Intercreditor Agreements in Mezzanine and Second-Lien Loans: Structuring and Enforcing Key Provisions
Negotiating Rights in Bankruptcy, Foreclosure and Sale of Collateral, Payment Blockages, Standstill Periods

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Today’s faculty features:
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Drafting Techniques and Negotiation Strategies for Intercreditor Agreements in Mezzanine and Second Lien Financings

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Experience

Mark B. Joachim is a Partner in the Washington, D.C. and New York offices of Arent Fox LLP. Mark regularly advises a variety of financial institutions, including specialty finance companies, business development companies, investment banks, commercial banks, asset-based lenders, funds, private equity firms, and other parties in structuring and implementing complex corporate and financing transactions. In addition, he has extensive experience representing lenders (as well as other creditors), official and unofficial committees of creditors, and debtors in connection with bankruptcy cases and out-of-court restructurings. His multifaceted experience also includes the purchase and sale of distressed businesses, and the financing of such transactions.

Representative Matters

-- The Official Committee of Unsecured Creditors in the Cengage Learning chapter 11 cases
-- The First Lien Term Lenders to The Newark Group in its recent successful refinancing transaction
-- A major bondholder and DIP lender in the Spectrum Brands cases
-- The senior secured lenders in the successful out-of-court restructuring of American Media
-- The second lien lenders in international insolvency proceedings for TOUSA, Inc., a leading home builder and financial services company
-- An ad hoc committee of bondholders in the restructuring and exit financing of Tembec, a leading Canadian-based international forest products company
-- The second lien lenders in international insolvency proceedings for Dura Automotive, the world’s largest independent designer and manufacturer of driver control systems
Biography

Mark B. Joachim

Education

-- J.D., with distinction, Hofstra University School of Law, 1992
-- B.A., State University of New York at Stony Brook, 1989

Bar Admissions

-- New York
-- District of Columbia
-- California
-- Massachusetts

Noteworthy

I. Types of Subordination

II. Introduction to Mezzanine Financings

III. Introduction to Second Lien Financings

IV. Intercreditor/Subordination Agreements

V. Negotiation Strategies for Intercreditor Agreements
I. Types of Subordination
I. Types of Subordination

- **Lien subordination** – a contractual agreement (generally set forth in an Intercreditor Agreement) between two senior lien creditors to establish the priority of their competing liens notwithstanding the priorities that might otherwise exist under law. But note the prevalence of “unitranche” deals in the current market (which lump the “first out” and “last out” components into one credit facility governed by a payment waterfall).

  -- Intercreditor Agreements also set out rights and obligations of each creditor with respect to one another;

  -- Creditors often **pari passu** in general priority of **payment** of the debt (with the exception of proceeds from common collateral dispositions).
I. Types of Subordination

Compare with:

**Payment (Claim) Subordination** – An agreement whereby a junior payment creditor (may be secured or unsecured) agrees to defer payment of its claims until the debt of the senior payment creditor is paid in full, and agrees that debt service (interest, fees, and principle) to that creditor will be “blocked” under certain circumstances.

**Structural Subordination** – Creditors of a holding company are structurally subordinated to all creditors of an operating subsidiary because the access of the holding company creditor to the assets of the holding company’s subsidiaries is only through the equity value of the holding company’s ownership interest in the subsidiaries (which, by statute, is subordinated to debt obligations of the subsidiaries themselves). Typically utilized in real estate mezzanine financings.

**Equitable Subordination** – A statutory and quasi-equitable doctrine applied in bankruptcy cases whereby a shareholder’s or other creditor’s debt claim may, under certain circumstances, be subordinated to the claims of other creditors by action of a court exercising equitable powers.
I. Types of Subordination

Nature of Lien Subordination

• Subordination of one creditor’s liens to another — theoretically no payment subordination or payment restrictions, except from common collateral proceeds after an Event of Default.
  -- In theory, second lien lenders may accelerate and enforce their rights against the debtor, but not against common collateral.
  -- Many first lien/second lien Intercreditor Agreements have the effect of creating payment subordination (whether intentionally or unintentionally).

• First lien lenders typically retain control over common collateral, with flexibility to administer and dispose of common collateral with minimal interference from the second lien lenders.

• Special provisions govern right to receive payments in bankruptcy and waiver of other rights of second lien secured creditors.
  -- The scope and potential impact of waivers is critical to second lien creditors, and often is not well understood.
II. Introduction to Mezzanine Financings
II. Introduction to Mezzanine Financings

Mezzanine Financing Basics

- Fixed interest rate
- Equity component typically included
- Very limited rights with respect to collateral enforcement or no security interest
- Lien and payment/claim subordination
II. Introduction to Mezzanine Financings

Payment/Claim Subordination

- Senior Lender has absolute right to payment in full of Senior Obligations prior to Mezzanine Lender regardless of source of funds for the payment

- Permitted Payments – Borrower may pay scheduled interest payments to Mezzanine Lender, until a senior default

- Payment Blockage – upon senior default, for some negotiated period of time

- Improper Payments – hold in trust and turn over to Senior Lender

Lien Subordination

- Shared collateral, with Senior Lender first in line for proceeds from shared collateral

- If Mezzanine Loan is secured by separate collateral, exclude from “shared collateral” definition
II. Introduction to Mezzanine Financings

“Senior Obligations”

• Typically broadly defined as all obligations under the Senior Loan Documents and any permitted amendments thereto, including principal, interest, fees, costs, indemnity payments

• Caps on Senior Obligations, and other restrictions on amendments to Senior Loan Documents

“Mezzanine Obligations”

• “Subordinated Debt” is typically all debt, obligations and liabilities owed under Mezzanine Loan documents.

• Restrictions on amendments to Subordinated Debt Documents
II. Introduction to Mezzanine Financings

**Enforcement Actions**

- Senior Lender typically has exclusive right to take enforcement action on collateral and/or against obligors without regard to Mezzanine Lender rights or marshaling of assets.
- Standstill period – Senior Lender exclusive right typically limited to 90-180 days.
- Mezzanine Lender retains certain rights – file proof of claim and vote claim in bankruptcy, perfect liens, respond to claims objecting to Mezzanine obligations or liens, etc. (but this varies by deal).
III. Introduction to Second Lien Financings
III. Introduction to Second Lien Financings

Development of the Second Lien Market

- In recent years, and with marked acceleration beginning in 2003, and deceleration as the overall debt market was in crisis, second lien financings have become an increasingly prevalent alternative to other forms of junior financing, such as unsecured subordinated “mezzanine” debt and “high yield” debt.

- Second lien financings offer borrowers an additional source of capital that generally has lower interest rates, and therefore substantially reduced cash outflows for debt service, than with the payment subordinated and unsecured alternatives.
III. Introduction to Second Lien Financings

Development of the Second Lien Market (Cont’d)

- First lien lenders obtain several benefits from a junior financing, including maintenance of a senior position at the top of the borrower’s capital structure, a defined position of control over the exercise of remedies against collateral and to some degree over the restructuring and bankruptcy process.

