

Bankruptcy Court Rules that “Uptier” Transaction in Serta Simmons Bedding Case Did Not Violate the Implied Covenant of Good Faith and Fair Dealing

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As we previously reported,^[1] in 2020 during the COVID-19 pandemic, Serta Simmons Bedding, LLC (“Serta”) sought additional funding, and certain of its existing lenders (the “Uptier Lenders”) provided \$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 (the “Uptier Transaction”). As a result of the Uptier Transaction, the debt held by the excluded lenders (the “Excluded Lenders”) who had not been invited to participate became subordinated.

The Uptier Transaction was effectuated in part by taking advantage of the “open market purchase” provisions of Serta’s credit agreement (the “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. Litigation ensued across several state and federal courts,^[2] with the Excluded Lenders contending that the Uptier Transaction violated the “open market purchase” provision of the Credit Agreement because the Uptier Lenders’ purchases were not offered to all lenders and were conducted via debt exchanges and not as purchases for cash. The Excluded Lenders also contended that the Uptier Transaction violated the implied covenant of good faith and fair dealing under New York law.

When Serta filed for bankruptcy in January 2023 in the U.S. Bankruptcy Court for the Southern District of Texas (the “Bankruptcy Court”),^[3] litigation shifted to the Bankruptcy Court, as Serta filed an adversary proceeding^[4] requesting declaratory relief regarding the propriety of the Uptier Transaction. Specifically, Serta sought a ruling that (1) the Uptier Transaction constituted an “open market purchase” within the definition of the Credit Agreement and (2) the Uptier Transaction did not breach the implied covenant of good faith and fair dealing under New York law. Because Serta’s plan of reorganization (the “Plan”) respects the priorities established by the Uptier Transaction and depends on its validity, Serta asserted that it was critical that the Bankruptcy Court resolve this issue at the outset of the case.^[5]

The Bankruptcy Court agreed. First, on April 6, 2023, the Bankruptcy Court issued a summary judgment ruling that the Uptier Transaction was an “open market purchase” consistent with the Credit Agreement.^[6] At summary judgment, however, the Bankruptcy Court did not provide guidance as to what kinds of transactions constitute open market transactions. The Court also deferred ruling on the issue of whether or not the Uptier Transaction violated the implied covenant of good faith and fair dealing under New York law to the Plan confirmation hearing. Next, on June 6, 2023, after a multiday confirmation trial, the Bankruptcy Court provided guidance on what constitutes “open

market transactions” and also ruled that the Uptier Transaction did not violate the implied covenant of good faith and fair dealing under New York law.¹²

The Confirmation Decision

The Bankruptcy Court concluded that the Uptier Transaction was not a breach of the implied covenant of good faith and fair dealing under New York law. In doing so, the Court noted that in the aftermath of the 2008 financial crisis, “commercial borrowers were able to negotiate more flexibility”—or “looseness”—in their loan documents. According to the Bankruptcy Court, this looseness “provides less protection for lenders and more opportunity for borrowers to manage their capital structure.” One form of such looseness “is the degree to which the borrower can subsequently take on additional debt on a priority basis.” Here, the Bankruptcy Court observed that the Credit Agreement “contains multiple provisions providing [Serta], as borrower, a great deal of flexibility to engage in liability management transactions” and therefore characterized Serta’s Credit Agreement as a “loose document.” The Bankruptcy Court also found that the parties, including the Excluded Lenders, “understood the implications of that looseness”; indeed, the Court noted that the Excluded Lenders had acquired most of their debt holdings after the original debt issuance in anticipation of pursuing their own “position enhancement transaction.”¹³ Under these circumstances—in which the parties, including the Excluded Lenders, understood the flexibility afforded by the Credit Agreement—the Bankruptcy Court concluded that there was no evidence of bad faith on the part of Serta or the Uptier Lenders, that Serta “always remained transparent in [its] goals,” that the Uptier Lenders “acted defensively and in good faith,” and that the Uptier Transaction “was the result of good-faith, arm’s length negotiations by economic actors acting in accordance with the duties owed to their respective creditors, investors and owners.”

In its opinion on confirmation, the Bankruptcy Court also provided guidance on what kinds of transactions constitute open market transactions. Turning to the dictionary, the Bankruptcy Court defined “open market purchase” as “something obtained for value in competition among private parties.” The Uptier Transaction satisfied this definition because:

[t]he process utilized by [the investment banker] to solicit interest from these existing lenders, the receipt and negotiation of multiple offers by [Serta] to achieve the greatest benefit for [Serta], the attempts by various lenders to “outmaneuver” one other with an ultimate winner announced, and the [Excluded] Lenders subsequent attempts to undermine the announced winning deal is the quintessential “Wall Street” open market purchase.

Thus, for the Bankruptcy Court, the relevant question to determine whether a transaction is an “open market purchase” was whether the *process* undertaken to achieve the transaction occurred in an open market—not whether the offer to participate in the transaction ultimately undertaken was open to every lender.

Takeaways

The Bankruptcy Court’s rulings are not the end of the litigation regarding the Uptier Transaction. The appeals of the Bankruptcy Court’s summary judgment ruling¹⁴ are still pending, and appeals of the Plan confirmation decision have been filed.¹⁵ Nevertheless, a decision affirming the Bankruptcy Court’s rulings could have wide-reaching effect.

