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CLIENT ALERT

Houston We Have a Problem Serta's Non-Pro Rata Uptier Transaction Is Reversed on Appeal

January 14, 2025

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On December 31, 2024, a three-judge panel of the Fifth Circuit Court of Appeals (the "Court") issued its much anticipated decision in *Excluded Lenders v. Serta Simmons Bedding, LLC (In re Serta Simmons Bedding, LLC)* (the "Appellate Decision").[1] Applying New York law, the Court held that the non-ratable debt-for-debt exchange (the "Exchange") integrated into Serta's 2020 uptier transaction was not an "open market purchase" under its First Lien Term Loan Agreement (the "2016 Credit Agreement"). As a result, the Court concluded that the lenders excluded from the Exchange (the "Excluded Lenders") had a "strong case" that Serta and the majority lenders (the "Prevailing Lenders")[2] breached the 2016 Credit Agreement's sacred right of pro rata treatment. The Court also excised the Prevailing Lenders' indemnity included in Serta's confirmed chapter 11 plan (the "Plan") and clarified the narrow scope of the equitable mootness doctrine in the Fifth Circuit.

1 *Excluded Lenders v. Serta Simmons Bedding, LLC (In re Serta Simmons Bedding, L.L.C.)*, No. 23-20181, 2024 U.S. App. LEXIS 32969 (5th Cir. Dec. 31, 2024).

2 The Prevailing Lenders constituted "Required Lenders" under both the 2016 Credit Agreement and the Second Lien Term Loan Agreement.

As we explore further, while its impact will be felt beyond the Fifth Circuit (which includes two of the most popular bankruptcy venues), time will tell whether the Appellate Decision means that lenders can truly rest easy.

Background

In 2020, Serta had (i) $1.95 billion in first lien term loans; (ii) $450 million in second lien term loans; and (iii) a $225 million asset-based revolving loan. The 2016 Credit Agreement governing the first lien term loans included a few key provisions relevant to this dispute:

Section 2.18 required that "each payment . . . of principal . . . be allocated pro rata among the Lenders" and required Lenders to share any payments on a pro rata basis if they received more than their pro rata share of any payments on their loans.[3] Section 9.02(b)(A) provided that this "sacred right of pro rata sharing" could not be waived, amended or modified "in any way that would 'alter the pro rata sharing of payments required thereby'" without the consent of each affected lender unless an enumerated exception applied.[4]

However, Serta and the Prevailing Lenders relied on an exception to Section 2.18's pro rata protections under Section 9.05(g), which provided that a lender may assign its rights to Serta on a non pro rata basis either through an "open market purchase" or a "Dutch auction" open to all lenders.

Faced with tightening liquidity during the COVID-19 pandemic, Serta engaged in negotiations with two competing lender groups, the Prevailing Lenders and a subset of the Excluded Lenders, which resulted in the "uptier" transaction with the Prevailing Lenders. The uptier transaction included two related components. First, the issuance of additional "super-priority" debt, whereby Serta and the Prevailing Lenders amended the 2016 Credit Agreement to allow Serta to incur $200 million in first-out super-priority loan financing, to be financed with new money, and $875 million in second-out super-priority loans, to be used in the Exchange. Both tranches of super-priority loans were senior in priority to the existing first lien term loans. Second, the Exchange, whereby the Prevailing Lenders exchanged $1.2 billion in first and second lien term loans for $875 million in second-out super priority debt.[5] This left the Excluded Lenders behind, subordinating their claims to $1.075 billion of the new super-priority loans of the Prevailing Lenders.

Following the Exchange, certain Excluded Lenders brought suit in the Southern District of New York, challenging the Exchange as violating Section 2.18 because it did not provide for a pro rata exchange of debt and was neither a "Dutch auction" nor an "open market purchase."[6] In March 2022, the district court denied Serta's motion to dismiss the complaint, finding the term "open market purchase" ambiguous and undefined in the 2016 Credit Agreement,

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3 2016 Credit Agreement §§ 2.18(a), (c); see also *Excluded Lenders*, No. 23-20181, 2024 U.S. App. LEXIS 32969 at *10.

