Preserving the Bankers' Bargain: Intercreditor Agreements and Bankruptcy

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Introduction

Over the last decade, corporate borrowers accessing the capital markets have issued an ever increasing amount of multi-tranched secured debt with tiers of lien priority on the same collateral. In order for this stacking of senior and junior secured debt to work efficiently in default and other troubled situations, fairly complex intercreditor agreements delineating the respective rights of each loan tranche were created, and were intended to be separate contracts between lenders that were enforceable in bankruptcy proceeding, foreclosures and other court driven processes. Initially there was little uniformity across intercreditor agreements, but as the market developed and courts started to interpret lenders' rights under the agreements they became more consistent.

The basic intent of an intercreditor agreement is to ensure that the senior lender controls all collateral actions until it no longer desires to do so or it's interests are repaid. Often junior lien parties are referred to as "silent lenders" with "silent junior liens", meaning that the intercreditor agreement silences the junior lenders' rights to act with respect to its liens until the senior lenders allow it. To the extent that collateral value extends to junior liens, however, junior secured debt will still maintain a priority over general unsecured claims in connection with a bankruptcy proceeding. Consistent with the expansive situations in which the junior liens are to be silenced, intercreditor agreements typically include provisions relating to lien priorities, application of proceeds of collateral, enforcement rights, access rights, rights to provide debtor-

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in-possession financing, rights to purchase or buy-out senior debt, and the waiver of various rights in bankruptcy. Although the intercreditor agreements should be enforceable prepetition contracts that remain in effect after the filing of a borrower's bankruptcy petition, early cases questioned the enforceability of certain waivers in bankruptcy cases. However, the growing trend in bankruptcy proceedings is for courts to enforce intercreditor agreements.[2]

Bankruptcy Decisions Regarding Enforceability of Intercreditor Agreements

A. Section 510(a) and *Hart Ski* and its Progeny

Section 510(a) of the Bankruptcy Code provides that "[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law." 11 U.S.C. § 510(a). Although one might consider this provision to be clear on its face, courts were initially not willing to so conclude.

An early case addressing the enforceability of an intercreditor agreement under section 510(a) of the Bankruptcy Code was *In re Hart Ski Manufacturing Co., Inc.*, 5 B.R. 734 (Bankr. D. Minn. 1980). In *Hart Ski*, the debtor's former owner sold its business and, in connection with the sale, the seller agreed to provide certain purchase-money financing. *Id.* at 735. At the same time, the purchaser entered into a working-capital facility to allow it to operate its business. An intercreditor agreement was entered into between the seller and the working-capital facility lender that provided for subordination of the purchase-money financing to the working-capital facility, wherein the subordinated lender could not "assert collect, enforce or release the indebtedness or any part thereof or realize any collateral securing the indebtedness or enforce

[2] We refer in these materials to "intercreditor" and "subordination" agreements interchangeably. Nevertheless, to clarify that an intercreditor agreement is intended to "subordinate" junior lenders' liens and bring the agreement within the scope of section 510(a) of the Bankruptcy Code, some practitioners title the agreement a "Subordination Agreement."

any security agreements, real estate mortgages, lien instruments, or other encumbrances securing said indebtedness except that it may collect regularly schedule payments when and as due" without the consent of the senior lender. *Id.* The intercreditor agreement also provided that any monies collected by the subordinated lender be paid over to the senior lender until the senior lender was paid in full. *Id.*

After the borrower filed for bankruptcy, the subordinated lender filed an adversary proceeding seeking adequate protection or to lift the automatic stay. *Id.* at 736. Not surprisingly, the senior lender opposed the request and sought summary judgment on the basis that the intercreditor agreement prohibited the subordinated lender from enforcing its rights before the senior lender was paid in full. *Id.* The court refused to grant summary judgment, holding that although Congress recognized the ability of creditors to contractually alter the priority of payment, "[t]here is no indication that Congress intended to allow creditors to alter, by a subordination agreement, the bankruptcy laws unrelated to distribution of assets." *Id.* Giving effect to the Bankruptcy Code over private contracts between parties, the court reasoned that

> The Bankruptcy Code guarantees each secured creditor certain rights, regardless of subordination. These rights include the 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.

Id. Because these rights were not related to priority of distribution as contemplated by section 510(a) of the Bankruptcy Code, such rights "cannot be affected by the actions of the parties prior to the commencement of a bankruptcy case when such rights did not even exist." *Id.* The narrow interpretation of section 510(a) in *Hart Ski* produced uncertainty regarding the enforceability of intercreditor agreements in bankruptcy and led to much greater explicitness in drafting regarding the rights of junior parties, especially in the context of adequate protection and modification of the automatic stay.

