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The End of Non-Pro Rata Uptiers? Fifth Circuit Rules that Serta Exchange was Not an "Open Market Purchase"

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The United States Court of Appeals for the Fifth Circuit (the "**Fifth Circuit**") ruled on December 31, 2024 that Serta Simmons Bedding's ("**SSB**") 2020 uptier exchange included a transaction that, contrary to the assertions of SSB and participating lenders, did not constitute an "open market purchase" because it was not "a purchase of corporate debt…on the secondary market for syndicated loans," reversing the judgment of the Bankruptcy Court for the Southern District of Texas. This ruling has significant implications for non-pro rata debt exchanges and may mark the end of the first era of liability management exercises ("**LMEs**").

Background

In 2020, facing liquidity and other financial difficulties, SSB and lenders holding a majority of term loans under both its first lien and second lien credit facilities (the "**Participating Lenders**") structured an uptier LME with two critical features.

- First, the Participating Lenders provided $200 million of new money in the form of super-priority "first-out" term loans under a new super-priority loan agreement ("**New Priming Facility**"). To accomplish this, SSB and the Participating Lenders amended the existing credit agreements to allow for the issuance of new priming debt. This aspect of the LME is not the subject to the appeal.
- Second, the Participating Lenders (but not any other lenders) "rolled up" (*e.*, exchanged on a cashless basis) their first lien and second lien loans at discounted exchanged ratios into $875 million of "second-out" term loans in the New Priming Facility (the "**Non-Pro Rata Exchange**"). SSB and the Participating Lenders styled the exchange of their existing loans for the new super-priority loans as an "open market purchase" and cashless exchange, which they maintained was permitted by SSB's credit agreements.

As a result of the LME, both tranches of the New Priming Facility ranked senior to the existing first and second lien term loans (effected by way of a new intercreditor agreement), thereby subordinating the loans of the lenders who did not participate in the transaction (the "**Excluded Lenders**") to over $1 billion in new super-priority loans.

SSB's 2020 LME "was the first major uptier" and set off a wave of non-pro rata uptier and exchange transactions utilizing the common "open market purchase" exception to the pro rata repayment requirements in credit agreements. At the time of its consummation, the SSB LME was highly controversial, dividing industry observers as to whether the Non-Pro Rata Exchange was a permitted "open market purchase," or a prohibited non-pro rata repurchase, prepayment or exchange.

The Excluded Lenders sued SSB and Majority Lenders in the United States District Court for the Southern District of New York. In March 2022, District Judge Failla denied the defendants' motion to dismiss and ruled that the term "open market purchase" was sufficiently ambiguous to necessitate a trial on merits to determine the meaning of the phrase and thus whether a breach of SSB's first lien loan agreement (the "**Credit Agreement**") occurred.

In January 2023, SSB filed for bankruptcy in Houston and filed a declaratory judgment suit against the Excluded Lenders seeking a ruling from the bankruptcy court that New Priming Facility and Non-Pro Rata Exchange was valid. After a brief trial in May 2023, the bankruptcy court took a decidedly different view of the issue than the New York court, citing Merriam-Webster dictionary in a brief opinion passage holding that an open market purchase is "something obtained for value in competition among private parties" and that the Non-Pro Rata Exchange was unambiguously "the quintessential 'Wall Street' open market purchase." Many observers initially thought that this was the moment that cemented the non-pro rata uptier transaction as a legitimate restructuring strategy. An appeal was certified directly to the Fifth Circuit.

Fifth Circuit's Ruling

The Fifth Circuit began its analysis with the importance of ratable treatment:

“Ratable treatment is an important background norm of corporate finance. Pursuant to this norm, a borrower must treat all of its similarly situated lenders, well, similarly. Ratable treatment is such an important norm that it is often described as a lender’s “sacred right” under syndicated loan agreements.” (citations omitted).

As is typical, SSB’s Credit Agreement protected the sacred right of pro rata sharing and provided in relevant part that “each payment or prepayment…shall be allocated pro rata among the Lenders.” The Credit Agreement, however, contained a common exception to the ratable sharing provisions for an “open market purchase” pursuant to which any lender may assign loans to SSB on a non-pro rata basis. Consistent with market practice, the phrase “open market purchase” is undefined in the Credit Agreement.

