Clients&FriendsMemo

The Twilight, or Rebirth, of Liability Management? *Serta* and *Mitel* Decisions Reach Opposite Conclusions on the Permissibility of Uptier Exchange Transactions

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Introduction & Key Takeaways

The year 2024 ended with some major legal fireworks, as two important courts issued contrasting New Year's Eve decisions on the validity of "uptier" liability management transactions that have played a large role in corporate debt restructurings for the past several years.

On December 31, 2024, the Fifth Circuit rendered its highly anticipated decision on the *Serta* uptier transaction, ruling the transaction did not constitute an "open market purchase" under Serta's existing credit agreements and therefore violated those credit agreements' *pro rata* sharing provisions.[1]

In contrast, the New York State Supreme Court (Appellate Division, First Department) in *Mitel Networks*[2] found a similar uptier transaction did not violate the *pro rata* sharing provisions of Mitel's credit agreement as such agreement allowed Mitel to acquire loans via any "purchase" permitted under the assignment provisions thereof.

The diverging opinions in *Serta* and *Mitel* highlight that uptier transactions remain contentious. While time will tell how the market responds to these rulings, a few key takeaways now are:

- The Fifth Circuit's ruling in *Serta* may prove to be a seminal event in the world of liability management transactions. The decision casts doubt on the validity of uptier transactions in the broadly syndicated market based on the current "open market" construct of the loan assignment provisions found in credit agreements. As a result, sponsors and borrowers will have to weigh the risks of other courts deferring to the Fifth Circuit's logic in conducting future uptier transactions premised on similar assignment provisions as *Serta*.

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1 *See Excluded Lenders v. Serta Simmons Bedding, LLC (In re Serta Simmons Bedding, LLC)*, Nos. 23-20181, 23-20450, 23-20363 (5th Cir. Dec. 31, 2024) ("*Serta*").

2 *See Ocean Trails CLO VII et al. v. MLN Topco Ltd.*, No. 2024-00169 (N.Y. App. Div. Dec. 31, 2024) ("*Mitel Networks*").

- However, the *Serta* ruling is not a blanket condemnation of uptier transactions. The Fifth Circuit only addressed what qualified as an open market purchase in the context of a broadly syndicated loan. The Court did *not* address what constitutes an open market purchase more broadly, such as in the context of a smaller club deal or a private credit, direct lending deal. And the Fifth Circuit's reasoning (discussed further below) could support an interpretation that credit facilities with fairly illiquid secondary markets could have a different "market" that more closely resembles a privately negotiated deal.
- In fact, *Mitel* can be read in harmony with the *Serta* ruling. The *Mitel* court analyzed an uptier transaction premised on a very different loan buyback provision than the one in *Serta*. The credit agreement in *Mitel* did not limit such purchases to "open market" purchases, and therefore afforded its borrower a broader interpretation of the loan buyback ability. The contrasting rulings in *Serta* and *Mitel* demonstrate how parties must pay close attention to the specific language contained in each credit agreement.
- Finally, the *Serta* ruling is likely to be a positive development for the US BSL CLO market overall, as CLOs are typically minority lenders and consequently are historically at risk of exclusion from these transactions absent specific language in CLO indentures allowing participation. The CLO market will need to remain vigilant in the coming months to respond against any prospective changes in underlying documentation seeking to work around this ruling. Additionally, we will separately consider the impact of this ruling on Private Credit CLOs in a future Clients & Friends memo.

For further discussion and analysis, below is a brief summary of the key contractual provisions and disputed issues in each of these cases.

Serta Simmons

The key background facts in the *Serta* case are as follows:

- In 2016, Serta Simmons Bedding, LLC ("*SSB*") refinanced its existing debt by issuing $1.95 billion in first-lien syndicated loans and $450 million in second-lien syndicated loans pursuant to two separate credit agreements.[3]
- Then, during 2020, a group of lenders comprising "required lenders" under Serta's first-lien and second-lien credit facilities (these participating lenders, the "*Prevailing Lenders*") amended those facilities to permit SSB to incur (i) $200 million in new money, first-out super-priority financing provided by the Prevailing Lenders, and (ii) $875 million in second-out super-priority financing by exchanging approximately $1.2 billion of first-lien and second-lien debt held by

[3] The key agreement at issue for purposes of the Fifth Circuit litigation was the First Lien Term Loan Agreement (the "*2016 Credit Agreement*").

those Prevailing Lenders, effectively leaving the remaining (former) first-lien and second-lien lenders in third-lien and fourth-lien positions, respectively.

