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Fifth Circuit Rejects Serta Uptier Transaction in Favor of Pro Rata Treatment

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On December 31, 2024, the U.S. Court of Appeals for the Fifth Circuit ruled that mattress company Serta Simmons Bedding, LLC (*"Serta"*) violated the "sacred right" of its lenders to ratable repayment by placing more than $1 billion of new super-priority debt that would have priority over its existing loans and offering to "purchase" or "exchange" only a portion of its existing indebtedness for such new indebtedness, The Fifth Circuit held that such an exchange was not a permitted "open market purchase" under the terms of the existing indebtedness. While still significant, this ruling underscores the importance of the language in existing and future debt instruments which could either facilitate or inhibit similar transactions involving "liability management" or "lender-on-lender violence".[1]

Background

The dispute stems from a controversial transaction between Serta and its lenders in 2020. Previously, in 2016, Serta refinanced its debt with $1.95 billion in first-lien syndicated loans (the *"First Lien Loans"*) and $450 million in second-lien syndicated loans.[2] However, following the 2016 refinancing, Serta's business suffered, and the company found itself in need of new money.

To meet its capital needs, in 2020 Serta arranged an uptier transaction (the *"Uptier Transaction"*) in which it would issue new debt and provide existing lenders participating in such new debt issuance with claims and liens that are contractually senior to the claims and liens securing its existing indebtedness. Serta and certain of its existing lenders holding first lien and second lien debt (the *"Participating Lenders"*) agreed to (i) provide Serta with $200 million in new financing in exchange for $200 million in first-out, super-priority debt and (ii) exchange $1.2 billion of their first lien and second lien loans for approximately $875 million in second-out, super-priority debt.[3] Both tranches of the new facility ranked senior to the existing first and second lien term loans, thereby subordinating the loans of the lenders who did not participate in the Uptier Transaction (the *"Excluded Lenders"*) to the new super-priority loans.

The loan agreement governing the first lien loans (the *"First Lien Agreement"*) protected the sacred right of pro rata sharing among lenders by requiring unanimous consent in order to waive, amend or modify the pro rata sharing provision (unlike other non-sacred rights, which could be amended with majority consent) "in any way that would 'alter the pro rata sharing of payments required thereby.' "[4] The First Lien Agreement, however, contained an exception to pro rata sharing: any lender could assign all or a portion of its rights and obligations under the First Lien Agreement in respect of its term loans to any Affiliated Lender on a non-pro rata basis (A) through Dutch Auctions or (B) *through open market purchases*. The definition of Affiliated Lenders included Serta, effectively enabling the company to buy back its own debt on a non-ratable basis.

Serta was able to incur this new super-priority debt despite these restrictions in two steps. First, with the consent of the Participating Lenders (who constituted a majority under the First Lien Agreement), Serta amended the First Lien Agreement to allow for new senior liens and remove the requirement that incremental equivalent debt not be senior to the existing debt, thereby permitting the new $200 million in first-out, super-priority debt. Second, Serta issued the $875 million in exchange debt with only the Participating Lenders (*i.e.,* on a non-pro rata basis) asserting that it was an "open market purchase" and therefore permitted under the First Lien Agreement. The result of these transactions was that Serta essentially repaid a portion of the Participating Lenders' debt rather than making a prepayment of the First Lien Loans that would be distributed ratably to all holders.[5]

The Excluded Lenders filed suit in the Southern District of New York, arguing that the Uptier Transaction (i) did not constitute an "open market purchase" as permitted by the First Lien Agreement and (ii) violated the implied covenant of good faith and fair dealing as well as the pro rata sharing provisions of the First Lien Agreement, which required that any payment be distributed ratably among all lenders. Serta took the position that the Uptier Transaction was

permissible under the First Lien Agreement because (i) the amendment to the First Lien Agreement required consent from only a majority of lenders (which Serta obtained), and (ii) the issuance of the $875 million in exchange debt fell within the scope of the First Lien Agreement's description of "open market purchase." Serta argued that an "open market purchase" is "merely an acquisition of 'something for value in competition among private parties.' "[6]

Before the New York court could reach a decision, Serta filed for chapter 11 bankruptcy in the Southern District of Texas in January 2023. Simultaneously with its bankruptcy filing, Serta initiated a declaratory judgment suit against the Excluded Lenders seeking a ruling from the bankruptcy court that the Uptier Transaction was valid.[7]

