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"SECOND LIEN" LOANS

Executive Summary. During the past few years, the financial markets have enabled borrowers to issue multiple layers of debt in sophisticated financings, particularly in the case of highly leveraged companies. Thus, second lien financing has not only become a recognized part of the capital structure of such financings, but has experienced impressive expansion. The "market" terms that govern the second lien layer of debt evolved in light of increased involvement of nonbank investors (i.e., private equity sponsors, hedge funds, distressed debt funds, etc.). As the continued level of involvement of these nonbank investors remains uncertain and the credit markets tighten, the relationships between senior and junior secured lenders will change and certain provisions not typically found in recent intercreditor agreements may once again surface. This article discusses in detail the recent progression of second lien financing structures and certain relevant intercreditor provisions (including payment subordination, enforcement actions, amendment rights and rights in bankruptcy) that may face increased scrutiny by first lien and second lien lenders alike.

Special Report

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RECENT TRENDS IN SECOND LIEN LOANS

Over the past several years, lenders have offered borrowers many alternative financing vehicles as options for financing their acquisitions, corporate restructurings or operations. The creative and complex financing structures that resulted gave rise to many different classes and types of lien priorities. As senior debt became more affordable due to a prolonged period of low interest rates and as traditional banks and other nontraditional investors, such as private equity sponsors, hedge funds, distressed debt funds, competed to provide these various layers of structured financing, the result was a marked increase in junior debt secured by a second lien.

Financing involving a second lien loan offers advantages for borrowers and lenders alike. Second lien loans provide borrowers with an additional source of capital and access to interest rates that are typically lower than those found in more traditional subordinated or mezzanine debt. For the lenders, the first lien lender ("First Lien Lender") reduces its own credit exposure with respect to the borrower while enhancing the borrower's overall capital structure. The second lien lender ("Second Lien Lender") gains critical secured creditor rights that are unavailable to unsecured creditors (especially in the event of any insolvency or bankruptcy proceeding involving the borrower), most prominently a position ahead of general trade creditors.

Early-stage second lien loans were designed to provide temporary incremental liquidity for a specific purpose. They were funded by a small group of institutional investors focused on making loans to underperforming companies with sufficient collateral to cover both the first lien obligations and the second lien obligations. As a result, these early investors were comfortable making the investments with an understanding that they would have few, if any, rights with respect to the collateral securing their loans (i.e., their liens would be "silent" liens).

Beginning in 2003, the rate of growth within the second lien loan market increased significantly and rapidly. According to Standard & Poor's Leveraged Commentary and Data ("LCD") quarterly reviews, between 2003 and 2005, second lien loan volume spiked from $3.1 billion to $16.3 billion. By 2006, LCD that reported the volume increased to $28.3 billion; in 2007, the volume grew to nearly $30 billion, with more than 90% of the loans funded during the first three quarters of the year. Notwithstanding the rapid growth over a relatively short period of time, this loan product continued to evolve and its interplay within more traditional capital structures remained unclear. As a result, the terms of the intercreditor agreement—a critical document from the perspectives of both the First Lien Lender and the Second Lien Lender—varied, sometimes significantly, among transactions.

During this period, documentation for very large, widely syndicated second lien loans remained relatively uniform among transactions. Most other second lien loans (particularly middle-market "club" deals) were characterized by a lack of uniformity. Particularly during 2006 and the early part of 2007, Second Lien Lenders began to participate in transactions that were less clearly overcollateralized. Further, the relatively few borrower defaults and bankruptcies provided fewer opportunities for testing the terms of intercreditor agreements. The result was a decline in confidence that loans made by Second Lien Lenders were relatively low-risk but would provide high returns. The Second Lien Lenders began to demand additional collateral rights and a greater level of involvement in enforcement actions. At the same time, because the Second Lien Lender often was providing a layer of capital that was unavailable elsewhere, the First Lien Lender at times experienced significant pressure from its own borrower to accommodate the requests of the Second Lien Lender wherever possible. It was not unusual to see the basic terms of the intercreditor agreement outlined in the first lien financing term sheet or commitment letter. The fully deferential second lien structure that was the norm in early-stage second lien loans began to change and the liens that were held by Second Lien Lenders could be characterized more accurately as "muffled" rather than "silent."

