

Pratt's Journal of Bankruptcy Law

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Intercreditor Agreements and the Bankruptcy Code

*By Michael H. Goldstein, Howard Steel, Kizzy L. Jarashow and Artem Skorostensky**

This article is a guide for understanding the basic mechanics and strategic bankruptcy considerations in negotiating and documenting intercreditor arrangements.

There is no set of fixed rules when negotiating intercreditor arrangements as every deal is fact-specific, generally subject to significant negotiation and ultimately dependent on competing business rationales and negotiating leverage. This article is a useful tool for understanding the basic mechanics and strategic bankruptcy considerations in negotiating and documenting intercreditor arrangements.

INTERCREDITOR AGREEMENTS UNDER THE BANKRUPTCY CODE

Bankruptcy courts routinely enforce appropriately drafted intercreditor agreement (or “ICA”) provisions that subordinate the rights of junior lenders as to collateral and payments; Bankruptcy Code Section 510(a) provides that a “subordination agreement” is enforceable in bankruptcy to the same extent it is enforceable under applicable non-bankruptcy law.

In addition to enforcing the subordination of debts and liens, bankruptcy courts have enforced standstill requirements, prohibitions on challenging the validity of liens, prohibitions on objecting to the use of cash collateral and debtor in possession financing, and restrictions on voting on bankruptcy plans,

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although the scope of such enforcement depends, in large part, on the specific contract language.

Practice Point: General rules of contract interpretation apply to ICAs. Thus, of utmost importance in negotiating an ICA is to avoid ambiguous, conflicting, and imprecise drafting language (e.g., “with respect to,” “notwithstanding,” “contravene,” “inconsistent with,” “subordinated to the same extent”). Key concepts and defined terms should be specific.

PREVALENT TYPES OF INTERCREDITOR ARRANGEMENTS

ICAs that govern lien priority can take on many forms:

- *Pari Passu*;
- First/Second Lien;
- Crossover or Split Collateral; or
- First Out/Last Out (agreement among lenders).

In each instance, the ICA defines the collateral that secures each tranche of debt, the relative lien priority of the debt holders, and relative enforcement rights both in and out of bankruptcy. Where unsecured debt is subject to payment subordination (whether as junior subordinated debt or structurally subordinated mezzanine debt), the ICA will govern permitted payments and enforcement rights both prior to and after a default.

Practice Point: In all instances, the relative provisions regarding available sources of recovery and enforcement rights require each party to an ICA to determine if there is an alignment between the benefits/risks of the ICA provisions and the pricing of the debt.

LIEN SUBORDINATION VS. PAYMENT SUBORDINATION

Lien subordination means that one lender (junior lender) agrees that its lien on property, which is shared collateral with the other lender (senior lender), is subordinate to the lien of the senior lender. Importantly, the relative priority of each lender’s lien on the shared collateral applies whether or not the lien is perfected, subject to avoidance, void or voidable, or never granted. This effectively turns lien subordination into payment subordination with respect to the value of the shared collateral.

Payment subordination is where the subordinated (junior) lender agrees to defer payment of some or all of its obligations until the senior lender has been paid in full (sometimes with limited exceptions for reorganization securities). Typically, junior lenders will retain the right to receive regular payments of interest on their debt as long as there is no default under the senior debt at the time the payments are made.

The distinction between lien subordination and payment subordination is material.

- If the transaction involves only lien subordination, then after the collateral is fully liquidated, the senior lender's general unsecured claim for the amount of the shortfall is *pari passu* with the general unsecured claim of the junior lender.
- If the transaction involves payment subordination, the junior debt is subordinated in right of payment to the senior debt, and the senior lender continues to receive payments that would otherwise belong to the junior lender until it is paid in full.

Practice Point: For Lien Subordination: Is the lien at issue co-extensive with the assets of the borrower, or is there leakage? Is subordination language precisely drafted so as to avoid inadvertently being subject to payment subordination?

Practice Point: For Payment Subordination: Are there any obligations, or contractual or other relationships (e.g., equity rights), that should be carved-out of the subordination provision?

Practice Point: For both: Ensure that the language works as intended and does not inadvertently waive or grant rights to the opposing lien/claimholder.

ENFORCEMENT STANDSTILL PROVISIONS

An enforcement standstill provision operates to prevent the junior lender from taking any enforcement action against the shared collateral for a specified period of time. The standstill provision is usually triggered by an event of default or other significant event in the borrower's performance of its loan agreement obligations.

After the standstill period expires, the junior lender can exercise remedies against the collateral. However, if the senior lender has commenced an enforcement action against all or a significant portion of the common collateral before the standstill period expires, it will typically retain the exclusive right to direct the exercise of remedies thus rendering the standstill permanent.

Intercreditor agreements commonly allow junior lenders to take certain actions during the standstill period to preserve their lien and enforcement rights, including:

- Accelerating their loans;
- Demanding payment from the borrower;
- Demanding payment from any guarantor;

- Commencing an action against the borrower or any guarantor for non-payment;
- Obtaining a judgment against the borrower or any guarantor (but not enforcing that judgment);
- Taking action to ensure or preserve the perfection of their liens;
- Taking action to prevent any applicable statute of limitations from running;
- Filing necessary responsive or defensive pleadings (the scope of which turning on the precise contractual language);
- Filing a proof of claim in the borrower's bankruptcy; and
- Voting on a plan of reorganization (which, depending upon the negotiated language, can be with defined limitations).

