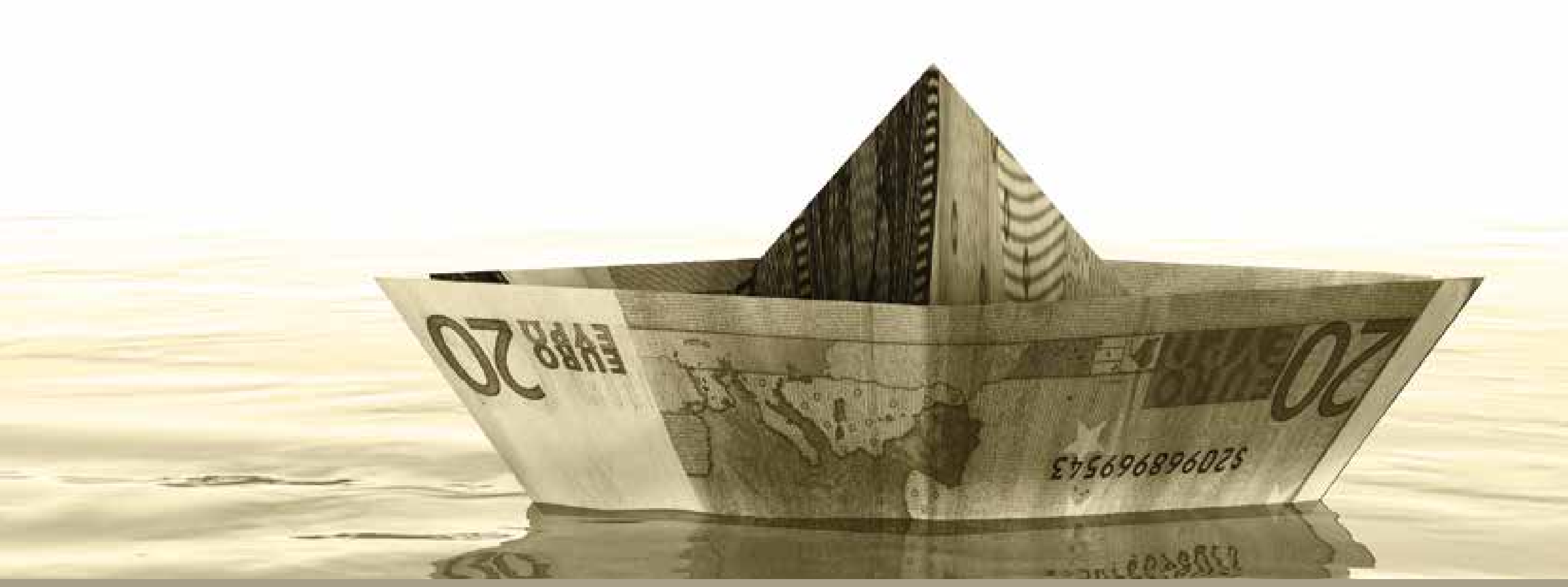

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The International Comparative Legal Guide to:

Lending & Secured Finance 2015

3rd Edition

A practical cross-border insight into lending and secured finance

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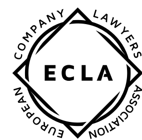

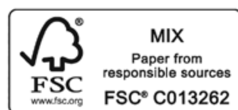

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Developments in Intercreditor Dynamics

Davis Polk & Wardwell LLP

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Monica Holland

Introduction

Over the past 10 to 15 years, lien subordination and tiering has moved from the periphery of the finance markets to the very heart of U.S.-based leveraged finance. Whereas the predominant means of distinguishing creditor priorities historically was "secured *vs*. unsecured" or "senior *vs*. subordinated", companies considering a leveraged financing can now choose from a variety of intermediate and hybrid forms, seeking to match investor demand with the credit profile, asset base and other characteristics of the borrower/issuer. While different forms of lien subordination are routinely discussed in short-hand form, as though each product would produce a predictable result, the truth has proved to be somewhat more complex. As the mix of collateral type and scope has met the interplay of general creditors' rights with imperfectly understood or tested contract provisions in a contested court proceeding – sometimes in unexpected jurisdictions – market participants have come to better understand the limitations and uncertain advantages of different structures and protections. In addition, as the complexity of cross-border financings continues to increase, new issues will arise as others are settled. And, as is often the case where a lesson learned on one set of facts does not apply squarely to another, the agreed means of resolving one issue can often create a new one.

