NAVIGATING CREDITOR-ON-CREDITOR VIOLENCE: LESSONS FROM THE REVLON & SERTA CASES

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Distressed companies must often look for creative ways to raise capital. In recent years, so-called "liability management" or "position enhancing" transactions have gained popularity. In those deals, distressed borrowers typically enlist a majority of existing lenders to amend or work around their secured-debt documents so they can raise new capital. The lenders who team up with the issuer to enable these sorts of transactions can gain substantial benefits at other creditors' expense. This creditor-on-creditor violence has sparked an arms race between creditors seeking to restrict flexibility in debt documents and other creditors (and borrowers) seeking ever more ingenious ways to find cracks in those documents' armor.

For directors and officers of distressed companies, the stakes of that arms race are high. Newly raised capital could provide much-needed breathing room, stave off bankruptcy, and preserve jobs and shareholder value. But directors and officers must be prepared for contentious litigation if they choose to raise capital this way. Excluded lenders may try to

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block or unwind the transaction because it effectively leaves them in a subordinated position with lower expected recoveries in bankruptcy. The resulting court battles can destroy value and threaten massive liability for the company—and, in some cases, liability for directors and officers personally.

Just this year, litigation over liability management transactions has been front and center in two high-profile bankruptcy cases, one involving Revlon Inc. and the other Serta Simmons Bedding LLC. These and other recent cases can illuminate key lessons for directors and officers who are exploring, negotiating, or defending similar liability management transactions.

Revlon

Revlon, the well-known multinational beauty company, issued $1.8 billion in secured term loans under a 2016 credit agreement.[1] The 2016 facility was secured, in part, by liens on Revlon's intellectual property in beauty brands. In late 2019, Revlon approached the 2016 facility lenders for new money to address its severe liquidity needs. The new transaction—a type commonly called a drop-down transaction—would transfer IP collateral under the 2016 facility to unrestricted subsidiaries, known as BrandCos, that would not be subject to the 2016 credit agreement. The transferred collateral could then be pledged to secure new debt.

The BrandCo transaction required amendments to the 2016 credit agreement, which only a majority of the 2016 facility debtholders could approve. The lenders splintered into two groups—one group of lenders (BrandCo lenders) agreed to support the transaction, while a group of dissenting lenders organized to block the necessary amendments. After failing to win an initial vote on the deal, the BrandCo lenders funded $65 million in new incremental revolving loans under the 2016 facility. With the votes from the incremental loans, the BrandCo lenders now held a bare majority of the 2016 facility debt, and the transaction closed. The BrandCo lenders provided $880 million of new money and rolled up their existing 2016 facility debt into the new, super-senior facility.

The new financing gave Revlon breathing room, though it ultimately filed for bankruptcy in 2022. Certain dissenting lenders then filed an adversary proceeding in the bankruptcy court to unwind the BrandCo transaction. (Revlon and the BrandCo lenders filed a motion to dismiss, arguing that the plaintiffs lacked standing because any claim seeking equitable relief would be an estate cause of action belonging to the Revlon debtors. The bankruptcy court sided with Revlon, dismissing all claims against the debtors and all claims for equitable relief. After that decision, the dissenting lenders settled their dispute with the debtors and the BrandCo lenders.

Serta Simmons Bedding

One of the largest bedding manufacturers and distributors in North America, Serta Simmons Bedding issued $1.95 billion in first-lien secured term loans under a 2016 credit agreement. Like Revlon, Serta began exploring options for additional financing in late 2019. The company ultimately completed an exchange transaction with a group of participating lenders using an uptier exchange structure. The company chose that proposal over a competing proposal from a second group of excluded lenders who were not allowed to take part in this exchange transaction.

In the uptier exchange, the participating lenders—who held a majority of first-lien term loans and thus could approve amendments to the 2016 credit agreement—amended the contract to permit the issuance of higher-priority debt. The participating lenders then exchanged their old term loans for the new, higher-priority debt, while the excluded lenders retained their old, now lower-priority debt. The transaction structure was different than the Revlon deal, but the practical effect was similar—the transaction subordinated the excluded lenders' first-priority lien on valuable collateral.

