"CHANGING ROLES IN COMMERCIAL CASES: THE IMPACT OF HEDGE FUNDS ON THE RESTRUCTURING LANDSCAPE"

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I.

INTRODUCTION[1]

Recent years have seen the geometric growth of investments by well-heeled hedge funds in insolvency situations. The liquidity and sophistication that the hedge funds have brought to insolvency cases has dramatically changed the landscape of many larger bankruptcy cases. The dynamic among hedge funds, private equity funds, and traditional banks is just starting to play out at the bargaining table and in the courts.

One cannot discuss the explosion of hedge fund investments in insolvency scenarios without addressing the dramatic explosion of two forms of second lien financings commonly marketed in the U.S: (i) second lien term loans designed for sale in the institutional loan market; and (ii) second lien high yield offerings. According to Standard & Poor's ("S&P"), 172 second lien deals raised $16.298 billion in 2005 compared with 129 deals raising $12.012 billion in 2004 and 25 deals raising $3.076 billion in 2003. S&P 1Q06 Second Lien Lending Review (see chart attached as Exhibit 1).

This paper will explore the nature of these new hedge fund players, the nature of the explosion of second lien deals, and the new dynamics of many large insolvency cases.

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[1] These materials reflect the input of all the panelists, but does not necessarily reflect the views of their respective firms. The second lien portion of these materials are based in large part on materials which Mr. Gilhuly prepared with fellow panelists Ben H. Logan of O'Melveny & Myers LLP, David A. Hollander of Tennenbaum Capital Partners LLC and William Shpall of Credit Suisse First Boston for the 2005 ABI Bankruptcy Battleground West entitled *"The New Squeeze – Coming Second Lien Bankruptcy Issues").* The first section relies significantly on a paper prepared by panelist Steven Strom, Managing Director, Jefferies & Company, Inc., *Hedge Fund Power Plays in the Distressed Arena*, Turnaround Management Association, Journal of Corporate Renewal at 8 (December 2005) ("Strom").

II.

THE GROWTH AND UNIQUENESS OF HEDGE FUNDS

The significant involvement of hedge funds in chapter 11 cases is a relatively recent phenomena. With vast amounts of money at their disposal and finite opportunities for significant upside investments, hedge funds have been drawn to taking stakes in distressed companies they believe to be undervalued, either by capitalizing on successful turnarounds or by controlling or strongly influencing restructuring negotiations, with the intention of selling their investments on a short-term basis. The involvement of hedge funds brings both benefits and problems to chapter 11 cases. Due to the immense growth in the number and size of hedge funds, it is important to fully understand how they approach chapter 11 proceedings, and to evaluate the benefits and problems associated with their involvement.

With well over $1 trillion under their control, hedge funds wield a great deal of power and control over the financial markets.[2] Hedge funds are similar to other investment funds in that they have members who invest a certain minimum amount and then share the return on the total investment. They may invest in many of the same assets – high yield bonds, common stock, bank debt – as do mutual funds, insurance companies, and collateralized loan obligation bonds. That, however, is the extent of the similarities. Many hedge funds have minimum investments of well over $1 million per member and are designed to avoid regulation and oversight by the Securities and Exchange Commission.[3] Managers of hedge funds are paid a fee similar to those of mutual fund managers (generally one to two percent of asset values) but are also given a share (often twenty percent of the profits. Unlike other funds, hedge funds are not

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2 Strom at 8; David Skeel, *Behind the Hedge*, 2005-DEC Legal Aff. 28, 30 (November/December 2005) ("Skeel").

3 Skeel at 30-31.

required to make disclosures of their investments or strategies.[4] This operates to create an air of secrecy and fear around hedge funds.

In addition, hedge funds are not bound by the same limitations on investments as mutual funds.[5] They can pursue aggressive and high risk investment strategies that include selling short, and investing in derivatives and commodities. Hedge funds can also invest in unregistered securities and non-securities such as trade claims and can invest in distressed companies via debt or equity securities. In addition, they can provide debtor-in-possession (DIP) financing and reorganization plan exit financing in the form of debt or equity. These aggressive strategies have been successful as hedge funds have been able to obtain double and even triple digit returns on their investments. The enormous returns have sparked the interest of investors and as a result the number of hedge funds has increased from 300 in 1990 to over 8,000 in 2005.[6] The dollar value of assets under the control of hedge funds has doubled since 2001.[7]

In order to maintain these enormous returns, hedge fund managers have sought new and more aggressive investment opportunities. Managers have turned their eyes to distressed companies on the verge of Chapter 11 filings or ones that have recently filed such cases. Hedge funds generally look for companies they believe to be undervalued but will be profitable after restructuring.[8] Their objective is simply to make a profit from distressed situations.

A. Hedge Funds and Distressed Securities Trading: Loan-to-Own

There are two main avenues by which hedge funds invest in distressed companies: making or acquiring loans, and equity/securities purchases. These two avenues allow hedge

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4 *Id.*

5 *Id*

6 *Id.*

7 *Id.*

8 Dion Friedland, *Distressed Securities Investing*, available at http://www.magnum.com/About.aspx?RowID=38&GroupName=DionArticles, last accessed June 13, 2006.

funds to influence any restructuring that takes place, and to have potential ownership interests in the companies after restructuring.

1. Debt Investments

Debt investments give hedge funds more clout and priority than equity investments. Post-petition, hedge funds may offer secured DIP financing. Pre-bankruptcy, they may offer second-lien financings, or consolidate ("roll-up") multiple secured loans into a single credit facility, which positions the hedge fund to become the DIP lender and influence initial bankruptcy filing decisions such as where and when to file. Hedge funds also purchase unsecured debt in the form of bond, trade and note claims at significant discounts from creditors that are unwilling or unable to continue holding claims in financially troubled companies.

Before bankruptcy hedge funds may also engage in balance sheet arbitrage and pinch plays, selling short a distressed company's unsecured debt and buying long the secured facilities. When the secured facilities require covenant waivers, hedge funds may demand stringent terms. To the extent the absence of a waiver causes a distressed company to file for Chapter 11 relief, the unsecured notes may decline further in value, resulting in gain for the short position. Similarly, hedge funds can go long on bonds and short equity to take advantage of perceived balance sheet arbitrage.[9] Hedge fund actions in distressed situations may be driven by credit default swaps or other derivatives that provide payment if an issuer defaults before a certain date. Ownership of these instruments can provide an incentive to accelerate or defer a restructuring process.[10]

DIP financing generally gives hedge funds the most leverage over a debtor company's restructuring. DIP loans often prime existing secured loans, are collateralized by all or virtually

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9 Strom at 9.

10 *Id.*

all of the estate's assets, and receive administrative super-priority status to enjoy the first right to repayment. DIP lenders gain access to confidential debtor information, and the right to credit bid in the event of collateral asset sales. DIP loans also must be paid upon plan confirmation, giving the lender a significant voice in the debtor's exit strategy, and often include exit financing opportunity rights. In addition, DIP financing terms generally include financial covenants that may be difficult to achieve. Any time a waiver of those covenants is required, the DIP lender hedge fund is placed at a significant advantage in negotiations with the debtor and its other creditors and parties in interest.[11]

By making second-lien loans, hedge funds enjoy the preferred status of a secured creditor, seizing the right to excess collateral value, usually with the bonus of higher interest rates.[12] Holding secured creditor status, the hedge fund acquires rights which include adequate protection of their collateral interests, cash collateral leverage, credit bidding opportunities, and a significant voice in the debtor's restructuring plan.[13]

When acquiring unsecured debt, hedge funds take advantage of investment professionals who specialize in researching distressed companies to understand their true value. Hedge funds can capitalize on such knowledge and on flexibility and patience other creditors may lack. Often banks and other creditors do not want to wait, or cannot wait, for a plan distribution at the end of a lengthy restructuring process. Hedge funds may gain simply on account of their sophisticated analysis of appropriate discounts for unsecured claims. Depending on the amount of debt

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11 *Bad News is Good News: 'Distressed for Control' Investing* ("*Bad News*"), (April 26, 2006) available at http://knowledge.wharton.upenn.edu/index.cfm?fa=printArticle&ID=1455, last accessed June 13, 2006.

12 David Batty, *"Silent" Second Liens – Will Bankruptcy Courts Keep the Peace*, 9 N.C. Banking Inst. 1, 16 (April 2005).

13 Christopher Rockers, *Exploring the Possibilities for No. 2*, 14-FEB Bus. L. Today 35, 39 (2005).

acquired, they may also gain control over a class of creditors or a creditors committee, and thereby gain influence over the debtor's reorganization.

The restructuring of *Barney's* in New York City is a classic example. Barney's was a strong company that had simply over-borrowed and needed to reduce its debt. Clothing designers sold their trade claims for pennies on the dollar in an attempt to recoup their costs of production, frequently to hedge funds. After restructuring, Barney's paid back a large portion of the trade claims and the price rose 50% in one month after a potential buyer for Barney's was found.[14]

Often, unsecured creditors' claims are satisfied through a distribution of stock in the reorganized company instead of cash, and that stock is worth much more than the prepetition stock because the company has emerged from its Chapter 11 case with restructured debt and a strong balance sheet. Hedge funds may expect and seek such treatment, or attempt to force it on the debtor, anticipating their ability to profit through selling those shares at the true value of the company.[15]

2. Equity Investments

Equity investment by a hedge fund into a distressed company is similar to debt investment, but with lower priority and more risk. Hedge funds may buy stock before or after the Chapter 11 case begins, often at steep discounts as other investors attempt to unload the company's stock. Hedge funds can then attempt to require appointment of equity committees that will have an official voice in shaping the reorganization plan, with professionals generally paid by the bankruptcy estate. For example, Appaloosa Management L.P. bought 9.3% of Delphi stock two days after Delphi filed its Chapter 11 petitions. At Appaloosa's request, the

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14 Strom at 8.

15 Strom at 8.

bankruptcy court ordered the creation of an equity committee, although the United States Trustee did not appoint Appaloosa as a member, a decision Appaloosa is currently challenging in court.

Hedge funds may also make private investments in public equity securities ("PIPES"). These private equity offerings are generally in the form of preferred stock convertible at a discount to market price into the public shares of the issuer. PIPES can provide distressed companies with needed liquidity, but can also result in significant ownership and economic dilution to existing shareholders. PIPES investors may prohibit a company from pursuing other financings for a minimum period.[16]

Hedge funds' principal goal in making equity investments is the same as their debt investments: participate in restructuring an undervalued corporation and then sell the stock or the company at a profit.[17]

3. Other Pre-Bankruptcy Strategies

Aggressive investors can jump ahead in the restructuring process by approaching potential investors of the company to gain insight into their valuation perspectives and overall asset liquidity. And if the hedge fund is dissatisfied with the company's actions, it can pursue an involuntary bankruptcy petition to accelerate restructuring or bring court supervision or examination to the debtor's activities.[18]

B. The Benefits and Problems of Hedge Fund Involvement in Chapter 11 Proceedings

There are benefits and problems associated with hedge funds participating in Chapter 11 proceedings. Hedge funds present the opportunity to infuse a company with cash and help bring about a successful restructuring. They may also cause the restructuring proceedings to drag on

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16 Strom at 8.

17 David Peress, *Nontraditional Lenders and the Impact of Loan-to-Own Strategies on the Restructuring Process*, 25-APR Am. Bankr. Inst. J. 48, (April 2006) ("Peress").

18 Strom at 9.

for significant periods of time and pose serious roadblocks to any plans that do not benefit their investment interests.

1. Benefits Associated with Hedge Fund Investments

Hedge funds can be a source of capital for distressed companies when more traditional lenders shy away. Second-lien investing may enable a financially troubled company to correct current problems and avoid bankruptcy altogether.[19] DIP financing from a non-traditional lender like a hedge fund may be critical to a successful Chapter 11 case if bankruptcy is necessary.

Hedge fund purchases of secured and unsecured debt also have market value, freeing creditors to move on and invest their money in other transactions better suited to their own goals and needs.