- Second lien lenders benefit from capturing the residual equity value in the collateral, which would otherwise have to be shared amongst all unsecured creditors of the borrower, and achieve many of the advantages available to secured lenders in the event of the borrower’s bankruptcy filing.

-- The lower coupon on second lien financings, as compared to unsecured mezzanine financings generally, reflects the parties’ assumption that the second lien creditors would obtain some value from their liens based on valuation of the collateral base at closing, and second lien lenders also assume that they would not be in the same position as unsecured, payment subordinated mezzanine debt.
III. Introduction to Second Lien Financings

Second Lien Financing Basics

- Second lien on all assets of borrower
- Typically, no equity component
- Generally intended to be lien subordinated, but not payment/claim subordinated.
- Often (but not always) common arranger for first and second lien credit facilities
- Can be widely-syndicated or “club” deals
- Often cash flow financings
- Usually no (or nominal) amortization
III. Introduction to Second Lien Financings

Second Lien Financing Basics (cont’d)

• Pricing: LIBOR plus margin – typically no pricing grid (often is a LIBOR floor)
• Modest prepayment premiums (usually only for the first few years)
• May be preferred to issuing subordinated debt (size, flexibility, etc.) but does bring another layer of complexity (Intercreditor Agreement) and secured lender group negotiations
• A key consideration when structuring a second lien deal is the nature of the first lien debt (e.g., ABL vs. cash flow, etc.) and whether the first lien and second lien are essentially looking to the same collateral as their source of repayment.
III. Introduction to Second Lien Financings

Current Market for Second Lien Loans

- Second lien financings used for every type of situation: acquisitions, growth, dividends, turnarounds, restructurings, and rescue financing.

- Lines between mezzanine and second lien debt have begun to blur, but certain differences, such as covenant structure, depth of subordination, and equity components, remain.

- Underwriting runs gamut from tangible asset value to going concern value (with mixes in between).

- Structuring, syndication, and a general market place for second lien loans are fully-developed.

- Many holders may hold both first and second liens (may be looking to maximize total recovery and also facilitates movement of information and transparency as to motives and strategy). This can either simplify or complicate restructurings.
IV. Intercreditor/Subordination* Agreements

* A note on terminology: in Second Lien Financings, these agreements are typically called “Intercreditor Agreements”. In Mezzanine Financings, they are typically called “Subordination Agreements”.
IV. Intercreditor/Subordination Agreements

Basic Terms of Subordination Agreements – Mezzanine Loans

- Typically prohibits both Senior Lender and Mezzanine Lender from challenging validity, enforceability or perfection of the other’s claims and/or liens.

- Prohibit Mezzanine Lender from most amendments (additional liens or security interests, shorten maturity date, increase principal amount of debt or interest, add default events or covenants).

- Senior Lender typically prohibited from amending to increase principal amount beyond a cap or extending maturity date.
IV. Intercreditor/Subordination Agreements

Basic Terms of Intercreditor Agreements – Second Lien Loans

• Contain key terms of rights of the second lien lenders vis-à-vis the first lien lenders and common collateral.

• Aggressive first lien lenders with significant negotiating leverage may try to relegate second lien lenders to a “silent second” position.

  -- How “silent” the second lien lender is depends on the circumstances of each deal (i.e., how critical the second lien’s money is, the relative sizes of the first lien and second lien, the nature of the common collateral, whether the second lien lender is an “insider” with respect to the borrower, who sourced the deal, etc.).

  -- First lien lenders want to ensure that they have, for at least some defined period of time, exclusive rights to manage the common collateral, as well as the exercise of certain other material secured creditor rights, both prior to and during a bankruptcy case.

• Second lien lenders often seek backstop protections, such as a purchase option to acquire the first lien debt at par.
Basic Terms of Intercreditor Agreements – Second Lien Loans (Cont’d)

- First lien lenders generally insist on separate loan documents in order to prevent first and second lien debt from being deemed “one class of debt” and risking under-collateralization of the first lien in bankruptcy (the “Ionosphere Problem”).

  -- Second liens would benefit from a single class to the extent that it prevents the first liens from accruing interest during a bankruptcy case at the second lien’s expense (and aligns interests of first and second liens re: accrual of interest).

  -- Second liens benefit from separate loan documents to the extent that it gives them a separate seat at the table during a restructuring and a separate voting class (but note that valuation of the debtor and common collateral is a key issue here).

- Second lien financial covenants and negative covenant baskets are also sometimes cushioned off of first lien numbers (usually a 10% variance). **However, this varies greatly depending upon the nature of the first lien deal and other factors.**
V. Negotiation Strategies for Intercreditor Agreements
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<th>Issue</th>
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<td>1. Definition of “Collateral” or “Common Collateral”?</td>
<td>• Only collateral in which, at any time of determination, both Firsts and Seconds have a valid and perfected security interest not subject to avoidance as a preferential transfer or otherwise by the debtor or a trustee in bankruptcy (Preferred Definition)</td>
<td>• Many current forms include anything in Firsts’ granting clause from time to time (whether or not valid or perfected or unavoidable)</td>
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<td>• Consider “Meridian Problem” (First’s mistakenly fail to maintain perfection; Seconds effectively “insured” validity of Firsts’ lien, creating payment subordination)</td>
<td>• Lien priority not affected by avoidability in bankruptcy (the ”Meridian Problem”)</td>
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<td>• If Firsts’ lien avoidable, subrogation rights of Seconds are effectively to an unsecured claim</td>
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<td>• All property that is not subject to a valid, perfected and unavoidable lien of the Firsts or the Seconds, the value of which would be shared <em>pari passu</em> with general unsecured creditors, should be likewise shared <em>pari passu</em> with the Seconds</td>
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<td>• All collateral that is not subject to a valid, perfected and unavoidable lien of the Firsts, but is subject to a valid, perfected and unavoidable lien of the Seconds (but not as a result of a breach of the Intercreditor Agreement) should not be subject to the payment turnover, and in any event the payment turnover should not require the Seconds to receive less than they would have received if the Firsts had properly created and perfected their liens</td>
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<td>Determines which assets the subordination and standstill provisions apply to</td>
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<td>Some Alternatives:</td>
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<td>- Anything in Firsts’ granting clause (whether or not valid, perfected)</td>
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<td>- Anything in Firsts’ granting clause in which Firsts’ have “at any time” a security interest</td>
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<td>- Anything in Firsts’ granting clause in which Firsts’ have “at any time” a perfected security interest</td>
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<td>- Anything in which, at any time of determination, both Firsts and Seconds have a valid and perfected security interest</td>
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<td>- Anything in which, at any time of determination, both Firsts and Seconds have a valid and perfected security interest not subject to avoidance as a preferential transfer or otherwise by the debtor or a trustee in bankruptcy</td>
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<td>2. Impact on lien subordination of avoidance or disallowance of claims of Firsts (e.g., disallowed interest (particularly default interest), fees, expenses)</td>
<td>• Priorities only apply to allowable claims (avoids Seconds inheriting a worthless or non-existent subrogation claim for things like disallowed post-petition or default interest) not in excess of any applicable First Lien Cap</td>
<td>Subordination applies to all amounts specified in First Lien documents, regardless of allowability in bankruptcy (i.e., “the deal is that we are paid before you are”). Creates payment subordination, which can be substantial issue.</td>
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<td>• Allow exception (i.e., interest still “accrues as against the Seconds”) where disallowance of interest results from Firsts and Seconds being deemed to hold a common lien resulting in Firsts being deemed undersecured, but only to the extent of interest which would have been allowed if Firsts had been awarded non-default interest as oversecured creditor</td>
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### V. Negotiation Strategies for Intercreditor Agreements

