ALERT MEMORANDUM

The Fifth Circuit Pushes Back on Uptier Transactions in *Serta*

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Key Takeaways

- On appeal, the Fifth Circuit reversed the U.S. Bankruptcy Court for the Southern District of Texas and ruled that Serta's 2020 uptier exchange was not a valid open market purchase under the Company's credit agreement.
- The Fifth Circuit also excised from Serta's confirmed bankruptcy plan a post-petition indemnity in favor of the majority lenders for losses arising from legal challenges to the uptier transaction.
- The decision only binds courts in the Fifth Circuit, but it shows that some courts will narrowly construe underlying debt documents, and consider contextual issues, when scrutinizing liability management exercises.
- Accordingly, *Serta* could impact the drafting of buyback provisions in syndicated credit agreements.

On December 31, 2024, the U.S. Court of Appeals for the Fifth Circuit (the "Fifth Circuit") issued its highly anticipated decision on the 2020 uptier exchange and subsequent bankruptcy plan of Serta Simmons Bedding, LLC ("Serta" or the "Company"),[1] overruling the U.S. Bankruptcy Court for the Southern District of Texas (the "Bankruptcy Court"). The Fifth Circuit held that (a) Serta's 2020 uptier exchange (the "Uptier Transaction") was not an open market purchase under the Company's First Lien Term Loan Credit Agreement (the "2016 Credit Agreement") and (b) an indemnity in favor of lenders participating in the Uptier Transaction contained in Serta's confirmed chapter 11 bankruptcy plan must be excised. While an important decision in its own right, this case is only binding on courts in the Fifth Circuit, and other circuit courts have yet to weigh in on these specific issues, as challenges to uptier exchanges and other liability management exercises ("LMEs") have only recently started making their way through courts.[2] While challenges to individual LMEs will be fact-intensive and turn on the specific language in the underlying documents, the Fifth Circuit's decision represents at least one circuit's willingness to interpret contractual language that is found in many syndicated loan agreements narrowly.

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[1] *In re Serta Simmons Bedding, L.L.C.*, Case No. 23-20181 (5th Cir. Dec. 31, 2024) (hereinafter, "*Serta*").
[2] *See* the discussion below of cases involving Mitel Networks, Wesco Aircraft (d/b/a Incora), and American Tire Distributors.

Background

Serta is a North American bedding manufacturer that has been a serial target of leveraged buyout transactions. Following a recapitalization in 2016, Serta's business foundered. In 2020, Serta announced an uptier exchange with a majority of its existing first-lien and second-lien lenders (the "Majority Lenders") to issue at least $1.075 billion in new super-priority loans. Serta's main debt at the time consisted of three credit facilities, including: (i) $1.95 billion in first-lien term loans governed by the 2016 Credit Agreement; (ii) $450 million in second-lien term loans governed by a separate credit agreement; and (iii) a $225 million asset-based revolving loan. The Uptier Transaction contemplated three different new super-priority loans that would prime the existing loans: (i) a $200 million super-priority "first-out" tranche of new money; (ii) a $875 million super-priority "second-out" tranche, consisting of debt exchanged on a cashless basis through an "*open market purchase*" for approximately $1 billion of existing first-lien term loans (at a 74% exchange rate) and approximately $300 million of second-lien term loans (at a 39% exchange rate); and (iii) a never-utilized super-priority "third-out" tranche. Serta amended the 2016 Credit Agreement with a narrow majority of its lenders to allow the Uptier Transaction. Upon completion, the $1.075 billion of super-priority term loans had priority liens on collateral, ahead of approximately $895 million of remaining first-lien term loans and approximately $128 million of second-lien term loans held by the lenders that did not receive the opportunity to participate in the Uptier Transaction (such lenders, the "Minority Lenders").