The second lien loan market experienced a significant drop in late 2007 and much of 2008 due to a variety of factors, most notably capital issues affecting the largest participants in the second lien debt market—hedge funds. When the second lien and subordinated debt markets again picked up in 2009, recent transactions involving second lien debt suggest that where second liens are permitted, they are allowed based on an understanding that the Second Lien Lender should expect to enter into an intercreditor agreement on terms more akin to mezzanine terms and the earlier transactions than those that closed as recently as 2007 (or, at the very least, a hybrid of the two generations of documents) as highlighted in this article.

THE INTERCREDITOR AGREEMENT

When a borrower's debt structure includes a second lien loan, the intercreditor agreement that will be entered into between the First Lien Lender and the Second Lien Lender should take center stage and be the focus of early-stage negotiations. The intercreditor agreement must act as a shield for the First Lien Lender against the actions of a Second Lien Lender when a borrower's financial situation or condition deteriorates by limiting the rights of the Second Lien Lender in a variety of subsequent actions or bankruptcy proceedings. Initially, it is important to focus on why the financing structure includes a second lien loan, as opposed to unsecured mezzanine loans. Developing this strategy early with respect to the role a Second Lien Lender will play in the capital structure and the impact of that role on various provisions of the intercreditor agreement is critical, as many of the key provisions of an intercreditor agreement can be drafted in significantly different ways depending on the relative strength of the Second Lien Lender's bargaining power. For example, a Second Lien Lender that is providing capital that the First Lien Lender is unwilling—or unable—to provide may have more negotiating power. Conversely, a Second Lien Lender that also is the borrower's equity sponsor has a weaker basis on which to demand more rights, often because the equity sponsor is acting as a lender of last resort. No matter what the role of the Second Lien Lender in the borrower's capital structure, a First Lien Lender must recognize and evaluate the potential risks of delay or interference with its ability to exercise rights and remedies with respect to the borrower and the collateral that may result from accommodating a Second Lien Lender's requests for rights beyond merely having a second lien position.

PAYMENT SUBORDINATION

As recently as the third quarter of 2007, it was widely accepted that Second Lien Lenders should not be expected to agree to payment subordination (also referred to as debt subordination) as a condition to receiving liens. A Second Lien Lender typically did not have to make the argument that it should not be required to subordinate its right to payment to the prior payment right of the First Lien Lender. A similar position championed by Second Lien Lenders was that they should be permitted to receive regularly scheduled payments on their debt irrespective of whether a payment default existed under the first lien loan documents, and initial drafts of intercreditor agreements were prepared without including payment subordination or payment blockage concepts. However, more recently, payment subordination and, particularly, payment blockages are reappearing in second lien intercreditor agreements. Even when a Second Lien Lender generally agrees that its payments will be subordinated and blocked, considerable time is spent negotiating "when" these blocks will occur and for "how long" they will last. A First Lien Lender will want to consider blocking scheduled payments in the event of any default under the first lien loan documents. A Second Lien Lender (particularly one with significant leverage) will argue for no payment block or, at least, to limit any payment blockage to certain material defaults under the first lien documents ("Material Defaults"), such as the following: (1) the existence of any payment default; and (2) the existence of any financial covenant default. A First Lien Lender should evaluate a request to limit the scope of

Material Defaults very carefully to ensure that the First Lien Lender retains the right to block payments in all circumstances where leakage to the Second Lien Lender may be detrimental to the First Lien Lender. For example, if a borrower is delinquent in meeting its financial reporting requirements, thus preventing the First Lien Lender from accurately measuring the borrower's financial performance, payments to the Second Lien Lender should be blocked. In any event, a First Lien Lender should insist upon a blockage right, and a Second Lien Lender should expect to be blocked, at any time when the First Lien Lender is enforcing its rights and remedies with respect to the collateral against the borrower, as well as after the commencement of any type of insolvency or bankruptcy proceeding involving the borrower.

