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. 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.

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. 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.

‘Boston Generating’

*In re Boston Generating, LLC* 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.* and *In re Erickson Ret. Cmty.*, 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 from objecting in either instance. Nonetheless, the bankruptcy court overruled the first lienholders on both points.

First Lien Lenders Beware: Drafting Points to Consider

ALAN M. CHRISTENFELD is senior counsel at Clifford Chance US. BARBARA M. GOODSTEIN is a partner at Dewey & LeBoeuf. BENNETT G. YOUNG, a partner at Dewey & LeBoeuf, co-authored this article and BENJAMIN HEUER, an associate at Dewey & LeBoeuf, assisted in its preparation.
object to the sale.10 Second lienholders would have standing to
for another day the question of whether the
court was careful to observe that its finding was
in favor of the second lienholders, the court
in a typical intercreditor agreement second
agreement. It further observed that under
which are not expressly waived in the
lienholders nonetheless retain those rights
collateral. However, it noted that second
lien as an offensive weapon with respect to
driver's seat" when it comes to decisions
to ensure that first lienholders remain "in the
intercreditor agreements are generally drafted
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
debtors' 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(l) 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

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
debtors engaged in the manufacture and
distribution of textiles. Prior to bankruptcy,
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.19

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.

3. 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).
5. 5. Id. at 316.
8. 8. Transcript of Chap 11 Hearing Re Doc # 168 at 54, In re WestPoint Stevens Inc., No. 10-144419 (SJC) (the "Transcript").
9. 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. 10. The Transcript at 53.
12. 12. Id. at 317.
13. 13. Id. at 318.
15. 15. See the comment in note 9 above.
16. 16. Id. at 320.
17. 17. Contrarian Funds LLC v. Aretex LLC (In re WestPoint Stevens Inc.), 600 F.3d 231 (2d Cir. 2010).
18. 18. In re WestPoint Stevens Inc., 600 F.3d at 251.
19. 19. Id.
20. 20. Id. at 253.
21. 21. Id. at 255.
22. 22. Id. at 259-262.

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