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Negotiating Points in Second Lien Financing Transactions

C. Edward Dobbs*

I. INTRODUCTION

This article summarizes some of the more significant issues faced by the senior working capital lender ("First Lien Lender") in negotiating intercreditor agreements with a provider of so-called second lien term loans (the "Second Lien Lender"). Typically, the Second Lien Lender is a non-regulated private investor, such as a hedge fund, mezzanine fund or specialized finance company, that is engaged in the business of making junior secured "stretch" loans in leveraged financing transactions.1 Although the lien securing the Second Lien Lender's loan is subordinate in priority to the liens of the First Lien Lender in the assets of the borrower, the term loan of the Second Lien Lender (the "Second Lien Loan") is not subordinated in right of payment to the indebtedness owed to the First Lien Lender.2 The Second Lien Lender predicates the amount of the Second Lien Lender upon the perceived "enterprise value" of the borrower's business, which ordinarily can be realized only from a going concern sale of the business after default.3

1. In many second lien financing transactions, the loan provided by the Second Lien Lender is utilized by the borrower to fill the gap between what an asset-based lender is prepared to lend against the collateral and the additional liquidity needed by the borrower, whether for operating capital purposes, consummation of a leveraged buyout or the funding of a dividend to an equity sponsor.

2. This distinction between a lien subordination and a debt (or payment) subordination is important to comprehend. In the former, the Second Lien Lender is generally not authorized to receive and retain any proceeds of collateral securing the Second Lien Loan until the indebtedness owed to the First Lien Lender is fully satisfied. However, after the collateral has been exhausted, any remaining claims of the First Lien Lender and Second Lien Lender would be on equal footing and would share ratably as unsecured creditors in distributions in a bankruptcy case. In a debt subordination, the junior creditor is not authorized to receive and retain any payment (except for certain mutually agreed upon pre-default debt services) until the senior debt is paid in full. See generally, C. Edward Dobbs, Debt Subordination in Howard Ruda, Asset-Based Financing: A Transactional Guide, Ch. 13 (Matthew Bender & Co. 2005).

3. The Second Lien Lender's assessment of "enterprise value" may be based upon a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization) or the Second Lien Lender's assessment of the going concern value of the collateral. If the Second Lien Lender is a so-called cash-flow lender, the Second Lien Lender may determine its pricing, the amount of its

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The market for second lien loans has mushroomed from less than $1 billion in 2002, to $12 billion in 2004 and almost $10 billion in the first half of 2005. 4 A variety of factors account for this substantial increase in the availability of second lien loans, including the ready availability of capital that can be employed at higher returns in highly leveraged transactions. However, there have been relatively few reported decisions in bankruptcy cases involving disputes between the First Lien Lender and Second Lien Lender and their relative rights in a bankruptcy case. It is anticipated that many borrowers that have obtained second lien financings will have little, if any, equity in their assets available for unsecured creditors. Indeed, in many instances, it is predictable that the Second Lien Lender’s claims will be substantially undersecured. As a result, the Second Lien Lender can be expected to use the leverage obtained by virtue of its junior lien position to extract concessions from the borrower or First Lien Lender in a bankruptcy or loan workout context. The documentation of the relative rights of the First Lien Lender and Second Lien Lender, therefore takes on increased importance.5

Second Lien Loan and the financial covenants to be included in the documentation based upon forecasted EBITDA of the borrower. If, on the other hand, the Second Lien Lender is more reliant upon the asset base of the borrower, it will likely derive the amount that it is willing to lend based upon its assessment of the going concern value of the borrower’s assets (i.e., the amount that would be obtained in a sale of the borrower’s entire business as a going concern). The cash-flow Second Lien Lender and the asset-reliant Second Lien Lender will have differing perspectives on many of the issues confronted in intercreditor agreements that they negotiate with First Lien Lenders. The cash-flow Second Lien Lender will be sensitive to negative variances in actual EBITDA compared with forecasted EBITDA of the borrower and will want to act quickly to protect itself in a downward spiral of the borrower’s business. The asset-reliant Second Lien Lender, however, may not be quite so concerned with actual financial performance and more concerned with asset levels in the value of the overall enterprise, including intangible assets (such as patents, trademarks, tradenames and trade secrets).


5. Until recently, banks and other traditional financing sources had exhibited hostility towards the idea of allowing second liens to be granted by their borrowers on collateral securing the claims of such lenders. The reasons prompting this reluctance to agree to second liens were several. First, under the U.C.C., a secured party disposing of collateral owes a non-waivable duty of commercial reasonableness not only to the borrower but also to other secured parties. See U.C.C. § 9-602(7) (2005); Id. § 9-610(b). In addition, the existence of a junior security interest can significantly decrease a senior secured party’s flexibility in managing its collateral, both in and out of bankruptcy. As will be discussed in later paragraphs in the text, a junior secured creditor in bankruptcy has a whole host of rights, which, if asserted, can substantially delay implementation of action agreed upon by the debtor and the senior secured party, increase the cost of the case and reduce the certainty of outcome of a variety of strategies that would be otherwise more certain. In those occasions when the senior secured party gave its consent to the grant of a second lien upon the collateral, the senior secured party generally conditioned such consent
In some second lien financings, the Second Lien Lender requests that the Second Lien Loan be included in and dealt with under the credit agreement between the First Lien Lender and the borrower. On occasion, the use of a common credit agreement is thought to be prudent due to the presence of a so-called “anti-layering” provision in high yield debt documents to which the borrower is a party and by which the borrower is prohibited from incurring any indebtedness that is senior in right of payment to the subordinated debt but junior to the borrower’s senior secured credit facility. The use of a single credit agreement for loans made by the First Lien Lender and Second Lien Lender presents a number of documentation challenges and raises significant legal issues, which are beyond the scope of this article. The more common approach is to require the Second Lien Loan to be separately documented and the liens granted to the Second Lien Lender to be the subject of an intercreditor agreement with the First Lien Lender.

In some second lien transactions, the Second Lien Lender will have a senior lien on its own “primary collateral” as security for the Second Lien Loan (such collateral usually consisting of fixed assets of the borrower) and a junior lien (behind the First Lien Lender’s liens) on working capital assets. In those transactions, the First Lien Lender retains a first priority lien on the working capital assets, with the parties left to negotiate the relative priorities of their liens on general

upon the execution of a stringent intercreditor agreement that “neutered” many of the rights and remedies of the junior secured party, with result that such junior liens came to be known as “silent seconds.” With the substantial increase in the volume of second lien loans and their increased importance to the marketplace, second lien lenders are no longer mute and, in some instances, have roared like lions.

6. Such “anti-layering” provisions can sometimes be construed to prohibit only the borrower’s incurrence of debt that is subordinate in right of payment to the senior secured credit facility and not to prohibit the incurrence of non-subordinated debt financings that are secured by a second lien.

7. In addition to significant drafting issues on voting rights under a shared credit agreement, such an agreement may give rise to an argument that the claims of the First Lien Lender and Second Lien Lender, to the extent secured by a common lien in favor of the collateral agent, are to be viewed as a unified secured claim. To the extent that that unified secured claim exceeds the value of the collateral, the consequence in a bankruptcy case of the borrower may be that the claim of the First Lien Lender will not be entitled, under Section 506(b) of the Bankruptcy Code, to accrue or be paid post-petition interest or expenses incurred in the bankruptcy case. See In re Ionosphere Clubs, Inc., 134 B.R. 528 (Bankr. S.D.N.Y. 1991). Some counsel for First Lien Lenders believe that this problem can be obviated by having separate grants of security interests and other liens (perhaps to separate collateral agents) for the benefit of the First Lien Lender and Second Lien Lender, with the intended result that there are clearly separate secured claims.

8. In transactions involving multiple parties, or in bond or public note transactions, the parties may select an independent collateral trustee and provide for the documentation of the first, second and possibly third liens pursuant to a collateral trust agreement.
intangibles and other miscellaneous assets. The more frequent convention, however, is for the First Lien Lender to obtain a senior security interest in substantially all of the assets of the borrower and for the Second Lien Lender to obtain a junior security interest in the same assets as security for the Second Lien Loan.

The discussion that follows assumes the more frequent scenario in which the Second Lien Loan is separately documented, the Second Lien Lender holds a junior security interest behind the First Lien Lender in all or substantially all of the assets of the borrower, the Second Lien Loan is a term loan, and the First Lien Lender is the provider to the borrower of an asset-based revolving credit facility (including a letter of credit subfacility), a term loan and various bank products, either as sole lender or in a syndicated loan arrangement.

This article is not intended to discuss each of the negotiation points in the intercreditor agreement or attempt to characterize what is the "market" position on the negotiation points that are discussed. As most players in the Second Lien Loan market and their counsel can attest, the market is quite fluid and therefore the perspective of the Second Lien Lender and the outcome of intercreditor negotiations will be driven significantly by (i) the identity of the Second Lien Loan Lender (whether a hedge fund, investment bank, private equity fund or affiliate of the First Lien Lender), (ii) the existence of prior transactions that the Second Lien Lender may have concluded with the First Lien Lender, (iii) the relative size of the Second Lien Loan to the aggregate exposure of the First Lien Lender, (iv) the nature of the First Lien Lender's loans (cash flow or hard asset-based), the intended use of proceeds of the Second Lien Loan (e.g., to pay down debt owed to the First Lien Lender, to effect a dividend to shareholders or to provide additional working capital), and (v) the sophistication and experience of the attorneys and loan officers in dealing with the intercreditor issues in these types of transactions. The focus of this article will be to highlight issues and the consequences of taking various positions on some of the key negotiation points.

II. Subordination of Liens

A. Overview

The provisions of the intercreditor agreement that address the subordination of the liens of the Second Lien Lender to those in favor of the First Lien Lender are, for the most part, not the subject of lengthy
debate. The Second Lien Lender will customarily request an exemption from the lien subordination with respect to collateral that is subject to an unperfected, avoided or invalid lien or a lien that the First Lien Lender has subordinated in favor of a third party.

B. Negotiating Points

1. Validity of First Lien Lender’s Liens

- The Second Lien Lender can be expected to argue that the subordination of its liens to the liens of the First Lien Lender with respect to any collateral is conditioned upon the validity, perfection and non-avoidance (in an insolvency proceeding or otherwise) of the liens of the First Lien Lender with respect to such collateral. The concern of the Second Lien Lender in this regard is that the avoidance of an unperfected (but contractually senior) lien of the First Lien Lender in an insolvency proceeding of the borrower may result in the preservation of the avoided lien for the benefit of the estate under § 551 of the Bankruptcy Code. By preserving the avoided lien for the benefit of the estate, a bankruptcy trustee will assert a right to the proceeds from the disposition of the collateral that had been subject to the avoided lien, at least to the extent of the amount of the claim secured by the avoided lien, and will distribute those proceeds to the holders of unsecured claims in the bankruptcy case. By conditioning the effectiveness of this subordination upon the perfection of the senior secured creditor's interest, the subordinating creditor hopes to avoid such an attack by the bankruptcy trustee. In most cases, the inclusion of such a conditional subordination in the intercreditor agreement is not a "sticking point" for the First Lien Lender.

9. U.C.C. § 9-339 contemplates that one secured party may subordinate its security interest to the security interest of another secured party in personal property collateral. U.C.C. § 9-339 (2005). Official Comment No. 2 to U.C.C. § 9-339 states that that section "makes it entirely clear that a person entitled to priority may effectively agree to subordinate its claim." Id. § 9-339 cmt. 2. For a discussion of lien subordinations generally, see Richard J. Goldstein et al., Intercreditor Agreements, in HOWARD RUDA, ASSET-BASED FINANCING: A TRANSACTIONAL GUIDE, Ch. 6 (Matthew Bender & Co. 2005).


11. Indeed, a more aggressive trustee may take the position that, having avoided the contractually senior lien, all of the proceeds from a disposition of the collateral subject to the avoided lien inure to the benefit of unsecured creditors, and the collateral proceeds available for unsecured creditors are not limited to the amount of the claim secured by the avoided lien.
2. No Contest of Liens

- The First Lien Lender and Second Lien Lender rarely debate the wisdom of including in the intercreditor agreement a provision to the effect that neither will challenge the validity, perfection or priority of the other's security interest in the collateral, except to the extent necessary to enforce the subordination provisions of the intercreditor agreement itself. Some intercreditor agreements go further by prohibiting either party from encouraging or supporting the efforts of the third parties to challenge the security interests of the other lender, so as to discourage one lender from "tipping off" a bankruptcy trustee or other creditor who might not otherwise detect infirmities known by the tipping lender to exist with respect to the other lender's liens.