Some 20 years later, the court in *Bank of America, N.A. v. North LaSalle Street Limited Partnership (In re 203 North LaSalle Street Partnership)*, 246 B.R. 325 (Bankr. N.D. Ill. 2000), relied upon the narrow interpretation of section 510(a) in *Hart Ski* and held unenforceable the contractual right of a first-lien lender to vote the claim of the second-lien lender in a plan of reorganization. *Id.* at 332-33. Bank of America, the first-lien lender, filed a complaint seeking a declaratory judgment as to the effect of subordination agreements entered into between Bank of America and North LaSalle Street Limited Partnership, the second-lien lender and general partner of the debtor. *Id.* at 328. The subordination agreement provided that "in the event of any . . . bankruptcy, insolvency or receivership . . . [the second-lien lender] irrevocably agrees that the [first lien lender] may, at its sole discretion . . . vote or consent in any such proceedings with respect to, any and all claims of [second-lien lender]." *Id.* at 327-28. The issue for the court to decide was whether the second-lien lender (general partner) could vote the subordinated claim or whether the vote of the first-lien lender included the claim of the second-lien lender. *Id.* at 328. Looking to Illinois state law to conclude that, in the absence of ambiguity, the terms of a contract are to be construed according to their plain language, the court began its analysis with section 1126 of the Bankruptcy Code, which provides that the "holder of a claim" is entitled to vote to accept a plan of reorganization. *Id.* at 331. The court held:

> While the language of the subordination agreements governs the outcome of the Bank's right to a repayment of any deficiency claim, the language of the Bankruptcy Code governs the determination of voting rights in this case. Section 1126(a) of the Code provides that "the holder of a claim" may vote to accept or

> reject a plan under Chapter 11. . . . North LaSalle is the holder of the claim. . . . North LaSalle should therefore be allowed to vote its claim in the confirmation process.

Id. at 330-31.

Applying the same reasoning as the *Hart Ski* court, the court determined that "[i]t is generally understood that prebankruptcy agreements do not override contrary provisions of the Bankruptcy Code . . . [because] bankruptcy is designed to produce a system of reorganization and distribution different from what would obtain under nonbankruptcy law." *Id.* at 331. Further, the court reasoned that it "would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply." *Id.*

Following the narrow reading of section 510(a) in *Hart Ski* and *203 North LaSalle*, intercreditor agreements that addressed the order of priority of claims and collateral proceeds distribution would be enforceable in bankruptcy, but provisions that related to the waiver of statutory rights unique to the Bankruptcy Code would not. However, six years after *203 North LaSalle*, the Bankruptcy Court for the Northern District of Georgia considered a factually similar scenario and reached the opposite conclusion. In *Blue Ridge Investors, II, LP v. Wachovia Bank, N.A. and Aerosol Packaging, LLC (In re Aerosol Packaging, LLC)*, 362 B.R. 43 (Bankr. N.D. Ga. 2006), the court considered whether the provisions in a subordination agreement that authorized the first-lien lender to take certain actions on behalf of the second-lien lender was enforceable. *Id.* at 45-46. The terms of the subordination agreement provided that the first-lien lender was authorized and empowered to take certain actions in its own name and in the name of the second-lien lender, including substantive rights affecting (i) the right to vote in any bankruptcy proceedings, (ii) the right to demand, sue, collect or receive any distribution of any assets of the debtor, and (iii) the right to recover any amounts payable until such time as the first-lien lender claims are paid in full. *Id.* at 45. Both the first-lien lender and the second-lien lender returned conflicting ballots. *Id.* The court was tasked with determining whether the ballot of the first- or second-lien lender should be recognized with respect to confirmation of the plan as it relates to the claim of the second-lien lender. *Id.* at 44-45.

The second-lien lender, citing *203 North LaSalle*, argued that the voting waiver was unenforceable because section 1126(a) of the Bankruptcy Code expressly provided it the right to vote its claims. *Id.* at 45-46. The court disagreed, finding nothing in the language of section 1126(a) to prevent the second-lien lender from delegating or bargaining away its right to vote; as long as the subordination agreement was enforceable under applicable nonbankruptcy law, any provision, whether related to substantive bankruptcy rights or not, was enforceable in bankruptcy. The first-lien lender was entitled to vote the claim of the second-lien lender, though the second-lien lender was not without recourse – it could "free itself from the ongoing effect" of the subordination agreement by paying the first-lien lender's claim in full in cash. *Id.* *But see In re SW Boston Hotel Venture, LLC*, 460 B.R. 38, 52 (Bankr. D. Mass. 2011) (following *203 North LaSalle* and *Hart Ski*, and rejecting *Aerosol Packaging*, holding that intercreditor agreements "cannot nullify provisions of the Bankruptcy Code" and "[t]o the extent a provision in a subordination agreement purports to alter substantive rights under the Bankruptcy Code, it is invalid.").

