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Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

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American Tire: Rubber Hits the Road in Non-Ratable Chapter 11 Liability Management Transaction

By Lynne B. Xerras and Faisal Kraziem*

In this article, the authors explain that liability management transactions continue as a viable and meaningful option for distressed companies seeking new capital. They also discuss a recent decision involving a non-ratable debtor-in-possession loan.

Minority senior secured lenders in syndicated deals rely on, among other provisions, the "sacred right" protections contained in the credit documents to protect the benefit of their bargained-for agreement: primarily, that they will remain in a senior secured position and enjoy payments and distributions ratably. As distressed companies consider options to extend looming maturities and secure liquidity, however, borrowers increasingly take advantage of "loopholes" or loose language in credit documents that permit amendment by only a simple majority to structure "liability management transactions" (LMTs) favoring some, but not all, of the loan participants, under catchy names such as "uptiering," "drop-downs," "double dips" and more. By the time these LMTs close, despite seemingly clear expectations, a certain subset of lenders will often find themselves holding debt relegated from a senior secured first lien position to something lesser. Though this result is hardly ratable, as recent court decisions highlight, it is not always prohibited by the language in the credit documents.

Given this reality, these LMTs will likely continue to be implemented (e.g., see the recent *Better Health* and *Oregon Tool* transactions evolving in real time) and challenged in state and federal courts, with market participants and their professionals paying close attention to the results. Two significant cases at the end of the year, *Serta* and *Mitel*, underscored the critical importance of clear and precise contractual language in protecting sacred rights and avoiding the risk of subordination as a minority lender.

Although these cases garnered considerable attention, the ruling of the U.S. Bankruptcy Court for the District of Delaware (Bankruptcy Court), in connection with the Bankruptcy Court's consideration of a proposed debtor-in-possession financing negotiated by debtor American Tire Distributors Inc. and its affiliated debtors (collectively, American Tire), received less attention but

* The authors, attorneys with Holland & Knight LLP, may be contacted at lynne.xerras@hklaw.com and faisal.kraziem@hklaw.com, respectively.

nonetheless serves as a stark reminder that "ambiguous or contradictory provisions" in credit documents can be exploited if the language supports such a reading, as previously cautioned in *In re TPC Group Inc*.[1]

BACKGROUND AND COURT RULING

On October 22, 2024, American Tire, one of the largest replacement tire distributors in North America, filed for bankruptcy with the Bankruptcy Court after having negotiated terms of a restructuring support agreement (RSA) with an ad-hoc group of some, but not all of, its secured lenders (Priming Lenders), including key terms of (1) a $1.123 billion superpriority debtor-in-possession term loan credit facility, and (2) a $1.2 billion superpriority debtor-in-possession asset-based financing facility (collectively, DIP Loan), both to be funded by the Priming Lenders. The DIP Loan provided only $250 million in new cash, with the balance comprising a roll-up of $750 million of the Priming Lenders' prepetition term loans (a 3-to-1 ratio of rolled-up debt to new money), a full roll-up of a $75 million First In, Last Out (FILO) facility funded by the Priming Lenders in 2024 and a variety of fees due to the Priming Lenders. Simultaneously, the American Tire debtors filed a motion seeking approval of the DIP Loan on an interim and final basis (DIP Motion).[2] On October 25, 2024, the Bankruptcy Court entered an order approving the DIP Motion on an interim basis and scheduled a final hearing for November 19, 2024.[3]

An ad hoc group of lenders holding less than 10 percent under American Tire's prepetition term loan facility (Excluded Lenders) opposed American Tire's DIP Motion, arguing that the roll-up of some, but not all, of the outstanding prepetition term loan into statutorily superpriority DIP Loan claims violated the requirement in American Tire's credit agreement that any paydown of term loans be on a pro rata basis. The Excluded Lenders did not challenge approval of the DIP Loan generally but requested that any Bankruptcy Court order approving its terms be conditioned on ability of the Excluded Lenders to participate in the roll-up and DIP Loan on equal terms. According to the Excluded Lenders, in violation of certain credit agreement provisions: "[t]he DIP Term Roll-Up, together with the DIP FILO Roll-Up . . . moves approximately $1.123.3 billion of debt ahead (in both lien and payment priority) of the Prepetition Term Loans held by the Excluded [Term] Lenders."[4]

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[1] In re TPC Group Inc., No. 22-50372 (CTG) (Bankr. D. Del. July 6, 2022) [ECF No. 72].

[2] See Dkt. No. 16.

[3] In re American Tire Distributors, et al., U.S. Bankruptcy Court, District of Delaware, Case No. 24-12381 (jointly administered) (hereinafter, Bankruptcy Case at ___), ECF No. 90.

[4] Bankruptcy Case, ECF No. 186, at p. 2.

The Priming Lenders countered that the roll-up was not a "payment" on account of their prepetition debt but a cashless conversion providing consideration for the DIP Loan, thus not violating the ratable payment requirement, echoing similar arguments made in the *JCPenney* case, where similar issues arose.[5] Discovery, demands and negotiations ensued.