3. Further Subordination by First Lien Lender

- In the ordinary course of administering an asset-based loan relationship, the First Lien Lender may give lien subordinations to third parties who deal with the borrower, such as suppliers, mortgagees, warehousemen, common carriers, custom brokers, factors and depository banks. Notwithstanding these subordinations, the First Lien Lender expects that its liens with respect to the specific collateral as to which such an "ordinary course subordination" is given should not result in a forfeiture of its priority vis-à-vis the Second Lien Lender's liens. Accordingly, the First Lien Lender will often seek clarification in the document that the subordination of its liens in such circumstances does not result in a demotion of its liens to those of the Second Lien Lender with respect to the specific collateral.\(^\text{12}\)

4. Liens Subject to Subordination

- The Second Lien Lender will seek to confine its subordination to those liens held by it that are granted under the credit documentation evidencing the Second Lien Loan ("Second Lien Credit Documents"). Further, it will seek to restrict the liens to which it yields priority to those liens of the First Lien Lender that arise under the First Lien Lender's credit agreement and related documents ("First

\(^{12}\) Absent the agreement of the Second Lien Lender, a subordination by the First Lien Lender of its security interest will not effect a subordination of the Second Lien Lender's lien to any third party. See AmSouth Bank, N.A. v. J & D Fin. Corp., 679 So. 2d 695, 698 (Ala. 1996) (subordination agreement between first and third secured creditors did not give third secured creditor priority over second secured creditor); see ITT Diversified Credit Corp. v. First City Capital Corp., 737 S.W. 2d 803, 804 (Tex. 1987) (subordination by first secured creditor in favor of third secured creditor gave third secured creditor priority over second secured creditor, but only to the extent of first secured creditor's claim).
Lien Credit Documents”) and that secure the payment of the obligations arising under that agreement. In contrast, the First Lien Lender will attempt to broaden the scope of the subordination so that all liens at any time obtained by the Second Lien Lender are subordinated in priority to all Lens of the First Lien Lender. If successful in negotiating this point, judgment liens of the Second Lien Lender (which might otherwise take priority over the First Lien Lender’s security interest under the UCC after the passage of 45 days\(^{13}\)) and liens obtained by the Second Lien Lender in the borrower’s bankruptcy proceeding (including adequate protection and DIP financing liens\(^{14}\)) will be junior to the liens of the First Lien Lender. Specifically, the First Lien Lender will argue that any lien obtained by it, whether under the First Lien Credit Documents, in bankruptcy or otherwise, should be superior to any lien at any time obtained by the Second Lien Lender. This debate typically engenders significant discussions regarding DIP financing issues, which are discussed below. One significant measure of protection for the Second Lien Lender is the limitation on the amount of the indebtedness owing to the First Lien Lender that enjoys the benefit of the priority liens, a subject that is discussed below.

III. **Maximum First Lien Lender Debt**

A. **Overview**

The Second Lien Lender can be expected to ask for a cap on the total amount of indebtedness outstanding to the First Lien Lender (the “First Lien Lender Debt”) that will enjoy the benefit of a senior lien. The First Lien Lender Debt that is secured by liens in favor of the First Lien Lender may include advances outstanding under a revolving credit facility, reimbursement obligations associated with letters of credit, term loans made by the First Lien Lender, bank products\(^{15}\), claims under indemnities given by the borrower, and inter-

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13. Pursuant to revised U.C.C. § 9-323(b), a security interest is subordinate to the rights of the person that becomes a “lien creditor” to the extent that the security interest secures advances made more than 45 days after the person becomes a lien creditor, unless the advance is made without knowledge of the lien or pursuant to a commitment entered into without knowledge of the lien.

14. See infra notes 36-53 and accompanying text.

15. As used in this article and as conventionally used in credit agreements between a First Lien Lender and a borrower, the term “bank products” embraces the full range of products offered by the First Lien Lender (assuming it is a bank) to the borrower, including, without limitation, depository accounts, automatic clearinghouse services, electronic funds transfer services, commercial credit cards, merchant card services, hedging agreements, lock-box services and other types of banking products or cash management services provided by the First Lien Lender.
est, fees (including legal fees) and other charges payable in connection with the foregoing. However, the manner in which such a cap is negotiated and documented can have significant consequences for the First Lien Lender. Accordingly, careful drafting by the First Lien Lender is essential to avoid the loss of senior lien status for part of the First Lien Lender Debt that might inadvertently exceed the cap.16

B. Negotiating Points

1. Absolute Dollar Cap

- Some Second Lien Lenders are content simply to establish an absolute dollar cap on the total amount of debt that may be outstanding in favor of the First Lien Lender and that is secured by a senior lien. In that context, the amount of the cap is generally pegged at the initial maximum credit facility under the First Lien Credit Documents plus a negotiated “cushion” for expected growth in the credit facility.

2. Borrowing Base Cap

- More commonly, the Second Lien Lender will seek both an overall senior debt limit and separate caps on each component of the overall credit facility offered by the First Lien Lender. The amount of First Lien Lender Debt within the cap is often referred to in an intercreditor agreement as “Priority Lender Debt” and the amount over the cap is often called “Non-Priority Lender Debt.” To that end, the Second Lien Lender will ask for a ceiling on the principal amount of the First Lien Lender Debt consisting of revolver debt (which includes revolver loans and letters of credit) at an amount equal to the lesser on any date of a maximum dollar amount (the “Revolver Line Cap”) or the borrowing base on such date (the “Borrowing Base Cap”), de-

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16. There is an important distinction between a negotiated cap on First Lien Lender Debt which, if exceeded, would mean that the First Lien Lender has breached a covenant in the intercreditor agreement, and a cap on the amount of First Lien Lender Debt that will enjoy the benefit of the senior lien. In the first instance, the consequence of exceeding the cap includes the recovery of any damages sustained by the Second Lien Lender as a result of the First Lien Lender’s breach. In the second scenario, the First Lien Lender’s liens are demoted in favor of the Second Lien Lender to the extent of the excess. One might question why the First Lien Lender would ever intentionally allow the First Lien Lender Debt to exceed the cap if the result was a reversal of lien priorities for the excess of the First Lien Lender Debt. If the value of the collateral is inadequate to cover the full amount of the First Lien Lender Debt, and the prospects of recovering a deficiency from the borrower are remote, the First Lien Lender may be willing to fund “overadvances” to the extent necessary to allow for an orderly liquidation or a going concern sale, in the hopes of reducing the size of its deficiency claim. Of course, in such circumstances, making loans in breach of a covenant in the intercreditor agreement capping the aggregate First Lien Lender Debt might very well be found not to have caused any damage to the interests of the Second Lien Lender.
NEGOTIATING POINTS

termined pursuant to the First Lien Credit Documents as in effect on the date of the intercreditor agreement.17

- From the First Lien Lender's perspective, it is important that only the unpaid principal balance of the revolver portion of the First Lien Lender Debt be subjected to the Revolver Line Cap. Otherwise, when the revolver is fully funded up to the Revolver Line Cap, the aggregate revolver indebtedness may exceed the Revolver Line Cap by virtue of accruals, such as interest, fees and other charges.18 With regard to the dollar cap on the revolver facility, the First Lien Lender should insure that the cap is sufficiently high to allow room for future growth in the revolver facility. With respect to the borrowing base cap, a frequent compromise is to allow for "overadvances"19 (whether advertently or inadvertently made by the First Lien Lender) in an amount not to exceed the greater of a specific dollar amount or a percentage (say, 10%) of the borrowing base in effect from time to time. To avoid situations where the revolver debt outstanding inadvertently exceeds the cap solely by virtue of receivable agings or other changes in collateral eligibility (a so-called "backed-in overadvance"), the First Lien Lender should make clear in the intercreditor agreement that, in calculating the maximum revolver debt that may be funded on any date, the First Lien Lender may rely upon the borrowing base calculation shown in the last borrowing base certificate received from the borrower, without regard to any subsequent changes in the quality, quantity or mix of the reported collateral or any errors of the borrower in such reporting.

17. In most asset-based financings, the lender agrees to make revolver loans up to the lesser, in any date, of a line of credit amount or the amount of a so-called "borrowing base" at such date. The borrowing base is typically calculated as a percentage rate of advance (say, 80%) against eligible accounts and a separate rate of advance (say, 50%) against eligible inventory of the borrower. The borrowing base automatically adjusts as the composition of the borrower's eligible accounts and eligible inventory increases or decreases from time to time. The amount of a borrower's availability for borrowings under an asset-based financing arrangement on any date will be equal to the borrowing base on that date less the amount of loans and letters of credit outstanding on that date.

18. Consideration should be given to excluding from the Revolver Line Cap any increase in the outstanding principal amount of revolving credit loans that result from so-called "refunding loans," which are advances automatically made under the revolving credit facility to pay First Lien Lender Debt that is then due and payable, such as interest, fees and other charges. Since such refunding loans are used to pay First Lien Lender Debt that would otherwise constitute Priority Lender Debt, the Second Lien Lender ordinarily will have no objection to the inclusion of such provision.

19. An "overadvance" exists in an asset-based lending facility when outstanding revolver loans on any date (together with any outstanding letters of credit) exceed the borrowing base on such date.
3. First Lien Lender’s Term Loans

- In order to capture any perceived “equity” in the collateral, the Second Lien Lender will press for provisions in the intercreditor agreement limiting or prohibiting the funding of additional term loans by the First Lien Lender, disallowing any “reloading” of term loans funded at closing, and requiring that the proceeds of any non-ordinary course dispositions of fixed-asset collateral be used to reduce, permanently, either the outstanding term loans of the First Lien Lender or the Revolver Line Cap. While a requirement of permanent reduction of the term loans generally is not problematic for the First Lien Lender, care must be taken in drafting provisions that address permanent reductions in the Revolver Line Cap. Such reductions may have the unexpected consequence of depriving the borrower of needed liquidity and causing an overadvance to exist. Typically, the Revolver Line Cap should not be reduced (nor any borrowing availability reserve increased) by the application of proceeds of fixed asset dispositions to the revolver loans prior to default and the First Lien Lender’s commencement of lien enforcement action. In addition, the First Lien Lender will wish to avoid any undertaking in the intercreditor agreement to reduce the term loans from proceeds of non-ordinary course dispositions of collateral if, in the First Lien Credit Documents, the borrower is authorized to use a portion of such proceeds (such as insurance proceeds or condemnation awards) to rebuild or replace damaged or condemned collateral.

4. Bank Products Limitations

- A First Lien Lender that provides bank products may insist upon including such bank products as a component of the Priority Lender Debt. The Second Lien Lender will counter with a requirement for some dollar cap on the amount of bank product obligations that will enjoy the benefit of the first lien and, therefore, constitute Priority Lender Debt. If the First Lien Credit Documents impose a reserve against borrowing availability in an amount equal to bank

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20. See supra note 15.
21. If the First Lien Lender is the administrative agent for a syndicate of lenders and if the negotiated cap on Priority Lender Debt is exceeded, the question will arise as to how the resulting Non-Priority Lender Debt is to be allocated among the syndicate members. A pro rata allocation would appear to be the logical result, but such a result may not be warranted where the syndicate members do not participate on a pro rata basis in all of the credit facilities provided for under the First Lien Credit Documents. If the excess First Lien Lender Debt above the Priority Lender Debt amount results from banking relationship debt and such banking relationship debt is, pursuant to the terms of the First Lien Credit Documents, to be paid after all other obligations owed to the syndicate members, then the holder of such banking relationship
product obligations outstanding from time to time, the dollar cap on
the amount of bank product obligations might be set at the amount of
the reserve. Normally, the First Lien Lender will exclude from the
definition of “bank products” any letters of credit that are issued
under to the revolving credit facility. Otherwise, there may be an un-
intended limitation on the aggregate amount of letters of credit that
may be outstanding, which is in addition to the limitations on the
amount of revolving facility indebtedness that qualifies as Priority
Lender Debt.

5. Add-Ons to Priority Lender Debt

- After negotiating the various dollar caps for components of the
First Lien Lender Debt, the First Lien Lender will likely insist upon
certain add-ons to the Priority Lender Debt. Those add-ons will likely
include interest accruals, enforcement expenses (broadly defined to
include all expenses associated with realizing upon the collateral or
collecting the First Lien Lender Debt after default), fees provided for
under the First Lien Credit Documents, and amounts owing at any
time under indemnity agreements from the borrower under any of the
First Lien Credit Documents. Those add-ons, which are not usually
subject to a dollar limitation, are of critical importance to the First
Lien Lender because their incurrence or accrual might otherwise
cause the aggregate amount of the First Lien Lender Debt to exceed
the cap.

The Second Lien Lender may want assurances that any accruals,
enforcement expenses or indemnity amounts that relate exclusively to
any Non-Priority Lender Debt will be excluded from treatment as Pri-
ority Lender Debt. Moreover, the Second Lien Lender may insist that
only interest at the non-default rate will constitute Priority Lender
Debt, with the differential between the non-default interest rate of
interest and the default rate of interest constituting Non-Priority
Lender Debt. The Second Lien Lender will frequently take the posi-
tion that any termination charges or prepayment premiums (other
than LIBOR breakage costs) payable to the First Lien Lender must
be included in the basket of Non-Priority Lender Debt.

