VEDDER PRICE®

Spring/Summer 2011

The Practical Lender

Special Report

THE STATE OF PLAY: INTERCREDITOR TERMS FOR SECOND LIEN LOANS

Introduction

As the credit markets loosen up and offer liquidity, lenders continue to offer borrowers a variety of alternative financing vehicles as options for financing acquisitions, recapitalizations, corporate restructurings and day-to-day operations.

The creative and complex financing structures that are available offer different classes and types of lien priorities. As senior debt becomes more available and affordable due to a prolonged period of low interest rates; and as finance companies, traditional banks and other nontraditional investors, such as private equity sponsors, hedge funds and distressed-debt funds, compete to provide various layers of structured financing, there has again been a marked increase in junior debt secured by a second lien. On the flip side, as many lenders and attorneys have anticipated, the recent wave of bankruptcies has focused attention on a variety of issues regarding the contractual arrangements between different classes of lenders and, in particular, the enforceability of various provisions found in intercreditor agreements among groups of secured lenders.

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The State of Play: Intercreditor Terms for Second Lien Loans

As lenders providing second lien loans have experienced, financing involving these loans 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. Often, second lien loans do not involve the lenders taking equity, so equity dilution is less of a concern for the borrowers and sponsors.

Among the lenders, the first lien lender ("First Lien Lender") reduces its credit exposure to the borrower while the borrower's overall capital structure is enhanced. 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 proceedings involving the borrower), most prominently a position ahead of general trade creditors.

Historical Overview

The emphasis on second lien loans has shifted in the last ten years, from heavily collateralized asset-based loans to cash flow loans where the Second Lien Lender is providing liquidity but does not expect asset coverage. As their position in the credit markets became more accepted, and as their leverage with borrowers and First Lien Lenders increased, Second Lien Lenders began to demand additional collateral rights and a greater level of involvement in enforcement actions. Often as a result of the Second Lien Lender's willingness to provide a layer of capital that was unavailable elsewhere, borrowers exerted significant pressure on their First Lien Lenders to accommodate the requests of the Second Lien Lenders wherever possible. The silent, deferential second lien structure that was the norm in early-stage second lien loans evolved over time to 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. Since the second lien and subordinated debt markets again picked up in 2009, intercreditor agreement terms have continued to evolve. The current state of play is described in this article and in the summary chart following it.

The Intercreditor Agreement

General

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 is a focal point. The intercreditor agreement is the key document that governs the actions and conduct of the First Lien Lender and a Second Lien Lender when a borrower's financial situation or condition deteriorates. It generally limits the rights of the Second Lien Lender in a variety of subsequent actions or bankruptcy proceedings. Conversely, it provides the leverage points for the Second Lien Lender that may disagree with the viewpoint and actions of the First Lien Lender. Initially, it is important to focus on why the financing structure includes a second lien loan, as opposed to unsecured mezzanine loans. 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 is also 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 or providing bridge financing. 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

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.

accommodating a Second Lien Lender's requests for rights. As the recent cases discussed in this article attest, these risks arise pre- and postbankruptcy.

Payment Subordination

As recently as 2007, it was widely accepted that Second Lien Lenders should not be expected to agree to payment subordination (also referred to as debt subordination). A Second Lien Lender typically did not have to argue about whether it should 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

Payment subordination and payment blockages are appearing in second lien intercreditor agreements.

documents. It became "market" to leave payment subordination and payment blockage concepts out of intercreditor agreements.

