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CLIENT ALERT

In Landmark Ruling, Bankruptcy Court Upholds "Uptier" Transaction in Serta Simmons Bedding Case

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In 2020, Serta Simmons Bedding, LLC ("Serta") launched one of the first of the now common uptiering transactions, resulting in some – but not all – of Serta's existing lenders (the "Uptier Lenders") providing new priming loans and exchanging some of their existing loans for new priority debt (the "Uptier Transaction"). When the excluded lenders (the "Excluded Lenders") who were never invited to participate found themselves being subordinated by the Uptier Transaction, litigation ensued. One group of Excluded Lenders sued in the U.S. District Court for the Southern District of New York (the "SDNY"), and another group of Excluded Lenders sued in New York state court. The litigation continued for three years before Serta and its affiliates determined to file chapter 11 bankruptcy petitions in the U.S. Bankruptcy Court for the Southern District of Texas (the "Bankruptcy Court"). Serta immediately filed an adversary proceeding against the Excluded Lenders, alleging that no cause of action existed against Serta and the Uptier Lenders and seeking a declaratory judgment that the Uptier Transaction was permitted.

On April 6, 2023, the Bankruptcy Court held that the Uptier Transaction was permitted under Serta's credit agreement.[1] The Bankruptcy Court rejected arguments by the Excluded Lenders that they had been improperly excluded from the Uptier Transaction.

Pre-Bankruptcy Background

The parties' dispute began in June 2020, years before Serta's bankruptcy filing. Seeking additional funding during the pandemic, Serta and the Uptier Lenders proposed entering into the Uptier Transaction after the Excluded Lenders proposed that Serta undertake a "J. Crew" drop down transaction.[2] The Uptier Lenders prevailed and entered into the Uptier Transaction, providing $200 million of new first-out superpriority debt and exchanged their existing first- and second-lien debt for $875 million in senior and second-out superpriority debt, with the result that the debt held by the Excluded Lenders was subordinated (i.e., third-out debt).

The Uptier Transaction was effectuated in part by taking advantage of the "open market purchase" provisions of Serta's Credit Agreement. An open market purchase is a transaction in which a borrower purchases its own debt from lenders under a credit agreement's terms. The Uptier Transaction's open market purchases drew the ire of the Excluded Lenders because the purchases were not offered to all lenders and were conducted via debt exchanges, not as purchases for cash.

Prior to Serta's filing for bankruptcy in January 2023,[3] the Excluded Lenders challenged the Uptier Transaction in litigation that has spanned a number of federal and state courts.[4] In addition to arguing that the Uptier Transaction was not an "open market purchase," the Excluded Lenders contended that it violated the implied covenant of good faith and fair dealing under New York law and violated the pro rata sharing provisions of the Credit Agreement, which require that any payment be distributed ratably among all lenders. In March 2022, the SDNY denied Serta's motion to dismiss the Excluded Lenders' claims, holding that the term "open market purchase" was ambiguous, and the court therefore required discovery to determine its meaning in the context of the parties' agreement. The SDNY also rejected Serta's argument that the Excluded Lenders' complaint failed to state a claim for a violation of the implied covenant of good faith and fair dealing, permitting that claim to proceed in the alternative to the Excluded Lenders' claim for breach of contract.[5] That case was pending when Serta filed its chapter 11 petition in January 2023.

Litigation in Bankruptcy Court

On the same day Serta filed for bankruptcy, it also filed its adversary seeking a declaratory judgment that the Uptier Transaction was permitted under the terms of Serta's Credit Agreement. Serta's proposed plan of reorganization, which it filed the day after it filed its bankruptcy petition and the adversary proceeding, respects the priorities established by the Uptier Transaction and would exchange and eliminate much of Serta's $1.9 billion secured debt, giving the Uptier Lenders a near par recovery and the Excluded Lenders much less. Because Serta's proposed plan of reorganization depends on the validity of the Uptier Transaction, it was critical to Serta that the Bankruptcy Court resolve this issue at the outset of the case. The Bankruptcy Court agreed.

As in prior litigation over Serta's Uptier Transaction, the litigation before the Bankruptcy Court focused on the meaning of the phrase "open market purchase" and the implied covenant of good faith and fair dealing. The Excluded Lenders argued that the phrase "open market purchase" required Serta to allow *all* lenders, not just the Uptier Lenders, the chance to swap older debt into the new, more senior loans, and that the debt exchange Serta orchestrated was not a purchase at all.