2. Problems of Hedge Fund Investments – Hedge Fund Strategies

Potential problems abound with hedge fund participation in bankruptcy reorganizations. Hedge funds can change the entire landscape of a Chapter 11 case, and can make it more complicated and expensive. Hedge fund strategies to gain control or at least advantage in the restructuring process, in addition to DIP financing, plan funding and simple acquisition of reorganization value for a cheap price include:

- Gaming Committees: Hedge funds may seek to have a separate committee formed to advocate for their interests, adding costs and administrative burdens to an already struggling debtor's business. Alternatively, they may acquire claims held by members of existing committees, acquiring rights to confidential information and even taking majority control of committee decision-making.[20] In the *Adelphia Communications* case, distressed debt traders and investors did just that, buying so much

[19] Strom at 8-9; Peress at 58.

[20] Strom at 9.

Adelphia bond and other debt that the creditors committee had to be reorganized with additional members to give a meaningful voice to trade claimants.[21]

- Controlling a Class of Creditors: Hedge funds can also buy enough debt of one class that they effectively control that class of debt and its vote on any reorganization plan – one third of the claims in a given class. That enables the hedge fund to exert enormous pressure and force a restructuring plan that is favorable to its own investment plan, regardless of the best long-term interest of the company.[22] The hedge fund obtains leverage in negotiating a reorganization plan because it implies a contested confirmation hearing if an agreement is not reached.

- Acquiring Claims at Subsidiaries: In large, complex, multi-debtor cases, where substantive consolidation is possible, a hedge fund may acquire claims in subsidiaries' cases, asserting foundations for different recoveries by virtue of guarantor or non-guarantor status or the effect of substantive consolidation.

Hedge funds often have conflicting interests and values with other debt holders. A hedge fund becomes involved in a distressed company to make a return based on a certain strategy. It is not concerned with the ultimate well-being of the company or the ultimate restructuring success, but with the effect of any action or plan on making its investment return. Hedge funds are not designed to build value in the long run.[23] Whether taking control of a class through buying claims/votes or by acquiring a blocking position or control on a committee, hedge funds

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21 *In re Adelphia Communications Corp.*, 336 B.R. 610, 623 (Bankr. S.D.N.Y. 2006).

22 Skeel at 32; Strom at 9.

23 James Drummond, *Hedge Funds: Value or Vultures, They Play a Critical Role*, Financial Times, March 10, 2005. Post-confirmation, a hedge fund may seek to engineer a merger with another company, to exit its concentrated position, using industry expertise gained during the restructuring process. The hedge fund may exercise its power to select directors of the reorganized company to increase the likelihood of the post-confirmation strategies it desires. The hedge fund may also seek to enhance trading and exit opportunities through developing its own market research and research coverage of the reorganized entity's securities. Strom at 10.

can destroy months of effort and compromise to force restructuring plans that are beneficial to their short-term profit goals.

If not providing DIP financing themselves, hedge funds may oppose DIP financing arrangements that are not in line with their investment goals. Resulting litigation can force potentially viable companies out of Chapter 11 and into Chapter 7 liquidation proceedings. For example, DIP financing in the *American Remanufacturers* case (discussed in section IV below) came to a screeching halt when two hedge funds opposed a DIP financing plan that was contrary to their investment goals. The resulting delay and litigation cost forced American Remanufacturers into Chapter 7 because the corporation ran out of cash.[24]

Hedge funds also interject uncertainty into bankruptcy cases and out-of-court work-outs. It is difficult for a distressed corporation to be sure of its future when a hedge fund invests significant amounts of money and time into the restructuring process. The secrecy of hedge funds makes it difficult for corporations to know whether the hedge fund is there to rebuild the company into a financially stronger entity with greater stock value, or acquiring interests to force a break-up and sale of the pieces. The uncertainty created when hedge funds square off with other creditors over DIP financing arrangements, committee membership, plan votes and other reorganization strategies and actions forces "managers to leave, inhibits investment in product developments, and may ultimately lead to operational stagnation."[25]

Hedge funds are likely to continue to play significant roles in Chapter 11 cases for the foreseeable future. As the number of hedge funds and the amount of money under their control continues to grow, and as hedge fund managers are forced to look for more aggressive investments to maintain high rates of return, more will probably turn to distressed company debt

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24 Peress at 57.

25 *Id*.

and equity acquisitions. According to one analyst, hedge funds are posed to have significant influence in the next wave of bankruptcies coming in 2006-2007.[26]

It is unclear whether hedge funds are doing more harm than good. The infusion of cash from hedge funds might help to prevent some companies from filing Chapter 11 cases or help them through their restructurings. On the other hand, hedge funds might also cause some companies to fold under the pressures of competing investment interests. What is clear is that hedge funds are, and will continue to be, a force to be reckoned with in bankruptcy reorganizations.

III.

THE EXPLOSION OF SECOND LIEN DEALS

Until 2003, second lien debt was not a major part of the financial landscape. The current wave of second lien debt traces its origins to efforts to circumvent anti-layering covenants found in many high-yield public debt indentures.

A. Second Lien Financing Enables Mezzanine Lenders to Avoid Anti-Layering Covenants.

Typically, high-yield public debt indentures prohibit the incurrence of debt junior to the senior debt facility (generally provided by a bank group) but senior to the subordinated high-yield debt.[27] A number of borrowers with existing high yield debt wanted to slot in some mezzanine financing below their senior debt but senior to their existing high yield debt. For

26 See *Bad News*.

27 The theory behind these anti-layering covenants has been debated by some, but they were probably designed to ensure to the holders of the high-yield subordinated paper that additional debt would not be incurred senior to them unless that new debt had the same basic risk profile as senior bank debt – the theory was that new senior lenders would be part of the bank group and, presumably, would not agree to make the loan unless the creditworthiness of the borrower was sufficient to support comparatively low-cost senior debt. These indentures typically also contained covenants prohibiting the incurrence of debt or the granting of liens unless the issuer met certain financial tests. The anti-layering covenant prohibited the incurrence of mezzanine debt even if the issuer could satisfy the debt and lien incurrence tests and, therefore, must have had a different purpose.

many of these borrowers, their ability to raise additional financing depended on their ability to give the new lenders priority over existing subordinated debt – they had tapped out their senior borrowing capacity and could not raise junior debt if it had to share pro rata with an existing issue of subordinated debt. Moreover, if such issuers could find a way to raise mezzanine financing without tripping their anti-layering covenants, their costs of borrowing would be reduced, perhaps dramatically. But how could they accomplish this given the anti-layering covenants found in their existing subordinated debt indentures? The solution that soon evolved was to incur additional debt that was secured by a subordinate, or second, lien. The new debt was *pari passu* with the existing senior bank debt and the subordinated high yield debt, so it did not literally trip the anti-layering covenant, which only prohibited debt, not lien, subordination. But by virtue of its second priority lien, this new layer of debt effectively ranked between the senior bank facility and the high-yield bonds.

Having opened the door in connection with trying to structure around anti-layering covenants, the financial markets soon realized that the benefits of second lien financing could be used in a multitude of settings. Second lien debt allows its holders to recover against their collateral (which in these transactions generally consists of a blanket lien on all assets) and thereby places them ahead of trade creditors, landlords, tort claimants and effectively any other unsecured creditors. As a result, second lien debt is perceived as having lower risk than more traditional unsecured senior notes or subordinated notes. The resulting lower pricing for second lien paper makes this form of financing attractive both for borrowers and for first lien lenders.[28] The advent of second lien debt also has allowed some companies to incur incremental debt - it has increased their borrowing capacity.

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[28] Second lien financing can be attractive to senior lenders since the additional capital coming in below the senior lenders increases the borrower's liquidity (and, therefore its ability to service the senior debt) and this low interest rate debt places less of a burden on the borrower than would traditional unsecured high yield financing.

What started out as a relatively small financial product in 2002 expanded greatly in 2003, and then exploded in 2004 and 2005. Indications are that the wave of second lien financing will continue to grow in 2006, with some participants forecasting a 20 percent increase in second lien financing compared to 2005. In many respects, second lien debt has supplanted debt that previously would have been issued as senior unsecured notes or even high-yield subordinated notes. The underwriting of this second lien paper generally does not bear much resemblance to an asset-based analysis of collateral coverage. Rather, much of the second lien paper could not pass muster based on traditional measures of "hard" collateral and some of it is probably undersecured when issued. It is relatively high risk debt that has a lien to bolster its standing in the capital structure vis-à-vis unsecured creditors. The granting of the lien does not imply that the collateral is sufficient to pay the second lien debt, certainly not in a meltdown scenario.

B. Challenges Faced by Second Lien Creditors When Debtors Default.

The explosion in second lien debt provides great opportunities for restructuring professionals. Obviously, a number of the companies that obtain second lien financing will fail and this debt will need to be restructured. Many analysts expect a wave of second lien debt defaults commencing in late 2006 and growing substantially thereafter. When this wave of defaults hits, second lien paper will present a number of new challenges. This follows for several reasons.

First, there is no such thing as <u>standard</u> second lien debt. Intercreditor and subordination agreements that are currently found in the marketplace vary significantly in many of their most material provisions.[29] While parties trying to negotiate the terms of an intercreditor agreement often argue that certain provisions are "market", truly trying to divine the "market" for the terms

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[29] In contrast, over the years, high-yield subordinated debt and senior unsecured notes have developed relatively standard provisions which have been tested in a number of bankruptcy cases. This is not to say that there are not differences in the rights of the holders of such unsecured debt, but they pale in comparison to the differences found among the widely divergent intercreditor provisions in today's second lien market.

of second lien intercreditor agreements is often difficult, if not impossible -- one can find "market" examples to support a widely divergent, contradictory and variable set of rights in second lien paper. Thus, it is important that prospective buyers of first and second lien paper analyze the specific intercreditor documentation for that debt before taking the plunge, and when a deal enters a restructuring phase, the legal analysis must focus on the specific provisions of the intercreditor agreement that governs that deal.

Second, by virtue of the fact that a whole new layer of the capital structure is secured, bankruptcy cases and out-of-court restructurings will be significantly affected. The proposed use of the second lien creditors' cash collateral, DIP loans that seek to prime second lien debt, proposed asset sales free and clear of these second liens, and attempted confirmation of a plan of reorganization over the objection of a whole new class of secured creditors, will introduce new complexities. Some prognosticators predict that the next wave of chapter 11 cases will be slower and more complicated because of the uncertainties and difficulties of dealing with second lien paper. This may reverse the recent trend of generally shorter and more efficient chapter 11 cases.

Most of the intercreditor agreements currently in the marketplace have attempted to deal with the complications that flow from the fact that this new type of mezzanine debt is secured through a complex assortment of waivers and consents that limit the rights of second lien lenders. Outside of bankruptcy, most first lien creditors start from the premise that the first lien parties should be free to exercise their rights with respect to the debtor independent of any interference by the secureds - - i.e., the second lien is "silent." In bankruptcy, the basic thesis of many first lien lenders is that second lien creditors are entitled to their priority vis-à-vis trade and other unsecured creditors, but should relinquish most of their other secured creditor rights that would otherwise interfere with the first lien lenders' ability to protect their interests. The first lien creditors generally argue that the second liens are designed to provide the second lien creditors with priority over trade debt, tort claims and any unsecured notes, but should not seriously impede the debtor's ability to reorganize or give the second lien lenders rights that they would not have had as unsecured mezzanine lenders, at least to the extent that those secured creditor rights would adversely encroach on the rights of the first lien lenders. The corollary to this thesis is that the second lien creditors should not be obligated to agree to bankruptcy waivers and consents that would disadvantage them compared to the position they would have enjoyed if they had provided senior unsecured debt – i.e., they should not be worse off by virtue of having a second lien.[30]

First lien lenders vary in their tolerance for significant rights in favor of second lien lenders. That appetite for accommodating second lien debt can be influenced by such matters as whether the first lien lenders view the deal as a tight asset-based loan with little margin for error or a strong cash-flow loan with abundant coverage and lots of competition to place the debt.

