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First Lien Lenders Beware: Drafting Points to Consider

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Intercreditor agreements are intended to prevent shared collateral from becoming a battleground in a distressed credit restructuring or bankruptcy. Creditor groups benefit by defining their relationship with each other before, rather than after, a debtor encounters financial difficulty. Historically, these agreements have been designed to enable senior creditors to control the disposition of collateral and to receive payment in full ahead of junior creditors, but well-organized junior creditors can also use them to gain valuable rights.

Last year we wrote in this column about the model first lien/second lien intercreditor agreement drafted by a task force of the Committee on Commercial Finance of the American Bar Association's Business Law Section.[1] We noted the growing importance of the second lien lender market and the objective of such task force to address the commercial finance industry's need for greater clarity and certainty in intercreditor agreement provisions.[2]

Today we look at two recent federal court opinions dealing with intercreditor agreements (one of which specifically cites the ABA model intercreditor agreement). Both opinions arose from bankruptcy cases in the Southern District of New York. Both involved sales of substantially all of the debtors' assets pursuant to §363(b) of the Bankruptcy Code.[3] In both instances, an intercreditor agreement failed to provide the desired protection for the first lien lenders, although for very different reasons. Finally, in both cases, the victories of the second lien lenders could have been prevented. As such, we discuss these cases to highlight points first lien lenders should consider when drafting or enforcing intercreditor rights.

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'Boston Generating'

In re Boston Generating, LLC[4] involved the chapter 11 bankruptcy proceeding of power plant operators that provide wholesale electricity to the Boston area.

The debtors' pre-petition operations were financed by two tranches of secured debt: (1) a $1.45 billion senior secured credit facility and (2) a $350 million second-lien term loan facility secured by second priority liens on the same collateral, in addition to unsecured mezzanine debt in the amount of $422 million. In connection with the issuance of such secured debt, the debtors, the first lienholders and the second lienholders entered into an intercreditor agreement. The relevant section of the intercreditor agreement provided that:

> Until the Discharge of the 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 [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….[5]

The debtors proposed to sell substantially all of their assets, free and clear of liens, to a stalking horse bidder under §363(b). The second lienholders objected to the bidding procedures and, subsequently, the sale itself. The first lienholders, in turn, argued that the intercreditor agreement barred the second lienholders from objecting in either instance. Nonetheless, the bankruptcy court overruled the first lienholders on both points.

The first lienholders argued that the second lienholders lacked standing to object to the bid procedures. In response, the court distinguished two cases, *In re Ion Media Networks Inc.*[6] and *In re Erickson Ret. Cmtys*,[7] both of which enforced intercreditor agreements restricting the rights of second lienholders in bankruptcy proceedings. In those cases, an express provision in the intercreditor agreement deprived the second lienholders of standing. Here, the court stated "[t]he plain language of the Intercreditor Agreement says the seconds are silent in certain circumstances, but I do not read any express prohibition against objection to bidding procedures anywhere in the inter-creditor agreement."[8]

Further, the court noted that both cases involved junior lenders that were far out of the money and therefore engaging in

obstructionist behavior. By contrast, the *Boston Generating* court determined that there was no basis to find obstructionist behavior, as the collateral, if properly marketed, might assure some recovery for the second lienholders.[9] However, in ruling in favor of the second lienholders, the court was careful to observe that its finding was limited to the bid procedures and reserved for another day the question of whether the second lienholders would have standing to object to the sale.[10]

That day came quickly. Less than one month later, the second lienholders filed an objection to the sale, arguing, inter alia, that the debtors were selling their assets at an inopportune time, that pending regulatory reforms would increase the value of the debtors' assets, and that the timing was motivated by an improper purpose of securing tax benefits for the debtors' parent. The first lienholders again sought to bar this objection based on the intercreditor agreement.

In its analysis, the court observed that intercreditor agreements are generally drafted to ensure that first lienholders remain "in the driver's seat" when it comes to decisions regarding collateral and to prevent second lienholders from using their subordinated lien as an offensive weapon with respect to collateral. However, it noted that second lienholders nonetheless retain those rights which are not expressly waived in the agreement. It further observed that under a typical intercreditor agreement second lienholders retain the ability to assert in a bankruptcy case those arguments that an unsecured creditor would have the standing (and the economic interest) to assert.[11]

The court stated that "[t]here is little dispute that the Intercreditor Agreement is not a model of clarity."[12] Then, despite the court's view that allowing the second lienholders to object to the debtors' sale of assets was contrary to the spirit of the subordination scheme, it refused to deprive the second lienholders of that right absent a waiver in the intercreditor agreement that was "clear beyond peradventure." The court held that "[u]nder New York law, the First Lien Lenders must point me to some provision that reflects an express or intentional waiver of rights."[13] The court contrasted the intercreditor agreement at issue with the ABA's model intercreditor agreement, quoting the following provision from the model:

> Second Lien Agent, as holder of a Lien on the Collateral and on behalf of the Second Lien Claimholders, will not contest, protest or object, and will be deemed to have consented pursuant to section 363(f) of the Bankruptcy Code, to a Disposition of Collateral free and clear of its Liens or other interests under section 363 of the Bankruptcy Code if First Lien Agent consents in writing to the Disposition provided that…(i) the liens of the second lien creditors attach to the proceeds of such disposition to the extent so ordered by the court, (ii) the net cash proceeds are applied to reduce the first lien obligations permanently, and (iii) the second lien creditors will not be deemed to have waived any right to bid in connection with such disposition.[14]

Finally, the court noted that while its reading of the intercreditor agreement was "a very close call," additional facts, though not dispositive, entered into its analysis, including that (1) at issue was a 363 sale of substantially all of the debtors' assets outside of a plan of reorganization, which, if approved, would effectively deprive the second lienholders of the opportunity to vote, in an economically meaningful way, on a plan of reorganization and (2) the second lienholders were on the "cusp" of a recovery and not engaging in obstructionist behavior.[15] Ultimately, this was a "hollow victory" for the second lienholders, as the court approved the sale notwithstanding their objections.[16]

These cases provide examples of how second lienholders might utilize the bankruptcy process to assert greater rights over collateral and how first lienholders might guard against such attempts in the future.

'WestPoint Stevens'

In re WestPoint Stevens Inc.[17] is an opinion of the Second Circuit Court of Appeals. This case is a cautionary example, not of poor drafting in an intercreditor agreement, but rather of first lienholders who failed to protect adequately their intercreditor rights.

WestPoint Stevens involved the bankruptcy of debtors engaged in the manufacture and distribution of textiles. Prior to bankruptcy, the first and second lienholders entered into an intercreditor agreement which provided, inter alia, that until all first lien indebtedness was paid in full in cash, the second lienholders were not entitled to exercise any rights or remedies with respect to their second priority liens or the collateral. The intercreditor agreement contained several exceptions to this prohibition, including that the second lienholders could receive (1) adequate protection payments and (2) permitted mandatory prepayments, defined to include net proceeds from the sale of the debtors' collateral after payment in full of the first lien indebtedness.

Initially, the bankruptcy court allowed adequate protection payments to be made to both the first and second lienholders. The first lienholders then objected to these payments being made to the second lienholders. This motion was resolved by a stipulation under which the second lienholders' adequate protection payments were deposited into escrow, to be held until the debtors' business was reorganized or sold.

The debtors then proposed to sell their assets pursuant to §363(b). Two groups, consisting of certain of the debtors' first and second secured creditors, emerged as bidders. The winning bid was submitted by a group headed by Aretex LLC (an affiliate of Carl Icahn), which held a minority share of the first lien and approximately 51 percent of the second lien debt. The unsuccessful bidder, led by Contrarian Funds, LLC, an affiliate of Wilbur Ross, held approximately 54 percent of the first lien debt. The bankruptcy court approved the transfer of the debtor's assets to a wholly owned subsidiary of WestPoint International Inc., Aretex's acquisition vehicle. Securities (actually, shares and subscription rights) of WestPoint International were to be distributed to the debtor's first lienholders in full satisfaction of their claims (there being insufficient cash to satisfy those claims) and additional WestPoint International securities, consisting of subscription rights (the "Additional Securities"), were to be distributed to the second lienholders. Aretex would then become the majority shareholder of WestPoint International.

Initially, Contrarian moved to stay the sale pending appeal. However, the parties agreed to yet another stipulation (the "Stay Stipulation") which provided for the withdrawal, with prejudice, of Contrarian's

motion to stay. In particular, the Stay Stipulation provided that the Additional Securities could be distributed to the second lienholders, but would be held in escrow until a subsequent court order resolved the proper allocation, if any, of the Additional Securities to the first lienholders. Shortly thereafter the sale closed. After the closing, the bankruptcy court ordered the release from escrow of the adequate protection payments to the second lienholders.

On appeal, the district court affirmed the release of the adequate protection payments, but held that the intercreditor agreement did not permit distribution of the Additional Securities to the second lienholders. Those rulings were both appealed to the Second Circuit.

Before the Second Circuit, then, were two principal issues: (1) whether the district court had authority to modify the sale order (and in so doing, to rule that it was improper to distribute the Additional Securities to the second lienholders, albeit subject to escrow) and (2) whether the adequate protection payments held in escrow were properly released to the second lienholders.