4 *Id.* at *11.

5 The only issue before the Court on appeal was whether the Exchange component of the uptier transaction amounted to an "open market purchase." The first and second lien obligations held by the Prevailing Lenders was uptiered at a discount to par but at a value in excess of the current trading price in the secondary loan market at the time.

6 Compl. at 11, *LCM XXI Ltd v. Serta Simmons Bedding, LLC*, No. 21 Civ. 3987 (S.D.N.Y. Mar. 4, 2021), ECF No. 1.

thus requiring further discovery.[7] However, on January 23, 2023, Serta and its affiliated debtors filed for chapter 11 relief in the Southern District of Texas Bankruptcy Court.[8]

In its chapter 11 cases, Serta, along with certain Prevailing Lenders, commenced an adversary proceeding against the Excluded Lenders seeking a declaratory judgment that the Exchange: (i) did not breach the terms of the 2016 Credit Agreement; and (ii) did not violate the implied covenant of good faith and fair dealing.[9] In response, the Excluded Lenders asserted various counterclaims, challenging the Exchange under both the terms of the 2016 Credit Agreement and the implied covenant of good faith and fair dealing.[10]

The bankruptcy court ultimately granted summary judgment in favor of Serta and the Prevailing Lenders, reasoning that the term "open market purchase" was clear and unambiguous and that the "Exchange" fit within the "common meaning" of the term.[11]

Serta then submitted its Plan for confirmation. The terms of the prepetition Exchange had included an indemnity from Serta which protected the Prevailing Lenders from any costs or damages resulting from or related to the 2020 uptier transaction. Serta initially sought to assume the prepetition indemnity, however, all parties recognized such assumption was not permitted under the Bankruptcy Code.[12] Recognizing the legal limitation, Serta amended the Plan on the eve of the confirmation hearing to include a "settlement indemnity" that effectively allowed the prepetition indemnity to survive the bankruptcy.[13] Certain Excluded Lenders objected to the Plan's indemnity, claiming that it was an impermissible end-run around section 502(e)(1)(B)'s limitation regarding such contingent claims.[14]

After a combined trial on the Plan and the remaining claims in the adversary proceeding, the bankruptcy court found that the Exchange did not breach the implied covenant of good faith and fair dealing, that the Plan indemnity was a permissible settlement under Section 1123(b)(3)(A) of the Bankruptcy Code and did not violate Section 502(e)(1)(B),

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7 *LCM XXII Ltd. v. Serta Simmons Bedding, LLC*, 2022 U.S. Dist. LEXIS 57976, at *19, 51 (S.D.N.Y. Mar. 29, 2022).

8 Voluntary Pet., *In re Serta Simmons Bedding, LLC*, Ch. 11 Case No. 23-90020-DRJ (Bankr. S.D. Tex. Jan. 23, 2023), ECF No. 1.

9 Am. Adversary Compl. at 4, *Serta Simmons Bedding LLC, et al. v. AG Centre Street Partnership, et al.*, Ch. 11 Case No. 23-90020-DRJ, Adv. No. 23-09001 (Bankr. S.D. Tex. Feb 14, 2023) ECF No. 38.

10 Answer to the Am. Adversary Compl. at 103-111, *Serta Simmons Bedding LLC, et al. v. AG Centre Street Partnership, et al.*, Ch. 11 Case No. 23-90020-DRJ, Adv. No. 23-09001 (Bankr. S.D. Tex. Feb. 24, 2023) ECF No. 68.

11 Mot. Hr'g at 133-134, *Serta Simmons Bedding, LLC v. AG Ctr. St. P'ship (In re Serta Simmons Bedding, LLC)*, Ch. 11 Case No. 23-90020-DRJ, Adv. No. 23-09001 (Bankr. S.D. Texas Mar 31, 2023) ECF No. 133, (finding that "[w]hen I get to Section 9.05(g) there simply is no ambiguity in my mind. . . . In looking at the words and the common meaning . . . it is very clear to me that the process that was engaged in, fit within 9.05(g).").

