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Fifth Circuit Ruling Alters Uptier Transaction Landscape

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Overview: The Fifth Circuit's highly anticipated decision on December 31, 2024, in the *Serta Simmons* case has significant implications for borrowers and lenders in financial distress situations. The issue on appeal concerned an uptier transaction, a liability management exercise sometimes referred to as "lender-on-lender violence." The Fifth Circuit's opinion addresses the contractual viability of uptier transactions and the enforceability of related indemnities in bankruptcy plans, potentially reshaping the landscape for future financial restructurings.

Background: Serta Simmons Bedding, LLC, a major mattress manufacturer, entered into secured financing transactions in 2016 and 2020 with various lenders. Facing financial distress exacerbated by the COVID-19 pandemic, Serta engaged in an uptier transaction in 2020, which involved issuing new super-priority debt to certain lenders (prevailing lenders) in exchange for their existing debt. This move was contested by other lenders who did not participate in the transaction, leading to litigation over the validity of the uptier under the original loan agreements.

Key Points of the Decision:

1. **Uptier Transactions and Open Market Purchases:**

   - The Fifth Circuit held that the 2020 uptier transaction was not a permissible "open market purchase" under the 2016 loan agreement. The court emphasized that an open market purchase must occur on a specific market generally open to various buyers and sellers, such as the secondary market for syndicated loans.

   - The court rejected broader definitions proposed by Serta and the prevailing lenders, which would have allowed almost any competitive transaction to qualify as an open market purchase, thereby undermining the specific procedures and protections intended by the loan agreement.

   - While the court focused on the terms of the particular loan agreement at issue, it did issue a broader warning: "[W]hile the loan market has seen an increase in contracts blocking uptiers … there are doubtless still many contracts with open market purchase exceptions to ratable treatment… Though every contract should be taken on its own, today's decision suggests that such exceptions will often not justify an uptier."

2. **Indemnities in Bankruptcy Plans:**

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- The court found that the inclusion of an indemnity in Serta's bankruptcy plan, which aimed to protect the prevailing lenders from liabilities arising from the 2020 uptier, was an impermissible end-run around the Bankruptcy Code.

- Specifically, the indemnity violated 11 U.S.C. § 502(e)(1)(B), which disallows contingent claims for reimbursement where the claimant is co-liable with the debtor. The court held that the indemnity could not be justified as part of a plan settlement and that its inclusion resulted in unequal treatment of creditors, violating the Bankruptcy Code's plan requirements.

Implications for Borrowers and Lenders:

1. **Scrutiny of Uptier Transactions:**

- The decision underscores the importance of adhering to the specific terms and procedures outlined in loan agreements. Borrowers and lenders must carefully evaluate whether proposed liability management strategies, such as uptiers, comply with contractual provisions and established market practices. They should not assume that an open market purchase exception will allow an uptier transaction to stand.

- Lenders should be vigilant in reviewing loan agreements for clauses that could be exploited to justify non-pro-rata transactions and consider negotiating for explicit protections against such maneuvers.

2. **Enforceability of Indemnities:**

- The ruling highlights the limitations on including indemnities in bankruptcy plans. Borrowers and lenders must ensure that any indemnities or similar provisions in restructuring plans comply with the Bankruptcy Code and do not result in unequal treatment of creditors.

- Lenders should be aware of the potential for indemnities to be challenged and invalidated, affecting their go-forward litigation risk arising out of dealings with bankruptcy borrowers.

Conclusion: The Fifth Circuit's decision in the *Serta Simmons* case sets a precedent that could limit the ability of borrowers to engage in lender-on-lender violence through uptier transactions and restrict the use of indemnities in bankruptcy plans. Borrowers and lenders must navigate these legal constraints carefully to avoid disputes and ensure compliance with contractual and statutory requirements, lest their liability management exercises simply lead to further liabilities.

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