

## Court Approves Serta's Chapter 11 Plan and Pre-Petition "Position Enhancement Transaction"

*By: Alexander Perez*

Following a multiday trial, on June 6, 2023, United States Bankruptcy Judge David R. Jones of the United States Bankruptcy Court for the Southern District of Texas (the "Bankruptcy Court") issued an opinion confirming the chapter 11 plan of Serta Simmons Bedding, LLC and its co-debtor affiliates (collectively, "Serta") and holding that a 2020 "position enhancement transaction"<sup>1</sup> (the "2020 PET") involving a subset of Serta's lenders did not violate Serta's 2016 credit agreement.<sup>2</sup>

### Background

Serta is widely known as one of the largest bedding manufacturers in North America. In 2016, Serta entered into three syndicated credit facilities providing first and second lien term loans and an asset-based revolving loan.<sup>3</sup> The 2016 credit agreement can be described as "loose," since Serta was given certain flexibility to manage its capital structure.<sup>4</sup> Specifically, the 2016 credit agreement expressly allowed Serta to repurchase its debt on a non-pro rata basis by either a Dutch auction<sup>5</sup> open to all lenders or open market purchases involving fewer than all lenders.<sup>6</sup>

Serta experienced financial difficulties pre-pandemic and evaluated various financing options to enhance liquidity.<sup>7</sup> Two separate groups of lenders, the "PTL Lenders" and the "Objecting Lenders," each made competing offers to Serta to address the liquidity issues.<sup>8</sup> Serta chose the 2020 PET offered by the PTL Lenders, which created a new priority tranche of debt consisting of \$200 million in new financing and exchange of prior first and

second lien debt at discounted rates.<sup>9</sup> The Objecting Lenders were not invited to participate in the 2020 PET and unsuccessfully sought to enjoin the transaction in New York state court.<sup>10</sup>

On January 23, 2023, Serta filed its chapter 11 case with the support of a majority of its lenders embodied in a restructuring support agreement.<sup>11</sup> The lead Serta debtor and the PTL Lenders filed an adversary proceeding against Objecting Lenders seeking a decision that the 2020 PET was permitted under the 2016 credit agreement and that the PTL Lenders did not violate the implied covenants of good faith and fair dealing by entering the 2020 PET.<sup>12</sup> The Objecting Lenders asserted counterclaims and third-party claims, and the parties filed competing motions for summary judgment.<sup>13</sup> In March 2023, the Bankruptcy Court awarded partial summary judgment to the PTL Lenders holding that the term "open market purchase" used in the 2016 credit agreement was unambiguous and that the 2020 PET was a permitted "open market purchase."<sup>14</sup>

Serta ultimately proposed a chapter 11 plan that *inter alia* provided for: (a) reduction of Serta's debt by means of a debt-for-equity swap; (b) new exit financing by the PTL Lenders in exchange for various consideration, including indemnification by the reorganized Serta against any liability arising from the 2020 PET; and (c) payment to existing equity holders as consideration for the preservation of valuable tax attributes.<sup>15</sup> The unsecured creditors' committee supported Serta's chapter 11 plan.<sup>16</sup>

## The Opinion

The Bankruptcy Court confirmed Serta's chapter 11 plan and overruled the unresolved objections thereto.<sup>17</sup> The Objecting Lenders opposed the chapter 11 plan and raised two objections.<sup>18</sup> First, the Objecting Lenders argued that the indemnity by Serta of the PTL Lenders violated §§ 502(e)(1)(B) and 509(c) of the Bankruptcy Code, and, second, they argued that the chapter 11 plan violated the absolute priority rule by providing a payment to equity holders while the Objecting Lenders were not being paid in full.<sup>19</sup>

The Bankruptcy Court stated that Serta's chapter 11 plan did not allow Serta's pre-petition indemnity of the PTL Lenders to pass through the chapter 11 plan unaffected, since the indemnification in the chapter 11 plan was new and replaced the prior indemnification provision that expired upon Serta's filing for bankruptcy protection.<sup>20</sup> Additionally, the PTL Lenders' agreement to equitize debt and provide exit financing made the new indemnification provision a sound exercise of Serta's business judgment and a fair and equitable settlement.<sup>21</sup> The Bankruptcy Court also ruled that the payment to equity holders did not violate the absolute priority rule, as the payment was in exchange for "new value" in the form of a tax benefit held by equity and within the range of reasonable business judgment.<sup>22</sup>

Regarding the adversary proceeding, the Bankruptcy Court found that the 2020 PET was the result of good faith, arm's length negotiations and was enforceable in all respects based on the overwhelming evidence adduced at trial.<sup>23</sup> The Bankruptcy Court noted that the evidence demonstrated that the parties were keenly aware that the 2016 credit agreement was a "loose" document, there was no evidence on the part of Serta or the

PTL Lenders of an improper motive, and the 2016 credit agreement was not breached by Serta or the PTL Lenders.<sup>24</sup>

The Bankruptcy Court also provided the following notable dicta:

The parties could have easily avoided this entire situation with the addition of a sentence or two to the 2016 Credit Agreement. They did not. And this litigation ends with each party receiving the bargain they struck—not the one they hoped to get....

[Position enhancement transactions] may or may not be a good thing. Lender exposure to these types of transactions can be easily minimized with careful drafting of lending documents. While the result may seem harsh, there is no equity to achieve in this case. Sophisticated financial titans engaged in a winner-take-all battle. There was a winner and a loser. Such an outcome was not only foreseeable, it is the only correct result. The risk of loss is a check on unrestrained behavior.<sup>25</sup>

Appeals related to Serta's restructuring efforts are currently pending, and there will certainly be more to tell about the use of position enhancement transactions as a tool for corporate liability management as case law further develops.

## Author



Alexander Perez is a Senior Attorney in the Bankruptcy, Restructuring & Insolvency section of the Houston office of Munsch Hardt Kopf & Harr, P.C.

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<sup>1</sup> “Position enhancement transaction” is a new term fashioned by the Bankruptcy Court to encompass and recognize a variety of transactions whereby a borrower and a group of secured creditors affect the relative priority or repayment schemes of another set of secured creditors. See *In re Serta Simmons Bedding, LLC et al.*, 2023 WL 3855820, at \*5 n.2 (Bankr. S.D. Tex. June 6, 2023).

<sup>2</sup> *Id.* at \*12, \*14.

<sup>3</sup> *Id.* at \*2.

<sup>4</sup> *Id.*

<sup>5</sup> A Dutch auction can generally be described as “an auction in which property is initially offered at an excessive price that is gradually lowered until the property is sold.” Black’s Law Dictionary 140 (8th ed. 2004).

<sup>6</sup> *Serta Simmons Bedding*, 2023 WL 3855820 at \*2.

<sup>7</sup> *Id.* at \*3.

<sup>8</sup> *Id.* at \*4-5.

<sup>9</sup> *Id.* at \*5.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at \*6.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at \*7.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at \*6, \*11.

<sup>16</sup> *Id.* at \*6.

<sup>17</sup> *Id.* at \*12.

<sup>18</sup> *Id.* at \*10-11.

<sup>19</sup> *Id.* at \*10.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at \*11.

<sup>23</sup> *Id.* at \*14.

<sup>24</sup> *Id.* at \*13-14.

<sup>25</sup> *Id.*