6. The “Waterfall” and Payment of Non-Priority Lender Debt

- Even if the amount owing to the First Lien Lender exceeds a
negotiated cap, the First Lien Lender should insist that such Non-Pri-
ority Lender Debt nevertheless remains secured by the collateral. The "waterfall" section of the intercreditor agreement, which allocates proceeds of collateral between the First Lien Lender and the Second Lien Lender, will usually provide for the payment of the Non-Priority Lender Debt after the payment of all principal and interest with respect to the Second Lien Loan, but before the payment of any early termination charges or other prepayment premiums to the Second Lien Lender. Issue may be joined on the question whether the termination charges or prepayment premiums payable to the First Lien Lender should be paid prior to, or after, payment in full of all termination charges or other prepayment premiums owing to the Second Lien Lender.

7. DIP Financing

- The First Lien Lender should include in the definition of Priority Lender Debt any financing provided to the borrower in a Chapter 11 case (called "DIP financing"), provided that the aggregate of the prepetition financing and the DIP financing does not exceed the negotiated dollar cap. The failure to do so may complicate the First Lien Lender's efforts, in a DIP financing context, to "roll up" the prepetition indebtedness owed to it into a DIP financing arrangement.22

IV. STANDBY AS TO ENFORCEMENT ACTIONS

A. Overview

Intercreditor agreements in second lien financing transactions routinely require the Second Lien Lender to refrain from taking certain enforcement actions, notwithstanding defaults under the Second Lien Credit Documents, unless the default is a so-called "actionable event of default" or the claims of the First Lien Lender have been fully paid.23 Actionable events of default normally include the institution

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22. See infra note 45 and accompanying text.
23. Official Comment No. 5 to U.C.C. § 9-610 is instructive and states: "Disposition rights under subsection (a) are not limited to first-priority security interests. Rather, any secured party as to whom there has been a default enjoys the right to dispose of collateral under this subsection. The exercise of this right by a secured party whose security interest is subordinate to that of another secured party does not of itself constitute a conversion or otherwise give rise to liability in favor of the holder of the senior security interest." U.C.C. 9-610 cmt. 5 (2005). For a discussion of the right of a secured party to foreclose upon collateral notwithstanding the existence of a prior security interest, see C. Edward Dobbs, Enforcement of Article 9 Security Interests - Why So Much Deference to the Junior Secured Party?, 28 Loy. L.A. L. Rev. 131 (1994).

Although waivers of rights by debtors and other obligors are restricted by U.C.C. § 9-602 (2005), there is no express prohibition in Revised Article 9 of the U.C.C. that would render unenforceable a junior secured party's agreement to waive or defer the exercise of certain lien
of a lien enforcement action by the First Lien Lender and the occurrence of payment and certain other critical defaults under the Second Lien Credit Documents. Notwithstanding the occurrence of an actionable event of default, the Second Lien Lender is required to forbear for a mutually agreed upon number of consecutive days (the "standby period")\(^{24}\). The standby period affords a "breathing spell" to allow the borrower and First Lien Lender either to cure the defaults or to prepare for alternative courses of action, including bankruptcy.

B. Negotiating Points

1. "Full Payment" of First Lien Lender Debt

- Absent an actionable event of default, the Second Lien Lender is usually prohibited by the intercreditor agreement from initiating enforcement action prior to payment in full of all First Lien Lender Debt (up to the Priority Lender Debt amount). Thus, both the First Lien Lender and the Second Lien Lender will be interested in defining the circumstances under which full payment will be deemed to have occurred. The First Lien Lender will wish to make clear in the intercreditor agreement that its claim has not been "fully paid" until all loans and other non-contingent obligations have been paid in full, all contingent obligations (such as outstanding letters of credit) have been cash collateralized, and all commitments to extend credit have been terminated. The Second Lien Lender should be alert to the presence of language in the intercreditor agreement that might be construed to delay its enforcement remedies until the cash collateralization or resolution of claims that might give rise to an indemnity from the borrower and that have yet to be asserted, such as unasserted potential claims of liability against the First Lien Lender. Such language may have the effect of forcing the Second Lien Lender to forbear from taking lien enforcement action until the expiration of


24. The First Lien Lender will resist efforts by the Second Lien Lender to include any event of default under the First Lien Credit Documents as an actionable event of default, as otherwise the occurrence of any such default would trigger the standby period even if the First Lien Lender elected to waive the default. Nevertheless, the Second Lien Lender may have a legitimate concern that, if the event of default under the First Lien Credit Documents is not waived within some specified period of time and is otherwise known to exist by the First Lien Lender, the First Lien Lender, in collaboration with the borrower, may orchestrate a forbearance arrangement and orderly winddown of the borrower's business in a manner that is not strictly a lien enforcement action by the First Lien Lender and that is inimicable to the interests of the Second Lien Lender.
applicable limitations periods for the assertion of potential claims against the First Lien Lender, even though the First Lien Lender's loans and letters of credit have been fully paid or cash collateralized.

2. Scope of Remedy Block

- A significant issue to be negotiated will be the scope of the block on remedies that may be exercised during the standby period. The Second Lien Lender may argue that any remedy block be confined to actions that it would otherwise be authorized to take to enforce its junior liens in the collateral. Such blocked remedies would include repossessions, foreclosures, attachments, garnishments, set-offs, lawsuits, commencement of involuntary bankruptcy cases, and the exercise of voting rights with respect to pledged equity securities. The First Lien Lender may push for a more expansive remedy block, to include a bar against acceleration of the maturity of the Second Lien Loan, primarily because of the adverse impact that such an acceleration might have on leases, licenses and other material agreements of the borrower and the potential effect upon trade creditors.

- The Second Lien Lender will ask that the remedy bar in the intercreditor agreement not operate to prohibit it from (i) filing proofs of claim in any insolvency proceeding, (ii) taking action to perfect its liens on the collateral; (iii) filing necessary responsive or defensive pleadings in opposition to proceedings instituted by others (including the borrower) to disallow the claims of the Second Lien Lender; (iv) voting on any plan of reorganization in a Chapter 11 case of the borrower; (v) joining in any judicial foreclosure or other judicial lien enforcement proceeding initiated by the First Lien Lender to the extent that such joinder is in a manner that is not adverse to the interests of the First Lien Lender, does not materially delay the First Lien Lender's exercise of its remedies and is necessary to preserve the rights or remedies of the Second Lien Lender; (vi) bidding at any public sale of the collateral; or (vii) receiving surplus proceeds from the First Lien Lender's sale or other disposition of collateral after payment in full of the Priority Lender Debt. Although the Second Lien Lender may also wish to reserve the right to file (or join in the filing by others of) an involuntary bankruptcy petition against the borrower, the invocation of such a remedy is rare and its exercise by the holder of a claim that is the subject of a bona fide dispute could prove risky.  

25. Under recent amendments to Section 303(b) of the Bankruptcy Code, a petitioning creditor may be disqualified if all or part of its claim is subject to a bona fide dispute. If an involuntary bankruptcy petition is ultimately dismissed, the petitioning creditors may be subject to a
3. Actionable Events of Default

- The First Lien Lender will be keenly interested in the defaults under the Second Lien Credit Documents that constitute "actionable events of default" and that may trigger the commencement of the standby period. The Second Lien Lender may initially insist that all events of default under the Second Lien Credit Documents constitute actionable events of default. The First Lien Lender will seek to limit those defaults to certain key ones, such as bankruptcy, the First Lien Lender's commencement of lien enforcement action and the expiration of the standby period following payment and other material defaults. In all events, the First Lien Lender will endeavor to exclude from the list of actionable events of default cross-defaults to the First Lien Credit Documents or at least to exclude cross-defaults based upon financial covenants in the First Lien Credit Documents that are more stringent than similar covenants contained in the Second Lien Credit Documents.

4. Standby Period

- A significant issue for both parties will be the duration of the standby period. A 60-day standby period would generally be regarded as shorter than normal and a period of 180 days or longer would exceed what is encountered in most intercreditor agreements. The standby period, whatever its duration, should not commence until receipt by the First Lien Lender of written notice from the Second Lien Lender that an actionable event of default has occurred under the Second Lien Credit Documents and that the Second Lien Lender intends that the standby period commence. Otherwise, the First Lien Lender may be surprised to learn that the standby period has run and the Second Lien Lender is no longer barred from commencing enforcement action with respect to the Collateral. Moreover, the Second Lien Lender will wish to make clear that the standby period ends

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26. If the standby period terminates upon an actionable event of default consisting of the First Lien Lender's commencement of a lien enforcement action, then the question is rightly asked whether the Second Lien Lender will be at liberty to conduct a simultaneous foreclosure on the same collateral in respect of which the First Lien Lender has commenced foreclosure. As noted later in the text, the First Lien Lender will argue that, notwithstanding the termination of the standby period, the Second Lien Lender is not authorized to initiate lien enforcement action at any time that the First Lien Lender is diligently pursuing such action with respect to all or any part of the collateral. The termination of the standby period should, nevertheless, permit the Second Lien Lender to join in any judicial enforcement action to the extent necessary to protect its interests (such as a mortgage foreclosure action) provided that in doing so it does not unduly hinder or impede the foreclosure action of the First Lien Lender.
on the date that the Priority Lender Debt is paid in full, if such full payment occurs sooner than the expiration of the number of days in the standby period. The Second Lien Lender often will seek to limit the number of standby periods that may be imposed during any period of 365 days (say, two) and to require that a minimum number of consecutive days (say, 120) elapse between the end of one standby period and the imposition of another.

- The intercreditor agreement normally provides that, during the standby period, only the First Lien Lender may initiate an enforcement action with respect to the collateral. At the conclusion of the standby period, the Second Lien Lender should nevertheless be precluded from commencing any lien enforcement action if, at the time of proposed enforcement, the First Lien Lender has commenced and is "diligently pursuing" such enforcement action with respect to a material part of the collateral or if the First Lien Lender is barred (by insolvency proceeding stays, specific court restraining orders or otherwise) from commencing an enforcement action.

5. Turnover of Collateral Proceeds

- The Second Lien Lender should not find objectionable a provision in the intercreditor agreement requiring it to turn over any proceeds of collateral that it may receive, prior to payment in full of the First Lien Lender Debt (at least to the extent of the Priority Lender Debt amount), during any period that the First Lien Lender is enforcing its liens. Even if the Second Lien Lender is authorized to commence an enforcement action upon termination of a standby period, the intercreditor agreement will often require that any proceeds received from any such action by the Second Lien Lender (exclusive of its reasonable enforcement expenses) must be turned over immedi-

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27. The Second Lien Lender may argue that it should not be precluded from commencing any lien enforcement actions unless the First Lender is foreclosing upon all of the collateral. It is unlikely, however, that the First Lien Lender will simultaneously foreclose on all of the collateral, particularly in situations where the collateral consists of fixed assets, such as real estate and equipment. In practice, the more readily liquidatable collateral (such as accounts and inventory) is foreclosed upon or collected first and the more difficult collateral to dispose of, such as real estate, is the last item of collateral from which the First Lien Lender would seek to recover its loans.

28. Upon the commencement of a bankruptcy case (whether voluntarily by or involuntarily against a debtor), Section 362(a) of the Bankruptcy Code imposes an "automatic stay" against certain creditor action against the debtor or its assets, including any lien enforcement action, without the bankruptcy court's approval. 11 U.S.C. § 362(a) (2005). Because the duration of the stay or a specific restraining order may be indeterminate, the Second Lien Lender may negotiate a period of time by which, if the stay or restraining order is not lifted, the Second Lien Lender (to the extent that it is not itself stayed or enjoined) would nevertheless be authorized to proceed with its own lien enforcement action.
ately to the First Lien Lender for application to the First Lien Lender Debt (exclusive of Non-Priority Lender Debt). On occasion, the First Lien Lender may encounter some debate from a Second Lien Lender that believes it should be entitled to retain all proceeds received from its enforcement action, without any obligation to turn over the net proceeds to the First Lien Lender to the extent of the Priority Lender Debt. Otherwise, the Second Lien Lender will argue, its authority to enforce its lien at the end of a standby period does not afford it any meaningful remedy. The common rejoinder by the First Lien Lender is that such an outcome would be inconsistent with the lien priorities established by the parties and that the purpose of allowing the Second Lien Lender to initiate an enforcement action when the First Lien Lender is inactive is to enable the Second Lien Lender to force some action to be taken, either by the First Lien Lender or by the borrower’s commencement of a bankruptcy case.

- The First Lien Lender may bargain for a provision to the effect that the Second Lien Lender will not interfere or object to any foreclosure proceeding initiated by the First Lien Lender. The Second Lien Lender’s response may be that it will refrain from doing so as long as the First Lien Lender is proceeding in a commercially reasonable manner and otherwise in accordance with applicable law.

29. The rationale generally offered by the Second Lien Lender for this position is that it is authorized under the U.C.C. to retain the proceeds from a foreclosure sale, without any obligation to turn the same over to the First Lien Lender. See U.C.C. § 9-607(a) (2005); id. § 9-607 cmt. 5. Such a result is particularly warranted if the Second Lien Lender undertakes the effort and expense of foreclosure when the First Lien Lender elects not to proceed with a disposition of the collateral after default.