The tightening of the credit markets brought renewed focus on certainty of payment for First Lien Lenders and more recently, payment subordination and payment blockages are appearing 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 (1) the existence of any payment default and (2) the existence of any financial covenant default. A First Lien Lender should carefully evaluate a request to limit the scope of Material Defaults to prevent leakage to the Second Lien Lender when it 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 are often 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 are often reasonable, a First Lien Lender should remain cognizant 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 forced to accelerate as the only available option to block the payment to the Second Lien Lender, which itself could have significant ramifications in a cash flow deal, such as diminution in enterprise value and reduced 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 if 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 present, lien subordination terms provide that the Second Lien Lender will contractually subordinate its lien to the lien held by the First Lien Lender. Equally as important from the First Lien Lender's perspective is the Second Lien Lender's agreement not to contest in any proceeding (including an insolvency or bankruptcy proceeding) the validity, enforceability, perfection or priority of any lien held by the First Lien Lender, or to join the attempt of any other third party to any such challenge of any lien. Conversely, from the Second Lien Lender's perspective, this agreement by the Second Lien Lender should only apply to those first lien obligations that are capped, if applicable. Moreover, in light of the recent *ION Media* decision in New York, if a Second Lien Lender desires to preserve an express right to challenge priority on the grounds that certain property does not constitute "first-lien collateral," the Second Lien Lender should require clear language to that effect.[1]

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.

As discussed briefly above, First Lien Lenders have become more successful in requiring subordinate liens to be neutralized as to the First Lien Lender 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 or supporting any other person 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 varies based on the economics of the transaction, the leverage of each of the First Lien Lender and Second Lien Lender, the financial strength of the borrower and the general economic climate. From a First Lien Lender's perspective, a Second Lien Lender should at least be silent in circumstances involving 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. The prevailing view among Second Lien Lenders is that they should not be stripped of their unsecured creditor rights simply because their collateral position is secured. The opposing view from First Lien Lenders is that you can't have it both ways—unsecured remedies *and* a lien. These clashing views are generally negotiated to a satisfactory resolution in the intercreditor agreement.

Remedy Standstill Periods

Another issue heavily negotiated 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. The First Lien Lender's preference is to have these discussions without any interference or pressure from the Second Lien Lender. As a result, the First Lien Lender will attempt to extend the standstill period for as long as possible. On the other hand, the Second Lien Lender does not want to forgo its remedies for too long, as it strongly desires to have a voice in a workout situation. 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. However, it should be noted that diminution of collateral arguments in cash flow lending are largely ineffective.

[1] *In re ION Media Networks, Inc.*, 2009 Westlaw 4047995 (Bankr. S.D.N.Y. Nov. 24, 2009). In *ION Media*, the intercreditor agreement included an express acknowledgment by the parties for "the relative priorities as to the Collateral . . . as provided in the Security Agreement" and an agreement by the parties that such priority would not be affected or impaired by "any nonperfection of any lien *purportedly securing* any of the Secured Obligations (emphasis added)." At issue were certain licenses and whether they constituted "collateral." The court found that the use of the term "purportedly securing" to describe the liens granted in the security agreement evidenced the intent of the secured parties to establish their relative legal rights vis à vis each other, regardless of the ultimate validity of each individual right granted by the debtors.

Depending on the nature of the deal, Second Lien Lenders in cash flow deals typically agree to a standstill period that falls somewhere between 120 and 180 days. It was not uncommon to see remedy standstill periods as short as 90 days for asset-based deals or when the Second Lien Lenders had negotiating leverage in the 2007 period. As First Lien Lenders began to experience more and more borrower defaults, it became clear that 90 days was barely long enough for the First Lien Lender to react to a financial covenant default, much less develop and implement a sale process. These firsthand experiences translated into intercreditor agreements (particularly those involving a Second Lien Lender that is an equity holder) that now typically impose longer standstill periods on Second Lien Lenders. These standstill provisions often are coupled with only a limited right in favor of the Second Lien Lender to accelerate its obligations (but do nothing further), but only after acceleration by the First Lien Lender. From the First Lien Lender's perspective, allowing a Second Lien Lender to accelerate its obligations prior to the First Lien Lender's acceleration could have potentially disastrous results for the borrower *vis à vis* the borrower's other creditors and essentially hasten an eventual bankruptcy filing. To prevent this risk, First Lien Lenders generally insist on the concept of acceleration being included in the definition of "Enforcement Action" (or analogous term) in the intercreditor agreement.

