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Caveat Intercreditor:Bankruptcy May Be Coming

Bankruptcy Provisions in First Lien/Second Lien Intercreditor Agreements

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While intercreditor agreements (ICAs) are not necessarily the most attention-grabbing of the various loan documents common to large financing transactions, they are nevertheless important, and lack of attention to detail with respect to their provisions could lead to unintended results in any future bankruptcy case. For example, in *Momentive Performance Materials, Inc. v. BOKF, NA* (In re MPM Silicones, L.L.C. "MPM") –F.3d–, 2017 WL 4700314, Nos. 15-1682 (2nd Cir. Oct.20, 2017), and in *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016), the first lien creditors may have assumed that the second lien creditors had agreed to be subordinated and silent during bankruptcy, but the second lien lenders were nonetheless able to participate materially in those cases and to obtain value at the expense of senior creditors, primarily because the pertinent sections in the applicable ICAs were not sufficiently clear and explicit.

Greater attention has been devoted to ICAs in recent years (by arrangers or underwriters of particular debt financings, as well as by potential investors in such debt), and enhanced scrutiny of the language utilized in ICAs has become the norm. This article highlights some of the key issues that arise in the drafting of ICAs related to the relative rights of holders of different layers of debt in the event of bankruptcy.

Background on Intercreditor Agreements

In exchange for permitting second lien secured creditors to receive junior liens, first lien secured creditors typically seek through the ICA to retain primary control over the collateral and the most significant decisions affecting such collateral, particularly in the event of bankruptcy. The formulation of the most material bankruptcy-related provisions of ICAs generally turn on the extent to which first lien creditors are able to limit second lien creditors from exercising various rights both in and outside of bankruptcy, especially those rights that are not explicitly linked to the second lien creditors' status as secured creditors, while at the same time providing second lien creditors with some limited

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rights, to address their likely contention that they should not have fewer rights than the borrower's unsecured creditors merely by virtue of having received subordinated interests in the collateral.

Unsecured Creditors' Rights

For this reason, it is also common for ICAs to include some form of acknowledgement of the second lien secured creditors' ability to assert certain rights that could otherwise be asserted by unsecured creditors, in an attempt to ensure that second lien creditors do not end up worse off than if they had not taken liens at all. It is helpful for first lien secured creditors, however, for an ICA to include language providing that the second lien creditors may only exercise unsecured creditor rights "to the extent not otherwise inconsistent with, or in contravention of," the other provisions of the ICA, the other loan documents, and applicable law. It is also helpful for first lien creditors if an ICA does not include any lead-in language to the unsecured creditors' rights provision in the form of "notwithstanding anything to the contrary in this agreement," to avoid any unintended override of other agreed-upon restrictions on the rights of second lien creditors.

It is also now common for ICAs to include a prohibition on second lien secured creditors' ability to object to the allowability of the first lien secured creditors' claims, consistent with the already-standard provisions whereby each set of secured creditors agrees not to contest the validity or enforceability of the others' liens. This prohibition has generally become mutual, so that first lien creditors will also agree not to object to the allowability of the second lien creditors' claims.

Voting Restrictions

It is fairly standard for ICAs to prohibit second lien secured creditors from proposing or voting in favor of a plan of reorganization or similar dispositive restructuring plan that is inconsistent with, or in violation of, the terms of the ICA, and most ICAs now further provide that second lien creditors may not do so "directly or indirectly" and "whether in the capacity of a secured or an unsecured creditor". Occasionally, language favoring first lien creditors will also prevent second lien creditors from proposing or voting to approve any plan that does not pay first lien creditors in full in cash, in order to prevent a cram down.

Sale Objections

Intercreditor agreements commonly prevent second lien secured creditors from objecting to sales of collateral that first lien secured creditors have consented to and, at the same time, require the second lien creditors to release their liens in such a sale, provided that the sale proceeds are either applied to pay down first lien creditors, or the parties' respective liens attach to such proceeds in accordance with the existing lien priorities. Second lien creditors, particularly in club deals (*i.e.*, those where at most only a few private equity or similar funds provide second lien financing to a borrower, and as such, are often separately represented and may have additional leverage) often try to preserve their rights to assert any unsecured creditor sale objections, such as that the sale does not maximize value or is not in the debtor's or its creditors' best interests.

The ability to raise these unsecured creditor objections could enable second lien creditors potentially to obstruct sales of collateral agreed to by first lien creditors, thus serving as a potential *de facto* override of the express restrictions against opposing sales that these creditors

have otherwise agreed not to oppose in an ICA. To limit these concerns on behalf of first lien creditors, compromise language is sometimes included whereby second lien creditors can raise objections that an unsecured creditor could raise only to proposed bidding and sale procedures, as opposed to the actual sale. This language ensures that the sale process is as fair and open as possible, without enabling second lien creditors to prevent or delay a sale of collateral once the applicable procedures have been approved.

DIP-Related Provisions

DIP financing and adequate protection provisions of ICAs typically require that second lien secured creditors not object to a proposed DIP loan and/or use of cash collateral that the first lien secured creditors propose or support or otherwise consent to, and also compel second lien creditors to subordinate their liens to such DIP loan and related adequate protection liens.

Additional language is often included, enabling second lien creditors to attach certain conditions to this consent, the most common of which is a DIP cap of between 10% and 20% of the maximum permitted first lien debt. In certain formulations, second lien creditors may also reserve the right to object to provisions in a proposed DIP financing that would dictate the ultimate terms of a plan of reorganization or to a required sale of collateral prior to a default.

In addition, ICAs typically preclude second lien creditors from objecting to any adequate protection sought by first lien creditors (or to any objection that their interests are not being adequately protected), so long as second lien creditors receive junior liens on additional or replacement collateral and/or a junior superpriority administrative expense claims as adequate protection. Whether second lien creditors may also receive cash payments for post-petition interest, fees, and/or expenses is not as clearly established.

Some ICAs, permit second lien creditors to seek adequate protection cash payments to the extent first lien creditors have been granted the same and subject to the right of the first lien creditors to object to the reasonableness of the amounts sought. In smaller deals, first lien creditors are often able to impose additional restrictions on such payments, including the ability to claw back such amounts in the event first lien creditors are not ultimately paid in full or to impose agreed-upon budgets for, or caps on, such fees and expenses.

Analysis

ICAs have received more focus in recent years, and certain of their provisions, as outlined above, are often the subject of detailed discussion in the drafting stage. Investors in first lien debt particularly have become more concerned about protecting their rights in a potential future bankruptcy and generally understanding the implications of the terms of ICAs. As in all drafting exercises, the ultimate terms of an ICA will depend on which parties are involved and paying attention, the leverage that any parties may have, the particular dynamics of the market at any given time, and the specific circumstances of any given transaction, but the foregoing bankruptcy-related provisions of ICAs are the ones that tend to receive the most attention.

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