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In The Know

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Un-Serta-inty: What now for uptiers in Europe?

On 31 December 2024, the Fifth Circuit Court of Appeals (the **"Federal Court of Appeals"**) ruled that the uptiering transaction conducted by Serta Simmons Bedding LLC (**"Serta"**) did not constitute an "open market purchase", reversing the 2023 summary judgment of the Bankruptcy Court for the Southern District of Texas (the **"Texas Bankruptcy Court"**) that rejected the excluded lenders' claims for breach of the credit agreement. The Federal Court of Appeals also reversed the approval of certain plan provisions relating to an indemnity for the uptiering transaction. The Federal Court of Appeals' decision indicates that the open market purchase exception to the pro rata treatment of lenders, found in many credit agreements, will not justify an uptier; "[t]hough every contract should be taken on its own, today's decision suggests that [the open market purchase] exceptions will often not justify an uptier". However, especially in light of the Mitel decision of the New York Supreme Court addressed below, it is unlikely that this will mark the end of attempted uptiering transactions — at least in the US. In Europe, the position is likely to remain largely the same.

Serta

The Serta uptier had two components. First, Serta raised USD 200 million in new financing in the form of first-out, super-priority debt from a subset of its existing lenders (the **"Prevailing Lenders"**). To facilitate the incurrence of the new debt, Serta amended its 2016 credit agreement (the **"Serta Credit Agreement"**). Second, the Prevailing Lenders exchanged USD 1.2 billion of their old loans for USD 875 million new second-out, super-priority loans. It is this second element, giving only a subset of lenders the opportunity to exchange into the new second-out, super-priority loans — i.e., the non-pro rata exchange — that is contentious.

The Serta Credit Agreement provided that any lender could assign its term loans back to Serta on a non-pro rata basis either (A) through Dutch auctions open to all lenders or (B) through "open market" purchases. Otherwise, as is standard in the leveraged loan market, the Serta Credit Agreement mandated pro rata sharing between lenders in a common syndicate. Pro rata sharing was also a "sacred right" — a right which generally requires unanimous consent of affected lenders to waive, amend or modify in any way that would "alter the pro rata sharing of payments required thereby". To facilitate its non-pro rata exchange, Serta hoped to rely on exception (B). The Federal Court of Appeals determined that the "market" referred to was the secondary market for syndicated loans. Serta, however, purchased its loans in privately negotiated transactions with certain lenders and not on the secondary market. Therefore, the transactions did not fall within the exception for "open market purchases" to the pro rata treatment of lenders, and on this basis the Federal Court of Appeals vacated the Texas Bankruptcy Court's summary judgment that upheld the transaction.

The immediate impact on Serta itself is not certain — the uptiering transaction was not unwound, and confirmation of Serta's bankruptcy plan was not reversed (other than in relation to certain specific indemnity provisions) — instead, the proceedings were remanded to the Texas Bankruptcy Court for further consideration. Upon motion of the excluded lenders, the Federal Court of Appeals issued an amended opinion on 21 January 2025, making clear that on remand its ruling applies to both the breach of contract counterclaims against the participating lenders and to claims against third-party participating lenders that were not named in the adversary proceeding before the Texas Bankruptcy Court. More broadly, however, the decision makes clear the Federal Court of Appeals' views on privately negotiated debt exchanges as a vehicle to repurchase debt in exchange for new priming debt: these are not "open market purchases".

However, the decision does not necessarily preclude uptiering transactions. A borrower can, subject to its terms, still amend a credit agreement to allow for new debt that has the effect of subordinating certain lenders. What a borrower will face opposition to is incentivising only a subset of its lenders in a common syndicate to consent to that amendment by exchanging their existing debt for the new priming debt in non-pro rata treatment of all the lenders in that syndicate. Any exchange of debt into the new priming tier would have to be offered to all lenders in the syndicate ratably. Another option for a borrower could be to amend the assignment provisions to allow for repurchases in "open market transactions or other privately negotiated transactions". Although pro rata protection is in most cases a sacred right, the exceptions may not be. If a credit agreement does not require all lender consent for amendments to the exceptions or amendments that have the effect of lien subordination, an uptiering transaction would still be possible. Furthermore, differences in the particular wording used in a given credit agreement may distinguish a future non-pro rata exchange from Serta.

