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ALERT

Bedtime for Serta: The Fifth Circuit Unravels Serta's Uptier LME Transaction

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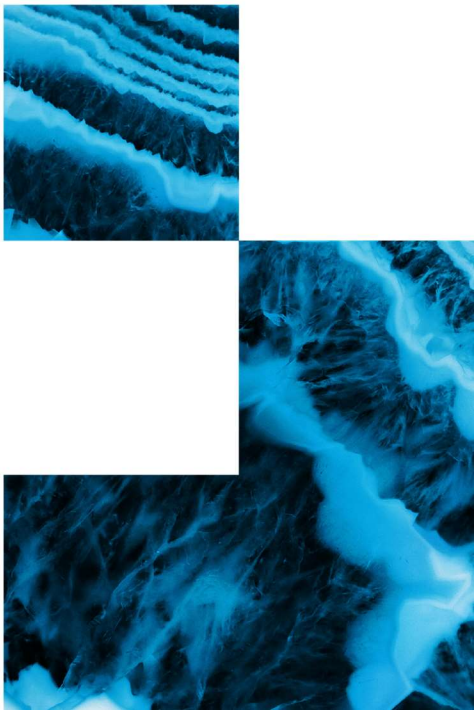

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Bedtime for Serta: The Fifth Circuit Unravels Serta's Uptier LME Transaction

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On Dec. 31, 2024, the US Court of Appeals for the Fifth Circuit issued a long-awaited decision reversing the ruling of former Judge David Jones of the Bankruptcy Court for the Southern District of Texas, blessing the Serta Simmons Bedding 2020 uptier transaction. The ruling deemed the uptier transaction impermissible and potentially puts pressure on other uptiering transactions. *In re Serta Simmons Bedding, LLC*, No. 23-20181 (5th Cir. Dec. 31, 2024).

More specifically, the Court held that Serta's exchange of the Prevailing Lenders' (i.e., participating lenders) existing debt for new super-priority debt — to the detriment of Excluded and LCM Lenders (i.e., non-participating lenders who objected to the transaction) — did not qualify as a permissible open market purchase under the governing loan agreement and violated the agreement's *pro rata* sharing provision. The Fifth Circuit also excised from Serta's bankruptcy Plan provisions indemnifying certain Prevailing Lenders that participated in the transaction and other selected parties. The Fifth Circuit remanded the Excluded Lenders' potential breach claims against the Debtors and Prevailing Lenders for further consideration at the Bankruptcy Court.

The Fifth Circuit's *Serta* decision reversed the Bankruptcy Court's decision that was notably favorable to the uptiering transaction. While the *Serta* ruling is contract-specific and does not signal any pattern for future liability management transactions, it does demonstrate that courts in the Fifth Circuit (most notably the Houston Bankruptcy Court) cannot rubber stamp similar transactions. Consequently, we expect increased caution in considering liability management transactions, especially ones that involve non-*pro-rata* debt exchanges. In its preamble, the Fifth Circuit states: "Ratable treatment is an important background norm of corporate finance. Pursuant to this norm, a borrower must treat all of its similarly situated lenders, well, similarly."

Background

A. The Terms of the 2016 Credit Agreement

In 2016, Serta entered into its First Lien Term Loan Agreement. The following provisions of the loan form the center of the case:

- **§ 2.18 (*Pro-Rata* Sharing):** Pursuant to § 2.18, "[e]ach Borrowing, each payment or prepayment of principal of any Borrowing, each payment of interest in respect of the Loans of a given Class and each conversion of any Borrowing…shall be allocated *pro rata* among the Lenders in accordance with their respective Applicable Percentages of the applicable Class."
- **§ 9.01(b)(A) (Protection of Sacred Rights):** As noted by the Fifth Circuit, "[r]atable treatment is such an important norm that it is often described as a lender's 'sacred right.'" To protect this sacred right, § 9.01(b)(A) requires "unanimous consent of any affected lender to waive, amend, or modify § 2.18 in any way that would 'alter the pro rata sharing of payments required thereby.'"

- **§ 9.05(g) (Exceptions to *Pro-Rata* Sharing):** § 9.05(g) sets out two ways through which Serta can repay loans without having to engage in *pro rata* sharing: (1) a Dutch auction, and (2) an open market purchase (which the loan leaves undefined).