A Second Lien Lender will want certain payment blockages to expire after a period of time. Another common request is for the intercreditor agreement to prohibit back-to-back payment blocks that have the effect of preventing payments to the Second Lien Lender indefinitely. Most often, a Second Lien Lender will argue that it should be entitled to at least one interest payment every 360 days. While these requests may seem reasonable, a First Lien Lender should remain cognizant of the fact that an impending payment block expiration could cause the First Lien Lender to take more aggressive action than necessary, or advisable, to prevent payments to the Second Lien Lender. The First Lien Lender may be left with premature acceleration as the only available option to block the payment to the Second Lien Lender, which itself could have significant ramifications, such as diminution in enterprise value and a reduction in credit terms from the borrower's trade creditors. In transactions in which a Second Lien Lender's requests for periodic payments during a default are accommodated (for example, where the interest payments are neither sizable nor frequent), an indefinite payment blockage should be in effect when the borrower is in payment default and/or financial covenant default under the first lien loan documents.

In the event that payments are blocked, the Second Lien Lender will seek to accrue and later recapture any missed payments in the event that such default is cured or waived. So long as the payment is not otherwise blocked under the intercreditor agreement, and provided the catch-up payment itself would not result in another default under the first lien loan documents, such a request is typically accommodated.

LIEN SUBORDINATION/ ENFORCEMENT RIGHTS

Where second liens are permitted, the concept of lien subordination provides that the Second Lien Lender will contractually subordinate its lien to the lien held by the First Lien Lender. Equally as important, the Second Lien Lender should agree not to contest the priority of the lien held by the First Lien Lender or to join the attempt of any other third party to challenge such liens.

As discussed briefly above, First Lien Lenders have become more successful in conditioning their consent to subordinate liens on the basis that such liens must be "silent" in certain important respects. In general, a "silent" second lien is one in which the holder of the lien agrees to refrain from initiating (or joining in) any enforcement action against the borrower or the collateral and waive certain secured creditor rights during an insolvency or bankruptcy proceeding. But just how silent should a Second Lien Lender expect to be? The answer is constantly evolving and varies based on the economics of the transaction, the financial

But just how silent should a Second Lien Lender expect to be? The answer is constantly evolving and varies based on the economics of the transaction, the financial strength of the borrower and the general economic climate.

strength of the borrower and the general economic climate. From a First Lien Lender's perspective, a Second Lien Lender should be silent when it comes to exercising creditor's rights, whether pre-bankruptcy or following the commencement of an insolvency proceeding. Most Second Lien Lenders, however, will expect to retain certain rights during the pre-bankruptcy standstill period and will strongly resist agreeing to intercreditor provisions in which they abandon all their rights in bankruptcy—particularly those afforded unsecured creditors. We discuss the remedy standstill periods and unsecured creditors rights below, and certain other bankruptcy provisions are addressed in more detail later.

Remedy Standstill Periods

Just as a Second Lien Lender often will negotiate an expiration of a payment blockage period, another highly negotiated issue in intercreditor agreements is the duration of the enforcement remedy standstill period. Although most Second Lien Lenders enter negotiations with an understanding that they will refrain from exercising certain remedies with respect to pending defaults, it is very rare that both parties start the process with a common understanding of what remedies should be the subject of a standstill period and how long this period should extend. The standstill period is critical to the First Lien Lender's ability to work with the borrower and/or determine exit strategies after a default occurs under the first lien loan documents without any interference or pressure from the Second Lien Lender; therefore, the First Lien Lender will attempt to extend the standstill period for as long as possible. The Second Lien Lender, however, does not want to forgo its remedies for too long, as it wants to have a voice in a workout. If a Second Lien Lender must wait silently for too long, it may lose an opportunity to intervene on its own behalf before the value of the collateral diminishes to a level that is incapable of supporting both the first lien loan and the second lien loan.