Mitel

On the same day as the Federal Court of Appeals released its initial opinion in the Serta case, the Supreme Court of New York, Appellate Division (the **"New York Supreme Court"**) found that the debt exchange used by Mitel Networks (**"Mitel"**) to facilitate its own uptiering transaction was permitted under its credit agreement. This decision appears to leave open the possibility for uptiering transactions — although it is clear any successful uptiering transaction will be heavily document- and fact-specific.

The facts in the Mitel uptier were similar to those in Serta: a borrower incentivised a group of its majority lenders to amend its first lien credit agreement to allow for the priming debt by exchanging their existing debt for the new priming debt in a non-pro rata transaction.

Whereas in the Serta Credit Agreement exceptions to the pro rata sharing between lenders were limited to Dutch auctions and open market purchases, the Mitel credit agreement permitted any "purchase by way of assignment". There was no requirement for Mitel to purchase the loans in a Dutch auction, open market purchase or any other particular way. As a result, the New York Supreme Court found that the non-pro rata exception applied and that the uptiering transaction was permitted.

Although the Mitel decision will likely be appealed further, it shows that specific drafting may make a difference to a non-pro rata exchange's viability. The New York Supreme Court also found that the Mitel uptier did not violate the lenders' sacred rights. The subordination of the excluded lenders' loans below the priming debt only indirectly affected those claims, rather than "directly adversely". In addition, the subordination did not actually "amend" the terms of the existing loans. Instead, the loans were cancelled and replaced with new loans on their own terms.

With the Serta and Mitel decisions highlighting how fact and document specific each case will be, borrowers and lenders should approach each potential uptiering transaction accordingly, noting that litigation risk will likely remain high around these transactions..

Impact on the European market

Despite a slight increase in the last year, uptiering transactions in Europe are still less common than in the US. This disparity is due to several contractual, legal and market factors (as we set out in our previous article on this topic). It seems unlikely that the latest developments in Serta and Mitel will change this.

The Serta and Mitel decisions turned on the interpretation of specific words under New York law. As such, they are unlikely to directly impact a borrower's ability to complete a non-pro rata transaction under its European debt documents.

In fact, the "open market purchase" exception to the pro rata treatment of lenders is not a typical feature of market standard European facility agreements. Rather, the exceptions that allow for non-pro rata transactions are typically captured in a process allowing the buyback of loans by the borrower (and related parties), termed "debt purchase transactions", which normally prescribes certain mechanics such

as solicitation and / or open order processes. These processes require offers to be made to all lenders, i.e. they prevent borrowers from excluding certain lenders in the first instance. In addition, amendments to the payment waterfall or subordination provisions in the intercreditor agreement are typically included as "sacred rights" in European documentation, thus providing further protection against uptier transactions. Further, the common approach in Europe is to require unanimous consent to subordinate (as well as release) obligations or liens.

On the other hand, given the general trend of Europe following the US, as the Serta and Mitel decisions have not closed the door on uptiers, they may yet continue to show up in the European market. For example, some European facility agreements do allow for debt purchase transactions via bilateral negotiation, which would allow a borrower to exclude certain lenders from participating in an exchange. Further, the provisions regulating debt purchase transactions are not always "sacred rights" and may, therefore, be open to amendment by a majority of lenders. This could pave the way for a non-pro rata exchange if the majority lenders amend the exceptions to pro rata sharing to make them more favourable, although, if the borrower has European debt documentation, perhaps not an uptiering/ subordinating change to the order of priority. In addition, although the requirements for debt purchase transactions start with an offer to all lenders, there is not always a requirement that any subsequent offer be made on the same terms or to the same all-lender group.

With litigation likely to continue in the US, and European practice and case law on these issues still in their early stages, borrowers, lenders, investors and sponsors should scrutinise on a case-by-case basis what they are, and are not, permitted to do under their documents. Whether any given transaction is liable to be challenged in court — let alone approved — will depend heavily on the wording of certain key provisions in loan agreements.

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