B. Enforcement of Intercreditor Agreements in Bankruptcy Proceedings

Most courts addressing intercreditor issues in bankruptcy proceedings since *Aerosol Packaging* have enforced the parties' agreement and permitted the rights of junior secured lenders to be restricted consistent with what was bargained for in the intercreditor agreement.

For example, in *In re Ion Media Networks, Inc.*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009) (Peck, J.), the court considered whether the second lien lenders had standing to object to the plan of reorganization on the basis that certain assets – FCC licenses – were unencumbered and, as a result, all parties (not just the first lien lenders) were entitled to distributions on account of the value attributable to the FCC licenses. *Id.* at 593-94. The *Ion Media* court concluded that the intercreditor agreement that governed the relationship between the first and second lien lenders expressly prohibited lien challenges, and, as a result, the second lien lender lacked standing to challenge the first lien lenders' liens and object to the plan on that basis. *Id.* at 593-97. The intercreditor agreement expressly recognized the priority of the first lien lenders' interest as follows:

> Each of the Secured Parties acknowledges and agrees (x) to the relative priorities as to the Collateral (and the application of the proceeds therefrom) as provided in the Security Agreement . . . and acknowledges and agrees that such priorities (and the application of proceeds from the Collateral) shall not be affected or impaired in any manner whatsoever including, without limitation, on account of . . . (iii) any nonperfection of any lien *purportedly securing* any of the Secured Obligations (including, without limitation, whether any such Lien is now perfected, hereafter ceases to be perfected, is avoidable by any bankruptcy trustee or otherwise is set aside, invalidated, or lapses).

Id. at 594 (emphasis added). The intercreditor agreement also included a silent "second lien" provision, essentially prohibiting the second lien lender from challenging the priority of the first lien lenders' liens, stating:

> [U]pon the commencement of a case under the Bankruptcy Code by or against any Grantor, . . . (b) each secured party agrees not to take any action or vote in any way inconsistent with this Agreement so as to contest (1) the validity or enforcement of any of the Security Documents . . . (2) the validity, priority, or enforceability of the Liens, mortgages, assignments, and security interest granted pursuant to the Security Documents . . . or (3) the

> relative rights and duties of the holders of the first Priority Secured Obligations.

Id. at 597.

The court concluded that the second lien lender, described by the court as "an activist distressed investor that purchased deeply discounted second lien debt . . . for pennies on the dollar" that "ha[d] been using aggressive bankruptcy litigation tactics as a means to gain negotiating leverage or obtain judicial rulings that will enable it to earn outsize returns on its bargain basement debt purchases," lacked standing to challenge the first lien lenders' liens and the priority of the first lien lender claims. *Id.* at 588, 593-97. Based on the "purportedly securing" language of the intercreditor agreement, the court concluded that the second lien lenders "agreed to grant an indisputable first lien interest . . . [in] 'purported' Collateral," including the FCC licenses at issue. *Id.* at 594. The court further recognized that "[a]ffirming the legal efficacy of unambiguous intercreditor agreements leads to more predictable and efficient commercial outcomes and minimizes the potential for wasteful and vexatious litigation." *Id.* at 595. The court characterized the litigation over the first lien lenders' priority as "obstructionist, destabilizing and wasteful" (*id.*), which may have influenced the court's decision to deny standing to the second-lien lender.

Along the same lines as the *Ion Media* decision, in *In re Erickson Retirement Communities, LLC*, 425 B.R. 309 (Bankr. N.D. Tex. 2010), the Bankruptcy Court addressed whether subordinated creditors had standing to bring a motion to appoint an examiner to investigate whether the debtors' property was being fairly allocated. The intercreditor agreement at issue specifically prohibited subordinated creditors from "exercis[ing] any rights or remedies or tak[ing] any action or proceeding to collect or enforce any of the Subordination Obligations" without "the prior written consent of the Agent" until the senior lenders were "fully satisfied." *Id.* at 313. The intercreditor agreement further provided that the second-lien lenders waived, for the benefit of the first lien lenders, "any principles or provisions of law, statutory or otherwise, which are or might be in conflict with the terms of this Agreement and any legal or equitable discharge of [the second-lien lenders'] obligations" under the intercreditor agreement. *Id.*

