

Credit Investment News 9/26/05 on *Second Lien Financings and the Intercreditor Agreement***What does the first lien holder want?**

First lien lenders want the Intercreditor Agreement to make the 2nd lien lenders as silent as possible after default

Assurance that they are first on all collateral and that the proceeds of collateral will be paid over to them until they are paid in full

Time after default to work things out with the borrower and during that period want no interference from the 2nd lien lenders

Need assurance that the second lien lenders will release their liens on the collateral

Outside of bankruptcy, assets cannot be sold without the consent of all parties who have liens on the assets

What do the second liens lenders want?

Ability to protect their second lien position from being jeopardized by actions first lien lenders might take

If 1st lien lenders get new collateral, 2nd lien lenders will want a subordinate lien on those new assets, too

Limitations on willingness to be silent in order to ensure the workout doesn't come at their expense

Second lien standstill period

Most agreements have a standstill period during which 2nd lien lenders "stand still" after an EOD for some fixed period of time

During this period, 2nd lien are restricted from exercising remedies against the borrower or against the collateral

Subject to negotiation at the time of the Intercreditor agreement, 180 days is standard (possibly extendible if progress being made)

Bankruptcy provisions

Valuation is a key determinative in a bankruptcy proceeding, as it determines whether a lien creditor has secured creditors' rights

Whether the 2nd lien is "over-secured" or "under-secured" is critical to 2nd lien recoveries

The negotiated provisions in the IC agreement can result in real value landing in the pockets of one lien creditor or another

DIP Financing

The first place adequate protection rights are likely to arise is in the context of DIP financing

Often provided to the debtor by the same lenders who provided senior debt financing prior to the filing

DIP lender will want to ensure that the borrower can maintain its going-concern value until a reorg or sale is realized

DIP likely secured by priming liens on all assets

Code requires that other lien holders be given consent rights, or alternatively, "adequate protection"

Therefore, 1st lien lenders' DIP arrangements with the debtor could be thwarted without the 2nd lien holders' cooperation/consent

So, most IC agreements include 2nd lien consent to any DIP financing provided or consented to by the 1st lien holder

Credit Investment News 9/26/05 on *Second Lien Financings and the Intercreditor Agreement***Adequate Protection and the Use of Cash Collateral**

Bankruptcy rights for the secured creditors include the right to be adequately protected if the debtor uses collateral, including cash, during the bankruptcy case

To the extent the collateral diminishes in value during the case, a secured creditor has the right to be protected from any decline in value

Adequate protection usually takes the form of replacement liens and cash payments

If AP cannot be provided, then the secured creditor can get relief from the automatic stay and proceed to foreclose on the collateral

If the right to foreclose has not been waived in advance, or curtailed significantly, the 1st lien lenders' rights to control the proceeding will be severely impaired

Sales of Collateral

Cooperation in the form of an agreement to release liens is not imperative because the bankruptcy judge has the power to order that property be sold free and clear of liens without the 2nd lien lenders' consent

The focus is getting the 2nd lien lender to agree in advance not to raise an objection to any sale that has the support of the 1st lien holder

POR and Voting

Most contentious negotiation in the IC negotiation is over the vote a 2nd lien holder will have on the POR

Bankruptcy plans are required to classify creditor claims

Generally, each secured creditor is placed in its own class

In addition to its own class for its secured claim, to the extent that a secured creditor is under-secured, its deficiency claim becomes part of the general unsecured class

Bankruptcy plans generally must be accepted by each class of impaired creditors, especially those more senior in right of payment

This means that ensuring the 2nd lien vote on the plan can greatly enhance the ability of the 1st lien lenders to effect a plan

Also greatly reduces the likelihood the 2nd lien holders present their own plan seeking to cramdown 1st lien lenders

There is an absolute lack of certainty as to whether the assignment of voting rights by a 2nd lien holder will be enforced in a bankruptcy case (little case law is inconsistent)

Option to Purchase First Lien Loan

One approach used by 2nd lien lenders to eliminate the provisions intended to limit their rights is the right to buy out the 1st lien lenders at par plus accrued interest

Syndicated Markets and the Herding Cats Problem

Lenders today often acquire pieces of both the 1st lien and 2nd lien debt

Increasingly concerned with the recovery of the combined holdings

Legal Bulletin "Recharacterization Battles Likely In Next Round Of Bankruptcies", October 2008

The ability of unsecured creditors to receive a meaningful distribution from estates with large 1st lien and 2nd lien secured debt may depend on the ability of the unsecured creditors to successfully recharacterize the claims of the 2nd lien holders

Under the present legal framework used by the courts, creditors must meet a high burden to demonstrate that nominally secured debt is in fact a disguised equity contribution

Courts will likely to have to liberalize the doctrine of recharacterization or shift the emphasis of the factors they consider in order to preserve the rights of unsecured creditors in the Chapter 11 process

It is important to distinguish recharacterization from equitable subordination

Both grounded in the Bankruptcy Courts' equitable authority to ensure "that substance will not give way to form, that technical considerations will not prevent substantial justice from being done."