Second lien lenders also vary in their structures (e.g., hedge funds, bond funds, CLOs) and those lenders focus on a variety of asset classes (e.g., par, mezzanine), all of which can influence their views on the issues covered by intercreditor agreements. Traditional high yield and mezzanine second lien investors are generally happy to have any kind of collateral and often accept the premise that that second liens are only intended to enhance their rights vis-à-vis unsecured creditors. At the other end of the spectrum, some buyers of second lien debt are more traditional secured creditors who view these loans as "stretch" senior secured loans; they analyze the collateral, and while they are willing to accept greater risk than the first lien holders, they expect and bargain for stronger rights.

[30] Some of the early second lien paper had such broad waivers that the second lien creditors may have been better off being senior unsecured.

The explosive growth of hedge funds has also helped to drive the demand for second lien paper. Hedge funds have been growing at the annual rate of 20% since 1990 – there are now well over 8,000 hedge funds. *See Hedge Fund Research QI 2006 (Industry Report); Inquiry Clouds Future for a Hedge Fund Survivor, New York Times, June 26, 2006.*. As noted above, many hedge fund players have identified second lien deals as a place to put their massive sums of money to work. These hedge funds often like: (i) second lien variable rates in the current interest rate environment; (ii) the protection second lien debt provides in insolvency; and (iii) the strategic opportunities secured debt offers (i.e., the ability to exercise remedies and have leverage in workouts). In addition, some hedge funds are restricted under their organizational documents from investing in subordinated debt.

These players come from different risk/return perspectives which accounts for some of the inconsistency in the negotiation of these deals. Even when the second lien lenders accept the premise that they are entitled to improve their position vis-à-vis the trade and other general unsecured creditors but not to encroach on the rights of the first lien creditors, carrying out these principles in practice is difficult – reasonable people can, and do, disagree as these principles are applied to specific provisions of an intercreditor agreement and many drafters disagree with these basic premises. The result is the cacophony of second lien paper that is presently in the marketplace.

These varying perspectives and divergent intercreditor agreements are bound to lead to some heated disputes in bankruptcy courts. S&P's ratings suggest that many of these deals will end up in bankruptcy court. In fact, S&P asserts that there will be insufficient collateral coverage to pay even the first lien lenders in the overwhelming majority of this recent wave of second lien deals. *See Standard & Poor's, Second Liens: Secured, Subordinated, or Both? (October 12, 2004)* ("Stated plainly, Standard & Poor's believes that, despite being nominally structured senior secured debt, a great percentage of second-lien bank debt is effectively unsecured"). Similarly, Miller Buckfire Lewis & Ying projected that the current wave of second lien debt issuances will be followed by an echo wave of second lien defaults beginning in late 2005 and escalating in 2006.

While many second lien investors may be relying on the extra 300-375 basis points of yield over first lien paper[31] to cover some losses, the bankruptcy issues will not go uncontested. These issues will affect all participants in the capital structure, including senior lien debt. Notwithstanding the bankruptcy waivers and consents described later in these materials, it is likely that the second lien creditors will have increased leverage in a bankruptcy case and, to the extent there is not adequate enterprise value to satisfy the first lien creditors and second lien creditors in full, the first lien creditors can be affected. This is increasingly true as the competitive pressures to sell second lien paper have led to an evolution towards more second-lien friendly paper.[32] This evolution may have contributed to the reduction in the spread over LIBOR for second lien paper. However, the relative reduction in risk for second lien paper flowing from the more second-lien friendly intercreditor agreements may have come at the expense of increased risk for holders of first lien paper to a degree that the holders of such paper do not fully appreciate.[33]

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31 According to S&P's 1Q06 Second Lien Lending Review, the average spread between second lien and first lien tranches was 367.2 basis points in 2005, decreasing to 344.8 in the first quarter of 2006. Average spreads over LIBOR for second lien debt were 668 basis points in 2005, decreasing to 614 in the first quarter of 2006.

32 Some market participants have predicted that the terms of these financings will increasingly be driven by the providers of the second lien debt, based on the thesis that it is harder to place than the first lien debt.

33 Obviously, the pricing for first and second lien paper in any particular transaction should depend largely on the creditworthiness of the borrower, in addition to the terms of the intercreditor arrangements between the two classes of secured creditors.

We presently have limited experience in the restructuring of debtors with significant first and second lien debt. That is starting to change. The next several years should be interesting. An analysis of several limited skirmishes is included in Section V below.

IV.

NEGOTIATION OF SECOND LIEN FINANCING AGREEMENTS

A. Capital Structures and Constituents' Perspectives

The capital structures of second lien financings raise a number of issues. In a typical second lien transaction, the first lien debt almost certainly consists of at least one credit facility – possibly just a revolver or a term loan in addition to a revolver – secured by a first lien on agreed-upon collateral. The second lien debt will typically take the form of tranche B term loans (with minimal or no amortization until the year prior to maturity) and/or high-yield bonds secured by a second lien on most, if not all, of the collateral that secures the first lien credit facility. The second lien bonds typically have longer maturities and their economic terms are richer than typical term B paper. Their covenants are typically "lighter" than first lien debt (sometimes they are close to high yield covenants and other times they are a first lien covenant package ratcheted back). Second lien bonds are often called "Secured Senior Notes" or "Second Lien Secured Notes" and are much like high-yield bonds except that they are secured. Many do not have "maintenance" covenants or cross-default provisions. However, the liens covenant (not the debt covenant) becomes the key limitation on future debt incurrence.

Second lien debt gets its name because the first and second lien creditors agree that, in the event any of their shared collateral (and most deals require all of the collateral to be shared) is sold in a foreclosure or other enforcement action, the first lien debt will be paid in full before any other proceeds from the collateral sale are distributed to the holders of the second lien debt. The second lien debt constitutes lien subordination -- NOT contractual subordination in the traditional sense (that is, payment subordination), but it is subordinated in its claim to the proceeds of the shared collateral. In fact, both tranches of debt are *pari passu* with each other and other creditors to the extent that assets to pay claims are outside the collateral umbrella.[34] In this respect, second lien debt is less beneficial for senior lien creditors than is subordinated debt. When the seniors rely purely on lien, instead of debt, seniority, the first lien lenders are dependent entirely on the scope and adequacy of their liens in order to achieve preferential recoveries compared to the second lien creditors.

Some debtors and unsecured creditors have argued that even blanket liens on all of a debtor's assets do not encumber the full going concern enterprise value of the estate. Relying purely on a first priority lien, as opposed to debt subordination, subjects the senior lien creditors to the risk that they may not be entitled to all of the enterprise value until they are paid in full, ahead of the junior financial institution creditors. In addition, relying purely on a first priority lien disadvantages the first lien creditors in that they do not receive the "double dividend" that results from debt subordination.[35]

1. First Lien Perspective

First lien lenders historically have not been inclined to share collateral with junior creditors at all. However, they are increasingly willing to tolerate second lien debt to get deals

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[34] For practical reasons, it is often not possible to obtain liens on quite all of the assets of a debtor. Leasehold mortgages are a typical example, where obtaining landlord consents for all leaseholds may prove impractical. Other typical examples, include stock of foreign subsidiaries, where pledges are typically limited to 66% of the stock of a first-tier foreign subsidiary, in order to avoid U.S. taxation of the income of these foreign subsidiaries, pursuant to Internal Revenue Code Section 956.

[35] In some of the earlier second lien transactions, the second lien debt was also subject to debt subordination. This structure provided the first lien creditors with the "belt and suspenders" of both lien and debt subordination. But for whatever reason, the current wave of second lien debt is rarely, if ever, subject to debt subordination. The authors believe that this is likely the result of the fact the current form of second lien debt arose in the context of trying to create a mezzanine level of debt without violating the anti-layering covenants of existing public subordinated debt. That rationale no longer carries through when first lien debt is being placed not in order to avoid an anti-layering covenant, but in order to establish an optimal capital structure. Once financial markets realize this, particularly if some of the structural issues inherent in second lien non-subordinated debt adversely affect first lien creditors, it is possible that the market will shift to second lien paper that is also subordinated debt.

done in cases where the proceeds from the second lien deals: (i) are needed to make a transaction feasible; (ii) are earmarked to pay down first lien debt; (iii) will effectively limit the amount of first lien debt needed; or (iv) will provide a company with needed liquidity. Moreover, the market has wholeheartedly endorsed second lien paper, so that if a proposed agent for a senior bank group opposed the borrower incurring second lien debt, that prospective agent would be viewed as out of synch with the market and would likely lose the deal to other institutions that are willing to accept second lien paper in the capital structure. In addition, often a single investment bank places and acts as agent for both the first and second lien paper, so that the creditor taking the lead in negotiating these transactions has both perspectives – it strives to structure a deal that is acceptable (or at least saleable) to both first and second lien creditors, for it needs to sell both issues and may well end up holding some of each.

The theory is that the first lien creditors can protect their interests through a lien subordination agreement that strips the second lien creditors of most of the secured creditor rights they might otherwise exercise to the detriment of the first lien creditors. This leaves the second lien creditors with a so-called "silent" second lien. The question in many of these deals is how "silent" is "silent." See Section IV B, *infra*.

Important issues for most first lien lenders include: (i) control of enforcement actions during an agreed-upon standstill period; (ii) ability to force assets sales free and clear of liens; (iii) agreement of second lien holder not to challenge liens or to object to asset sales; (iv) the ability to put DIP financing in place that primes the second liens; (v) the ability to obtain adequate protection without the second lien holders' objection; (vi) inability of second lien creditors to obtain cash payments (e.g., by way of adequate protection) in a bankruptcy case; and (vii) a broad waiver by the second lien holders' rights that would arise in bankruptcy from holding collateral, with the preservation of rights they would have if they were unsecured.

2. Second Lien Perspective

Many second lien creditors (especially traditional mezzanine or high yield debt investors) are willing to accept a "silent" second lien because even a silent second gives them effective priority over trade and other unsecured creditors but only *up to the value of the collateral which is in excess of the first lien*. In terms of payment priority, a second lien creditor is always better off than it would be if it were unsecured. In addition, if the second lien holders are oversecured, they are entitled to post-petition interest and fees.

High priority issues for most second lien lenders include: (i) the ability to assert rights of an unsecured creditor; (ii) the ability to vote their claims in bankruptcy; (iii) a limited duration of an enforcement standstill; and (iv) "tag along" rights whenever the first lien creditors obtain new collateral. To the extent the second lien holders view themselves as making "stretch" secured loans, they are likely to bargain harder for more rights on such issues as their ability to limit asset sales, limitations on priming DIP loans and a variety of other matters discussed below.

3. Borrower's Perspective

Borrowers generally have welcomed the availability of second lien debt. A borrower generally can get better pricing (a lower interest rate) for a second lien financing than it could for unsecured debt on substantially the same terms due to the perceived lower risk. For example, much of the second lien paper being issued currently is priced at approximately LIBOR plus 6.50%, whereas high yield unsecured mezzanine debt issued by the same borrower would likely require interest in the mid teens.[36] In addition, a borrower will get broader access to the debt markets because of the tremendous interest in second lien paper across the range of institutional investors. A borrower's debt capacity may be effectively increased by accessing the second lien

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[36] For private issuers, such mezzanine debt holders would also often get warrants. However, required rates or return for mezzanine loans have fallen recently, most likely in response to competitive pressure from second lien lenders.

market. For some companies, this deeper level of market interest can make the difference between getting a deal done and not having access to the capital markets at all.

However, the second lien covenant package will likely impose a more restrictive cap on the amount of first lien debt than otherwise would be the case. The borrower's ability to obtain first lien financing in the future may be impaired by the presence of a significant tranche of second lien secured debt on its balance sheet. Often, the total amount of additional second lien debt that may be incurred in the future will also be capped, usually based on the maximum leverage ratio or other financial test. Finally, it may be harder for the borrower to tap the unsecured debt market in the future because future unsecured creditors of the borrower would be behind the second lien debt. Accordingly, the borrower generally attempts to negotiate for some room for future borrowing on a secured basis.

