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Expert Views: The Cost of an Improper Uptier: Inside Serta's Damages Math and the Rejected Failure to Mitigate Defense

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Editor's Note: This latest installment in Octus' Expert Views series comes from Christopher Carty, Elizabeth Plowman and Hunter Waters, attorneys at Herrick, Feinstein specializing in bankruptcy, complex commercial litigation and financial restructuring.

The article focuses on Judge Christopher Lopez's damages ruling in his watershed July 2026 Serta decision. The authors explain how the decision provides the market with insight into how courts may measure damages in future disputes over non-pro-rata liability management exercises - and how excluded lenders may react to the ruling.

Introduction

Earlier this month, the Honorable Christopher Lopez of the U.S. Bankruptcy Court for the Southern District of Texas issued his long-awaited post-trial decision in the Serta Simmons chapter 11 case. He ruled that the majority participating lenders in Serta's uptier breached the pro-rata sharing provision in Serta's credit agreement and awarded $261.13 million in damages plus 9% prejudgment interest (which we estimate at over $400 million in total) to the excluded lenders (later adjusted down to $161.5 million in total).

The ruling is notable on multiple fronts. As previously covered on Octus, the court's determination that the pro-rata sharing provision in Serta's credit agreement (section 2.18(c)) - a common provision in syndicated loans - applies to noncash payments (here, a debt-to-debt exchange) has potentially wide-ranging market implications. Octus' prior coverage on the court's "payment" analysis can be found **HERE**.

The court's damages determination, and its rejection of a mitigation defense, are also significant. We focus on that analysis, and its market implications, here. At a high level, the court strictly read the credit agreement to require damages based on the face value of new uptier debt received by the participating lenders, regardless of its actual economic value. The court held that excluded lenders were not required to sell their post-LME debt holdings (and thus lose their LME-related claims) on the secondary market to mitigate their damages. And the court held that the participating lenders failed to show a viable secondary market existed to trade the excluded lenders' significant debt holdings post-LME.

As a rare post-trial ruling in an LME litigation, the *Serta* decision provides the market with new insight into how courts will measure damages in future LME disputes premised on a breach of a pro-rata sharing provision. Additionally, according to the court's reasoning, excluded lenders can help rebut a failure to mitigate defense by showing post-LME efforts to test the market to sell their debt, and by testifying to the subjective value of their LME claims.

The decision seems likely to incentivize excluded lenders to litigate non-pro-rata LMEs - rather than sell their subordinated debt at whatever price they can get. It shows the risks to participating lenders that they may ultimately bear the cost of an improper LME if the company later files for chapter 11. Earlier in the case, Serta's liability for claims resulting from the uptier transaction - indemnification claims that could have been asserted by the participating lenders and breach of contract claims by the excluded lenders - were discharged under Serta's plan, leaving the participating lenders as the only source from which the excluded lenders could recover damages and with no recourse against Serta. And the decision may encourage market participants to seek intercreditor contractual liability caps or to modify damages methods described in their pro-rata sharing provisions.

Serta's Competing Expert Damages Methodologies

The second half of the court's 48-page *Serta* decision focuses on damages and the parties' competing expert analyses.

The Excluded Lenders' Expert Opinion

The excluded lenders' expert Louis Dudney of AlixPartners calculated damages based on the face amount of the new uptier debt received by the participating lenders in the uptier. This analysis assumed that the credit agreement's pro-rata sharing provision mandates that the participating lenders ratably share the $734 million in face amount of new debt with the excluded lenders. If shared ratably, the excluded lenders would have received $348 million in face value of new uptier debt.

Using that baseline, the excluded lenders' expert then proffered two damages calculations, each with differing calculation dates and comparison benchmarks. In one, damages were determined as of Serta's emergence from chapter 11 (June 29, 2023), by comparing the excluded lenders' pro-rata share of the new debt ($348 million) to the excluded lenders' recovery in the Serta bankruptcy. But the court rejected this bankruptcy emergence approach, reasoning that New York law generally requires measuring damages at the time of the breach (i.e., three years before Serta's emergence).