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The date on which a remedy standstill period expires should be measured from the date the Second Lien Lender provides written notice to the First Lien Lender of a default under the second lien documents (generally describing any default in reasonable detail), not from the date the default occurred. The standstill period should also continue beyond the negotiated period if, prior to the commencement of an enforcement action by the Second Lien Lender, the First Lien Lender has commenced an enforcement action and is pursuing its remedies. It is also usually agreed to some degree that whether or not the standstill period has expired, if at any time the First Lien Lender is pursuing remedies (i.e., commencing an enforcement action), the Second Lien Lender must not pursue and should even abandon any enforcement action already commenced. Depending on the breadth of the definition of "Enforcement Action" (or any analogous term), this could potentially result in an indefinite standstill from the Second Lien Lender's perspective. As a result, 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. A typical concession from the First Lien Lender is to specify that the First Lien Lender must have commenced its enforcement action prior to the end of the standstill period and that the First Lien Lender is diligently pursuing its rights and remedies against the borrower *and* a material portion of the collateral. In any event, even if a First Lien Lender is inclined to permit the Second Lien Lender to manage an enforcement action (with prior notice to the First Lien Lender), the intercreditor agreement usually makes clear that any proceeds related to such action received by the Second Lien Lender prior to payment in full of the first lien obligations must 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 a bankruptcy proceeding, intercreditor agreements usually allow a Second Lien Lender to pursue certain unsecured creditor rights. The issue is whether this is an unfettered right provided to the Second Lien Lender, or whether the right is predicated upon compliance with the other terms and provisions of the intercreditor agreement. 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 contest the bid procedures in a debtor-in-possession ("DIP") financing, 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, among other things, what rights would be limited if it were negotiating an intercreditor agreement with an unsecured mezzanine lender. For example, it is 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.

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 theoretically contest the reasonableness of any sale or disposition of assets, or 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 a prenegotiated agreement that the First Lien Lender will control the process in bankruptcy. As a practical matter, any rights that a Second Lien Lender may assert in its capacity as an unsecured creditor would most likely be raised by the creditors' committee. First Lien Lenders typically argue that the Second Lien Lenders should not have unfettered unsecured creditor rights because the Second Lien Lender has the ability to protect itself through the exercise of the buyout right, or at a minimum, the First Lien Lender may require a concession or determination that all or a portion of the second lien obligations are unsecured. This concept remains a relatively heavily negotiated provision in intercreditor agreements. The leverage of each of the First Lien Lender and Second Lien Lender and specific deal circumstances ultimately may be the deciding factor as to the extent of the unsecured creditor rights maintained by the Second Lien Lender.

As a practical matter, any rights that a Second Lien Lender may assert in its capacity as an unsecured creditor would most likely be raised by the creditors' committee.

Release of Collateral

To afford the First Lien Lender the greatest flexibility in managing the borrower and the collateral, it will often negotiate in an intercreditor agreement 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) pre-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) postinsolvency 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 preconsent to dispositions that are permitted under the first lien documents to require that such dispositions are also permitted under the second lien loan documents. For example, such dispositions should only consist of "Permitted Dispositions" 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 preconsent 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.

One heavily negotiated provision of the intercreditor agreement is an irrevocable power of attorney allowing the First Lien Lender to file any release documents in the event that the Second Lien Lender refuses to abide by the terms of the intercreditor agreement. This right is fought for by the First Lien Lender, if a Second Lien Lender does not comply with the terms of the release provisions in the intercreditor agreement, the First Lien Lender merely has a breach of contract action against the Second Lien Lender. Also, more likely than not, the buyer has already walked from the sale while the lenders argue the release of collateral. In such a scenario, the First Lien Lender may have lost an opportunity to realize on the collateral, and the incurrence of costs and expenses in connection with the First Lien Lender pursuing its rights and remedies against the Second Lien Lender further diminishes the value of the collateral.