Unlike the SDNY, the Bankruptcy Court held that the phrase "open market purchase" was unambiguous. Partially granting Serta's summary judgment motion, the Bankruptcy Court concluded that the Uptier Transaction satisfied the definition of an "open market purchase." The Bankruptcy Court's order did not, however, define "open market purchase" or provide further guidance as what to kinds of transactions constitute open market purchases. In addition, the Bankruptcy Court denied summary judgment on other claims, including the Excluded Lenders' claims for breach of the implied covenant of good faith and fair dealing. Thus, as in the SDNY case, these claims remain subject to further litigation, including a potential trial.

The Bankruptcy Court certified the Excluded Lenders' right to appeal the ruling directly to the Fifth Circuit. The Excluded Lenders appealed on April 7, 2023[6] but elected to appeal to the district court instead.[7] The issues on appeal are: (1) whether the Bankruptcy Court erred in holding that the term "open market purchase" as used in the Credit Agreement was unambiguous; and (2) assuming that the Bankruptcy Court correctly held that the phrase "open market purchase" is unambiguous, whether the Bankruptcy Court erred in holding that the Uptier Transaction constituted an open market purchase as defined by the Credit Agreement.[8] Accordingly, on appeal, the district court may disagree with the Bankruptcy Court that the term "open market purchase" is unambiguous, sending the issue back to the Bankruptcy Court for further litigation, or may outright disagree that the Uptier Transaction satisfied the definition of "open market purchase," reversing the ruling below.

If, however, the Bankruptcy Court's decision is upheld on appeal, it could have significant effects on both Serta's bankruptcy and litigation regarding other uptier transactions. Serta's chapter 11 case and the Bankruptcy Court's ruling present a noteworthy procedural development (and a possible strategy) in litigation regarding uptier transactions. Since Serta filed for bankruptcy a few years after its Uptier Transaction with a plan to hand the keys to its lenders, it also calls into question whether these now-relatively-common strategies provide the intended benefit to borrowers or only delay the inevitable for troubled companies. For the Uptier Lenders on the inside of the Uptier Transaction, the advantage is obvious: they retain a full recovery, notwithstanding the chapter 11 case, but at great cost to Serta and the Excluded Lenders.

The Bankruptcy Court's ruling is also notable in that it contradicts the prior ruling in the SDNY. If other uptier transactions find themselves mired in state or district court litigation, it will be interesting to see if other companies commence chapter 11 cases to bless their own transactions—and whether bankruptcy courts acquiesce in that process. Alternatively, the possibility of different rulings in different courts may also result in reluctance to pursue uptiering transactions, given the uncertainty about the treatment such transactions will receive in court; whether a given uptiering transaction is permissible is ultimately a matter of contract law rather than bankruptcy law, so companies may find it premature to conclude that bankruptcy courts will be more likely than state or federal district courts to validate such transactions if they are challenged.

The market will soon learn which outcome will be more likely, once the Excluded Lenders' appeals have been addressed – so more to come on this topic soon.

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- Boardriders: In Important Uptiering Case, Minority Lender Claims Survive Another Day
- Bankruptcy Court Holds That Noteholders' "Sacred Right" Was Not an Anti-Lien Subordination Provision in Permitting Uptier Transaction

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[1] *Serta Simmons Bedding, LLC, et al. v. AG Centre Street Partnership L.P., et al.*, A.P. No 23-09001, Dkt. Nos. 141 & 142 (Bankr. S.D. Tex. 2023 April 6, 2023).

[2] In a "drop down" transaction, the borrower transfers assets (in J. Crew's case, its trademarks) subject to the secured lenders' security interest to entities that are not "restricted" subsidiaries or affiliates under the credit agreement and uses such assets (which after the transfer are no longer subject to the secured lenders' security interest) as collateral to secure new debt or to extend the maturity of existing debt.

[3] *Serta Simmons Bedding, LLC, et al.*, Case No. 23-90020 (Bankr. S.D. Tex. 2023).

[4] In addition to the cases cited herein, *see N. Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC*, Case No. 0652243/2020 (New York County Supreme Court 2020); *AG Centre Street Partnership L.P. et al v. Serta Simmons Bedding, LLC et al.*, Case No. 0654181/2022 (New York County Supreme Court 2022).

[5] *See LCM XXII Ltd. v. Serta Simmons Bedding, LLC*, No. 21-CV-3987, 2022 WL 953109 (S.D.N.Y. Mar. 29, 2022).

[6] A.P. No 23-09001 (Bankr. S.D. Tex. 2023), Dkt. Nos. 144 & 145 (April 7, 2023).

[7] A.P. No 23-09001 (Bankr. S.D. Tex. 2023), Dkt. Nos. 153 & 155 (April 11, 2023).

[8] A.P. No 23-09001 (Bankr. S.D. Tex. 2023), Dkt. Nos. 147 & 150 (April 7, 2023)

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