Several funds (the "Plaintiffs") quickly challenged the Uptier Transaction in the U.S. District Court for the Southern District of New York (the "SDNY District Court"). There, the Plaintiffs argued that the Uptier Transaction was not a permitted "*open market purchase*," because it was offered only to a "handpicked" group of lenders. Furthermore, the Plaintiffs asserted that even if Serta had not breached the specific terms of the 2016 Credit Agreement, it had violated the implied covenant of good faith and fair dealing under New York law. In March 2022, the SDNY District Court denied Serta's motion to dismiss and found that the term "*open market purchase*" was ambiguous, questioning Serta's interpretation that "*open market purchase*" simply meant negotiated at arms-length (regardless of whether such purchase was offered to only a subset of lenders). The SDNY District Court also found that the Plaintiffs had stated a claim for breach of the implied covenant of good faith and fair dealing.

The Uptier Transaction failed to forestall Serta's January 2023 chapter 11 bankruptcy filing. In its chapter 11 case, Serta (along with certain Majority Lenders) filed a declaratory action seeking a determination that the Uptier Transaction was not a breach of contract. Judge David Jones (who has since resigned) granted summary judgment for Serta, holding that the Uptier Transaction qualified as an "*open market purchase*," and that the Uptier Transaction did not violate the implied covenant of good faith and fair dealing. Unlike the SDNY District Court, Judge Jones held that "*open market purchase*" was a "clear and unambiguous term," and the Uptier Transaction did not violate the 2016 Credit Agreement's pro-rata sharing provision, which generally requires payments to lenders to be allocated to all lenders on a pro-rata basis with respect to their holdings, because it satisfied the exception for open market purchases. Judge Jones also confirmed Serta's second amended bankruptcy plan, including a new post-petition indemnity in favor of certain Majority Lenders that he found was a fair and equitable aspect of a settlement under 11 U.S.C. § 1123(b)(3). Minority Lenders appealed to the Fifth Circuit.

The Fifth Circuit Decision

Writing for a three-judge panel, Judge Andrew S. Oldham began his opinion with an overview of uptier transactions that foreshadowed the outcome of the appeal. "Ratable treatment is an important background norm of corporate finance,"[3] he explained, reasoning

[3] *Serta* at 4.

that the "costs of an uptier transaction are born (*sic*) entirely by the minority lenders."[4] After reviewing the jurisdictional issues, which we do not summarize here, Judge Oldham turned to analyzing the open market purchase provision of the 2016 Credit Agreement and the indemnity under Serta's chapter 11 plan.

The Fifth Circuit concluded that the Uptier Transaction did not constitute an "*open market purchase*" under the 2016 Credit Agreement and reversed the Bankruptcy Court. The panel determined that "an 'open market' is a specific market that is generally open to participation by various buyers and sellers," and an "*open market purchase*" occurs on such market "as is relevant to the purchased product."[5] In this instance, the Fifth Circuit found that the relevant market was the secondary syndicated loan market. By contrast, the Uptier Transaction saw Serta negotiate privately with individual lenders "outside" the secondary market, thereby, according to the Fifth Circuit, forgoing the open market purchase exception to ratable treatment.[6] The Fifth Circuit noted that to read the open market purchase provision more broadly, as Serta and the Majority Lenders proposed, would render redundant the 2016 Credit Agreement's detailed procedure for repurchases of debt by a Dutch auction, the other specific exception to ratable treatment.

The Fifth Circuit declined to accept arguments by Serta and the Majority Lenders for a broader reading of "*open market purchase*" based on textual interpretation, industry usage, and the fact that a subset of the Minority Lenders had proffered a similar restructuring transaction at one point. Additionally, the Fifth Circuit rejected the argument that the open market purchase provision's omission of the words "open to all Lenders" (which appeared in the Dutch auction mechanics) suggested that buybacks could be open only to certain lenders. Instead, the Fifth Circuit found that the term "*open market purchase*" by its own meaning contemplates a transaction public and open to most, if not all, lenders.[7] While the Company and the Majority Lenders pointed to the guide published by the Loan Syndications and Trading Association ("LSTA") as supporting their position, the Fifth Circuit disagreed, noting that the LSTA guide was not binding authority and, even if it were, it did not support the Company and the Majority Lenders' position, either because it contemplated a debt buyback (rather than a debt-for-debt exchange) or because it included language referring to an agreed-upon cap, which was not present in the Uptier Transaction.[8]

