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An Update on Second-Lien Financings and Intercreditor Agreements: Part II

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In previous articles[1] and the handbook,[2] we examined various provisions found in most versions of an intercreditor agreement used in second-lien financings, as well as most of the case law that has developed around the enforcement of intercreditor or subordination agreements in bankruptcy proceedings over the past five years. In Part I,[3] we examined four additional bankruptcy court decisions, handed down in late 2009 and 2010, that advanced one's understanding of how bankruptcy courts are likely to deal with the issues that intercreditor or subordination agreements present in the chapter 11 context. In Part II, we now look at an additional intercreditor decision from late 2010, some concerns raised by the *Lehman* decision on the rights of a derivative counterparty and the concept of "collective action," which has been used in several cases to overcome disagreements between two groups of creditors within the same level of priority and, therefore, without the benefit of an intercreditor agreement to guide the result.

Second-Lien Holders, § 363 Sales: Boston Generating


Mark N. Berman

In *In re Boston Generating*,[4] Judge **Shelly Chapman** entered an order upholding the right of the second-lien lenders to object to bidding procedures proposed for a § 363 sale despite language in the intercreditor agreement providing first-lien lenders with the "exclusive right to...make determinations regarding the...sale" of collateral. The court ruled that the language was not specific enough to extend to objections to bidding procedures for the sale. Judge Chapman cited *Ion Media* and *Erickson*,[5] where both bankruptcy courts refused to permit a second-lien lender to pursue a remedy in bankruptcy court, but distinguished each case. *Ion Media* was distinguished because the relevant intercreditor agreement contained specific language prohibiting the second-lien lender from objecting to a plan confirmation and the second-lien lender was viewed by the court as being both obstructionist and considerably out of the money. The *Erickson* case was distinguished because, even though the language of the intercreditor agreement was not specific in restricting the second-lien lender from requesting the appointment of an examiner, the lender was viewed as being obstructionist and out of the money. Overall, while Judge Chapman allowed the objection, she made it clear that she thought that clear provisions in intercreditor agreements should be enforced.

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Feature

Moreover, in a subsequent *Boston Generating* decision,[6] Judge Chapman allowed the second-lien lenders standing to object to the sale itself (which had the consent of the first-lien lenders). Specifically, the court stated:

> After extensive briefing and oral argument as well as 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. Here, the perfect storm of a poorly drafted agreement, the ill-defined scope of section 3.1(g)'s retained right to object as an unsecured creditor, and the

1 *See* Jo Ann J. Brighton and Mark N. Berman, "Second-Lien Financings: Enforcement of Intercreditor Agreements in Bankruptcy," Parts 1-6, *Am. Bankr. Inst. J.*, Vol. XXV, No. 1, 2, 4-6 (February, March, April, June and July/August 2006).

2 Berman and Brighton, *Handbook on Second Lien Loans and Intercreditor Agreements* (ABI, 2009).

3 Berman and Brighton, "An Update on Second-Lien Financings and Intercreditor Agreements: Part I," XXIX *Am. Bankr. Inst. J.* 10; 40-41, 95-96; December/January 2011.

4 *In re Boston Generating LLC*, No. 10-14419 (SCC) (Bankr. S.D.N.Y. Oct. 12, 2010).

5 *In re Ion Media Networks Inc.*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009); *In re Erickson Retirement Communities*, 425 B.R. 309 (Bankr. N.D. Tex. 2010).

6 *In re Boston Generating LLC*, 440 B.R. 302, 320, (Bankr. S.D.N.Y. 2010).

fact that, pursuant to the Secured Parties' own stipulation, there is "no exercise of remedies" leads me to conclude that the Second-Lien Agent and Second-Lien Lenders have standing to object to the 363 sale.

The case provides a good reminder of the need for clear drafting of specific provisions in intercreditor agreements. Simply stated, the more specific that the intercreditor agreement is in listing a restriction on a second-lien lender's rights in bankruptcy, the more likely that restriction will be upheld. It is a great advertisement for getting bankruptcy attorneys involved in the drafting of these agreements.

Lehman Brothers Holdings[7]

It is almost impossible to let an update pass without at least mentioning something from Lehman. While the derivatives litigation that abounds in the Lehman cases do not involve second-lien financings and traditional intercreditor agreement disputes, some of the reasoning applied in the bankruptcy court's decisions may have implications for how bankruptcy courts might decide similar issues if presented in a second-lien-financing context.

