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U.S. Court of Appeals for the Fifth Circuit Rules That Serta Simmons Bedding's 2020 Uptier Transaction Violated Pro Rata Distribution Covenant

By Robert Klyman and Scott Shelley*

In this article, the authors discuss a federal appellate decision involving an "uptier transaction" that revived claims for breach of contract against certain lenders by other lenders that had been excluded from the transaction.

In a landmark ruling, the U.S. Court of Appeals for the Fifth Circuit ruled that a June 2020 refinancing transaction (the Uptier Transaction) entered by Serta Simmons Bedding, LLC (SSB or the Debtor) and certain of its lenders (Prevailing Lenders) violated the provisions in the applicable credit agreement that required ratable treatment with respect to distributions to all lenders.[1] In reversing the Bankruptcy Court ruling to the contrary, the Fifth Circuit held that the Uptier Transaction did not qualify as a permissible open market purchase otherwise excepted from ratable treatment.[2] This ruling revived claims for breach of contract against the Prevailing Lenders by certain lenders that had been excluded from the Uptier Transaction (Excluded Lenders).[3]

The Fifth Circuit also ruled that a "settlement indemnity" in SSB's Chapter 11 plan (the plan), designed to protect the Prevailing Lenders from liability arising from the Uptier Transaction constituted an improper attempted end-run of relevant Bankruptcy Code provisions and would be excised from the plan.[4]

BACKGROUND

SSB makes mattresses and other bedding products. SSB entered into a $2.4 billion syndicated loan agreement in 2016 (2016 Credit Agreement), which

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[1] See Excluded Lenders v. Serta Simmons Bedding, LLC (In re Serta Simmons Bedding, LLC), No. 23-20181 (5th Cir. Dec. 31, 2024) (hereafter, the "Opinion").

[2] Opinion at 38.

[3] Id.

[4] Id. at 54.

provided for $1.95 billion of first lien loans, and $450 million of second lien loans. In the years following execution of the 2016 Credit Agreement, SSB faced ongoing financial struggles and began looking for a creative financing solution.[5]

As with many corporate credit agreements, the 2016 Credit Agreement contained a "pro-rata sharing" provision that generally required SSB to allocate any payments to the lenders on a ratable basis. In other words, the 2016 Credit Agreement prohibited SSB from paying some lenders while offering nothing (or a different amount) to other lenders. Moreover, if a favored lender received a separate payment from SSB, that lender was obligated to share the payment ratably with the other lenders. This provision constituted one of the "sacred rights" that lenders under a syndicated loan typically enjoy, and it could not be amended, waived, or modified without the consent of each affected lender.[6]

The 2016 Credit Agreement contained two exceptions to this general rule: (i) a Dutch auction open to all lenders on a pro rata basis, and (ii) open market purchases.[7]

Under a Dutch auction, the borrower is required to give notice to its lenders that it wants to repurchase an amount of outstanding loans, and the proposed repurchase price. Typically, if one or more of the lenders agree to sell at or below the proposed price, the sale is consummated at the lowest price necessary to consummate the transaction. The procedures for a Dutch auction were set forth in great detail in the 2016 Credit Agreement.

In contrast, the 2016 Credit Agreement did not define "open market purchase," or provide guidance on the steps necessary to consummate a valid open market purchase. SSB sought to exploit the uncertainty surrounding this undefined provision to improve its financial position.[8]

In June 2020, SSB signed an agreement to implement the Uptier Transaction with the Prevailing Lenders, pursuant to which the Prevailing Lenders would provide SSB with $200 million in new, first-out, superpriority financing, and exchange $1.2 billion of existing first and second lien loans for approximately $875 million in second-out, superpriority loans. The implementation of the Uptier Transaction would provide SSB with a much-needed cash infusion. The Prevailing Lenders would take a reduction on the principal amount of their debt, but gain priority in SSB's capital structure, to the detriment of the

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[5] Id. at 10.

[6] Id. at 8.

[7] Id. at 9–10.

[8] Id. at 10.

Excluded Lenders who did not participate in the Uptier Transaction. To fit within the exception to the ratable sharing provisions in the 2016 Credit Agreement, SSB also described the Uptier Transaction as an "open market purchase" of existing debt, since all lenders were free to make similar proposals to SSB.[9]

In June 2020, prior to consummation of the Uptier Transaction, certain of the Excluded Lenders sued SSB and certain of the Prevailing Lenders in the New York Supreme Court, seeking an injunction to prohibit completion of the Uptier Transaction. The New York Supreme Court denied that request, and that case was dismissed without prejudice.[10]

The Uptier Transaction was thereafter implemented by SSB in cooperation with the Prevailing Lenders. In an effort to fit the Uptier Transaction into the exceptions to the ratable payment provisions discussed above, SSB and the Prevailing Lenders described the Uptier Transaction as an "open market purchase," to which the ratable sharing provision would not apply. Anticipating that the Uptier Transaction might lead to further litigation, SSB also agreed to indemnify the Prevailing Lenders for all losses and liabilities that they might incur as a result of the Uptier Transaction.[11]