Some excluded lenders unsuccessfully sought to enjoin the transaction in New York state court before it closed. After the deal closed, a group of excluded lenders filed suit in federal court in the Southern District of New York (SDNY). The district court denied a motion to dismiss and allowed claims for breach of contract and breach of the implied covenant of good faith and fair dealing to proceed to discovery.

In January 2023, Serta filed for bankruptcy in Texas. The bankruptcy filing allowed Serta to stay the SDNY action and file an adversary proceeding seeking the bankruptcy court's blessing of the exchange transaction. In the bankruptcy court, the excluded lenders argued both that the transaction violated the 2016 credit agreement's text and that it breached the implied covenant of good faith and fair dealing. Contrary to the earlier decision in the SDNY action, the bankruptcy court ruled that the exchange transaction was unambiguously permitted under the credit agreement. Then, in June, after a trial, the bankruptcy court rejected the excluded lenders' claims of bad faith and again ruled that the 2020 exchange transaction was valid.

Pitfalls & Considerations

Directors and officers of distressed companies considering new financing deals that pit existing creditors against each other should proceed cautiously. As recent situations show, liability management transactions can be hotly contested. Directors and officers should bear in mind their fiduciary duties when evaluating or negotiating such transactions.

D&O Responsibilities. Directors and officers owe fiduciary duties to the corporation and its shareholders—to act in good faith, with loyalty, and with due care. The duty of loyalty requires directors and officers to prioritize the interest of the corporation over their own. The duty of care requires directors and officers to take an active and direct role in major corporate decisions and to consider all material information reasonably available. In Delaware, a related duty of oversight also requires directors and officers to make a good faith effort to monitor risks, be properly informed, and not ignore red flags. For financing transactions, directors should carefully monitor the actions of the company's management and financial and legal advisors. In addition to understanding the substance of advisors' recommendations, directors should also probe whether advisors have any conflicts of interest that may taint their work.

Disgruntled creditors may sue directors and officers for breaching these duties if they approve a liability management transaction for an insolvent company. In 2007, the Delaware Supreme Court held that creditors may bring derivative claims against directors and officers for breach of fiduciary duty on behalf of the insolvent corporation once a corporation is truly insolvent. (By contrast, directors and officers do not owe any duties to creditors when the corporation is merely trending toward insolvency.) As the Revlon case demonstrates, however, if a company later files for bankruptcy, objecting lenders must satisfy standing requirements to pursue derivative claims on behalf of the debtors.

The bar for obtaining derivative standing in bankruptcy is high. The creditor typically must show that the claim is colorable and that the debtor-in-possession unjustifiably refused to bring suit on its own. But this standard is by no means insurmountable, and courts have granted creditors derivative standing to pursue breach of fiduciary duty claims against directors and officers. Directors and officers should also be aware that existing D&O liability insurance may not cover claims by creditors, as some policies include creditor exclusions.

To fulfill their duties, directors and officers should begin analysis of a liability management transaction with a close review of existing debt documents to understand what may be permitted under the contract. Courts are likely to look first to the contractual language in deciding any dispute. For example, in rejecting the excluded lenders' arguments, the Serta bankruptcy court emphasized that it cannot rewrite the contract and explained that the parties could have avoided the situation with the addition of a sentence or two in the credit agreement.

Considerations for Directors and Officers When Negotiating a Transaction. How negotiations were conducted can play an important role in later litigation. Evidence that the company conspired with participating lenders to deprive excluded lenders of their bargain can bolster excluded lenders' litigating position. A borrower's directors and officers should consider the following when negotiating a contentious creditor transaction.

First, open dialogue with all creditor groups is essential. Soliciting proposals from many lenders will improve the competitiveness of the financing deal and demonstrate that directors and officers complied with their fiduciary duties by conducting a thorough process for raising capital. Both Revlon and Serta, for example, allowed multiple existing lender groups to submit financing proposals. Involving all lenders also means that more parties will share their understanding of what is permitted by the existing debt documents. Evidence that the dissenting lenders had recognized the permissibility of the challenged transaction can undercut later claims of bad faith. In the Serta case, for example, the bankruptcy court rejected the excluded lenders' bad faith claims in large part because the excluded lenders had earlier proposed their own transaction using a similar structure.