Lehman Brothers Special Financing Inc. (LBSF) and a single purpose vehicle (SPV) holding collateralized debt obligations entered into a swap agreement. Obligations owed by the SPV to LBSF were secured by the assets of the SPV, which were held in trust by Bank of New York (BNY) as trustee. Regular swap payments due to LBSF by the SPV were, according to the swap agreement and trust, entitled to a priority of payment over payments due to the SPV's noteholders. However, in the event of a default, which included the filing of LBSF's bankruptcy as well as the bankruptcy filing by its parent, Lehman Brothers Holdings Inc. (LBHI), the payments due to noteholders took priority over payments due to LBSF (the so-called "flip provision"). The swap agreement was governed by the laws of England.

Noteholders sued BNY as trustee and LBSF in the English court system, seeking a declaratory judgment that the flip provision was enforceable under English law. During the pendency of the English litigation, LBSF commenced an adversary proceeding in bankruptcy court, seeking a determination that (1) the flip provision was an *ipso facto* clause made unenforceable against it by §§ 365(e)(1) and 541(c)(1)(B) of the Bankruptcy Code and (2) any action to enforce the flip provision would be a violation of the automatic stay.[8] The English courts, in the meantime, had determined that the flip provision was enforceable under English law. However, looking at the unique provisions of the Bankruptcy Code, the court reached three critical decisions.

Going forward, to create more predictability as to result, first-lien lenders would be best served by being as specific as possible in listing in the intercreditor agreement the specific bankruptcy rights to be silenced rather than relying on general language.

First, following the familiar *Countryman* definition of "executory," it found that because the parties to the swap agreement still owed each other enough performance such that a failure by either party to perform would lead to a material breach excusing the nonbreaching party from continued performance, the swap agreement was an executory contract.[9] Second, it held that the flip provision was an *ipso facto* clause that was rendered unenforceable by both §§ 365(e)(1) and 541(c)(1)(B).[10] Third, it concluded that even though the flip provision might be enforceable under applicable nonbankruptcy law (*i.e.*, English law), enforcement of the flip provision against LBSF would violate the automatic stay.[11] The court reasoned that any act to enforce the priority flip would "violate the automatic stay because it would deprive LBSF and its creditors of a valuable property interest." As a postscript, on Sept. 20, 2010, the U.S. District Court for the Southern District of New York granted BNY's request to appeal Judge **James Peck**'s decision on the flip provision. However, the matter has since been settled among the parties, so there will be no further appeals in the U.S. or England.

Lehman is not a dispute between lenders in the context of an intercreditor agreement. However, because the bankruptcy court concluded that provisions in agreements triggered by a bankruptcy filing, even a bankruptcy filing by a non-party to the agreement, are unenforceable *ipso facto* clauses, the reasoning must be considered in the context of intercreditor agreements. Bankruptcy provisions in intercreditor agreements, applicable only when a bankruptcy filing occurs and therefore having the *ipso facto* taint, might suffer a similar fate if they implicate rights possessed by the debtor.

Collective Action

Most credit agreements and their related loan documents contain provisions authorizing the lenders' agent, with majority lender consent (determined by value), to take certain actions or refrain from taking certain actions on behalf of the syndicate of lenders. Such actions might include consenting to the debtor's sale of collateral, credit-bidding when the collateral is sold at auction, enforcing or forbearing from enforcing remedies, or foreclosing on the collateral. There now exists a significant string of cases where bankruptcy courts have focused on the provisions of the credit agreement or collateral-security agreement to bind recalcitrant minority lenders to the will of the majority lenders and/or the agent.

As seen in *Erikson Retirement*, a bankruptcy court may decide not to appoint an examiner at the request of a single second-lien lender who contractually gave to the lending syndicate's agent the right to pursue remedies on behalf of the lender syndicate, notwithstanding that the requirements for mandatory examiner appointment under § 1104(c) were otherwise met. Other examples include consenting to a § 363 sale with a distribution of consideration to subordinate creditors and providing a credit-bid when collateral was sold.[12] These cases severely limit the ability of a minority lender in a lending syndicate

7 *Lehman Bros. Special Financing Inc. v. BNY Corporate Trustee Services Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407, 416 (Bankr. S.D.N.Y. Jan. 25, 2010).

8 *Id.*

9 *Id.* at 415.