As to the first issue, the court held that it had no authority to review the order based on "statutory mootness" under Bankruptcy Code §363(m), which bars appellate review of any sale authorized by §363(b) or (c) so long as the sale was made to a good-faith purchaser and was not stayed pending appeal. Indeed, the court determined that it lacked jurisdiction to review the entire sale order and not just the sale transaction.[18]

The court next addressed the district court's finding that statutory mootness did not apply to certain parts of the sale order, namely the distribution of the Additional Securities, because it was subject to the Stay Stipulation. The Second Circuit determined that "[w]hile we understand the District Court's concern with the merits of the contention that the [s]ale [o]rder violated the several credit agreements and arguably effected a circumvention of the safeguards of a Chapter 11 reorganization proceeding…the District Court in effect read a stay of the [s]ale [o]rder into the [Stay Stipulation] despite the lack of any basis for such a reading."[19] Thus, the court determined that the district court erred when it read the Stay Stipulation to have stayed parts of the sale order and reaffirmed that §363(m) precluded review.[20]

Having determined that the district court had no authority to revise the sale order, the Second Circuit then turned to the allocation explicitly stayed by the Stay Stipulation. The Second Circuit agreed with the district court that the original distribution of securities to the second lienholders violated the intercreditor agreement because the first lienholders had the right to be paid in cash. But because the first lienholders had withdrawn their appeal of their right to be paid in cash, the circuit court held they could not maintain an argument that they were entitled to all of the Additional Securities. Noting the first lienholders were not as "powerless" as the second lienholders and "indeed, had contributed to their own perceived misfortune by agreeing to the Stay Stipulation,"[21] the court fashioned an equitable remedy under which it allocated to Aretex the percentage of Additional Securities needed for Aretex to retain control of WestPoint International (i.e., 40 percent), allocated to the second lienholders their pro rata portion of the total Additional Securities (i.e., 49 percent), and allocated to the first lienholders (other than Aretex) the remainder of the Additional Securities (i.e., 11 percent).

Finally, the Second Circuit affirmed the bankruptcy court's order releasing the escrowed cash payments to the second lienholders.[22] The court found that the escrowed funds were "adequate protection payments" within the exception in the intercreditor agreement. Accordingly, the intercreditor agreement did not prohibit the second lienholders' receipt of the funds.

Conclusion

In *Boston Generating* and *WestPoint Stevens*, first lienholders were unable to rely upon their respective intercreditor agreements to remain in complete control over, respectively, the disposition of their collateral and the distribution of collateral proceeds.

Boston Generating demonstrates the importance and benefits to the industry of greater clarity and detail in waiver language, following the lead of the ABA model intercreditor agreement. As *Boston Generating* illustrates, inclusion in an intercreditor agreement of express, specific provisions depriving the second lienholders of standing to object, as well as waivers of the right to object, to disposition of collateral would have spared the first lienholders in that case the risks, time and expense of litigation, as well as the loss of negotiating leverage. On the other hand, *WestPoint Stevens* teaches that first lienholders must remain vigilant in bankruptcy proceedings to ensure that their rights under an intercreditor agreement are preserved. The failure of first lienholders in that case to obtain a stay of the sale pending appeal caused them to lose valuable negotiated rights under their intercreditor agreement. These cases provide examples of how second lienholders might utilize the bankruptcy process to assert greater rights over collateral and how first lienholders might guard against such attempts in the future.

1. See Alan M. Christenfeld and Barbara M. Goodstein, "New ABA Model Intercreditor Agreement OffersGuidance," NYLJ, Aug. 5, 2010.
2. See Committee on Commercial Finance, ABA Section of Business Law, Report of the Model First Lien/Second Lien Intercreditor Agreement task force, 65 Bus. Law. 810 (May 2010).
3. Section 363 governs a sale of a debtor's assets prior to, rather than in connection with, a plan of reorganization. See 11 U.S.C. §363(b).
4. 440 B.R. 302 (Bankr. S.D.N.Y., Dec. 3, 2010).
5. Id. at 316.
6. 419 B.R. 585 (Bankr S.D.N.Y. 2009).
7. 425 B.R. 309 (Bankr. N.D. Tex. 2010).
8. Transcript of Chap 11 Hearing Re Doc # 168 at 54 , *In re Boston Generating, LLC*, No. 10-144419 (SCC) (the "Transcript").
9. We note that although the judge clearly focused heavily on the precise language of the Boston Generating intercreditor agreement, she also appeared influenced by whether the second lienholders, in seeking the right to object, had actual economic interests to protect.
10. The Transcript at 53.
11. *In re Boston Generating*, 440 B.R. at 318. (citing *In re Ion Media Networks Inc.*, 419 B.R. at 595).
12. Id. at 317.
13. Id. at 318.
14. Id. at 319.
15. See the comment in note 9 above.
16. Id. at 320.
17. *Contrarian Funds LLC v. Aretex LLC (In re WestPoint Stevens Inc.)*, 600 F.3d 231 (2d Cir. 2010)
18. *In re WestPoint Stevens Inc.*, 600 F.3d at 251.
19. Id.
20. Id. at 253.
21. Id at 255.
22. Id. at 259-262.

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