The central dispute in *Serta* was whether the uptier transaction violated the existing first-lien and second-lien credit agreements' *pro rata* sharing provisions requiring payments made to similarly situated lenders be shared ratably among such lenders.[4] SSB and the Prevailing Lenders argued the uptier transaction did not violate the *pro rata* sharing provisions of the credit agreements because the exchange of existing debt for super-priority debt constituted an "open market purchase" under the credit agreements, which such purchases were permitted to occur on a non pro-rata basis.[5] The minority lenders (*i.e.*, those lenders who did not participate in the uptier transaction, the "*Nonparticipating Lenders*"), on the other hand, argued the debt exchange was not open since it was conducted pursuant to a private negotiation among SSB and the Prevailing Lenders.

Procedural history and subsequent bankruptcy filing:
Certain Nonparticipating Lenders sued SSB and the Prevailing Lenders in the U.S. District Court for the District of New York. In March 2022, District Judge Failla denied the defendants' motion to dismiss the Nonparticipating Lenders' complaint, ruling that the term "open market purchase" was sufficiently ambiguous and that a trial on the merits was required to determine whether a breach of the loan agreements had occurred. After the Southern District of New York issued its decision, SSB filed for chapter 11 bankruptcy in January 2023 in the U.S. Bankruptcy Court for the Southern District of Texas.

On January 24, 2023, SSB and certain of the Prevailing Lenders filed an adversary proceeding against the Nonparticipating Lenders, whereby the Prevailing Lender plaintiffs sought and obtained a declaration from the bankruptcy court that the 2020 uptier exchange did not violate the 2016 Credit Agreement's ratable-sharing provisions. The Nonparticipating Lenders then appealed to the Fifth Circuit.

Additionally, SSB's bankruptcy filing raised a related dispute involving certain indemnity provisions contained in the debtor's confirmed chapter 11 plan for the benefit of the Prevailing Lenders – and whether these indemnity provisions could be revisited by the Fifth Circuit or were equitably moot. Pre-petition, SSB had agreed to indemnify the Prevailing Lenders for any and all losses, claims, damages and liabilities they might incur in connection with their participation in the uptier

[4] Importantly, the *pro rata* sharing provisions were sacred rights under the existing credit agreements, meaning any amendment to the credit agreements that altered the *pro rata* sharing requirements could not be approved by just a simple majority of lenders but had to be approved by all lenders affected by such change.

[5] *See* Section 9.05(g) of the 2016 Credit Agreement ("[A]ny Lender may, at any time, assign all or a portion of its rights and obligations under this Agreement in respect of its Term Loans to any Affiliated Lender on a non-*pro rata* basis (A) through Dutch Auctions open to all Lenders holding the relevant Term Loans on a *pro rata* basis or (B) through open market purchases ...[.]").

exchange.[6] The debtor's approved chapter 11 plan incorporated these indemnity provisions, characterizing them as "executory contracts" that would be assumed under the plan.[7] Certain of the Nonparticipating Lenders thereafter appealed these indemnity-related issues, asking the Fifth Circuit to excise the indemnity provisions from the confirmed plan.

Fifth Circuit ruling and reasoning:
The Fifth Circuit reversed the bankruptcy court, ruling that the 2020 uptier exchange did not constitute a permissible "open market purchase" under section 9.05 of the 2016 Credit Agreement. The Fifth Circuit provided two major reasons for its conclusion.

First, the Fifth Circuit focused on the meaning of the term "open market" in the 2016 Credit Agreement, holding that that term referred to a "specific market that is generally open to participation by various buyers and sellers," namely the established "secondary market for syndicated loans."[8] Therefore, in order to avail itself of section 9.05(g) – and circumvent the "sacred right" of ratable treatment – the court explained that SSB "should have purchased its loans on the secondary market." [9] However, "[h]aving chosen to privately engage individual lenders outside of this market, SSB lost the protections of [section] 9.05(g)."[10]

Second, the Fifth Circuit noted that reading the "open market purchase" exception as broadly as SSB and the Prevailing Lenders proposed would render redundant the second major exception to ratable sharing recognized under the 2016 Credit Agreement, namely the provision permitting SSB to conduct a "Dutch auction."[11] Under SSB and the Prevailing Lenders' "expansive" definition of an "open market purchase," such a "Dutch auction" would also qualify as an "open market purchase," meaning that the "open market purchase" provision of the 2016 Credit Agreement would essentially swallow the "Dutch auction" provision and the "Dutch auction" provision would not do any independent work. As the Fifth Circuit held, "the appellees' expansive definitions thus render the entire Dutch auction exception superfluous, contrary to standard rules of New York contract interpretation."[12]

While the Fifth Circuit only addressed the facts before it, the court was seemingly aware of the implication its ruling would have, cautioning that while "every contract should be taken on its own,"

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6 Serta Opinion, at 10.

