

An Update on Second-Lien Financings and Intercreditor Agreements: Part I

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In previous articles¹ and *ABI's Handbook on Second Lien Loans and Intercreditor Agreements*,² the authors examined various provisions found in many intercreditor agreements used in second-lien financings as well as case law that has developed around the enforcement of Intercreditor or Subordination Agreements in bankruptcy proceedings. In Part I of this article, four recent bankruptcy court decisions are examined to advance our understanding of how bankruptcy courts are likely to deal with the issues presented by intercreditor or subordination agreements. Part II will look at other notable decisions, which also deal with miscellaneous issues relating to intercreditor or subordination agreements.

Ion Media



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The *Ion Media*³ decision is decidedly in favor of bankruptcy courts enforcing the “stay silent” provisions in second-lien intercreditor agreements. In the court’s view, plainly-worded contracts that establish priorities and

limit obstructionist behavior should be enforced and creditor expectations should be appropriately fulfilled.

The issue in *Ion Media* was whether the first-lien lenders had a properly perfected security interest in the debtors’ Federal Communications Commission (FCC) licenses. The intercreditor agreement anticipated that there might be assets of the debtors that were not subject to a perfected first lien, referring to these assets as “special property.” If the FCC licenses were not subject to a properly perfected security interest, then the second-lien lenders as general unsecured

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creditors would receive a larger distribution. The value of the collateral available to first-lien lenders is always a key issue in a chapter 11 case. Value of collateral can be affected by the intrinsic nature of the collateral, how that collateral is used, or which assets are subject to the first-lien

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lender’s perfected security interests and mortgages. In *Ion Media*, the extent of first lien lenders’ collateral (*i.e.*, whether collateral included the FCC licenses, and their value) was key to the ability of the first-lien lenders to roll up first-lien debt into the debtor in possession (DIP) loan facility and was also key to the treatment afforded different classes of claims in the debtors’ plan. One of the second-lien lenders thought they were being short-changed because the favorable treatment of the first-lien lenders was premised on the value attributable to those FCC licenses being included in the first-lien lenders’ collateral.⁴ In objecting to the DIP loan facility and later to the plan and disclosure statement, the second-lien lender was faced with overcoming the following “stay-silent” provisions of the intercreditor agreement:

– No Contest Clauses:

– “Each of the Secured Parties acknowledges and agrees (x) to the relative priorities as to the Collateral (and the application of the proceeds therefrom) as provided in the Security Agreement... and acknowledges and agrees that such priorities...shall not be affected or impaired in any manner whatsoever including, without limitation, on account of...(iii) any nonperfection of any lien purportedly securing any of the Secured Obligations...”

– “[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... or (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

¹ See *ABI Journal*, Volumes XXV, No. 1, 2, 4, 5 and 6.

² See Berman and Brighton, *Handbook on Second Lien Loans and Intercreditor Agreements* (ABI, 2009).

³ *Ion Media Networks Inc., et al.*, 419 B. R. 585 (Bankr. S.D.N.Y. 2009).

⁴ The debtors’ plan proposed to distribute \$5 million in cash and warrants for 5 percent of the equity of the reorganized debtors to unsecured creditors, a class that included the second-lien lenders on the basis that their liens did not reach any value in the debtors’ assets.

the First Priority Secured Parties under the Security Agreement.”

The first-lien lenders asserted that these clauses prohibited the second-lien lender from contesting either the DIP loan facility, approval of the disclosure statement or confirmation of the plan. In response, the second-lien lender asserted its right to act as an unsecured creditor under the following clause in pursuing oppositions to each event.

– Rights as an Unsecured Creditor Clause:

– Except as otherwise specifically set forth in section 11 of this Agreement, the Second Priority Secured Parties may exercise rights and remedies as unsecured creditors against any Grantor in accordance with the terms of the Second Priority Documents and applicable law.”

