Memorandum

Serta & Mitel: A Tale of Two New Year's Eve LME Decisions

January 8, 2025

Executive Summary

Liability management exercises, or LMEs, have continued to gain popularity among borrowers looking to improve their balance sheets by taking advantage of flexibility in their debt documents. 2024, like 2023, saw significant LME activity as borrowers continued to seek to address capital structure issues through out of court refinancings and restructurings and thereby avoid the costs attendant to formal restructuring proceedings. On the last day of the year, two different courts issued important decisions relating to one type of LME: the non-pro rata uptier exchange.

First, in *In re Serta Simmons Bedding, L.L.C.,* 2024 U.S. App. LEXIS 32969 ("Serta Simmons Bedding"), the United States Court of Appeals for the Fifth Circuit held that a governing credit agreement's "open market purchase" exception to the pro rata sharing provision did not permit a private exchange between the borrower and participating lenders that was not pro rata to all lenders. Although the Fifth Circuit's decision involved a New York law-governed document, its decision is not binding on New York courts. Shortly thereafter, in *Ocean Trails CLO VII v. MLN Topco Ltd.*, 2024 N.Y. App. Div. LEXIS 7034 ("Mitel Networks"), the Appellate Division of the Supreme Court of the State of New York upheld a non-pro rata uptier exchange because it found that the exchange constituted a "purchase" permitted by the governing credit agreement. Although the two courts reached different conclusions, the takeaways from these cases are similar: (i) effecting capital transactions in reliance on lack of specific clarity and/or undefined terms in debt agreements increases transaction risk, as they are subject to a reviewing court's application of its judgment as to the interpretation of contractual provisions, and (ii) market participants can be expected to rely increasingly on creative structures in which exchange participation is offered to all creditors so as to avoid running afoul of pro-rata sharing provisions.

Serta Simmons Bedding

Serta Simmons Bedding entered into a non-pro rata exchange pursuant to which certain of Serta's existing lenders—the "participating lenders"—provided Serta with $200 million of new-money for a first-out, super-priority loan. The participating lenders also exchanged approximately $1.2 billion of their first-lien and second-lien loans for approximately $875 million in second-out, super-priority debt. The lenders that were not given the opportunity to participate in the exchange were effectively subordinated.

The Serta credit agreement, governed by New York law, included a pro-rata sharing provision, which required lenders to be paid on a pro rata basis. The credit agreement, however, excepted from the pro rata sharing provision: (i) a "Dutch Auction," governed by a very specific set of procedures, and (ii) an "open market purchase," an undefined term in the credit agreement. Serta and the participating lenders took the position that the uptier exchange was an "open market purchase" between Serta and the participating lenders. Recognizing that the exchange was not risk-free, Serta agreed to indemnify the participating lenders for losses incurred in connection with their participation in the exchange.

After the transaction closed, Serta continued to suffer financial distress and ultimately filed for chapter 11 protection in the United States Bankruptcy Court for the Southern District of Texas. Serta filed an adversary proceeding seeking approval of the uptier exchange and subsequently filed a plan of reorganization that provided for the survival of the indemnity—styled as a "settlement indemnity"—in favor of the participating lenders. The Bankruptcy Court upheld the uptier transaction, confirmed the plan, including the indemnity, and certified a direct appeal to the Fifth Circuit.

The Fifth Circuit reversed the Bankruptcy Court's decision, holding that the credit agreement did not permit the uptier exchange. Focusing on the meaning of the word "market," and drawing on a variety of sources, the court interpreted the undefined term "open market purchase" to be specifically referring to an actual market for syndicated loans. The Fifth Circuit ruled that the private exchange between Serta and the participating lenders did not fall within the ambit of an "open market purchase." The court also further reasoned that, if any private exchange between two parties were deemed to constitute an "open market purchase," that interpretation would impermissibly render the more specific "Dutch Auction" exception superfluous. Noting that the transaction likely constituted a breach of the credit agreement, the Fifth Circuit remanded the case back to the bankruptcy court for further proceedings because the breach of contract issues had not been sufficiently briefed on appeal.

The Fifth Circuit also rejected the plan indemnity as an impermissible end-run around the Bankruptcy Code. The court reasoned that the Bankruptcy Code disallows indemnity claims where the claimant is co-liable with the debtor on the underlying obligation and, as Serta's contractual partner in the uptier exchange, the participating lenders' indemnity claim against Serta would otherwise be disallowed. Disguising a prepetition indemnity claim as a "settlement indemnity" in the chapter 11 plan could not salvage the indemnity. The Fifth Circuit also found that the indemnity violated the Bankruptcy Code's requirement for equal treatment because the value of the indemnity, even amongst members of the same creditor class, varied depending on whether a particular creditor participated in the exchange.

Mitel Networks

Mitel entered into an uptier exchange pursuant to which certain of Mitel's first lien and second lien lenders provided Mitel with new money as a super priority loan. The participating lenders also exchanged their existing holdings into new second-out and third-out loans. The non-participating lenders were effectively subordinated.

The non-participating lenders filed suit in NY state court, alleging that the non-pro rata exchange violated their "sacred rights" under the credit documents. The trial court denied Mitel's motion to dismiss the breach of contract claims.

In a very brief decision, the Appellate Division dismissed the breach of contract claims because, among other things, the credit agreement authorized the borrower to "purchase by way of assignment and become an Assignee with respect to Term Loans at any time." Interpreting the term "purchase," the court explained that there was no indication in the credit agreements that (i) a refinancing or exchange cannot constitute a "purchase" or (ii) a "purchase" requires payment upfront in cash.

Key Takeaways

A few observations can be made from these two important decisions, notwithstanding their differing conclusions:

- *Courts continue to focus their analysis on the particular language of the underlying debt document, and different courts can reach different conclusions based on the same, or similar, language. The* Mitel *court interpreted a "purchase" provision broadly, while the Fifth Circuit interpreted "market" narrowly when considering the meaning of "open market purchase." Relying on ambiguous and/or undefined language in a debt document to effectuate an LME can significantly increase the risk of a transaction.*
- *On the other hand, if the debt document language is not clearly prohibitive, more aggressive borrowers and debtholders may still elect to transact and assume the risk of an adverse judicial interpretation. Given the Serta decision, however, borrowers and debt holders must consider the implications of not having an enforceable indemnity to protect against claims arising from the transaction, should the borrower subsequently seek chapter 11 protection.*
- *The exchanges at issue in* Serta *and* Mitel *were non-pro rata uptier exchanges where the offer to exchange was limited to certain debt holders. Although not binding on other jurisdictions (including New York), given the prominence of the Fifth Circuit, borrowers and debt holders may now be even less willing to rely on "open market purchase" exceptions to effectuate non-pro rata exchanges. In situations in which the underlying debt documents contain such restrictions, debt exchanges in connection with LMEs will likely increasingly be replaced by transaction structures in which the exchange is offered to all debt holders, but the treatment of exchanging debt holders may not necessarily be the same.*

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