

Emerging Trends in the Enforceability of Bankruptcy Waivers in Second Lien Financing Transactions

Article contributed by: Michael H. Torkin, Jill K. Frizzley, and Craig R. Culbert

The wave of private equity M&A and dividend recapitalization transactions that began in 2004 and continued until the onset of the credit crisis in 2008 resulted in unprecedented growth in the second lien market. During that period, the number and amount of second lien loan transactions increased exponentially from approximately 25 transactions in 2004 (with a face amount of approximately \$3.1 billion) to over 190 transactions in 2007 (with a face amount of approximately \$30 billion).¹ As a general matter, second lien financings are structured to fund a company's extraordinary transactions, where the company's pro forma leverage would exceed the threshold tolerated by first lien lenders. Given the protection afforded by the lien granted to second lien lenders, spreads on second lien debt generally are more favorable to borrowers than unsecured debt. It is therefore not surprising that during the private equity boom, where sponsors sought to maximize leverage to fund acquisitions or dividends and increase returns to their limited partners, second lien loans (despite more restrictive covenants than unsecured high-yield debt) offered borrowers the cheapest alternative to increase pro forma leverage.

A gating item when structuring a second lien financing is negotiating an acceptable intercreditor agreement with the borrower's senior lenders. As a practical matter, first lien lenders will require that they maintain the exclusive right to realize on the collateral package for a specified period following a borrower default and that the second lien lenders waive numerous rights that otherwise would be granted to them as secured lenders in a chapter 11 case of the borrower. The rights granted in favor of the first lien lenders, however, generally are counterbalanced by certain protections afforded to the second lien lenders, including the rights to buy out the first lien lenders at a predetermined price, to limit the amount of debt that the borrower can incur, and to restrict amendments to first lien credit documentation (for example, extending maturities or increasing interest rates). Given the number of second lien transactions and the rights afforded to secured lenders under the Bankruptcy Code, the intersection between the terms of intercreditor agreements and the chapter 11 process creates an additional level of complexity in corporate reorganizations, particularly given the relative dearth and inconsistency of case law regarding the enforceability of pre-petition bankruptcy waivers.

© 2010 Bloomberg Finance L.P. All rights reserved. Originally published by Bloomberg Finance L.P. in the Vol. 4, No. 28 edition of the Bloomberg Law Reports—Bankruptcy Law. Reprinted with permission. Bloomberg Law Reports[®] is a registered trademark and service mark of Bloomberg Finance L.P.

The discussions set forth in this report are for informational purposes only. They do not take into account the qualifications, exceptions and other considerations that may be relevant to particular situations. These discussions should not be construed as legal advice, which has to be addressed to particular facts and circumstances involved in any given situation. Any tax information contained in this report is not intended to be used, and cannot be used, for purposes of avoiding penalties imposed under the United States Internal Revenue Code. The opinions expressed are those of the author. Bloomberg Finance L.P. and its affiliated entities do not take responsibility for the content contained in this report and do not make any representation or warranty as to its completeness or accuracy.

The most highly negotiated insolvency related intercreditor agreement provisions include the second lien lenders' waiver of their rights to: (a) object to adequate protection granted in favor of the first lien lenders, (b) object to the use of cash collateral by the debtor, (c) object to the debtor's incurrence of debtor-in-possession financing on a priming basis, (d) object to requests of the first lien lenders to lift the automatic stay, (e) object to the sale of shared collateral pursuant to section 363 of the Bankruptcy Code, and (f) vote in favor of a plan of reorganization not supported by the first lien lenders or object to a plan of reorganization supported by the first lien lenders. Few bankruptcy courts have ruled on the enforceability of these waivers, and, to the extent that courts have ruled on their enforceability, the results historically have been inconsistent. Not surprisingly, second lien lenders have sought to capitalize on the uncertainty by agreeing to pre-petition bankruptcy waivers in their intercreditor agreements and then, following the commencement of a chapter 11 case by the borrower, asserting that the waivers are not enforceable. Understanding whether "pre-wired" consents will be enforced in a chapter 11 case is important to both lender constituents and the debtor because resolving these disagreements is time consuming and expensive, as well as disruptive to the debtor's restructuring process.