Depending on the nature of the deal, Second Lien Lenders typically agree to a standstill period that falls somewhere between 120 and 180 days. As an indicator of the rapid evolution of terms, at the beginning of the third quarter of 2007, it was not uncommon to see remedy standstill periods as short as 90 days, which was just barely long enough for the First Lien Lender to react to a financial covenant default, much less develop and implement a sale process. Recently, intercreditor agreements (particularly those involving a Second Lien Lender that is an equity holder) have begun to impose upon Second Lien Lenders indefinite standstill periods, with only a limited right in favor of the Second Lien Lender to accelerate its obligations (but do nothing further) if the First Lien Lender has done the same.

The date on which a remedy standstill period expires should be measured from the date the Second Lien Lender provides notice to the First Lien Lender of a default under the second lien documents, not from the date the default occurred. In other words, a standstill period cannot commence without the First Lien Lender's knowledge. No matter how long the standstill period extends, it should also continue beyond the negotiated period if the First Lien Lender is diligently pursuing its rights and remedies against the borrower or a material portion of the collateral (whether such remedies are underway at the expiration of the standstill period or are later commenced by the First Lien Lender). Recently, there has been pushback against the concept that a Second Lien Lender must abandon an enforcement proceeding if the First Lien Lender later decides to commence a similar action. A Second Lien Lender typically argues that if it has invested the time, effort and expense in pursuing the action, it should be able to continue such action throughout the process. While a First Lien Lender may be inclined to accommodate this request and permit the Second Lien Lender to manage the enforcement action (with prior notice to the First Lien Lender), any proceeds of the action received by the Second Lien Lender prior to payment in full of the first lien obligations should be turned over to the First Lien Lender.

Unsecured Creditor's Rights

While it is typical for a Second Lien Lender to be prohibited from pursuing its rights as a secured creditor during the standstill period and in bankruptcy, intercreditor agreements usually allow a Second Lien Lender to pursue certain unsecured creditor rights that comply with the terms and conditions of the intercreditor agreement itself. This is an element of intercreditor agreements that has remained largely unchanged in recent months. A Second Lien Lender will argue that it should not be expected to give up any rights it would have as an unsecured mezzanine lender by virtue of receiving liens to secure its collateral. Examples of such actions include the right to request dismissal or conversion of the borrower's bankruptcy case, the right to vote against and object to plan confirmation or the right to propose a creditor's plan in bankruptcy. When evaluating these requests, a First Lien Lender should consider what rights would be limited if it was negotiating an intercreditor agreement with an unsecured mezzanine lender. For example, it is not uncommon for an intercreditor agreement with an unsecured lender to impose upon that lender a standstill period with respect to exercising rights available to it under contract or at law.

> [A] First Lien Lender should be wary that allowing a Second Lien Lender to retain certain unsecured creditor rights may result in a Second Lien Lender's ultimate ability to circumvent the standstill period and other provisions of the intercreditor agreement.

When evaluating a request to preserve unsecured creditor rights, a First Lien Lender should be wary that allowing a Second Lien Lender to retain certain unsecured creditor rights may result in a Second Lien Lender's ultimate ability to circumvent the standstill period and other provisions of the intercreditor agreement. In particular, a Second Lien Lender that maintains its unsecured creditor rights under the intercreditor agreement could join with other unsecured creditors and file an involuntary petition against the borrower, pushing the borrower into bankruptcy and effectively halting any enforcement action that the First Lien Lender has commenced. Similarly, a Second Lien Lender that retains a right to file motions and make objections as an unsecured creditor in bankruptcy may be able to circumvent the pre-negotiated agreement that the First Lien Lender will control the process in bankruptcy. Thus, it is important to evaluate the various unsecured creditor rights a Second Lien Lender seeks to retain in light of the terms of the intercreditor agreement. Instead of granting a Second Lien Lender's request for unfettered unsecured creditor rights, those rights that are left intact should be subject to the terms and conditions negotiated in the intercreditor agreement and, in particular, the standstill period.

