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Bankruptcy considerations for second lien loans

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As reported in the January issue of *Financier Worldwide*, second lien financing is the fastest growing sector of debt structure within the United States. Yet because this boom is so recent, second lienholder markets have yet to confront how their second liens will be affected in a bankruptcy of the borrower. In determining the ultimate treatment of second liens in bankruptcy, several factors are determinative. The first and most significant is the terms of any prepetition intercreditor agreement between the first and second lienholder. Other important factors are the value of the jointly held collateral, the debtor's ability to effectuate a cram down in a Chapter 11 proceeding, and the debtor's ability to "strip away" the first and/or second lien. Understanding the nuanced interaction between these various factors is critical to a complete evaluation of a junior lender's portfolio.

Intercreditor agreements

Intercreditor subordination agreements are enforceable in bankruptcy and thus, directly affect a junior lienholder's rights in a bankruptcy of the borrower. Typically, senior lenders demand as much control as possible and seek to limit a junior lender's rights, remedies and freedom of action upon default, especially in a bankruptcy context. Senior lenders will often demand that a junior lender not only waive its right to participate in a bankruptcy proceeding (except for the filing of a proof of claim), but also authorise the senior lender to act on its behalf. Indeed, intercreditor agreements often empower a senior lender to vote a junior lender's claim in connection with a Chapter 11 plan or the appointment of a trustee. Some clauses even go so far as to pre-authorise the senior lender to enter into a post-petition financing agreement that is secured by liens with priority over those of the junior lender.

By obtaining control of the bankruptcy process through an intercreditor agreement, a senior lender can effectively "sell out" the junior lender for its own benefit. This can be accomplished through the negotiation of a Chapter 11 plan that is favourable to the senior lender (which, for example, fixes a beneficial collateral value or payment stream) or through a debtor-in-possession financing facility that grants superior lien interests to the senior lenders (effectively wiping out any equity in the junior lender's collateral).

The interests of senior and junior lienholders usually conflict on two principle issues: the valuation of collateral and the right to negotiate Chapter 11 plan provisions. However, there are instances where the interests of the senior and junior lienholders are harmonious and, in those instances, the junior lienholder should be entitled to act.

The following is a summary of some key bankruptcy concepts and rules that govern the rights of secured creditors generally, and which have important implications for second lien lenders. When reading the following, it is important to consider the implications of these provisions in the context of a typical intercreditor agreement that precludes a junior lender from participating in the bankruptcy process.

Valuation issues

Valuation of collateral is necessary in connection with a number of critical issues in bankruptcy. These include:

- requests for relief from automatic stay,
- adequate protection issues,
- Chapter 11 cram downs; and
- whether a secured creditor is entitled to post-petition interest and charges.

Understanding the purposes for, and methods of, valuation in the bankruptcy context is necessary for all secured creditors, and particularly holders of second liens, to understand their potential exposure.

Under the Bankruptcy Code, a claim is a secured claim only to the extent of the "value" of the collateral and is an unsecured claim for the remainder. As a result, a junior lender's secured claim will be reduced or eliminated by the establishment of a collateral value that is less than the aggregate of all senior and junior debt.

Since the Bankruptcy Code does not dictate the precise valuation method to be utilised by the courts, several different valuation methods have been adopted. These include: (i) replacement value; (ii) liquidation value; (iii) going concern value; or (iv) some other value (e.g., an intermediate value, book value, or depreciation value). Going concern and replacement values are often used in reorganisation cases while liquidation value is often used in bankruptcy liquidations. While valuation for one purpose does not preclude a creditor from arguing a different value for another purpose, judges may resist changing their initial valuations. Thus, the inability of a second lienholder to participate at the inception of valuation proceedings can have a dramatic effect on its position for the remainder of the case.

Relief from the automatic stay

Immediately upon the filing of a bankruptcy petition, a creditor is prohibited from taking any action to collect a debt or recover property of the debtor. The scope of the stay is broad and includes most collection activities. A secured creditor may seek relief from the automatic stay if, among other things, the debtor lacks equity in the collateral. The secured creditor, as the party seeking relief, has the burden of proving that the debtor lacks equity in the property at issue. In determining valuation for purposes of stay relief, no one particular valuation method is used. Rather, courts will consider the specific facts and circumstances of the case, such as the nature of the debtor's business, market conditions, the debtor's prospects for rehabilitation, and the type of collateral.

For purposes of determining whether a debtor lacks equity in collateral, the vast majority of courts will consider the difference between the current value of the collateral and the total of all liens on the collateral, including senior and junior liens. However, a small minority of bankruptcy courts have excluded junior lienholders' claims from the equity calculation if the interests of junior lienholders differ from those of the senior lenders.

Adequate protection and cash collateral issues

The Bankruptcy Code provides that a secured creditor is entitled to adequate protection against any diminution in value of its collateral that is being used, sold or leased by the debtor. Under the Code, an oversecured creditor is entitled to a claim for post-petition interest as well as reasonable fees, costs and charges as provided for under the loan agreement. Unless there is sufficient value in the collateral to pay both senior and junior liens, any interest paid on the senior lender's debt will directly decrease the junior lender's equity.

It is in the junior lienholder's best interest to establish as large an equity cushion or collateral value as possible to preserve its position. This is an example of the type of situation that is often not adverse to a senior lender and under which a junior lender might be able to negotiate participation rights in the borrower's bankruptcy.

Cramdown in Chapter 11

Section 1129(b) of the Bankruptcy Code, often referred to as "cram down," provides a means by which a debtor can seek confirmation of a plan over the objection of a secured creditor. Under section 1129(b)(2)(A)(i), the debtor must first establish a lien value for the collateral. The US Supreme Court has held that replacement cost to the debtor is the proper valuation method under this section of the Bankruptcy Code. The Court gave the bankruptcy court, as the trier of fact, discretion to determine the best way to ascertain replacement value.

In that regard, the debtor may seek to establish a low collateral value that wipes out the junior lienholder's security interest and relegates its claim to unsecured status. This is another example of a situation where the interests of the senior and junior lienholders to establish a high value should be harmonious, except that the junior lienholder has more reason to fight for a higher value.

Section 1111(b) election

Section 1111(b) of the Bankruptcy Code provides secured creditors with special rights regarding the treatment of their claims. Unless the collateral is sold in the bankruptcy or pursuant to a Chapter 11 plan, a secured creditor is entitled to an unsecured deficiency claim regardless of whether the creditor had recourse on its claim.

Section 1111(b)(2) provides special rights to undersecured creditors and is thus significant to junior lenders who are more likely to be undersecured. Under this section, if a creditor is undersecured, then it may elect to have its claim treated as an allowed secured claim to the full extent of the claim if the secured creditor can comply with the other terms of this section.

Typically, an undersecured creditor would want to make a section 1111(b)(2) election if it is unhappy with the treatment being offered to unsecured creditors, or if it believes that the collateral is undervalued or likely to be sold at a later date. On the other hand, if an undersecured creditor believes that its unsecured deficiency claim will govern the vote of the class of unsecured creditors and it wishes to defeat the debtor's plan, then it should not make the section 1111(b)(2) election.

Conclusion

The fees and interest rate charged by a second lienholder must take into account the risk of bankruptcy of the borrower, and the voluntary surrender of valuable participation rights to a senior lender under an intercreditor agreement. Moreover, since the interests of the senior and junior lender are not always adverse, it may be possible for a junior lender to negotiate participation rights in bankruptcy where such interests are not adverse. ■