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Appellate Review of Uptier Transactions: *Serta* and *Mitel* Decisions Reversed on Appeal

New Year's Eve was especially exciting for the debt restructuring markets with the issuance of two appellate decisions addressing uptier transactions. First, the Fifth Circuit Court of Appeals reversed the Southern District of Texas Bankruptcy Court's decisions validating Serta's 2020 uptier transaction.[1] Second, the Appellate Division of the New York Supreme Court held that the New York Supreme Court erred in failing to dismiss various causes of action challenging Mitel's uptier transaction.[2] As discussed below, these appellate decisions focused on the distinct language set forth in Serta's and Mitel's credit agreements, leading to the divergent results. Among other things, the Fifth Circuit concluded that Serta's 2020 uptier transaction did not satisfy the "open market purchase" exception to the pro rata sharing provisions set forth in Serta's credit agreement. On the other hand, the Appellate Division of the New York Supreme Court concluded that Mitel's 2022 uptier transaction satisfied the "purchases" exception to the pro rata sharing provisions of Mitel's credit agreement. While courts are of course obligated to follow the plain language of contracts, the charged nature of contested liability management transactions like those at issue in *Serta* and *Mitel* create a risk that courts may be swayed by extra-contractual arguments. And to date, few appellate courts have addressed challenges to such transactions. These two appellate decisions, each of which reversed a lower court decision, suggest that appellate courts may pay little heed to such arguments. Collectively, these decisions send a strong signal that courts should take a plain meaning approach to interpreting key debt document provisions when adjudicating challenges to liability management transactions, and that each transaction will rise or fall on the specifics of the debt documents at issue.

Serta

Background

Serta executed its uptier transaction in 2020. Participating lenders, which held a bare majority of Serta's first and second lien term loans, provided $200 million of new money superpriority first-out loans and simultaneously exchanged and uptiered their existing first and second lien loans into new superpriority second-out loans at a 26% and 61% discount to par, respectively. The excluded lenders were not offered the opportunity to participate in the uptier transaction, which resulted in the subordination of their loans to the new superpriority loans.

In January 2023, Serta commenced chapter 11 cases in the Southern District of Texas. Shortly thereafter, Serta and certain of the participating lenders commenced an adversary proceeding before the bankruptcy court, seeking a declaratory judgment that Serta's 2020 uptier transaction (a) complied with the express terms of Serta's credit agreement, including because the uptier transaction satisfied the credit agreement's "open market purchase" exception to pro rata sharing and (b) did not violate the implied covenant of good faith and fair dealing.

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1 *Excluded Lenders* v. *Serta Simmons Bedding, L.L.C.*, No. 23-20181, 2024 WL 5250365 (5th Cir. Dec. 31, 2024). Paul, Weiss acted as counsel to the Excluded Lenders.

2 *Ocean Trails CLO VII* v. *MLN Topco Ltd.*, No. 2024-00169, 2024 WL 5248898 (N.Y. App. Div. Dec. 31, 2024).

The bankruptcy court granted partial summary judgment to Serta and the participating lenders, holding that the "open market purchase" provision was unambiguous and that the uptier transaction constituted an "open market purchase." The bankruptcy court reasoned that because different creditor groups (including the excluded lenders challenging the transaction) had been negotiating with the company over various liability management transactions, the uptier was the product of the "open market." The bankruptcy court then held a trial with respect to the remaining claims asserted in the adversary proceeding—principally the excluded lenders' claim for the violation of the covenant of good faith and fair dealing—and again sided with Serta and the participating lenders, entering a final judgment in their favor. Both the bankruptcy court's summary judgment and final judgment were certified for direct appeal to the Fifth Circuit.