In the second, damages were calculated on the breach date (i.e., the 2020 LME closing), by comparing what the excluded lenders would have received without a breach of the pro-rata sharing provision (i.e., the "but/for world") to what the excluded lenders actually received. In this "but/for world," excluded lenders would have received (i) $348 million in exchange for 38.9% of their $895 million in aggregate Serta first lien term loans, plus (ii) the value of the remaining 61.1% of their first lien term loans (based on the market price of the first lien term loans at the time of the breach). Under this methodology, damages ranged from $240.24 million to $313.36 million, depending on the market price determination.

The Participating Lenders' Expert Opinion

Unsurprisingly, the participating lenders' expert Yvette Austin of Compass Lexecon criticized this approach, offering damages calculations ranging from zero to $46.1 million.

The participating lenders' expert opined that the excluded lenders' expert improperly conflated "face value" with "economic value" when determining that excluded lenders were entitled to $348 million as their ratable share of new uptier debt.

According to the expert, it would be improper to base damages on the new debt's face value ($734 million) because the participating lenders did not receive $734 million in cash. Instead, they surrendered their $992 million of first lien term loans in exchange for newly created paper worth less than its face amount, given the borrower's distress, the execution risk and the lack of a secondary market to trade this debt when received. Similarly, basing damages on face value would, in the expert's opinion, result in a windfall to the excluded lenders, who would receive the face value of their participations in first lien term loans that were trading at only 42 cents before the uptier's announcement.

Instead, to the participating lenders' expert, the controlling question for damages was what (if any) benefits the participating lenders received from the 2020 uptier transaction that the excluded lenders did not. Using this framework, the participating lenders' expert provided two damages calculations (the net benefit of the LME, and a comparison of indicated market prices pre-LME announcement and post-LME).

First, if all lenders' expected recovery improved after the 2020 uptier, and if excluded lenders' improvements were proportionate or greater than their pro-rata share of the total benefit, there was no net benefit to reallocate under the pro-rata sharing provision, and therefore no damages. According to this expert, the benefits of the 2020 uptier for all lenders included $200 million of new money that reduced debt and decreased the likelihood of a Serta bankruptcy in 2020. According to this analysis, there was no net benefit to reallocate, so the excluded lenders had no damages.

Second, the expert compared indicated market prices for Serta's first lien term loans from the first quarter (pre-LME announcement) to third-quarter 2020 (post-LME, when the uptier's results could be priced in) to calculate the non-pro-rata benefit that should have been shared. Based on this analysis, damages were, at most, $46.1 million.

<u>The Bankruptcy Court Adopted the Excluded Lenders' Methodology</u>

The court sided with the excluded lenders' damages analysis, based on the text of section 2.18(c) of the Serta credit agreement:

> If any Lender obtains payment . . . in respect of any principal of or interest on any of its Loans of any Class held by [the Lender] resulting in [that] Lender receiving payment of a greater proportion of the aggregate amount of its Loans of such Class and accrued interest thereon than the proportion received by another Lender with Loans [of the same] Class, then the Lender receiving the greater proportion ***shall purchase (for Cash at face value) participations in the Loans of other Lenders of [that] Class at such time outstanding to the extent necessary so that the benefit of all such payments*** shall be shared by the Lenders of [that] Class ratably...

The court found that section 2.18(c) focuses on the benefits of the non-pro-rata payment to the participating lenders - not the broader transaction benefits. In the court's view, considering the global transaction benefits (like the new money injection or debt reduction) was counter to the text of section 2.18(c). Instead, the participating lenders' "benefit" from the uptier was the new uptier debt.

And this benefit equaled the face amount of new debt received in the exchange (i.e., $734 million). In so ruling, the court rejected arguments that the face value of the new debt was greater than its economic value. Rather, it was meaningful to the court that the face amount of the new debt was the contract price that the participating lenders negotiated for themselves and accepted as the exchange ratio for their first lien term loans. And section 2.18(c) required sharing that non-ratable benefit across all lenders holding first lien term loans.