Release of Collateral

In order to afford the First Lien Lender the greatest flexibility in managing the borrower and the collateral, the intercreditor agreement should identify certain pre-established "release events" where a Second Lien Lender's lien on shared collateral is released without its consent. Such "release events" typically include

(1) prior to an insolvency proceeding,
   (a) a release that is permitted by the terms of the first lien documents;
   (b) a release that is consented to by the First Lien Lender following the occurrence of an event of default under the first lien loan documents; and
   (c) a release that occurs in connection with the First Lien

Lender's exercise of rights and remedies against collateral; and

(2) after an insolvency proceeding, a release in accordance with

(a) a sale pursuant to a confirmed plan of reorganization or liquidation;

(b) a sale in a bankruptcy proceeding of one or more assets, free and clear of all liens, claims and encumbrances (commonly referred to as a "Section 363 Sale"); and

(c) an order by the bankruptcy court to vacate the automatic stay under Section 362 of the Bankruptcy Code to allow the First Lien Lender to exercise its enforcement rights against the collateral.

A common request of Second Lien Lenders is to expand the pre-consent to dispositions that are permitted under the first lien documents to require that such dispositions also be permitted under the second lien loan documents. A First Lien Lender should be aware that this request creates a disguised consent right in favor of the Second Lien Lender that could interfere with the First Lien Lender's exercise of rights and remedies against the collateral. Similarly, a request by a Second Lien Lender to pre-consent only to dispositions that are made when an event of default under the second lien loan documents does not exist effectively forecloses the First Lien Lender's ability to realize on its collateral during an event of default. Any concerns a Second Lien Lender has about providing a "blanket" consent to dispositions outside of bankruptcy or an event of default under the first lien loan documents can be satisfactorily addressed by limiting the disposition terms under the first lien loan documents to those in effect on the effective date of the intercreditor agreement.

To further protect a First Lien Lender's exercise of rights and remedies with respect to a borrower and thwart any possible interference by a Second Lien Lender, the intercreditor agreement should provide for an irrevocable power of attorney allowing the First Lien Lender to file any releases in the event that the Second Lien Lender refuses to abide by the terms of the intercreditor agreement.

MODIFICATIONS TO CREDIT AGREEMENTS

Given that the terms of an intercreditor agreement are negotiated based on the "closing day" terms of the first lien loan documents and second lien loan documents, and the rights of each lender thereunder, both parties will seek to restrict the other party from subsequently amending its loan documents to circumvent the restrictions set forth in the intercreditor agreement.

Most Second Lien Lenders will desire to limit the total outstanding indebtedness to the First Lien Lender, since the First Lien Lender enjoys the benefit of both lien and payment priority (commonly referred to as the "Senior Debt Cap"). The Senior Debt Cap typically is the sum of (a) the maximum amount of first lien revolving and term loan credit facilities *plus* (b) a "cushion" of approximately 10-15% above that total amount prior to any insolvency or bankruptcy proceeding involving the borrower *plus* (c) an additional "cushion" of approximately 10% to provide debtor-in-possession ("DIP") financing after any insolvency or bankruptcy proceeding involving the borrower *plus* (d) indebtedness related to hedging agreements, cash management or other related obligations *plus* (e) interest, fees, costs, charges, expenses, indemnities and other amounts payable pursuant to the terms of the first lien documents, including protective advances in bankruptcy. A First Lien Lender will often accommodate the request of a Second Lien Lender to reduce the Senior Debt Cap by any permanent reductions of revolving loan commitments and principal payments on term loan debt, which prevents the "reloading" of any credit facilities.

Whether the First Lien Lender will suffer consequences if it exceeds the Senior Debt Cap

amount depends on the nature of the deal. A Second Lien Lender may request that the First Lien Lender agree that any outstanding indebtedness in excess of the Senior Debt Cap will be subordinate to, and paid out after, the second lien obligations. If a First Lien Lender agrees to this restriction, it must carefully evaluate two elements of the restriction. First, the Senior Debt Cap must be large enough to accommodate the future of the credit facility. For example, if the borrower has acquisitions planned that will require an increase in senior loans, that increase should be taken into account, in addition to the general 10-15% cushion for additional debt. Second, the First Lien Lender must restrict the amount of the Second Lien Lender's obligations to that contemplated on the date of the intercreditor agreement and not simply rely on the total leverage covenant in the first lien loan documents as a debt governor. This planning is essential to make sure that any first lien obligations in excess of the Senior Debt Cap are not subordinate to an undefined amount of second lien obligations.