In November 2022, certain Excluded Lenders again sued SSB and the Prevailing Lenders in New York state court, alleging that the Uptier Transaction violated the terms of the 2016 Credit Agreement, as well as the implied covenant of good faith and fair dealing. This lawsuit was subsequently stayed by SSB's Chapter 11 filing.[12]

THE BANKRUPTCY CASE AND THE ADVERSARY PROCEEDING

On January 23, 2023 (the petition date), SSB filed for bankruptcy protection in the U.S. Bankruptcy Court for the Southern District of Texas (the Bankruptcy Court). On January 24, 2023, SSB and the Prevailing Lenders commenced an adversary proceeding seeking a declaratory judgment against the Excluded Lenders that the Uptier Transaction did not breach the ratable sharing provision in the 2016 Credit Agreement, or the implied covenant of good faith and fair dealing.[13] The Bankruptcy Court granted partial summary judgment

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[9] Id. at 11–12.

[10] See Disclosure Statement for Joint Chapter 11 Plan of Serta Simmons Bedding, LLC and its Affiliated Debtors (the "Disclosure Statement"), Docket No. 545 at 18, Case No. 23-90020 (Bankr. S.D. Tex. 2020).

[11] Opinion at 12.

[12] Disclosure Statement at 18.

[13] Opinion at 12-13.

to SSB and the Prevailing Lenders, holding that the term "open market purchase" was clear and unambiguous. As a result, the Bankruptcy Court found that the Uptier Transaction was a valid open market purchase that did not implicate the ratable sharing provision of the 2016 Credit Agreement. The Bankruptcy Court certified that ruling for direct appeal to the Fifth Circuit Court of Appeals.[14]

After the Excluded Lenders filed a notice of appeal, the Bankruptcy Court entered a final judgment dismissing the remaining counterclaims and third-party claims in the adversary proceeding, and the parties agreed to certify that judgment to the Fifth Circuit, which granted permission to appeal.[15]

THE SSB PLAN OF REORGANIZATION

SSB also filed a plan of reorganization on the petition date that provided for the survival of SSB's indemnification obligations to Prevailing Lenders that participated in the Uptier Transaction. After the Prevailing Lenders filed proofs of claims for these reimbursement claims, the Excluded Lenders objected to those proofs of claims on the grounds that their contingent claims for reimbursement must be disallowed under Bankruptcy Code Section 502(e)(1)(B). This section provides in relevant part that "the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor . . . to the extent that– . . . (B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution."[16]

In response, SSB filed an amended Chapter 11 plan in which it recharacterized the indemnification obligation in the plan as a "settlement indemnity" that provided indemnification to all parties that continued to hold debt claims that had been refinanced through the Uptier Transaction, regardless of whether the party had participated in that transaction. The Prevailing Lenders attempted to justify this modification by arguing that the indemnity obligation under the plan was a "new" undertaking that was given as consideration to induce Prevailing Lenders to vote in favor of the plan, not as consideration for the existing – but contingent – indemnity obligation. The Excluded Lenders objected, but the Bankruptcy Court overruled the objection and confirmed SSB's Chapter 11 plan.[17]

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[14] Id. at 16.

[15] Id. at 13.

[16] Id. at 14.

[17] Id. at 14–16.

The Bankruptcy Court certified the confirmation order for direct appeal to the Fifth Circuit, and that appeal was consolidated with the appeals concerning the Uptier Transaction.[18]

THE FIFTH CIRCUIT'S RULING

On December 31, 2024, the Fifth Circuit reversed the Bankruptcy Court and held that the Uptier Transaction constituted a breach of the 2016 Credit Agreement, as it did not involve a valid "open market purchase."[19] The Fifth Circuit remanded the case to the Bankruptcy Court for reconsideration of the Excluded Lenders' counterclaims related to that breach.[20]

Similarly, the Fifth Circuit reversed the Bankruptcy Court's approval of SSB's Chapter 11 plan, finding that the "settlement indemnity" in the plan was an invalid end-run around the Bankruptcy Code's disallowance of contingent claims for reimbursement.[21] Lastly, the Fifth Circuit found that the Excluded Lenders had abandoned their claims for breach of contract *other than* the open market purchase claims, as well as their claims based on the implied covenant of good faith and fair dealing, and held that no further action was required as to those claims.[22]

The Fifth Circuit analyzed the key issues as discussed below.

Open Market Purchases

As an initial matter, the Fifth Circuit noted that the dispute was governed by New York law, which requires courts to interpret contracts like the 2016 Credit Agreement to determine the parties' intent.[23] Moreover, in determining the meaning of a particular contractual term, New York courts often look to dictionaries for guidance. However, in the context of a particular industry or trade, courts will also construe terms "in light of the custom or usage in that industry or trade."[24]

After surveying various dictionaries and New York state precedents, the Fifth Circuit observed that the term "open market purchase" would "contemplate a specific market in which various parties may participate, and prices are set by

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[18] Id. at 16.

[19] Id. at 38.