In his opinion confirming Serta's chapter 11 plan of reorganization (the "*Plan*"), bankruptcy court judge David R. Jones found that the Uptier Transaction constituted a valid "open market purchase" because it was "something obtained for value in competition among private parties" following a process he described as "the quintessential 'Wall Street' open market purchase."[8] Further, Judge Jones determined that the Uptier Transaction "was negotiated in good faith and at arm's length by and among" Serta and the Participating Lenders, "and was the result of a highly competitive process amongst sophisticated financial actors."[9] In furtherance of the Uptier Transaction, the confirmed Plan contained an indemnity provision in favor of the Participating Lenders against any liability to the Excluded Lenders, which Judge Jones found "represent a valid exercise of the Debtors' business judgment" and "were given in exchange for good and valuable consideration provided by" the Participating Lenders.[10]

Fifth Circuit Ruling

The Fifth Circuit rejected the bankruptcy court's conclusions, saying that Serta did not buy back its loans on a transparent and competitive secondary loan market, instead choosing to engage privately with its individual lenders.[11] The Court held that the exchange of new super-priority loans for old loans in the Uptier Transaction was not a permissible "open market purchase" of the old loans within the bounds of the First Lien Agreement.[12] Rather, an "open market purchase" is limited to the purchase of corporate debt that occurs on the secondary market for syndicated loans.[13] By transacting with the Participating Lenders on a private basis in a way that was not open to all sellers of the old loans, Serta avoided the secondary market altogether and violated the Excluded Lenders' right to ratable repayment.

The Fifth Circuit also held that the related indemnity granted to the Participating Lenders in Serta's Plan violated the Bankruptcy Code and should be excised from the Plan, which the Participating Lenders' had argued the Court was barred from reviewing on equitable mootness grounds (in addition to arguments that the indemnity itself was permissible under the Bankruptcy Code).[14] The Court found that the indemnity violated Section 502(e)(1)(B) of the Bankruptcy Code, which disallows contingent claims for reimbursement where the claimant is co-liable with the debtor.[15] Because the Participating Lenders and Serta were both liable to the Excluded Lenders for breach of the First Lien Agreement, the Participating Lenders were not entitled to any protection through the bankruptcy case of their contingent reimbursement claims against Serta.[16]

Next Steps

Serta's Plan remains valid and binding, albeit without the indemnity provision in favor of the Participating Lenders. The Fifth Circuit's opinion preserved the Excluded Lenders' breach of contract claim against the Participating Lenders, who now have no right to indemnification from Serta if the Excluded Lenders' claims are successful.

It remains for the Bankruptcy Court to adjudicate the Excluded Lenders' claims for breach of contract, including breach of the implied covenant of good faith and fair dealing (which the Fifth Circuit ruled had not been sufficiently briefed) and determine whether any of the Participating Lenders' recovery under the Plan should be disgorged in favor of the Excluded Lenders in order to achieve pro rata treatment.

On January 7, 2025, Serta and the appellees/Participating Lenders filed a motion for an extension of time to file rehearing petitions in the Fifth Circuit, requesting a 21-day extension of the January 14, 2025 deadline to file a petition for rehearing to February 4, 2025. Per the motion, the appellants/Excluded Lenders have consented to the requested extension.

Market Implications

The Fifth Circuit's decision provides minority lenders with more support to challenge liability management transactions to the extent they rely on "open markets" language to offer senior debt on a non-pro rata basis. However, the success or failure of these transactions (or challenges to such transactions) will always come down to the language in the applicable debt instrument. For example, on the same day the Fifth Circuit issued its decision discussed here, the Supreme Court of New York, Appellate Division upheld a similar uptier transaction.[17] The New York decision upheld the transaction because the loan agreement there permitted the borrower to purchase loans by ordinary assignment and did not require an "open market" process.[18]

For More Information

We are available at any time to answer questions, discuss scenarios, and provide guidance. If you would like further information concerning the matters discussed in this article, please contact the following attorneys or the Chapman attorney with whom you regularly work.

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1 *In re Serta Simmons Bedding, LLC*, Case No. 23-20181 (5th Cir. Dec. 31, 2024).
2 *Id.* at 8.
3 *Id.* at 11.
4 *Id.* at 8.
5 *Id.* at 10.
6 *Id.* at 32-33.
7 *Id.* at 12-13.
8 *Serta Simmons Bedding, LLC v. AG Centre Street Partnership*, Adv. Case No. 23-9001 (June 6, 2023).
9 *In re Serta Simmons Bedding, LLC*, Case No. 23-90020 (S.D. Tex. June 14, 2023).
10 *Id.* at 19.
11 *Serta*, Case No. 23-20181 at 29.
12 *Id.*
13 *Id.*
14 *Id.* at 39-46.
15 *Id.* at 47.
16 *Id*.
17 *Ocean Trails Co., et al. v. MLN Topco Ltd., et al.,* Case No. 2024-00169 (N.Y. App. Div. Dec. 31, 2024).
18 *Id.*