The First Lien Lender must maintain this flexibility with respect to its loan documents to protect itself from future changes or events that impact the collateral or the borrower's performance under the credit facility.

Typically, the parties to an intercreditor agreement agree to mutually limit increases to interest rates under the first and second lien loan documents. The range agreed to is usually between 200 to 300 basis points. Given the recent events in the interest rate markets, a First Lien Lender should ensure that it maintains the right to impose an interest rate "floor" without requiring the Second Lien Lender's consent, whether that floor is applied to the applicable margin of interest or to the underlying rate indices. Since the most recent second lien loans typically bear interest at a fixed rate, flexibility for the Second Lien Lender to similarly impose a floor usually is not required (but should be granted if the second lien obligations do not have a fixed interest rate). It is also customary for the Second Lien Lenders and the First Lien Lenders to agree in the intercreditor agreement not to amend the loan documents by changing the repayment obligations of the borrower in a way that would accelerate the scheduled dates of permitted principal payments on the second lien loans, or extend the maturity date of the first lien loan.

The First Lien Lender should maintain its ability to amend the first lien loan documents in order to (1) shorten the final maturity; (2) accelerate or change the amount of payments (in a non-default situation); (3) release or implement reserves; (4) change the borrowing base or eligibility criteria which constitute the borrowing base (if the first lien loan documents include a borrowing base); (5) increase or add fees; and (6) waive a payment default. The First Lien Lender must maintain this flexibility with respect to its loan documents to protect itself from future changes or events that impact the collateral or the borrower's performance under the credit facility. On the other hand, Second Lien Lenders are usually prohibited from modifying their loan documents in any manner adverse to the First Lien Lenders or in any respect that makes the provisions more restrictive or more burdensome on the borrower.

RIGHTS IN BANKRUPTCY

As noted above, the bankruptcy provisions of the intercreditor agreement are likely to be highly negotiated, particularly when dealing with a Second Lien Lender with bargaining power. Giving a Second Lien Lender greater rights in bankruptcy, and thus the opportunity to be "less silent," is an accommodation the First Lien Lender should carefully scrutinize. In a bankruptcy context, accommodations that seemed reasonable at the outset of a lending relationship can suddenly turn destructive. In an insolvency or bankruptcy

proceeding, the First Lien Lender will expect the Second Lien Lender to allow it to work with the borrower to restructure the debt free from any interference in an attempt to maximize repayment of the borrower's obligations to the First Lien Lender. The Second Lien Lender, however, has a competing interest in maximizing repayment of the borrower's subordinated obligations to it. While the enforceability of certain pre-bankruptcy waivers is not entirely clear because few reported decisions have addressed subordination issues (and those that do exist tend to have contradictory results), the First Lien Lender typically will require in the intercreditor agreement that the Second Lien Lender waive and consent to certain bankruptcy provisions including, at a minimum, the following: (1) debtor-in-possession financing ("DIP Financing"); (2) use of cash collateral; (3) adequate protection; and (4) sales of collateral.[1]

DIP Financing; Use of Cash Collateral

Once in bankruptcy and attempting to reorganize, a borrower often will need additional financing to continue its operations. The cash to fill this gap will come in the form of a DIP Financing. The lenders providing the DIP Financing receive a super priority lien, which will prime the liens held by both the First Lien Lenders and the Second Lien Lenders. The First Lien Lender often desires to provide the DIP Financing and will require that the Second Lien Lender

(1) consent in advance (and not object) to any such DIP Financing, or the use of cash collateral that has been consented to by the First Lien Lender, and

(2) agree to subordinate its liens to the prior liens securing the DIP Financing (and any cash collateral or "carve outs" approved by the court), in any case so long as certain conditions are met:

(a) the First Lien Lender must retain its pre-petition lien priority status (subordinated to the DIP lender);

(b) the Second Lien Lender must receive a replacement lien on post-petition assets to the same extent as, but junior to, the liens of the DIP lender;

(c) the aggregate principal amount of loans and letter-of-credit obligations, together with the outstanding pre-petition First Lien Lender debt, does not exceed the negotiated Senior Debt Cap; and

(d) the terms of the DIP Financing are subject to the intercreditor agreement.