Rights in Bankruptcy

As noted above, the bankruptcy provisions of the intercreditor agreement are often highly negotiated. While Second Lien Lenders are increasingly aggressive in attempting to obtain expanded rights within the context of a bankruptcy, the First Lien Lender examines them with particular caution based on the economics of the transaction. In a bankruptcy proceeding, accommodations that appeared reasonable at the beginning of a lending relationship can rapidly lead to significant barriers and other obstacles to managing the borrower relationship and restructuring the debt.

In a bankruptcy proceeding, accommodations that appeared reasonable at the beginning of a lending relationship can rapidly lead to significant barriers and other obstacles to managing the borrower relationship and restructuring the debt.

There is continued uncertainty surrounding the enforceability of certain prebankruptcy waivers due to the existence of only a handful of reported decisions addressing such subordination issues and contradictory results of even those few decisions. Thus, the First Lien Lender typically will require in the intercreditor agreement that the Second Lien Lender waive and consent to certain bankruptcy provisions involving, 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.

DIP Financing; Use of Cash Collateral

Once in bankruptcy and attempting to reorganize, a borrower will often need additional liquidity to continue operating its business. The cash needed to fill this gap will be in the form of either DIP Financing or borrower's use of a lender's cash collateral. Lenders providing DIP Financing receive, among other things, a super priority lien that primes the existing liens held by both the First Lien Lenders and the Second Lien Lenders. Often, the First Lien Lender desires to provide the DIP Financing and will require that the Second Lien Lender (1) consent in advance to (and neither object to nor contest) 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 as long as the following conditions are met:

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

(b) the Second Lien Lender must receive a replacement lien on borrower's postpetition 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 prepetition 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 desire that the terms of the DIP Financing be "commercially reasonable under the circumstances" as a condition to its advance consent. A First Lien Lender should recognize that the "commercially reasonable" language will provide the Second Lien Lender with an opportunity to object in the future and further delay the process. Instead, a First Lien Lender often counters with a condition requiring that the bankruptcy court find the DIP Financing to have been "negotiated at arm's length and in good faith"—language that is found in most court orders approving DIP Financing. It should be noted that courts do not use a "commercially reasonable" standard when evaluating a proposed DIP Financing, nor is there a readily available market against which to judge the commercial reasonableness of the DIP Financing.

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The Second Lien Lender may also seek 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 condition 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 postbankruptcy "cushion" intended for 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 have it addressed within the context of the bankruptcy court.

The Second Lien Lender may also negotiate to add, as an additional consent to the prenegotiated 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 together with a plan of reorganization. Depending on the express rights the Second Lien Lender has elsewhere in the intercreditor agreement, the First Lien Lender may agree to this request. Nevertheless, the First Lien Lender often seeks to limit the Second Lien Lender's rights to object to the DIP Financing to only the situation where it also includes a plan of reorganization.

Finally, a Second Lien Lender often attempts to retain any right to object to DIP Financing that it could otherwise assert generally as an unsecured creditor—often arguing that without this right, the Second Lien Lender is in an even worse position than that of an unsecured creditor. However, a Second Lien Lender has specifically negotiated its right to a second lien for the express purpose of raising its position in a bankruptcy proceeding above that of unsecured creditors, which have less extensive rights in such proceedings than secured creditors. The First Lien Lender generally pushes back on this request.

Adequate Protection

One of the main protections afforded secured creditors in respect of a borrower's bankruptcy proceeding is that of adequate protection. Adequate protection provides for the ability to request additional or substitute collateral to protect against declines in the value of the lender's collateral. A Second Lien Lender usually expects 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 a right to request and receive adequate protection itself with respect to the Second Lien obligations in connection with any DIP Financing or use of cash collateral. A First Lien Lender often will accommodate this request as long as certain conditions are met, including the following: (1) any adequate protection is limited to the Second Lien Lender receiving a replacement lien on additional or replacement postpetition 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 to the same extent as set forth in the intercreditor agreement.

