FINANCING ORDERS-AT THE END OF THE DAY, YOU MAY NOT GET WHAT YOU BARGAINED FOR

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In basic terms, the beginning phase of the negotiation of financing orders in bankruptcy can typically be summarized as follows: the debtor requests additional credit and/or permission for the use of cash collateral from its existing secured lender. The secured lender declines the request (since "no" is the most popular word in a lender's vocabulary), as even though it maintains a lien upon all of the debtor's assets, from the lender's perspective, there can never be enough collateral to secure repayment. From there, the parties either work out the terms of the appropriate order, or have their differences resolved by the court.

Since financing orders can include a myriad of provisions designed to protect the interests of the parties, the local court rules which govern the obtaining of credit in the districts throughout the Midwest are reflective of the types of clauses which lenders and other secured parties have sought to impose upon the debtor.

Summary of Requirements of Motions to Obtain Credit and Proposed Financing Orders

A review of the local court rules applicable to motions for use of cash collateral or to obtain financing reveals that many districts require the moving party to highlight key provisions in the motion, rather than allowing them to be buried in the text, perhaps in the hope of allowing them to be included without the appropriate degree of scrutiny. Many districts require either a cover sheet or checklist, to assist in the determination of whether certain types of clauses are contained within a proposed order.

In the Eastern[1] and Western Districts of Michigan[2], the motion must explicitly state the moving party's position as to the value of each of the secured interests to be protected, with pertinent appraisals and projections to be summarized therein. The motion may be granted

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[1] L.B.R. 4001-2 (E.D.Mich.)
[2] L.B.R. 4001-2 (W.D.Mich.)

without a hearing if the provisions of F.R.Bankr.P. 4001(d)(1)(B) have been complied with, and, *inter alia,* if the proposed order has been approved by all creditors who may have an interest in the credit to be extended, by the chairperson or attorney for each official committee, and by the United States trustee; and, the proposed order provides for the debtor to use cash collateral or to obtain credit in a maximum specified dollar amount necessary to avoid immediate and irreparable harm only until the earlier of the date of the final hearing or the date that the order would become final. If such consent is not forthcoming, after proper notice and provided all other applicable rules have been complied with, the court can enter the order upon a finding that the protection offered is adequate, and the adequate protection is incorporated into the order.

The local rules in effect in the Northern District of Illinois[3], the Southern District of Indiana[4], the Southern District of Ohio[5] and the Eastern District of Wisconsin[6] each require that all proposed financing orders recite whether the proposed order contains any of the following provisions, and if so, must identify the location of the provision in the proposed form of order, and must state the justification for its inclusion:

i. The grant of cross-collateralization provision (other than replacement liens or adequate protection), *i.e.*, the securing of pre-petition debt with post-petition assets, where no prior lien existed.

ii. Provisions or findings of fact that bind the estate or parties in interest with respect to the validity, perfection or amount of the secured creditors' pre-petition lien, or a waiver of claims against the secured creditor, without giving parties in interest at least 75 days from the date of entry of the order, and any official creditors' committee 60 days from the date of its formation to investigate the claims or matters.

iii. Provisions that seek to waive any of the estate's rights under 11 U.S.C. §506(c)(3).

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3 L.B.R. 4001-2 (N.D.Ill.)
4 L.B.R. 4001-2 (S.D.Ind.)
5 L.B.R. 4001-2 (S.D.Ohio)
6 L.B.R. 4001-2 (E.D.Wisc.)

iv. Provisions granting a pre-petition secured creditor a lien upon the debtor's causes of action under 11 U.S.C. §§544-549.

v. Provisions that deem a pre-petition debt to be post-petition debt, or that are post-petition loans to pay all or part of that secured creditor's pre-petition debt.

vi. Provisions that provide for the committee's professionals to receive different treatment from the professionals retained by the debtor with respect to any carve out for fees, and which limit the committee's counsel's use of the carve out.

vii. Provisions which prime a secured lien without the consent of the existing lienholder.

viii. Provisions that grant the lender expedited relief from the automatic stay without the further order of the court.

ix. Any declaration that the order does not impose lender liability upon the secured creditor.

In the Northern District of Illinois, the proposed financing order must include the essential terms of the financing, and also provide a budget covering the time period for which the order is to remain in effect, including projected receipts and disbursements. The court also is empowered to deem any of the foregoing provisions which are not highlighted in the proposed order to be unenforceable.

In the Southern District of Indiana, financing orders must also disclose provisions which call for the payment of fees and costs by the debtor, other than reasonable attorney's fees for loan documentation. Additionally, there must be disclosure of any provision which purports to limit or restrict the right of the debtor or other party in interest to submit a plan of reorganization, or which would affect the terms of such a plan.