The Second Lien Lender may require that the DIP Financing be on "commercially reasonable terms" as a condition to consenting in advance. A First Lien Lender should instead consider adding a condition that requires that the bankruptcy court find the DIP Financing to have been "negotiated at arms' length and in good faith." This language is found in most court orders approving DIP Financing. A court does not use a "commercially reasonable" standard when evaluating a proposal for DIP Financing, nor is there a readily available market against which to judge the commercial reasonableness of the DIP Financing. The "commercially reasonable" merely provides the Second Lien Lender with an opportunity to object to DIP Financing.

Another common request by the Second Lien Lender is to include the amount of any "carve outs" in the calculation of whether the Senior Debt Cap has been exceeded. Depending on the size of the borrower and the state it is in when entering bankruptcy, the carve out for professional fees could be significant, and including such fees in the Senior Debt Cap calculation could consume the entire post-bankruptcy "cushion" intended for

[1] For example, see *In re 203 North LaSalle Street Partnership*, 246 B.R. 325 (Bankr. N.D. Ill. 2000) (holding that a voting provision in the applicable subordination agreement whereby the second lien lender waived its voting rights in bankruptcy was unenforceable); and *In re Aerosol Packaging, LLC*, 362 B.R. 43 (Bankr. N.D. Ga. 2006) (upholding a provision whereby a junior creditor waived its voting rights in bankruptcy and specifically rejected the courts reasoning in the *In re 203 North LaSalle Street Partnership* decision).

principal increases. Often, the best solution is to allow the Second Lien Lender to preserve its objection right with respect to this discrete issue and address it in the context of the bankruptcy court.

A Second Lien Lender may seek to add, as an additional consent to the pre-negotiated conditions, a requirement that the order approving the DIP Financing not describe or require a plan of reorganization. This prevents a First Lien Lender from forcing the Second Lien Lender to give up rights otherwise available to it in the intercreditor agreement by coupling DIP Financing and a plan of reorganization together. Depending on what rights the Second Lien Lender has elsewhere in the intercreditor agreement regarding a plan of reorganization, a First Lien Lender may agree to this request. In any event, however, the First Lien Lender should seek to limit the Second Lien Lender's rights to only the right to object to the DIP Financing on the basis that it also includes a plan of reorganization.

Adequate Protection

Secured creditors generally desire to obtain adequate protection by requesting additional or substitute collateral to protect against declines in the value of the collateral after the commencement of an insolvency or bankruptcy proceeding. A Second Lien Lender should expect to waive any right to dispute actions taken by First Lien Lenders to seek adequate protection with respect to the collateral securing the First Lien Lender obligations. In return for waiving this right, the Second Lien Lender may ask to retain the right to request and receive adequate protection with respect to its own obligations in connection with any DIP Financing or use of cash collateral. A First Lien Lender often will accommodate this request so long as certain conditions are met, including the following: (1) any such adequate protection is limited to the Second Lien Lender receiving a replacement lien on additional or replacement post-petition collateral; (2) the First Lien Lenders must also receive a replacement lien on the same collateral securing either the First Lien Lender debt or any DIP Financing provided by the First Lien Lenders that is senior to the lien granted to the Second Lien Lender; and (3) the replacement lien granted to the Second Lien Lenders must be subordinate to all liens securing the First Lien Lender debt or any DIP Financing as reflected in the intercreditor agreement.