A Second Lien Lender additionally may request the right to receive adequate protection payments in cash. Note that the First Lien Lender often argues it is disadvantaged by agreeing to this, as allowing additional cash payments will affect the borrower's liquidity by reducing the cash available to it during the bankruptcy proceeding. If the First Lien Lender agrees to this request, two aspects of the intercreditor agreement are often modified accordingly. First, the Senior Debt Cap often increases by an amount equal to all adequate protection payments paid to the Second Lien Lender. Second, the intercreditor agreement typically includes 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)

The First Lien Lender typically wants to require that the Second Lien Lender waive any rights to object to a Section 363 Sale. As evidenced by the recent decision of *In re Boston Generating, LLC*, No. 10-14419 (SCC) (Bankr. S.D.N.Y. Oct. 4, 2010), the First Lien Lender should not rely on "general" language in the intercreditor agreement to "silence" the Second Lien Lender during a Section 363 Sale.[2] Instead, the intercreditor agreement should contain unequivocal language for such a waiver by the Second Lien Lender, including provisions clearly and specifically addressing objections to bid procedures. It should be noted that this waiver should be less objectionable to a Second Lien Lender in light of the additional protections that are built into the bankruptcy process requiring the reasonableness of any Section 363 Sale, including oversight from a creditors' committee and required approval from the bankruptcy court itself.

Two other decisions merit discussion regarding the scope of Section 363 Sale waivers. The first decision is *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, No. 07-1176 (Bankr. 9th Cir. July 18, 2008), which required the Second Lien Lender to both agree to refrain from objecting to a Section 363 Sale and to expressly provide advance consent to any such disposition free and clear of any liens or claims. The court in *Clear Channel* held that Section 363(f) of the Bankruptcy Code prohibits a senior secured creditor from credit bidding its debt and purchasing 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.

Additionally, *In re American Safety Razor, LLC, et al.* (Case No. 10-12351 (MFW), Bankruptcy Court, District of Delaware) makes it appropriate to have the Second Lien Lender's express waivers as to Section 363 Sales also apply to any corresponding sale process. The facts of *American Safety Razor* are unique in that an aggressive borrower attempted to push through an order to approve a Section 363 Sale in what appeared to be an attempt to quash the efforts of a competing bidder.[3] The judge held that, while the Second Lien Lenders had agreed not to object to any Section 363 Sale, such creditors had not agreed to waive any rights to object to the actual sale process.

As a result of this line of cases, the First Lien Lender typically stresses that its "Section 363 Sale" waivers include, among other things, an express

[2] In the case of *In re Boston Generating*, the borrower sought approval from the bankruptcy court for a sale of substantially all of its assets at the same time that it filed for bankruptcy. The proposed sale contemplated a purchase price in an amount just under the outstanding amount of the first lien obligations. With all of the proposed proceeds of the sale being paid solely to the First Lien Lenders, the First Lien Lenders supported the proposed sale, while the Second Lien Lenders opposed it. As a result, the Second Lien Lenders (1) contested the bidding procedures and (2) in connection with the hearing to approve the proposed sale, asserted their right to object to the Section 363 Sale. The First Lien Lenders argued that the Second Lien Lenders had waived their rights to object in both cases and relied on the following provision in the intercreditor agreement: "Until the Discharge of First Lien Obligations has occurred, whether or not any Insolvency or Liquidation Proceeding has been commenced . . . the First Lien Collateral Agent, at the written direction of the Required First Lien Secured Parties, shall have the exclusive right to enforce rights, exercise remedies and make determinations regarding the release, sale, disposition or restrictions with respect to the Collateral without any consultation with or the consent of the Second Lien Collateral Agent or any Second Lien Secured Party or any Second Lien Secured Debt Representative in respect thereof. . . . [The Second Lien Agent may] file any pleadings, objections, motions or agreements which assert rights or interests available to unsecured creditors . . . arising under any Insolvency or Liquidation Proceeding . . . in each case not inconsistent with the terms of this Agreement . . ." The court upheld the right of the Second Lien Lenders to object to both the bidding process and the Section 363 Sale. In so holding, the court specifically noted that the intercreditor agreement lacked an unequivocal and express waiver by the Second Lien Lenders to object to either the bidding procedures or a Section 363 Sale, making reference to, among other things, the ABA's model intercreditor agreement. Additionally, the court was influenced by the fact that, during oral argument, the lenders had stipulated that consent to a Section 363 Sale by the First Lien Lenders did not constitute an "exercise of remedies" under the intercreditor agreement. The judge noted that, had that stipulation not been made, she may have altered her conclusion on the issue.