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| 3. How are payments outside common collateral proceeds treated and applied? (lien subordination vs. payment subordination) | • Allow scheduled payments of interest (standard) and principal (negotiated, depending on scope of Common Collateral and source of payments)  
• Payments not restricted other than from enforcement actions against Common Collateral or from Common Collateral following Event of Default on Firsts  
• Add express override provision that agreement does not create payment subordination  
• Eliminate all payment subordination provisions (e.g., eliminate provisions such as for recovery of interest "whether or not allowed in bankruptcy") | • With deepest subordination, no payment of interest or principal on Second's debt until Firsts paid in full (payment subordination)  
• Generally, Firsts will permit scheduled interest payments on Seconds' debt  
• If payment of principal is permitted, tie to certain financial thresholds for extra cushion  
• If proceeds of Common Collateral received from sale of Common Collateral, turnover to Firsts provided that Firsts have a perfected and unavoidable Lien |
## V. Negotiation Strategies for Intercreditor Agreements

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| 4. Standstill with respect to Seconds’ exercise of remedies against and payment blockage from Common Collateral on an Event of Default under Firsts’ loans. | • Limit Seconds’ standstill period to set period of time (usually 90-180 days) unless Firsts' have commenced (and are diligently pursuing) enforcement of remedies against a material portion of the Common Collateral (exclude enforcement by set-off from this)  
  • Standstill only occurs upon certain "serious" defaults (i.e., payment)  
  • No payment blockage, but turnover only for payments from Common Collateral  
  • Standstill ends once default is cured  
  • Limit multiple standstill periods based on "different" defaults | • Should seek no time limitation or other restrictions on payment blockage from Common Collateral following a default on, or acceleration of, Firsts' loans  
  • Often try to block all post-default payments (which becomes payment subordination) |
### V. Negotiation Strategies for Intercreditor Agreements

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| 5. Restrictions on Seconds’ enforcement rights in respect of Common Collateral | • Insist upon right to take actions with respect to Common Collateral to preserve and protect the value of recovery therefrom to the extent it does not interfere with or harm Firsts during standstill  
  • Include a "use-it-or-lose-it" provision that forces Firsts to make election of remedies within specified time or forfeit the right to take exclusive future remedial actions  
  • Require that Firsts’ enforcement actions be against a material portion of the Common Collateral (exclude enforcement by set-off from this)  
  • Exclude from restrictions commencement of an involuntary proceeding joined in by Seconds, and other unsecured creditor remedies | • Similar concerns as in payment blockage standstill period above; Firsts want exclusive right to manage and enforce collateral rights. This is usually fair for a defined period.  
  • Include in restriction commencement of an involuntary proceeding joined in by Seconds  
  • Proceeds of Seconds' enforcement actions against Common Collateral must be paid over to Firsts (up to any applicable "cap")  
  • Reinstate standstill period (i) if bankruptcy petition filed with respect to any debtor, (ii) so long as Firsts are diligently pursuing remedies against any Common Collateral, or (iii) if Seconds’ default waived |
V. Negotiation Strategies for Intercreditor Agreements

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| 6. Reservation of rights of Seconds to exercise rights and remedies as unsecured (or undersecured) creditors (either generally, in accelerating, filing involuntary bankruptcy petition, seeking a judgment or foreclosing on property not constituting “Common Collateral”, and other key issues) | • Extremely important  
  • Consider issue of conflict between “No challenge of First’s lien” and need to determine and resolve scope of Common Collateral  
  • If limited, try to be specific as to limitations, not general reference to consistency with intercreditor  
  • To the extent possible, seek to preserve right to seek adequate protection, to file competing DIP, propose competing plan, etc. | • Examine closely, but market is to give this (some forms place filing of bankruptcy into bucket of “collateral actions”; may negotiate limited standstill in this case)  
  • More favorable to Firsts is language such as unsecured rights preserved where exercise is in a manner consistent with intercreditor agreement |
V. Negotiation Strategies for Intercreditor Agreements

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<td>7. Restrictions on Seconds’ enforcement rights in respect of Seconds’ loans (other than with respect to Common Collateral)</td>
<td>• Waiver of enforcement rights only with respect to Common Collateral and only during negotiated standstill period</td>
<td>• Waiver of enforcement rights only with respect to Common Collateral and only during negotiated standstill period</td>
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<td>• Seconds can obtain judgment and enforce it against assets other than Common Collateral</td>
<td>• Seconds can obtain judgment and enforce it against assets other than Common Collateral</td>
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<td>• Seconds have ability to accelerate</td>
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| 8. Scope of First Lien Obligations | • First Lien Obligations should exclude:  
  – Amounts not allowed or allowable in an Insolvency Proceeding (failure to exclude this creates payment subordination and loss of subrogation rights of the Seconds)  
  – Amounts in excess of any applicable First Lien Cap (capped either at a fixed dollar amount or by reference to a maximum leverage ratio, the Borrowing Base, or other financial test)  
  – Where appropriate, Hedging Obligations other than those relating to interest on First Lien Principal Obligations not in excess of any applicable First Lien Cap | • Any First Lien Cap should include a reasonable amount of flexibility to deal with an emergency situation (including a cushion to allow "protective advances"), or to accommodate a borrower request.  
• Ensure any reinstated First Lien obligations increase First Lien Cap, if cap reduced by prior payment |
### V. Negotiation Strategies for Intercreditor Agreements

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| 9. Implications of a First Lien Cap without any provision for treatment of the excess. | • Expressly exclude from "First Lien Obligations," and subordinate Firsts' lien securing, all interest, fees and other amounts attributable to principal of first lien debt in excess of the First Lien Cap, and any excluded categories, such as hedging obligations  
• Excess over cap to be expressly lien subordinated to the Seconds, creating a third lien tranche and rights comparable to Firsts to be given expressly to Seconds against the excess debt  
• Seconds need adequate protection rights in the event of a DIP financing in excess of the First Lien Cap | • Merely excluding excess over cap from definition of "First Lien Obligations" does not prevent subordination – the excess first lien debt will still have priority as a matter of law assuming the first lien perfected first.  
• Consider impact of extensions, renewals, financings and upsizing of Second Lien Obligations on third lien status of excess First Lien Obligations over applicable First Lien Cap |
## V. Negotiation Strategies for Intercreditor Agreements