B. How Silent Are "Silent" Seconds?

Parties often use the label "silent" to describe second lien debt. The label "silent" means different things to different people and encompasses a wide range of terms found in intercreditor agreements. "Silent", "quiet" and "sleeping" second liens are all labels that have been used in the marketplace. But they are just labels. The specifics vary enormously and are often the subject of intense negotiation. No matter what label is applied (or appropriate), these transactions typically involve an agreement by the second lienholders not to exercise some or all of their rights as a secured creditor. The terms of the "silent" second are usually set out in an agreement entered into by the various classes of creditors, usually called a subordination and/or intercreditor agreement. Second lien bond deals tend to be more "silent" than second lien term loan deals because of the historical unsecured orientation of bond investors and the difficulty of getting public bondholders to organize, to agree to receive material non-public information (which is necessary for them to make informed decisions, but which will restrict their ability to trade in these securities) and to reach a consensus on action (whether it be a waiver or exercise of remedies).

While generalizations in this area are dangerous, the second lien subordination agreements that are used when the second liens are intended to be more or less silent tend to have four common themes:

- prohibitions or limitations on the right of the second lien holders to take enforcement actions (*i.e.*, foreclosure) with respect to their liens, usually subject to time or other limitations;
- agreements by the holders of second liens not to challenge enforcement or foreclosure actions taken by the holders of the first liens, possibly subject to time or other limitations;
- prohibitions on the right of the second lien holders to challenge the validity or priority of the first liens; and
- waivers of or limitations on secured creditor bankruptcy rights (adequate protection, DIP financing, cash collateral, etc.) by the holders of second liens.

Many of these relate to the first lienholders' desire to "drive the bus" with respect to remedies against the shared collateral.

As mentioned above, in a second lien bond deal, the second lien creditors tend to be almost totally silent. This means that the first lien lenders generally control all decisions regarding the enforcement of remedies against the collateral as long as the first lien debt is outstanding. However, if there is significantly more second lien bond debt in the capital structure than first lien bank debt, the second lien bonds may expect to have an active voice in the exercise of remedies under the security agreements. Also, since most intercreditor agreements allow the second lien holders to buy at the first lien holders at a certain price, second lien holders can always "drive the bus" if they want to pay for the privilege.

By contrast, in a second lien term loan deal, the second lien could often be more accurately described as a "quiet" second. Generally, these second lien lenders will only agree to refrain from exercising their secured creditor rights for a limited period of time -- typically 90 to 180 days. At the end of this standstill period, the first lien lenders typically lose their monopoly on the exercise of secured creditor remedies, unless they have commenced and are diligently pursuing foreclosure.

Both second lien term lenders and second lien bond holders typically waive their right to challenge the validity, enforceability or priority of the first liens. The first lien lenders also generally waive their right to challenge the second priority liens. This is generally not viewed as a serious concession by either group, as challenging the other's lien (usually created at the same time and under the circumstances) is probably a dangerous game (i.e., people who live in glass houses should not throw stones).[37]

C. Specific Intercreditor/Subordination Provisions That Can Have A Major Impact During An Out-Of-Court Restructuring Or Bankruptcy Case

The following is a list of some of the major provisions currently being negotiated in intercreditor agreements and deal structures that are likely to have a major impact on the wave of

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[37] If the first lien is avoided in bankruptcy (for example, because it was not properly perfected), but the second lien withstands challenge (for example, because the second lien collateral agent properly perfected the lien), an interesting issue can arise. Intercreditor agreements generally provide that the first lien is first in priority notwithstanding the time, manner or order of perfection or other normal rules of lien priority. But what happens if the first lien is avoided? Many intercreditor agreements provide that, as between the two groups of creditors party to the intercreditor agreement, the holders of the "first" liens still receive first distributions. If so, that subjects the holders of the "second" liens to the risk that their distributions will be turned over to a group of creditors that turned out to be unsecured. Other more second-lien friendly intercreditor agreements limit this agreed-upon ranking to validly perfected and non-avoidable liens. Since most of these transactions involve blanket liens that are perfected at the same time by either a single collateral agent acting on behalf of both sets of secured creditors or two collateral agents who coordinate, it is likely that lien perfection problems will affect many of these groups equally, lessening the practical risk of this issue.

restructurings and bankruptcies that is likely to follow the present wave of issuance of second lien debt.

1. Waiver of the Right to Oppose Adequate Protection for First Lien Debt

One of the most important rights of a secured creditor in bankruptcy is to obtain "adequate protection" of its secured claim (i.e., protection against the diminution of the value of its collateral during the bankruptcy case). "Adequate protection" is not defined in the Bankruptcy Code except by way of non-exhaustive examples and it is meant to be a flexible concept. See MBank Dallas, N.A. v. O'Connor (In re O'Connor), 808 F.2d 1393, 1396-97 (10th Cir. 1987) (adequate protection is "a concept which is to be decided flexibly on the proverbial 'case-by-case' basis"); Bankers Life Ins. Co. v. Alyucan Interstate Corp. (In re Alyucan Interstate Corp.), 12 B.R. 803 (Bankr. D. Utah 1981). Among other things, it can consist of periodic cash payments, replacement liens, an existing equity cushion, and/or insurance. It has Constitutional underpinnings in that property interests cannot be taken away without "just compensation." Adequate protection is prominent in three places in the Bankruptcy Code: (i) Section 362 (relief from the automatic stay can be granted for lack of adequate protection); (ii) Section 363 (debtors can only use, sell or lease a secured creditor's collateral out of the ordinary course of business if the secured creditor is adequately protected); and (iii) Section 364(d) (cannot prime an existing secured creditor with a DIP loan unless that secured creditor is adequately protected).

First lien creditors typically demand that second lien lenders waive any right to dispute actions taken by the first lien lenders to seek adequate protection with respect to the collateral securing the first lien debt. This waiver is generally not controversial given that: (i) second lien deals presume that the first lien debt will get paid first; and (ii) second lienholders typically have "tag along" rights if first lienholders obtain new collateral. One question is whether and to what extent a bankruptcy court will recognize or enforce such "tag along" rights.

2. Waiver of the Second Lien Creditors' Right to Seek Adequate Protection Other than Replacement Liens

Second lien creditors are also entitled to adequate protection of their collateral. But it may be particularly difficult for a debtor to provide the sort of adequate protection required by the Bankruptcy Code to second lien creditors. This follows for several reasons. First, to the extent that the first lien creditors are oversecured, they will be entitled to accrue post-petition interest and fees, assuming that these rights are provided for in their documents (which they almost always are), pursuant to Bankruptcy Code Section 506(a).[38] Assuming that the value of the enterprise remains stable, this continued accrual of interest, fees and costs under the first lien debt will encroach on the value available for the second lien creditor. The second lien creditors should be entitled to adequate protection for that diminution of value. And if the value of that collateral is not sufficient to cover the second lien debt in full (which is likely to be the case in many instances), there will be no available equity cushion and replacement liens alone are likely to be inadequate.[39] It is also usually impossible for the debtor to provide adequate protection by granting liens on unencumbered assets, since there generally are no unencumbered assets - - both the first and the second lien lenders typically have blanket liens. Second, for many companies in chapter 11, declining operating results and the enormous incurrence of professional fees will

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[38] As outlined below, if the first and second lien creditors, in fact, have a single shared lien and the combined secured debt exceeds the value of the collateral, post-petition interest and fees will not continue to accrue on either tranche. But since this issue came to the fore fourteen years ago, almost all transactions have been structured so that separate liens are granted to the first lien creditors and to the second lien creditors.

[39] If there is sufficient value to cover the second lien debt in full, an equity cushion may suffice. This may be the result for some chapter 11 debtors where the first and second lien secured debt is well covered but the company needs to reorganize because of excessive unsecured debt or tort claims or desires to take advantage of other bankruptcy rights (e.g., rejection of leases) or to use the shelter of bankruptcy to deal with other operations issues. In addition, if the debtor's operations are sufficiently robust that the second lien creditor's collateral is appreciating, <u>net</u> of interest and fees for the first lien creditors and estate professional fees, it should be possible to provide the second lien holders with adequate protection; this situation, however, is likely to be relatively unusual.

further diminish the value available for distribution to creditors and entitle second lien creditors to adequate protection.

How then to provide the second lien creditors with adequate protection? Since replacement liens are not likely to suffice and there are generally no unencumbered assets to pledge, cash payments would be one of the few possible forms of adequate protection that might be offered to the second lien holders. However, cash payments during a bankruptcy case would encroach on the value available for the first lien holders, a result that would be abhorrent to many first lien creditors.

The difficulty of providing adequate protection to a second lien creditor presents a true quandary. If the second lien creditors' rights to seek adequate protection are left unfettered, the second lien creditors often will legally have the right to prevent the use of their cash collateral, essentially stopping a reorganization. Whether the second lien creditors choose to go to that extreme will depend on their objectives, but at a minimum, if second lien creditors have the unfettered right to demand adequate protection, their leverage will be increased substantially. Some second lien creditors (particularly those who view their loans as "stretch" secured loans) argue that this is appropriate given that it is their collateral that is being diminished. But many first lien creditors and debtors are unwilling to give such substantial power to the seconds, particularly when the second lien debt is viewed as akin to mezzanine financing that happens to have a lien.

The solution adopted in many intercreditor agreements is to provide that the second lien creditors agree not to seek any form of adequate protection other than replacement liens,[40] generally junior to the replacement liens granted to the first lien creditors and to any liens

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[40] Some intercreditor agreements literally prohibit the second lien creditors from demanding any adequate protection. Although it is likely that these agreements were intended only to prohibit cash payments, they technically may cover replacement liens as well.

securing DIP financing.[41] The theory is that replacement liens preserve the fundamentals of the capital structure – the second lien creditors stay ahead of unsecured creditors – but avoid the potential shift of bargaining power to the second lien holders and the potential disruption to a reorganization that would result if the debtor were required to provide truly adequate protection to second lien creditors. This approach also is consistent with the theory that second lien creditors should waive rights that flow from their collateral that would significantly adversely affect the bankruptcy case and the rights of the first lien creditors, but not waive rights that they would have had if they held senior unsecured debt - - if the second lien debt were unsecured, the holders would not be entitled to adequate protection.

While restricting second lien holders to obtaining adequate protection in the form of replacement liens is common, it is not followed universally. Some intercreditor agreements allow second lien creditors to seek to obtain cash adequate protection payments, often in an amount equal to interest on the second lien debt. The second lien creditors' argument on this score is strongest when they are providing a "stretch" secured loan and can argue that they are entitled to protection against deterioration of their collateral. Cash interest may not fully compensate the seconds for that deterioration, but allowing cash payments pegged at the interest rate on the second lien debt is a compromise adopted in some intercreditor agreements.[42]

3. Use of Cash Collateral.

Since second lien creditors generally have a lien on current assets (second lien creditors generally get blanket liens on all assets), all cash generated during the case will be their cash

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41 Sometimes intercreditor agreements also allow second lien creditors to obtain other forms of non-monetary adequate protection that would not adversely affect the first lien creditor. A typical example is periodic reports.

42 Many intercreditor agreement have language that allows second lien creditors to accrue post-petition interest and fees if their collateral is sufficient to support it, as is provided under Bankruptcy Code Section 506(a). That is materially different than providing for cash payment of this interest. The concepts, however, are confused in some intercreditor agreements.

collateral. Bankruptcy Code Section 363 provides that the debtor cannot use this cash collateral unless the secured creditor consents or the debtor provides adequate protection. As noted above, providing truly adequate protection to second lien creditors for the use of their cash collateral could prove to be extremely difficult. Thus, many intercreditor agreements provide that the second lien creditors will not oppose the use of cash collateral agreed to by the first lien creditors and, similarly, will not oppose the use of their cash collateral, so long as they receive replacement liens. This is simply a variant on the adequate protection issues discussed immediately above.

Particularly when the premise of the transaction is that the second lien creditors are providing a “stretch” secured loan supported by collateral, some second lien creditors have been able to negotiate intercreditor agreements with more favorable terms concerning use of cash collateral. Such intercreditor agreements either contain no pre-consent to the use of cash collateral or provide that while the second lien lenders will not object to the use of cash collateral under Bankruptcy Code Section 363(c), they retain the right to argue that replacement liens alone are not sufficient. Again, the issues are the same as in the discussion above concerning adequate protection.