Bankruptcy Judge **James Peck** found that the second-lien lender did not have standing to object to the adequacy of the disclosure statement or to confirmation of the plan, having ceded that standing by the provisions of the intercreditor agreement.⁵ Judge Peck cited *Hart Ski*,⁶ *203 N. LaSalle*⁷ and *Aerosol Packaging*⁸ in finding that bankruptcy courts have “refrained from enforcing a creditor’s waiver of bankruptcy rights in a pre-bankruptcy intercreditor agreement on public policy grounds,” but he distinguished those cases because they involved the right to vote on a plan.⁹ The *Ion Media* issues before the bankruptcy court did not affect the second-lien lender’s right to vote. Judge Peck noted that voting is a special bankruptcy right, and bankruptcy courts appear reluctant to enforce clauses that restrict the free exercise of that right.

However, with the second-lien lender objecting to the plan and challenging the first-lien lenders’ lien on the FCC licenses, the bankruptcy court required silence and denied the

second-lien lender standing. The court focused on the “except as otherwise specifically set forth in section 11 of the Intercreditor Agreement” language that is at the beginning of the “Rights of an Unsecured Creditor Clause” to specifically limit those rights. The “Plan Support Clause” was found in § 11(b) of the intercreditor agreement.

The court seems troubled by the second-lien lender having objected despite clear limitations in the intercreditor agreement, as well as the motivations of the second-lien lender. Specifically, the court was influenced by the second-lien lender having acquired its claims post-petition at a steep discount and was proposing an alternative plan under which it would acquire the debtors’ business. In a footnote, the court noted 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. This is certainly an invitation to litigation and a warning to subordinated creditors who limit their rights as an unsecured creditor via the introductory language in the Rights of an Unsecured Creditor Clause.

Erickson

The Bankruptcy Court for the Northern District of Texas waded into the intercreditor enforcement debate stemming from a request by subordinated creditors to have an examiner appointed. In *Erickson Retirement Communities*,¹⁰ subordinated creditors sought the appointment of an examiner to inquire into the debtors’ pre-petition activity. The motion was filed approximately two months after the petition date. Before the court considered the motion, the debtor sold substantially most of its assets and proposed a plan relating thereto. As a result, one of the movants withdrew its support of the motion and the remaining two creditors limited the scope of the proposed examiner’s duties so that the examiner, if appointed, would only inquire into the proper allocation of the proceeds of the auction. The examiner motion was opposed by, among others, the agent for the subordinated creditors. The bankruptcy court, following the major-

ity rule, concluded that the appointment of an examiner was mandatory because the debtors’ fixed, liquidated, unsecured debts exceeded \$5 million,¹¹ unless the movants either lacked standing or had waived the right to do so. To examine the standing/waiver issue, the court looked at the subordination agreements and found several applicable provisions. The subordinated creditors had agreed, among other things:

- 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”;
- to waive, “for the benefit of the Agent and the Lenders...any principles or provisions of law, statutory or otherwise, which are or might be in conflict with the terms of this Agreement and any legal or equitable discharge of the [subordinated] obligations hereunder”;
- to an assignment to the agent for the subordinated creditors of their interests in the subordinated creditors’ loan documents;
- that upon the request of the agent, to endorse and deliver over to the agent their loan documents (the agent had made the required request);
- not to oppose any agreement by the agent in any bankruptcy case to provide DIP financing or to allow cash collateral usage by the debtor; and
- not to take a contrary position to the agent with regard to DIP financing or cash collateral usage.

Because § 510(a) of the Bankruptcy Code dictates that subordination agreements are enforceable in bankruptcy cases to the same extent they are enforceable under applicable non-bankruptcy law, the court looked to Maryland law for instruction. The court found that the subordination agreement provisions prohibited the subordinated creditors from seeking the appointment of an examiner. To do so was, in the court’s view, to seek to file an “action,” to seek to enforce “remedies” and to pursue “collection” of their claims—each prohibited without the consent of the agent who was opposing their motion. Perhaps angered by the subordinated creditor trying to get in the way of a process that appeared acceptable to the vast majority of creditors, the court quoted *Ion Media* in saying that “[t]his is the very type of obstructionist

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⁵ The court suggests that rather than risk being in breach of the intercreditor agreement, the second-lien lender should have first sought a declaration that its interpretation of the intercreditor agreement should prevail. Having not done so, the court virtually invited the other parties in the case to pursue a claim against the second-lien lender for what it believed may have been damages measured by a material increase in administrative expenses in the cases.