First, in upholding the Uptier Transaction as consistent with both the Credit Agreement’s terms and the implied covenant of good faith and fair dealing under New York law, the Bankruptcy Court’s rulings may set a precedent for other debtors and lender groups to pursue similar up-tier transactions as a liability management strategy, particularly in anticipation of or preparation for a bankruptcy filing.

Second, the Bankruptcy Court departs from earlier decisions regarding the Uptier Transaction, including by the New York Southern District Court¹⁶ and the New York state court’s decision in the “Boardriders” case,¹² not only in ruling that the term “open market” purchase or transaction is unambiguous but by going further and holding that “open market” refers to the environment of competitive negotiations from which the victorious transaction emerges rather than the availability of the specific transaction to all lenders. It is important to note, however, that the Bankruptcy

Court's rulings with respect to both open market purchases and good faith and fair dealing were fact specific. Debtors and lenders seeking approval of position enhancement transactions in reliance on "open market" provisions may fail where Serta succeeded if a court determines that the transaction was not negotiated in a comparable arm's length, competitive environment.

Third, the Bankruptcy Court resolved the parties' disputes regarding the Uptier Transaction and confirmed Serta's Plan notwithstanding the pending New York Southern District Court litigation. If the Uptier Transaction and Plan confirmation survive the challenges on appeal, this may encourage other companies to commence Chapter 11 cases to receive relatively prompt—and potentially favorable—legal determinations from bankruptcy courts regarding the validity of their position enhancement transactions, either bypassing proceedings pending in state or district court or skipping such non-bankruptcy proceedings altogether.

Finally, the Bankruptcy Court's confirmation opinion characterizes the litigants as "[s]ophisticated financial titans" engaged in "a winner-take-all battle" that knew the risks of becoming parties to the "loose" Credit Agreement. The decision adds that the lending documents could have been drafted to minimize lenders' exposure to position enhancement transactions. In the absence of language preventing such transactions, the Bankruptcy Court refused to rewrite the parties' contracts, stating that the outcome, in which one side won and the other side lost, "was not only foreseeable, it is the only correct result." If this opinion portends that other courts may be inclined to uphold such transactions because all parties are sophisticated market participants, lenders should pay attention to exactly what their credit agreements allow and assess how much tolerance they have for the risk that they find themselves on the losing end of a position enhancement transaction.

For more insights related to this topic, read our additional briefings:

[In Landmark Ruling, Bankruptcy Court Upholds "Uptier" Transaction in Serta Simmons Bedding Case](#)

[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](#)

^[1] [In Landmark Ruling, Bankruptcy Court Upholds "Uptier" Transaction in Serta Simmons Bedding Case](#).

^[2] 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); *LCM XXII Ltd. v. Serta Simmons Bedding, LLC*, No. 21-CV-3987 (S.D.N.Y. 2021) (the "New York Southern District Court").

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

^[4] *Serta Simmons Bedding, LLC, et al. v. AG Centre Street Partnership L.P., et al.*, A.P. No 23-09001 (Bankr. S.D. Tex. 2023) (the "Adversary Proceeding").

^[5] Pursuant to the Plan, much of Serta's \$1.9 billion secured debt is exchanged for equity and eliminated, resulting in a near par recovery for the Uptier Lenders and a much smaller recovery for the Excluded Lenders.

^[6] Bankruptcy Case, Dkt. Nos. 141 & 142 (April 6, 2023).

^[7] Bankruptcy Case, Dkt. No. 1045; Adversary Proceeding, Dkt. No. 324. On June 14, 2023, the Bankruptcy Court entered final judgments relating to the Trial Decision. see Bankruptcy Case, Dkt. No. 1070; Adversary Proceeding, Dkt. No. 324.

^[8] The Bankruptcy Court uses the term "position enhancement transaction" as a catch-all terms for liability management transactions, whether characterized as uptier or drop-down, that "effectively remove a borrower's most valuable assets from the non-participating lenders' collateral base until the participating lenders are paid in full."

^[9] Adversary Proceeding, Dkt. Nos. 144, 145, 147 & 150 (April 7, 2023).

¹⁰⁰ Bankruptcy Case, Dkt. Nos. 1080 (June 15, 2023), 1109, 1115, 1120 (June 21, 2023) & 1125 (June 22, 2023); Adversary Proceeding, Dkt. Nos. 330 (June 20, 2023) & 331 (June 21, 2023). On June 21, 2023, the Bankruptcy Court denied motions to stay the Confirmation Order or extend the effective date of the Confirmation Order pending appeal, with the exception of a slight extension of the effective date from June 21, 2023 to June 23, 2023. See Bankruptcy Case, Dkt. No. 1124.

¹¹¹ *LCM XXII Ltd. v. Serta Simmons Bedding, LLC*, No. 21-CV-3987, 2022 WL 953109 (S.D.N.Y. Mar. 29, 2022).

¹¹² *ICG Global Loan Fund 1 DAC v. Boardriders, Inc.*, No. 655175/2020 (N.Y. Sup. Ct. Oct. 17, 2022). See [Boardriders: In Important Uptiering Case, Minority Lender Claims Survive Another Day](#).

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