A Second Lien Lender additionally may request the right to receive adequate protection payments in cash. However, the First Lien Lender could be disadvantaged, as allowing additional cash payments in bankruptcy will affect the borrower's liquidity. If the First Lien Lender agrees to this request, two aspects of the intercreditor agreement must be modified accordingly. First, the Senior Debt Cap should increase by an amount equal to all adequate protection payments paid to the Second Lien Lender. Second, the intercreditor agreement must include a "clawback" provision providing that, if the borrower exits bankruptcy without paying the First Lien Lender's obligations in full, any adequate protection payments received by the Second Lien Lender must be paid over to the First Lien Lender, to the extent of the shortfall.

Sale of Collateral (§363 Sale)

It is typical for the First Lien Lender to require that the Second Lien Lender waive any rights to object to a Section 363 Sale. This waiver is rarely objectionable to a Second Lien Lender because additional protections with respect to the reasonableness of any Section 363 Sale are automatically built into the bankruptcy process, including oversight from a creditors' committee and required approval from both the U.S. Trustee and the bankruptcy court itself. However, it should be noted that the recent decision by the Ninth Circuit Bankruptcy Appellate Panel in *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, No. 07-1176 (Bankr. 9th Cir. July 18, 2008), makes it necessary for the Second Lien Lender to refrain from objecting to such sale and expressly provide advance consent to any such disposition free and clear of any liens or other claims under

Section 363 of the Bankruptcy Code or any other similar bankruptcy law. *Clear Channel* held that Section 363(f) of the Bankruptcy Code does not permit a senior secured creditor to credit bid its debt and purchase estate property free and clear of valid, nonconsenting junior liens on the collateral, notwithstanding a prior agreement from the junior creditor to refrain from objecting to such sale. A First Lien Lender should ensure that its "Section 363 Sale" waiver clause also includes a consent (or deemed consent) by the Second Lien Lender to such sale.

The X-Clause

A provision that has been appearing more frequently in intercreditor agreements addresses the Second Lien Lender's rights to receive and retain debt or equity securities issued pursuant to a plan of reorganization by the borrower. This has become known as the "X-Clause" because it constitutes an exception to the general rule of lien subordination that requires that any and all First Lien Lender debt must be paid in full, in cash, before anything of value is distributed to the Second Lien Lender with respect to the second lien obligations. Where a Second Lien Lender is more aggressive or has more leverage, it may be able to negotiate permission to receive debt securities issued under a plan of reorganization or similar restructuring plan secured by liens on certain collateral as long as (1) the First Lien Lender also receives such debt securities secured by liens on the same collateral and (2) the liens received by the Second Lien Lender constitute liens that are subordinated to those held by the First Lien Lender on the same terms as provided in the intercreditor agreement. However, the concept of debt subordination should continue to apply with respect to the receipt by a Second Lien Lender of equity securities under an organization plan, requiring that any such equity securities be turned over to the First Lien Lender until all the First Lien Lender debt is paid in full.

CONCLUSION

The evolution of "market" terms will continue for second lien loans, particularly in light of the rapidly changing financial markets. Second lien loans continue to be attractive options for recapitalizations, DIP Financings, exit financings and restructurings. As mezzanine financing becomes more costly, whether due to tightening of liquidity in the market or by virtue of pure supply-and-demand economics, second lien loans may again return to their former position as the prominent subordinated loan product. For transactions in which second liens are part of the capital structure, the tables appear to be turning in favor of the First Lien Lenders on terms.

Authors: ***Dana S. Armagno, Marie H. Godush, Kathryn L. Stevens and Michael M. Eidelman***
Editor: ***Michael A. Nemeroff***

If you have any questions or wish to discuss this topic further, please contact Dana S. Armagno at 312-609-7543, darmagno@vedderprice.com, Michael A. Nemeroff at 312-609-7858, mnemeroff@vedderprice.com, any member of our Finance and Transactions Group listed on the last page or your Vedder Price contact attorney.

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222 NORTH LASALLE STREET
CHICAGO, ILLINOIS 60601
312-609-7500 FAX: 312-609-5005

1633 BROADWAY, 47th FLOOR
NEW YORK, NEW YORK 10019
212-407-7700 FAX: 212-407-7799

875 15th STREET NW, SUITE 725
WASHINGTON, D.C. 20005
202-312-3320 FAX: 202-312-3322

www.vedderprice.com

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