⁶ 5 B.R. 734 (Bankr. D. Minn. 1980).

⁷ 246 B.R. 325 (Bankr. N.D. Ill. 2000).

⁸ 362 B.R. 43 (Bankr. N.D. Ga. 2006).

⁹ The reference to *Hart Ski* is surprising because that case held that a junior lien-holder has the right to seek and receive adequate protection for its lien, despite a provision in an intercreditor agreement limiting its ability to assert that right.

¹⁰ 425 B.R. 309 (Bankr. N.D. Tex. 2010).

¹¹ See 11 U.S.C. §1104(c)(2). See also *In re Loral Space & Communications Ltd.*, No. 04-CV-8645RPP, 2004 U.S. Dist. LEXIS 25681, 2004 WL 297985, at *4 (S.D.N.Y. Dec. 23, 2004); *In re UAL Corp.*, 307 B.R. 80, 84 (Bankr. N.D. Ill. 2004); *In re Schepps Food Stores Inc.*, 148 B.R. 27, 30 (S.D. Tex. 1992).

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behavior that the agreement [is] intended to suppress.”¹²

In an interesting discussion, the court cited to *Collin County v. Siemens Business Services Inc.*¹³ for the proposition that “[i]t is well-settled that rights under statute may be contractually waived,” but also noted the conflicting authority over the enforceability of a debtor’s pre-petition waiver of the automatic stay or the ability of a debtor to commence a bankruptcy case. The *Hart Ski* and *203 N. LaSalle* decisions concluded that the pre-bankruptcy waiver of the right to seek adequate protection or the assignment of the right to vote were not enforceable. Therefore, it appears there is still much to be resolved in the context of the ability to enforce a specific pre-bankruptcy waiver of a bankruptcy right.

TCI 2 Holdings LLC

Just to make sure first-lien lenders do not get too comfortable with what appears to be a trend toward the enforcement of the “stay-silent” provisions of intercreditor and subordination agreements, we now turn to a Code provision that specifically limits the enforceability of those restrictions in the context of a plan proposing the cramdown¹⁴ of a secured claim. The provision is § 1129(b)(1), the cramdown provision in chapter 11, that is introduced by the clause, “Notwithstanding section 510(a) of this title.”

The bankruptcy court in *TCI 2*¹⁵ was presented with two competing plans. The first was proposed by the first-lien lenders that were owed \$488 million and proposed to convert the first lien claims into 100 percent of the reorganized debtors’ equity with all other claims, including the \$1.25 billion owed to second lien lenders, being wiped out. That plan was opposed by the second-lien lenders and unsecured creditors that proposed a cramdown plan that fixed the amount of the first-lien lenders’ secured claims at the value of their collateral and gave them cash in the amount of \$125 million plus a new note for \$334 million payable over time at what they asserted was a market rate of interest and secured by a new first lien on the debtors’ assets (*i.e.*,

a cramdown of the first-lien position under § 1129(b)(2)(A)(i) of the Code). Under this alternative plan, the second-lien lenders were to receive the right to participate in a \$225 million rights offering for 75 percent of the reorganized debtor’s equity. The court had before it two confirmable plans and decided to prefer confirmation of the plan proposed by the second-lien lenders.¹⁶

However, in order to confirm the second-lien lenders’ plan, the court had to address the first-lien lenders’ objection that the second-lien lenders’ plan violated provisions of the intercreditor agreement requiring that first-lien lenders be paid in full and in cash before second-lien lenders would be entitled to a distribution. The court overruled that objection because it found that the intercreditor agreement provisions restricting distributions to subordinate creditors were not enforceable when the plan could otherwise be confirmed by cramdown under § 1129(b)(2).¹⁷

The decision is presently under appeal. Left unresolved is whether the first-lien lenders can pursue a breach-of-contract action against the second-lien lenders for violating the intercreditor agreement. Left in place, and if no action is successful in an effort to hold the second-lien lenders from breaching the intercreditor agreement, the decision presents an inviting avenue for subordinated creditors to pursue an alternative that the intercreditor agreement would otherwise forbid. Also unresolved is whether an intercreditor-agreement provision prohibiting the subordinated creditors from proposing a cramdown plan (*i.e.*, waiving § 1129(b)(1)), might be enforceable.