In this article we discuss recent developments in intercreditor rights, including recent U.S. bankruptcy court decisions as they relate to and potentially impact disputes among groups of secured creditors and related proposals by the American Bankruptcy Institute. We consider possible documentary responses to some of these court decisions and responses from the market. We also look at the increasing number of European acquisitions that are being financed with debt raised in the U.S. market under New York law governed finance documentation, discuss current issues in transatlantic intercreditor practice and seek to identify some of the ways in which the efforts to reconcile these emerging issues have themselves further affected the market for tiered collateral financings. Just as market observers in the U.S. have noted for years the convergence of practice and participants in the leveraged loan and high yield debt markets, they are now watching for convergence between the UK and U.S. leveraged finance markets.

Background: The U.S. Bankruptcy Code and Structural Proliferation

Section 510(a) of the U.S. Bankruptcy Code (the "Bankruptcy Code") provides that subordination agreements are enforceable in a U.S. Chapter 11 bankruptcy proceeding to the same extent they would be under non-bankruptcy, state law. As markets have become more comfortable with borrowers incurring higher leverage and credit standards of lenders have become more relaxed, the reliance on tiering of creditor positions in collateral – lien subordination – has increased. One obvious manifestation of this trend is the increased ability of borrowers to incur junior lien debt as part of an initial capital structure, and then to incur additional first lien, second lien or more junior lien debt post-closing, often based on serial incremental secured leverage ratio tests. This is also the case in many "crossing-lien" asset-based deals, where a foundational structure often includes a revolving credit facility secured by a first lien on accounts receivable, inventory, and other "ABL priority collateral" – and a second lien on substantially all other assets of the borrower (the "term priority collateral") – with availability under such facility based on a "borrowing base" calculated by reference to the value of the ABL priority collateral. Term loan lenders are, in turn, secured on a first lien basis by the term priority collateral and have a second lien on the ABL priority collateral.[i]

Typical Features of a U.S. Intercreditor Agreement

Although there are a vast number of subtle differences in wording in U.S. intercreditor agreements, the essence of a collateral intercreditor agreement in a large, leveraged financing may be boiled down thus: the senior lien secured parties' lien in specified "common collateral" is senior to the lien of the junior lien secured parties in such collateral. Typical intercreditor agreements also provide that the senior lien secured parties exclusively control remedies with respect to common collateral (sometimes, subject to a right of the junior lien holders to assume control if the senior lien parties have failed to take action after a specified "standstill" period). Intercreditor agreements further require that, regardless of the party exercising remedies, proceeds of common collateral are to be distributed first to the senior lien holders until the senior lien obligations are paid in full. In a crossing-lien structure, the agreement will typically dictate the application of proceeds of mixed ABL and term priority collateral – if, say, a division or subsidiary is sold in foreclosure or through a "Section 363" sale in bankruptcy – and the ability of ABL lenders to use term priority collateral (e.g., the use of intellectual property or real estate to sell inventory). Finally, such agreements set forth parameters on the junior lien creditors' conduct – rights they may and may not exercise – in any bankruptcy proceeding, including, most importantly: (i) the ability of junior lien creditors to propose a debtor-in-possession ("DIP") financing or object to a DIP financing proposed or supported by the senior lien creditors; (ii) the rights of junior lien creditors to request "adequate protection" (*i.e.*,

cash or other additional collateral granted to a secured creditor to protect it from the diminution in value of its collateral that is being used by the debtor) or contest the senior lien creditors' right to do so; and (iii) the ability of junior lien creditors to vote for or against a plan of reorganisation that is supported by the senior lien creditors.