In the Southern District of Ohio, there must also be disclosure of:

i. the granting of equal priority liens to any creditor, without the consent of the existing lienholder;

ii. any provision that waives procedural requirements for foreclosure required under applicable non-bankruptcy law;

iii. any provision which waives the debtor's right to move for authorization for use of cash collateral upon maturity or default;

iv. any provision which grants a lien in excess of the amount of cash collateral authorized under any applicable order granting its use;

v. any findings of fact or matters extraneous to the approval process; and,

vi. any provisions which bar the debtor from future bankruptcy filings.

The motion must contain a statement in support of the feasibility of the request; a description of the collateral to be affected by the credit to be obtained; a description of any interest held by other entities having an interest in the collateral affected by the credit; a statement as to why the credit is needed; and, a description as to how the entity having an interest in the property affected may be protected.

In the Eastern District of Wisconsin, any provision for super-priority positions must be highlighted, unless a significant carve-out has been proposed, as must be any provision granting a secured creditor a higher administrative expense priority than Chapter 11 expenses of administration or Chapter 7 expenses of administration, in the event of a conversion. Any provision which purports to allow automatic perfection of a security interest in replacement lien collateral, without the filing or refiling of a financing statement must also be highlighted.

The Effectiveness of the Intercreditor Agreements and Subordination Provisions

Although many smaller bankruptcies typically involve only a single secured creditor (*i.e.*, a traditional bank), many large Chapter 11 proceedings entail financing on various levels, including that offered by hedge funds, which in exchange, obtain liens upon the debtor's assets

which are subordinated to those held by the debtor's primary pre-petition lender. Without adequate controls, senior secured creditors are reluctant to consent to the placement of subordinate liens, as it is conceivable that the subordinate creditor, without a standstill agreement, would otherwise have the ability to cause a liquidation, to the ultimate detriment of the senior creditor.

The relatively recent phenomenon of Chapter 11 proceedings involving second lien financing has resulted in many issues arising regarding the scope, validity and enforceability of certain provisions contained within inter-creditor agreements between the lenders. Although these agreements are negotiated early in the bankruptcy process, often the issues do not arise or are not resolved until a plan of reorganization has been proposed, and confirmation is being sought.

Unfortunately, there is not a great deal of guidance available in the few decisions which interpret such agreements, as the courts have come to differing conclusions regarding the enforceability of some clauses.

Second lien financing has become more prevalent in circumstances where a senior lender is unwilling to risk further credit exposure to the debtor, but will, with the appropriate protections, allow a subordinate lien to be granted to another lender which offers financing. Typically, the terms and conditions under which the senior lender allows a subordinate lien are contained in an inter-creditor agreement.

Some typical provisions found in inter-creditor agreements include:

- Acknowledgments of amounts and validity of the debt, lien priorities, and standstill agreements for a specified period of time.
- Agreements of the second lien lender not to receive payments in the event of a default of the first lien relationship.

- The agreement of the second lien lender not to change the terms of the governing documents signed by the debtor, without the prior consent of the first lien lender.

- The capping of the amount of the first lien debt.

- The consent to debtor in possession financing and a priming lien by the first lien lender, use of cash collateral with the first lien lender's consent, waivers of adequate protection rights, or the subordination of same to the first lien lender, agreements by the second lien lender not to enforce its own rights, and, the agreement to grant voting rights to the first lien lender.

Issues have arisen when the second lien lender has not received all that it bargained for, with the primary controversy being what rights the respective parties hold when the senior lender favors a proposed plan of reorganization, and the subordinated creditor opposes confirmation.

First lien lenders seeking to uphold the validity of the provisions of inter-creditor agreements rely upon 11 U.S.C. §510(a):

> A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable non bankruptcy law.

Second lien lenders have attempted to minimize the impact of these agreements, by claiming that certain of the waiver provisions, such as conveying the right to vote for or against the plan is unenforceable, as only the holder of a claim is permitted to do so under 11 U.S.C. §1126(a).

In *In re 203 North LaSalle Street Partnership*, 246 B.R. 325 (N.D.Ill.2000), Judge Wedoff upheld the provisions of a subordination agreement pertaining to the granting of senior status of the first lien lender's unsecured claim as against the rights of the subordinating creditor, but held that the portion of the agreement which purported to grant the senior lender the right to vote to accept or reject the plan on behalf of the subordinated creditor was violative of 11 U.S.C. §1126(a).

The court in *In re Hart Ski Mfg. Co., Inc.*, 5 B.R. 734 (Minn.1980) rejected the claim of the senior secured creditor, Aetna Business Credit ("Aetna"), that Beatrice Foods Co., which had entered into a pre-petition agreement subordinating its interests to the repayment of the debtor's obligations to Aetna, was not entitled to seek adequate protection or relief from the automatic stay until the senior debt had been fully satisfied.