Equitable subordination is apt when, due to creditors' misconduct, equity demands that the payment priority of claims of an otherwise legitimate creditor be changed to fall behind those of other claimants

Recharacterization does not require a showing of misconduct

Courts technically do not alter any party's substantive rights

When a court recharacterizes debt as equity, it merely acknowledges economic reality by treating as equity a capital contribution that was only nominally a "loan" from the outset

The focus of the recharacterization inquiry is whether a "debt" actually exists and what is the proper characterization in the first instance of the investment at issue

Recharacterization is more promising for unsecured creditors because it does not require demonstration of inequitable conduct

Courts have sought to enumerate a list of factors to aid in determining whether an obligation was really intended to be a debt or equity transaction

1. Names given to the instruments, if any, evidencing the indebtedness
2. Presence or absence of a fixed maturity date and schedule of payments
3. Presence or absence of a fixed rate of interest and interest payments
4. Source of repayments
5. Adequacy or inadequacy of capitalization
6. Identity of interest between the creditor and the shareholders
7. Security, if any, for the advances
8. Corporation's ability to obtain financing from outside lending institutions
9. Extent to which the advances were subordinated to the claims of outside creditors
10. Extent to which the advances were used to acquire capital assets
11. Presence or absence of a sinking fund to make repayments

The characterization of a capital contribution as debt or equity is a court's attempt to discern whether the parties called an instrument one thing when, in fact, they intended it as something else

Legal Bulletin "Recharacterization Battles Likely In Next Round Of Bankruptcies", October 2008

Intent may be inferred from what the parties say in their contracts and do through their actions and from the economic reality of the surrounding circumstances

An important factor that courts consider in construing the parties' intentions is whether the transaction bears the earmarks of an arms' length negotiation

The more an exchange appears to reflect the characteristics of an arms' length negotiation, the more likely it is that such a transaction is to be treated as debt

Business Bankruptcy Blog: The Credit Crisis and DIP Financing

A company that has already encumbered its assets with secured financing may have little or no assets to offer the DIP lender as collateral

Fewer companies in chapter 11 will be able to find new lenders to provide DIP financing, giving the DIP's existing lenders the advantage in negotiating DIP financing terms such as interest rates and fees

Alternative sources of DIP financing may be able to be found in certain circumstances

In some cases, the buyer in a S 363 asset sale may provide DIP financing to bridge to the closing of the sale

Business Bankruptcy Blog: The 2005 Bankruptcy Law Changes and Their Impact on Retail Reorganization

The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCA) has had an impact on retail reorganizations

The 2005 amendment to the code limiting the time within which a debtor may assume or reject commercial real estate leases to a total of 210 days (if a 90-day extension is granted)

This amendment along with other BAPCA provisions reducing a retailer's liquidity has had a devastating impact on a retailer's ability to reorganize

Retailers now enter the Chapter 11 arena with little choice but to narrow their strategy to ensure that their lenders are not deprived of the substantial benefits and protections conferred by S 363(b) of the Bankruptcy Code, which authorizes the use, sale or lease of estate property outside the ordinary course of business upon court approval

S 363(b) offers the unique ability to cleanse the assets of a distressed company by permitting debtors to convey assets "free and clear", thereby maximizing value by removing the uncertainty of such stigmas as successor liability, fraudulent transfer claims and lien issues that often accompany asset purchases

Constricted time frames and liquidity problems created by BAPCA have effectively eliminated the need for existing lenders to provide any more financing than necessary to position the debtor to liquidate its assets in the first few months of the case

BAPCA's constrictive liquidity provisions and the enormous leverage handed to secured lenders as a result thereof have eliminated the ability of retailers to control the Chapter 11 process as a "debtor-in-possession"

Rather, the process is not controlled almost exclusively by prepetition lenders, who have essentially assumed the position of "creditor-in-possession"