30. The First Lien Lender might also point to Official Comment No. 5 to U.C.C. § 9-610, which states in part that the “holder of a senior security interest is entitled, by virtue of its priority, to take possession of collateral from the junior secured party and conduct its own disposition, provided that the senior enjoys the right to take possession of the collateral from the debtor.” See also U.C.C. § 9-609 cmt. 5 (2005). Conflicting rights to possession among secured parties are resolved by the priority rules of this Article. Thus, a senior secured party is entitled to possession as against a junior claimant. Normally, a junior who refuses to relinquish possession of collateral upon the demand of a secured party having a superior possessory right to the collateral would be liable in conversion.

31. In addition, the Second Lien Lender may seek to include a covenant in the intercreditor agreement compelling the First Lien Lender to conduct any foreclosure sale in a commercially reasonable manner. Because the U.C.C. already imposes a non-waivable obligation on the part of the secured party to proceed in a commercially reasonable manner, the addition of a covenant to that effect in the intercreditor agreement would be superfluous. See U.C.C. § 9-602(7); id. § 9-610(b) (2005). Moreover, the inclusion of such a superfluous covenant might be misconstrued by a court as imposing an even higher duty of commercial reasonableness on the First Lien Lender than is required under the U.C.C.
6. Second Lien Lender’s Cure Rights

- Occasionally, the Second Lien Lender may request cure rights with respect to defaults that may occur under the First Lien Credit Documents. While the First Lien Lender may be predisposed to agree to such cure rights, a word of caution is in order. First, the intercreditor agreement should delineate those defaults that the Second Lien Lender may cure, which should include only defaults which by their nature are curable, such as payment defaults. In addition, the First Lien Lender should make clear that, by conferring upon the Second Lien Lender a right to cure, the First Lien Lender is not obliged to forbear from exercising rights and remedies under the First Lien Credit Documents pending such a cure. Otherwise, the First Lien Lender may find itself in the position of having to forbear pending a cure that may or may not be forthcoming from the Second Lien Lender and at a time when immediate action by the First Lien Lender is necessary to safeguard the collateral.

7. Keeping Perspective on Issues

- In practice, the parties may expend considerable time and energies in negotiating the standby provisions of the intercreditor agreement. In doing so, they may overlook the fact that, especially in sizeable credit facilities to substantial companies, the likelihood of lien enforcement action by either party is remote. Rather than suffer a lien foreclosure, most borrowers will seek relief under the Bankruptcy Code. Furthermore, the Second Lien Lender should be mindful of the fact that its ability to dispose of tangible items of collateral (such as inventory, equipment or real estate) is considerably hampered by the existence of a prior lien in favor of the First Lender as purchasers of the collateral from the Second Lien Lender will take subject to the lien of the First Lien Lender.\(^3\)\(^2\) Hence, the parties would have little to gain from, and should not expend undue effort in negotiating, positions on lien enforcement action issues that are extreme or clearly beyond the norm.

32. A secured party’s disposition of collateral after default transfers to a purchaser for value all of the debtor’s rights in the collateral and discharges the security interest of the foreclosing secured party, and subordinate security interest, but does not cut off security interests senior in priority to the security interest of the foreclosing secured party. See U.C.C. § 9-617(a) (2005). With respect to accounts receivable collateral, a foreclosure remedy by the Second Lien Lender is generally exercised by collection of the accounts, rather than by a foreclosure sale of them. As a result of the collection effort, the First Lien Lender’s security interest is dissipated by the amount of the collections and, if the Second Lien Lender is authorized to retain the collections, the dissipation is permanent and irrevocable.
V. RELEASE OF LIENS

A. Overview

Parties to an intercreditor agreement often include provisions addressing the circumstances under which the Second Lien Lender is obligated to release its liens with respect to specific collateral sold by the borrower with the First Lien Lender's consent. As a general rule, the First Lien Lender will take steps to ensure that the Second Lien Credit Documents contain the same provisions with respect to the borrower's authority to dispose of collateral free of liens as are contained in the First Lien Credit Documents.33 The First Lien Lender's failure to do so may empower the Second Lien Lender to block the implementation of the bargain between the borrower and the First Lien Lender on the subject of permitted asset sales. There are, however, other instances in which the First Lien Lender may consent to dispositions of collateral that are not permitted by its credit documentation and desire that the Second Lien Lender release its liens in order to facilitate the disposition.

B. Negotiating Points

1. Pre-Default Releases

- Most Second Lien Lenders will be disinclined to commit themselves to lien releases except as agreed to with the borrower in the Second Lien Credit Documents. After all, through the process of negotiation, the Second Lien Lender and the borrower have established in the Second Lien Credit Documents the ground rules upon which, prior to default, the borrower will be permitted to make dispositions of assets constituting collateral. If those ground rules are substantially the same as those contained in the First Lien Credit Documents (and the First Lien Lender can be expected to insist that they be), then it may fall on deaf ears for the First Lien Lender to argue that the ground rules should be loosened still further in the intercreditor agreement.

2. Post-Default Releases

- After default, and in connection with a debt restructuring or forbearance agreement, it may be necessary and prudent for the borrower to make certain asset dispositions outside of the ordinary

33. U.C.C. § 9-315(a) provides that a security interest continues in collateral notwithstanding any sale or other disposition of the collateral, unless the secured party authorized the disposition free of its security interest. U.C.C. § 9-315(a) (2005).
course of business for a variety of purposes, including to generate needed liquidity or to divest itself of unprofitable operations. Because post-default dispositions of assets outside the ordinary course of business are typically not permitted by either the First Lien Credit Documents or the Second Lien Credit Documents, the Second Lien Lender's refusal to give its consent to such a disposition consented to by the First Lien Lender may frustrate the borrower's debt restructuring plan. Faced with such a refusal, the borrower may have no option other than to seek bankruptcy relief. Recognizing the potential for stalemate, the First Lien Lender may seek to induce the Second Lien Lender's consent to dispositions that are conditioned upon a range of pre-determined dollar baskets, the application of disposition proceeds as a permanent reduction of the Priority Lender Debt, release prices that are pegged to the fair value of the assets in question and the triggering of an option in favor of the Second Lien Lender to purchase the First Lien Lender Debt (exclusive of Non-Priority Lender Debt), in the manner discussed in greater detail below.\textsuperscript{34}

- The Second Lien Lender should make clear, either in the Second Lien Credit Documents or in the intercreditor agreement, that any permitted asset disposition must be for a purchase price payable in cash or such other consideration as is acceptable to the Second Lien Lender. Non-cash consideration, to the extent it remains uncollected, will not reduce the amount of the indebtedness owed to the First Lien Lender and could, therefore, dilute the Second Lien Lender's position in the collateral.

3. Proceeds Application

- With respect to the application of asset disposition proceeds, the Second Lien Lender will usually require that fixed asset proceeds be applied first in reduction of any outstanding term loans of the First Lien Lender and, after payment in full of such loans, to the revolver obligations. Because application to the revolver obligations may create additional borrowing availability that can be reborrowed under the revolving credit facility, the Second Lien Lender will seek to prevent fixed asset disposition proceeds from being used simply to generate working capital. To the extent that fixed asset proceeds are applied to the revolving obligations, the Second Lien Lender will urge that the payments result in a permanent reduction of the Revolver Line Cap.\textsuperscript{35} With these types of restrictions, the Second Lien Lender

\textsuperscript{34} See infra note 67 and accompanying text.

\textsuperscript{35} While a permanent reduction in the Revolver Line Cap may be helpful, the Second Lien Lender might also argue that the borrowing availability under the Revolver Line Cap be blocked
may be comforted that asset dispositions after default will not result in a dissipation of any equity in the collateral to which its lien has attached and, if all else fails, it has the option to purchase the Priority Lender Debt and thereafter control the collateral.

4. Power of Attorney to Release Liens

- As a measure of protection against a recalcitrant Second Lien Lender who refuses to file appropriate lien releases in connection with asset dispositions to which it has given its advance consent, the First Lien Lender should include in the intercreditor agreement an irrevocable power of attorney to file such releases if the Second Lien Lender fails or refuses to do so within a prescribed time period.

5. Permanent Paydown of First Lien Lender Debt

- The outcome of negotiations over the Second Lien Lender’s release of liens are varied and depend upon the nature of the borrower, the nature of the collateral, the forecasted likelihood of the borrower making asset dispositions, and the relative amount of the claims of the First Lien Lender and Second Lien Lender. Equally as important, the negotiations may well turn on the First Lien Lender’s willingness to accept net disposition proceeds as a permanent paydown of the First Lien Lender Debt. To the extent that it agrees to such a permanent paydown, the First Lien Lender must insure that the First Lien Credit Documents expressly authorize it, vis-à-vis the borrower, to effectuate such a permanent paydown, including any reductions in the Revolver Line Cap and the imposition of any borrowing availability reserves.

VI. AGREEMENT ON CERTAIN BANKRUPTCY MATTERS

A. Overview

The intercreditor agreement provisions that deal with bankruptcy matters are usually the most vigorously negotiated portion of the agreement. By virtue of having a lien upon property of a debtor in bankruptcy, a secured creditor (including the holder of a junior lien) is afforded many rights and privileges. Those rights and privileges give it considerable leverage in a bankruptcy case and include the right to (i) receive “adequate protection” of its interest in the debtor’s prop-

by an amount equal to the fixed asset disposition proceeds applied to the revolver loan obligations instead of the term loan. This will better ensure that the amount of fixed asset disposition proceeds applied to the revolver loans are not simply reborrowed up to the Revolving Line Cap. The First Lien Lender will, as a result, be motivated to apply all fixed asset disposition proceeds first in payment of any outstanding term loans and other obligations before application of such proceeds is made to the revolving loan obligations.
erty as a condition to any use, sale or other disposition of such prop-
erty, including the debtor's use of cash collateral or the granting of
any priming liens to secure DIP financing;\(^{36}\) (ii) to seek relief from the
automatic stay in order to foreclose if such adequate protection is not
provided; (iii) to accrue (and, in many jurisdictions, to receive current
payment of) interest, fees and other charges provided for under the
pre-petition documentation to the extent that the secured creditor's
claim is "fully secured" (i.e., the value of the collateral exceeds the
secured creditor's claim);\(^{37}\) (iv) to object to any sale of collateral pur-
suant to § 363 of the Bankruptcy Code unless the net sale proceeds
will satisfy the creditor's claim or such a sale could be effectuated
under other applicable law despite the creditor's opposition;\(^{38}\) and

\(^{36}\) There is no definition of "adequate protection" in the Bankruptcy Code, but Section 361
provides a nonexclusive list of forms that adequate protection may take. 11 U.S.C. § 361 (2005).
The purpose of adequate protection is to provide secured creditors with sufficient protection
against diminution and the value of the secured creditor's interest in the debtor's assets, failing
which protection, the debtor's use or the disposition of the collateral would constitute a "taking"
in violation of fifth amendment rights.

A common form of adequate protection of the holders of liens upon a debtor's current assets
(such as accounts receivable and inventory) is to grant the secured creditor a "replacement lien"
in the same type of property acquired by the debtor in its bankruptcy case after the commence-
ment of the case. See 11 U.S.C. § 361(2) (2005) (which contemplates the provision of an "addi-
tional or replacement lien" to a secured creditor as a means of adequate protection). Absent the
provision of such a "replacement lien," the value of the secured creditor's interest in such cur-
rent asset collateral may diminish significantly during the pendency of the bankruptcy case by
virtue of the debtor's use, sale or other disposition of such assets. By virtue of Section 552 of the
Bankruptcy Code, a security interest in pre-petition assets of the debtor (such as accounts and
inventory) does not extend to the same types or items of property acquired by the debtor after
the commencement of the bankruptcy case, except to the extent that any such assets acquired by
the debtor after bankruptcy constitute proceeds or products of pre-petition collateral and the
security interest created by the debtor extends to such proceeds or products. 11 U.S.C. § 552(a)
(2005); id. § 552(b).

If the adequate protection granted to the Second Lien Lender proves to be inadequate, the
Second Lien Lender (like any other secured creditor) is allowed a claim under Section 507(b) of
the Bankruptcy Code that is entitled to priority under Section 507(a)(2). Prior to exiting a
Chapter 11 case, the debtor is obligated by Section 1129(a)(9)(A) of the Bankruptcy Code to pay
all such priority claims in cash, including those of inadequately protected secured creditors under
Section 507(b). That cash out obligation may significantly increase the cash requirements neces-
sary for the debtor's confirmed reorganization plan to be implemented. It should be noted that
the priority claims under Section 507(a)(2) will be entitled to payment prior to any general un-
secured deficiency claim of the First Lien Lender.