In addition, many intercreditor agreements provide that the second lien holders agree to a carve out from their collateral equal to whatever carve out is agreed to by the first lien holders for the fees of estate professionals, U.S. Trustee fees and a potential chapter 7 trustee. The argument goes that unless the second lien holder can be dragged along on a carve out, they will effectively be able to prevent the use of cash collateral, or use leverage on this issue to reopen many of the other issues painstakingly negotiated in the intercreditor agreement. First lien creditors also often argue that the seconds should consent to any such carveout for this issue would not even arise if they held senior unsecured paper. The first lien holders point out that the seconds will still be free to object to any fee applications, so they reserve their rights to object to any fees they believe are inappropriate even if they agree to such a carve out. Sometimes, second lien holders resist, arguing that they should be entitled to negotiate over the size of any such carve out for, after all, it is their collateral that is being used to pay these professionals. Like most issues involving second lien debt, there is no uniformity on this issue – some intercreditor agreements do not obligate the seconds to agree to any carve out.

4. DIP Financing.

Obtaining DIP financing is often critical to a successful reorganization. DIP lenders almost invariably require that liens securing their facility prime any existing liens (with certain minor exceptions for equipment financing and other "dog and cat" liens). But priming a pre-petition secured creditor is difficult. It can be done pursuant to Bankruptcy Code Section 364(d) only if the secured creditors being primed receive adequate protection. That is always difficult to achieve with respect to traditional commercial bank secured debt. It is even more difficult to accomplish with an additional layer of secured debt behind the first liens. Non-consensual priming DIP loans are interesting in theory, but extraordinarily rare in practice.

As a result, if second lien creditors have the ability to insist on adequate protection, they could defeat virtually any DIP loan. First lien lenders are often unwilling to grant this much leverage to second lien holders. They often argue that the ability to block a priming DIP is a right that flows from the fact that the mezzanine lenders got a lien - - they would not be able to raise this issue if they held unsecured debt - - and, thus, should be one of the rights waived in an intercreditor agreement. First lien lenders also are generally willing to concede that second lien lenders can raise objections to a DIP financing based on issues other than priming - - e.g., the seconds are free to object to the terms of the DIP facility, including any provisions that might let the DIP lenders unduly gain control over the case. The first lien holders also typically argue that the money advanced under a DIP loan will create value by providing funds to pay necessary post-petition reorganization expenses and to buy additional collateral, so the seconds' liens are benefited by the DIP funding. The firsts also often argue that if the second lien creditors could block DIP financing, they would either be able to halt a reorganization prematurely or extract other concessions, including seeking protections inconsistent with other provisions of the intercreditor agreement. These arguments have particular weight when the second lien loans are a substitute for a mezzanine or high yield financing where the second lien is designed primarily to give the seconds priority vis-à-vis unsecured creditors.

Second lien creditors often counter by arguing that they, not the first lien creditors, have the most legitimate interest in ensuring that a DIP loan does not encroach on the value of their collateral. If the first lien creditors are significantly oversecured, they are unlikely to be concerned about a priming DIP loan dissipating their collateral cushion. The second lien holders, in contrast, may be greatly concerned about collateral deterioration resulting from a priming DIP, particularly if the DIP loan proceeds are used to fund operating losses and to pay estate professionals. As with many of these issues, these arguments by second lien holders will be stronger if the deal is structured so that the second lien paper is to be sold as "stretch" secured debt supported by real collateral value.

A common compromise is for the second lien creditors to agree not to oppose their liens being primed by a DIP loan, so long as they receive replacement liens junior to the liens securing the DIP loan and the replacement liens received by the first lien creditors, <u>but</u> to reserve their rights to oppose other aspects of the DIP loan that they could have objected to if they held senior unsecured debt. For example, the typical intercreditor agreement allows second lien creditors to oppose the DIP loan based on arguments that the proposed DIP loan is subject to excessive pricing terms, contains provisions that pre-ordain the resolution of the case (e.g., require filing a plan of reorganization acceptable to the DIP lenders, who are often also the pre-petition first lien creditors) require fire-sale asset disposition programs, grant the DIP (and generally the first lien creditors) undue control on the business operations of the debtors and other objections that could be raised by unsecured creditors.

Other intercreditor agreement provide that if the first lien creditors receive cash payments as adequate protection for being primed by a DIP facility, so may the seconds. There are a large number of variants found in today's intercreditor agreements with respect to DIP loans.

a. Cap on the Size of the Priming DIP. Many intercreditor agreements try to impose a limit on the amount of DIP financing to which the second lien creditors agree to be primed. Often, this cap is borrowed from the basket found in the second lien documentation that restricts the amount of pre-bankruptcy first lien debt that can be incurred. But that basket may have no particular relevance to the borrower's needs for financing in chapter 11. It is also often a comparatively small basket, sized based on the company's projections that it will not need additional financing. That basket and the projections on which it is based, may prove grossly inadequate when a company fails.[43] If the parties try to predict the size of a DIP loan that the company may need if it fails, that effort will entail great uncertainty, for it inherently involves trying to predict events that are dramatically different than the borrower's current business plan, and will require the investment bankers and the company to try to put themselves in a very foreign mindset, radically different than their belief that the business plan will succeed, as they must assume if they are to successfully syndicate the first lien loan and place the second lien

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[43] For example, in Tower Automotive, the prepetition first lien debt was $425 million and the second lien debt was $155 million. The intercreditor agreement provided that the second lien creditors agreed to be primed by a DIP facility of no more that $15 million. Tower Automotive is a large company - - annual revenues in excess of $3 billion. So when it filed chapter 11 in February 2005, it needed to seek a "new money" revolving DIP facility of $300 million. The second lien creditors consented, but extracted several concessions, including getting cash payments of interest at a rate 1.75% higher than their contract rate, notwithstanding provisions in the intercreditor agreement that restricted them to replacement liens. The firsts also got their pound of flesh. The DIP facility included a $425 million term facility that was used to retire in total the prepetition first lien debt.

paper. In sum, if the intercreditor agreement places a cap on the amount of priming DIP financing to which the second lien creditors consent and that cap proves to be inadequate, this provides an opener for the second lien creditors to revisit all the other bankruptcy waivers and consents that are often contained in an intercreditor agreement. In other words, an inadequately small basket for DIP financing can be an Achilles heel in all of the other painstakingly negotiated bankruptcy protections that are supposed to protect the first lien lenders and the debtor.

For this reason, first lien creditors and the borrower often fight against any cap on the amount of a priming DIP loan. But second lien creditors often push back hard, arguing that allowing an unlimited amount of senior DIP financing runs the risk that their entire collateral will be "liened away."

This issue is complicated further by the possibility of a "roll-up" DIP loan – a structure where collections on current assets are used to repay the prepetition first lien loan, with the first lien lenders readvancing the collections (plus presumably some new money) as a DIP loan. Undoubtedly the intent of a cap on a DIP loan is to limit the amount of a new money DIP facility. That cap could easily be more than totally consumed by a roll-up of prepetition debt before even addressing any new money. But sometimes this issue is missed in the drafting. If so, it can have the effect of preventing a roll-up, which might be the intent of some sophisticated second lien creditors, but more likely is the result of less than precise drafting by loan origination counsel who do not fully appreciate some of the nuances of DIP loans.

Presently, there is no common or "market" approach. A large number of variants are found in today's intercreditor agreements. And for those intercreditor agreements that cap the amount of DIP loans, there is enormous potential for second lien creditors to have greater and stronger rights than if they held senior unsecured paper.

b. Identity of the DIP Lenders. Intercreditor agreements vary as to whether the allowed DIP loans must be provided by the existing first lien creditors or can be provided by third-party DIP lenders so long as the DIP is supported by the existing first lien creditors. Intercreditor agreements are also often imprecise as to what level of support or participation by the first lien creditors is required to bring the DIP loan into the protected class – e.g., must all first lien creditors participate or support the DIP loan, is it permitted if any of them do, is it a requisite lender issue, or is it entrusted to the first lien agent?

Restricting a permitted DIP priming loan to a loan provided solely by the existing first lien creditor group (or some subset of it) limits the debtor's flexibility. The first lien creditors might like such restrictions, for this gives them the inside track to provide DIP financing. If second lien creditors thought in that light, they might agree to a broad consent to being primed by any DIP lender, in order to avoid lodging the power to provide a DIP loan solely in the hands of their primary competitors in the chapter 11 case.[44]

c. Sharing the Pain. Second lien bondholders will often consent to DIP financings approved by first lienholders in advance only if first lien holders "share the pain" (i.e., the DIP financing lender obtains a security interest in the borrower's assets that primes or ranks *pari passu* with the first lien). Many second lien holders retain the right to object to a DIP financing which primes the second lien but not the first. Second lien term loan holders tend to be a little more vigorous in insisting on sharing the pain and also negotiating for a hard dollar cap on the amount of the DIP loan than is the case with second lien high yield debt.

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[44] Of course, the second lien creditors could always waive this limitation on DIP loans being provided only by the first lien lenders. But obtaining waivers from the second lien lenders can be problematic, particularly when the second lien debt is widely held. If nothing else, needing to obtain a consent from the second lien creditors creates another issue and is therefore a potential impediment to obtaining third party DIP financing, which may strengthen the inside track of the holders of the first lien debt.

5. Asset Sales.

Second lien debt can impose an impediment for first lien creditors and debtors if the second lien holders are able to prevent asset sales by refusing to release their liens on the assets to be sold. On the other hand, if second lien creditors have no say in asset sales, it is possible that first lien creditors would have incentives to sell essential parts of the business for prices that are sufficient to cover the first lien debt, but leave the second lien creditors holding the bag. Of course, such asset sales typically require the debtor also to endorse the sale and debtors are less likely to be motivated to accept a fire sale of a key asset than are the first lien creditors. However, this natural incentive of a debtor may provide little comfort to the seconds, since a debtor facing a liquidity crisis may have limited options other than selling a key asset, even if the price is inadequate. As a result, provisions concerning asset sales are often hotly negotiated.

a. Sales Outside of Bankruptcy. Almost all intercreditor agreements provide that the second lien creditors agree to release their liens on an asset sold outside of bankruptcy, often subject to certain terms and conditions. But as simple as this seems, there are a number of subtleties that can have a major impact on actually carrying out an asset sale outside of bankruptcy.

First, many intercreditor agreements provide that the seconds release their liens only if the sale fits the standards for allowed asset dispositions contained in the second lien documentation. If the second lien credit agreement places limits on the borrower's ability to sell assets, the lien release will be dependent on satisfying those standards. For example, many second lien credit agreements prohibit a borrower from selling all, or "substantially all," of its assets without the second lien creditors' consent. Others require third party valuations for large asset sales, fairness opinions, most of the consideration to be in cash, or that the sale be for "fair market value." If those standards involve an element of subjectivity – for example, that the sale must be for fair market value without any specificity as to how this is determined – second lien creditors can question whether a sale free and clear is authorized.

Second, buyers typically expect to receive lien releases from the secured creditors of record, which may be difficult to obtain in practice if the second lien debt is trying to exert influence in a restructuring. The second lien collateral agent may be less than fully responsive to a request to release the second liens. Drafters have traditionally tried to deal with this problem by providing that the lien release is automatic without any action by the second lien creditors. That sounds great on paper, but practical experience is that buyers do not feel comfortable relying on such an automatic collateral release. It is also common for an intercreditor agreement to provide that the first lien collateral agent can release the second lien if the second lien agent balks. Again that sounds great on paper, but collateral agents are often conservative and risk adverse and without an indemnification from the first lien creditors, a buyer may be reluctant to rely on a release by a party other than the secured creditor of record. The best structure for the first lien creditor may be when the first and second lien collateral agents are the same institution – unless there is a serious doubt that the sale and lien release are authorized under the second lien documents, it is more likely that the joint lien releases will be issued without much controversy. When the first and lien debt is placed by the same institution, which is increasingly common, it is also common to have the same collateral agent for both.[45]

b. Sales in a Bankruptcy Case. Bankruptcy Code Section 363(f) authorizes the sale of assets free and clear of liens without the secured creditor's consent if certain tests are met,[46] the most commonly applied of which is a sales price greater than the value of all liens on

45 Having a single collateral agent serve both sets of secured creditors raises its own set of conflict issues, which typically are addressed by broad waivers and exculpatory provisions.