In considering the enforceability of bankruptcy waivers contained in intercreditor agreements, bankruptcy courts have analyzed § 510(a) of the Bankruptcy Code. Section 510(a) provides that a "subordination agreement" is enforceable in a bankruptcy case to the same extent that the agreement is enforceable under applicable non-bankruptcy law. The case law is clear that the term "subordination agreement" includes both lien and debt subordination.² Thus, to the extent provisions in an intercreditor agreement relate to lien subordination, the provisions should be enforceable; in contrast, provisions that go beyond lien subordination and purport to abrogate other rights of secured creditors – particularly those that are statutorily granted – may be subject to challenge.

There are a number of cases that junior lenders rely upon in seeking to invalidate pre-petition bankruptcy waivers. In *Hart Ski Mfg. Co.*,³ the intercreditor agreement was executed in connection with the sale of the borrower almost four years prior to the commencement of its bankruptcy case. At the time of the sale, the sellers were issued a promissory note as part of the purchase price and agreed to subordinate the promissory note to the first lien lenders, Aetna Business Credit, Inc., who provided post-acquisition financing to the debtor. After commencement of the chapter 11 case, the first lien lenders objected to the second lien lenders' request for adequate protection and lifting of the automatic stay on the basis that the second lien lenders' motion was contrary to the terms of their intercreditor arrangement. Although the court recognized the enforceability of the agreement's claim subordination provisions, it overruled the first lien lenders' objection. In reaching its decision, the court concluded that Congress did not intend for parties to contract around the protections afforded by the Bankruptcy Code unrelated to distribution of assets, such as a creditor's "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."⁴

As mentioned above, intercreditor agreements also typically require that the second lien lenders not oppose any plan of reorganization supported by the first lien lenders

or support any plan objected to by the first lien lenders. A frequently cited case supporting the proposition that such a provision is unenforceable is *203 North LaSalle Street P'ship*.⁵ Similar to the court in *Hart Ski Mfg. Co.*, the *203 North LaSalle* court concluded that while the lien subordination provisions of the intercreditor agreement were enforceable, it would not enforce the provisions that purported to prevent the second lien lender, who also was the debtor's general partner, from voting on the proposed plan of reorganization. Specifically, the court held that "[a]lthough a creditor's claim is subordinated, it may very well have a substantial interest in the manner in which its claim is treated. Subordination affects only the priority of payment, not the right to payment. If the 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 [c]hapter 11 voting rights."⁶ In both of these early cases addressing intercreditor agreements, the courts were faced with second lien lenders of a more traditional fashion – junior creditors attempting to recover on their claims – rather than sophisticated financial institutions or investors that acquired the junior debt in the secondary market, with a view to gaining control of the reorganized debtor or maximizing their own pecuniary gain through the chapter 11 process.