Meanwhile, in the main chapter 11 cases, the participating lenders had filed proofs of claim against Serta with respect to Serta's credit agreement obligations to indemnify the participating lenders for any damages related to the uptier transaction. Serta's initial chapter 11 plan of reorganization provided that such indemnification obligations would be deemed to constitute executory contracts assumed by Serta under the chapter 11 plan, such that Serta's indemnification obligations would survive Serta's emergence from bankruptcy. The excluded lenders objected to the participating lenders' indemnification claims on the grounds that they were contingent claims for reimbursement disallowed by section 502(e)(1)(B) of the Bankruptcy Code. Serta subsequently modified the plan's indemnification provisions to provide that reorganized Serta would instead provide holders of the superpriority loans as of the plan's effective date with new indemnification rights covering the same scope of potential damages related to their participation in the 2020 uptier transaction. Serta and the participating lenders conceded that the participating lenders' prepetition indemnity claims could not be assumed (as Serta had proposed in its initial chapter 11 plan), but they argued that the new indemnity rights set forth in Serta's amended plan were permissible as part of a settlement and to help gain the participating lenders' support for the plan. The bankruptcy court again agreed with Serta and the participating lenders, overruling objections asserted by the excluded lenders and others and confirmed Serta's amended chapter 11 plan.

Fifth Circuit Decision

The Fifth Circuit broadly reversed the bankruptcy court's decisions on appeal, although it left in place the bulk of the confirmation order, which was not challenged on appeal. With regard to the bankruptcy court's adversary proceeding decisions, the Fifth Circuit rejected Serta's and the participating lenders' arguments that an "open market purchase" occurs whenever something is acquired for value and there is competition, stating that their proposed definitions failed to recognize that an "open market purchase" is a purchase of a specific loan in a designated market, not merely the background concept of free competition for comprehensive restructuring proposals. The Fifth Circuit agreed with and adopted the excluded lenders' arguments that an "open market purchase," as used in the Serta credit agreement's exceptions to pro rata treatment, is a substantially narrower concept – namely, a purchase of corporate debt that occurs on the established secondary market for syndicated loans. Accordingly, the Fifth Circuit held that Serta's uptier transaction did not constitute an "open market purchase," reversed the bankruptcy court's contrary summary judgment ruling and remanded the participating lenders' breach of contract counterclaims for reconsideration.

The Fifth Circuit similarly reversed the bankruptcy court's approval of the chapter 11 plan's indemnification provisions. Emphasizing that the bankruptcy court, Serta and the participating lenders had recognized that section 502(e)(1)(B) of the Bankruptcy Code disallows the participating lenders' contingent prepetition indemnification claims, the Fifth Circuit held that recharacterizing such claims as a so-called new "settlement indemnity" was an impermissible end-run around section 502(e)(1)(B). The Fifth Circuit rejected Serta's and the participating lenders' arguments that the impermissible nature of the settlement indemnity was remedied by recasting the indemnity as part of a settlement and narrowing its scope to exclude participating holders who no longer held their debt as of the plan's effective date. The Fifth Circuit also held that the settlement indemnity likely only provided significant value to the participating lenders, and thus its inclusion in the plan violated the Bankruptcy Code's requirement that each non-consenting creditor in a particular class of claims receive the same treatment.

Finally, the Fifth Circuit held that the excluded lenders' appeal was not equitably moot and that the settlement indemnity could be excised from Serta's chapter 11 plan without unwinding the entire plan, including because: (a) excision would not adversely affect the rights of parties not before the court; (b) the excluded lenders received barely anything under the plan, and thus the

participating lenders made no meaningful concession under the plan raising fairness or reliance concerns; and (c) holding otherwise would effectively amount to stripping appellate courts of their jurisdiction over bankruptcy appeals. The Fifth Circuit accordingly reversed in part the bankruptcy court's confirmation order insofar as it approved the indemnity and excised such indemnity from Serta's chapter 11 plan.

Mitel

Background

Mitel executed its uptier transaction in October 2022. Participating lenders, which held a majority of Mitel's first and second lien term loans, provided approximately $156 million of new money superpriority first-out loans and simultaneously exchanged and uptiered (a) their existing first lien loans into new superpriority second-out loans at a 5% discount to par and (b) their existing second lien loans into new superpriority third-out loans at an 18% discount to par. Excluded lenders were not offered the opportunity to participate in the uptier transaction, which resulted in the subordination of their loans to the new superpriority loans.