\(^{37}\) Under Section 506(b) of the Bankruptcy Code, the holder of an allowed claim that is
secured by property having a value in excess of the amount of the claim may seek recovery of
interest accrued on the claim during the bankruptcy case and any reasonable fees, costs or
charges provided for under the agreement (or any state statute) under which the claim arose. 11

\(^{38}\) Pursuant to Section 363(f) of the Bankruptcy Code, a debtor may sell property of the
estate, without the necessity of obtaining the consent of a creditor holding a lien upon such
property, if the proceeds to be derived from the sale will satisfy in full the creditor's claim or the
(v) to seek separate classification of its claim for plan purposes and to vote against the debtor's plan of reorganization.39

Many Second Lien Lenders suggest a "jump ball" on these issues, meaning that the parties should be free to take any position that they might otherwise be lawfully able to take in the absence of an intercreditor agreement between them. In all events, a Second Lien Lender will argue that its rights should not be so restricted as to place it in a worse position than it would occupy if it simply released its liens and assumed the position of an unsecured claimant in the bankruptcy case. The First Lien Lender will usually insist upon addressing in the intercreditor agreement basic rules that will apply, between the First Lien Lender and the Second Lien Lender, in the event of the bankruptcy of the borrower. Failure to reach closure on these issues in an intercreditor agreement may cede significant leverage to the Second Lien Lender in the bankruptcy case, particularly at the critical early stages of the bankruptcy when time is of the essence.40

B. Negotiating Points

1. Consent to DIP Financing and Cash Collateral

- It is a common occurrence in Chapter 11 cases for the incumbent (i.e., pre-petition) secured lender of the borrower to offer DIP financing to sustain the borrower's operations during the bankruptcy case pending a reorganization or a § 363 sale of assets.41 As a general rule, such DIP financing is secured by a first priority lien on all of the borrower's pre-petition and post-petition assets.42 The existence of a

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39. Under Section 1122 of the Bankruptcy Code, secured creditors having liens on the same property, but with differing priorities, typically will be placed in separate classes for plan purposes. Pursuant to Section 1129(a)(7)(A) of the Bankruptcy Code, a plan cannot be confirmed (other than by a "cram down" confirmation under Section 1129(b)) unless each class of creditors votes to accept the plan. 11 U.S.C. § 1129 (2005).

40. A recent example of a Second Lien Lender's using the leverage of a secured creditor in a bankruptcy case occurred in In re Tower Automotive, Inc., Case No. 05-10578 (ALG) (Bankr. S.D.N.Y. Sept. 19, 2005). There, the Second Lien Lenders as a group held approximately $155,000,000 in indebtedness of the debtor. See id. One of the Second Lien Lenders objected to the proposed priming of its junior liens absent the provision of adequate protection. See id. A significant, and costly, negotiation and court proceedings ensued as a result. See id.

41. See infra note 56 and accompanying text.

42. Because the Second Lien Lender will often realize considerably more on its claim through a going concern sale in a Chapter 11 reorganization of the borrower, the Second Lien Lender will generally be supportive of a reasonable DIP financing arrangement, whether offered by the First Lien Lender or others. Accordingly, except in circumstances where the Second Lien Lender perceives itself to be "out of the money" and objects to virtually everything in an effort to exact concessions in its favor, the Second Lien Lender normally will not oppose DIP financing
subordinate lien in favor of the Second Lien complicates the process of obtaining approval for such financing. In order for the First Lien Lender to obtain such a first priority lien, the bankruptcy court must approve the borrower's grant of a "priming lien" (i.e., one that is senior to the Second Lien Lender's second priority lien on the borrower's pre-petition collateral) to secure the DIP financing. If it is prepared to yield to such a priming, the Second Lien Lender may condition its consent upon a requirement that the aggregate of the pre-petition debt owing to the First Lien Lender and all post-petition DIP financing not exceed the pre-negotiated cap in the intercreditor agreement on First Lien Lender Debt, as discussed earlier. If those limits are exceeded, then a portion of the obligations would constitute Non-Priority Lender Debt and the Second Lien Lender's liens would take precedence over those of the First Lien Lender to that extent.

Additionally, the Second Lender may argue that the "priming lien" granted to secure the DIP financing should be senior in priority not only to the pre-petition liens of the Second Lien Lender but also to the pre-petition liens of the First Lien Lender. Such a joint priming, the Second Lien Lender will argue, better ensures that the First Lien Lender does not offer an overly aggressive DIP financing that serves only to "push down" (and thereby dilute) the position of the Second Lien Lender. The First Lender should be mindful of the potential negative affects that such a structure might have upon its ability to

or, for that matter, consensual cash collateral usage by the borrower in bankruptcy. The tension that may arise results from differing opinions as to the best method to maximize the return on the collateral. The Second Lien Lender may believe that a well-orchestrated and prompt disposition of all of the collateral in a Section 363 sale, in the early stages of the case and prior to a plan, is necessary to prevent erosion in the value of the collateral as a result of a borrowers ongoing losses through continued operations. Thus, the Second Lien Lender may desire that the term of the DIP financing facility be on the shorter end of the spectrum (say, 120 days) in order to force action by the borrower to initiate and actively pursue a Section 363 sale process.

43. In a syndicated loan transaction, an administrative agent is typically the party to the intercreditor agreement, for itself and for the benefit of the syndicate lenders (whose composition may change from time to time). In obtaining the advance consent to a DIP financing, the intercreditor agreement should be worded in such a way that the Second Lien Lender consents to DIP financing led by the administrative agent and one or more financial institutions (some or all of which may or may not be parties to the pre-petition credit facility with the borrower).

44. Section 364 of the Bankruptcy Code sets forth the parameters within which a trustee (or debtor-in-possession) may obtain credit secured by a lien on property of the estate. 11 U.S.C. § 364 (2005). If the trustee satisfactorily demonstrates to the bankruptcy court that the trustee is unable to obtain unsecured credit, credit secured by a lien on unencumbered property of the estate, or credit secured by a junior lien on encumbered property of the estate, then the court may authorize the trustee to obtain credit secured by a "senior or equal lien" on property of the estate, subject to the provision of adequate protection to the interests of the holder of a lien on such property. 11 U.S.C. § 364(c) (2005); id. § 364(d).
“roll over” or “roll up” its pre-petition claims into post-petition DIP financing.45

Finally, the Second Lien Lender may condition its consent to DIP financing on the bankruptcy court’s determination that the economic terms of the DIP financing are fair and reasonable as well as the Second Lien Lender’s receipt of an adequate protection lien with respect to post-petition assets. Such a lien will serve to safeguard against any diminution in value of the Second Lien Lender’s liens on the pre-petition collateral that may result from the borrower’s use, sale or other disposition thereof in the bankruptcy case.46 Any such adequate protection lien, however, should expressly be made inferior to the First Lien Lender’s pre-petition liens, any adequate protection liens conferred upon the First Lien Lender in the bankruptcy case, and the liens securing the DIP financing.

- It is commonplace for negotiated orders approving DIP financing to include a so-called “carve-out” from the liens and priority status securing the DIP financing for the payment of fees and expenses of professional persons retained by the debtor and the creditor’s committee. In some jurisdictions, the failure to make provision for such a “carve-out” in the proposed DIP financing may result in the bankruptcy court’s declining to approve the DIP financing. Accordingly, the First Lien Lender may press the Second Lien Lender to consent in

45. A so-called “roll over” occurs in a DIP financing when proceeds of pre-petition collateral received during the bankruptcy case (including collections after bankruptcy of pre-petition accounts receivable) are applied to reduce the pre-petition indebtedness owed to the First Lien Lender and the First Lien Lender re-advances those amounts post-petition as part of the DIP financing. As proceeds of pre-petition collateral are so applied, the pre-petition indebtedness is ultimately paid off and “rolled over” into the DIP financing. A so-called “roll up” occurs in a DIP financing context when the initial advance made by the First Lien Lender is used to repay in full all of the pre-petition indebtedness owed to the First Lien Lender. As a result of this “rolling up” of the pre-petition indebtedness into the DIP financing, the First Lien Lender ceases to be a pre-petition creditor of the borrower and becomes the holder of a DIP financing claim in the bankruptcy case that is secured by a priming lien on the assets of the borrower and is entitled to administrative expense priority pursuant to Section 364(c)(1) of the Bankruptcy Code. It is not uncommon for bankruptcy courts to look askance at roll ups, except where there is clear and convincing evidence that the First Lien Lender’s pre-petition claim is oversecured (i.e., secured by collateral having a value clearly in excess of the indebtedness owed to the First Lien Lender).

46. In most cases, the First Lien Lender will have no objection to the Second Lien Lender’s receipt of adequate protection in connection with any priming DIP financing. However, the First Lien Lender may seek to restrict the scope of such adequate protection to the granting of a replacement lien and disallow any other form of protection, such as current payments of post-petition interest and legal fees of the Second Lien Lender, in order to preserve needed liquidity for the borrower in its Chapter 11 bankruptcy case. Some Second Lien Lenders will push hard for the right to seek the same type of adequate protection that is afforded the pre-petition liens of the First Lien Lender, meaning that the Second Lien Lender would be entitled to receive current payments of post-petition interest accruals to the same extent that such payments were made to the First Lien Lender.
advance to any professional fee "carve out" that is negotiated by the First Lien Lender in the DIP financing order. Without the consent of the Second Lien Lender, it may be difficult for the First Lien Lender to obtain court approval for such a "carve-out" for professional fees. The effect of such a "carve-out" is to layer an amount of unsecured debt (albeit entitled to administrative expense priority under § 503 of the Bankruptcy Code) in a position senior to the First Lien Lender Debt, the DIP financing and the Second Lien Loan, thereby further diluting the interests of the Second Lien Lender. In exchange for such a pre-consent, the Second Lien Lender will likely insist that any "carve-out" be reserved against borrowing availability under the DIP financing as a means of offsetting the collateral dilution.

- It is important to understand that, without the pre-consent of the Second Lien Lender to the priming of its liens in connection with the First Lien Lender's provision of DIP financing, the bankruptcy court may decline to approve, or may delay giving approval for, the financing at the early, critical stages of the case) absent the provision of adequate protection of the Second Lien Lender's liens. Adequate protection may be demonstrated by showing that there is a substantial "equity cushion" in the collateral for the benefit of the Second Lien Lender that will not be eroded by the DIP financing or that the financing will preserve or otherwise enhance the value of the collateral by an amount that exceeds the amount of the priming DIP financing. Because a showing of adequate protection may be both time-consuming and expensive, and the outcome of a hearing on such financing may well be uncertain, obtaining the pre-consent of the Second Lien Lender to a priming DIP financing is often crucial and should not be bargained away lightly by the First Lien Lender.


48. See, e.g., MBank Dallas, N.A. v. O'Connor, 808 F.2d 1393, 1397 (10th Cir. 1987) (authorizing use of cash collateral to drill gas wells expected to produce substantial additional revenues); In re 495 Cent. Park Ave. Corp., 136 B.R. 626 (Bankr. S.D.N.Y. 1992) (projected property improvements constituted adequate protection when increase in rents would increase the value of the real estate by some $800,000).

49. In the Chapter 11 case of In re New World Pasta Company, Case No. 04-02817 (pending in the United States Bankruptcy Court for the Middle District of Pennsylvania), the second lien lender objected to the entry of a DIP financing order that, as drafted by the first lien lender, would have recognized and given effect to the provisions of a pre-petition intercreditor agreement in which the second lien lender waived, among other things, rights to adequate protection in connection with the debtor's use of cash collateral and the right to vote on a Chapter 11 plan. The second lien lender argued that the "offending language" in the order should be eliminated and the right of the second lien lender to challenge the enforceability of the provisions contained in the intercreditor agreement (which it freely signed) should be preserved. The bankruptcy court ultimately approved the DIP financing, but embraced the second lien lender's request that
Notwithstanding the consent of the Second Lien Lender to a pre-negotiated form of DIP financing arrangement, the First Lien Lender should expressly reserve in the intercreditor agreement the right to provide DIP financing on any other terms that may be approved by the bankruptcy court. Such a reservation should negate any inference that the First Lien Lender has limited itself to the terms of the pre-negotiated DIP financing. While such a reservation of rights is not usually a sticking point, the Second Lien Lender will also retain its right to object to any DIP financing that falls outside of the parameters of the pre-negotiated DIP financing.

If the borrower and the First Lien Lender have not completed the negotiation or documentation for DIP financing prior to commencement of the bankruptcy case, the borrower’s immediate liquidity needs may have to be met through the use of collateral proceeds securing the claims of the First Lien Lender and Second Lien Lender, including collections on accounts receivable. Without the consent of all holders of claims secured by the collateral to the borrower’s use of such cash during the bankruptcy case, the borrower is not allowed to use cash collateral unless approved by the bankruptcy court. Any such approval is generally conditioned upon the provision of “adequate protection” to the holders of liens with respect to the cash collateral. A contested cash collateral fight can be time consuming and disruptive to the borrower’s operations, thereby jeopardizing the prospect for a successful reorganization.