After concluding that subordination agreements are enforceable under applicable Maryland law, the court found that the motion to appoint an examiner was "tantamount to both a pursuit of a remedy and the commencement of an action" that violated the "standstill" provisions of the intercreditor agreement. *Id.* at 314-16. The court held that the second-lien lenders lacked standing or contractually waived their right to bring the examiner motion. *Id.* at 315. Citing the *Ion Media* decision, the court recognized that the examiner motion was "unmistakably aimed at slowing down the confirmation process and gaining leverage to enhance or create recoveries for the Subordinated Creditors" the "very type of obstructionist behavior that the agreements are intended to suppress." *Id.*

The Court of Appeals for the Second Circuit in *In re WestPoint Stevens, Inc.*, 600 F.3d 231 (2d Cir. 2010), considered whether second lien lenders could receive certain subscription rights and interests following a sale of the debtor's assets, when the first lien lenders were not paid in full in cash and the second lien lenders were the winning bidder. *Id.* at 237. The intercreditor agreement provided that "[u]ntil all First Lien Indebtedness has been paid in full in cash . . . the Second Lien Lenders shall not be entitled to . . . exercise any rights or remedies with respect to the Second Priority Liens or the Collateral . . . ." *Id.* at 238. There were several exceptions to this agreement, including the right of the Second Lien Lenders to receive (1) adequate protection payments and (2) permitted mandatory prepayments. *Id.*

After approval of the sale of the debtors' assets by the Bankruptcy Court, which included the good faith protections of section 363(m) of the Bankruptcy Code, the parties entered into a stipulation whereby the distribution of securities to the second lien lenders would be stayed until the issue of whether the receipt of securities by the second lien lenders violated the intercreditor agreement. *Id.* at 242-43. On appeal, the District Court concluded that the distribution of certain interests to the second lien lenders violated the applicable provision in the intercreditor agreement that required the first lien lenders to be satisfied in full, in cash, before any distribution to the second lien lenders could be made. *Id.* at 242. On remand from the District Court, the Bankruptcy Court implemented the district court's decision and distributed the securities and interests that were to be paid to the second lien lenders to the agent for the first lien lender. *Id.* at 246. A direct appeal followed to the Second Circuit.

The Court of Appeals reversed the District Court, holding that section 363(m) of the Bankruptcy Code barred the court from modifying the sale order to comply with the intercreditor agreement because re-allocation of the securities of the debtors denied the second lien lenders' control over the debtor's business, which they had bargained for in the sale process. *Id.* at 247. According to the Second Circuit, section 363(m) creates a rule of "statutory mootness" which barred appellate review of an asset sale so long as the sale was made to a good-faith purchaser and was not stayed pending appeal. The absence of a stay or challenge to the good-faith aspect of the sale precluded appellate review. *Id.*

Nevertheless, the Second Circuit concluded that the original contemplated distribution of securities and interests under the sale order violated the intercreditor agreement because the first lien lender had the right to be paid in full, in cash. *Id.* at 253. However, because several years had passed since the securities and other interests had been redistributed pursuant to the

Bankruptcy Court order, the Second Circuit was hamstrung as to what remedy it could order. Accordingly, to fashion an appropriate remedy that enabled the second lien lender group to retain a 50.5% interest in the new entity that it bargained for in the sale process, the Second Circuit ordered that 11% of the securities be distributed to the first lien lenders for the erroneous ruling relating to the first lien lenders' priority rights to cash payments. *Id.* at 255. Though the *WestPoint Stevens* decision does not specifically hold that intercreditor agreements are enforceable in bankruptcy and largely relies on the protections of section 363(m), the Second Circuit's holding recognizes that a first lien lender that allows a sale to close or a plan to be confirmed may lose the opportunity to object to a distribution to a second lien lender, even when that distribution would violate an intercreditor agreement.

Requiring that the waiver in a prepetition intercreditor agreement be express and unambiguous, the court in *In re Boston Generating, LLC*, 440 B.R. 302 (Bankr. S.D.N.Y. 2010) (Chapman, J.) considered the enforcement of intercreditor agreements in the context of bidding procedures and the sale of the debtors' assets. There, the court determined whether the second lien lenders had standing to object to the bidding procedures in connection with a section 363 sale of the debtors' assets that was supported by the first lien lenders. *Id.* at 308. The debtors entered into an asset purchase agreement after an extensive prepetition marketing and sale process for substantially all of the debtors' assets. *Id.* at 310. The second lien lenders, who were "out of the money," objected to the bid procedures and to the sale. *Id.* at 316. The intercreditor agreement at issue provided:

> Until the Discharge of First Lien Obligations has occurred, whether or not any Insolvency or Liquidation Proceeding has been commenced . . . the First Line Collateral Agent, at the written direction of [First Lien Lenders holding a majority of the First Lien Debt], 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 . . . provided that the Lien securing the Second Lien Obligations shall remain on the proceeds of such Collateral released or disposed of subject to the relative priorities.