10 There were several significant steps taken by the bankruptcy court to reach this conclusion. The flip provision existed in both the swap agreement and trust agreement, but the debtor was only a party to the swap agreement, and therefore, the court effectively found unenforceable as an *ipso facto* clause a provision in an agreement to which the debtor before it was not a party. Second, the flip provision was triggered by the LBHI filing that occurred before the LBSF filing so that by the time the swap counterparty filed its bankruptcy case, the flip had already occurred and the debtor's rights to payment were subordinated to the rights of noteholders. Third, the court found that the debtor's right to payment in priority to noteholders, even though it did not exist when the case was filed, was a property interest protected by the automatic stay.

11 *Id.* at 420.

to object to action in a bankruptcy court that has the support of a majority of syndicate lenders and the agent.

The language in the credit agreements and their related loan documents is often quite broad, suggesting that a court wanting to side with the minority syndicate lender might use the same approach as *Boston Generating* to uphold the objection because the language was not specific in prohibiting the objection. Conversely, a court wanting to overcome the objection and permit a § 363 sale to proceed, as took place in *Chrysler* and *General Motors*, will seize on the general language to reign in the arguments advanced by a minority of lenders.

Conclusion

As anticipated, the current economy has resulted in more instances where bankruptcy courts have been forced to consider the impact of intercreditor agreement provisions in chapter 11 cases. While the general trend appears to be in favor of enforcement at some level, every case will be reviewed on a case-by-case basis and be somewhat dependent on the facts. Unfortunately, at the present time, too many of the cases are in conflict and, as a result, a single rule is impossible to discern.[13] Going forward, to create more predictability as to result, first-lien lenders would be best served by being as specific as possible in listing in the intercreditor agreement the specific bankruptcy rights to be silenced rather than relying on general language. Conversely, second-lien lenders would appear to be advantaged by: (1) using more general language; (2) being in a position to prove to the court that the value of the assets is sufficient to entitle them (or as in *Boston Generating* nearly entitle them) to some distribution; and (3) avoiding the label of being obstructionist to the reorganization process. ■

Editor's Note: *The book is available for purchase at bookstore.abi.org (ABI members must log in first to obtain the member price).*

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[12] *See, e.g., In re GWLS Holdings Inc.*, 2009 WL 453110, Case No. 08-12430 (Bankr. D. Del. Feb. 23, 2009); *In re Metaldyne Corp.*, 409 B.R. 671 (Bankr. S.D.N.Y. 2009), *aff'd*, 421 B.R. 620 (S.D. N.Y. 2009); *In re Chrysler LLC*, 405 B.R. 84, (Bankr. S.D.N.Y. 2009), *leave to appeal granted*, 2009 WL 1532960 (2d Cir. 2009), *aff'd*, 576 F.3d 108 (2d Cir. 2009), *cert. dismissed*, 130 S.Ct. 41, (2009), and *cert. granted*, judgment vacated, 130 S.Ct. 1015 (2009), and *judgment vacated*, 592 F.3d 370 (2d Cir. 2010), and *appeal dismissed*, 592 F.3d 370 (2d Cir. 2010); *In re General Motors Corp.*, 407 B.R. 463, 496, (Bankr. S.D.N.Y. 2009), *cert. denied*, 409 B.R. 24, 51, and *aff'd*, 430 B.R. 65 (S.D.N.Y. 2010); *In re Delphi Corp.*, 2009 WL 2482146 (Bankr. S.D.N.Y. July 30, 2009) (Drain, J.); *Bank of Am., Nat'l Assoc. v. 203 N. LaSalle St. P'ship (In re 203 N. LaSalle St. Ltd.)*, 246 B.R. 325 (Bankr. N.D. Ill. 2000) (Wedoff, Jr.); *see also Beal Sav. Bank v. Sommer*, 8 N.Y.3d 318 (N.Y. 2007) (Kaye, C.J.) (holding that under New York law, credit agreement authorizing agent to assert all collection remedies precluded dissenting lender from seeking collection where agent, at request of required majority, granted forbearance); *see also* Marc Abrams and Rachel Strickland, "Lender 'Collective Action' Doctrine Provokes Controversy: A Consensual Solution for the Greater Good," *N.Y. L.J.*, Dec. 14, 2009 (describing positive aspects of collective action as providing (1) ease of administration, (2) fairness and (3) predictability). *See* Gonzalez, Drain, Peck, Abrams and Bernstein, "Bankruptcy Court Jurisdiction over Intercreditor Issues and Subordinate Financing Agreements," *ABI Views from the Bench*, Oct. 1, 2010, p. 38-39.

[13] At an earlier date, we considered there to be a general trend in favor of the enforceability of intercreditor agreement provisions in bankruptcy cases. *Boston Generating* has forced a reconsideration of that conclusion.