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Serta:
Implications of the Fifth Circuit's "Open Market Purchase" Holding in *In re Serta*

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2024

Research Date: January 2, 2025

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The Bottom Line™:

- On December 31, 2024, the United States Court of Appeals for the Fifth Circuit rejected arguments that Serta's infamous exchange of existing term loans for new supersenior debt constituted a valid "open market purchase" under its then-applicable credit agreement.
- In this report, we analyze the court's holding regarding open market purchases and assess potential implications for liability management transactions going forward.

On December 31, 2024, the United States Court of Appeals for the Fifth Circuit (the "Fifth Circuit") handed down a hotly anticipated decision—*In re Serta Simmons Bedding, L.L.C.* (the "Opinion")[1]—in which a three-judge panel addressed certain appeals that arose from Serta Simmons' 2023 bankruptcy. The decision dealt with a number of bankruptcy-specific issues but was also focused heavily on the validity of Serta's infamous 2020 "uptier" liability management transaction (the "2020 LMT"). Such direct commentary from the judicial branch on liability management transactions ("LMTs") is a rare occurrence, and the Opinion here is unique for its direct repudiation of at least certain LMT methodologies. As such, it is likely to prompt significant discussion among market participants over the next several months.

In this report, we provide our initial impressions of the Opinion, unpack some of the Opinion's key holdings, and consider implications for other distressed borrowers contemplating similar "uptiering" LMTs.

Additional reporting on the Opinion from our colleagues at LFI can be found here. Our colleagues at CreditSights have also published a report (the "CS Report") discussing bankruptcy-related matters from the Opinion, available here.

Background

We have discussed Serta's 2020 LMT in a number of reports and also have discussed how uptiering liability management transactions typically work.[2] Serta's 2020 LMT can be described in simplified terms as follows:

[1] The full opinion is available here via PacerMonitor.
[2] See: Serta Simmons: More on Priming Debt Front, Serta Simmons: Defendants Respond Priming Debt is AOK, The Duty of Good Faith in Serta and TriMark, , Serta Simmons: Preliminary Bankruptcy Observations, and Serta Simmons: The Near End of this Infamous Priming Saga? For more on uptiering LMTs generally: A Survey of Recent Notable "Liability Management" Transactions in the Loan Markets, Part I: Uptiering Transactions and Liability Management Transactions: Quarterly Update Through Q3 2024.

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- Like most broadly syndicated loan facilities, Serta's first and second lien credit agreements (referred to herein generally as the "2016 Credit Agreement") included customary provisions requiring the ratable treatment of lenders vis-à-vis each other.[3]
- The pro rata treatment requirement in the 2016 Credit Agreement included an express exception in the context of Dutch auctions and, more importantly, "open market purchases," which allowed non-pro rata treatment in those circumstances.
- A bare majority of Serta's lenders agreed to be subordinated to new supersenior debt because subordination was not considered a "sacred right" requiring unanimous or affected lender consent.
- In order to entice the consenting lenders to agree to subordination, the company offered to exchange the consenting lenders into the new supersenior debt via the "open market purchase" exception, thereby bypassing any pro rata treatment requirements.

See Annex I below for a graphic representation of the 2020 LMT.

Despite the 2020 LMT, the company eventually succumbed to its economic reality and filed for bankruptcy in January 2023. In connection with its bankruptcy, Serta also filed an adversary proceeding on January 24, 2023 seeking declaratory relief against non-participating lenders in the 2020 LMT, essentially requesting the court to declare that the 2020 LMT was in fact permitted under the terms of the pre-petition 2016 Credit Agreement. Judge Jones, who was presiding over Serta's bankruptcy at the time, held that the term "open market purchase" was "clear and unambiguous" and that the 2020 LMT was indeed a valid open market purchase under the 2016 Credit Agreement. The bankruptcy court certified its decision for direct appeal to the Fifth Circuit. All appeals were then consolidated.

See the CS Report for a more detailed discussion of the history of Serta's bankruptcy and associated litigation generally.

The Decision

In this report, we focus primarily on the Fifth Circuit's discussion of Serta's 2020 LMT (and we do not comment directly on the bankruptcy-related issues of equitable mootness or appellate remedy of excision, both of which are discussed in more detail in the CS Report). The relevant portion of the Opinion states that the exception to pro rata treatment in the 2016 Credit Agreement applies only to an open market purchase that "is a purchase of corporate debt that occurs on the secondary market for syndicated loans."[4] Accordingly, the court holds that the 2020 LMT was *not* a permissible open market purchase.

The Fifth Circuit grounds this holding primarily on the idea that the term "open market purchase" necessarily requires an "*open market*" (referring to the secondary market for syndicated loans), which implicitly is distinct from a *private* transaction between the borrower and one or more specific lenders. Thus, an "open market purchase" does not justify one-on-one private negotiations as these do not operate within an "open market" and are instead "merely a general context where private parties engage in non-coercive transactions with each other."[5] The term "market" moreover is not created by the simple existence of "competition" but instead must be a "designated market" such as a stock, commodities, or securities

[3] See page 8 of the Opinion; additionally, see Covenant Primer: Pro Rata Sharing in US Leveraged Loans (Part 1) and Covenant Primer: Pro Rata Sharing in US Leveraged Loans (Part 2).
[4] Page 29 of the Opinion.
[5] Page 31 of the Opinion.

market.[6] Per the Fifth Circuit, in order for the 2020 LMT to be justified as an "open market purchase," Serta would have had to:

> "purchas[e] its loans on the secondary market. Having chosen to privately engage individual lenders outside of this market, SSB lost the protection of § 9.05(g) [of the 2016 Credit Agreement]."[7]

Or, as the court later indicates, Serta was broadly limited to two options to bypass the ratable treatment exception:

> "[Serta] may go to the secondary market and submit bids to complete an open market purchase of any amount. Or [Serta] may conduct an off-market Dutch auction, wherein it must notify all relevant lenders of its intent, purchase at least $10 million of debt, and follow the procedures in the 2016 Credit Agreement."

