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Client Alert

Bankruptcy & Restructuring Department

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Fifth Circuit Rejects Non-Pro Rata Uptier Transaction From Serta Simmons; Landmark Ruling May Have Chilling Effect on Similar Uptier Transactions

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On December 31, a unanimous three-judge panel of the U.S. Court of Appeals for the Fifth Circuit (the Court or the Fifth Circuit) held that the controversial $200 million Serta Simmons Bedding (SSB) uptier financing transaction that was available only to a subset of SSB's lenders violated the "sacred right" to pro rata payment under the existing credit agreement. In so ruling, the Court held that the transaction was not a permissible "open market purchase" exception to pro rata payment, thereby reversing a decision from former Bankruptcy Judge David R. Jones.

The Court also held that certain Chapter 11 plan provisions requiring the SSB debtors to indemnify the participating lenders for damages arising from the uptier transaction must be excised from the plan (which has been effective since June 2023), overcoming arguments that the issue cannot be reviewed on the grounds of equitable mootness.

Background and Procedural History

In 2016, SSB refinanced its debt through the issuance of $1.95 billion of first-lien debt and $450 million of second-lien debt. The first-lien credit agreement included a pro rata sharing provision that required repayments of the first-lien loans to be allocated ratably among all the lenders. The credit agreement included a common exception that permitted non-pro rata loan repurchases in an open market purchase. The term "open market purchase" was not defined in the credit agreement.

In 2020, facing liquidity and other financial stress, SSB entered into an uptier transaction that included some but not all of its secured lenders. The Fifth Circuit's opinion describes this transaction as "the first major uptier."

According to the terms of the uptier, the participating lenders (1) provided the company with $200 million of new money in the form of "first out" superpriority loans and (2) exchanged approximately $1.2 billion of their existing first- and second-lien loans into "second out" superpriority loans. As a result, both tranches of new superpriority debt ranked senior to the existing debt, and the excluded lenders held subordinated debt that was worth less than before.

The participating lenders labeled the uptier transaction as an open market purchase, which was one of the two exceptions to the requirement for pro rata treatment under the existing credit agreement.

When SSB filed for Chapter 11 in January 2023, the uptier transaction became a major focus of the bankruptcy proceedings. Among other things, SSB and the participating lenders filed an adversary proceeding seeking a declaratory judgment from the bankruptcy court that the uptier transaction was valid. The excluded lenders filed counterclaims for breach of contract. SSB also filed a Chapter 11 plan that recognized the treatment of the new superpriority debt that was issued as part of the uptier transaction.

The bankruptcy court ultimately held that the term "open market purchase" was "clear and unambiguous" and the uptier transaction was a valid open market purchase under the exception to pro rata sharing in the existing credit agreement. The bankruptcy court also confirmed SSB's Chapter 11 plan and approved a slightly modified indemnity provision in favor of the participating lenders.

The excluded lenders appealed the bankruptcy court's decision as to the validity of the non-pro rata uptier transaction, the plan's indemnity provisions, and the denial of their counterclaims for breach of contract.

The Fifth Circuit's Holding

The Fifth Circuit held that the SSB uptier transaction, which was available to some but not all lenders, was not a permissible open market purchase under that exception to pro rata treatment. In its analysis of the term "open market purchase," the Court looked to various sources, including dictionaries and the Federal Reserve, and concluded that the phrase requires a *specific* market, and in this case, the secondary market for syndicated loans. The Court explained that because SSB repurchased the participating lenders' claims privately outside this market, SSB "lost the protection" of the open market purchase exception to pro rata treatment.

With respect to the excluded lenders' counterclaims for breach of the credit agreement, the Fifth Circuit remanded those claims to the lower court for further proceedings but noted that the excluded lenders "have a strong case."

The Fifth Circuit also held that the indemnity provision in the Chapter 11 plan relating to the uptier transaction must be excised because it is an "end-run" around Section 502(e)(1)(B) of the Bankruptcy Code, which disallows contingent claims for reimbursement. In so ruling, the Fifth Circuit held that equitable mootness arguments did not prevent it from reviewing (and ultimately removing) an indemnity provision contained in a plan that has been substantially consummated. Notably, the Court described equitable mootness as a "judicial anomaly" that constrains appellate review of plan confirmation orders.

Analysis and Conclusion

The Fifth Circuit's ruling has important implications for uptier transactions, which have become commonplace in corporate restructurings of late.

Among other things, the decision will likely chill non-pro rata uptier transactions that rely on an open market purchase exception. In fact, the Fifth Circuit aptly points out that while the loan market has seen an increase in contracts blocking uptiers (so-called uptier blockers) since 2020, there are still many contracts with open market purchase exceptions to ratable treatment. The Court then commented, "Though every contract should be taken on its own, today's decision suggests that such exceptions will often not justify an uptier."

The Court's critique of equitable mootness may also have a ripple effect in the Fifth Circuit, including in the complex case panel in Houston. Specifically, the opinion may embolden parties to appeal confirmation orders in hopes of a more substantive review on the merits as opposed to a dismissal on account of the underlying Chapter 11 plan having been substantially consummated. It remains unclear whether this line of thinking will apply to appeals of sale orders, which are also commonly dismissed due to equitable mootness.

Finally, it is worth noting that the Fifth Circuit's opinion did not overturn SSB's confirmed Chapter 11 plan; it just excised the offending indemnity provision. While this may be viewed as a Pyrrhic victory, the opinion specifically preserved the excluded lenders' breach of contract claims against the participating lenders. Given that the participating lenders are no longer indemnified by SSB, these claims may have real economic consequences for the participating lenders. The extent and nature of remedies for the excluded lenders' breach of contract claims will unfold on remand.

The Fifth Circuit's opinion can be found here.

If you are interested in exploring this issue further, please reach out to one of the attorneys in the Bankruptcy & Restructuring Department.

Contact

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