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How Intercreditor Agreements Shape Bankruptcy Proceedings and Outcomes for Secured Creditors

By Kim Wynn, Christopher Combest and Jason Curry*

In this article, the authors follow a borrower through key events in its bankruptcy proceeding and look at the impact a detailed intercreditor agreement can have on the proceeding.

Junior and senior lenders work hard to negotiate intercreditor agreements. What difference does it make? Is it not enough to simply agree that the junior lender is in a junior position?

This article follows a borrower, referred to as Starcomp, through key events in Starcomp's bankruptcy proceeding and looks at the impact a detailed intercreditor agreement can have on the proceeding.

A few themes will emerge. The senior lender wants the intercreditor agreement to enable the senior lender, as holder of the first lien on the assets, to protect its rights without interference from the junior lender and wants the intercreditor agreement to limit the leverage the junior lender would have if it had the right to object to events in the proceeding. The junior lender wants to protect its rights and prevent its position from eroding.

BANKRUPTCY FILING AND THE AUTOMATIC STAY

The junior and senior lenders both have blanket liens on all of Starcomp's assets, including inventory and accounts receivable. Starcomp wants to prevent the junior and senior lenders from seizing assets while it restructures its balance sheet and continues to operate its business. By filing the bankruptcy proceeding, Starcomp can take advantage of the automatic stay that bars any action by a creditor against a debtor or its property. It arises automatically upon the filing of a bankruptcy proceeding, without the need for any court action.

Any creditor can seek the court's approval for relief from the automatic stay. As holder of the senior lien, the senior lender will want the right to manage the collateral, including that the senior lender will want to determine whether and how to seek relief from the automatic stay and foreclose on the assets. To prevent interference by the junior lender, the senior lender wants the intercreditor agreement to include a waiver of the junior lender's right to seek

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relief from the automatic stay and waiver of the junior lender's right to object to the senior lender's motion for relief from the automatic stay. If the senior lender seeks relief from the stay, the intercreditor agreement would likely permit the junior lender to seek relief as well and participate in the foreclosure proceeding.

USE OF CASH COLLATERAL

Starcomp will need to use cash generated from its business in order to operate during the bankruptcy. Since that cash is proceeds of accounts and inventory, the cash is subject to the junior and senior lenders' liens and is referred to in the bankruptcy as cash collateral. Under federal bankruptcy law, a debtor may not use cash collateral of its secured lenders unless (i) the secured lenders consent to such use, or (ii) the court authorizes the use of cash collateral, after determining that the secured lenders are adequately protected against deterioration in the value of their collateral packages that might result from the debtor's use of cash that is not later replenished from the debtor's operations during the bankruptcy case. Adequate protection may take various forms, including periodic cash payments by the debtor to the secured lenders, additional liens, additional collateral, or other protections. This means that the junior lender could object to the use of the cash collateral unless it receives adequate protection.

As the senior lienholder, the senior lender will want the power to consent to Starcomp's use of cash collateral, and an intercreditor agreement would usually provide that if the senior lender consents to the use of cash collateral, the junior lender may not require adequate protection for the junior lender in return for the use of cash collateral. This preserves the senior lender's senior position and limits junior lender's leverage to require concessions in return for permitting the cash collateral to be used. The document would usually permit the junior lender to also have junior liens on any replacement collateral, but would not allow the junior lender to share in any payments being made to the senior lender or receive priority liens.

In addition to the junior and senior lenders, other parties to the bankruptcy will have rights to participate in hearings regarding use of cash collateral, including unsecured creditors. The junior lender will want the intercreditor agreement to state that it retains all rights to participate in hearings and make objections as would be available to unsecured creditors of Starcomp.

