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Liability Management Update: Fifth Circuit Rejects Controversial *Serta* Transaction

Court Holds That Non-Pro Rata Exchange Offer Violates "Sacred" Lender Rights and Chapter 11 Plan May Not Indemnify Participating Lenders Against Related Lawsuits

SUMMARY

On December 31, 2024, the United States Court of Appeals for the Fifth Circuit (the "Fifth Circuit" or the "Court") held that the "sacred" rights of lenders to pro rata payment under the Serta Simmons Bedding, LLC ("SSB") credit agreement prevented a non-pro rata exchange of participating lenders' existing debt for "new" superpriority debt. The Court held that the "open market purchase" exception to pro rata payment - which appears in many credit agreements - could not be interpreted broadly enough to permit such an exchange. The Court also held that the related indemnity granted to the participating lenders in SSB's confirmed chapter 11 plan of reorganization violated the Bankruptcy Code and should be excised from the chapter 11 plan, overcoming the participating lenders' arguments that equitable mootness barred the Court's review and that the indemnity was a permissible component of the Plan under the Bankruptcy Code.

The decision has important implications for both borrowers and lenders in distressed scenarios:

- Participants in liability management transactions may no longer confidently rely on the open-market purchase exception to effectuate non-pro rata exchanges of existing debt in return for majority or requisite lender consent; and
- Chapter 11 cannot be relied on to clean-up a transaction that is ultimately held to violate the express terms of a credit agreement through releases and indemnities - lenders who participate in such transactions may be exposed to litigation that survives the consummation of the Chapter 11 plan.

FACTS

In 2016, SSB issued (1) $1.95 billion in first-lien syndicated loans and (2) $450 million in second-lien syndicated loans.[1] The credit agreement for the first-lien loans (the "Credit Agreement") contained a pro rata sharing provision which required ratable repayment of the first-lien loans amongst all lenders.[2] The Credit Agreement contained an exception that permitted non-pro rata loan repurchases by an SSB affiliate in an "open market purchase," which was not defined in the Credit Agreement.[3]

In 2020, SSB entered into an "uptier" transaction (the "2020 Uptier") that included some of its lenders (the "Participating Lenders") and excluded others (the "Excluded Lenders"). In the 2020 Uptier, the Participating Lenders, who held a slim majority of first-lien debt and provided $200 million of new money financing, were given the opportunity to exchange $1.2 billion of their existing loans for super-priority debt.[4] The Excluded Lenders did not have the opportunity to participate on the same terms.

In January 2023, SSB filed for chapter 11 protection in the Southern District of Texas. The 2020 Uptier was immediately disputed. SSB filed an adversary proceeding against the Excluded Lenders seeking declaratory relief that the 2020 Uptier was permitted under the Credit Agreements, and the Excluded Lenders filed counterclaims.[5] SSB then sought confirmation of a chapter 11 plan (the "Plan") that respected the super-priority debt received by the Participating Lenders in the 2020 Uptier and, in addition, indemnified the Participating Lenders against any liability to the Excluded Lenders.[6] The Bankruptcy Court sided with the Participating Lenders and approved the Plan.[7]

The Excluded Lenders appealed as to both the validity of the 2020 Uptier and whether the Plan's indemnity provision protecting the Participating Lenders was permissible.

CASE HOLDING AND ANALYSIS

The Exchange Offer in the 2020 Uptier Was Not an "Open Market Purchase"

The Court held that the exchange of new super-priority loans for old loans in the 2020 Uptier was not a permissible "open market purchase" of the old loans within the meaning of the Credit Agreement. The Court expressly determined that an "open market purchase" is limited to the purchase of corporate debt that occurs on the secondary market for syndicated loans. SSB did not purchase the debt on the secondary market, but rather privately engaged with individual lenders outside of the secondary market in a transaction that was not open to all sellers of the old loans.

The Court disagreed with each of the counterarguments raised by the Participating Lenders in support of their more expansive definition of "open market purchase," including that (i) the credit agreement did not state expressly that "open market purchases" must be "open to all Lenders," (ii) the Excluded Lenders had made their own non-pro rata proposal to SSB and should be estopped from complaining, and (iii) loan market usage of the phrase "open market purchase" supported a broad reading. The Court found none of

these arguments persuasive and, accordingly, reversed the Bankruptcy Court's declaratory ruling in favor of SSB and the Participating Lenders. The Court focused on the words expressly written in the contract, particularly giving great meaning to "open market." The Court narrowly interpreted these words in light of the inclusion of the Dutch auction provision in the Credit Agreement.

The Court ruled that if SSB's interpretation was valid it would make the Dutch Auction provision meaningless and would violate the interpretive doctrine of the rule of surplusage.

The Court remanded the breach of contract issue for further review as a result of this holding.

Equitable Mootness Did Not Bar Review of the Plan Indemnity

The Court also held that the judicially-created doctrine of equitable mootness did not prevent the Court from reviewing - and ultimately striking - an indemnity in favor of the Participating Lenders contained in the confirmed Plan. While the Court did not reject the doctrine as a general matter, the Court described equitable mootness as a "judicial anomaly" distinguishable from "real mootness" that would render the Court unable to alter the outcome of plan confirmation. The Court held that in this case, because, among other reasons, the Excluded Lenders timely moved for appeal and equitable mootness would frustrate their rights to that appeal, the appeal was not equitably moot. The Court also rejected with a "full-throated rebuttal" the argument by the Participating Lenders that post-confirmation review would be unfair because the Participating Lenders bargained for the indemnity as a condition to supporting the Plan. The Court held that this argument had no merit because it would defeat any appellate review of a plan provision, even if clearly unlawful.

