that they like the idea of controlling the restructuring more, by they themselves proposing a non-pro rata uptier or IP transfer!).

Serta Summary

I initially intended to just write a few pages on all this. But, as with everything in restructuring, it gets complicated rather quickly and I wanted to touch on all the main points.

There are many other aspects to this case that are interesting and that I've glazed over or haven't fully touched on, but what we've covered here are the important points.

Backing up for a minute, let's remember why it's practical to be able to talk about all of this in an interview. No one in an interview will ever pre-emptively ask you about Serta, IP transfers, or non-pro rata uptiers. These are all topics that interviewers (reasonably!) don't expect most interviewees to know much of anything about.

However, it's quite common in an interview to be asked to talk about recent trends in restructuring. It's even more common to be asked to talk about a recent restructuring deal (which Serta most certainly is and is a great one to discuss in an interview).

So, let's recap the case of Serta and why it matters for more than just the company itself and the secured lenders that battled over what Serta should do.

The two major trends over the past five years in restructuring, in my view, are IP transfers and non-pro rata uptiers. These are specific restructuring *solutions* that would be virtually unrecognizable to folks who were active in restructuring ten or twenty years ago.

Not every debtor has the capacity to enact either of these restructuring solutions. In fact, the vast majority of debtors can't (for reasons articulated previously).

IP transfers were first popularized by J. Crew in 2017. Non pro-rata uptiers, on the other hand, became popularized in just 2020 by Serta Simmons.

Like in every area of finance, once one company does something successfully copycats begin to flood the zone. J. Crew's successful IP transfer led to many debtors – in particular in the retail space, where debtor's have valuable IP – emulating what J. Crew did. Likewise, even though Serta just completed their uptier in late June of 2020, TriMark and Boardriders have already followed along doing similar transactions.

For a restructuring investment banker, these two types of solutions are now options that they can present to a debtor (or that they can present to large, secured creditors who are seeking to work with debtors).

The best – or at least the most interesting - way to discuss these two novel solutions is via the case of Serta.

Serta was in trouble in 2020 and two distinct groups of creditors banded together to offer different solutions for the company's diminishing liquidity and large debt load. In particular, the debt that needed attention were the term loans, which had the following size prior to the restructuring:

Pre-Transaction Secured Cap Table		
1L TL	$	1,884
2L TL		424
Total Secured	**$**	**2,308**

On the one hand, you have Apollo, Angelo Gordon, and a few others who wanted Serta to implement an IP transfer (they held $600M of the 1L). In this case, it would mean transferring most of the IP of Serta – likely valued between $465M and $590M – to an unrestricted subsidiary (thus pre-existing secured creditors would no longer have a direct claim on the collateral). Apollo, et al. would then exchange their *existing* term loans down for new securities in this unrestricted sub and also lend Serta fresh money as well (in return for more securities at the unrestricted sub).

IP transfers generally benefit the debtor by virtue of the fact that most of the time existing debt holders will exchange their debt for new securities at the unrestricted sub at a discount (thus diminishing the aggregate amount of debt outstanding for the debtor). This is often paired with new money being lent as well (for new securities at the unrestricted sub). So, the company gets a lower debt burden and more cash (most of the time, it all depends on what the discount is and how much new money is lent, of course).

The obvious question about IP transfers is how can a debtor just transfer an asset – that secured creditors have a claim on – down to an unrestricted sub where they no longer have a direct claim on it?

The answer is the basket capacity that is specified within the credit docs. In the case of Serta, they probably had the capacity to transfer around $675M to an unrestricted sub.

The primary loser in an IP transfer – at least at time zero – is the existing secured lenders who do not exchange their loans for new consideration at the unrestricted sub. These folks will have a diminished collateral base in the event of default.

A second group of secured lenders to Serta – led by Eaton Vance and Invesco – weren't too pleased with the idea of Serta doing an IP transfer. They held over 50% of both the 1L and 2L and what they proposed instead was a non-pro rata uptier exchange.

This involved amending the existing credit docs to allow for the creation of three new "super priority" tranches of debt above the existing 1L and 2L. Eaton, et al. would lend the company $200M in new money, as a super priority "first out" tranche, and exchange their existing 1L and 2L positions into a new super priority "second out" tranche of $875M. The 1L would be exchanged at 74 cents on the dollar and the 2L at 39 cents on the dollar. Eaton, et al. also proposed the creation of a "third out" tranche that would be able to be utilized in the future at some point (although not right away).