Id. at 316-17. The first lien agent argued that, based on this provision, the second lien lenders lacked standing to object to the bidding procedures and the sale. *Id.* at 316. The second lien agent posited that even though the first lien agent was not required to consult with the second lien collateral agent regarding the sale, the applicable provisions did not "silence" the second lien lenders from objecting. *Id.* at 317. The court agreed, finding that there was no "express prohibition against objection to bidding procedures anywhere in the inter-creditor agreement." *Id.* Further, the court, in a "very close call" held:

> Although I believe it goes against the spirit of the subordination scheme in the Intercreditor Agreement to allow the Second Lien Lenders to be heard and to attempt to block the disposition of the Collateral supported by the First Lien Agent, I am now . . . constrained by the language of the Intercreditor Agreement. After extensive briefing and oral argument as well as a detailed review of the Intercreditor Agreement, the Court finds no provision which can be read to reflect a waiver of the Second Lien Agent's right to object to a 363 sale motion, either in its capacity as a Secured Party or in its capacity as an unsecured creditor.

Id. at 320. Notably, the court distinguished *Ion Media* (and later *Erickson Retirement Communities*), concluding that the "Second Lien Lenders are on the 'cusp' of a recovery and are not engaging in the type of obstructionist behavior" identified in those cases. *Id.*

The effect of an intercreditor agreement in bankruptcy was also considered by the court in *In re Centaur, LLC, et al.*, Case No. 10-10799 (Bankr. D. Del. 2009) (KJC). As in *Ion Media*, the court considered whether the second lien agent could argue that the first lien lenders did not have a perfected prepetition security interest in certain assets. In connection with approval of the use of cash collateral both on an interim and final basis, the second lien agent asserted that the assets of the debtor were substantially unencumbered and should be available for unsecured creditors. At the final cash collateral hearing, the second lien agent attempted to question the debtors' witness in support of the cash collateral motion on the propriety of the adequate protection package. The first lien agent interposed an objection to the inquiry, arguing that such questioning violated the intercreditor agreement. Specifically, the intercreditor agreement provided as follows:

> Until the Discharge of First Lien Obligations has occurred, if the Company or any other Grantor shall be subject to any Insolvency or Liquidation Proceeding and the First Lien Collateral Agent shall desire to permit the use of Cash Collateral . . . , on which the First Lien Collateral Agent or any other creditor has a Lien or to permit the Company or any other Grantor to obtain financing, . . . then the Second Lien Collateral Agent, on behalf of itself and the Second Lien Claimholders, agrees that it will raise no objection to such Cash Collateral use . . . and will not request adequate protection or any other relief in connection therewith (except, as expressly agreed by the First Lien Collateral Agent or to the extent permitted by Section 6.3).

The second lien agent opined that the intercreditor agreement permitted it to make arguments relating to the debtors' plan of reorganization and believed that the adequate protection package was such a matter. However, the Bankruptcy Court concluded that the specific terms of the intercreditor agreement barred the second lien agent from pursuing its objection to the cash collateral motion and noted that through there may be certain circumstances when provisions of an intercreditor agreement should not be enforceable "because the bankruptcy imperative may be more important," such was not the case in *Centaur*.

The issue of whether the second lien agent could challenge the validity of liens arose again in the context of plan confirmation. The debtors proposed a plan that incorporated a settlement among the debtors, first lien agent and unsecured creditors' committee which resolved various alleged estate claims brought by the creditors' committee. The second lien agent challenged the debtors' plan and disclosure statement with respect to the validity of the first lien agent's liens on the debtors' assets, and served broad discovery requests upon the parties. The first lien agent responded that such challenges were barred by the prohibition against contesting liens in the intercreditor agreement, which also precluded the second lien lender from "contest[ing] or support[ing] any other Person in contesting, in any proceeding (including any Insolvency or Liquidation Proceeding), the priority, validity, perfection or enforceability of a Lien held by or on behalf of any of the First Lien Claimholders in the First Lien Collateral[.]" The second lien agent took a similar position as the second lien lender in *Ion Media*, arguing that the second lien agent was not violating the intercreditor agreement because the assets were "excluded collateral" and the intercreditor agreement permitted the second lien agent to exercise rights and remedies against the debtors as unsecured creditors. The Bankruptcy Court disagreed and concluded that the terms of the intercreditor agreement barred the second lien agent from pursuing its objection because, at bottom, its objection was a lien challenge and the intent and purpose of the intercreditor agreement and final cash collateral order was to "box" out the second lien agent. Though the court's decision was in the context of a discovery dispute and rendered on the record at the confirmation hearing and not in a written opinion, the *Centaur* decision reflects the trend toward enforcing intercreditor agreements in the bankruptcy process.