Accordingly, the First Lien Lender will normally push for intercreditor provisions by which the Second Lien Lender will be deemed to have consented to the borrower’s use of cash collateral in any bankruptcy case to the extent of any consent given by the First Lien Lender. In return, the Second Lien Lender will reserve its right to seek adequate protection against any diminution in the value of its pre-petition liens on the collateral. Typically, the First Lien Lender will acquiesce in such a reservation if the adequate protection liens to be granted to the Second Lien Lender are subordinate in priority to those in favor of the First Lien Lender. The Second Lien Lender may limit its consent to the borrower’s cash collateral usage to the borrower’s adherence to the same Borrowing Base Cap that may have been negotiated in the intercreditor agreement as part of an overall

its rights to challenge the enforceability of the waivers in the intercreditor agreement be preserved.

limit on the amount of Priority Lender Debt. By the imposition of such a condition, the Second Lien Lender hopes to prevent any further erosion in its equity in the working capital collateral of the borrower.

2. Second Lien Lender’s DIP Financing

- Many First Lien Lenders believe that intercreditor agreements to which they are currently a party effectively preclude the Second Lien Lender from offering a DIP financing facility that primes (or is on a parity with) the pre-petition liens of the First Lien Lender. This belief may be based upon the mistaken assumption that, if the intercreditor agreement expressly states that it is applicable during the pendency of a bankruptcy case (as many do), any post-petition liens in favor of the Second Lien Lender would automatically be subordinate to those pre-petition liens of the First Lien Lender.

However, the subordination provisions may only apply to the specific liens granted to the First Lien Lender under the First Lien Credit Documents and only to the extent they secure the pre-petition obligations owing to it. Further, the agreement may provide that those liens of the First Lien Lender are senior only to the Second Lien Lender’s liens under its pre-petition credit agreements with the borrower and not to any liens of the Second Lien Lender obtained in connection with any DIP financing under § 364 of the Bankruptcy Code. The subordination provisions may be altogether silent on the priority of other liens obtained by the Second Lien Lender, including liens obtained by way of judgment or during the pendency of a bankruptcy case.

Accordingly, to avoid doubt, the First Lien Lender might seek an explicit provision in the agreement to the effect that all liens of the Second Lien Lender, however and whenever obtained, are junior in priority to the liens of the First Lien Lender. From the vantage point of the First Lien Lender, the Second Lien Lender should not be authorized to prime the liens of the First Lien Lender (whether those liens are granted under the pre-petition credit documents or other-

52. See supra note 17 and accompanying text.

53. See supra note 36. In The Enstar Group, Inc. v. Bank of New York, 174 B.R. 315 (N.D. Ala. 1994), the court ruled that a pre-petition subordination agreement signed by one Chapter 11 debtor in favor of a bank with respect to claims that that debtor might hold against an affiliate continued in effect after the commencement of the bankruptcy case of both the debtor and its affiliate, with a result that a post-petition loan made by the debtor to its affiliate in the Chapter 11 cases was junior in right of payment to the pre-petition claims of the bank, even though the loans were otherwise accorded senior status under the bankruptcy court’s approval order for the post-petition loan.
wise) until after payment in full of all of the First Lien Lender Debt (including DIP financing, but excluding any Non-Priority Lender Debt). The value of such a concession by the Second Lien Lender should be kept in perspective, however, as the Second Lien Lender may easily be able to arrange for a priming DIP facility through affiliates, clients or fund participants.

- The Second Lien Lender may also insist upon reserving its right to offer DIP financing, on a priming or pari passu basis, if the First Lien Lender declines to provide any DIP financing to the borrower or to agree to the use of cash collateral. The Second Lien Lender ordinarily will have a strong desire to preserve the going concern value of the borrower's business (to the extent that the Second Lien Lender believes that the business has some going concern value). While the First Lien Lender will ordinarily be strongly resistant to any pre-consent to a priming lien, it may be persuaded to give its advance consent in the intercreditor agreement with certain conditions attached, such as a limitation on the amount of DIP financing that may be provided (e.g., limited to the amount of the borrowing availability that would otherwise exist under the pre-petition First Lien Credit Documents), the current payment of interest on the First Lien Lender Debt, reimbursement of the First Lien Lender's expenses and attorneys' fees (to the extent allowed by the bankruptcy court); and the conferral of a right upon the First Lien Lender at any time after default under such DIP financing (with the Second Lien Lender required to give notice of any default upon which it intends to act) to acquire, at par, the outstanding DIP financing and related documents from the Second Lien Lender.

3. Stay Relief

- The First Lien Lender will commonly seek the Second Lien Lender's commitment not to seek relief from the automatic stay except in a narrowly defined set of circumstances, including the granting of relief from the automatic stay in favor of the First Lien Lender. It should be borne in mind, however, that, if the Second Lien Lender has already agreed not to enforce its liens at any time the First Lien Lender is stayed or enjoined from doing so (see discussion above), the

54. Pursuant to Section 362(a) of the Bankruptcy Code, the commencement of a bankruptcy case operates as an “automatic stay” of certain creditor actions against the debtor or property of the debtor’s estate in bankruptcy. 11 U.S.C. § 362(a) (2005). Creditors may petition the bankruptcy court for a termination, modification, conditioning or nullification of the automatic stay, for cause, including lack of adequate protection of an interest in property of the petitioning creditor. Id. § 362(b) (2005).
Second Lien Lender's obtaining stay relief would be of no significant consequence since it would be barred from enforcing its liens in any event.

4. Adequate Protection

- The First Lien Lender will usually request that the Second Lien Lender not object to any adequate protection relief sought by the First Lien Lender in the bankruptcy case, but the reverse is not always the case. While the First Lien Lender can be expected to agree to the grant to the Second Lien Lender of an adequate protection replacement lien in post-petition assets acquired by the debtor during the Chapter 11 case, the First Lien Lender may desire to reserve its right to object to any request of the Second Lien Lender to receive adequate protection in the form of periodic cash payments, for a number of reasons. First, the Second Lien Lender's liens may have no value if there is no equity in the collateral, and therefore the Second Lien Lender would not be entitled to receive adequate protection payments. Second, the provision of adequate protection to the First Lien Lender in the form of periodic cash payments will serve to preserve or build up equity in the collateral for the benefit of the Second Lien Lender. Finally, a requirement for cash payments to the Second Lien Lender may deplete needed liquidity under the DIP financing facility provided by the First Lien Lender.

5. 363 Sales

- As its opening salvo in the intercreditor negotiations, the First Lien Lender will argue that the Second Lien Lender must give its advance consent to any sale of the borrower's assets under §363 of the Bankruptcy Code (a "363 Sale") that is consented to by the First Lien Lender. The First Lien Lender may reap substantial benefits from having such advance consent, as otherwise the Second Lien Lender that objects to a 363 Sale may be able to delay, through court hearings, the consummation of the sale or potentially block the sale. The First Lien Lender will likely argue, as justification for the Second Lender's advance consent, that a sale in the bankruptcy is generally

55. See supra note 36.
56. Section 363 of the Bankruptcy Code authorizes a trustee (or debtor-in-possession) to sell property of the estate free and clear of any lien or other interest in the property if (1) applicable non-bankruptcy law permits the sale free and clear of such interest; (2) the holder of the interest consents; (3) the interest is a lien and the price at which the property is to be sold is greater than the "aggregate value of all liens on such property"; (4) the interest is in bona fide dispute; or (5) the holder of the interest could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of the interest. 11 U.S.C. § 363 (2005).
subject to competitive bidding, the bankruptcy court will ultimately be called upon to "bless" the terms of a proposed sale (including the results of any auction), and, at least in Chapter 11 cases, a creditor’s committee will exercise oversight and have a substantial voice in reviewing the proposed auction procedures for fairness.

In addition, the First Lien Lender will direct the Second Lien Lender’s attention to the provisions of § 363(k), which authorizes a holder of a lien to bid at the auction sale for the property and to offset its claim against the purchase price (a so-called "credit bid"). This option to submit a credit bid will serve to protect the Second Lien Lender from a potential "fire sale" of any of the collateral. On the other hand, both parties to the intercreditor agreement may request the other to waive all credit bidding rights for fear that the possible exercise of those rights in a 363 Sale context may discourage third parties from bidding at an auction for the borrower’s assets.

To the extent that it is prepared to make that concession (which, in the case of most sophisticated Second Lien Lenders, is certainly not routine), the Second Lien Lender will likely insist, as a trade off, that the filing of a 363 Sale motion triggers its purchase option (discussed below), and that if such purchase option is not exercised, any proceeds from such a 363 Sale must be used to effectuate a permanent reduction in the outstanding First Lien Lender Debt (in the same manner discussed above for pre-bankruptcy sales outside the ordinary course of business).

The Second Lien Lender will sometimes argue for retention of the right to object to any 363 Sale on any basis that could be advanced if it did not have a lien upon the collateral to be sold and was the holder of an unsecured claim in the bankruptcy case.\(^{57}\) Holders of unsecured claims in a bankruptcy case may object to 363 Sale on a number of grounds, including alleged unfairness of the price and other terms of the proposed sale and, in the case of a proposed 363 Sale of substantially all of the debtor’s assets, the alleged impropriety of such a sale outside of the context of a confirmed reorganization plan.

6. Plan Confirmation

- A dissident Second Lien Lender can make confirmation of a borrower’s reorganization plan in a Chapter 11 case substantially

\(^{57}\) Retaining the right to object to a 363 Sale on the same grounds that could be urged by the holder of an unsecured claim may provide only marginal leverage to the Second Lien Lender if the unpaid balance of the Second Lien Loan is not sizeable in relation to the other unsecured indebtedness in the Chapter 11 case and the committee of unsecured creditors is supportive of the 363 Sale.
more time consuming and expensive and may succeed in blocking confirmation altogether. The plan of reorganization may not be confirmed (other than by way of a judicial process known as “cram down”) unless each class of creditors that is impaired by the plan votes to accept the plan. The claim of the Second Lien Lender will likely be placed in a class separate and apart from the claim of the First Lien Lender, thereby affording the Second Lender potential veto rights with respect to the plan if its claim is impaired by the plan. A “no vote” by the Second Lien Lender would force the proponent of the plan to seek confirmation (by “cram down”) of the plan over the objection of the dissenting class consisting of the Second Lien Lender.

Accordingly, the First Lien Lender may attempt to procure the Second Lien Lender’s commitment in the intercreditor agreement to support any plan that is supported by the First Lien Lender and that is otherwise confirmable. However, it will be a rare case in which such a concession from the Second Lien Lender will be given. Indeed, there is some question as to the enforceability of a pre-petition undertaking by a Second Lien Lender to support a plan that is supported by the First Lien Lender.

- It is possible that, pursuant to a confirmed reorganization plan, new debt instruments will be issued to both the First Lien Lender and the Second Lien Lender to evidence a restructuring of the payment terms of the First Lien Lender Debt and Second Lien Loan. Both parties may wish to provide that, if such debt instruments continue to be secured by assets of the reorganized debtor, the provisions of the intercreditor agreement will remain effective to govern their rights, priorities and duties in respect of such liens.

7. Reinstatement

- The First Lien Lenders should be mindful of the fact that, after what it expects to be final payment of the First Lien Lender Debt, some or all of the payments made to it might be recaptured as preferential or otherwise voidable transfers. The First Lien Lender, therefore, would be well advised to attempt to include in the intercreditor agreement a stipulation to the effect that, if it is required to disgorge any payment received and applied to Priority Lender Debt, the amount of the Priority Lender Debt will be revived to the extent of

59. See id. § 1129(b) (2005).
60. See supra note 36.
such disgorgement and will be entitled to the benefit of all of the terms of the intercreditor agreement.\textsuperscript{61}

8. Enforceability

- There is scant case law addressing the enforceability in bankruptcy of many of the issues discussed in this section of the article. Section 510(a) of the Bankruptcy Code provides that a “subordination agreement” is enforceable in a bankruptcy case to the same extent that such agreement would be enforceable under applicable nonbankruptcy law. A plausible reading of Section 510(a) is that the term “subordination agreement” includes lien subordination agreements as well as debt subordinations (as to which the cases are clear that Section 510(a) is applicable).\textsuperscript{62}

Nevertheless, it is unlikely that a bankruptcy court would give effect to every provision in the agreement, particularly if the court were to conclude that a provision violated some fundamental policy of the Bankruptcy Code.\textsuperscript{63} For example, in the context of debt subordinations, the courts have divergent views on the enforceability of provisions that empower the senior creditor to vote the junior creditor’s claim with respect to a reorganization plan.\textsuperscript{64} There does not appear

\textsuperscript{61} A more difficult question to be resolved in the intercreditor agreement is whether the Second Lien Lender is obliged to remit to the First Lien Lender any proceeds of the collateral that were received by the Second Lien Lender after the discharge of the Priority Lender Debt but before the First Lien Lender is required to disgorge a preferential or otherwise voidable payment.

