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"LMEs" – A.K.A., LANGUAGE MATTERS EXERCISES: FIFTH CIRCUIT DISAGREES WITH SERTA BANKRUPTCY COURT'S INTERPRETATION OF "OPEN MARKET PURCHASES"

Fifth Circuit reverses Bankruptcy Court and holds that the 2020 uptier transaction was not a permissible "open market purchase" under an exception to the pro rata sharing provision of the applicable credit agreement because it did not take place on the secondary market for syndicated loans.

On the same day, the New York Supreme Court's Appellate Division (First Department) held that the Mitel *non pro rata uptier exchange did not violate the applicable credit agreement, in part, because the relevant provision allowing the borrower to "purchase" term loans did not preclude a refinancing or exchange of the existing debt.*

Although liability management exercises ("**LMEs**") are not a new concept for addressing a borrower's balance sheet, recent LMEs – especially transactions that favor some lenders over others – have been embroiled in litigation.

On the last day of 2024, the Fifth Circuit Court of Appeals (the "**Fifth Circuit**") issued its decision involving one of the most notable (and litigated) LME transactions to date – a 2020 uptier transaction (the "**2020 Uptier Transaction**") among Serta Simmons Bedding, L.L.C. and its affiliates (collectively, "**Serta**") and certain of Serta's existing lenders.[1]

In summary, the Fifth Circuit:

- reversed the decision of the Bankruptcy Court for the Southern District of Texas (the "**Bankruptcy Court**"), which had (i) rejected claims made by certain lenders excluded from the 2020 Uptier Transaction that the 2020 Uptier Transaction violated Serta's 2016 credit agreement (the "**2016 Credit Agreement**") and (ii) confirmed provisions of Serta's Plan that required the reorganized Debtors to indemnify the participating lenders against claims arising from the transaction;

Key issues

- In the context of LMEs, the language and words in financing agreements matter – viability will largely depend on the specific language relevant to each situation
- Litigation over ambiguous terms in financing documents is often expensive, lengthy and leads to uncertain outcomes
- As courts provide more clarity in how they evaluate particular LMEs, borrowers, lenders and boards should take note of judgments and the consequences of unfavorable outcomes
- As a result of the Fifth Circuit's Serta decision, parties pursuing an uptiering LME may now pause over (1) reliance on the "open market purchase" exception to the "pro rata sharing" requirements and (2) the risk of no indemnity for participating lenders against LME challenges
- Lenders should carefully evaluate precedent case studies when negotiating (or evaluating) provisions in a financing agreement

[1] Serta filed for bankruptcy on January 23, 2023. On the same day, Serta filed its Chapter 11 plan of reorganization (the "**Plan**"). Serta subsequently filed an adversary proceeding in the Bankruptcy Court, seeking the approval of the 2020 Uptier Transaction. The issues relevant to the Fifth Circuit's decision stem from both the main bankruptcy proceeding, including the Plan, and the adversary proceeding, including the 2020 Uptier Transaction.

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- held that the 2020 Uptier Transaction was not a permissible "open market purchase" under an exception to the pro rata sharing provision of the 2016 Credit Agreement because it did not take place on the relevant specific market (i.e., the secondary market for syndicated loans);
- held that the indemnity provisions related to the 2020 Uptier Transaction contained in the Plan were an impermissible attempt to circumvent the Bankruptcy Code's disallowance of contingent prepetition indemnification claims and violated the Bankruptcy Code's requirement for equal treatment of similarly-situated creditors; and
- held that the doctrine of equitable mootness did not prevent the Fifth Circuit's review of the indemnity claims.

We discuss the Fifth Circuit's reasoning for each of these issues below.

BACKGROUND

By way of brief background, in 2016 Serta refinanced its then existing debt through the issuance of US$1.95 billion of first-lien syndicated loans and US$450 million of second-lien syndicated loans under the 2016 Credit Agreement. The 2016 Credit Agreement contained a pro rata sharing provision which provided, in relevant part, that:

> [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.

Additionally, the 2016 Credit Agreement required consent from any affected lender to waive, amend or modify this provision in any way that would "alter the pro rata sharing of payments required thereby."

THE 2020 UPTIER TRANSACTION

Fast forward to 2020, Serta entered into the 2020 Uptier Transaction with a majority of the lenders holding first-lien and second-lien debt issued in connection with the 2016 refinancing (the "**2020 Uptier Lenders**"). Consistent with a classic uptiering LME, the 2020 Uptier Lenders rolled US$1.2 billion of their existing first-lien and second-lien debt into approximately US$875 million in super-priority debt, which was only junior to US$200 million in new money superpriority first-out loans provided by the same lenders. All such new and uptiered debt would prime the existing debt of the non-participating lenders.