In a recent case out of the District of Arizona, the court strictly interpreted the language of an intercreditor agreement and affirmed a Bankruptcy Court decision which held that "subrogation" language authorized the first lien lender to vote the second lien lender's claim with respect to the plan of reorganization. In *In re Avondale Gateway Center Entitlement, LLC*, Case

No. CV10-1772-PHX-DGC, 2011 WL 1376997 (D. Ariz. Apr. 11, 2011), two secured lenders entered into an intercreditor agreement which subrogated the first lien lender to the rights of the second lien lender until the first lien lender was paid in full:

> Subrogation. [Second Lien Creditor] agrees that [First Lien Creditor] shall be subrogated to [Second Lien Creditor] with respect to [Second Lien Creditor's] claims against Borrower and [Second Lien Creditor's] rights, liens, and security interest, if any, in any of the Borrower's assets and the proceeds thereof (excluding, however, [Second Lien Credtor's] rights under any pledge of Borrower's membership interest made under the Subordinate Debt Documents) until the Senior Debt shall have been paid in full, in cash.

Id. at *2. The second lien lender cast a vote in favor of confirmation of the plan of reorganization. *Id.* at *1. However, the first lien lender cast two votes against confirmation of the proposed plan: one vote on its own behalf and one vote as the holder by subrogation of the claim asserted by the second lien lender on the vacant land. *Id.* The Bankruptcy Court ruled that the subrogation clause authorized the first lien lender to vote both claims. *Id.* The debtor then appealed the decision to the District Court, arguing that a subrogation clause is not enforceable in bankruptcy citing to *203 North LaSalle* and *Hart Ski*. *Id.* However, the District Court affirmed, finding that the *203 North LaSalle* and *Hart Ski* decisions were distinguishable because the disputes in those cases were over "subordination" clauses, not "subrogation" clauses. *Id.* at *4. According to the District Court, the policy implications in *203 North LaSalle* and *Hart Ski* – permitting subordinated creditors to protect their claims – was not applicable in *Avondale* because a subrogee "steps into the shoes of the subrogor and succeeds to the latter's rights." *Id.* Further, the District Court concluded that cases like *Aerosol Packaging* and *Erickson Retirement Communities* lend support to the notion that bankruptcy voting rights can be assigned.

C. The Interplay Between Sections 510(a) and 1129(b) of the Bankruptcy Code

Section 1129(b)(1), which permits a bankruptcy a bankruptcy court to confirm a plan of reorganization notwithstanding the dissent of one or more classes of claims or interest, if, among other things, the plan is "fair and equitable" and does not discriminate unfairly, provides:

> ***Notwithstanding section 510(a) of this title***, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

11 U.S.C. § 1129(b)(1) (emphasis added). In what was apparently a case of first impression, the court in *In re TCI 2 Holdings, LLC*, 428 B.R. 117 (Bankr. D.N.J. 2010) addressed the meaning of the introductory phrase "[n]otwithstanding section 510(a) of this title . . ." in section 1129(b)(1). *Id.* at 140.

In *TCI 2 Holdings*, a case involving the Trump Entertainment Resorts casinos in Atlantic City, the first lien lenders and second lien lenders each proposed their own plans of reorganization. *Id.* at 128. The first lien lenders objected to the second lien lender plan, claiming, among other things, that the proposal of a plan violated the intercreditor agreement by proposing to make deferred cash payments to the first lien lenders and distributions of cash, rights and other property to the second lien lenders before the first lien lenders were paid in full, in cash. *Id.* at 139. The first lien lenders also argued that the second lien lender plan violated the intercreditor agreement by recharacterizing adequate protection payments made to the first lien lenders as repayments of principal by violating the second lien noteholders' waiver of the right to object to adequate protection payments to the first lien lenders, or to contest the status of the first lien lenders' secured claims. Although the court took note of the first lien lenders' arguments, it concluded that it need not decide the issue to confirm the second lien lenders' plan because the second lien lender plan sought nonconsensual confirmation under the cram down sections of 1129(b) of the Bankruptcy Code. *Id.* at 140.

Finding no case law interpreting the meaning of the introductory phrase of section 1129(b)(1), the court found the second lien lender plan to be confirmable:

> The only logical reading of the term "notwithstanding" in section 1129(b)(1) seems to be: "Even though section 510(a) requires the enforceability of subordination agreement in a bankruptcy case to the same extent that the agreement is enforceable under nonbankruptcy law, if a nonconsensual plan meets all of the § 1129(a) and (b) requirements, the court 'shall confirm the plan.'"

