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Watch Your Language! Non-Pro Rata Uptier Transactions and the Serta and Mitel Decisions

By Kaitlin R. Walsh and Timothy J. McKeon*

In this article, the authors review two important decisions challenging non-pro rata uptier transactions that reached different results.

Among the many financial innovations that came out of the COVID-19 era, non-pro rata uptier transactions as a liability management exercise (LMEs) are among the more controversial. While lawsuits challenging non-pro rata uptier transactions are making their way through the courts, two important decisions were recently issued by the U.S. Court of Appeals for the Fifth Circuit and the New York Appellate Division.

In an appeal of a decision by the U.S. Bankruptcy Court for the Southern District of Texas in the Chapter 11 bankruptcy of Serta Simmons Bedding, LLC, a three-judge panel of the Fifth Circuit found that an uptier transaction undertaken in the years prior to the bankruptcy was impermissible under the terms of the applicable documents.[1]

Conversely, in the case of *Ocean Trails CLO VII v. MLN Topco Ltd.* (Mitel), the New York Appellate Division found that a similar uptier transaction was permissible under applicable documents.[2]

The reasons how and why these transactions were upheld by one court and undone by another offer important insights into how these transactions may be analyzed by courts and structured by parties.

UPTIER TRANSACTIONS

Developed in response to the liquidity constraints felt by many businesses during the COVID-19 era, uptier transactions allow cash-strapped companies to redesign their capital structure while gaining access to new liquidity and refinancing existing debt.

In its simplest terms, an uptier transaction works as follows: a borrower enters into an agreement with only some of its lenders under an existing credit

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[1] Excluded Lenders v. Serta Simmons Bedding, LLC (In re Serta Simmons Bedding, LLC), Case No. 23-20181, 2024 U.S. App. LEXIS 32969 (5th Cir. Dec. 31, 2024).

[2] Ocean Trails CLO VII v. MLN Topco Ltd, Index No. 651327/23, 2024 N.Y. App. Div. LEXIS 7034 (N.Y. App. Div. 1st Dep't Dec. 31, 2024).

facility to allow the borrower to issue new, superpriority debt, some of which is then used to purchase the existing debt of participating lenders. The result is that participating lenders now hold new debt that is senior to the claims and liens securing existing debt, while non-participating lenders are, effectively, subordinated.

Non-participating and (suddenly) subordinated lenders have challenged these transactions on various grounds, including that they violate a credit agreement's "sacred right" of pro rata sharing among lenders under the same facility. Under this theory, non-participating lenders argue that the exchange of existing debt held by only some lenders into new senior debt effectuated through the non-pro rata uptier transaction violates the requirement that any payments by the borrower must be distributed pro rata among all lenders party to the credit agreement. In response, borrowers argue that such transactions fall within various exceptions in the credit agreements, two of which are explored below.

THE FIFTH CIRCUIT'S DECISION IN *SERTA*

In 2020, in an effort to improve its financial condition, Serta executed an uptier transaction with a majority, *i.e.*, some (but not all), of its first and second lien lenders. Under the terms of the agreement, Serta and the participating lenders first amended the existing credit agreement to allow for the issuance of priming debt. With the amendment in place, the participating lenders provided $200 million in new financing and exchanged $1.2 billion of existing first and second lien term loans for $875 million of superpriority first and second-out term loans. As a result of the transaction, non-participating lenders, who held $895 million of remaining first-lien term loans and approximately $128 million of second-lien term loans, were relegated to third and fourth tier status, subordinate to $1.075 billion in new debt.

Non-participating lenders challenged the transaction and, following Serta's Chapter 11 bankruptcy filing, the dispute was litigated before the U.S. Bankruptcy Court for the Southern District of Texas. In response to the non-participants' challenge, the debtor and the participating lenders argued that the transaction fell within the "open market purchase" exception to the pro rata requirement under the relevant credit agreement. Although the term was not defined in the credit agreement, the bankruptcy court agreed, finding that the transaction "clearly" fell within the unambiguous terms of the "open market purchase" exception.