As part of the transaction, Serta also agreed to indemnify the 2020 Uptier Lenders from all losses, claims, damages and liabilities they might incur in connection with their participation in the 2020 Uptier Transaction.

POST-2020 UPTIER TRANSACTION LITIGATION

Following completion of the 2020 Uptier Transaction, litigation ensued in state, federal and bankruptcy courts. In the adversary proceeding running concurrent with the main bankruptcy case, Serta and certain of the 2020 Uptier Lenders asked the Bankruptcy Court to effectively "bless" the 2020 Uptier Transaction as permissible under the 2016 Credit Agreement. The Bankruptcy Court found that the 2020 Uptier Transaction was a permitted "open market" transaction that did not have to be made pro rata with all lenders. Among other things, Judge Jones of the Bankruptcy Court held that, "in looking at the words and

given the common meaning and then looking at the transaction that [was] engaged in, it is very clear to me that the process that was engaged in fit within [the open market purchase exception]."[2]

Additionally, Serta's ultimate Plan sought to provide indemnification to certain of the 2020 Uptier Lenders still holding super-priority debt as of the effective date of the Plan and other persons that did not participate in the 2020 Uptier Transaction, but which later purchased such super-priority debt. The Bankruptcy Court approved the Plan, and both the Plan and above issues were considered by the Fifth Circuit on direct appeal.

RELEVANT PROVISIONS OF THE 2016 CREDIT AGREEMENT REGARDING "OPEN MARKET PURCHASES"

The primary provision of the 2016 Credit Agreement in dispute was Section 9.05(g) – which permits non-pro rata treatment through Dutch auctions (not relevant here) and, importantly, open market purchases. Specifically, Section 9.05(g) provided, in relevant part, that:

> Notwithstanding anything to the contrary contained herein, any Lender may, at any time, assign all or a portion of its rights and obligations under this Agreement in respect of its Term Loans to any Affiliated Lender on a non-pro rata basis (A) through Dutch Auctions open to all Lenders holding the relevant Term Loans on a pro rata basis or (B) *through open market purchases*.

Notably, "open market purchases" are neither described nor defined in the 2016 Credit Agreement.

OPEN MARKET PURCHASES

Applying New York law, the Fifth Circuit noted that New York courts will give practical interpretation to the language employed and read the contract as a whole. New York courts will often look to dictionaries to understand the meaning of contractual terms. Here, the Fifth Circuit looked at dictionary definitions of "open market" to determine the phrase's meaning. Below are the definitions the Fifth Circuit cited.

Black's Law Dictionary (10th ed. 2014)	"[a] market in which any buyer or seller may trade and in which prices and product availability are determined by free competition."
Oxford English Dictionary (3d revised ed. 2004)	"[a]n unrestricted market in which any buyer or seller may trade freely, and where prices are determined by supply and demand."
Webster's Third New International Dictionary 1580 (2002)	"a freely competitive market in which any buyer or seller may trade and in which prices are determined by competition."

Taking these definitions, and other factors into account, the Fifth Circuit ultimately found that an "open market purchase" takes place on a specific market relevant to the purchased product; in this case, the secondary market for syndicated loans. Since the 2020 Uptier Transaction took place outside this

2 Of note, in the previous matter before the District Court for the Southern District of New York on a motion to dismiss, the District Court found that "open market" was, at best, an ambiguous term.

market (i.e., in a private setting), it did not fall within the exception to the 2016 Credit Agreement. To this end, the Fifth Circuit rejected the expansive position urged by Serta and the 2020 Uptier Lenders – i.e., that an open market purchase could include any acquisition for value among parties.[3]

EQUITABLE MOOTNESS / PLAN'S INDEMNIFICATION PROVISIONS

The Fifth Circuit also held that the settlement indemnification provisions relating to the 2020 Uptier Transaction were impermissible and that excision was the proper remedy in this case. In reaching this conclusion, the Fifth Circuit first addressed the issue of whether the doctrine of equitable mootness barred its review of the order confirming the Plan and then whether inclusion of such indemnity provisions was an impermissible end-run around the Bankruptcy Code.

A creditor may appeal an order confirming a plan of reorganization; however, actions subsequent to a plan's confirmation can render an appeal moot if not stayed. The doctrine of equitable mootness provides that an appeal may be dismissed as moot when, even though effective relief could be granted, implementation of that relief would be inequitable. This judicially created doctrine is rather limited, especially in the Fifth Circuit. In assessing equitable mootness, courts in the Fifth Circuit consider three factors:

1. whether a stay has been obtained;
2. whether the plan has been "substantially consummated"; and
3. whether the relief requested would affect either the rights of parties not before the court or the success of the plan.