12 Section 502(e)(1)(B) provides that the bankruptcy court must disallow any contingent claim for reimbursement where the claiming entity is co-liable with the debtor.

13 Section 1123(b)(3)(A) provides that a plan of reorganization may provide for the settlement or adjustment of any claim or interest belonging to the debtor or to the estate.

14 Suppl. Obj. to Plan Of Reorganization at 3, *In re Serta Simmons Bedding, LLC*, Ch. 11 Case No. 23-90020-DRJ (Bankr. S.D. Tex. May 25, 2023), ECF No. 998.

and that the Plan satisfied the other applicable requirements for confirmation.[15] Both decisions were certified for direct appeal to the Fifth Circuit.[16]

The Fifth Circuit Overturns the Bankruptcy Court's Decision and Holds that the Exchange Was Not an Open Market Purchase

In the Appellate Decision, the Court overruled the bankruptcy court's decision and held that the Exchange was not an "open market purchase" within the meaning of Section 9.05(g). As a result, the Court noted that the Excluded Lenders have "a strong case" that Serta and the Prevailing Lenders breached the 2016 Credit Agreement. The Court also found that the equitable mootness doctrine did not bar review of the Plan, and that the Plan's indemnities were improper under Section 502(e)(1)(b) of the Bankruptcy Code and should be excised.

The Court began with a discussion of ratable treatment and its importance in corporate finance. The Court noted that "[r]atable treatment is such an important norm that it is often described as a lender's sacred right under syndicated loan agreements" and that under the ratable treatment framework "lenders are treated equally, and individual lenders are protected from potential machinations by the majority."[17] With this background policy in mind, the Court then addressed the interplay of Sections 2.18 and 9.05(g).

The Court found that under the ratable treatment requirement incorporated into Section 2.18, Serta could not choose to pay its obligations to one lender within a class while offering nothing to the rest—unless one of the Section 9.05(g) exceptions applied.[18]

Serta and the Prevailing Lenders asserted several interpretations to cabin the 2020 transaction within the bounds of the "open market purchase" exception. Serta defined "open market purchase" as meaning "to acquire something for value in competition among private parties,"[19] and claimed that the Exchange met this standard because its terms were arrived at after receiving competing offers from a subset of the Excluded Lenders. Similarly, the Prevailing Lenders argued that an "open market purchase" should mean "a transaction where something is obtained for monetary value in a market where prices are set by competitive negotiations between private parties."[20]

The Court however, adopted a narrower view. Applying New York case law precedent, the dictionary definition of "open market" and other market guidance, the Court concluded that an "open market" does not exist merely because there was competition. Rather, "an open market is one tied to *a specific market*, like the stock market or the commodities market or the securities market. An open market is a *designated market*, not merely the background concept of free competition that characterizes much of modern American commerce."[21] Thus, the relevant "open

15 *Serta Simmons Bedding, LLC*, 2023 Bankr. LEXIS 1479, at *37–42.
16 *Excluded Lenders*, No. 23-20181, 2024 U.S. App. LEXIS 32969 at *17, 20.
17 *Id.* at *7.
18 *Id.* at *10-11. Here, only the "open market purchase" exception was at issue.
19 *Id.* at *39.
20 *Id.* at *39-40.
21 *Id.* at *40 (emphasis added).

market" for the original first and second lien loans was the secondary market for syndicated loans, where prices are set by competition and open to other market participants. If Serta wished to evade the requirement of ratable treatment and make an "open market purchase" under Section 9.05(g) "it should have purchased its loans on the secondary market."[22]