On appeal, the Fifth Circuit reversed the bankruptcy court's decision and found that the non-pro rata uptier transaction conducted by Serta was impermissible under the terms of the applicable credit facility. Central to the

court's decision was its rejection of the bankruptcy court's finding that the transaction fell within the "open market purchase" exception.

In support of the transaction, the participating lenders argued that "an open market purchase means to acquire something for value in competition among private parties." The Fifth Circuit rejected this argument, finding that it relied on a "open purchase" concept rather than the term "open market purchase."

Under the court's interpretation, "the words 'open market' point to a specific 'market,' not merely a general context where private parties engage in noncoercive transactions with each other." In other words, "the point . . . is not whether the open market *purchase* . . . was open to anyone, but whether such a purchase took place on a *market* that was generally open to anyone."

The court then held that an open market purchase occurs on the specific market for the product that is being purchased. In *Serta*, the relevant product is first-lien debt issued under the first lien credit agreement, and the market for that product is the secondary market for syndicated loans. Therefore, the court reasoned, if Serta wished to make an open market purchase and thereby circumvent the sacred right of ratable treatment, it should have purchased its loans on the secondary market.

In other words, because Serta chose "to privately engage individual lenders" outside the secondary market, they lost the ability to rely on the "open market purchase" exception.

THE DECISION IN *MITEL*

The dispute in *Mitel* was similar to the one in *Serta*: the company executed a non-pro rata uptier transaction that was challenged by non-participating lenders on the basis that, among other things, it violated the pro rata sharing requirement in the credit agreement. However, unlike the Fifth Circuit, the New York Appellate Division – in a decision that was issued the same day as the decision of the Fifth Circuit in *Serta* – found that the transaction was permissible under the credit agreement.

As in *Serta*, the borrower and the participating lenders argued that the transaction fell within an exception to the pro rata requirement. Unlike in *Serta*, the exception language in the operative documents was much broader in scope and not limited to an "open market purchase." Rather, the relevant language provided that "[n]otwithstanding [the pro rata sharing requirement]," Mitel "may purchase by way of assignment and become an [a]ssignee with respect to the Terms Loans at any time and from time to time from Lenders" if certain conditions are satisfied.

The parties disputed whether the purchase of existing debt with newly issued priority debt effectuated through the uptier transaction was, in fact, a

"purchase" (which would be permitted under the documents) or, rather, a "refinancing" or "exchange"(which they argued would not).

The non-participating lenders argued that the transaction involved an *exchange* of existing debt with newly issued priority debt, and, therefore, did not qualify as a "*purchase*," which, they asserted, necessitated payment in full, upfront, and in cash. The Appellate Division dismissed this argument, finding that the concepts of "purchase," "refinance," and "exchange" are "not mutually exclusive." The court also noted that the "requirement of cash payment or prohibition on the use of debt as payment would . . . not be consistent with the common understanding of the word 'purchase.'"

CONCLUSION

Judicial interpretation of these transactions is controversial and quickly evolving. While some courts may disagree with the Fifth Circuit's interpretation of "open market purchase," the decision in *Mitel* demonstrates that agreements can be drafted to allow for non-pro rata uptier transactions through a broadly worded exception to the pro rata requirement. Conversely, agreements can be drafted to prevent, or at least more effectively constrain, such transactions. In light of these rulings, borrowers and lenders alike may wish to consider adding a definition of "open market purchase" to their credit agreements or otherwise provide for clearly stated exception language.

As the law develops, sophisticated parties will continue to fashion creative means to address any adverse rulings. The use of "Serta blockers" and other LMEs, such as "double-dip" transactions, are still relatively new, but, as always, challenges can be expected. What is certain, however, is that this area of law and responses in credit documentation are going through a period of rapid evolution.