\textsuperscript{62} See Goldstein, supra note 9, § 6.03[2]. The bankruptcy court in Citibank, N.A. v. Smith Jones, Inc., 17 B.R. 128, 131 (Bankr. D. Minn. 1982) concluded that an intercreditor subordination agreement by which one creditor agreed to subordinate its liens in favor of a bank was effective under Section 510(a) of the Bankruptcy Code with respect to advances made by the bank to the debtor during the pendency of the debtor’s bankruptcy case, even though the agreement was silent as to the applicability of the lien subordination to advances made to the debtor after bankruptcy. See also, In re Mihalko, 87 B.R. 357, 360 (Bankr. E.D. Pa. 1988) (a pre-petition agreement between first and second lenders, that the second lender’s mortgage would be recorded first, qualified as a valid “subordination agreement” under applicable state law and such a subordination agreement was enforceable under Section 510(a)); see also, In re Cormarc, Inc., 29 B.R. 569, 571 (Bankr. S.D. Fla. 1983) (giving effect to the terms of a pre-petition lien subordination agreement under Section 510(a) of the Bankruptcy Code).

\textsuperscript{63} See Jo Ann J. Brighton, Second-Lien Financings: Enforcement of Intercreditor Agreements in Bankruptcy Part I: More Questions than Answers, 25 AM. BANKR. INST. J. NO. 1, at 38 (wherein the authors question whether the bankruptcy court might decline to enforce certain provisions of lien subordination agreements, either on the grounds that the resolution of the particular inter-creditor dispute did not affect the administration of the case or the enforcement might violate some fundamental policy of the Bankruptcy Code).

\textsuperscript{64} Compare In re 203 N. LaSalle Street P’ship, 246 B.R. 325, 331 (Bankr. N.D. Ill. 2000) (Section 510(a) does not allow for waiver of voting rights by junior creditors), and In re Hart Ski Mfg. Co., 5 B.R. 734, 736 (Bankr. D. Minn. 1980) (rejecting senior creditor’s argument that junior creditor was not authorized, by virtue of the subordination agreement, to seek adequate
to be any sound justification for a court to decline to enforce the terms of a freely negotiated pre-petition intercreditor agreement between sophisticated parties, especially when those agreements merely establish lien priorities and embody waivers or deferrals of certain known rights and remedies of the Second Lien Lender. However, to the extent provisions in these agreements adversely impact fundamental rights of the debtor in a bankruptcy case or the rights of other creditors generally, a bankruptcy court may be inclined to find a basis for refusing to enforce such provisions.  

VII. SECOND LIEN LENDER’S PURCHASE OPTION

A. Overview

Many Second Lien Lenders will bargain hard for the inclusion in the intercreditor agreement of an option to purchase the First Lien Lender Debt upon the occurrence of certain triggering events, such as the bankruptcy of the borrower, the commencement by the First Lien protection or lifting of the automatic stay, with In re Inter Urban Broadcasting of Cincinnati, Inc., 1994 WL 646176, at *2 (E.D. La. Nov. 16, 1994) (sanctioning senior creditor’s voting of junior’s claim), and In re Curtis Center L.P., 192 B.R. 648, 660 (Bankr. E.D. Pa. 1996) (upholding senior’s right to vote junior’s claim on plan of reorganization, despite absence of any provision in the plan for payment on the junior’s claim). See also, In re Davis Broadcasting, Inc., 169 B.R. 229 (Bankr. M.D. Ga. 1994). The courts rejecting the enforceability of a junior creditor’s waiver of rights afforded in the Bankruptcy Code appear to do so based upon a literal reading of sections of the Bankruptcy Code that require such rights to be protected. Those courts that uphold the enforceability of junior’s waiver of rights appear to give more weight to freedom of contract between the parties. It is possible to explain the rulings in the anti-waiver cases by noting the potentially adverse effect of the waiver upon the rights of the debtor and other creditors.

65. To be distinguished from pre-petition waivers by a creditor of its protections under the Bankruptcy Code are pre-petition waivers made by a debtor, which, if given effect, may have an adverse impact not only upon the debtor’s estate in bankruptcy but also upon the rights and recoveries of other creditors. Bankruptcy courts have had conflicting views on the enforceability of pre-petition waivers by debtors of the benefits of the automatic stay and consent to a secured creditor’s obtaining relief from the automatic stay in event of a subsequent bankruptcy case. Compare In re Excelsior Henderson Motorcycle Mfg. Co., 273 B.R. 920, 924 (Bankr. S.D. Fla. 2002) (enforcing stay waiver), In re Club Tower, L.P., 138 B.R. 307, 312 (Bankr. N.D. Ga. 1991 (holding that pre-petition stay waivers are enforceable in a single-asset real estate cases), and In re Cheeks, 167 B.R. 817, 819 (Bankr. D. S.C. 1994) (stating that enforcement of a stay waiver in a forbearance agreement is to further the public policy and encouraging of out-of-court restructuring and settlements), with In re Desai, 282 B.R. 527, 533 (Bankr. M.D. Ga. 2002) (declining to enforce stay waiver due to potential equity in collateral); In re Powers, 170 B.R. 480, 484 (D. Mass. 1994) (“the waiver is a primary element to be considered in determining if cause exists for relief from the automatic stay . . . [h]owever, the existence of the waiver does not preclude third parties, or the debtor, from contesting the motion.”), Maritime Elec. Co., Inc. v. United Jersey Bank, 959 F.2d 1194, 1204 (3rd Cir. 1991) (stay serves the interests of both debtors and creditors and may not be waived nor its scope limited by a debtor), and Ostano Commerzanstalt v. Telewide Systems, Inc., 790 F.2d 206, 207 (2nd Cir. 1986) (debtor may not waive automatic stay without authorization of bankruptcy court).
Lender of its lien enforcement rights, or the requirement by the First Lien Lender that the Second Lien Lender release its liens on certain collateral not already contemplated by the Second Lien Credit Documents. The Second Lien Lender’s request to include a purchase option is generally acceded to by the First Lien Lender. However, there are several nuances to a purchase option that need to be considered carefully by both the First Lien Lender and Second Lien Lender.

B. Negotiating Points

1. Triggering the Option

- An initial question to be addressed by the parties regards the circumstances that will trigger the right to exercise an option to purchase. As a general rule, those circumstances will include (i) the Second Lien Lender’s receipt of notice of the First Lien Lender’s intent to commence a lien enforcement action (which notice the First Lien Lender will usually agree to give except in those circumstances that constitute “exigent circumstances” or where applicable law might otherwise dispense with any obligation to provide notice); (ii) the Second Lien Lender’s receipt of a request from the First Lien Lender for the Second Lien Lender to release its liens on collateral in connection with a disposition of collateral that is not otherwise contemplated by the Second Lien Credit Documents; and (iii) the First Lien Lender’s refusal to consent to the use of cash collateral by the borrower in connection with the Second Lien Lender’s provision of DIP financing in a bankruptcy case. In some transactions, the Second Lien Lender may successfully negotiate for an option to purchase in the event of the borrower’s bankruptcy. Except in those circumstances where the First Lien Lender may desire to retain the credit facility, such a provision may not be objectionable.

- A provision should be added to this section of the intercreditor agreement to clarify that the option to purchase in favor of the Second

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66. In the view of some Second Lien Lenders, the inclusion of a purchase option in the intercreditor agreement is not so critical, as they believe that a First Lien Lender, confronted with a troubled loan, will almost always be receptive to selling its claim.

67. The term “exigent circumstances” ordinarily would be defined to mean events or conditions of such immediacy and urgency that the First Lien Lender should be excused from providing prior or concurrent notice of intended enforcement action. Such events or conditions might include waste or concealment of collateral, attachment or execution upon such collateral by third party judgment creditors, fraudulent concealment or removal of collateral, waste or failure to maintain insurance.

68. Under U.C.C. § 9-611(b), prior notice of a secured party’s disposition of collateral after default is dispensed with if the collateral is “perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market.” U.C.C. § 9-611(b) (2005).
Lien Lender does not preclude the First Lien Lender (or any syndicate member in the First Lien Lender's credit relationship with the borrower) from selling its position to a third party prior to the Second Lien Lender's option notice, subject to the such third party's being bound by the intercreditor agreement as a successor or assign.

2. Option Exercise Period

- The First Lien Lender will wish to require the Second Lien Lender to "fish or cut bait" on the purchase option within a relatively short period of time after the occurrence of an option triggering event (say, five to 10 days). The First Lien Lender will commonly require that the Second Lien Lender give the First Lien Lender written notice of the exercise of the election within the required period of time (failing which, the option expires as to that triggering event). If the Second Lien Lender elects to exercise the option, the closing on the option should occur within some relatively short time frame (say, five to 10 days at the outside) after the giving of the option notice. The Second Lien Lender's obligation to consummate the purchase after its notice of intent to exercise the option should be irrevocable. Depending upon the identity of the Second Lien Lender, the First Lien Lender may want some confirmation of the Second Lien Lender's financial ability to consummate the sale at the time of notification of its exercise of the option.

- The Second Lien Lender may request that the First Lien Lender agree not to take (or to continue) any lien enforcement action during the period between the date that the Second Lien Lender gives notice of its exercise of the purchase option and the date of closing. While the First Lien Lender may be amenable to such a standby, absent exigent circumstances,\(^69\) the willingness of the First Lien Lender to forbear from exercising remedies may be dependent upon the length of the period given to the Second Lien Lender to close on the option.\(^70\)

\(^69\). See supra note 67.

\(^70\). It is appropriate to point out at this juncture the importance of defining what constitutes an "enforcement action" or a "lien enforcement action" under the intercreditor agreement. The First Lien Lender will want to carve out from that definition actions taken by it in the ordinary course of administering its loans, such as reductions in advance rates, imposition of reserves against borrowing availability, collection of accounts receivable through lockboxes or other means (short of notification as part of a collection action), offsets for customary fees and charges in connection with bank products, the imposition of a default rate of interest or late charges, the cessation of lending, demand for payment of any obligations payable on demand and the filing of a proof of claim in any insolvency proceeding.
3. Option Price

- The next issue pertains to the option price and the claims of the First Lien Lender that are to be assigned upon the exercise of the option. The price should be 100% of all non-contingent obligations that comprise the Priority Lender Debt and the depositing of cash collateral in an amount equal to 105% of all contingent obligations represented by letters of credit that constitute Priority Lender Debt. Bank product obligations, to the extent constituting Priority Lender Debt, should also be the subject of either a cash payment or a cash deposit as security for payment.\textsuperscript{71} If prepayment premiums and termination charges have not already been excluded from the definition of Priority Lender Debt, the Second Lien Lender will likely require that the purchase price not include those components of First Lien Lender Debt.\textsuperscript{72} The amount of Non-Priority Lender Debt should be excluded from the purchase price and such debt typically is retained by the First Lien Lender.\textsuperscript{73}

4. Treatment of Non-Priority Lender Debt

- The First Lien Lender will bargain to include provisions in the intercreditor agreement to the effect that the liens acquired by the Second Lien Lender in connection with the purchase will continue to secure Non-Priority Lender Debt as well as any indemnity amounts that become due and payable to the First Lien Lender after the purchase. Such Non-Priority Lender Debt would only be paid after payment in full of the Second Lien Loan as well as the Priority Lender Debt acquired by the Second Lien Lender pursuant to the exercise of

\textsuperscript{71} Certain bank product obligations may be both contingent and unliquidated in amount, such as obligations that arise from the liquidation of a hedging arrangement. Whether or not the parties are able to agree upon a calculus for estimating the potential amount of bank product obligations, the First Lien Lender may wish to make clear in the intercreditor agreement, with the consent of the borrower, that it will no longer have any obligation to provide banking services after the exercise of the purchase option.

\textsuperscript{72} The First Lien Lender should be mindful of the possibility of collusion between the borrower and Second Lien Lender in effectuating a termination of the First Lien Lender's credit facility, without prepayment fees or termination charges that would otherwise be payable under the First Lien Credit Documents. If the events that trigger the purchase option in favor of the Second Lien Lender are narrowly drawn and confined to post-default circumstances, the First Lien Lender may welcome a takeout of its position by the Second Lien Lender's exercise of the purchase option.

\textsuperscript{73} On occasion, the Second Lien Lender will attempt to negotiate a right to purchase the entirety of the First Lien Lender Debt, including all Non-Priority Lender Debt, for a purchase price equal to the Priority Lender Debt only. The more common convention, however, is for the Second Lien Lender to acquire only what it is willing to pay for, and typically the Second Lien Lender is only willingly to pay for the amount of the First Lien Lender Debt that does not exceed the Priority Lender Debt.
the purchase option. If agreed to, such a provision would constitute the Second Lien Lender as the collateral agent for the First Lien Lender and may limit the Second Lien Lender's flexibility in administering its lending relationship with the borrower at a time when the borrower is in default or in difficult financial circumstances. Accordingly, the Second Lien Lender may insist upon broad rights to deal with the collateral and to release liens in connection with enforcement actions and liquidation sales.