The court also adopted the excluded lenders' approach of (i) using $348 million as the baseline amount that the excluded lenders would have received but/for the breach and (ii) comparing the value of the excluded lenders' retained first lien term loans to what they would have received in the debt exchange. In this but/for world (i.e., absent a breach), the excluded lenders would have been entitled to $484.88 million in value, i.e., (i) the $348 million in face amount of new uptier debt, plus (ii) the value of the first lien term loans the excluded lenders would have retained ($136.71 million), applying the 25 cent trading price for first lien term loans as of the uptier's closing date. Instead of receiving $484.88 million, the excluded lenders were left with only $233.75 million of value (i.e., their total holdings of $895 million in first lien term loans multiplied by the 25 cent trading price). The excluded lenders' total damages equaled the difference between what they should have received ($484.88 million) and what they actually received, $233.75 million; i.e., $261.13 million.

The $261.13 million was then adjusted down to $161.5 million. This was inclusive of $56.9 million in pre-judgment interest (applying the 9% New York prejudgment interest rate), and accounted for lender settlements, other removals of certain parties and a reduction to one excluded lender's award based on a prior discovery dispute.

The Bankruptcy Court Rejected Arguments That the Excluded Lenders Failed Their Duty to Mitigate Damages

The participating lenders further argued that damages should be reduced because the excluded lenders failed to mitigate damages by not selling their debt post-LME on the secondary market, and instead holding the debt while its value continued to decline leading up to Serta's bankruptcy. Among other things, the participating lenders' expert opined that the excluded lenders could have sold their debt positions at or around 74 cents, based on the midpoint of the bid-ask spread for London Stock Exchange indicative pricing in 2021. She also argued that the excluded lenders lost economic value by entering a cooperation agreement with sale restrictions.

The bankruptcy court rejected these arguments. Based on fact and expert testimony, the court found the participating lenders failed to establish that there was a meaningful market for the excluded lenders to sell their debt or any bona fide offers to buy the excluded lenders' debt, such that their failure to sell could be deemed unreasonable.

But, and perhaps more importantly, the court held that, even if a meaningful market or bona fide offer existed, the excluded lenders could not be forced to abandon their claims against the participating lenders. If the excluded lenders had sold, the buyer of their debt would have acquired their claims. Based on testimony, the excluded lenders held their positions because they subjectively believed the right to litigate the breach claim was more valuable than any sale price they could achieve. So, there was no breached duty to mitigate.

Final Takeaways From *Serta* on Damages and the Duty to Mitigate

In addition to treating a cashless debt exchange as a “payment” triggering pro rata sharing, the bankruptcy court’s decision lays new ground in calculating damages for challenged LMEs and rebutting a failure to mitigate defense in the context of an LME. Absent settlement, we anticipate some sort of appeal, which could involve challenging either (or both) the court’s finding that a debt-to-debt exchange is a “payment” subject to the pro-rata sharing provision or the court’s damages calculations. So, whether the bankruptcy court’s opinion is the final word in *Serta* remains to be seen.

In the meantime, the *Serta* decision sets precedent in calculating substantial LME damages based on the face value of new debt, even if that face value could not be achieved on secondary markets. Applying the court’s reasoning, excluded lenders can help rebut a failure to mitigate defense by showing their post-transaction efforts to assess their ability to sell their debt, and by testifying to the perceived value of their LME-related claims. The decision seems likely to encourage excluded lenders to litigate non-pro-rata LMEs (rather than offload their subordinated debt), and highlights the risks to participating lenders (and benefits to borrowers) that they will ultimately bear the cost of an improper LME if, like in *Serta*, indemnities from the borrower are extinguished in a post-LME chapter 11. And market participants may seek to set forth, or refine, the damages methodologies described in their pro-rata sharing provisions, or to impose intercreditor contractual liability caps.