7 Serta Opinion, at 12.

8 Serta Opinion, at 29 (emphasis added).

9 Serta Opinion, at 30.

10 Serta Opinion, at 30.

11 Serta Opinion, at 10.

12 Serta Opinion, at 33.

it simultaneously warned that in future liability management transactions, contractual exceptions to the ratable treatment rule "will often not justify an uptier."[13]

On the issue of equitable mootness, the Fifth Circuit rejected arguments by SSB and the Prevailing Lenders that the doctrine of equitable mootness barred the Court's review of the plan confirmation order previously issued (and which remained unstayed) by the bankruptcy court, explaining that equitable mootness "cannot be a shield for sharp or unauthorized practices."[14] Turning to the three-part test for equitable mootness, the Court found that excising the indemnity provisions from the plan would not affect either the rights of parties not before the Court or the success of the plan.[15] On this point, the Court emphasized that excising the indemnity obligations from the plan would actually improve the debtor's chances for long-term financial success.[16] The Court further ruled that the inclusion of the challenged indemnity provisions in the plan – which were "potentially worth tens of millions of dollars" – "was an impermissible end-run around the Bankruptcy Code."[17] Specifically, the Court found that the indemnity provisions ran afoul of section 502(e)(1)(B)'s prohibition on contingent claims. That the debtors and Prevailing Lenders had dressed up the indemnity as a purported settlement under Bankruptcy Code section 1123(b)(3)(A) did not change the Court's conclusion that the indemnity "was an impermissible end-run around [section] 502(e)(1)(B)'s disallowance of contingent claims for reimbursement."[18] Notably, the Court excised the indemnity provisions despite its finding that the approved plan had already been substantially consummated.[19]

Mitel Networks

Also on December 31, 2024, in a decision seemingly more favorable to the viability of uptier transactions, the New York State Supreme Court (Appellate Division, First Department) reversed a trial court decision denying motions to dismiss contractual challenges to an October 2022 uptier transaction executed by Mitel Networks. The First Department directed the lower court to grant the participating lenders' motions to dismiss. In doing so, the Court held that the challenged uptier transaction did not breach the terms of the original loan agreements, and further ruled that the amended agreements at issue "are valid and enforceable contracts."[20]

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[13] Serta Opinion, at 54.

[14] Serta Opinion, at 43.

[15] Serta Opinion, at 39.

[16] *Id.* at 40.

[17] Serta Opinion, at 37, 42.

[18] Serta Opinion, at 45.

[19] Serta Opinion, at 39.

[20] *Mitel Networks*, at 2.

In an unsigned *per curiam* opinion, the First Department held that the uptier transaction did not breach the *pro rata* sharing requirements of the Mitel credit agreement because the transaction constituted a permitted "purchase" under section 9.04(i) which "authorizes the borrower to 'purchase by way of assignment and become an Assignee with respect to Term Loans at any time.'"[21] After explaining that the terms "purchase," "refinancing" and "exchange" "are not mutually exclusive," the Court concluded that "[t]here is no indication in the agreements that a refinancing or exchange cannot include a purchase, nor is there any indication that a purchase requires payment in full, upfront, in cash, or that debt cannot constitute payment."[22]

The *Mitel* court also found that the subordination of the existing debt to the newly issued uptier exchange debt did not violate the excluded lenders' "sacred rights." On this point, the court noted that the sacred rights provision contained in the credit agreement "only requires the consent of 'each Lender directly adversely affected' by a change in loan terms."[23] Per the court, the subordination of the excluded lenders' loans accomplished by the uptier transaction (behind the new first-priority loans held by the participating lenders) only indirectly affected the claims of the excluded lenders – and did not *directly adversely affect* those claims.[24]

Finally, the *Mitel* court agreed with the company and the participating lenders that none of the uptier-related amendments actually "waived," "amended" or "modified" the terms of the original loans.[25] Rather, as the court explained, "the participating lenders' loans were assigned back to the borrower, cancelled, and then replaced with new loans with their own, new terms."[26]

Key distinctions between *Serta* and *Mitel*

While the *Serta* and *Mitel* cases are similar in that each involves a challenged uptier transaction, there are three key distinctions between these two cases:

- First, in *Serta*, the credit agreement included only two relatively narrow exceptions to the general requirement of *pro rata* treatment, including an exception for "open market purchases." Conversely, the Mitel credit agreement included a significantly broader exception to the *pro rata* treatment rule whereby the company could elect to "purchase" its own loans "at any time."
- Second, the Fifth Circuit held the actual purchase of loans by SSB from the Prevailing Lenders violated the "ratable treatment" requirement under the 2016 Credit Agreement which also

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[21] *Mitel Networks*, at 2-3.