B. The Uptier

In 2020, after facing years of financial hardship, exacerbated by the pandemic, Serta entered into the uptiering transaction with the Prevailing Lenders. To carry out the uptier, Serta and the Prevailing Lenders took the following steps:

- Taking advantage of the Prevailing Lenders' majority of the outstanding first-lien debt, Plaintiffs amended the loan to allow the uptier.
- Plaintiffs preemptively labeled the uptier an "open market purchase," "apparently in recognition that the 2016 Agreement's ratable-sharing provision would otherwise bar the 2020 Uptier."
- Serta agreed to indemnify Prevailing Lenders for any and all future losses, claims, damages and liability incurred in connection with Prevailing Lenders' participation in the uptier.

C. Prior Proceedings

In January 2023, Serta filed for Chapter 11 Bankruptcy in the Southern District of Texas. On Jan. 24, 2023, Plaintiffs (here, the Debtors and Participating Lenders) filed an action in the Bankruptcy Court seeking a declaratory judgment that the uptier (i) was permitted by the loan agreement's *pro-rata* provision, and (ii) did not violate the implied covenant of good faith and fair dealing. The Bankruptcy Court ruled for Plaintiffs, granting partial summary judgment and holding that the uptier was an open market purchase.

Serta then proposed a Chapter 11 Plan premised upon the capital structure implemented following the uptier. Serta's final proposed Plan contained an indemnity that only covered certain Prevailing Lenders and other selected parties. The Bankruptcy Court ultimately confirmed this Plan and ruled in favor of the indemnity provision.

The Excluded and LCM Lenders appealed both the open market purchase ruling and the indemnity ruling, and the Fifth Circuit consolidated the appeals for resolution.

The Validity of the Uptier as an Open Market Purchase

The Fifth Circuit held that the uptier was not a permissible open market purchase within the plain meaning of § 9.05(g) of the loan. Focusing on the language of the loan itself, the Fifth Circuit reached this conclusion for two reasons.

First, the Fifth Circuit found that an "'open market' is a specific market that is generally open to participation by various buyers and sellers" and an open market purchase "takes place on such a market as is relevant to the purchased product — here, the secondary market for syndicated loans." Thus, "if [Serta] wished to make a § 9.05(g) open market purchase and thereby circumvent the sacred right of ratable treatment, it should have purchased its loans on the secondary market," not "privately engage individual lenders outside of this market."

Second, the Court's definition of open market purchase comports with § 9.05(g)'s other exception (i.e., the Dutch auction), while Plaintiffs' more expansive definition of an open market "would swallow that exception and render it surplusage." According to Serta's brief, an open market purchase is simply an acquisition of "something for value in competition among private parties." The Fifth Circuit noted that if Plaintiffs' definition governs, "the Dutch auction exception does no work," because "the completion of a Dutch auction and accompanying buyback of loans would constitute an acquisition for value in competition among participants."

Based upon the above analysis, the Fifth Circuit reversed the Bankruptcy Court's decision and remanded Excluded Lenders' breach of contract counterclaims for reconsideration.

Invalidating the Plan's Indemnity

A. The Merits of Excising the Indemnity

Turning to the merits of the confirmed Plan's indemnity, the Fifth Circuit held that the indemnity "was an impermissible end-run around" Bankruptcy Code § 502(e)(1)(B) and violative of the Code's equal treatment requirement.

- **§ 502(e)(1)(B)**

The Fifth Circuit ruled in favor of excising the indemnity from the confirmed Plan because it is impermissible under § 502(e)(1)(B).

Bankruptcy Code § 502(e)(1)(B) prohibits reimbursement of contingent claims where the claiming entity is co-liable with the debtor. However, Bankruptcy Code § 1123(b)(3)(A) allows a plan to provide for the settlement of any claim belonging to the debtor.

Because Prevailing Lender plaintiffs' claims for indemnification fall within § 502(e)(1)(B), Plaintiffs recharacterized the initial indemnity as a settlement between Serta and Prevailing Lender plaintiffs in the confirmed Plan, hoping for it to fall within the ambit of § 1123(b)(3)(A). In support of this recharacterization, Plaintiffs argued that the Plan indemnity differed from the pre-petition indemnity provisions. More specifically, Plaintiffs argued that the "pre-petition indemnity covered all of and only the Prevailing Lenders who participated in the 2020 Uptier, whereas the settlement indemnity covered only those holders of super-priority debt as of June 29, 2023," meaning that "the settlement indemnity was not an impermissible attempt to resurrect the pre-petition indemnity."