Because the market-standard collateral intercreditor agreement in the U.S. purports to govern only the relative rights of secured creditors, one often-noted anomaly is that holders of unsecured debt – intended to be junior in the capital structure to junior lien holders – are not party and are not bound. As a result, unsecured creditors are not subject to any of the restrictions described above, and, instead, have the unfettered ability to exercise rights afforded them under the Bankruptcy Code. To address this incongruence, many junior lien creditors have negotiated (i) to retain all rights they would have as unsecured creditors – so long as such rights are not exercised in a manner inconsistent with the other terms of the intercreditor arrangement, (ii) to limit the "waterfall", "turnover" obligation of junior lien creditors and certain other limitations to proceeds of or with respect to common collateral, and (iii) to narrow the prohibition on junior lien creditors challenging the "liens" of senior lien creditors; rather than a broader restriction on challenging their claims. While, on its face, each of these negotiated provisions is consistent with the concept of lien subordination (*vs*. payment subordination), from the perspective of senior lien creditors, these exceptions may well swallow the rule.

Recent U.S. Bankruptcy Court Decisions Concerning Creditors' Rights

Certain of the tensions latent in the scope of common collateral and the overlap of a secured creditor's rights as an unsecured creditor came to the fore in the recent *Momentive* decision[ii] In *Momentive*, holders of first lien notes and "1.5 lien notes"[iii] rejected a plan of reorganisation that would not have paid them a make-whole premium that they asserted was due under the terms of their debt, which plan was supported by holders of second lien debt. The debtors then proceeded with an alternate plan – which was confirmed by the court – that distributed to the first and 1.5 lien creditors (collectively, the "senior lien creditors") replacement "take-back" debt at a below-market interest rate with the second lien creditors receiving substantially all of the equity of the reorganised company. This plan was put in place without the support of the senior lien creditors, in effect "cramming" those creditors with instruments found by the court to constitute fair market satisfaction of their claims.

The risk that a senior lien creditor may be forced to accept take-back debt, and be deemed to have been paid in full by the bankruptcy court, creates a very significant issue for a secured creditor, as it allows a debtor to exit bankruptcy without paying secured creditors in full in cash prior to distributing value to other creditors. From the perspective of intercreditor arrangements, however, perhaps more important was the dispute between the Momentive senior lien creditors, on the one hand, and the second lien creditors, on the other, that followed.[iv] After confirmation of the plan described above, the senior lien creditors sought to recover distributions made to the second-lien noteholders pursuant to the terms of the intercreditor agreement which prohibited second lien noteholders from receiving any recovery from common collateral until the senior lien creditors were "paid in full in cash" and from taking certain actions in opposition to the senior lien creditors. The court dismissed the senior lien creditors' claims, holding that (1) the equity interests of the reorganised company distributed to second lien noteholders did not constitute "'proceeds' of common collateral", and (2) the second lien noteholders' intervention in the make-whole dispute and supporting the debtors' "cramdown" plan did not violate the intercreditor agreement because the second lien noteholders were acting in their capacity as unsecured creditors; simply disputing the amount of the senior lien creditors' claims, not their entitlement to collateral.

Another example of a dispute over scope of collateral arose in *ResCap*,[v] in which a class of junior secured noteholders argued that they were oversecured and, thus, entitled to post-petition interest and fees.[vi] The *ResCap* court held, in relevant part, that intangible assets and goodwill generated in the sale of assets during the bankruptcy proceeding were not identifiable proceeds of collateral and were not subject to the liens of the junior noteholders. The basis for this holding was that the Bankruptcy Code limits secured creditors' interest in property of the estate acquired after the commencement of the bankruptcy proceeding to "proceeds, products, offspring or profits" of pre-petition collateral arising after the petition date. The *ResCap* court found that in order to be entitled to the value of post-petition goodwill, the junior noteholders were required to show that the goodwill was exclusively the product of their pre-petition collateral, and that they failed to meet that burden.

For senior secured creditors in multiple-lien capital structures, the exclusion of post-petition sale proceeds and goodwill from their collateral has a double effect. It simultaneously expands the pool of assets available to unsecured creditors – increasing their recovery at the expense of secured creditors – and reduces the scope of "collateral" subject to the limitations of the intercreditor arrangement, permitting junior lien creditors to claim *pari passu* treatment, exercise remedies and challenge the senior secured creditors' positions with respect to such assets.