Practice Point: Pay particular attention to the definition of “enforcement action.” If the enforcement standstill provision is not limited to the “collateral,” lien subordination can transmute into payment subordination.

PAYMENT STANDSTILL PROVISION

A payment standstill provision, which is typically seen in senior/mezzanine intercreditor arrangements, operates to prevent a junior lender from receiving payments, whether made voluntarily or as a result of an exercise of remedies, for a specified period of time after an event of default.

Different types of payments are subject to different restrictions. Ordinary payments of scheduled interest or fees are typically permitted during a standstill period unless there is a default under the senior debt facility.

Practice Point: Principal and interest are always subject to payment blockage after an event of default, but fees and costs can be included in permitted payment provisions, before and after an event of default.

COMMON BANKRUPTCY SPECIFIC PROVISIONS

- Advance consent of junior lender to DIP financing and use of cash collateral.
- Advance consent of junior lender to the sale of collateral and release of liens.
- Waiver of junior lender's right to vote against or oppose a Chapter 11 plan supported by the senior lender.
- Waiver of junior lender's right to challenge the validity of the senior

lender's liens.

- Waiver of junior lender's right to seek relief from the automatic stay without consent of the senior lender.
- Waiver of junior lender's right to adequate protection and post-petition interest payments.
- Inability to file an involuntary bankruptcy case against the borrower.

Practice Point: Issues always open to negotiation include:

- DIP financing, subject to market terms, with junior lender having the right to propose junior DIP financing;
- Any sale of collateral has to be pursuant to approved sale and bidding procedures and applicable law;
- Junior lender's right to vote on a plan provided that such plan does not violate the lien priority provisions of the ICA;
- Challenge waivers do not include disputes over collateral value; and
- If senior lender receives relief from stay, or adequate protection payments, the junior creditor is entitled to the same.

RIGHTS TYPICALLY MAINTAINED BY JUNIOR LENDERS IN BANKRUPTCY CASES

- The right to file a proof of claim.
- The right to take any action, which is not adverse to the senior lender or to the senior lender's exercise of remedies, to preserve or protect its lien and rights as a junior lender.
- A general reservation of unsecured creditor rights, subject to express prohibitions in the agreement.
- The right to receive and retain reorganization securities.

Practice Point: The extent to which a junior lender retains rights in a bankruptcy case will determine whether the lien subordination is, in effect, a silent second agreement.

REORGANIZATION SECURITIES

A confirmed plan of reorganization sometimes provides for the distribution of new debt or equity securities of the reorganized debtor to the first and/or second lien lenders on account of their respective claims. The "X Clause" in an ICA serves to confirm that it is permissible for the junior lender to retain

reorganization securities before the first lien lender has been paid in cash in full. Reorganization securities are typically subject to being subordinated to the same extent that the junior debt is subordinated to the senior debt.

Practice Point: Because equity is by definition subordinated to debt, ambiguity is avoided by specifically defining what is intended by equity reorganization securities being subordinated to the same extent as the junior debt is subordinated to the senior debt.

BUYOUT RIGHT OR PURCHASE OPTION

ICAs typically include express provisions permitting the junior lender to purchase the senior debt. The junior lender's rights to purchase the senior debt is typically triggered by a list of events itemized in the intercreditor agreement—which can occur sequentially or simultaneously. The purchase price can be at par, or par plus. The documentation can follow standard assignment documentation, or be left for negotiation.

Practice Point: A buyout right or purchase option can provide a meaningful optionality to the parties in a downside scenario.

OTHER KEY PROVISIONS OF INTERCREDITOR AGREEMENTS

Limitations on Amendments to Debt Documents

ICAs will specify limitations, if any, on the ability of the senior and junior lenders to amend their existing debt documents (and define the type of amendments that require consent of the other lender). It is typical that senior debt documents cannot be amended to increase the amount of senior debt or interest rate above a certain threshold or extend the maturity date of the senior debt beyond the maturity of the junior debt.

Anti-Layering

The junior lender may prohibit amendments to the senior debt documents if they would permit financing that is junior to the first lien but senior to the second lien, or otherwise reserve its right to object to any financing (including DIP financing) that is junior to the first lien but senior to the second lien (anti-layering provisions).

Drag Rights

Actions taken by senior lenders with respect to enforcement of rights and remedies, such as waiving defaults under the senior debt, will be deemed to have also been taken by the junior lenders with respect to the junior debt. In addition, general language in an ICA can typically impose broad waivers of junior rights if not otherwise qualified.

Turnover of Proceeds

Turnover provisions ensure that the priorities established by the intercreditor agreement as to collateral and its proceeds are not evaded if payments that are not permitted by the intercreditor agreement or are inconsistent with the ranking of the claims or liens, are made to junior lenders.

Dispute Resolution

Jurisdiction, venue, subrogation and jury waivers are always included terms.

Practice Points: Amendment provisions should protect against unilateral changes to the bargained deal. The scope of the collateral and its proceeds should be well defined as it will determine allocation of value. Broad waivers inject ambiguity in the contract provisions. Jurisdiction by the bankruptcy court if there is an insolvency proceeding, and the right to assert, but not enforce, subrogation rights, should be preserved.