Certain excluded lenders sued the participating lenders, Mitel and Mitel's equity sponsor in the New York Supreme Court, contending, among other things, that the uptier transaction violated their express sacred rights to consent to (a) any non-pro rata distribution and (b) any reduction of term loan principal (including a reduction in the principal amount of the participating lenders' loans pursuant to the uptier exchange) that adversely impacted the value of the excluded lenders' loans. The defendants contended, among other things, that (a) the uptier transaction satisfied the credit agreements' exception to pro rata treatment for loan "purchases" (which exception was broader than the "open market purchase" exception at issue in *Serta* and other uptier cases) and (b) the uptier transaction did not directly affect the excluded lenders' loans because they remained in place under the same economic terms.

The New York Supreme Court granted and denied in part the defendants' motions to dismiss. The court dismissed the plaintiffs' claims that the uptier transaction violated the implied covenant of good faith and fair dealing, constituted tortious interference with contract and constituted a fraudulent transfer, but it declined to dismiss the plaintiffs' breach of contract claims, holding that the credit agreements' undefined "purchases" exception to pro rata treatment was ambiguous, and thus that a trial was therefore warranted on the contract claims. Both the plaintiffs and defendants appealed.

Appellate Decision

On appeal, the Appellate Division of the New York Supreme Court, First Department, sided entirely with the defendants. The Appellate Division reversed the New York Supreme Court's decision not to dismiss the excluded lenders' breach of contract claims and affirmed the dismissal of the remaining claims. The Appellate Division held that the credit agreements' "purchases" exception was unambiguous and that the uptier transaction satisfied that exception as a matter of law. The Appellate Division emphasized that the "purchases" exception, which contained no "open market" qualifier, did not contain any indication that the purchase price could not be paid through the issuance of new loans, as opposed to cash or any other consideration. Furthermore, the Appellate Division agreed with the participating lenders that the uptier transaction did not modify the economic terms of the excluded lenders' loans and thus did not have any direct adverse effect on their loans. According to the Appellate Division, the subordination of the excluded lenders' loans below the new superpriority loans only *indirectly* affected such loans, and accordingly did not violate the excluded lenders' sacred consent rights.

In affirming dismissal of the tortious interference with contract claim, the Appellate Division held that there was no underlying breach of contract, and that any tortious interference claim was also independently barred by the economic interest defense. The Appellate Division found that the defense was established as to Mitel's equity sponsor, noting that it sought to enhance the borrower's prospects by raising money to buy another company and pay down debt. The administrative agent under Mitel's credit agreements was indisputably a creditor that sought to protect its interests as a lender. The Appellate Division rejected Plaintiffs' contention that the subject transaction was "contrary to the borrower's interest" and held that it "did not matter" when applying the economic interest defense "whether the borrower could have secured an even more favorable deal had it sought financing from all lenders." The court further noted that the conduct alleged did not demonstrate fraudulent, illegal or

malicious intent, as would be necessary to overcome the economic interest defense. Importantly, the Appellate Division confirmed that the economic interest defense could be determined at the pleading stage on a motion to dismiss, making it more likely that similar tortious interference claims in liability management litigation will face early dismissal in the future.

Conclusion

The Fifth Circuit's and New York Appellate Division's decisions in *Serta* and *Mitel* both reinforce the principle that documents matter. Debt documents can vary materially in their terms, and these decisions suggest that liability management transactions will rise or fall based on the specific language of the documents at issue. Both courts focused on the plain meaning of the applicable debt document provisions before them. The Appellate Division's decision in *Mitel* emphasized that the Mitel credit agreements' "purchases" exception to pro rata distributions (without an "open market" qualifier) did not contain any indication that the purchase price could not be paid through the issuance of new loans, while the Fifth Circuit's decision in *Serta* emphasized the importance and, in the view of the Fifth Circuit, plain meaning of the "open market" qualifier in Serta's credit agreement. Notably, the Fifth Circuit stated that its decision in *Serta* indicates that "open market purchase" exceptions in other companies' debt documents "will often not justify an uptier," but it also recognized that "every contract should be taken on its own."[3] Finally, the Fifth Circuit's decision in *Serta* also provides an important reminder that lenders participating in liability management transactions may not be able to rely upon indemnities granted by the distressed companies with whom they transact.

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[3] *Serta*, 2024 WL 5250365, at *24.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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