Indemnity of Participating Lenders Not Permitted Under the Bankruptcy Code[8]

With regard to the merits of the Plan's indemnification of the Participating Lenders against challenges to the 2020 Uptier, the Court held that this indemnity in favor of the Participating Lenders violated 11 U.S.C. § 502(e)(1)(B), which disallows contingent claims for reimbursement where the claimant is co-liable with the debtor.[9] The Court held that the Participating Lenders and the debtor were both liable to the Excluded Lenders for breach of the Credit Agreement and, accordingly, the Participating Lenders were not entitled to any protection through the chapter 11 case of their contingent reimbursement claims against the Debtor (regardless of whether such protection came in the form of a prepetition claim under the Credit Agreement or on a post-effectiveness basis under operative Plan provisions). The Court also rejected attempts by the Participating Lenders to characterize the indemnity claim for the 2020 Uptier as new consideration from SSB in exchange for resolution of a potential Plan objection by the Participating Lenders. The Court held that using the settlement authority in the Plan in this manner would be an improper "endrun" around the limitation on contingent reimbursement claims by co-obligators in Section 502(e)(1)(B). Accordingly, the Court "excised" the indemnity for the Plan.

The Court's decision does not overturn SSB's Plan, which otherwise remains effective and binding. However, the Court's decision preserves a breach of contract action by the Excluded Lenders against the

Participating Lenders for which the Participating Lenders have no right to indemnity against SSB. The nature of the remedies available to the Excluded Lenders against the Participating Lenders upon remand remains to be determined by the Bankruptcy Court in the first instance.

MITEL DECISION

On the same day, the New York Supreme Court's First Appellate Division (the "NY Court") also ruled on a similar uptier transaction by Mitel Networks ("Mitel").[10] In contrast to *Serta*, participants in Mitel's transaction relied on a "purchase" exception rather than an "open market purchase" exception to the prohibitions on non-pro rata transactions. The NY Court held that there was nothing in the credit agreement to suggest a refinancing or exchange could not be a "purchase."

The distinction between the two provisions "open market purchase" and "purchase" led to the two different outcomes. Courts will give great meaning to the words in the contract. The focus by the NY Court on "purchase" alone rather than "open market" seems to indicate that the NY Court may have come out differently had the underlying credit agreement contained the phrase "open market purchase".

Furthermore, the Mitel credit agreement only required lender consent for those lenders "directly adversely" affected by a change in loan terms. The NY Court held that subordination of non-participant lenders as a result of the exchange was an indirect adverse impact rather than a direct one, so consent from non-participating lenders was not required.

TAKEAWAYS

Some potential takeaways of the Fifth Circuit Decision include:

- ***Distressed Companies***: Prior to this decision, selective exchange offers had become an accepted tactic for distressed companies to entice (and sometimes coerce) lenders to provide new money. Following this decision, distressed companies will be less able to rely on "open market purchase" provisions as a basis for special treatment of a narrow majority of consenting lenders.
- ***Liability Management Participants***: Lenders who seek to improve their position in a distressed capital structure at the expense of other lenders via uptier or similar exchange offer transactions may face real (and un-indemnified) liability to excluded lenders if the transaction structure is successfully challenged. Although the Court noted that "every contract should be taken on its own," the Court made clear its view that contracts with similar language "will often not justify an uptier" and that excluded lenders deserve a day in court and meaningful chance to appeal.
- ***Non-Participating Lenders***: This decision may provide some level of comfort to lenders who are excluded from certain types of liability management exercises, as there is less certainty that certain maneuvers will be found to be valid or protected by a favorable plan confirmation by a bankruptcy court.
- ***Bankruptcy Planning***: The *Serta* case, along with a series of other reversals of bankruptcy courts in recent years, stands a reminder as to the fragility of any doctrine that prevents meaningful appellate review of bankruptcy court decisions, especially those that go to questions of lender and insider releases for prepetition conduct. Bankruptcy process continues to permit broad finality on appropriate facts, but appellate courts have always been - and are increasingly now - ready to

reverse bankruptcy courts as they would any other lower court when the appellate court feels the bankruptcy court got it wrong. Accordingly, reliable chapter 11 case planning must consider more than current practice conventions and choice of venue – it must look to a potential appeal and factor in appellate risk to decision-making.

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ENDNOTES

1 *In re Serta Simmons Bedding, LLC*, *Excluded Lenders*, Case No. 23-20181 (5th Cir. Dec. 31, 2024) [D.I. 233-1], at 8.

2 *Id*.

3 *Id*. at 9-10.

4 *Id*. at 11.

5 *Id.* at 12-13.

6 *Id*. at 15.

7 *In re Serta Simmons Bedding, LLC*, *Excluded Lenders*, Case No. 23-20181 (5th Cir. Dec. 31, 2024) [D.I. 233-1], at 13, 16.

8 Additionally, the Court held that even if the indemnity were found to be consistent with § 502(e)(1)(B), it would still run afoul of the requirement in the Bankruptcy Code for equal treatment of creditors within a class of claims under 11 U.S.C. § 1123(a)(4). While the Court did not define the exact scope of § 1123(a)(4) in its decision, it did hold that the Settlement Indemnity was a violation because even though all members of Classes 3 and 4 under the Plan received the Settlement Indemnity, the value of the indemnity was significantly greater for the subset of class members that participated in the 2020 Uptier than for those class members who did not. Whether this particular part of the Court's ruling develops any traction in other courts remains to be seen, but such a broad interpretation of 1123(a)(4) could have significant consequences for chapter 11 practice and plan drafting and related litigation.

9 *Serta Simmons Bedding*, 2023 WL 3855820, at *10.

10 *Ocean Trails CLO VII v. MLN Topco Ltd.*, Case No. 2024-00169 (N.Y. App. Div., 1st Dep't, Dec. 31, 2024).

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