Significantly, the Fifth Circuit also overruled the Bankruptcy Court by excising from Serta's confirmed plan an indemnity in favor of the Majority Lenders that continued to hold super-priority claims (as of the plan's effective date) for losses arising from legal challenges to the Uptier Transaction. The Fifth Circuit termed the indemnity provision an "impermissible end-run around the Bankruptcy Code,"[9] as 11 U.S.C. § 502(e)(1)(B) disallows contingent claims when the claimant is co-liable with the debtor. The amended plan's characterization of the indemnity as a "settlement" under 11 U.S.C. § 1123(b)(3)(A) did not cure the fact that the indemnity was a contingent claim. Finally, the Fifth Circuit determined that the indemnity breached the Bankruptcy Code's "equal treatment" requirement,[10] because the indemnity was provided to all creditors holding super-priority debt as of the chapter 11 plan effective date, whether such creditors had participated in the Uptier Transaction or had subsequently acquired super-priority debt in secondary markets. The Fifth Circuit specified that the indemnity provided negligible value to holders of super-priority debt that had not originally participated in the Uptier Transaction, but was "potentially worth tens of millions of dollars" to creditors that had originally participated in the Uptier Transaction.[11] In

[4] *Id.* at 7.
[5] *Id.* at 29.
[6] *Id.*
[7] *Id.* at 33-34.
[8] *Id.* at 35-38.
[9] *Id.* at 39.
[10] *See* 11 U.S.C. § 1123(a)(4) (requiring that a plan "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest").
[11] *Serta* at 44.

keeping with its historical skepticism of "equitable mootness," a judicial doctrine that promotes finality in bankruptcy cases, the Fifth Circuit reasoned that equitable mootness could not serve as a "shield" against the excision of the indemnity,[12] because such excision would not "affect either the rights of parties not before the court or the success of the plan."[13] Rather than causing the plan's collapse, the Fifth Circuit observed that Serta would benefit from the excise of the indemnity, as it would no longer be burdened by potential indemnity claims.

Based on its reading of the open market purchase provision, the Fifth Circuit vacated the Bankruptcy Court's ruling in part and remanded the Minority Lenders' claims for breach of contract, including breach of the implied covenant of good faith and fair dealing, which it stated had not been sufficiently briefed. The Fifth Circuit also reversed the confirmation of Serta's bankruptcy plan with respect to the indemnity.

Implications and Ongoing Cases

While Serta is widely cited as one of "the first major uptier" exchanges,[14] numerous LMEs since the J.Crew transaction in 2016 have relied on similar interpretations of syndicated credit agreements, and LMEs have proliferated in Serta's wake, resulting in ongoing litigation as courts determine the boundaries of permissible LMEs. Outcomes in these cases will continue to turn on often minute differences in the relevant debt documentation.

On the same day as the Fifth Circuit's decision in *Serta*, the Appellate Division of the Supreme Court of New York, First Department (the "Appellate Division") upheld an uptier transaction by telecommunications company Mitel Networks.[15] However, in *Mitel*, the issue was not the meaning of the open market purchase exception to lien subordination, but rather language in the applicable credit agreement that allowed the borrower to "purchase by way of assignment and become an Assignee with respect to Term Loans at any time."[16] According to the Appellate Division, this language allowed the uptier transaction, because it permitted individual purchases of debt at any time on a non-pro-rata basis – a critical difference compared to the "open market" requirement at issue in *Serta*. Moreover, unlike the transaction structure in *Serta*, the assignment, cancellation, and replacement of loans on new terms did not represent an amendment of the loans, and the effect on the minority lenders' loans was indirect, whereas a change in the loan terms required the consent of "each Lender directly adversely affected."[17]