The ABI Commission Report

In 2011, the American Bankruptcy Institute organised a Commission to Study the Reform of Chapter 11 of the U.S. Bankruptcy Code (the Chapter under which a typical corporate insolvency takes place) in light of the considerable changes in financial markets, capital structures and participants since the last revision of the Bankruptcy Code in 1978. The report, which addresses certain of the topics raised by the *Momentive* and *ResCap* decisions, is likely to be considered by Congress and may result in changes to the Bankruptcy Code. However, whether or not the Commission's recommendations are ultimately adopted into law, the report will heavily influence the thinking of practitioners, judges, lenders and investors in Chapter 11 cases going forward.

In response to the *Momentive* decision, the report proposes that any take-back paper issued to a crammed-down class of creditors bear interest at a market rate. In addition, the report suggests imposing limitations on the ability of junior lien creditors to entirely waive their plan voting rights in Chapter 11 cases, but, importantly, does not propose to nullify specific limitations to voting rights, including the prohibition on voting for a plan opposed by the senior lien creditors. As such, under the ABI proposal, the senior lien creditors in *Momentive* would have been able to prevent the second lien creditors' intervention in their make-whole dispute with the debtor had the intercreditor agreement expressly prohibited second lien creditors from supporting any plan opposed by senior lien creditors.

In response to *ResCap*, the ABI report also sought to address senior secured creditors' rights to the value that accrues to collateral after commencement of the Chapter 11 process. The report focused on the ability of secured creditors to benefit from the preservation of a debtor's going concern value because of the protections Chapter 11 affords. From this perspective, the ABI report proposes that adequate protection should be determined based on the foreclosure

value of the collateral, measured by the net value that secured creditors would realise in a hypothetical, commercially reasonable foreclosure sale. Also, since the foreclosure value is the value that the ABI considers to require "adequate protection", the protection itself should also be calculated based on the foreclosure value. The report suggests that if the reorganisation value is sufficiently higher than the foreclosure value, this differential alone might constitute sufficient adequate protection. However, the report provides that when reorganisation value is realised in a Section 363 sale or a plan of reorganisation, the secured creditor should be entitled to that full going concern value.

Possible Intercreditor Drafting Responses

Momentive is an example of the attention that must be paid to the drafting of specific provisions in intercreditor agreements. Had the intercreditor agreement barred junior lien holders from supporting a plan of reorganisation opposed by the senior lien holders, the restriction might have been enforceable. This would likely be true even if the ABI report's recommendations were implemented. Similarly, the *Momentive* intercreditor agreement could have been drafted to require the second lien creditors to turn over all distributions received (instead of only proceeds of collateral), including of the equity interest of the reorganised business until the senior lien creditors were paid in full – of course, this could be said to reflect a fundamental business change in the nature of lien priority. Another possibility would be to clarify that sale of assets that derived their value from collateral (which, for example, could be stipulated to include the equity of the reorganised business) should be included in the determination of priority payment.

Another clarification – to attempt to deal with the cram-down of the Momentive senior lien creditors – would be provisions clarifying that payment of the senior lien creditors with below-market take-back paper or other non-cash assets do not result in the senior creditors being "paid in full as a matter of law". Of course, whether or not a bankruptcy judge would determine that the court was bound by such a provision is not clear. Even so, this sort of additional provision could provide the senior lien creditor a better position in seeking to enforce its creditor rights through an ordinary contract action in non-bankruptcy court.

As noted above, though it involved a dispute between secured and unsecured creditors, *ResCap* too has implications for intercreditor agreements, since it provides a second lien creditor with arguments to limit a first lien creditor's claims to asset value generated post-petition. Given the ABI report's suggested treatment of the foreclosure value and the reorganisation value of the collateral, first lien creditors may begin to include specific language in intercreditor agreements that the "common collateral", subject to the waterfall, turnover and limitations on remedies provisions of such agreements, includes the reorganisation value of the debtor.