DIP FINANCING

Starcomp will not generate sufficient cash during the bankruptcy to cover its operating and restructuring expenses; therefore, it wants the senior lender to provide financing during the proceeding, referred to as debtor-in-possession financing, or DIP financing. The senior lender will want the intercreditor agreement to contain the junior lender's agreement that the senior lender may extend DIP financing secured by the senior liens. This is common language in intercreditor agreements in order to preserve the senior lender's priority position with respect to advances made after the bankruptcy is filed. It also is common for the document to contain an overall cap on the amount of the senior lender's debt. This cap is an important point of the negotiations. If the senior lender is not able to extend sufficient DIP financing secured by senior liens without the junior lender's consent, then the senior lender will not be able to manage its debt and liens through the proceeding without junior lender's interference. This cap is important to the junior lender as well. The junior lender wants to limit the amount of debt secured by senior liens in order to maintain the value of its junior liens and increase the likelihood that the junior lender will be repaid.

In negotiating the cap on senior debt, the parties should consider the potential for future increases in the senior loan facilities and potential DIP financing. An intercreditor agreement will often allow the senior lender to increase its loans to 110 percent to 120 percent of the senior pre-bankruptcy debt level. Depending on the language in the agreement, this increase may be used for increases in the loan facilities prior to a bankruptcy case, such as for an acquisition or to fund the borrower's growth. Once a bankruptcy petition is filed, the senior lender will want enough remaining cushion so it can manage the situation and protect its position by providing DIP financing if it chooses to do so, while the junior lender will be concerned that additional senior debt will erode its position as more debt is secured by the senior liens.

The intercreditor agreement will usually limit the junior lender's ability to object to DIP financing as it affects the junior lender's secured position, but the junior lender will want to retain the right to make any arguments that would be available to an unsecured creditor as it relates to DIP Financing. Such as arguments may include (i) that the senior lender is proposing to acquire liens on unencumbered assets that should be available for the benefit of unsecured creditors, or (ii) that the proposed financing is too expensive or otherwise not in the best interests of the debtor or its creditor body as a whole.

The senior lender may be unwilling to make additional advances in the form of DIP Financing. It may not want to increase its exposure to Starcomp, or it may believe its position is safe without providing additional financing.

Typically, the intercreditor agreement would provide that the junior lender may step in to provide the DIP financing if the senior lender decides not to do so, and the agreement would be expected to also provide that the junior lender's DIP financing would be secured by its junior liens. Most often the junior lender would not want to take the risk of advancing additional subordinated loans to a bankrupt debtor, but it may be the case, for example, that the collateral does not have sufficient value to pay the junior loans if the collateral is liquidated. Starcomp may be able to reorganize its business and finances, emerge from bankruptcy, and pay the junior debt from future operations, or the parties may be able to arrange a sale of Starcomp as a going concern and receive additional proceeds that can pay the junior debt. The junior lender will want the right to provide DIP financing if it chooses to do so, and the senior lender will want assurance that its liens will continue to be senior as to any junior lender DIP financing.

PLAN OF REORGANIZATION

At its most basic level, a Chapter 11 plan of reorganization is a contract between the debtor and its creditors and equity holders that describes how those parties (and their respective claims and interests) will be treated in the bankruptcy case. Unlike most contracts, however, a plan: (i) must be approved by the bankruptcy court, and (ii) may bind a creditor, even without the creditor's consent.

Creditors are entitled to vote to accept or reject a plan. Ordinarily, plans are heavily negotiated between creditors and the debtor over a period of months or even years. By the time the plan is before the court for confirmation, it is likely full of precarious concessions among the stakeholders, whereby a single troublesome secured creditor may cause the plan to collapse. As with other aspects of the bankruptcy case, the senior lender wants to limit the junior lender's ability vote against an outcome that the senior lender supports.

As part of the senior lender's effort to protect its right as first lienholder to manage the collateral and the collection process, the senior lender would prefer language in the intercreditor agreement to the effect that the junior lender may not take a position contrary to that of the senior lender regarding a plan. The senior lender may also want the junior lender to assign its voting rights to the senior lender. The senior lender is in a tricky position, though, because bankruptcy courts are divided on whether waivers or assignments of plan voting rights are enforceable. Whether out of concern for enforceability of broad limits on the junior lender's voting rights or due to negotiations among the parties, the intercreditor agreement may allow the junior lender to retain its voting rights with protections for the senior lender, such as a waiver by junior lender of its right to propose or vote for a plan that the senior lender opposes, particularly if the plan does not pay the senior lender in full.