You can see what the pro forma secured cap table looks like here:

Pro Forma Cap Table		
First Out (New Money)	$	200
Second Out (Debt Exchange)		875
Third Out (Not Filled)		-
1L TL (Pre-Existing)		814
2L TL (Pre-Existing)		211
Total Secured	**$**	**2,100**

Below illustrates the amount of debt Eaton, et al. were exchanging into the "second out" and how we end up getting to the $875M value you see in the pro forma cap table above:

Second Out Debt Exchange		
1L Exchange Rate		74%
1L $ Exchanged		1070
1L Second Out Debt	**$**	**792**
% of 1L Exchanged		*57%*
2L Exchange Rate		39%
2L $ Exchanged		213
2L Second Out Debt	**$**	**83**
% of 2L Exchanged		*50%*
Total Second Out Debt	**$**	**875**

So, while an IP transfer involves *stripping* collateral from secured lenders, what Eaton, et al. proposed via a non-pro rata uptier was the *priming* of secured lenders who weren't participating in this transaction without moving the collateral around.

Because Eaton, et al. held over 50% of the 1L and the 2L they were able to amend certain elements of the credit docs. Practically, what this meant is that Eaton, et al. could allow the company to create these three super priority tranches of debt – because there was no anti-subordination clause in the credit docs that would require unanimous consent to create debt capacity above the 1L and 2L – and then just exchange their own debt into the newly created "second out" tranche (meaning, Apollo, et al. were left holding their pre-existing securities and couldn't participate in any of this). You can see the value of those "left behind" as a result of this transaction in the pro forma cap table: there's $814M of the 1L and $211M of the 2L that could not participate.

So effectively, if the transaction proposed by Eaton, et al. were accepted by Serta, the pre-existing 1L would become a 3L (potentially a 4L if the "third out" tranche was utilized) and the pre-existing 2L would become a 4L (potentially a 5L if the "third out" tranche was utilized).

Needless to say, if you were a pre-existing 1L and are now effectively a 3L (or 4L!) you shouldn't expect your recovery to be nearly as high in the event of a Chapter 11 filing.

Ultimately, Serta went with the Eaton, et al. proposal. This is largely because it appears to have provided a substantially bigger decrease in net debt because of this group of lenders a) holding so much debt to begin with and b) exchanging it at such a heavy discount.

You can see the discount capture below as a result of the exchange being done at such a heavy discount. Effectively, net debt was reduced by $408B (remember there's $200M in new debt, as a result of the "first out" tranche, but also $200M in new cash the company got for issuing this new debt).

Discount Capture		
1L Discount %		26%
1L $ Exchanged		1070
1L Discount Capture	**$**	**278**
2L Discount %		61%
2L $ Exchanged		213
2L Discount Capture	**$**	**130**
Total Discount Capture	**$**	**408**

Now, the obvious question: is this all legal?

Apollo, et al. sued and the judge sided definitively with Serta. Apollo made a number of arguments. Primarily they argued that this transaction effectively released all of the collateral pledged to them, given just how primed they were (there's over a billion dollars in debt in front of them now!).

However, this doesn't hold too much water in literal terms as, of course, no collateral has been moved (they just have a claim that is behind much more debt now).

While there were other arguments – about their declining priority in the waterfall after the transaction and about the definition of open-market purchases – Serta's credit docs address these rather soundly (although these arguments may hold weight for other debtors who try this and don't define open-market purchases as including cashless debt-for-debt exchanges, for example).

Ultimately, with the court case quickly resolved in Serta's favor, the non-pro rata uptier was implemented on June 22nd, 2020 and was quickly followed by a number of others like TriMark and Boardriders.

Serta's success – and Evercore's, since they advised on the transaction - opens a new restructuring possibility for troubled companies to consider, just like what happened after J. Crew's successful IP transfer.

Now if a group of lenders control a simple majority of a company's secured debt then, with credit docs permitting, they can effectively prime all other secured debt holders if they so choose.

However, just because lenders may have the capacity to do either an IP transfer or a non-pro rata uptier it doesn't invariably mean they'll want to do it. Both usually involve exchanging their current debt at a discount and lending new money. Potentially existing creditors may not have the appetite to get further enmeshed in a company or feel their current debt will likely provide a better return (even in the event of a Chapter 11 filing).

While the future is always uncertain, these two trends of IP transfers and non-pro rata uptiers are likely here to stay. Not just because they can provide relief for debtors in a rather clever way – when perhaps they have few other options to look at – but also because secured lenders don't seem overly interested in actually changing around credit docs moving forward to include language that would preclude (or at least make more difficult) the ability to do these kinds of transactions.