Id. at 141. The court, therefore, did not decide whether the second lien lenders violated the intercreditor agreement. *Id.* at 184-85.

Left to their contractual remedies, the first lien lenders sued the second lien lenders for breach of the intercreditor agreement in New York state court seeking damages for the alleged violations. *Id.* at 140. The matter was eventually settled in connection with a global settlement agreement entered into by the debtors, the first lien lenders and the second lien lenders.

D. Conclusion

The specific terms of the intercreditor agreement will ultimately determine what, if any, ability junior secured lenders will have to participate in the bankruptcy process. The waiver by the junior secured lenders must be clear and unambiguous for a court to determine that a bankruptcy right has been waived or otherwise consented to. In this regard, courts may also focus on the nature of the waiver and whether the second lien lender has waived a fundamental bankruptcy "right," such as the right to vote on a plan of reorganization. As long as the language of the waiver is clear and unambiguous, courts have, with some exceptions, generally enforced these provisions.

<u>Negotiating and Drafting Intercreditor Agreements</u>

Regardless of whether counsel represents the first lien lender or the second lien lender in negotiating and drafting the intercreditor agreement, the task is to negotiate an unambiguous agreement that leaves no room for interpretation. From the perspective of the first lien lenders, the ultimate goal is to limit the ability of the second lien lenders to interfere with any and all action taken on behalf of the first lien lenders, whether in or out of bankruptcy. The second lien agent and lenders, on the other hand, will be seeking to secure a meaningful seat at the negotiating table so that they are not rendered silent because they hold junior secured debt.

As noted, the first lien lender should attempt to “box in” the second lien lenders to the maximum extent possible during the bankruptcy proceeding and render them “silent seconds.” First lien lenders often seek advanced waivers of, or restrictions on, the rights of second lien lenders as a means to protect their investment or collateral. However, it is important to note that certain courts, including *203 North LaSalle*, *Hart Ski* and *SW Boston Hotel Venture* have held that certain bankruptcy rights, including the right to adequate protection, the right to seek relief from the automatic stay and the right to vote on a plan, cannot be waived. Such provisions may be unenforceable in bankruptcy.

<u>No Challenge to Liens</u>. Both the first lien lender and the second lien lender typically agree not to challenge the validity, priority, perfection and enforceability of each other’s liens. First lien lenders want reassurance from the second lien lenders that their liens are first in priority, even if the liens are not properly perfected or otherwise suffer from any defect or deficiency, as was the case in *Ion Media*. The first lien lender should negotiate to prohibit the second lien lender from challenging any purported or actual lien on collateral. The second lien lender may balk at a provision that precludes any challenge to the validity or perfection of the first lien lender's liens in the absence of a mutual waiver by the first lien lender.

Right to Assert Unsecured Creditor Rights. Typically, second lien lenders will seek to retain their rights as unsecured creditors, including the right to accelerate debt and sue the borrower, the right to file an involuntary bankruptcy against the borrower, and the right to object to DIP financing or a sale or disposition of assets. If the value of the collateral is less than the amount of the debt owed to the second lien lenders, the assertion of unsecured creditors rights can be a major bargaining chip during the course of the bankruptcy. First lien lenders may seek a waiver of many unsecured creditor rights during the course of the negotiation, however the parameters of such waiver will likely be a hotly negotiated topic.

Adequate Protection. The first lien lender may also seek a provision in the intercreditor agreement that precludes the second lien lender from opposing adequate protection payments to the first lien lender during the bankruptcy proceeding. In exchange for its consent, the second lien lender may reserve their rights to seek adequate protection themselves for any loss in the value of its prepetition liens in the cash collateral. The first lien lenders often view adequate protection payments to second lien lenders as an unnecessary expense for the estate at a time when the administrative costs are a burden on the debtors. As a result, the first lien lenders may seek to limit the second lien lender's ability to receive cash payments as adequate protection. In response, the second lien lender may condition their receipt of adequate protection payments in a number of ways, including if the court determines that the first lien lenders are fully secured, the second lien lender agrees to pay over the adequate protection payments to the first lien lenders until the first lien lenders are paid in full, or, if the court later determines that the second lien debt is not oversecured, the adequate protection payments may be recharacterized as repayments of principal.

<u>Stay Relief</u>. The first lien lender may include a provision that prohibits the second lien lender from seeking stay relief or opposing stay relief sought by the first lien lender. In response to this request, the second lien lender may seek certain limitations, including a reservation of the right to seek relief from the stay if the first lien lender receives relief from the stay themselves.