Despite the *203 North LaSalle* ruling, however, a number of other courts have been systematically more supportive of pre-petition bankruptcy waivers. For example, the court in *Aerosol Packaging*⁷ upheld a provision in a subordination agreement that permitted the first lien lenders to vote the second lien lenders' claim in the context of a plan of reorganization. The court noted that the second lien lenders "provided no evidence, argument or authority that the Subordination Agreement is not enforceable under applicable nonbankruptcy law."⁸ The court was influenced by the fact that because the subordination agreement provided the second lien lenders with the option to purchase the first lien lenders' claim, the second lien lenders were not without a remedy because such option, if exercised, would essentially free themselves from the ongoing effects of the subordination agreement.⁹ In *Inter Urban Broadcasting of Cincinnati, Inc.*,¹⁰ the district court relied on the language of § 510 of the Bankruptcy Code to enforce a waiver the effect of which permitted the senior lender to vote the junior lender's claim where the plan provided for the junior lender to receive no distribution. Likewise, the bankruptcy court in *Curtis Center Limited Partnership*¹¹ used similar logic to enforce a waiver the effect of which permitted the senior lender to vote the junior lender's claim when the debtor attempted to rely on a second lien lender's acceptance of plan for purposes of cramdown under § 1129(a)(10) of the Bankruptcy Code. The line of cases finding pre-bankruptcy waivers of rights enforceable continued with *Tousa* in which the bankruptcy court held that the second lien creditors' waiver of their right to object to the use of cash collateral pursuant to the intercreditor agreement precluded their ability to raise a limited objection to the permitted use of proceeds to sue them under the cash collateral order.¹² *Erickson Retirement Communities*¹³ is another example where a bankruptcy court enforced the terms of an intercreditor agreement in the context of a junior lenders' motion seeking the appointment of an examiner. In reaching its conclusion to deny the junior creditors' motion, the court relied on the breadth of the intercreditor agreement's standstill provision, which prevented the junior creditors from exercising their rights or remedies or enforcing the subordinated obligations until the first lien lenders had been repaid in full.

In one of the most recent decision in this area, *ION Media Networks*,¹⁴ the United States Bankruptcy Court for the Southern District of New York denied standing to a second lien creditor seeking to challenge ION Media's plan of reorganization, and broadly interpreted the second lien lenders' waiver of their right to challenge the extent and perfection of the first lien lenders' liens. In an often quoted excerpt from the decision, Judge Peck concluded that "[p]lainly worded contracts establishing priorities and limiting obstructionist, destabilizing and wasteful behavior should be enforced and creditor expectations should be appropriately fulfilled."¹⁵ Nevertheless, Judge Peck recognized that in the context of a creditor's pre-petition waiver of its right to vote on a plan or reorganization, other bankruptcy courts have refrained from enforcing such a provision on public policy grounds.¹⁶

Taken together, the recent cases reveal a clear trend toward the enforcement of intercreditor agreements according to their terms – as bilateral contracts between a borrower's senior and junior lenders – giving effect to the parties' commercial expectations and leaving the bargained-for rights intact. In requiring sophisticated parties to adhere to their pre-petition agreements – designed to streamline a chapter 11 case and drafted with that specific intent – bankruptcy courts can focus on the debtor's restructuring efforts as opposed to re-writing pre-petition arrangements among lenders groups (whose members likely were not present at the time that the terms of the financing were initially negotiated). This phenomenon has been particularly true in the latest wave of restructurings in which sophisticated investors have voraciously acquired the fulcrum security in the debtor's pre-petition capital structure in the secondary market with a view to either owning the reorganized company upon emergence from chapter 11 or maximizing returns on debt purchased at a deep discount. In that regard, bankruptcy judges in several recent decisions (many of which are unrelated to the enforcement of intercreditor agreements) have been delivering a clear and consistent message to investors that they will not tolerate what they view to be inappropriate uses of the chapter 11 process for the investors' advantage that are unrelated to maximizing returns or otherwise obstructionist. For example, recent Delaware and Southern District of New York decisions have required ad hoc committees to strictly comply with the provisions of Federal Rule of Bankruptcy Procedure 2019, requiring the public disclosure of the members' trading and other information over the committee's objection.¹⁷ In addition, in *DBSD North America*, the bankruptcy court invalidated the votes cast by a creditor that purchased its claims as a strategic investment to ultimately gain control of the debtor.¹⁸ In dicta, the *DBSD North America* court noted that although the investor was not acting as "obnoxious as creditors" in similar cases, its purpose was wholly apart from maximizing recovery, and the court urged Congress to modify the Bankruptcy Code to allow courts to invalidate votes for overly-aggressive and other egregious conduct.