Many of these provisions are easier for a lawyer representing a senior lien creditor to write than they are to implement a financing transaction. For example, limiting junior lien creditors from supporting a plan opposed by senior lien creditors and requiring junior lien creditors to "turn over" all distributions until the senior lien creditors are paid in full (whether or not such distributions are proceeds of collateral), will be strongly resisted by the junior lien creditors as it puts those secured creditors at a disadvantage to unsecured creditors. As noted above, a broad "turn-over" requirement may amount to payment subordination resulting in more limited – or even no – recovery for second lien creditors.

More generally, secured creditors have long understood and assimilated the rights of unsecured creditors into their credit analysis and pricing of any secured financing. In contrast, as highlighted by the recent decisions discussed above, the market has not yet settled on an appropriate balance for the rights of senior and junior secured creditors. This may be due, in part, to the implicit tension of whether the junior lien creditors are holding a claim that is purely derivative of and secondary to the senior lien creditors, silently accepting whatever remains after senior lien creditors are paid in full. Or, whether junior lien debt is an independent tranche, distinct from both senior secured and unsecured obligations, with both a (residual) entitlement to proceeds of collateral as well as a (limited) right to act independently of, and in opposition to, the senior lien creditors in protection of their interests in collateral.

Junior lien creditors have, in practice, been loath to give up rights they would have had were they unsecured. And the trend in intercreditor dynamics has, perhaps accordingly, been toward incremental expansion of junior lien holders' rights. Whether this expansion was evident to senior lien holders prior to the *Momentive* decision, or whether they now begin to insist on senior-lien friendly revisions to "market-standard" intercreditor terms, is not yet clear. More and clearer language expanding the scope of collateral to include post-petition goodwill and the equity interests in the reorganised debtor, to the extent the equity value reflects in part the value of "Collateral" indirectly disposed of, might have helped the senior lien creditor in each of the *Momentive* and *ResCap* cases, but the inherent contradictions in junior lien debt do not have easy drafting solutions. Given the extremely high demand in first lien term loan B markets for the past several years, the negotiation of intercreditor agreements has often been limited to second lien creditor's pushing for an expansion of their rights, with little or no focus from first lien holders. It appears likely – and we are beginning to see some evidence – that first lien holders are beginning to take a more active role in attempting to arrest, and in some cases reverse, that expansion.

As financing conditions evolve and, especially, as corporate restructurings and insolvencies increase from their historically low levels, the many variations of intercreditor agreement in the U.S. market will no doubt see further tests, and lead to further interesting twists in implementation and interpretation.

Transatlantic Intercreditor Arrangements; Recent Efforts to Reconcile European and U.S. Approaches

One of the key trends of the last few years is the increasing number of acquisitions of European businesses, with little or no presence in the U.S., that are financed with debt raised in the U.S. markets under New York law governed finance documentation. The significant differences in European and U.S. insolvency regimes and in laws relating to the creation and enforcement of collateral give rise to interesting points of comparison and contrast.

In Europe, senior secured creditors (for a number of reasons) prefer a controlled out-of-court restructuring or enforcement to a formal insolvency process. Traditionally this is achieved by structuring the transaction so that there is a single enforcement point at the top of the corporate group at which senior lenders can enforce their security interest in the shares of the top level corporate entity and sell the group as a whole free and clear of any material debt, guarantee or security claims in the disposed group prior to the occurrence of a formal insolvency process, with the proceeds of such sale being applied pursuant to a waterfall agreed among all significant providers of debt. If structured correctly (from the senior secured creditors' perspective), junior creditors should not have any "hold-out" value by virtue of surviving claims in the disposed

group. Maintenance by the senior secured creditors of control over the capital structure of the group, any claims into the group and the enforcement process itself is key to maximising the recoveries of senior secured creditors.

A detailed comparison of the differing intercreditor practices is beyond the scope of this article, but to achieve the objectives stated above, the European collateral intercreditor agreement has given the senior-most secured creditors a great deal of contractual rights against not only the junior secured creditors but significant unsecured creditors as well. A creditor accustomed to a U.S. collateral intercreditor agreement looking at a European agreement might be surprised to find that the first lien creditor has the benefit of full payment subordination, a more comprehensive standstill and payment block, and a right to have junior secured and most unsecured debt claims released upon an agreed form of "distressed disposal". A U.S. creditor will rely on the Bankruptcy Code for some of these outcomes (discharge and satisfaction of junior creditors upon confirmation of an approved plan, for example); and simply will not expect some others (e.g., full payment subordination even after application of collateral proceeds).