CONTRACT INTERPRETATION CHALLENGES

As in any litigation attacking the propriety of new debt resulting from a LMT, the Bankruptcy Court was tasked with interpretation of the governing loan documents to determine if the structure of the DIP Loan did – or did not – violate the Excluded Lenders' sacred rights of ratable treatment and no-subordination.

Among other standard provisions, the *American Tire* prepetition credit agreement contained what is now referred to as a "*Serta* blocker," a sacred right protection that has gained broad market acceptance following the "uptier" LMT transaction at issue in the *Serta Simmons* case (circa 2020), discussed above. *Serta* blockers typically require consent (either all lenders or adversely affected lenders) to any amendment of the credit documents that would result in subordination of certain existing lenders' claims or liens to other debt or liens. However, the exact wording of these *Serta* blockers tends to fall somewhere on a sliding scale from very robust, minority lender-friendly to less robust, borrower-friendly variations. One common exception to *Serta* blockers, which was present in *American Tire*, is language that permits priming debt without consent of all lenders or all affected lenders if the ability to participate in such priming transaction was offered to all lenders or all affected lenders on a pro rata basis. The relevant language at issue in *American Tire* is in Section 10.01 of the *American Tire* prepetition credit agreement, which provides (with emphasis added) that any "amendment, waiver or consent" shall not:

> (d) change any provision of this Section 10.01 or Section 8.04 [entitled "Application of Funds"] or Section 10.07(b)(ii)(F)-(J) that would *alter the pro rata sharing of payments, ratable reduction of Loans or the definition of "Required Lenders" without the written consent of each Lender directly and adversely affected thereby;* [or]
>
> . . .
>
> (h) (i) *except to the extent the opportunity to participate as a consenting Lender in any applicable amendment pursuant to which such provisions are so modified has been offered on an equal and ratable basis to all existing*

[5] Bankruptcy Case, ECF No. 223.

> *Lenders*, amend Section 2.12(a), 2.13 or 8.04 in a manner that would alter the pro rata sharing of payments thereunder or (ii) **except to the extent an opportunity to participate in the applicable 'priming' debt has been offered to all existing Lenders on a pro rata basis**, modifications that subordinating [sic] any of the Obligations to any other Indebtedness or subordinating the Liens securing the Obligations to the Liens securing any other Indebtedness (in each case of the foregoing, except (x) Indebtedness that is permitted under this Agreement (as in effect on the Closing Date) to be senior in right of payment to the Obligations **and/or be secured by a Lien on the Collateral that is senior to the Lien securing the Obligations, as applicable or (y) in connection with any 'debtor-in-possession' facility (or similar financing under applicable law))**, in each case **without the written consent of each Lender directly and adversely affected thereby**.

For proper framing of the issues, as noted by counsel to the Excluded Lenders, the transaction can be viewed as having two separate steps: one step is the incurrence of the new DIP Loan without the roll-up, and the other step is the exchange of the prepetition debt into new priming DIP debt through the roll-up. A central question of contract interpretation in *American Tire* was whether the Excluded Lenders' consent was needed to cause the non-ratable roll-up of prepetition debt through the DIP Loan or whether the roll-up was permitted under the carve out above in subclause (y) of Section 10.01(h) (see bolded text above).

As for the first step, i.e., the incurrence of the DIP Loan without the roll-up, the parties seemed aligned that it fell within the carve-out in subclause (y) of Section 10.01(h) (see bolded text above), which allowed for debtor-in-possession financings without any further consent of minority lenders, a point the Excluded Lenders eventually conceded.

As for the second step, i.e., the roll-up, the parties strongly contested that the carve-out in subclause (y) of Section 10.01(h) (see bolded text above) applies. According to the Excluded Lenders in their limited objection to the DIP Motion, "[i]f the parties intended for non-pro rata payment of term loans in connection with debtor-in-possession financing to be a valid and permissible basis to get around the various pro rata sharing protections set forth in Section 10.01(d) and (h)(i), such a carveout would have – and could have – been included." This interpretation, the Excluded Lenders insisted, was in line with the holding involving interpretation of the credit agreement at issue in the *TPC Group* bankruptcy.[6]

Though not abundantly clear, there is some textual argument that the bolded text in subclause (y) of Section 10.01(h) is a carve-out to Section 10.01(h)(i), as well because of the use of the words "in each case of the foregoing," which is similar to the phrasing used at the end of that paragraph, and that latter use is clearly intended to apply to all of Section 10.01(h) and not just subclause (h)(ii). On the other hand, the two items carved out in the bolded language above both appear to be related to the incurrence of debt, the topic addressed in Section 10.01(h)(ii) and not in Section 10.01(h)(i), suggesting that the carve-out related only to Section 10.01(h)(ii) with "in each case of the foregoing" applying each time debt is incurred.