<u>Plan Support</u>. The first lien lender may include a provision that prohibits the second lien lender from supporting or proposing a plan of reorganization or other restructuring that fails to pay the first lien lenders in full, in cash. Similarly, first lien lenders may draft a provision that assigns all the second lien lenders' voting rights to the first lien lenders. Whether such provisions are enforceable may depend upon the jurisdiction; as discussed above, *Aerosol Packaging* held such a provision enforceable, while the *203 North LaSalle* and *SW Boston Hotel Venture* courts did not.

Second lien lenders are unlikely to grant a blanket concession waiving their right to vote or giving their right to vote to the first lien lenders. Accordingly, second lien lenders will often retain their voting rights, subject to certain limitations. These limitations include waiving the right to vote against a plan supported by the first lien lender, waiving the right to vote for a plan that does not provide for the first lien lender to be paid in full or waiving the right to object to a plan of reorganization that is consistent with the rights of the first lien lenders under the intercreditor agreement. The breadth of this the voting / plan support provision will likely be the subject of significant negotiation between the parties.

Right to Object to DIP Financing and Use of Cash Collateral. The first lien lender may require the second lien lender to consent in advance (or waive its right to object) to any debtor-in-possession financing arrangement provided or approved by the first lien lender. In addition, the first lien lender may also require that the second lien lender consent in advance (or waive the right to object) to approval of use of cash collateral by the first lien lender.

In return for the second lien lender's advance consent or agreement not to object to DIP financing or use of cash collateral, the second lien lender may request a "cap" on first lien debt, with any amounts in excess of the cap not having priority over the second lien lender's liens. The second lien lender may also seek priority over any professional expense "carve out" in a DIP financing order to the extent that the first lien lenders agree to such provision. In addition, the second lien lender may retain its right to object to DIP financing on the same grounds as an unsecured creditor, such as an argument that the new financing package is not in the best interests of the estate. The second lien lenders may specifically request a provision that allows the second lien lenders to propose their own DIP financing, or, at a minimum, may request that the intercreditor agreement be silent on the issue.

Consultation Rights. The first lien lender may also request certain consultation rights with respect to any disposition of collateral. This may include consultation rights with regard to bidding procedures for a sale of assets pursuant to section 363 of the Bankruptcy Code, negotiation of sale orders and retention agreements for financial advisors and investment bankers in connection with a sale of the assets. In this regard, the first lien lenders may seek provisions that prevent the second lien agent or lenders from objecting to bidding procedures, sale orders or issues regarding retention of professionals in connection with the disposition of assets.

<u>Sale of Assets and Approval of Bidding Procedures</u>. First lien lenders may propose a provision that if the requisite first lien lenders have consented to the sale or disposition of collateral, then the second lien lenders will be deemed to have consented to the sale or disposition of collateral pursuant to section 363(f) of the Bankruptcy Code. In light of the decision in *Boston Generating*, we may see a proliferation of provisions in intercreditor agreements where second lien lenders waive their right to object to bidding procedures proposed in connection with a section 363 sale of assets. The second lien lender may condition its consent to the sale or disposition of collateral on the retention of its right to credit bid. Further, the second lien lender may seek an affirmative provision that permits it to retain its rights as an unsecured creditor to object to a sale of disposition of the collateral pursuant to section 363 or otherwise. Such objections may include the fairness of the price, lack of sound business judgment or that the sale is an improper *sub rosa* plan.

<u>Standstill Provision</u>. In addition to agreeing to not challenge the first lien lenders' liens, the second lien lenders are often barred for a period of time (commonly referred to as a "standstill" period) from taking enforcement actions of their own against the shared collateral in response to a default under the second lien loan. The "standstill" is designed to give the first lien lenders an exclusive period in which to exercise their priority rights and remedies against the shared collateral. The length and termination of the "standstill" provision is a matter of negotiation, but a common "standstill" period ranges from 90 to 180 days.

<u>Recent Trends in Intercreditor Agreements and Agreement Formats</u>

In an attempt to codify the recent changes in the law and establish a market-based model form of intercreditor agreement, the American Bar Association Business Law Section has drafted the “Model Intercreditor Agreement.” Completed on January 15, 2010, the Model First Lien/Second Lien Intercreditor Agreement Task Force attempts to specify “the rights of first lien and second lien lenders holding *pari passu* senior debt secured by identical collateral that fairly protects the respective interests of first lien and second lien lenders while reflecting market expectations and standard practices.” A copy of the model intercreditor agreement is available at http://apps.americanbar.org/dch/committee.cfm?com=CL190029.