If *Momentive* and *ResCap* represented outcomes under U.S. intercreditor agreements that might have been surprising to senior secured creditors in the U.S., in the European market, practice has evolved in a way that anticipates and prevents such outcomes. Though the concepts of payment subordination and other abrogation of fundamental creditor rights are unattractive to U.S. second lien creditors as discussed above, they equate roughly to a position that European mezzanine or junior creditors have largely accepted. But with the emergence of the market for transatlantic deals, even the fairly settled European practice may be reopened for debate and modification. At present, practice varies significantly and is driven by a number of factors including (i) the likelihood of a U.S. bankruptcy filing in respect of the group (which is of course hard to quantify at the outset of a transaction since the jurisdiction of the borrower and "centre of gravity" of the group's total assets are relevant but not necessarily determinative), (ii) the perceived effect on syndication of the approach to intercreditor arrangements including for follow-on financings, not only for first and second lien financings but also for senior unsecured bonds, (iii) the increased influence of U.S.-based financial sponsors and their market expectations, and (iv) the borrower's appetite for complex cross-border intercreditor negotiations often in the context of a compressed timetable. Some deals therefore proceed without a nod to European considerations, whilst others adopt full European intercreditor provisions with barely a nod to the U.S.

The treatment of material unsecured debt is of course a key deciding factor in what rights junior lien creditors will insist upon. Unsecured creditors are not normally party to intercreditor arrangements in the U.S. or in Europe; but in Europe this is because a group's ability, pursuant to the terms of the relevant facilities agreements, to incur material unsecured debt is typically more limited than in the U.S. Where material unsecured debt is permitted, it would be challenging to convince second lien creditors to agree to payment subordination unless there is a requirement that material additional unsecured debt must either be (i) structurally subordinated through issuance at a holding company level (i.e. above the single point of enforcement), or (ii) subject to the intercreditor agreement and the agreement to accept, among other things, discharge upon a qualifying out-of-court enforcement. Of course borrowers and their financial sponsors have a stake in this debate and would be concerned about losing flexibility to incur unsecured debt and paying higher interest rates for second lien debt that is also subordinated in right of payment. Those factors will thus also drive the direction of resolution.

What is clear is that there is still significant variation in the detail of transatlantic intercreditor arrangements. Transatlantic financing deals that have broadly similar capital structures may have fundamentally different intercreditor arrangements, which may result in very different outcomes in an enforcement scenario for similarly situated creditors – just as in the U.S., subtle differences in the scope of the collateral or the turnover provisions may also lead to very different outcomes. While there is not yet agreement on the "right" approach to resolving these challenging intercreditor issues, movement toward a more consistent approach would advance the cause of predictability for the benefit of all stakeholders.

Endnotes

i. Another factor that may affect intercreditor dynamics in any bankruptcy proceeding is the increasingly broad exclusion of categories of assets from collateral in many large-cap, primarily equity sponsor transactions. These exclusions will have consequences not only for the relative positions of secured and unsecured creditors, but also for the interplay among secured creditors, if their relative rights are defined (as they frequently are) by reference solely to the collateral.

ii. *In re* MPM Silicones, LLC, No. 14-22503, 2014 WL 4436335 (Bankr. S.D.N.Y. 2014).

iii. "1.5 lien notes" is a colloquial term used to describe notes with second-priority liens where there are additional secured creditors with further subordinated liens.

iv. *In re* MPM Silicones, LLC, 518 B.R. 740 (Bankr. S.D.N.Y. 2014).

v. *In re* Residential Capital, LLC, 501 B.R. 549 (Bankr. S.D.N.Y. 2013).

vi. While the specific dispute in *ResCap* was between secured and unsecured creditors, the court's holding as to the scope of the collateral may have implications for similar disputes among lien holders.

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