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| 10. Amendments to Seconds’ loan documentation without waiver from Firsts | - Firsts’ consent not required to restrict increases in interest, fees, etc. on Firsts' debt  
- Firsts' consent not required to restrict grant of additional collateral on Firsts’ debt  
- Firsts' consent not required to restrict covenant/default tightening on Firsts’ debt  
- Firsts' consent not required to increase amount or type of non-collateral asset dispositions, the proceeds of which are required to be applied to reduce Seconds’ obligations (to the extent consistent with Firsts' loan documents)  
- Firsts' consent not required to change the definition of Borrowing Base or loosen covenants/defaults | - Ability to restrict increases in interest, fees, etc. on Firsts’ debt without consent from Firsts should be limited  
- Ability to increase interest, fees, etc. on Seconds’ debt without consent of the First should be limited  
- Seconds should have no ability to tighten covenants/defaults on Seconds’ debt  
- Seconds should have no ability to strengthen mandatory prepayments on Seconds’ debt, to shorten the maturity on Seconds' debt or shorten the amortization period of Seconds' debt  
- Seconds have no ability to lower First Lien Cap |
## V. Negotiation Strategies for Intercreditor Agreements

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<td>11. Automatic application to Seconds’ security documentation of</td>
<td>• No, represents an abdication of control over Seconds' security interest</td>
<td>Firsts control Common Collateral at both levels, even if it adversely affects Seconds without their consent</td>
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<td>waivers, consents and amendments (other than releases of collateral or</td>
<td>• Firsts should not be able to disenfranchise Seconds</td>
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<td>guarantees) given by Firsts under their security documentation</td>
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<td>12. Option of Seconds to buy out Firsts (price (at par or premium) and timing (anytime; upon default; upon event of default; upon acceleration))</td>
<td>• Very important right to minimally safeguard Seconds' interests&lt;br&gt;• No limit on timing of exercise after trigger event&lt;br&gt;• Exclude prepayment premiums from buyout price, perhaps with incremental price if a prepayment premium received by Seconds within some defined time frame (i.e., clawback)&lt;br&gt;• Many &quot;form&quot; buyout provisions don't work and fail to address (i) process for multi-party Second lien holders and (ii) L/C’s, hedges and bank products exposure: use a well thought out provision&lt;br&gt;• Permit buy-out combined with credit bid for excess</td>
<td>• Firsts should not care if procedure is fast and if enforcement standstill has escape clause for material disadvantage to Firsts&lt;br&gt;• Include detailed logistics provisions similar to loan payoffs re: disposition of outstanding letters of credit, cash collateral, etc. upon buy out&lt;br&gt;• Consider how to treat hedges and bank products exposure</td>
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## Issue 13. Ability of Seconds to veto a proposed sale of all or substantially all of the borrower's assets

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| • Yes, very important, since alternative allows Firsts to negotiate a "give away" of the Seconds' collateral value for a quick deal that pays off the Firsts.  
  • Fall-back: buy-out rights  
  • Seconds preserve right to be heard, and credit bid (subject to buy-out of Firsts), in bankruptcy context | Often resisted |
## V. Negotiation Strategies for Intercreditor Agreements

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<td>14. Waiver by Seconds of right to object to a sale of collateral under § 363(b) of the Bankruptcy Code (outside of the ordinary course) approved by Firsts</td>
<td>• Can disenfranchise Seconds&lt;br&gt;• May limit to sales where proceeds go either to Firsts to permanently reduce or to Seconds (with carveout for professional fees if granted in DIP/adequate protection order)&lt;br&gt;• Try to preserve unsecured creditor rights to object to sale or process, waive rights only in capacity as holder of lien on Common Collateral (i.e., maintain the right to object to the process, but not the price)&lt;br&gt;• Preserve right to credit bid subject to payment in full of Firsts&lt;br&gt;• Condition waiver on attachment of Second’s liens to (excess) net proceeds with same priority and validity as Seconds’ other liens on Common Collateral</td>
<td>Desire to control process; otherwise, Seconds could just play hold-up and reject any offer that does not pay the Seconds off as well, effectively undoing the lien subordination</td>
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### V. Negotiation Strategies for Intercreditor Agreements

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| 15. Right of Seconds to act separately as proponent of a plan of reorganization | • Very important right  
• Generally, Seconds must have plan proponent right to have maximum value  
• Firsts are protected anyway by § 510(a) of the Bankruptcy Code (which gives force to subordination agreements) and the “absolute priority rule” of § 1129(b)(2) of the Bankruptcy Code | • Firsts prefer to control plan structure  
• Seconds' plan proponent right must not permit Seconds to challenge status or priority of First’s liens if one plan alternative is a First Lien cram-down or plan challenges, or preserves right to challenge, validity of Firsts' lien |
### V. Negotiation Strategies for Intercreditor Agreements

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| 16. Right of Seconds to vote separately on a plan of reorganization | Extremely important to preserve separate voting right; Firsts are protected anyway by § 510(a) of the Bankruptcy Code (which gives force to subordination agreements) and the “absolute priority rule” of § 1129(b)(2) of the Bankruptcy Code | • Firsts' prefer control over plan  
• Seconds' voting rights should not permit Seconds to challenge status or priority of First’s liens if one plan alternative is a First Lien cram-down or plan challenges, or preserves right to challenge, validity of Firsts' lien |
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| 17. Limit on type of adequate protection Seconds can receive | • No limitation, provided any lien given is subordinate to any lien of Firsts on same collateral and any administrative priority is subordinate to Firsts administrative priority  
• Seconds likely will have to agree, with such agreement incorporated into the court’s adequate protection order, not to require payment in full in cash of administrative claim on confirmation and to allow payment over time (equal to present value of administrative claim); under the Bankruptcy Code, administrative claimants can agree to take less than payment in full, in cash, on confirmation  
• Unlimited right to seek adequate protection (including cash payment of interest and expenses including professional fees) can vastly increase leverage at the outset of a case and at plan confirmation | • Yes, any lien given Seconds to be subordinate to lien on same collateral given to Firsts  
• No administrative priority since it gives Seconds right to block a Plan unless paid in full in cash, even if subordinated  
  – Consider impact of post petition cash interest and expense payment to Seconds – allows payment from the estate prior to Firsts being paid in full  
• Limit Seconds' ability to seek adequate protection to subordinate replacement Liens and subordinate Liens on additional collateral |
V. Negotiation Strategies for Intercreditor Agreements