Although the lenders excluded from the 2020 Uptier Transaction failed to obtain a stay of confirmation and the Plan had been substantially consummated, the Fifth Circuit held that equitable mootness did not apply, and it would not dismiss the appeal as equitably moot. In so determining, it found that excision of the indemnification provision would not affect either (i) the rights of parties not before the court (because both Serta and the 2020 Uptier Lenders were present before the court) or (ii) the success of the Plan (because Serta would benefit if relieved of its indemnification obligations), and the Fifth Circuit could not identify any third parties that would be harmed by excision.

The Fifth Circuit also disagreed that it would be unfair to excise the indemnity provisions without allowing renegotiation of the Plan, because (i) the 2020 Uptier Lenders relied upon the indemnity in supporting the Plan and (ii) the adverse appellate consequences were foreseeable and equitable mootness should not be used as a shield. Moreover, it noted that the application of equitable mootness would defeat the purpose of expediting appeals in significant cases (such as this).

Having declined to dismiss the appeal as equitably moot, the Fifth Circuit next found the inclusion of the indemnity provision to be impermissible under the Bankruptcy Code. Section 502(e)(1)(B) of the Bankruptcy Code requires the disallowance of any contingent claim for reimbursement where the claiming entity is co-liable with the debtor thus protecting the debtor from multiple

[3] The 2020 Uptier Lenders attempted to offer counter arguments to favor their interpretation of Section 9.05(g), including citing to a canon of statutory interpretation, course of performance, and industry custom and practice, but the Fifth Circuit was not convinced by such counter arguments.

liabilities. Notwithstanding the fact that the 2020 Uptier Lenders agreed that their indemnification claims were impermissible contingent claims, in a further amendment to the Plan, Serta included a similar indemnification provision couched as a "settlement." The Fifth Circuit found that characterization of the indemnity as a settlement did not change the analysis. While the court acknowledged that the Bankruptcy Code authorizes a Chapter 11 plan to provide for the settlement of claims, it does not allow for a back-end resurrection of claims already disallowed on the front end.

The Fifth Circuit also found that the settlement indemnity violated the Bankruptcy Code's requirements for equal treatment. Section 1123(a)(4) of the Bankruptcy Code provides that a Chapter 11 plan must provide the same treatment for all claims of a particular class, unless the holder of the claim agrees to less favorable treatment. The Fifth Circuit found that the value of the indemnity varied depending on whether members of the class participated in the 2020 Uptier Transaction, thus providing unequal value to the members with those who participated receiving value potentially worth millions. But to others that were not involved, the indemnity was worth little or nothing.

POSTSCRIPT: MITEL NETWORKS

On the same day as the Fifth Circuit's decision in *Serta* which (as noted) favored the non-participating lenders, New York Supreme Court's Appellate Division, First Department (the "**Appellate Division**") decided an LME uptier dispute in favor of the participating lenders. *See Ocean Trails CLO VII v. MLN TopCo Ltd., No. 2024-00169*) (N.Y. App. Div. 1st Dep't Dec. 31, 2024) ("**Mitel**"). In *Mitel*, the company had acquired and cancelled existing loans from certain lenders and concurrently reissued them superpriority loans that primed the non-participating lenders. Among other things, the Appellate Division determined that this transaction only "*in*directly" affected the non-participating lenders, and thus, their sacred veto rights were not implicated. In addition, the Appellate Division endorsed an exception to the pro rata requirements – namely, the provision authorizing the borrower to "*purchase* by way of assignment and become an Assignee with respect to Term Loans at any time" extended to a "refinancing" or "exchange" of the existing loans for new loans. The Appellate Division found that:

> [t]here is no indication in the agreements that a refinancing or exchange cannot include a purchase, nor is there any indication that a purchase requires payment in full, upfront, in cash, or that debt cannot constitute payment . . . A requirement of cash payment or prohibition on the use of debt as payment would also not be consistent with the common understanding of the word "purchase."

Thus, in *Mitel*, the Appellate Division found that the uptier transaction was permitted by the credit agreement.

CONCLUSION

There will be much written about the *Serta* and *Mitel* decisions and their impact on liability management transactions; however, as of now the primary takeaway is that the language in the applicable credit and debt documents matters – transactions that fit within the applicable language will withstand scrutiny and transactions that go beyond the language will not.

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