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Texas Bankruptcy Court Approves Serta Simmons "Uptier" Transaction

The ruling, which held that the transaction did not violate the implied covenant of good faith and fair dealing, highlights the importance of carefully drafting lending documents.

On June 6, 2023, Judge David Jones of the United States Bankruptcy Court for the Southern District of Texas (the Bankruptcy Court) held that the 2020 Serta Simmons "uptier" transaction (the Transaction) was permitted under Serta's existing 2016 credit agreement (the Credit Agreement), a decision that could have broad implications for the permissibility of such transactions.[1]

Background

In January 2023, simultaneously with its chapter 11 filing, Serta Simmons Bedding LLC (Serta) and the participating lenders initiated an adversary proceeding before the Bankruptcy Court, seeking a declaratory judgment that, among other things, the Transaction was permitted under the Credit Agreement because it was an "open market purchase" and that they did not violate the implied covenant of good faith and fair dealing under the Credit Agreement.

In March 2023, the Bankruptcy Court held that, as a matter of law, the Credit Agreement allowed Serta to buy back debt on a non-pro rata basis in the "open market." In other words, the Bankruptcy Court accepted the participating parties' argument that an "open market" debt-for-debt exchange did not need to be open to all lenders. On the other hand, the Bankruptcy Court said that whether the participating parties violated the implied covenant of good faith and fair dealing was a question of fact that would need to be determined at trial.

The Bankruptcy Court then presided over a joint trial on plan confirmation and the adversary proceeding in May 2023.

No Violation of the Implied Covenant of Good Faith and Fair Dealing

Following trial, the Bankruptcy Court issued a decision on June 6, 2023 confirming the plan of reorganization and resolving the claims asserted in the adversary proceeding concerning the Transaction.

With regard to the Transaction, the Bankruptcy Court found that the "overwhelming evidence adduced at trial" showed that Transaction did not violate the implied covenant of good faith and fair dealing.[2] This finding was based on the "undeniable" evidence that all of the parties were "keenly aware" that the Credit Agreement was a "loose document" and "understood the implications of that looseness." That is, all of the lenders knew the Credit Agreement expressly allowed any lender to sell its debt back to Serta on a non-pro rata basis as long as it was done through an "open market purchase." The lenders also knew that an "open market purchase" does not require including all lenders.

The relatively short decision focused in large part on the conduct of the parties relative to one another. The Bankruptcy Court emphasized that Serta "always remained transparent in [its] goals," and found that the participating lenders, who had proposed the Transaction only after learning that the non-participating lenders were already proposing their own exclusive transaction, "acted defensively and in good faith."

By contrast, the Bankruptcy Court found that "it is the conduct of the [non-participating lenders] that raises an eyebrow," noting that the non-participating lenders "acquired the majority of their loan holdings long after the original issuance and in anticipation of negotiating and executing a PET ["position enhancement transaction"] to the exclusion of the [participating lenders]—exactly what they complain was done to them using the same provisions of the [Credit Agreement]."

Thus, the court found that neither Serta nor the participating lenders acted with an improper motive, and that the Transaction "was the result of good faith, arm's-length negotiations by economic actors acting in accordance with the duties owed to their respective creditors, investors, and owners."

What's Next? Contracts Between Sophisticated Parties and the Importance of Careful Drafting

Ultimately, the basis for the Bankruptcy Court's decision was clear: the Credit Agreement was the product of negotiations between sophisticated parties, all of whom were fully aware of the terms of the agreement and their implications. As the Bankruptcy Court stated, "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."

If it survives appeal, the Bankruptcy Court's decision appears to suggest that, in the future, sophisticated parties may be able to rely on similar language without fear of violating the implied covenant of good faith and fair dealing. Market participants should note that it remains to be seen how much of this decision rests on the fact that the non-participating lenders were the first movers in a competition to execute an exclusive debt-for-debt exchange with the borrower. And, of course, how this decision will impact other courts — especially those in New York — deciding similar issues is uncertain.

Regardless, the Bankruptcy Court's primary lesson is clear: "Lender exposure to these types of transactions can be easily minimized with careful drafting of lending documents."

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Endnotes

[1] See Memorandum Opinion [ECF No. 1045], *In re Serta Simmons Bedding, LLC*, No. 23-90020 (Bankr. S.D. Tex. June 6, 2023). On June 7, 2023, some of the non-participating lenders filed an appeal, which is pending as of the time of writing.

[2] Under New York law, which governed the credit agreement, proving a breach of an implied covenant of good faith and fair dealing requires demonstrating a reasonable understanding that the contract imposes a duty on the parties to act in a certain way.