The Fifth Circuit goes on to bolster its holding via more technical canons of contractual interpretation (including that allowing Serta's and the prevailing lenders' broader interpretation of "open market purchase" renders other parts of the Credit Agreement—specifically the "Dutch auction" provisions—superfluous). The Court also rejected arguments based on the purported market practice for broadly syndicated loans, and instead applied standards and practices applicable to securities markets.[8] We leave these analyses to the law professors and legal scholars of the world. For most market participants, however, the upshot is, as the court concludes—that while "every contract should be taken on its own, today's decision suggests that [open market purchase] exceptions will ***often not justify an uptier***" (emphasis added).[9]

The Fifth Circuit thus reversed Judge Jones' earlier contrary ruling and remanded the case back to the lower bankruptcy court (the case now being overseen by Judge Lopez) for reconsideration of the minority lenders' breach of contract counterclaims.

Implications for LMT practice generally

So, is the Opinion by the Fifth Circuit the death knell of uptiering? Not exactly. *In re Serta* is almost certainly going to have significant reverberations throughout the leveraged debt markets and the LMT practice specifically. However, we do not expect uptiering to disappear entirely. First off, the Opinion is admittedly limited in focus and the court itself acknowledges that each contract must ultimately be analyzed on its own merits. Moreover, the Opinion is at its heart about whether "open market purchases" function as an exception to pro rata treatment—and not about the *per se* validity of uptiering generally.

That said, we broadly anticipate that distressed borrowers and their advisors may find uptiering to be a far less attractive avenue for LMTs then previously, even with the caveat that the Fifth Circuit's decision is—while highly influential—not dispositive precedent for all other courts in the United States, including New York state courts and the Second Circuit. The parameters of the Opinion, however, may still allow uptiering in a number of scenarios, including the following:

- The Opinion broadly does not address the issue of subordination as a sacred right in the 2016 Credit Agreement, implicitly accepting that the absence of subordination from the list of such

[6] Page 31 of the Opinion.
[7] Page 32 of the Opinion.
[8] Page 37 of the Opinion.
[9] Page 54 of the Opinion.

rights is sufficient to allow subordination via majority lender consent alone. Thus, uptiering where there is only new money superpriority debt but no exchange mechanism is unlikely to be affected by the Fifth Circuit's holding.

- Uptiering exchanges may be enacted cleanly in credit agreements that do not utilize the term "open market purchase" at all but instead broadly permit the borrower to simply acquire term loans on a non-pro rata basis via assignment. In such cases, the borrower in theory would not be beholden to the Fifth Circuit's determination that an "open market purchase" must be conducted via the secondary loan market. It is also possible that sponsors and borrowers may attempt to move towards this style of drafting in new issuances, specifically to bypass the Opinion.

- Similarly, distressed borrowers may consummate uptier exchanges under credit agreements that explicitly *include* privately negotiated transactions and debt for debt exchanges as a specific exception to the ratable sharing provisions. Indeed, we have already encountered numerous credit agreements that include similar language (including a small but not insignificant minority of deals closed in 2024[10]). Both removing the term "open market purchase" *and* explicitly including privately negotiated transactions would function as contractual workarounds of the Opinion's potential limitations.

- There is a discussion in the Opinion which suggests that the failure of the 2020 LMT to comply with the 2016 Credit Agreement lies at least partially in the fact that it was conducted as a debt-for-debt exchange rather than a true buyback.[11] Accordingly, it is possible that some borrowers may attempt an uptiering where actual cash proceeds of priming debt are received and then applied to repurchase consenting lenders on the secondary market. This would, however, add an additional layer of complexity to any such LMT (and the parties would have to negotiate appropriate risk allocation). However, it is questionable whether this would actually work conceptually within the confines of the Opinion as it would appear that any such cash roundtripping buyback would still need to be conducted on the "open market" (i.e., via a bid issued to the market generally, rather than as privately negotiated with specific lenders). Specific wording of the applicable credit agreements will also matter here.

- Sponsors and borrowers may also begin focusing again on removing pro rata sharing provisions generally from the list of sacred rights, allowing a bare majority to change those terms to allow for uptiering without needing to address open market purchase flexibility.[12]

- Finally, although we are not yet aware of any uptiering LMTs in the private credit market, there is a colorable argument that that the Opinion may not apply to private credit loans, given the absence of a robust "secondary market" for such loans and the customary private negotiations that characterize that market.

Ultimately, we expect that while uptiering may start to fall off as a preferred LMT methodology, it is unlikely to disappear entirely. Whether this means that other forms of LMTs (including drop-downs or double dips) will become more prevalent remains to be seen.

[10] Covenant Review tracked 102 separate transactions in 2024 that explicitly referenced privately negotiated transactions in addition to or as an alternative to open market purchases, representing 20% of all deals surveyed in the year.
[11] See discussion of the arguments posed by Serta and prevailing lenders that the LSTA's Complete Credit Agreement Guide specifically endorses uptiering via private negotiations on page 37 of the Decision.
[12] Modifications to pro rata sharing can have a similar effect to uptiering, as seen in the 2018 LMT for NYDJ. See NYDJ: A Nightmare Scenario Realized for Investors in a Distressed Credit.

Covenant Review will of course continue to assess new LMTs and assess how the market may react to the Opinion in the coming months.

— *Covenant Review*

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Annex I

2020 LMT Diagram