The Fifth Circuit rejected this argument, holding that "the settlement indemnity is sufficiently similar to the pre-petition indemnity so as to still view it as an end-run around § 502(e)(1)(B)." The Fifth Circuit went on to explain that if Plaintiffs' argument was "[t]aken to its logical conclusion, a § 1123(b)(3)(A) settlement could thus resurrect a clearly disallowed claim or related indemnity so long as it was modified slightly from its original form."

- **Equal Treatment**

The Fifth Circuit additionally held that "[e]ven if the settlement indemnity was justified under § 1123(b)(3)(A), its inclusion in the Plan violated the Code's requirement of equal treatment."

Bankruptcy Code § 1123(a)(4) sets out that a plan must "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."

The Fifth Circuit found that the Plan's inclusion of the indemnity violated § 1123(a)(4) because "the expected value of the indemnity varied dramatically depending on whether members had participated in the 2020 Uptier." For example, to Prevailing Lender plaintiffs, the indemnity could be worth millions of dollars, but to class members who had no involvement with the uptier, the indemnity was worth little or even nothing.

The Fifth Circuit further stated that the Supreme Court, in *Czyzewski v. Jevic Holding Corp.*, 580 U.S. 451 (2017), previously held that the Bankruptcy Code's priority scheme is embedded in the entire Bankruptcy Code – and any actions under the Bankruptcy Code must comport with bankruptcy priority – irrespective of the language of a specific provision of the Bankruptcy Code. Quoting *Jevic*, the Fifth Circuit held: "'statutory construction . . . is a holistic endeavor,' by which courts must 'look to the provisions of the whole law.' . . . Without adequate textual support for its maneuver, the bankruptcy court was wrong to approve such an end-run around the Code."

Holding that the court may "fashion whatever relief is practicable' for the benefit of [Defendants]," the Fifth Circuit excised the offending indemnity.

B. Plaintiffs' Equitable Mootness Argument

In ruling whether to excise the indemnity from the confirmed Plan, the Fifth Circuit also addressed Plaintiffs' argument that the request for excision is equitably moot. The Fifth Circuit held that the argument is not equitably moot.

To determine equitable mootness, courts analyze three factors: "(i) whether a stay has been obtained, (ii) whether the Plan has been 'substantially consummated,' and (iii) whether the relief requested would affect either the rights of parties not before the court or the success of the Plan." The Fifth Circuit exercises caution in applying equitable mootness to direct appeals from the Bankruptcy Court.

The Fifth Circuit held that while Defendants failed to obtain a stay of the Plan's confirmation and the Plan had been substantially consummated, these two factors are not dispositive. Instead, the Fifth Circuit looked to the third factor, holding that no third party rights would be affected by excision. The Fifth Circuit also rebuked Plaintiffs' contention that by excising the indemnity the entire Plan would be unwound, stating that "excision does not toll doom for the Plan, and the third factor properly weighs against equitable mootness." Moreover, the Court stated: "To the extent equitable mootness exists, we affirm that it cannot be 'a shield for sharp or unauthorized practices.'"

Takeaways

- The *Serta* ruling marks the first federal Court of Appeals ruling on the recent spate of liability management transactions. Thus it will receive significant attention from other courts.
- However, its practical impact (and applicability to other LMEs) remains unclear. The *Serta* decision (like other recent LME opinions) is focused on the plain language of the specific loan agreement. Of course, each credit agreement has its own language.
- Questions remain whether the *Serta* decision will apply to other uptier LMEs where credit documents contain dissimilar buyback language but the uptier LME has the same net effect as the *Serta* LME.
- What remains clear, however, is that *Serta* demonstrates that uptier transactions will continue to receive close judicial scrutiny.
- As the Fifth Circuit's ruling regarding the Plan's indemnity demonstrates, the Bankruptcy Code's core principles and provisions (*e.g.*, § 502(e)(1)(B) and equal treatment) will prevail once LMEs are brought to courts that must apply Federal bankruptcy law. Any use of a Plan to resolve a LME will face typical plan scrutiny.
- The Court makes general statements about ratable treatment and cites to the Code's precepts of ratable treatment consistent with *Jevic.*
- The decision revives the breach of contract claims of the non-participating lenders. We expect litigation to continue as the non-participating lenders reevaluate their claims against the participating lenders following this decision.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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