Yet *Serta* is not the only recent example of a court invalidating an uptier transaction. In the *Wesco Aircraft* case,[18] Judge Marvin Isgur of the U.S. Bankruptcy Court for the Southern District of Texas declared in a July 2024 ruling that the March 2022 non-pro-rata exchange transaction by Wesco Aircraft Holdings (d/b/a Incora) violated its notes indenture, because the transaction did not meet the requisite 66 2/3% consent threshold, and the company's attempt to issue additional notes to certain holders to satisfy that threshold breached the underlying indenture's terms. Thus, the court restored all "rights, liens and interests" of the relevant secured noteholders. The question of open market purchases was not relevant in *Wesco Aircraft*, because notes issued under an indenture were involved which, unlike credit agreements, do not include pro-rata sharing provisions. As in *Serta*, *Wesco Aircraft* shows that courts may closely scrutinize underlying debt documents and look at the overall impact of an LME in deciding whether an LME is permissible under the applicable agreements.

[12] *Id.* at 45.
[13] *Id.* at 41 (internal citations and quotations omitted).
[14] *Id.* at 54.
[15] *Ocean Trails CLO VII et al. v. MLN Topco Ltd. et al.*, Case No. 2024-00169 (N.Y. App. Div. Dec. 31, 2024) (hereinafter, "*Mitel*").
[16] *Id.* at 3.
[17] *Id.* at 2.
[18] *Wesco Aircraft Holdings, Inc. et al. v. SSD Investments Ltd. et al.*, Case No. 23-03091 (Bankr. S.D. Tex. July 10, 2024), ECF No. 1466.

As the Fifth Circuit noted, many lenders now negotiate for so-called "uptier blockers" or "Serta blockers."[19] For instance, the credit agreement at issue in the contested DIP financing hearing in *In re American Tire Distributors* includes Serta blocker language that requires each affected lender's consent for an amendment that would subordinate senior liens to super-priority liens, unless all lenders receive the same opportunity pro rata, with a DIP financing exception. Judge Craig T. Goldblatt of the U.S. Bankruptcy Court for the District of Delaware indicated that, while the proposed DIP lenders could rely upon the DIP financing exception in the Serta blocker to avoid giving all lenders the same opportunity to participate in the priming DIP facility, a rollup of prepetition debt into the DIP facility would, in his view, violate the pre-bankruptcy credit agreement's prohibitions on non-pro-rata payments, which did not contain a DIP facility exception.[20] To avoid litigation, the proposed DIP lenders abandoned the rollup.

Potential Changes in Documentation

The Fifth Circuit's decision in *Serta* will likely impact the drafting of buyback provisions in syndicated credit agreements that contain similar language permitting open market purchases and Dutch auctions.[21] The outcome will depend on the scope of the other protections against LMEs in such credit agreements.

In the wake of *In re American Tire Distributors*, we may see additional exceptions for DIP financings, not only in Serta blockers, but also in the sacred rights protection for the pro-rata provisions.

Finally, the Fifth Circuit's decision to excise the Majority Lender indemnity from the confirmed bankruptcy plan, while limited to courts within the circuit, could have broader implications for bankruptcy cases and indemnities in agreements to implement LMEs.

Conclusion

The Fifth Circuit's ruling in *Serta* is significant with respect to the permissibility of LMEs under syndicated loan agreements, but it is not binding on courts outside the Fifth Circuit and, at this point, there is no emerging uniform trend in the caselaw. Decisions on LMEs will continue to be fact-specific, based on the language of the underlying contracts. Overall, the *Serta* decision demonstrates that at least some courts will carefully construe language, in context, with a view towards fundamental bankruptcy principles, such as equal treatment for similarly situated creditors.

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[19] *Serta* at 54.

[20] *In re American Tire Distributors, Inc.*, Case No. 24-12391-CTG (Bankr. D. Del. Nov. 19, 2024), ECF No. 292.

[21] The *Serta* decision should not necessarily have similar implications for bond documentation, where broader buyback provisions are more typical.