46 The liens attach to the proceeds of the sale, but the buyer takes free and clear.

the property.[47] If the second lien creditor is undersecured, this test cannot be met literally, for even if the lien is set at the value of the collateral pursuant to Bankruptcy Code Section 506(a), the sales price will equal, not exceed, the value of the liens. Many courts have found a way around this technical issue, which may be an unintended anomaly in the statutory drafting, in order to allow sales free and clear of liens of undersecured creditors. But in order to avoid the need to wade into that thicket, many intercreditor agreements provide that second lien creditors waive the right to argue that it is impossible to sell assets free and clear of their liens without their consent.

Intercreditor agreements also generally preserve the second lien creditors' ability to oppose an asset sale on other grounds. For example, they could argue (i) that no sale is appropriate and that the assets should be preserved for a reorganization, (ii) that the sale price is inadequate, (iii) that the marketing of the assets was inappropriate, or (iv) any other manner of other possible objections to the sale, other than the fact that the assets are being sold free of the second liens. Such provisions are designed to protect the rights of second lien creditors, who are leery of granting too much discretion to borrowers and first lien lenders, particularly since the first lien creditors will have no incentive to try to realize any more on these assets than the amount of the first lien debt. Moreover, objections to the price or wisdom of the sale could be raised by the second lien creditors if they had provided senior unsecured debt, so the argument goes that there is no reason to penalize them for taking a lien.

Some intercreditor agreements also attempt to block the second lien creditors' ability to credit bid at a bankruptcy sale. Bankruptcy Code Section 363(k) provides that unless the court orders otherwise, a secured creditor may bid at any sale and offset its claim against the purchase price of the property. This is commonly known as a "credit bid" and is based on the logic that

47 Bankruptcy Code section 363(f)(3).

there is no reason to force a secured creditor to pay cash for its collateral since the cash will be subject to the creditor's lien (as a proceed of its collateral) and will ultimately cycle back to the creditor anyway. If the intercreditor agreement is silent, the second lien creditors will presumably be able to credit bid their debt, which currency will have value only if the first lien debt is satisfied in full. Some first lien creditors have argued that the second lien creditors should waive their right to credit bid, because the first lien creditors fear that bidding will be chilled if outside bidders fear that second lien creditors will be able to credit bid a large second lien debt, paying with debt offsets rather than cash. The counter argument is that second lien creditors will not credit bid unless they truly believe that the assets are worth more than the cash bid (otherwise they would be happy to accept the cash bid) and it does not make sense to force the second lien creditors to pay in cash just to have it ultimately recycled to them. Indeed, the same arguments in favor of having the second lien creditors waive their right to credit bid could be made with respect to the firsts, but when this issue is raised it is usually only directed towards a waiver by the seconds.

6. Plan Voting Agreements

a. <u>Assignment of Plan Voting Rights or Agreement not to Vote for Certain Plans of Reorganization</u>. Negotiators of intercreditor agreements often grapple over whether the second lien creditors should be able to vote their claims freely. Second lien creditors are very likely to be placed in their own class, so if they oppose a plan of reorganization, it can be confirmed only if the plan satisfies the cram down test for a secured class.[48] First lien

[48] It is extremely likely, although not certain, that first and second lien creditors will be separately classified, particularly if they are granted two separate liens (as opposed to one shared lien). As explained in Section III(C)(8) below, there are other reasons that the two groups will likely be granted separate liens. Some intercreditor agreements specifically provide that the two groups agree that they should be separately classified, but even without this express language this is the likely result.

creditors are often concerned that it is substantially more difficult to cram down a plan of reorganization on such a class of secured creditors than a class of unsecured creditors. For example, a class of secured creditors cannot be forced to accept equity in a reorganized debtor.[49] Bankruptcy Code Section 1129(b)(2)(A) establishes a relatively stringent cram down standard for secured creditors that requires them to receive new secured debt.[50] Giving the second lien creditors a veto over any deleveraging of their debt will significantly shift the negotiating power concerning a plan of reorganization. They certainly will have a substantially greater degree of bargaining power than they would if they held senior unsecured debt. Thus, first lien creditors often argue that the seconds should waive their right to vote on a plan of reorganization. This is phrased different ways – sometimes an actual assignment of their votes to the first lien creditors, other times as an agreement not to vote in favor of a plan unless the plan either pays the firsts in full in cash or is supported by the holders of the first lien debt.

Second lien creditors often strenuously resist any such plan voting provision. They argue that taking away their right to vote on a plan would eviscerate their most basic rights and would severely diminish their rights compared to what they would have if they were holders of unsecured notes -- it is rare that subordinated unsecured or senior unsecured notes waive their rights to vote on a plan of reorganization.

On this issue, it is hard to divine a "right" answer that would be consistent with the theory that the second lien holders should waive rights that they would not have but for their collateral,

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Indeed, if the two groups were classified together, creditors with very different interests and legal rights would be classified together. And the vote of this class would turn on such matters as the relative size of the two tranches and how widely they are held.

49 Bankruptcy Code section 1129(b)(2)(B) allows cram down on an unsecured class if no junior class receives any distribution and if the plan otherwise meets the fair and equitable standard. Thus, it is possible to convert unsecured debt to equity even if the unsecured class rejects the plan.

50 The rate of interest required on such debt has been the subject of significant litigation, including the Supreme Court's recent decision in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004).

but retain rights they would have had as unsecured creditors. If they waive their right to vote, the intercreditor agreement will violate the second premise. If they retain their right to vote, the intercreditor agreement will violate the first.[51]

As a result, this issue is hotly contested in many second lien deals. Some senior lenders insist on a waiver of the seconds' voting rights, while some potential purchasers of second lien paper refuse to buy second lien paper with such a waiver. This is one of the most critical issues that can affect the balance of power and relative rights of the first and second lien debt holders. There is a great deal of variability in the terms of intercreditor agreements, although the trend is probably towards letting the second lien creditors vote on a plan of reorganization. This should be one of the more interesting issues that we will face in the upcoming years.

2. Enforceability of Voting Agreements. It is not clear that an agreement by the second lien holders to transfer their votes to the holders of the first lien debt or to vote only in favor of certain plans will be enforceable.

An analogous issue has occasionally been litigated in the context of debt subordination. Some debt subordination agreements provide for similar waivers of the subordinated creditors' right to vote on a plan of reorganization. Sometimes debt subordination agreements provide that the senior is entitled to vote the claim of the junior. This is more common in private subordinations, but occasionally finds its way into a public indenture. Is this enforceable? The law is split.

Some cases, particularly older Bankruptcy Act cases, imply that an assignment of voting rights is enforceable. *See, e.g., In re Itemlab*, 197 F. Supp. 194 (E.D.N.Y. 1961); *Meinhard, Greef & Co. v. Brown*, 199 F.2d 70 (4th Cir. 1952). Two Bankruptcy Code cases also hold that an assignment of a voting right to the senior is enforceable in bankruptcy. *In re Curtis Center*

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[51] Some intercreditor agreements try to split the baby by providing that the second lien creditors waive their rights to vote with respect to their secured claims, but retain their right to vote their unsecured deficiency claims.

Ltd., 192 B.R. 648, 659-60 (Bankr. E.D. Pa. 1996), *In re Inter Urban Broadcasting of Cincinnati, Inc.*, 1994 WL 646176 (E.D. La. 1994). In addition, a relatively recent case held that an agreement by the juniors not to vote their claims in a manner that is inconsistent with the subordination agreement is enforceable (but holding on the facts that supporting the plan was not mandated by the subordination agreement, even though the plan was supported by the seniors). *In re Sentry Operating Co. v Texas, Inc.*, 264 B.R. 850 (Bankr. S.D. Tex. 2001).

There is substantial doubt on this issue, however. At least some cases and commentators would restrict the senior's right to vote the subordinated claim to the situation where the subordinated creditor is clearly out of the money. *See, e.g., In re Alda Commercial Corp.*, 300 F. Supp. 294, 296 (S.D.N.Y. 1969); Carlson, A Theory of Contractual Debt Subordination and Lien Priority, 38 Vand. L. Rev. 975, 1006 n.116 (1985) ("the difference between the face amount of the senior claim and the eventual senior dividend . . . defines the senior creditor's right to vote the junior claim. The junior creditor should vote the surplus").

The SEC has taken the position that it is against public policy and violative of section 316(b) of the Trust Indenture Act to deprive <u>public</u> subordinated debt holders from voting even if the subordinated debt is clearly out of the money. In *In re National Gypsum, Co.*, this issue was litigated. The case received wide publicity, although the decision is unreported. The Court refused to grant the seniors the right to vote the subordinated creditors' claims, concluding that such an assignment of voting rights was violative of many of the basic principles of the Bankruptcy Code and public policy. The bondholders in *National Gypsum* relied on *In re Hart Ski Manufacturing Co*., an unreported 1980 bankruptcy case out of the District of Minnesota, where the court had made an observation, albeit in dictum, that a waiver of the right to vote on a plan of reorganization contained in a subordination agreement would not be enforceable.

The Bankruptcy Court for the Northern District of Illinois also refused to enforce such a voting provision for the benefit of the senior, even though the junior was an out-of-the-money sophisticated institution holding private mezzanine debt. *In re 203 North La Salle Street Partnership*, 246 B.R. 325 (Bankr. N.D. Ill., 2000). Similarly, in a recent ruling on the confirmation of the plan of reorganization in *In re Spring Air Partners — North America, Inc.* (Case No. 04-11915 RDD), a Bankruptcy Judge implied that he would not have enforced an advance plan voting agreement if the junior creditor was to receive anything less under the plan than it was entitled to under the intercreditor agreement (Docket No. 202).

There has also been a recent round of concern that lock-up agreements, essentially agreements among a group of creditors to support a plan of reorganization, are inappropriate. In *Stations Holding Co.* and in *NII Holdings, Inc.*, Judge Walrath of the Delaware Bankruptcy Court held that if a lock-up agreement was signed <u>post</u>-petition, the votes should be designated (i.e., not counted)[52] since votes were solicited without the imprimatur of a disclosure statement. Judge Walrath's decisions did not question the propriety of prepetition lock-up agreements, for the evil she saw was solicitation of votes after filing a bankruptcy petition when the requirement for a disclosure statement kicks in. After all, prepetition votes on a prepackaged plan without the benefit of a court-approved disclosure statement are expressly sanctioned in the Bankruptcy Rules and have been solicited for years. But the U.S. Trustee in some Districts has taken the position that parties subject to such <u>pre</u>petition lock-up agreements may not sit on a Creditors' Committee since those creditors will not be free to exercise their fiduciary duties to all unsecured creditors by considering alternative plans. As a result, some parties have recently become skittish about entering into lock-up agreements. This analysis is suspect and not strictly

[52] Bankruptcy Code section 1126(e) provides that a vote can be designated if the vote was not made in good faith, or if the vote was not solicited in good faith or in accordance with the other provisions of the Bankruptcy Code.

applicable to the sort of plan voting issues addressed in some second lien debt intercreditor agreements, but the current concern about the enforceability or wisdom of lock-up agreements may have an influence on the somewhat similar issue of voting by second lien creditors.

7. Are There Limits on Future First and Second Lien Debt?

The typical covenant package in a second lien deal will fix the maximum principal amount of first lien debt that may be incurred (usually based on the amount of first lien commitments at the closing, plus a cushion). The typical second lien covenant package will cap the borrower's ability to incur additional second lien debt. The cap on future second lien debt is usually based on a maximum leverage ratio or other financial test although it could be expressed a dollar cap.