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<td>18. If Intercreditor Agreement contains advance consent to DIP</td>
<td>• Is DIP subject to First Lien Cap? Separate DIP cap?</td>
<td>• Firsts likely to push back on each of these issues</td>
</tr>
<tr>
<td>financing/use of cash collateral (whether provided by Firsts or third</td>
<td>• If First Lien cap is reduced by paydowns does this block the DIP, if used in roll up?</td>
<td>• Firsts will seek broad advance consents from Seconds</td>
</tr>
<tr>
<td>parties), what conditions or exceptions to that consent exist</td>
<td>• Is DIP covered in First Lien refinancing in a roll up?</td>
<td></td>
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<td></td>
<td>• Exception for provisions in DIP dictating Plan terms</td>
<td></td>
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<td>• Exception for provisions in DIP governing &quot;sale of collateral&quot; terms (to prevent a</td>
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<td>quick sale that just pays off the Firsts)</td>
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| 19.  Waiver by Seconds of right to accrue postpetition interest (i.e., to extent it is deemed “oversecured”) | • Seconds should resist granting such a waiver  
• Alternate - May seek to accrue postpetition interest if Firsts seek or obtain | Often requested, and usually received to the extent that the Seconds have an equity cushion after giving effect to the Firsts' principal and accrued obligations |
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<td>20. Discharge of First Lien Obligations definition - Is it express that distributions pursuant to § 1129(b)(2) of the Bankruptcy Code (i.e., “cram up”) do not constitute payment in full?</td>
<td>No, Seconds retain right to proceeds of secured claim even if Firsts are &quot;crammed-up&quot;</td>
<td>Yes</td>
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| 21. Treatment of Reorganization Securities, debt and/or equity (the "X Clause") | Reorganization Securities to be expressly excluded from "proceeds" of Common Collateral, and permitted to be retained by Seconds | • Reorganization Securities are "proceeds" of Common Collateral to the extent of the value of the Seconds' interest in Common Collateral  
• Reorganization Securities in any event to be subject to Intercreditor Agreement if secured by "Common Collateral" on bankruptcy exit  
• Reorganization Securities received by Seconds on account of Seconds' obligations that constitute a secured claim to be paid to Firsts unless distribution is made under Plan consented to by affirmative vote of all classes composed of the secured claims of Firsts |
ENFORCING INTERCREDITOR AGREEMENTS IN BANKRUPTCY
BY MARK N. BERNMAN
Section 510(a) of the Bankruptcy Code:

A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.
Section 510(a) of the Bankruptcy Code:

• So……what is a subordination agreement?
  • Priority for sure
  • Waivers of rights in bankruptcy cases-maybe

• So……to what extent is a subordination agreement enforceable outside of bankruptcy?
  • Section 9-339 of the UCC provides that “This article does not preclude subordination by agreement by a person entitled to priority.”
  • Courts generally look to state contract law, but there is little out there about content. Most is about interpretation, i.e. are the provisions clear and unambiguous. If ambiguous, what was the intent of the parties?
Section 510(a) of the Bankruptcy Code:

- Are UCC §§1-102(3) and 9-602 cmt. 2, relevant?

“... in the context of rights and duties after default, our legal system traditionally has looked with suspicion on agreements that limit the debtor’s rights and free the secured party of its duties. As stated in former Section 9-501, Comment 4, ‘no mortgage clause has ever been allowed to clog the equity of redemption.’ The context of default offers great opportunity for overreaching. The suspicious attitudes of the courts have been grounded in common sense. This section . . . codifies this long-standing and deeply rooted attitude. The specified rights of the debtor and duties of the secured party may not be waived or varied except as stated. Provisions that are not specified in this section are subject to the general rules in [Section 1-302].”

WHY DOES IT MATTER?

In the context of a Second Lien Financing:

• Secured creditors have an interest in the debtor’s property and, therefore, the right to have that interest protected.
  – This gives the secured creditor a role to play in the context of DIP Financing or the debtor’s efforts to use of cash collateral in the early days of a case.

• Secured creditors are usually entitled to be classified separately from other secured and all unsecured creditors.
  – This gives them a role to play in the context of voting and confirmation of a plan.
In the context of Mezzanine Financing:

- Mezz is generally not secured by assets of the debtor, so there is no adequate protection issue.
  - Be careful-some mezz deals include a subordinate lien on a borrower’s assets.
  - The mezz lender generally lends on an unsecured basis to the holder of equity with a pledge of that equity to secure the loan.
    - Again, be careful, some mezz is structured as a subordinate loan to the borrower rather than equity.
    - If it’s a mezz loan to the borrower and depending on the size of the mezz debt, the mezz lender may be able to control the class of unsecured creditors voting on the plan of reorganization and, thereby, make confirmation of that plan more difficult.
    - If the mezz lender is lending to the equity holder secured by a pledge of that equity, the mezz lender may be able to exercise the pledge.
SECOND LIEN ISSUES ADDRESSED IN CASE LAW

- Adequate Protection for Use of Cash Collateral
- Providing DIP Financing
- Appointment of an Examiner
- Bidding Procedures for Sales of Assets
- Sales of Assets
- Plan Voting Rights
- Objections for Confirmation of a Plan
- Cram Down of a Secured Creditor Under a Plan
- Subrogation
ADEQUATE PROTECTION

  
  • Subordinated creditor (Beatrice) filed a complaint seeking adequate protection of its secured interest in the debtor’s property or a lifting of the stay so that it could proceed to foreclose.
  
  • The subordination agreement entered into by Beatrice and Aetna prior to the bankruptcy case provided:
    
    “Creditor (Beatrice) will not, without your (Aetna’s) written consent, assert, collect or release the indebtedness or any part thereof or realize any collateral securing the 
    indebtedness or enforce any security agreements, real estate mortgages, lien instruments, or other encumbrances securing said indebtedness except that it may collect regularly scheduled payments when and as due as provided above.”
The Bankruptcy Court said:

- "The intent of §510(a)(Subordination) is to allow the consensual and contractual priority of payment to be maintained between creditors among themselves in a bankruptcy proceedings. There is no indication that Congress intended to allow creditors to alter, by a subordination agreement, the bankruptcy laws unrelated to distribution of assets."
The Bankruptcy Court also said:

- The Bankruptcy Code guarantees each secured creditor certain rights, regardless of subordination. These rights include the right to assert and prove its claim, the right to seek court-ordered protection for its security, the right to have a stay lifted under proper circumstances, the right to participate in the voting for confirmation or rejection of any plan of reorganization, the right to object to confirmation, and the right to file a plan where applicable. The above rights and others not related to contract priority of distribution pursuant to Section 510(a) cannot be affected by the actions of the parties prior to the commencement of a bankruptcy case when such rights did not even exist. To hold that, as a result of a subordination agreement, the “subordinor” gives up all its rights to the subordinee” would be totally inequitable.”
The Bankruptcy Court went on to say:

• “No prejudice can be shown by Aetna if Beatrice is allowed to assert its claim. Any money collected by Beatrice must be held in trust by Beatrice and paid to Aetna until Aetna is paid in full.”

• However, more recently, in *Aurelius Capital Master v. Tousa* (S. D. Fla. 2/6/2009):

  • A waiver of the right to object to a cash collateral order that was supported by the senior lienholders was enforceable against the junior lienholder.