Westpoint Stephens

When we last visited the confrontation between first- and second-lien lenders in *Westpoint Stephens*,¹⁸ the District Court for the Southern District of New York had reversed a bankruptcy court order allowing a § 363 sale under which

second-lien lenders would receive a controlling portion of the equity in the purchaser. The district court held that a sale of the debtor’s assets with the distribution to second-lien lenders of equity in the purchaser violated an intercreditor agreement provision that required first-lien lenders to be paid in full and in cash before second-lien lenders received anything an account of their second lien position.¹⁹ It ordered that the equity allotted by the plan to second-lien lenders be turned over to the first-lien lenders. On appeal to the Second Circuit, the second-lien lenders have now prevailed, at least in part, because of the statutory mootness doctrine.

The first-lien lenders had first 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 was delayed until the parties or the courts could resolve the right of second-lien lenders to a distribution before senior lenders. The Second Circuit found that the first-lien lenders had thereby lost the right to object to the second-lien lenders receiving equity. The Second Circuit determined that control of the purchaser was an integral part of the sale. As a result, with the sale closed, the distribution to second-lien lenders of a controlling interest in the purchaser was beyond the court’s power to alter because it did not have jurisdiction to review the sale order to alter that integral part.²⁰ However, the Second Circuit ordered that 11 percent of the purchaser’s equity, a percentage that would not alter the second-lien lender’s control of the purchaser, could be taken away from second-lien lenders and ordered that it be turned over to the first-lien lenders. Solomon would have been proud.

Conclusion

As anticipated, the current economy has resulted in more instances where bankruptcy courts have been forced to consider the impact of intercreditor agreement provisions in chapter 11 cases. Some might discern a slight trend in favor of the enforceability of intercreditor agreements by bankruptcy

¹² *Id.* at 315.

¹³ 250 Fed.Appx. 45, 50 (5th Cir. 2007).

¹⁴ Also referred to as a “cram-up.”

¹⁵ 428 B.R. 117 (Bankr. D. N.J. 2010).

¹⁶ Section 1129(c) allows the court, when confronted by two confirmable plans, to consider the preferences of creditors and equity-securityholders in determining which plan to confirm. With unsecured creditors getting nothing under the first-lien lenders’ plan, the preferences were obvious.

¹⁷ The *TCI 2* decision is in conflict with the decision in *In re Consul Restaurant Corp.*, 146 B.R. 979, 988 (Bankr. D. Minn. 1992), that a subordination agreement is enforceable in a cramdown context “under the discrimination and fair and equitable concepts of the statute.”

¹⁸ 600 F.3d 231 (2d Cir. 2010). See also Berman and Brighton, “Second Lien Financings: Part V—Who Gets What?,” Vol. XXV, No. 6, *ABI Journal* (July/August 2006).

¹⁹ *In re Westpoint Stephens Inc.*, 333 B.R. 30, 45-54 (S.D.N.Y. 2005).

²⁰ A contrary view is expressed in *Clear Channel v. Kruipfer (In re PW LLC)*, 391 B.R. 25, 35-36 (9th Cir. B.A.P. 2008), where the court found a right to eliminate certain features of the sale even after it had closed. But see *In re Stadium Management Corp.*, 895 F.2d 845, 848-49 (1st Cir. 1990).

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courts as exemplified by *Ion Media* and *Erickson*. The *TCI 2* decision identifies quite a gaping hole in the senior lenders' ability to enforce the terms of an intercreditor agreement that will no doubt be used by enterprising counsel for debtors and subordinated lenders to cram down

a plan on senior lenders. Just how far that avenue will take them will be left to future case law. In Part II, other decisions that affect the predictability of dealing with intercreditor agreements will be discussed. ■

Editor's Note: *The authors' book, Handbook on Second Lien Loans & Intercreditor Agreements (ABI, 2009), is available for purchase at <http://bookstore.abi.org> (members must log in first to obtain member price).*

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