[20] Id.

[21] Id. at 39.

[22] Id. at 24.

[23] Id. at 27.

[24] Id. at 28.

competition."[25] Since the term envisions a specific market, the Fifth Circuit rejected SSB's contention that the Uptier Transaction involved "open market purchases" merely because it involved free competition – holding that "[a]n open market is a designated market, not merely the background concept of free competition."[26]

Accordingly, the Fifth Circuit ruled that if SSB had wanted to make an open market purchase, it should have purchased loans in the secondary loan market. Due to the fact that SSB had instead privately engaged with individual lenders outside of the secondary loan market, its purchases were not made on the open market.[27]

Consequently, the Fifth Circuit held that SSB's private purchases did not fall within the "open market purchase" exemption and thus violated the ratable sharing requirement under the 2016 Credit Agreement.[28]

Appeal of Plan Confirmation

Although the plan had been confirmed and consummated, the Fifth Circuit noted that the appeal of the confirmation order was not equitably moot, because the indemnity provisions could be excised from the plan without unduly burdening the Debtor or third parties.[29] The Fifth Circuit also noted that a finding of equitable mootness would undermine the purpose of direct appeals from bankruptcy courts, namely, to facilitate meaningful appellate review of significant issues and to generate binding bankruptcy precedents.[30] Accordingly, the Fifth Circuit held that the confirmation appeal was not equitably moot.[31]

The plan appeal focused on whether the settlement indemnity violated the Bankruptcy Code. The Prevailing Lenders originally filed proofs of claims for the indemnity obligations under the Uptier Transaction. The parties agreed that those claims were contingent claims for reimbursement that were disallowed under Bankruptcy Code Section 502(e)(1)(B).[32] Rather than deleting the

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[25] Id. at 29–30.

[26] Id. at 31.

[27] Id. at 32.

[28] Id. at 38.

[29] Id. at 43–45.

[30] Id. at 43.

[31] Id. at 46.

[32] Id.

indemnity in the next draft of the plan, SSB and the Prevailing Lenders recharacterized and included in the plan the pre-petition indemnity as a "settlement indemnity."

They then argued that this settlement indemnity was permissible under Bankruptcy Code Section 1123(b)(3)(A). This section generally provides for the inclusion of the settlement of any claim in a Chapter 11 plan. The Bankruptcy Court agreed with SSB and the Prevailing Lenders, and approved the settlement indemnity and part of its confirmation order.[33]

The Fifth Circuit reversed that approval as "a mistake." According to the Fifth Circuit,

"[t]he settlement indemnity was an impermissible end-run around 502(e)(1)(B)'s disallowance of claims for reimbursement. And the appellee's characterization of the indemnity as part of a 1123(b)(3)(A) settlement does not change the analysis."[34]

In particular, the Fifth Circuit held that although the Bankruptcy Code permits settlements under a plan, "it does not affirmatively provide for the back-end resurrection of claims already disallowed on the front end."[35] Noting that the settlement indemnity mirrored the terms of the indemnity provided in connection with the Uptier Transaction that had been disallowed, the Fifth Circuit held that the settlement indemnity must be excised from the plan.[36]

Additionally, the Fifth Circuit found that inclusion of the settlement indemnity would violate Bankruptcy Code Section 1123(a)(4), which requires the plan to provide the same treatment for all claimants within a particular voting class.[37] Although the settlement indemnity was facially applicable to all claims held by lenders under the 2016 Credit Agreement, the value of the indemnity varied greatly depending on whether a claimant had participated in the Uptier Transaction. For those that had participated, the indemnity could be worth millions of dollars, while for those that had not participated the indemnity was valueless.

The Fifth Circuit held that this disparate treatment of similar claims violated the Bankruptcy Code, because those class members received "settlements with

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[33] Id. at 47.

[34] Id.

[35] Id. at 48.

[36] Id. at 50, 54.

[37] Id. at 50-51.

higher effective values than their co-class members."[38] The Fifth Circuit noted that because the confirmation order was not equitably moot, the court was free to craft an appropriate remedy, and elected to delete the settlement indemnity from the plan.[39]

KEY TAKEAWAYS OF *SSB*

The *SSB* ruling represents a significant development in the ongoing disputes referred to as "liability management exercises" that have often resulted in what is colloquially referred to as "lender on lender violence." The Fifth Circuit noted that SSB's Uptier Transaction was the first major uptier transaction, and observed that each subsequent liability management transaction would be reviewed on its own. It also observed that many of these transactions might not stand up to individualized scrutiny, particularly where borrowers attempted to rely on open market purchases to avoid ratable sharing provisions.[40]

The SSB ruling revived claims by the Excluded Lenders more than four years after the consummation of the Uptier Transaction. Although the commercial finance sector has responded to liability management exercises by implementing certain "uptier blockers," the holding in SSB sends a strong signal to lenders considering such transactions that any uptier transaction could be scrutinized against the plain language of the applicable credit agreement.

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[38] Id. at 51.

[39] Id. at 54.

[40] Id.