In addition to a plain language analysis, the Court concluded that the Exchange could not be an "open market purchase" for other reasons. If an "open market purchase" merely required competitive negotiations between private parties, the term "Dutch auction" would be encompassed by the term "open market purchase" and rendered surplusage.[23] Moreover, while some Excluded Lenders had allegedly proposed a non-pro rata transaction that exploited the "open market purchase" exception, their conduct did not amount to a "course of performance," let alone one that would be binding on all Excluded Lenders.[24] Finally, the Court analyzed industry custom and concluded that the Loan Syndications and Trading Association's discussion of "open market purchase" was limited to debt buy-backs in the context of retiring existing debt—not a debt-for-debt exchange as occurred here,[25] and declined to follow it.

The Fifth Circuit Holds that the Appeal Is not Equitably Moot and Excises the Prevailing Lenders' Indemnity from the Plan

The Court's decision also narrowed the equitable mootness doctrine and excised the Prevailing Lenders' indemnity from the Plan.

The Court distinguished real mootness from equitable mootness. The former is a jurisdictional bar under Article III of the Constitution, while the latter is "a judicial anomaly, a judge-created doctrine of pseudo-abstention that favors the finality of reorganizations and thus constrains our appellate review of plan confirmation orders."[26] The Court further affirmed that to the extent the doctrine exists at all, "it cannot be a shield for sharp or unauthorized practices."[27] Against that backdrop, the Court declined to spare the Plan indemnity on the basis of equitable mootness. The Prevailing Lenders filed contingent proofs of claim seeking reimbursement for any future losses arising out of the uptier for which they were co-liable with Serta. A claim of this nature runs directly afoul of Section 502(e)(1)(B), and cannot be rescued by the broad catchall language of Section 1123(b)(3)(A).[28] In other words, the Court held that Serta cannot use the power to settle a claim under the Plan, when that claim would otherwise be

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22 *Id.* at *40.

23 The term "Dutch auction," as defined in the 2016 Credit Agreement, is a closed auction between Serta and any other lender that wished to participate. It "provides a mechanism by which [Serta] can leverage open competition among its lenders to retire its debt at the lowest possible price." *Id.* at *13.

24 *Id.* at *43-45.

25 *Id.* at *47-48.

26 *Id.* at *51.

27 *Id.* at *58.

28 Section 1123(b)(3)(A) provides that a plan of reorganization may provide for "the settlement or adjustment of any claim or interest belonging to the debtor or to the estate. . . ."

disallowed by the Bankruptcy Code.[29] The Court harshly rebuked the Prevailing Lenders' argument that without the Plan indemnity they would not have supported the Plan noting that "[s]uch an aggressive position requires nothing less than a full-throated rebuttal. If endorsed . . . [it] would effectively abolish appellate review of even clearly unlawful provisions in bankruptcy plans."[30]

Conclusion

A three-judge panel of the Fifth Circuit Court of Appeals has interpreted the term "open market purchase" to exclude a debt-for-debt exchange that was not offered to all lenders of the same tranche through the secondary market for syndicated loans. While the decision is fairly technical and relies on the specific language of the loan agreement in question, its holding will make it more challenging in the future to structure non-pro rata debt-for-debt exchanges as an "open market" purchase. The decision also reaffirms the "sacred" nature of pro-rata treatment generally, but it remains to be seen whether this indicates a shifting tide in how courts will view liability management transactions going forward. What also remains to be seen is how the bankruptcy court will address the difficult question of providing a remedy to the Excluded Lenders if it finds the Exchange breached the 2016 Credit Agreement. Unscrambling transactions at this point may be impossible, and proving damages may also be a challenge if they are too speculative. Therefore, equitable remedies may be most appropriate. While each liability management transaction is bespoke, at a minimum, this decision warns future proponents of non-pro rata transactions that they should consider more carefully whether the transaction violates sacred rights to pro rata sharing in their loan agreement.

[29] *Excluded Lenders*, No. 23-20181, 2024 U.S. App. LEXIS 32969 at *62.

[30] *Id.* at *57.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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