8. Are Two Sets of Security Documents Needed?

A single case, *In re Ionosphere Clubs, Inc.*, 134 B.R. 528 (Bankr. S.D.N.Y. 1991), has provoked debate as to whether the first and second liens can be granted in a single set of security documents (containing separate grants of security interests for the first and second liens) rather than in separate sets of security documents. In *Ionosphere*, three series (series A, B and C) of creditors had a security interest in the same assets of the bankrupt company. The security interest for each of the series A, B and C creditors was granted in the same security agreement. The security agreement contained a single "granting clause" that granted one security interest in favor of the series A, B and C creditors. The issue at stake in the case was whether the series A, B and C creditors held three separate secured claims or were co-owners of a single combined claim. The answer would determine whether the series A creditors were entitled to post-petition interest.

In bankruptcy, only an oversecured creditor is entitled to post-petition interest. A creditor is oversecured if the value of its collateral exceeds the amount of its claim. If the series

A, B and C creditors each held a separate secured claim, the series A creditors would be oversecured and the series B and C creditors would be undersecured. However, if the series A, B and C creditors were co-owners of a single combined secured claim, the entire class, including the class A creditors, would be undersecured.

The bankruptcy court held that the series A, B and C creditors were co-owners of a single secured claim because the series A, B and C creditors were secured by a single security interest. The court stated that, if the three series had been secured by three separate liens on the collateral, there would have been three separate secured claims.

Because of *Ionosphere*, some first lien lenders are concerned that they may prejudice their right to post-petition interest unless the first and second liens have completely separate security documents. Clearly there should be separate grants, and on that subject there is little disagreement that *Ionosphere* was correctly decided. *Ionosphere* did not suggest that the first lien creditor would be prejudiced if separate liens were granted in a single security agreement, but some lenders and their counsel have taken the conservative position that each group of secured creditors needs totally separate documentation. However, in most cases a single set of security documents should work to ensure that the first and second liens creditors hold separate secured claims as long as the security documentation contains two separate granting clauses and a clear statement of an intention to create two separate classes of secured creditors.

This is a different issue than whether the same collateral agent can serve for both classes of secured creditors. Using the same collateral agent for both is relatively common when a single placement agent is used for both issues. And from the first lien creditors' perspective this approach may offer certain practical benefits, for as noted in section IV(E) above, a single collateral agent is probably more likely to sign lien release documents to effectuate an out-of-court asset sale, in comparison to a separate collateral agent solely for the seconds who might be tempted to be less forthcoming in an effort to exercise hold up value for the seconds or if there is any subjectivity as to whether the seconds are required to release their liens.

9. Separate Credit Documents.

Sometimes the basic credit agreements for the first and second lien debt are also combined in a single credit agreement. This is most common with second lien term loans. Is this wise? Probably not. The first and second lien creditors will have widely divergent interests, particularly if the debtor is in a restructuring. And if the first and second lien facilities are governed by a single credit agreement the voting issues can become extremely complex – do the firsts and seconds vote together on amendments and waivers, are special class votes required, etc. Each group will likely be concerned that it can be outvoted by the others and this dynamic can change over time particularly as the first lien debt is amortized.

10. Amendment and Consent Rights

First and second lien holders each have a powerful interest in obtaining consent rights over possible amendments or other modification to material provisions of the other creditor constituencies' credit documents. Often the first and second lien holders will agree in their intercreditor agreement not to approve certain credit modifications without the consent of the other. Many intercreditor agreements provide that second lien debt cannot be materially modified (at least in any way that would be materially detrimental to the first lien debt) without first lien approval, sometimes with specified limits on increases in the principal amount of second lien debtor rate of interest on this debt. First lien holders will generally agree not to modify their documents only in certain fundamental areas (increasing principal amount or interest rates above a pre-approved cap, shortening maturity or increasing amortization, etc.).

V.

SKIRMISH CASE STUDIES

A. *Nellson Nutraceutical, Inc.* (Bankr. Del. – Judge Walsh - 2006)

1. Background.

Nellson Nutraceutical, Inc. is a leading manufacturer of energy and nutrition bars and powders. It entered into what ultimately become a $275+ million first-priority secured financing in July 2001. In February 2004, it amended the first lien facility and entered into a $75 million second lien facility. One entity was the agent for both the first and second lien facilities.

In November 2004, Nellson informed the lenders under the first and second lien facilities that it would be unable to comply with certain financial covenants in the first and second lien credit agreements. The resulting Events of Default (as well as other Events of Default) continued through the fourth quarter of 2005. In May 2005, Nellson and the required lenders under the first lien facility and the aggregate required lenders under the first and second lien facilities entered into a limited 60-day waiver of certain enumerated Events of Default. This waiver terminated in accordance with its terms in July 2005.

In the several months after the conclusion of this waiver period, Nellson delivered a strategic and financial plan to the lenders that projected that its performance over the next few years would be lower than the levels contained in projections provided when the second lien facility was negotiated, as well as lower than revised projections that had been provided to the lenders in the spring of 2005. In addition, Nellson's equity sponsor informed the lenders that it would not make any further infusion of capital into Nellson. As a result of these and other developments, the lenders accelerated the first and second lien loans in December 2005. Nellson filed a chapter 11 case in January 2006 in Delaware.

2. <u>Observations</u>

Potential conflicts between the first and second lien lenders in default situations place significant stress on an entity that is acting as agent under both the first and second lien facilities.

The agent and its counsel must be prepared to confront these conflict issues, which will only intensify as the borrower's financial condition deteriorates. As a result of these latent conflict issues, the agent and its counsel should carefully consider how information is communicated to the lenders, how the views of the lenders are solicited, what forums or procedures should be put in place to facilitate such communication and discussion and to what extent, and in what ways, the agent should engage in activities that are not mandated by the credit agreements.

In the Nellson matter, a significant number of lenders hold both first and second lien loans while fewer lenders hold only first or second lien loans, but not both. Prior to the commencement of the chapter 11 case, an informal committee of lenders was formed to advise the Administrative Agent. Not surprisingly, many of the members of this committee hold both first and second lien loans.

Some lenders who hold only first lien loans formed their own informal committee and have been attempting to get the fees of their professional advisors paid by Nellson. They argue that there is a present and irreparable conflict between the first and second lien lenders that precludes the agent from acting as agent under both the first and second lien facilities. They further assert that agent is taking its direction from a committee that is dominated by lenders who hold both first and second lien loans, and thus is not acting in the interests of those lenders who hold only first or second lien loans, but not both.

To date, the agent has asserted in its court filings that no conflict presently exists because a plan of reorganization has not yet been proposed and it is uncertain how the first and second lien lenders will be treated. The agent also states that it is attempting to negotiate a deal with Nellson that it can take back to all lenders for their consideration. The agent maintains that while it is consulting with the informal lender committee it is not taking direction from that entity and is acting within the authority granted to it under both the first and second lien loan documents.

To date, the bankruptcy court (Judge Walsh) has rebuffed the dissident first lien lenders' requests to compel payment of their professionals' fees. However, he has stated his view that a conflict might exist or arise for the agent. He has not taken any action to address these potential conflict issues or indicated that he has the jurisdiction or inclination to do so. In fact, he has suggested that the lenders should look to their rights under the credit agreements to address any concerns that they might have with the agent.

These intra-lender disputes put considerable stress on debtors as well as other creditor constituencies. In Nellson, both the debtor and the creditors' committee have expressed their concern about potential run-away administrative expenses as a result of the proliferation of professionals retained by individual lenders or groups of lenders. The debtor is also concerned about the impact that "Balkanization" within the lender group could have on the negotiation and implemental of a plan of reorganization.

While this case is in its early stages, it seems apparent that even more significant intra-lender disputes are likely to arise unless Nellson puts forward a plan that is acceptable to the second lien lenders and that does not impair to any material degree the first lien lenders. Given Nellson's debt load ($350+ million) and acknowledged EBITDA ($40 million), such a plan may not feasible unless there is a dramatic upturn in Nellson's performance. Thus far, Nellson has not needed debtor-in-possession financing and the bankruptcy court has not had to consider the intercreditor agreement.

Buyers have approached the Debtor and the Debtor has informed such buyers that the company is not for sale. It appears that the second lien holders want to own the company if the sale value is not enough to pay them off.

B. *In re Meridian Automotive Systems – Composites Operations, Inc., et al.;* (Bankr. Del. – Judge Walrath - 2005)

1. Summary

The adequate protection provisions of the intercreditor agreement in this case were modified consensually during negotiations regarding DIP financing. This appears to have been due to the substantial amount of second lien debt held by entities that also held a substantial amount of first lien debt. The result was a complex final DIP order, the intricacies of which may be tested in the event there is no agreement on a consensual plan of reorganization.

2. Facts

Meridian Automotive Systems, Inc. ("Meridian") and its domestic subsidiaries (together with Meridian, the "Debtors") filed voluntary chapter 11 petitions on April 26, 2005 (the "Petition Date"). The Debtors produce and supply to the North American automotive industry front- and rear-end modules, bumper systems, and other interior and exterior modules and components, and the Debtors had about 4,700 employees as of the Petition Date.

In addition to unsecured bonds and third lien notes, Meridian was the borrower under a first lien credit facility with approximately $310 million outstanding as of the Petition Date and a second lien credit facility with approximately $175 million outstanding as of the Petition Date. The intercreditor agreement between the first and second lien lenders prohibits (with limited exceptions) the second lien lenders from objecting to, or requesting adequate protection in connection with, a DIP financing supported by the first lien lenders. As of the Petition Date, there were substantial cross-holdings among the first and second lien lenders, most of whom were not original lenders.

The Debtors filed their bankruptcy petitions with a commitment from JPMorgan Chase Bank ("JPMCB") to provide a $375 million DIP facility. The proceeds were to be used for working capital and to repay in full the first lien indebtedness upon entry of the final DIP order.

During the time between entry of the interim DIP order and the hearing on the final DIP order, Ford and GM (two of the Debtors' largest customers) announced cutbacks in production. As a result, JPMCB invoked the MAC clause and pulled its commitment to fund beyond the $30 million allowed under the interim DIP order.

After the news emerged from Ford and GM, the Debtors revised downward their projected EBITDA, and a DIP facility large enough to repay in full the first lien indebtedness was no longer an option. This development led to extensive, and often very contentious, negotiations among the first lien lenders, the second lien lenders, the Debtors and the creditors' committee as to who would provide the new DIP facility and on what terms. The end result was that the Debtors agreed to a DIP facility that was supported by the first lien lenders, and due to the significant cross-holdings among first and second lien lenders, the final DIP order provided adequate protection to the second lien lenders beyond their contractual entitlements. The circumstances also gave rise to certain unconventional provisions in the final DIP order, including attorneys' fees for an informal committee of first lien lenders and the concept of special priority first lien debt. The salient adequate protection provisions of the final DIP order are as follows:

- For the first lien lenders, (i) replacement liens and a priority claim under section 507(b) of the Bankruptcy Code to the extent of diminution in the value of their interest in their collateral, (ii) payment of the reasonable fees and expenses of counsel and financial advisor to the first lien agent, and (iii) monthly payment of post-petition interest on the first lien debt at LIBOR plus 7.00% per annum, of which 5.00% per annum is payable in cash and 2.00% per annum accrues and is capitalized as additional principal on each interest payment date

- The second lien lenders received the above protections and rights, except they did not receive any cash payment of post-petition interest but rather accrual on the second lien debt at LIBOR plus 11.00% per annum to be capitalized monthly

- In addition to the more typical adequate protection above, the first lien lenders were also granted a superpriority administrative expense claim in the amount of approximately $136,470,000 principal amount of the first lien debt, of which (i) approximately $86,470,000 must be paid in full in cash prior to confirmation of a plan, subject to the ability of the first lien lenders to vote for different treatment in connection with a plan, and (ii) $50,000,000 shall be subject to "cramdown" in accordance with the provisions of the Bankruptcy Code