This is consistent with the theme espoused by Judge Peck in *Ion Media Networks* in which he sought to "limit[] obstructionist, destabilizing and wasteful behavior" that he attributed to a junior creditor seeking to undermine its pre-petition intercreditor agreement.¹⁹ With this trend in mind, first and second lien investors should assume that bankruptcy courts will enforce and broadly construe an intercreditor agreement's terms, especially where a junior creditor appears to be disrupting or destabilizing the debtor's reorganization process. Likewise, there is sufficient room in the case law for courts to limit the terms of the agreement in situations where the debtor's first lien lenders appear to be "unfairly" co-opting the chapter 11 process to their advantage by seeking to strictly enforce the terms of an intercreditor

agreement in a manner that unduly prejudices the debtor or its junior creditors. Bankruptcy judges' ability to act deftly in this regard is consistent with the fundamental precept that bankruptcy courts are courts of equity, and that a judge's role is to administer chapter 11 cases in an orderly, efficient, and fair manner. Given the number of second lien transactions with near-term maturities, there is little doubt that the enforceability of intercreditor agreement insolvency provisions will continue to shape and define negotiations among senior and junior lenders and to be a source of leverage in those discussions both prior to and during a chapter 11 case.

Mr. Torkin is a partner at Shearman & Sterling LLP in the Bankruptcy & Restructuring Group. He routinely advises debtors on chapter 11 reorganizations and out-of-court restructurings, acquirers of distressed businesses, including through loan-to-own and 363 sale transactions, and boards of directors of financially distressed companies. Ms. Frizzley is a counsel in the Bankruptcy & Reorganization Group and regularly represents debtors, creditors and acquirers of assets in chapter 11 cases and out-of-court restructurings. Mr. Culbert is an associate in the Bankruptcy & Restructuring Group.

¹ Woyma, R. and Polenberg, R., *1Q10 Second-Lien Lending Review*, Standard & Poor's LCD.

² See Richard J. Goldstein et al., *Inter-creditor Agreements*, in Howard Ruda, *Asset-Based Financing: A Transactional Guide*, Ch. 6 (2005).

³ *In re Hart Ski Mfg. Co.*, 5 B.R. 734 (Bankr. D. Minn. 1980).

⁴ *Id.* at 736.

⁵ *In re 203 North LaSalle Street Ltd. P'ship*, 246 B.R. 325 (Bankr. N.D. Ill. 2000).

⁶ *Id.* at 332.

⁷ *In re Aerosol Packaging, LLC*, 362 B.R. 43 (Bankr. N.D. Ga. 2006).

⁸ *Id.* at 46.

⁹ *Id.* at 47.

¹⁰ *In re Inter Urban Broadcasting of Cincinnati, Inc.*, Civ. A. Nos. 94-2382, 94-2383 (E.D. La. Nov. 16 1994).

¹¹ *In re Curtis Ctr. Ltd. P'ship*, 192 B.R. 648 (Bankr. E.D. Pa. 1996).

¹² *Aurelius Cap. Master, Ltd. v. Touse, Inc.*, Nos. 08-61317-CIV (S.D. Fla. Feb. 6, 2009).

¹³ *In re Erickson Retirement Communities, LLC*, 425 B.R. 309 (Bankr. N.D. Tex. 2010).

¹⁴ *In re Ion Media Networks, Inc.*, 419 B.R. 585 (S.D.N.Y. 2009), *appeal docketed*, No. 09-10596 (S.D.N.Y. Dec. 30, 2009).

¹⁵ *Id.* at 595.

¹⁶ *Id.*

¹⁷ See *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007) (court found that an ad hoc committee of equity holders was a "committee" under Rule 2019 and required compliance); see also *In re Washington Mutual, Inc.*, 419 B.R. 271 (Bankr. D. Del. 2009) (bankruptcy court held that an ad hoc committee was a "committee" for purposes of Rule 2019 and that such committee had to comply with the Rule).

¹⁸ *In re DBSD North America*, 421 B.R. 133 (Bankr. S.D.N.Y. 2009), *aff'd* (S.D.N.Y. 2010).

¹⁹ *Ion Media Networks*, 419 B.R. at 595.