BANKRUPTCY ISSUES IN INTERCREDITOR AGREEMENTS

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Introduction

This article addresses bankruptcy issues commonly arising in connection with intercreditor agreements, and is intended to provide a general examination of provisions that relate specifically to bankruptcy or other insolvency proceedings. By reviewing variations of these provisions that have appeared in negotiated second lien financings, the discussion provides a checklist that will be useful at the front end of deals of this kind.

The scope and context of this discussion is limited to a basic structure involving a privately-negotiated financing extended by first lien and second lien lenders holding *pari passu* senior debt with liens on the same collateral. A typical arrangement would have the first lien lender extending a revolver and a term loan (aka "Term Loan A") with the second lien lender holding only a term loan (aka "Term Loan B"). (A common variation on this structure is a "split collateral pool" transaction where an asset-based lender holds a first lien on working capital assets to secure a revolver, while a fixed asset lender holds a first lien on hard assets to secure a term loan; and each holds a second lien on the other collateral pool.) As senior creditors, second lien lenders retain the right to accelerate debt and demand payment, but remedies against collateral are stayed as provided in the intercreditor agreement. These transactions are to be distinguished from certain other junior capital arrangements, such as traditional unsecured mezzanine debt, where there is payment or debt subordination upon an event of default under the senior debt.

There are no hard and fast rules in privately-negotiated first and second lien deals, as first and second lien intercreditor agreements, particularly in the middle market, are generally subject to significant negotiation, with the end result heavily influenced by the parties' negotiating leverage (including, for example, where the second lien lenders are the borrower's equity sponsors), the particular circumstances of the financing, and prevailing economic and credit market conditions. (This is not the case where, for example, a mezzanine lender, or some other "hybrid" lender such as a convertible debt layer, is granted a "silent" second lien. There, the second lien may be granted only to enable the lender to come in ahead of unsecured creditors such as trade debt but is intended to have virtually no ability to impede the first lien lender's actions.)

In an effort to develop a "market standard," the Model Intercreditor Agreement Task Force of the Syndications and Lender Relations Subcommittee of the Commercial Finance Committee of the ABA's Business Law Section is currently developing a model form of

intercreditor agreement, the current draft of which is dated April 11, 2009 (referred to below as the "ABA Model").

Bankruptcy-Related Provisions of the Intercreditor Agreement

Rights Typically Maintained by Second Lien Lenders

Although generalizations should be viewed with caution, second lien lenders will typically retain the following bankruptcy-related rights in intercreditor agreements:

- To file a proof of claim;
- To take any action (not adverse to the priority status of the first lien or to the first lien lender's exercise of remedies) to preserve or protect the second lien;
- To file any necessary responses or defensive pleadings in opposition to any pleading objecting to or seeking to disallow the second lien claims;
- To vote on any plan of reorganization. However, this may *not* be the case where the junior capital is mezzanine financing or some other product where the second lien or subordinate lender's leverage is minimal. Published court decisions have reached opposite results on whether a provision in a "subordination agreement" granting the senior creditor the right to vote is enforceable under Bankruptcy Code section 510(a) (which provides that a "subordination agreement is enforceable in a [bankruptcy] case to the same extent that such agreement is enforceable under applicable nonbankruptcy law"). *See Blue Ridge Investors, II, LP v. Wachovia Bank, N.A. (In re Aerosol Packaging, LLC),* 362 B.R. 43 (Bankr. N.D. Ga. 2006) (subordination agreement provision granting right to vote to senior creditor would be enforced under section 510(a); section 1126(a) does not prevent the right to vote from being delegated or bargained away by such holder); *Bank of America, National Ass'n v. North LaSalle Street Limited Partnership (In re 203 North LaSalle Street Partnership),* 246 B.R. 325 (Bankr. N.D. Ill. 2000) (in light of Bankruptcy Code section 1126(a)'s language that "the holder of a claim" may vote on a plan, the junior mortgagee was entitled to vote its claim despite subordination agreement language granting senior mortgagee right to vote the claim; section 510(a) directs enforcement of a "subordination agreement" but subordination refers to the priority of claims, not the transfer of voting rights); *In re Curtis Center Limited Partnership,* 192 B.R. 648 (Bankr. E.D. Pa. 1996) (senior creditor could vote the subordinated (payment and lien) creditor's claim based on language of subordination agreement, which the court found clear, unambiguous and enforceable under section 510(a)). With a view to these cases, the intercreditor agreement may provide an express acknowledgement that the agreement is a "subordination agreement" under section 510(a).

Effect of Avoidance or Subordination of First Lien

Does the first lien retain its priority if it is subordinated or avoided in bankruptcy (or is not properly perfected or lapses)? The ABA Model contains alternative provisions, one answering this question in the affirmative, the other in the negative. Second lien lenders would argue that if the first lien is subordinated or avoided but maintains priority, the second lien debt essentially becomes subordinate in payment to the first lien debt that has been converted into unsecured debt, and that risk is not reflected in the second lien deal terms. However this issue is resolved, the first and second lien lenders will agree not to challenge (or support any other person in challenging) the validity or perfection of each other's liens or the validity of each other's debt.