While acknowledging the validity of the subordination agreement, the court held that the parties could not abrogate the rights granted secured creditors by the Bankruptcy Code, including the ability to seek adequate protection, to assert and prove claims, to vote in favor or against confirmation, or to have the automatic stay lifted under proper circumstances.

Conversely, in *In re Aerosol Packaging, LLC (Case No. 06-67096-MHM-N.D.Ga., Docket No. 216,* attached at Tab 1*)*, the court sustained the right of Wachovia Bank to vote in favor of the proposed plan of reorganization on behalf of the second lien lender, Blue Ridge Investors II, LP, with whom it had entered into a subordination agreement. Under the terms of the agreement, Blue Ridge had subordinated its claims and liens to those of Wachovia, had agreed to refrain from taking other actions against the debtor until such time Wachovia had been fully repaid in cash, and irrevocably empowered Wachovia to take certain actions both in its own name, and in the name of Blue Ridge, even to Blue Ridge's detriment.

The court reasoned that (i) 11 U.S.C. §510(a) upholds the enforceability of subordination agreements in bankruptcy, to the extent enforceable under non bankruptcy law; (ii) there is no prohibition against a creditor delegating, assigning, or otherwise transferring the right to vote a claim from the holder of a claim to others; and, (iii) Wachovia was acting as the duly authorized agent of Blue Ridge in this instance.

In *In re Dura Automotive Systems (Case No. 06-11202-KJC-D.Del., Docket No. 53)*, the court was called upon to interpret the rights of first and second lien lenders in bankruptcy, with regard to a provision commonly known as the "X-clause," which was contained in a pre-petition subordinated notes indenture among the parties.

Under the terms of the X-clause, in the event of a liquidation or dissolution of the company in a bankruptcy or similar proceeding, the holders of the senior debt were entitled to receive payment in full of all obligations due in respect of such senior debt before holders of the subordinated notes, except that the subordinated note holders were allowed to receive, *inter alia,* permitted junior securities. The term "permitted junior securities" was defined to include equity interests in the company, or debt securities which were subordinated to all senior debt, and any debt securities issued in exchange for senior debt to substantially the same extent as, or to a greater extent than the notes are subordinated to the senior debt.

The proposed plan of reorganization included a rights offering of between $140,000,000 and $160,000,000 in new cash investments, in exchange for between 39.3% and 42.6% of the new common stock of the reorganized company. The balance of the new common stock was to be distributed among the senior note holders and large trade creditors, resulting in the senior note holders to receive substantially less than full recovery. The subordinated note holders were not permitted to participate in the rights offering, were to receive no distributions, and were not entitled to vote, as being conclusively deemed to have rejected the plan. The new common stock which would otherwise have been distributed to the subordinated note holders was instead to be distributed to the senior note holders.

The subordinated note holders filed an adversary proceeding, seeking to have the court determine that the plan improperly excluded them from all distributions and recovery, and

violated applicable law by denying them the ability to participate in the rights offering and to otherwise receive distributions of the new common stock. They contended that the X-clause allowed them to receive the new common stock as being within the definition of "permitted junior securities," and since the senior note holders were to be able to participate in the rights offering and to receive distributions of the new common stock, the plan unfairly discriminated between classes of creditors having equal priority under 11 U.S.C. §1129(b).

The court rejected the subordinated note holders' argument, interpreting the X-clause as requiring that the senior note holders receive payment in full before any payment or distribution to them:

> "... To interpret the X-Clause to include the New Common Stock and the Rights Offering in the definition of "Permitted Junior Securities" would eviscerate the purpose of the subordination provisions in the Subordinated Notes Indenture and expand the limited carve out beyond its intended scope...."

The *Dura* court further pointed out that each "X-clause" is different, and must be considered only in the specific context of the applicable contract; thus, it can be assumed that the interpretation of similar clauses will lead to future litigation when matters do not work out as well as originally contemplated.[7]

The Consequences

Obtaining both debtor-in-possession and exit financing has become more difficult than ever, as traditional and non-traditional lenders face monumental challenges to their bottom line. One must consider whether, given the apparent inconsistency in the courts' rulings regarding the enforcement of provisions contained in intercreditor and subordination agreements, potential

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[7] For additional discussion regarding the *Dura* decision and the "X-clause," see Berman, Mark, Brighton, Jo Ann J., *The Dura Decision: Junior Creditors Again Strike Out Interpreting the Elusive X-Clause,* ABI Journal, Vol. XXVII, No. 2 (March, 2008).

lenders will be even more reluctant to take on additional risk, making the availability of credit even more limited.

The apparent disparity in the courts' willingness to enforce the terms of negotiated intercreditor and subordination agreements offers little comfort to the parties and their counsel. Future cases involving such agreements will reflect how much risk first and second lien lenders are willing to take.