[22] *Id.* at 2.

[23] *Id.*

[24] *Id.*

[25] *Mitel Networks*, at 2.

[26] *Id.*

constituted a "sacred right", meaning that any deviation from ratable treatment would require the unanimous consent of all affected lenders. By contrast, since the *Mitel* loan purchases did not violate the *pro rata* sharing requirements of its credit agreement, the sacred right at issue in *Mitel* was a question of subordination, whereby the *Mitel* court concluded the applicable loan documents permitted the existing loans to be subordinated to newly issued debt with a bare majority of lender consent.

- Third, the procedural posture of *Serta* and *Mitel*, respectively, was vastly different at the time of each ruling. Serta had a multi-year and well-documented procedural history at the time of the Fifth Circuit's ruling, including litigation in the S.D.N.Y. and an intervening chapter 11 filing in the Southern District of Texas. Conversely, the trial court ruling overturned in *Mitel* was merely an oral ruling that allowed certain challenges to proceed past the motion-to-dismiss stage. Consequently, the precedential value of *Mitel* perhaps should not be overstated, especially given the Fifth Circuit's more emphatic rejection of the uptier transaction in *Serta*.

Looking Ahead

Future courts assessing uptier transactions are likely to scrutinize the specific loan agreements at issue to determine whether they more closely resemble the terms of the *Serta* or the *Mitel* loan agreements, respectively, before deciding what precedential weight to give to either the Fifth Circuit's or the First Department's opinion. In the interim, companies or lenders who contemplate undertaking or participating in a "liability management exercise" should carefully scrutinize the relevant loan documentation for similarities and differences as compared to the *Serta* and *Mitel* documents as one means of assessing how likely the proposed transaction is to survive a legal challenge. In particular, participants holding broadly syndicated loans in future uptier transactions should probably place less reliance on "open market purchase" provisions as a contractual support for the transaction, because the Fifth Circuit's *Serta* decision has revealed this support to be potentially unreliable.

Furthermore, based on the Fifth Circuit's ruling on the equitable mootness issue in *Serta*, participants in future uptier transactions should be aware that equitable mootness may not shield plan provisions that are clearly contrary to the Bankruptcy Code and that such plan provisions may be susceptible to future excision by an appeals court – even where the plan has already been substantially consummated. Appeals courts may be more likely to excise plan provisions from already-consummated plans where, as in *Serta*, the challenged provisions create a "massive liability" for the debtor that potentially jeopardizes the debtor's chances at long-term financial success.[27]

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[27] Serta Opinion, at 40.

If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Ingrid Bagby	+1 212 504-6894	ingrid.bagby@cwt.com
Joseph Beach	+1 704 348-5171	joseph.beach@cwt.com
Tom Curtin	+1 212 504-6063	thomas.curtin@cwt.com
Christopher Floyd	+1 212 504-6080	christopher.floyd@cwt.com
David Samuel Gingold	+1 212 504-6386	david.gingold@cwt.com
Gregg Jubin	+1 202 862-2485	gregg.jubin@cwt.com
Ron Lovelace	+1 704 348-5228	ronald.lovelace@cwt.com
Christopher McDermott	+1 704 348-5184	chris.mcdermott@cwt.com
Jeffrey Nagle	+1 704 348-5267	jeffrey.nagle@cwt.com
Greg Petrick	+1 212 504-6373	gregory.petrick@cwt.com
Joey Polonsky	+1 704 348-5242	joseph.polonsky@cwt.com
Michael Rupe	+1 212 504-6171	mike.rupe@cwt.com
Casey Servais	+1 212 504-6193	casey.servais@cwt.com
Nate Spanheimer	+1 704 348-5195	nathan.spanheimer@cwt.com
Skyler Walker	+1 704 348-5169	skyler.walker@cwt.com
Eric Waxman	+1 212 504-6739	eric.waxman@cwt.com
Neil Weidner	+1 212 504-6065	neil.weidner@cwt.com
Patrick Yingling	+1 704 348-5230	patrick.yingling@cwt.com
Jared Zajac	+1 704 348-5234	jared.zajac@cwt.com