[3] In *American Safety Razor*, the borrower claimed that the competing bidder would not be able to obtain the necessary regulatory antitrust approval to consummate the sale. Ultimately, the competing bidder entered the prevailing bid at the auction.

waiver by the Second Lien Lender to object to the bidding and sale procedures themselves.

The X-Clause

A provision that has been become fairly customary in intercreditor agreements is the "X-Clause." Its intent is to provide a limited exception to a First Lien Lender's right to be paid in full in cash prior to payments on subordinated debt. This provision addresses the Second Lien Lender's often requested right to receive and retain equity and debt securities issued pursuant to a plan of reorganization by the borrower. The X-Clause is 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 a Second Lien Lender with respect to the second lien obligations. Second Lien Lenders are frequently able to negotiate permission to receive equity and 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 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 parties' intercreditor agreement. Recent case law has strictly construed the language in these provisions, and courts seek to ensure that the intent of the parties as to the security being issued is consistent with the subordination terms of the intercreditor agreement, such that the distributed securities must be completely subordinate to any distribution to the holders of First Lien Lender debt.[4] For the concept of debt subordination to apply to the receipt by a Second Lien Lender of equity and debt securities under a reorganization plan, any such securities must be turned over to the First Lien Lender until all the First Lien Lender debt is paid in full.

The X-Clause is 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 a Second Lien Lender.

Conclusion

Market terms for intercreditor agreements will continue to evolve for second lien loans, particularly in light of the rapidly changing financial markets and the continuing interpretation and testing of current intercreditor terms by the courts within the context of bankruptcy proceedings. Second lien loans continue to be available and attractive options for acquisition financings, recapitalizations, DIP Financings, exit financings and restructurings. Continued focus on intercreditor provisions is imperative as the courts dissect and evaluate their meaning and intent in and outside of bankruptcy, and the leverage of the parties shifts from time to time. An Executive Summary of the key intercreditor and subordination terms follows.

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[4] *See In re Envriodyne Indus., Inc.*, 161 F.3d 301, 306 (7th Cir. 1994) (Posner, J.); and *Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136, 140 (2d Cir. 2005) (Jacobs, J.).

The State of Play—Executive Summary of Intercreditor and Subordination Terms

Term	Second Lien Lender	Mezzanine Lender
Lien Subordination:	Secured loan; second position lien	Unsecured loan
Debt Subordination:	Partial or no subordination	Fully subordinated
Payments to Lender:	Interest payments permitted; principal amortization more typically granted and heavily negotiated	Current interest payments permitted; often deferred or “PIK” interest paid at maturity; no principal amortization
Payment Blocking:	Interest payments not typically blocked; if principal payments are permitted, they are usually subject to borrower performance conditions prior to payment and blocked on a default	Complete block until senior payments resume; makeup payments typically permitted
“A” Lender Debt Cap:	Customary	Customary
Enforcement Standstill:	90–180 days	Complete standstill
Release of Collateral:	Customary for Second Lien Lender to release lien if specific conditions are met	Not applicable
Prewaiver Request:	Second Lien Lender rarely grants waivers in advance of a default (i.e., at closing)	Not applicable
Application of Proceeds of Collateral (Prebankruptcy):	Second Lien Lender second in payment	Secured creditors paid first
Application of Proceeds of Collateral Post-“A” Enforcement Action or Bankruptcy:	Prenegotiated waterfall is typical	Secured creditors paid first
Amendments to Loan Documents:	No amendments that would negatively impact borrower or its ability to pay “A” lender	No cross-default or changes to covenants to make more restrictive
Purchase Option:	Customary, but payment terms heavily negotiated	Not typical

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