At the conclusion of testimony and argument during the final hearing held on November 19, 2024, the Bankruptcy Court seemed skeptical of the Priming Lenders' argument that Section 10.01(d)'s protection of pro rata payments provisions included a carve-out for the non-pro rata roll-up (i.e., non-ratable payment) of term loan claims through debtor-in-possession financing. The Bankruptcy Court stated that after having worked through the various provisions at play, it seemed as though the DIP Loan's roll-up feature breached the prepetition credit agreement, entitling the Excluded Lenders to damages and preventing the court from issuing a finding in favor of the Priming Lenders to "bless" the roll-up aspects of the transaction through a final DIP order. Judge Craig Goldblatt explained that:

> Where you lose me is what the rollup is . . . it seems to me what the rollup is, is a draw on the DIP to pay down the prepetition credit agreement, and it seems to me that nothing in saying that you can have a priming DIP with some, but not all, means that when you pay down the prepetition debt, you don't have to pay down the prepetition debt in accordance with the prepetition agreement, including its pro rata sharing agreement, and that's just from the language.
>
> Then you've got a layer on top of that, commercial rationality. And, the way I see it, it would be preposterous to enter into an agreement that provided for an exception to pro rata sharing in this context. It would turn every prepetition agreement into what is fundamentally a game of

[6] Bankruptcy Case, ECF No. 186 at p. 14 (citing In re TPC Grp., Inc., No-22-10493 (CTG) (Bankr. D. Del. July 6, 2022), aff'd, In re TPC Grp. Inc., No-22-10493 (CTG) (D. Del. July 26, 2022) ("[t]o the extent such holders want to be protected against self-interested actions by borrowers and other holders, they must include such protections in the terms of their agreements")).

> Russian roulette such that any time you find yourself standing when the music stops, you go to zero. And I don't see how anyone in their right mind would enter into such an agreement; it makes zero commercial sense to me. So I think it's both not the best reading of the words, but to the extent there's any ambiguity in the words that would be informed by ordinary commercial common sense, all of that counsels strongly against this. This strikes me as a preposterous – so the target you have to shoot at is that your reading of the document strikes me as a preposterous overreach.[7]

The Bankruptcy Court indicated that it was not convinced that labeling the roll-up as an "exchange" on a cashless basis or a conversion of prepetition debt to post-petition debt, or even subordination of the first lien loans, changed the contractual result that the roll-up structure violated the terms of the prepetition credit agreement. At this point, counsel to the Priming Lenders requested additional time to consult with the Priming Lenders regarding whether they would consent to funding of the DIP Loan without the desired findings approving the roll-up, and the hearing was rescheduled to November 21, 2024.

Less than 48 hours later, at that continued hearing, counsel for American Tire announced that there was "full resolution on all issues presented in the DIP," with the Priming Lenders having agreed to remove the term loan roll-up piece of the DIP Loan, with the roll-up of the FILO loan approved pursuant to the interim order to remain in place. A consensual form of order approving the modified DIP Loan on a final basis entered on November 22, 2024.[8] Subsequently, after a robust marketing process, the Priming Lenders were the only buyer to come forward, and acquired substantially all of American Tire's operating assets through a credit bid pursuant to a Bankruptcy Court order dated February 11, 2025.[9] A hearing to consider confirmation of the American Tire debtors' proposed plan of reorganization is scheduled for March 27, 2025. Despite the relative success of the reorganization, it is hard not to wonder whether the significant expense and burden on all parties associated with litigation surrounding the propriety of the DIP Loan could have been avoided with a simple fix to the contractual language at the drafting phase.

TAKEAWAYS, OBSERVATIONS AND PRACTICE TIPS

- Judge Goldblatt underscored the importance of precise contractual language when he stated, "I meant what I said" in the *TPC* case,

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[7] Bankruptcy Case, ECF No. 312, pp. 115-116.

[8] ECF No. 340.

[9] ECF No. 730.

reminding the parties that majority lenders may exploit a contractual "hole" in the credit agreement, even to the detriment of nonparticipating lenders.

- Borrowers may respond to *American Tire* by crafting in their "Serta blockers" broader DIP carve-outs or redefining "payment" to exclude noncash transactions (such as DIP loans), referring to the *JCPenney* LMT transaction as additional guidance.
- The proliferation of creative LMT strategies underscores the importance of precise, purpose-driven drafting as the best defense.
- Lenders in a syndicate can incorporate robust "blockers" and minority lender protections to prevent or mitigate uptiering, drop-downs, double dips and other LMTs that harm nonparticipating lenders, ensuring these protections are sacrosanct.
- Above all, definitional and textual clarity is paramount. The debate over "payment" illustrates the need to explicitly define key terms. Clarifying whether "payment" includes noncash exchanges (e.g., roll-ups) can prevent disputes.

CONCLUSION

The *American Tire* case illustrates the evolving challenges lenders face in LMTs and the critical importance of clear contract language. Lenders should closely track developments on these and related issues.