- As additional adequate protection, a provision was added to the final DIP order providing for the payment of the reasonable fees and expenses of (a) one law firm (if any) as counsel (the "First Lien Counsel") to an ad hoc committee of first lien lenders that hold only first lien debt, and (b) one law firm (if any) as counsel (the "Crossover Counsel") to an ad hoc committee of first lien lenders that hold both first lien debt and second lien debt. The provision imposes a monthly cap on the fees of such counsel, and requires (prior to payment) a letter in which the First Lien Counsel or the Crossover Counsel, as applicable, verifies to parties in interest that such counsel is acting as legal counsel for holders of 25% or more in amount of the first lien debt and (i) in the case of the First Lien Counsel, that each such holder included in calculating such percentage holds only first lien debt and not second lien debt or (ii) in the case of the Crossover Counsel, that each such holder included in calculating such percentage holds both first lien debt and second lien debt. Further, the First Lien Counsel and the Crossover Counsel are only entitled to payment for professional services relating to intercreditor issues, and then only to the extent that such services are not duplicative of professional services being provided by counsel to the first lien agent. Finally, the First Lien Counsel and the Crossover Counsel must file fee applications as required of professionals engaged pursuant to Section 327(a) of the Bankruptcy Code

Several parties objected to the First Lien Holders' counsel's first fee application on the basis that, among other things, counsel sought payment for fees incurred in connection with issues that were not intercreditor issues but rather were duplicative of the legal work performed by counsel to other parties. On February 13, 2006, more than seven months after entry of the final DIP order, a creditor filed a motion seeking to disqualify counsel as First Lien Counsel. The creditor held substantial amounts of the Debtors' first lien and second lien debt. In its motion, the creditor alleged that it retained first lien counsel in October 2004 to advise the creditor in its capacity as a second lien lender. The creditor alleged that counsel's representation of the ad hoc committee of first lien lenders constituted a conflict that the creditor did not waive in writing, and thus counsel violated the Delaware Lawyer's Rules of Professional Conduct and the Federal Rules of Bankruptcy Procedure. On March 14, 2006, the creditors' committee filed its statement urging the court to deny the creditor's motion, and stated as follows: "The principal reason these cases remain in bankruptcy is because of the inability of the holders of Pre-Petition First Lien Debt and Pre-Petition Second Lien Debt to resolve their differences with respect to the terms of a plan of reorganization. Thus, the Court should not countenance any attempt to use the filing or outcome of the [Creditor] Motion as a basis to delay the Debtors' Chapter 11 Cases."

3. Comments

Perhaps the most interesting lesson to be learned from the Meridian case is that substantial cross-holdings between first and second lien lenders can lead to complex negotiations and convoluted DIP orders. While an intercreditor agreement theoretically may eliminate key rights of a junior lien holder in connection with DIP financing, the practical effect may be limited where, as in Meridian, senior lien holders act to protect their economic interests as junior lien holders. As negotiations concerning a plan of reorganization unfold, the parties may find themselves arguing in court over the terms of the intercreditor agreement and the complex provision classifying a portion of the first lien debt as special priority first lien debt. The creditor's motion to disqualify counsel, and the statement of the creditors' committee in response thereto, illustrate some of the contentious behavior arising from intercreditor disputes.

It is also interesting to note that the relative interests of the first and second lien lenders, and hence their behavior, may change throughout the course of a case depending on a debtor's performance and the parties' views on the value of their collateral. Although a second lien lender might act as a senior secured creditor at the beginning of the case, if it becomes apparent that the second lien lender is deeply underwater then he may begin to act more like an unsecured creditor. This change in perspective may manifest itself in connection with KERP, exclusivity and other issues.

C. *In re American Remanufacturers, Inc. ("ARI");* (Bankr. Del. – Judge Walsh - 2005)

1. Summary.

An "out-of-the-money" group of second lien debt holders successfully blocked the debtor from obtaining debtor-in-possession financing from its prepetition senior lenders to finance the bankruptcy case through a going concern sale. The case converted to a Chapter 7 liquidation just 11 days after it was filed. The second lien debt holders obtained no recovery on their second lien debt of $40 million. Four weeks later, the Court approved the sale of most of ARI's assets in Chapter 7 for less than 20% of the first lien debt.

2. Facts

ARI, an auto parts remanufacturer with multi-state operations and approximately 1700 employees, filed a voluntary Chapter 11 petition on November 7, 2005 for the stated purpose of conducting a prompt orderly § 363 going concern sale of all of its assets. ARI's first lien debt holders was owed approximately $56 million, had submitted a "stalking horse" credit bid and had agreed to provide approximately $15 million of DIP financing to finance the bankruptcy case through a sale.

ARI introduced expert testimony at the interim DIP financing hearing to the effect that: (i) the aggregate value of all of the Debtor's assets on a going concern basis was less than $30 million (therefore the second lien debt would not enjoy any recovery in either a going concern sale or a liquidation), (ii) ARI had no real alternative to a §363 sale, and (iii) ARI would not be able to operate in Chapter 11 without the proposed DIP financing.

Second lien lenders held $40 million of second lien debt. The second lien lenders objected to the proposed DIP facility on the basis that their intercreditor agreement with the first lien debt holders precluded the first lien agent from consenting to the subordination of the first lien debt to the DIP financing, notwithstanding that the first lien debt was to have been subordinated, in effect, to additional first lien debt from the existing group of first lien lenders. The relevant language of the intercreditor agreement provided:

> if the First Lien Agent voluntarily agrees to subordinate any Liens on any Collateral securing the First Lien Obligations to any Liens securing obligations owing from the company or the other Credit Parties to any third party … then the provisions relating to the priority of Liens and subordination of payments set forth herein shall not be effective with respect to the Collateral which is the subject of the Liens securing the First Lien Obligations that were voluntarily made subordinate to the Lines securing the obligations owing to third parties.

After an accelerated flurry of briefing (which took place over just five days), the bankruptcy court ruled that the second lien lenders' interpretation of the intercreditor agreement was correct. While this interpretation did not preclude the DIP financing, it effectively meant that if the first lien lenders consented to the DIP financing, they would run a substantial risk that the second lien debt would become *pari passu* with the first lien debt, so they declined to make the DIP financing available and the case converted to Chapter 7.

Less than four weeks after the case converted, the bankruptcy court approved an expedited sale by the Chapter 7 trustee of substantially all of the assets of ARI to an affiliate of the first lien agent for less than $10 million.

3. Comments

While perhaps the most noteworthy aspect of the ARI case is that it is a stark illustration of a second lien holder's willingness and ability to crater a chapter 11 case even when doing so resulted in a complete loss for the second lien holder, it has other noteworthy aspects. First, ARI and its lenders were in some respects fortunate that they were in a bankruptcy court that was willing and able to devote a great deal of attention to the case in the first 11 days of the case, and that was willing to adjudicate an intercreditor dispute on an almost a real time basis dispute. (After initially raising procedural objections that might have precluded such a prompt adjudication, the second lien holders tacitly consented to the court's accelerated resolution of the issue.) Second, the intercreditor agreement at issue was unusually vague, and, atypically, made no specific provision for any DIP lending by the first lien holders. It is also worth noting that the first lien debt holders were not the original parties to the intercreditor agreement. Finally the case illustrates the calamitous results that can face a debtor, its employees, and other stakeholders when the first lien holders and second lien holders are unable to reach a negotiated resolution to an impasse.

VI.

CONCLUSION

Hedge funds are a force to be reckoned with in bankruptcy. Such funds presently have an enormous appetite for distressed securities and particularly for first and second lien debt. In the early skirmishes after the hedge funds have invested massive amounts in distressed securities, we are discovering that the specific provisions that govern the first and second lien creditors' rights in a restructuring vary greatly from deal to deal. These divergent provisions found in today's intercreditor agreements are having an enormous impact on the relative leverage of first and second lien holders.

We are just starting to see these provisions tested, so it is difficult to predict how these new players and their new sorts of financings will affect the restructuring of overleveraged companies. But it is clear that sorting through these issues will be a central part of the next wave of bankruptcies and out-of-court restructurings.

Exhibit A

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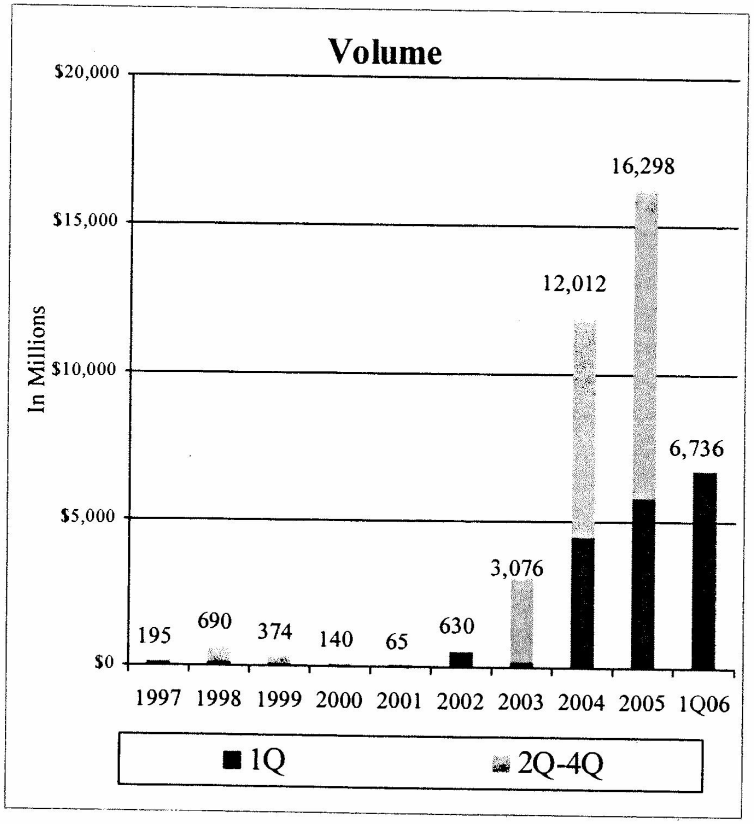
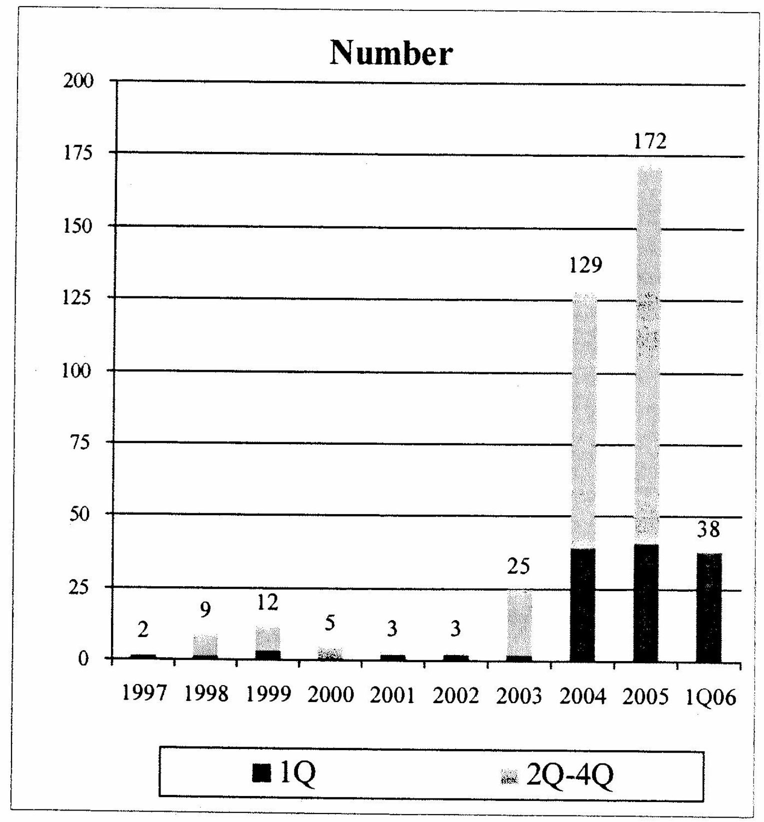
Volume and Number of Second-Lien Loans 1997 – 1Q06





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Volume of Second-Lien Loans
1Q97 – 1Q06