- Emphasis on carefully drafted intercreditor agreements.
- First lien lenders sued the second lien lenders for alleged violations of the intercreditor agreements.
  - Requests for adequate protection;
  - Intervening in an adversary proceeding contesting the first lien lenders’ make-whole premiums;
  - Supporting the Plan of Reorganization.
- Second lien lenders were to receive the reorganized company’s equity.
Momentive (con’t)

- Second Lien Lenders’ main defense was that the Intercreditor Agreement did not specifically restrict the actions they took and, therefore, were permitted under the clause that allowed them to retain whatever rights they would have as unsecured creditors.

- Second lien were required to consent to DIP financing supported by the first lien lenders, but were not prohibited from supporting other DIP financing or providing their own.

- The intercreditor agreement did not restrict the second lien lenders from supporting plan confirmation of a plan rejected by first lien lenders.

— The subordination agreement provisions:

- “North LaSalle covenants and agrees that the North LaSalle Loan and the North LaSalle Loan Documents, as they may be, at any time from time to time, amended, modified, supplemented, substituted, replaced or restated, are and shall at all times be and remain junior and subordinate to the [Senior Bank] Transactions…”

- “[North LaSalle] further agrees that in the event of any … reorganization … (c) [North LaSalle] hereby irrevocably agrees that the Bank may, at its sole discretion, in the name of [North LaSalle] or otherwise … file, prove, and vote or consent in any such proceedings with respect to, any and all claims of [North LaSalle] relating to the Junior Liabilities.”

— BofA, as the senior secured lender, filed a complaint seeking a declaratory judgment as to the effect of subordination agreements entered into between BofA and North LaSalle Street Limited Partnership, which was both the general partner of the debtor and a subordinated secured lender.

— North LaSalle’s claim was an “artificial deficiency claim created by §1111(b).”

- Issue was whether the North LaSalle could vote its subordinated claim or whether BofA, as the senior secured creditor, could vote BofA’s claim as provided in the subordination agreements.

- Pursuant to Section 510(a), the court looked to Illinois law which provides that in the absence of ambiguity, the terms of subordination agreements are to be construed according to their plain language.

• This is a rule of construction and not of enforceability!
What the Court held:

• “While the language of the subordination agreements governs the outcome of the Bank’s right to repayment of any deficiency claim, the language of the Bankruptcy Code governs the determination of voting rights in this case. Section 1126(a) of the Code provides that “the holder of a claim” may vote to accept or reject a plan under Chapter 11……North LaSalle is the holder of the claim….North LaSalle should therefore be allowed to vote its claim in the confirmation process.”
What the Court also held:

- “It is generally understood that prebankruptcy agreements do not override contrary provisions of the Bankruptcy Code….Indeed, since bankruptcy is designed to produce a system of reorganization and distribution different from what would obtain under nonbankruptcy law, it would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply.”
What the Court went on to say:

- “….§510(a), in directing enforcement of subordination agreements, does not allow for waiver of voting rights under §1126(a). “Subordination,” though not defined by the Code, has a common understanding in the law, reflected in Black’s Law Dictionary, which defines subordination as: “the Act or process by which a person’s rights or claims are ranked below those of other.”….Subordination thus affects the order of priority of payment of claims in bankruptcy, but not the transfer of voting rights.”
— Cites to *Hart Ski*.

— “Although a creditor’s claim is subordinated, it may well have a substantial interest in the manner in which its claim is treated. Subordination affects only the priority of payment, not the manner in which its claim is treated. Subordination affects only the priority of payment, not the right to payment. If assets in a given estate are sufficient, a subordinated claim certainly has the potential for receiving a distribution, and Congress may well have determined to protect that potential by allowing the subordinated claim to be voted. This result assures that the holder of a subordinated claim has a potential role in the negotiation and confirmation of a plan, a role that would be eliminated by enforcing contractual transfers of Chapter 11 voting rights.”
• Suggests that a different result may follow if subordinated claim had been assigned to senior lender.
  
  – This is a matter of leverage in the negotiations over the terms of subordination when the transaction is originally documented.
Other cases agreeing with *203 N. LaSalle*:

- *In re Croatian Surf Club, LLC*, 2011 WL 5909199 (Bkrtcy. E.D. N. C.)
  
  • “[Senior creditor] is “empowered…to file claims and proofs of claims and take such other action (including, without limitation, voting the Subordinate Debt…) as it may deem necessary or advisable for the exercise, enforcement or preservation of any rights or interests of [senior creditor] hereunder.”
In re: SW Boston Hotel Venture, LLC et al., 2011 WL 5520928 (Bkrtcy. D. Mass.);

- “In the event of …a bankruptcy…reorganization…whether or not pursuant to bankruptcy laws…Junior Lender will assign to Senior Lender the voting rights of Junior Lender in such proceeding…”

- “Although 11 U.S.C. § 510(b) (sic) provides for the enforceability of subordination agreements, such agreements cannot nullify provisions of the Bankruptcy Code. To the extent a provision in a subordination agreement purports to alter substantive rights under the Bankruptcy Code, it is invalid. This Court follows and adopts the reasoning of Judge Wedoff in [203 N. LaSalle…”] (emphasis added)

- The bankruptcy court’s decision was appealed and reversed on other grounds.
On junior creditor’s motion to determine voting rights in connection with a reorganization plan, where both senior and junior creditor cast conflicting ballots, court upheld provision in subordination agreement allowing senior lender to vote the junior lender’s claim:

- Junior creditor entered into a subordination agreement with senior creditor at inception of loan. Subordination agreement modified twice pre-petition.
- **Debtor** is a party to the subordination agreement and entitled to rely on its enforcement.
• Provisions in subordination agreement authorized senior creditor to vote the junior creditor’s claim, and to receive any distribution allocated to the junior creditor.

  “…Lender is hereby irrevocably authorized and empowered (in its own name or in the name of the Subordinated Creditor or otherwise), but shall have no obligation, to demand, sue for, collect and receive every payment or distribution referred to in subsection (a) above and give acquittance therefore and to file claims and proofs of claim and take such other action (including without limitation voting the Subordinated Debt or enforcing any security interest or other lien securing payment of the Subordinated Debt) as it may deem necessary or advisable for the exercise or enforcement of any of the rights of the Lender hereunder, and…”
• Court finds that junior creditor “has provided no evidence, argument or authority that the Subordination Agreement is not enforceable under applicable nonbankruptcy law.” Without analysis or citation, court says that “[t]he Subordination Agreement appears to be enforceable under Georgia law, which is the applicable nonbankruptcy law.”
  – Who has the burden of proof?
• Junior creditor apparently had the right to purchase the senior lender’s claim. The court felt this afforded the junior creditor a remedy.
• Same relevant facts as in the 203 N. LaSalle case. Court rejects 203 N. LaSalle reasoning.
PLAN VOTING RIGHTS (CON’T):

Other cases that stand for the same proposition as Aerosol:


OBJECTIONS TO CONFIRMATION OF A PLAN


  • “plainly worded contracts establishing priorities and limiting obstructionist, destabilizing and wasteful behavior should be enforced and creditor expectations should be appropriately fulfilled”

  • Intercreditor Agreement included silent second lien provisions:

    — **No Contest Clause:** “[U]pon the commencement of a case under the Bankruptcy Code by or against any Grantor, …(b) each secured party agrees not to take any action or vote in any way inconsistent with this Agreement so as to contest (1) the validity or enforcement of any of the Security Documents…(2) the validity, priority, or enforceability of the Liens, mortgages, assignments, and security interests granted pursuant to the Security Documents…(3) the relative rights and duties of the holders of the First Priority Obligations”
OBJECTIONS TO CONFIRMATION OF A PLAN


• The intercreditor agreement contained the following clauses:
  
  — **Support for Plan Clause**: Unless the First Lien Lenders are paid in full, the Second Lien Lenders may not “oppose, object to or vote against any plan of reorganization or disclosure statement the terms of which are consistent with the rights of the First Priority Secured Parties under the Security Agreement.”

• Clearly something beyond simple lien subordination
OBJECTION TO CONFIRMATION OF A PLAN
(CON’T)

No Contest Clause: “[U]pon the commencement of a case under the Bankruptcy Code by or against any Grantor, …(b) each secured party agrees not to take any action or vote in any way inconsistent with this Agreement so as to contest (1) the validity or enforcement of any of the Security Documents…(2) the validity, priority, or enforceability of the Liens, mortgages, assignments, and security interests granted pursuant to the Security Documents…(3) the relative rights and duties of the holders of the First Priority Obligations”
- **Support for Plan Clause:** Unless the First Lien Lenders are paid in full, the Second Lien Lenders may not “oppose, object to or vote against any plan of reorganization or disclosure statement the terms of which are consistent with the rights of the First Priority Secured Parties under the Security Agreement.”
- **Rights as an Unsecured Creditor Clause:** Provision in the intercreditor agreement allowed second lien Lenders to exercise rights of an unsecured creditor, but there was an exclusion for actions that were otherwise proscribed in certain sections of the agreement. The proscribed activities included i) objecting to the plan, objecting to the DIP Loan Facility, and objecting to the Disclosure Statement, all consistent with other clauses in the intercreditor agreement.
Bankruptcy Court distinguishes *203 N. LaSalle* and *Aerosol Packaging* cases because they involved the right to vote on a plan.

“plainly worded contracts establishing priorities and limiting obstructionist, destabilizing and wasteful behavior should be enforced and creditor expectations should be appropriately fulfilled”

• Bankruptcy courts have “refrained from enforcing a creditor’s waiver of bankruptcy rights in a pre-bankruptcy interecreditor agreement on public policy grounds,”
• In a footnote, court notes that violations of the intercreditor agreement that caused a material increase in the administrative expenses of the cases may be a measure of damages to be claimed against the second lien lender. An invitation to litigation.

• Bankruptcy Court was clearly influenced by what it saw as the subordinated creditors use of “obstructionist” tactics to put barriers in the way of plan confirmation despite agreements not to do so.
Westpoint Stephens, 600 F. 3d 231 (2\textsuperscript{nd} Cir. 2010)

- First lien lenders allow a sale to close or a plan to be confirmed where the sale or plan provides for a distribution to second lien lenders arguably in violation of an intercreditor agreement. They may forfeit their right to object to a distribution to second lien lenders in violation of an Intercreditor Agreement.
  - the statutory mootness doctrine.
  - First lien lenders obtained a stay of the sale, but later stipulated that the sale could close so long as the distribution of equity to second lien lenders provided for as part of the sale was delayed until resolution of whether second lien lenders could receive a distribution before senior lenders were paid in full.
  - The Second Circuit found that the first lien lenders lost the right to complain that second lien lenders would be receiving equity that allowed them to control the purchaser.
Appointment of an Examiner


Bankruptcy Court finds that Subordination Agreement provisions prohibited the subordinated creditors from seeking appointment of an examiner. To do so was, in the court’s view, to take ‘action,’ to seek to enforce ‘remedies’ and to pursue ‘collection’ of their claims, each prohibited without the consent of the agent.

- Administrative Agent opposed motion seeking to appoint an examiner.

- Language in the Subordination Agreement did not specifically define an enforcement action to include seeking the appointment of an examiner.
Follows the reasoning of *Ion Media* in finding that “[t]his is the very type of obstructionist behavior that the agreement are intended to suppress.”

The subordinated creditors had agreed not to “exercise any rights or remedies or take any action or proceeding to collect or enforce any of the Subordinated Obligations” without “the prior written consent of the Agent” until the senior secured lenders had been “fully satisfied.”

Maryland law controlled and was found to “follow the objective theory of contract law,” i.e. a court will “look at what a reasonable person in the same position would have understood as the meaning of the agreement.”
The intercreditor agreement included the following provisions:

- “Until the Discharge of First Lien Obligations has occurred, whether or not any Insolvency or Liquidation Proceeding has been commenced…the First Lien Collateral Agent, at the written direction of [First Lien Lenders holding a majority of the First Lien Debt], shall have the exclusive right to enforce rights, exercise remedies…and make determinations regarding the release, sale, disposition or restrictions with respect to the Collateral without any consultation with or the consent of the Second Lien Collateral Agent or any Second Lien Secured Party…provided that the Lien securing the Second Lien Obligations shall remain on the proceeds of such Collateral released or disposed of subject to the relative priorities described in Section 2.1…” (emphasis added)
The intercreditor agreement also included the following provision:

- “Without Limiting the generality of the foregoing, unless and until the Discharge of First Lien Obligations has occurred, except as expressly provided in …, the **sole right** of the Second Lien Collateral Agent, the Second Lien Administrative Agent, and any other Second Lien Secured Party **with respect to the Collateral is to hold a Lien** on the Collateral pursuant to the Second Lien Collateral Documents for the period and to the extent granted therein **and to receive a share of the proceeds** thereof, if any, after the Discharge of First Lien Obligations has occurred.”
“On October 4, 2010, the Court ruled that the Second Lien Agent had standing to object to the Bid Procedures, noting that "[t]he plain language of the Intercreditor Agreement says the seconds are silent in certain circumstances, but I do not read any express prohibition against objection to bidding procedures anywhere in the intercreditor agreement." The Court distinguished In re Ion Media Networks, Inc., 419 B.R. 585 (Bankr.S.D.N.Y.2009) and In re Erickson Retirement Communities, 425 B.R. 309 (Bankr.N.D.Tex.2010).”
SALES OF ASSETS CON’T)

— Court allowed the second lien lenders to object to bid procedures motion because the Intercreditor Agreement did not specifically restrict that action.