In analyzing the phrase “open market purchase,” the Fifth Circuit rejected the bankruptcy court’s approach and held that industry custom and usage is the appropriate standard for interpreting this phrase. Under this lens, the Fifth Circuit pointed to various sources — legal and other dictionaries, precedent cases, and the Federal Reserve’s “open market operations” — that indicate that the phrase requires a *specific* market. “An open market is a designated market, not merely the background concept of free competition that characterizes much of modern American commerce.” In the circumstances relevant to SSB’s loans, the Fifth Circuit held that the relevant specific market can only logically be the secondary market for syndicated loans.

As the Fifth Circuit notes, this secondary market is generally open to buyers and sellers, and its prices are set by competition. Accordingly, the court ruled that if SSB wished to make an open market purchase and thereby circumvent the sacred right of ratable treatment and the enumerated procedures for Dutch Auctions (discussed more below), SSB was required to purchase the relevant loans on the secondary market. Instead, by privately engaging individual lenders outside of this market, SSB lost the protection of the open market purchase provision.

The Fifth Circuit criticized the interpretations of SSB and the Participating Lenders of the phrase "open market purchase," which leaned heavily on the transaction's "open" (*i.e.,* competitive and arm's length) characteristics, without satisfyingly addressing the "market" requirement. The court emphasized that if SSB's and the Participating Lenders' reading of the phrase were to be accepted, it would render unnecessary and irrelevant the entirety of the Dutch Auction provisions — another key exception to the pro rata sharing requirement, which includes detailed terms and conditions for discounted loan buybacks that must be offered to all lenders of the same class — because any purchase negotiated privately but at arm's-length could be called an open market purchase, regardless of whether it complied with the agreed terms governing Dutch Auctions.

The Fifth Circuit remanded the breach of contract claims associated with the purported open market purchase to the bankruptcy court for it to reconsider them in a manner consistent with the Fifth Circuit's rulings. If the bankruptcy court finds a breach, we expect further disputes regarding appropriate remedies. For example, will the court require Participating Lenders to disgorge and turn-over plan distributions they received under the SSB reorganization plan on account of their uptiered debt, or to pay money damages to the Excluded Lenders? Notably, the Fifth Circuit also struck down an indemnity that would have allowed the Participating Lenders to shift this liability to the reorganized company.

Impact

Most out-of-court debt exchanges consummated — and an even larger number of such exercises threatened — since 2020 have relied upon an open market purchase provision like the one at issue in this case. While the Fifth Circuit's ruling is not binding on New York state or federal courts, or on bankruptcy courts outside of the Fifth Circuit, it is likely to be highly influential on other courts across the country. Accordingly, we expect to see far fewer (if any) LME's relying on the "open market purchase" as a basis for non-pro rata exchanges. This is true for exchanges that are coupled with uptiers or with "drop-down" LMEs.

Will creative borrowers utilize other provisions to try to realize the same result? Perhaps in some cases, but those efforts are likely to be closely scrutinized by courts who generally disfavor blatant attempts to circumvent rulings. We think more likely that borrowers will adjust their approach in two ways.

First, borrowers may accelerate an already established trend to minimize litigation risk while maximizing deleveraging with discounted debt exchanges by offering participation to all lenders ratably, but not on equal terms. For example, in many cases, the borrower — with majority lenders — could modify the Dutch Auction provisions to expressly permit an exchange transaction and allow payments to the consenting lenders in the form of backstop or structuring fees on a non-pro rata basis.

Second, borrowers with sufficient bargaining power may seek new non-pro rata repurchase provisions that replace the standard "open market purchase" exception and expressly permit privately negotiated loan repurchases or exchanges, subject to certain limitations. This term rarely exists in the market, and we expect this ruling to be an impetus for borrowers to push for these changes at origination. In any event, the Fifth Circuit's ruling is a game-changer for LMEs.

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