

# Liability Management Litigation Update: Bar Court Holds That 2020 Serta Transaction Is a Market Purchase<sup>1</sup>

March 28, 2023

Earlier today, Southern District of Texas Bankruptcy Judge David R. Jones (the “Court”) issued an oral ruling on motions for summary judgment regarding the propriety of Serta’s 2020 “uptier” liability management transaction (the “Transaction”). As described below, the Court ruled that the term “open market purchase” in the governing credit agreements was unambiguous, and that the Transaction “very clearly” was an open market purchase. This decision represents the first merits ruling on the permissibility of using “open market purchase” provisions to effectuate uptier liability management transactions, and has been eagerly anticipated by the credit investing community.

The underlying dispute dates back to June 2020, when Serta and certain “favored” lenders entered into an uptier liability management transaction, whereby the favored lenders (i) provided \$200 million of first out superpriority debt and (ii) exchanged their existing first- and second-lien debt for \$875 million in second out superpriority debt. Although the relevant credit agreements contain a “sacred right” requiring that any payment from Serta to any lender be distributed pro rata among all lenders, there is an exception to the pro rata provision for “open market purchases”, and Serta relied on this exception to consummate the exchange of existing first- and second-lien for superpriority debt. As a result, the “excluded” lenders not party to the Transaction were left with their previously first-lien debt subordinated to over \$1 billion in new superpriority loans (both new money and exchanged).

The Transaction was immediately challenged by the excluded lenders, and litigation regarding the propriety of the Transaction has been ongoing in federal and state court for the past several years. Through these various lawsuits, the excluded lenders generally have alleged that the Transaction breached the credit agreements both because it was not an “open market purchase” and because it separately violated the covenant of good faith and fair dealing implied in every contract under New York law. Of note, in March 2022, Judge Katherine Polk Failla in the United States District Court for the Southern District of New York denied Serta’s motion to dismiss, holding that the term “open market purchase” was ambiguous and allowing the breach of contract and implied covenant claims to proceed to discovery. See *LCM XXII Ltd. v. Serta Simmons Bedding, LLC*, 2022 WL 953109 (S.D.N.Y. Mar. 29, 2022).

On January 23, 2023, Serta filed for bankruptcy in the Southern District of Texas and simultaneously filed an adversary proceeding against the excluded lenders seeking a declaratory judgment from the Court that the Transaction was permitted under the credit agreement and did not breach the implied covenant of good faith and fair dealing. The existing federal and state court litigation against Serta and the favored lenders was stayed, and the Court set a briefing schedule for summary judgment motions on the meaning of “open market purchase.”

Today, the Court heard oral argument on the summary judgment motions, with a focus on the meaning of “open market purchase” and whether the Transaction violated the implied covenant of good faith and fair dealing. At the conclusion of the hearing, the Court issued a short oral ruling from the bench, holding that there was no ambiguity regarding the meaning of “open market purchase” and that it was “very clear” that the Transaction fit within the definition of an “open market purchase.” Notably, the Court did not define “open market purchase” or

provide guidance on what types of transactions would (or would not) qualify as open market purchases under the credit agreement or other financial instruments. The Court also stated that it was not sure what impact its holding would have on the rest of the case, nor was it prepared to find that Serta or the favored lenders complied with all aspects of the credit agreement.

Separately, the Court denied summary judgment on (i) the excluded lenders' claims for breach of the implied covenant of good faith and fair dealing, and (ii) other claims relating to whether certain excluded lenders were disqualified from holding debt under the credit agreement, which means those claims remain live for further litigation.

At the conclusion of the hearing, the excluded lenders requested an order permitting immediate appeal of the decision, but it is not yet known whether they will seek to appeal directly to the Fifth Circuit or instead first seek review from the District Court.

If you have any questions please contact your regular Akin lawyer or advisor.