— In the December 3, 2010 subsequent Boston Generating decision, bankruptcy court allows the second lien lenders standing to object to the sale itself. Court then overruled the objection and allowed the sale to proceed. Second lien lenders got nothing.
Sale of Assets Provision (examined in *Boston Generating*):

- “Second Lien Agent, as holder of a Lien on the Collateral and on behalf of the Second Lien Claimholders, **will not contest, protest, or object, and will be deemed to have consented** pursuant to section 363(f) of the Bankruptcy Code, **to a Disposition of Collateral** free and clear of its Liens or other interests under section 363 of the Bankruptcy Code if First Lien Agent consents in writing to the Disposition provided that ...(i) the liens of the second lien creditors attach to the proceeds of such disposition to the extent so ordered by the court, (ii) the net cash proceeds are applied to reduce the first lien obligations permanently, and (iii) the second lien creditors will not be deemed to have waived any right to bid in connection with such disposition.”
ABA MODEL INTERCREDITOR AGREEMENT (CON’T)

The Model First Lien/Second Lien Intercreditor Agreement Task Force was established by the ABA to develop a balanced, market-based model form of intercreditor agreement that specifies the rights of first lien and second lien lenders holding pari passu senior debt secured by identical collateral that fairly protects the respective interests of first lien and second lien lenders while reflecting market expectations and standard practices.

The Task Force Report along with the Model Agreement was published in the May 2010 edition of The Business Lawyer.

- A copy of the Task Force Report and of the Model Agreement with or without commentary is available on the Task Force website in both word format and pdf format.
  - http://www.abanet.org/dch/committee.cfm?com=CL190029
The ABA Model Agreement provides alternative language for provisions that address issues where there can be expected to be a difference of opinion between the first and second lien lender and the resolution is likely to be a matter of leverage in the negotiation. Some of these areas are:

• Whether the second lien lender should be subordinated even if the first lien lender fails to properly perfect, or maintain the perfection of its lien, the lien is avoided or subordinated? Can lead to hidden payment subordination.

• Should interest, costs, expenses, indemnities, hedging and other bank product obligations be included in the definition of senior obligations?
• The retention of the second lien lender’s rights as an unsecured creditor.

• Should marshalling be waived where there are assets that may be pledged to the first lien lender but not the second lien lender?

• Second lien lender purchase option need to be thought through so that it is workable from the second lien lenders’ standpoint. What are the triggers and what is the timing?

Points out that Section 1129(b)(1) of the Bankruptcy Code limits Section 510(a) of the Bankruptcy Code in the context of confirming a plan over the objection of a secured creditor via cram down.

• First lien lenders had objected to confirmation of a cram down plan proposed by second lien lenders because the Intercreditor Agreement required that first lien lenders must be paid in full and in cash before second lien lenders could receive a distribution.

• Court overruled first lien lenders’ objection finding that the Intercreditor Agreement provisions restricting distributions to subordinate creditors were not enforceable when confirmation of a plan takes place by cram down under Section 1129(b)(2).

Query: Do the first lien lenders have a cause of action against second lien lenders?

In the context of the financing of real estate, the intercreditor agreement provided:

- **“Subrogation.”** [MMA] agrees that [NBA] shall be subrogated to [MMA] with respect to [MMA’s] claims against Borrower and [MMA’s] rights, liens, and security interests, if any, in any of the Borrower’s assets and the proceeds thereof (excluding, however, [MMA’s] rights under any pledge of Borrower’s membership interests made under the Subordinate Debt Documents) until the Senior Debt shall have been paid in full, in cash.”
• District Court, analyzing AZ law held that a “subrogation” language contained in an intercreditor agreement authorized the first lien lender to vote the second lien lender’s claim with respect to the Debtor’s chapter 11 plan.

• Subrogation is not a typical term in a second lien or mezz intercreditor agreement.
  – May be more likely if subordinated lender is an equity holder of the borrower.
REAL ESTATE LOANS SECURED BY EQUITY PLEDGE

  - Court enforces Intercreditor Agreement. Mezzanine lender was prohibited from foreclosing on a pledge of the equity in the borrower until senior lender was paid in full.

  - Court enforces Intercreditor Agreement which prohibited subordinated lender from recovering against borrower or guarantor until senior lender was paid in full.

State court, on appeal, holds that provisions in an intercreditor agreement are ambiguous.

- Junior Lenders pursued a guarantor for a Guarantee Claim under the following language:
  - all [Junior] Lender rights were subordinate to the Senior Lender’s rights, except as otherwise provided in the agreement.
  - “[a]ny right of payment of any [Junior] Lenders under a Guaranty Claim shall be subject and subordinate in all respects to the rights and claims of Senior Lenders . . . against Guarantor . . . except in connection with any [Junior] Lender pursuing its rights under Section 15(q)” of the intercreditor agreement.
Section 15(q) provided that “each of the [Junior] Lenders shall have the right to commence and prosecute an action under its respective Guaranty, including without limitation, for up to the full amount of the Guaranty Cap and may apply any amounts recovered, up to its ratable portion, to the balance of its respective Junior Loan.”

• Trial Court holds for Junior Lenders and lets them pursue guarantor. Appellate court reverses.

• Cardinal rule of contract construction requires the court to avoid an interpretation that would render any clause meaningless. The junior lender’s position would make, in the court’s view, one of the subordination clauses superfluous.
WHERE DOES THAT LEAVE US?

— Understand which provisions of the intercreditor agreement affect priority and which do not?

  • Advise client that non-priority provisions, especially voting provisions, may not be enforceable. *(Hart Ski, 203 N. LaSalle, SW Hotel, Croatian Surf Club, but see Aerosol)*

— The real work begins when the agreements are negotiated, not when the borrower is in bankruptcy.

— Ambiguity will hurt!
WHERE DOES THAT LEAVE US?

First Lien Lenders might want to consider including those provisions that influenced the *Aerosol* and *Ion Media* courts to enforce the intercreditor agreement:

- Second lien lender buy out of first lien lender position
  - Usually hard for a second lien lender to resist including a buy-out provision in the negotiation of the agreement.

- Debtor a party to the intercreditor agreement
  - Second lien lenders should consider resisting this step. May impact jurisdiction
WHERE DOES THAT LEAVE US (CONT'D)?

- Be as specific as possible in identifying prohibited activities.
  - Limitations on the rights of second lien lenders as unsecured creditor.
  - Tied to specific provisions of the Intercreditor Agreement, e.g. DIP loan and other adequate protection objections; sales of assets, plan and disclosure statement objections.
    - Requires a full understanding of all that can occur in a chapter 11 context.
- Objecting Subordinated Lenders need to avoid being seen as “obstructionist.” *(Ion Media and Boston Generating)*
- It will help if Subordinated Lenders can show they are either in the money or close to being there. *(Boston Generating)*
Recommendations include:

- **DIP Loans**: provisions that would restrict the ability of a junior creditor to provide a DIP loan are unenforceable.
– Berman and Lee,

“The Enforceability in Bankruptcy Proceedings of Waiver and Assignment of Rights Clauses within Intercreditor or Subordination Agreements,”

THANK YOU!!

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