The plan will be created by Starcomp with input from the junior and senior lenders, but also from equity holders, unsecured creditors and others, with oversight and approval by the judge. The senior lender cannot by itself control the outcome of the plan process or all of the contents of the plan, and a plan might be approved that provides for the junior lender to receive payments that are contrary to the priorities in the intercreditor agreement. The senior lender will want the intercreditor agreement to state that the junior lender waives its right to receive or retain any property under the plan, except in strict compliance with the priorities in the intercreditor agreement.

SECTION 363 SALE

Rather than supporting a reorganization, the senior lender may want Starcomp to sell its assets to pay the senior lender in full. However, if Starcomp wants to sell property other than in the ordinary course of business, notice and a court hearing are required and the court must approve the sale. This type of sale is referred to as a Section 363 sale because it is authorized under Section 363 of the Bankruptcy Code. In a Section 363 sale, Starcomp may sell property free and clear of the liens of creditors under certain conditions. The property may be sold, with the lien attaching to the sale proceeds, if (i) the lien holder consents, or (ii) the purchase price is sufficient to pay the claim secured by the lien in full.

The senior lender may want a quick sale of all of Starcomp's assets so long as the price is sufficient to pay the senior lender an acceptable amount. The senior lender may not want to slow the sale down to ensure there are sufficient funds to pay the junior lender. Conversely, the junior lender may want to encourage an extended marketing process and expanded flexibility in the sale in a manner to ensure the highest possible price. In order to preserve its right to manage the sale of collateral as senior lienholder, the senior lender will want the intercreditor agreement to state that if the senior lender supports a sale, the junior lender must support it as well.

At any sale free and clear of liens, the holder of a lien may bid in the amount of its debt—referred to as a credit bid—unless the bankruptcy court, for cause, orders otherwise. In a credit bid, the creditor agrees to reduce the balance of its debt by the amount of its bid, rather than bringing cash to the table. For secured creditors, credit bidding is an essential protection against unreasonably low cash bids by third parties. Accordingly, the senior lender will want the junior lender to agree to that the senior lender has the right to credit bid.

Credit bidding is of particular concern to the parties to an intercreditor agreement because a credit bid permits one secured creditor to acquire collateral without any resulting cash proceeds to pay other creditors. For example, if the senior lender credit bids its entire claim and acquires all of the collateral in return for its claim, the junior lender is left without collateral even though the junior lender may think the collateral is worth more than the amount of the senior debt.

To prevent that outcome, the junior lender would have to outbid the senior lender if it believes the collateral is worth more than the senior lender's credit bid. To preserve its ability to be paid in cash, the senior lender will want the intercreditor agreement to include the junior lender's waiver of its right to credit bid at a Section 363 sale without the consent of senior lender unless the credit bid includes a hard cash component sufficient to pay the senior lender in full. Essentially, the junior lender's credit-bid would have to include the cash equivalent of a buy-out of the senior debt, with the junior lender taking ownership of the collateral.

As with other aspects of the bankruptcy case, the junior lender will want to retain the right to object to the Section 363 sale on any grounds available to an unsecured creditor, including:

- That the sale is not in the best interests of the creditor body as a whole;
- That the sale lacks a sound business purpose; or
- That the assets were insufficiently marketed.

CONCLUSION

An intercreditor agreement should address the automatic stay, cash collateral, DIP financing, Section 363 sales, and the plan confirmation process to preserve the parties' expectations in a proceeding and to reduce the likelihood of prolonged intercreditor disputes in a common debtor's bankruptcy. While addressing these complicated bankruptcy issues may make the negotiation process more tedious, failure to adequately address them can expose the junior and senior lenders to risk and be much more expensive and time consuming in the pressurized Chapter 11 context.

Given the prevalence of second lien financing in today's market, all lenders are well-advised to work with their counsel to address bankruptcy issues before signing an intercreditor agreement.