DIP Financing and Cash Collateral Issues

The intercreditor agreement will likely provide that the second lien lender waives the right to contest use of cash collateral or DIP financing where the first lien lender agrees to permit use of cash collateral or provide DIP financing or permit DIP financing by a third party. Note, however, that intercreditor agreements between first and second lien lenders always provide for a cap on the amount of the first lien debt. The agreement will typically require the second lien lender to waive the right to contest DIP financing that does not exceed the cap plus a negotiated dollar amount. (Such a provision should be drafted to ensure that a "roll-up" of prepetition debt does not inadvertently negate the parties' intent to provide the additional cushion above the first lien debt amount.) The second lien lender will typically be required to subordinate its lien to the lien of the DIP lender, any adequate protection liens granted to the first lien lender, and any carve-out agreed to by the first lien lender.

The foregoing waivers may be limited in one or more of the following ways:

- The second lien lender may retain the right to object to DIP financing or cash collateral usage on any ground that an unsecured creditor could object (perhaps limited by a "commercial reasonableness" standard, which raises the potential for uncertainty and argument), but the second lien lender would waive the right to object on the ground of lack of adequate protection.

- The second lien lender is commonly permitted to receive adequate protection in the form of additional collateral, including replacement liens on post-petition collateral, but only if the first lien lender is also granted a senior lien on the additional collateral.

- A second lien lender may be able to negotiate the ability to object to DIP financing if it does not prime or is *pari passu* with the first lien (*i.e.,* the second lien lender could object if the DIP loan is proposed to be junior to the first lien, but senior to the second lien).

- The agreement will commonly permit the second lien lender to object to DIP financing to the extent that it purports to dictate terms of a plan (other than that the plan must pay the DIP in full in cash).

Some intercreditor agreements absolutely bar a second lien lender from providing DIP financing that includes liens with priority equal or senior to the first lien lender's liens. Second lien lenders may resist this on the ground that they should have the same right to provide priming DIP financing as any third party. The ABA Model provides an alternative compromise position that permits a second lien lender to provide priming or *pari passu* DIP financing if a first lien lender does not offer to provide the financing, but enables the first lien lender to object to the proposed financing.

The ABA Model also provides that if the first lien lender so requests, the second lien lender will join any objection asserted by the first lien lender to the borrower's use of cash collateral.

Sale of Collateral

The second lien lender will waive the right to object to a sale of collateral to which the first lien lender consents, so long as the second lien attaches to the sale proceeds.

Possible limitations on this waiver include:

- The second lien lender does not waive the right to credit bid under section 363(k) of the Bankruptcy Code.

- The second lien lender may retain the right to object to a proposed sale on any ground an unsecured creditor could.

Automatic Stay

The second lien lender will waive the right to seek relief from the automatic stay without consent of the first lien lender, with the potential limitation that if the court has denied a request by the second lien lender for adequate protection permitted under the agreement, the second lien lender will be allowed to seek stay relief.

Adequate Protection and Post-Petition Interest

The second lien lender will typically waive the right to contest any request by the first lien lender for adequate protection or any objection by the first lien lender to any motion where the first lien lender's objection is based upon a lack of adequate protection. And, as noted above, the second lien lender will commonly waive the right to object to DIP Financing or use of cash

collateral on the ground of lack of adequate protection. Beyond these common waivers, one or more of the following variations may be negotiated:

- The second lien lender may be permitted to seek adequate protection in the form of an administrative expense claim or Bankruptcy Code section 507(b) superpriority claim so long as the first lien lender is also granted an administrative expense or superpriority claim that is senior. The second lien lender may be required to agree that the administrative expense or superpriority claim may be paid under a plan other than in cash.

- The second lien lender may be permitted to seek adequate protection in the form of cash payments if either (i) the first lien lender is also granted cash payments, or (ii) the cash payments do not exceed an amount equal to the interest accruing on the second lien debt.

- If the second lien lender receives adequate protection payments or post-petition interest and the first lien lender does not receive full payment of all first lien debt, the junior lien lender may be required to pay over to the first lien lender the lesser of the payments received by the second lien lender and the amount of the shortfall.

- The first lien lender may, in any event, retain its right to object to adequate protection in the form of cash payments to the second lien lender.

- The second lien lender may seek adequate protection in the form of payments in the amount of current post-petition interest, incurred fees and expenses or other cash payments if the court deems the first lien lender to be fully secured.

Avoidance Issues

If the first lien lender is required to turn over any payment received on account of the first lien debt, the first lien debt will be deemed reinstated to that extent and the second lien lender will be required to pay over to the first lien lender any amount received to that extent.

Reorganization Securities

Under the so-called "x-clause" (an exception to the general rule that the first lien lender must be fully paid before the second lien lender receives value), the intercreditor agreement may provide that the second lien lender may receive equity or debt securities under the borrower's plan of reorganization. However, the intercreditor agreement may provide that any secured debt obligations received by second lien holders must be paid over to the first lien lender unless the first lien lender affirmatively voted in favor of the plan. In addition, if secured debt obligations distributed under the plan are secured by liens on the same property, the intercreditor agreement will likely provide that it will continue to apply to those liens.

Classification and Treatment Under Plan

The first and second lien lenders may agree that if a court determines that the first and second lien may be classified together and treated the same under a plan, the parties nevertheless will treat all distributions as if there were two separate classes, *e.g.,* entitling the first lien lender to full payment including post-petition interest before distribution may be made to the second lien lender.

Conclusion

Despite the current economic climate, second lien financings will continue to play an important role in debt finance. While M&A activity may be depressed in the foreseeable future, second liens will undoubtedly be a common structure in workouts, restructurings, and bankruptcy exit financings. The above discussion of intercreditor agreement bankruptcy provisions hopefully will provide guidance in negotiating appropriate protections for the parties in this financing structure.

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