By contrast, in another well-known recent litigation over a liability management transaction involving the apparel company Boardriders, a New York state court allowed bad faith claims challenging a liability management transaction to proceed to discovery in part because the excluded lenders had reached out to the company repeatedly without response.

Second, where possible, directors and officers should make the new financing deal available to all lenders. Revlon used evidence that the BrandCo transaction was open to all lenders to undercut allegations that the transaction was intended to benefit only a subset of lenders. By contrast, the court in Boardriders cited evidence of secretive discussions with participating lenders as potential evidence of bad faith.

Third, directors and officers should attempt to ensure broad participation in the new financing deal. A transaction effectuated with a bare majority is more susceptible to challenge. In the Revlon transaction, the BrandCo lenders obtained a bare majority through the issuance of the incremental revolver, and that issue became a focal point in the ensuing litigation, with the dissenting lenders calling the revolver a sham. Obtaining a broader base of support for a potentially controversial transaction will prevent such arguments and improve the chances that a court will approve the transaction if need be.

These steps will not only help directors and officers avoid liability—they will also help the company avoid potential liability. As the Revlon and Serta cases demonstrate, creditors are likely to argue that a transaction breached the implied covenant of good faith and fair dealing, as a back-up or in addition to their breach of contract claims. Whether such bad faith claims may be viable when contesting liability, management transactions is still an open question. On the one hand, the contract language can be the end of the story, as a New York state court explained in a similar case involving Trimark, the food services provider. On the other hand, courts have allowed good faith claims to proceed to discovery and trial, as was the case for Serta and Boardriders. Ensuring an open, transparent, and fair process for a liability management transaction will help demonstrate the company's good faith and minimize the risk of liability for breach of the good faith covenant.

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Bankruptcy to Facilitate Dispute Resolution. A company's financial distress may persist after a liability management transaction. If directors and officers are assessing bankruptcy, an additional consideration may be whether a bankruptcy court could resolve pending disputes about the transaction faster and more cheaply than elsewhere.

With Revlon, the bankruptcy court ordered an accelerated litigation schedule—approximately four months between when the complaint was filed and the anticipated start of trial. The bankruptcy court rejected the plaintiffs' proposed year-long timetable because the claims at issue threatened Revlon's entire capital structure and thus needed to be resolved before any Chapter 11 plan was confirmed.

Filing for bankruptcy can also help a debtor place the dispute before a bankruptcy judge who may give greater deference to the debtor's reorganization strategy. For example, Serta's bankruptcy petition stayed pending lawsuits challenging the exchange transaction, including the SDNY action, which had allowed breach of contract and bad faith claims to proceed to discovery. The Serta debtors and participating lenders effectively got a second chance to litigate the claims by filing for bankruptcy.

Like in Revlon, the bankruptcy court adjudicated the Serta dispute quickly, less than six months after the complaint had been filed. By contrast, the SDNY action had been pending for two years and depositions had not even taken place. It appears as though no bankruptcy court has recently invalidated a liability management transaction. While that hardly guarantees that bankruptcy courts will bless future transactions, it provides a powerful reason to consider the advantages of Chapter 11 in litigation over contested liability management deals.

A decision from a bankruptcy court also offers more finality. Although appeals of the bankruptcy court's decisions are pending, the Serta debtors implemented their plan quickly and may now argue the appeals are equitably moot—a doctrine that appellate courts apply to prevent the unscrambling of complex bankruptcy reorganizations. Considering the lengthy appellate process in other venues and the uncertainty that process can create, bankruptcy provides a far faster and surer path to resolving these kinds of disputes.

Conclusion

While liability management transactions may offer a distressed company much-needed financing, they can result in contentious and costly litigation that threatens the company's capital structure. Directors and officers negotiating and defending those transactions should proceed thoughtfully and diligently by ensuring there is a strong argument that the transaction is permitted under existing debt documents, building as much support for the transaction as possible, and, if appropriate, considering whether resolving the disputes in bankruptcy court would be more favorable for the company.

[1] MoloLamken acted as special litigation counsel for Revlon in its Chapter 11 case and adversary proceeding.