5. Effect on Indemnities of First Lien Lender

- A critical area of concern for the First Lien Lender in connection with the sale of the Priority Lender Debt and assignment of the First Lien Credit Documents is the effect that such a sale will have on its right to ongoing indemnifications from the borrower for pre-assignment acts, events or transactions, whether or not any claim giving rise to such right of indemnification has been asserted by the time of the option exercise. To that end, the First Lien Lender will call upon both the Second Lien Lender and the borrower to agree that, notwithstanding the sale and assignment of the Priority Lender Debt and First Lien Credit Documents to the Second Lien Lender, all indemnities in the First Lien Credit Documents will continue in full force and effect for the benefit of the First Lien Lender. To the extent that any claim giving rise to a right of indemnity exists on or before the date of proposed sale pursuant to the purchase option, the First Lien Lender may argue that all liquidated amounts associated with such a claim, as well as all reasonably estimated costs and expenses to be incurred in the future, should be part of the purchase price or otherwise reserved for by the Second Lien Lender.

In some cases, the First Lien Lender will be successful in negotiating a requirement that proceeds of collateral be used to pay any indemnity claims that are outstanding and identified to the Second Lien Lender at the time of its exercise of the purchase option, despite the exercise of the purchase option and the assignment of all of the First Lien Credit Documents to the Second Lien Lender. In other cases, the First Lien Lender may negotiate for a set aside of a specific dollar amount to be held as security for the payment of indemnity claims that may arise in the future.

6. Bank Products

- To the extent that bank products made available under a syndicated facility by affiliates of the lenders are part of the secured obligations under the First Lien Credit Documents, care must be taken to
carve those bank products out of the description of obligations that may be assigned pursuant to the option exercise. The syndicate agent may not have any authority to obligate those affiliates to sell their bank product claims, even for cash at par. However, to the extent that such bank products are not included as part of the sale, the Second Lien Lender will likely insist that those bank products do not enjoy the benefit of the liens under the First Lien Credit Documents to be assigned by the First Lien Lender or, if they do, that they are last to be paid in the waterfall of collateral proceeds.

7. Limited Recourse Sale

- The transfer or assignment by the First Lien Lender pursuant to the exercise of the purchase option is customarily made without representation or warranty and without recourse, except for breach of specific warranties contained in the assignment that deal with the amount of the indebtedness and the authority of the First Lien Lender to assign the Priority Lender Debt and related documentation.\(^{74}\)

8. Assignee's Assumption

- The intercreditor agreement will commonly provide that, effective immediately upon the consummation of the purchase, any administrative or collateral agent for the First Lien Lender may resign, with the Second Lien Lender (or its designee) to be substituted in that position. In addition, the agreement will often specify that the Second Lien Lender will be deemed to have assumed all "going forward" obligations of the First Lien Lender (and those of any collateral or administrative agent for the First Lien Lender) and all antecedent contractual undertakings (such as those incurred pursuant to guarantees or indemnities given by the First Lien Lender to third parties). The Second Lien Lender will expressly exclude assumption of any liabilities arising out of tortious or other actionable conduct of the First Lien Lender. As discussed below, the borrower should be called upon to give its consent to the intercreditor agreement, including the provi-

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74. If the First Lien Credit Documents represent a syndicated facility with multiple lenders, the First Lien Credit Documents should specifically authorize the administrative agent for the First Lien Lenders to enter into the intercreditor agreement, and to bind all of the First Lien Lenders to the terms of the intercreditor agreement, including terms requiring the sale of all of the First Lien Lender's rights and claims under the First Lien Credit Documents. In addition, if a syndicated facility includes an agreed upon form for the assignment by each lender of its commitments and outstandings under the First Lien Credit Documents, the intercreditor agreement should provide that the assignment to the Second Lien Lender will be effective under the terms provided in the form attached to the First Lien Credit Documents or pursuant to another mutually agreed upon document.
sions that deal with the purchase option and that provide that the First Lien Lender ceases to have any obligations to the borrower under the First Lien Credit Documents after the closing on the purchase option.

VIII. AMENDMENTS TO CREDIT DOCUMENTS

A. Overview

The purpose of this part of the intercreditor agreement is to make clear, in circumstances where the First Lien Lender and Second Lien Lender have separate credit documentation with the borrower, that either lender may (subject to certain exceptions) amend, modify or waive provisions of those credit documents without the need to obtain the other lender's consent and without being deemed to have breached or tortiously interfered with negative covenants in the credit documents of the other lender. Any requirement for the giving of notice or obtaining of consents to amendments will generally be obligations that are binding only on the borrower and not the other lender.

B. Negotiating Points

1. Amendments of Second Lien Credit Documents

- The First Lien Lender will include in the First Lien Credit Documents specific covenants requiring notice of any proposed amendments or modifications to, or waivers of provisions or defaults under, the Second Lien Credit Documents. Further, the First Lien Credit Documents will almost invariably disallow the borrower from entering into amendments to the Second Lien Credit Documents that would have potentially undesirable effects upon the borrower or the First Lien Lender's position. For example, the First Lien Credit Documents likely will forbid the borrower from (i) shortening the maturity of the Second Lien Loan; (ii) agreeing to increase the amount of the Second Lien Loan or the amount of any scheduled amortization with respect to the Second Lien Loan; (iii) increasing the rate of interest payable on the Second Lien Loan (other than as contemplated by the Second Lien Credit Documents at the time of the intercreditor agreement); (iv) making more onerous any provisions in the Second Lien Credit Documents dealing with defaults, financial covenants or permitted asset dispositions; and (v) prepaying the Second Lien Loan other than mandatory prepayments as provided in the Second Lien Credit Documents at closing. Not infrequently, the Second Lien Lender will resist any attempt to make those agreements binding upon it in the intercreditor agreement and will argue that those re-
restrictions should be confined to the First Lien Credit Documents, with the result that any violation thereof will constitute an event of default under the First Lien Credit Documents.

2. Amendments of First Lien Credit Documents

- The Second Lien Lender can be expected to negotiate for certain restrictions in the intercreditor agreement on the right of the First Lien Lender to amend or otherwise modify its credit documents with the borrower. Among other things, the Second Lien Lender will seek to restrain the First Lien Lender from making changes to the First Lien Credit Documents that would (i) increase advance rates; (ii) alter eligibility criteria (while conceding the First Lien Lender’s authority and discretion to determine eligibility generally); (iii) add different types of property to the list of eligible collateral for borrowing base purposes; (iv) release availability reserves (which normally should be restricted to standard reserves, such as reserves for letter of credit obligations and bank products); (v) alter provisions requiring mandatory prepayments of the First Lien Lender’s term loan; or (vi) increase the required amortization of such term loan.

The First Lien Lender will be especially sensitive to restrictions on its right to administer its revolving credit facility with the borrower, but can be expected to make certain concessions to the Second Lien Lender. In all events, the First Lien Lender should be careful that it reserves the right to (i) determine eligibility of all borrowing base collateral; (ii) establish additional availability reserves (and eliminate any such additional reserves); (iii) increase the amount of existing reserves; (iv) increase advance rates on eligible collateral to a level existing at the time of the intercreditor agreement if those advance rates were previously reduced; and (v) forbear after default from re-

75. At first blush, it would appear contradictory for the Second Lien Lender to object to the inclusion in the intercreditor agreement of restrictions on its right to enter into amendments to the First Lien Credit Documents with the borrower while insisting that restrictions on the First Lien Lender’s right to enter into amendments be regulated by the intercreditor agreement. While the disparity of treatment may offend the First Lien Lender’s sense of equal treatment, the difference in treatment has some justification. If the borrower breaches a negative covenant in the First Lien Credit Documents prohibiting certain amendments to the Second Lien Credit Documents, the First Lien Lender’s collateral position is not eroded as a result of that action and the First Lien Lender retains its right to call its loans and enforce its liens. On the other hand, if the borrower enters into amendments to the First Lien Credit Documents in a manner that violates the Second Lien Credit Documents, the Second Lien Lender may suffer immediate harm and may have no viable remedy to redress that harm. Hence, the Second Lien Lender desires to have the First Lien Lender “on the hook” in the intercreditor agreement as a means of assuring that potentially damaging amendments are not entered into with the borrower.

76. All of the enumerated restrictions are designed to prevent a dilution in the equity in the collateral for the benefit of the Second Lien Lender.
quiring amortization on the First Lien Lender's term loan. This latter provision may be difficult to negotiate unless the First Lien Lender agrees that such a forbearance will trigger the commencement of a standby period and/or the purchase option in favor of the Second Lien Lender.

IX. Debt Subordination

A. Overview

Most Second Lien Lenders are altogether unwilling to subordinate the payment of the Second Lien Loan to the payment of the First Lien Lender Debt. Indeed, most Second Lien Lenders insist upon inclusion in the intercreditor agreement of an express acknowledgment to the effect that nothing in it is to be construed as a debt (or payment) subordination. In contrast to a debt subordination, a lien subordination merely adjust the priorities of the respective liens of the parties and generally provides for a standstill as to lien enforcement rights of the holder of the junior lien. After payment in full of the amounts owed to the senior secured party, the junior secured party is entitled to the balance of the collateral proceeds and holds an unsecured claim for any deficiency owed by the borrower. In a debt subordination, all amounts to which the subordinate creditor would otherwise be entitled to receive, from any source (whether from collateral, the primary obligor or secondary obligors) are required to be turned over to the senior creditor until the senior creditor's claim is fully satisfied.

B. Negotiating Points

- In certain transactions it may be appropriate for the First Lien Lender to bargain for a concession by the Second Lien Lender to refrain from accepting voluntary prepayments, mandatory prepayments from proceeds of collateral dispositions (since such proceeds are to be applied to the First Lien Lender Debt), and other payments that do not constitute regularly scheduled payments of interest or principal, or reimbursement for fees and expenses, under the Second Lien Credit Documents. To the extent that any prohibited payments are received by the Second Lien Lender, the intercreditor agreement should provide that they are to be held in trust by the Second Lien Lender and turned over promptly to the First Lien Lender for application to the First Lien Lender Debt. The First Lien Credit Documents should contain similar provisions restricting the right of the borrower to make any such payments that the Second Lien Lender is disallowed from accepting under the intercreditor agreement.
NEGOTIATING POINTS

• It is customary for debt subordination agreements to incorporate the so-called “rule of explicitness” by which the junior creditor agrees that it will turn over all payments that it receives on account of the subordinated debt to the senior creditor until such time as the senior creditor has received payment in full, including all interest, fees and other charges whether or not the same are an allowed claim under § 506(b) of the Bankruptcy Code or other applicable law. It is generally unnecessary to incorporate the rule of explicitness in intercreditor agreements where the First Lien Lender Debt and the Second Lien Loan are separately documented and secured by separate liens granted by the borrowers. The intercreditor agreement will provide for the disbursement of all collateral proceeds to the First Lien Lender, at least to the extent of the Priority Lender Debt. After exhaustion of all of the collateral, the deficiency claims of the First Lien Lender and Second Lien Lender will be entitled to share on a pro rata basis in any distributions made by the borrower in or out of bankruptcy. However, in the relatively rare circumstances in which the First Lender Debt and the Second Lien Loan are secured by a single lien in favor of a collateral agent or trustee, incorporation of the rule of explicitness is warranted.

X. SHARING OF FIELD AUDITS AND APPRAISALS

A. Overview

Some Second Lien Lenders are not equipped to conduct their own field audits and may not wish to burden the borrower with the expense of obtaining appraisals that are duplicative of appraisals obtained by the First Lien Lender. Accordingly, a sharing arrangement may be agreed to in the intercreditor agreement.

B. Negotiating Points

• It is not uncommon for the First Lien Lender to agree to share the results of its field audits and appraisals with the Second Lien Lender, subject to the Second Lien Lender’s understanding that it has

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77. The rule of explicitness is an equitable principle that post-petition interest on senior indebtedness takes priority over payment of junior indebtedness only if the subordination agreement “explicitly” addresses the issue. For a good discussion of the rule, its history and the effect of the enactment of the Bankruptcy Code, see In re Bank of New England Corp., 364 F.3d 355, 363 (1st Cir. 2004) (stating that, after enactment of the Bankruptcy Code, “if the Rule of Explicitness retains any vitality, it does so only as part and parcel of state law”). See also In re Southeast Banking Corp., 179 F.3d 1307, 1308 (11th Cir. 1999) (applicability of rule of explicitness must be determined under state law).

78. See supra notes 6 and 7 and accompanying text.

79. See supra note 2.
no right of recourse against the First Lien Lender for any errors or omissions in those reports or appraisals. Additionally, the Second Lien Lender should be required to agree to receive and hold all such reports and appraisals in confidence.

- The First Lien Lender may wish to exclude from its sharing obligation any appraisals commissioned after default or during the pendency of any litigation or insolvency proceeding, as such appraisals may constitute protected attorney work-product. The sharing of such appraisals with the Second Lien Lender may compromise the work-product privilege. 80

XI. SUCCESSORS AND ASSIGNS

A. Overview

Both parties normally request that the intercreditor agreement be binding upon successors and assigns so that, in the event of assignment of their respective claims, the assignee will not be obliged to enter into new negotiations with the other party on intercreditor issues. Furthermore, both parties will desire that successors and assigns be bound by the agreement.

B. Negotiating Points

- While a successors and assigns clause is customary and, therefore, generally not controversial, the First Lien Lender should bear in mind that, if the agreement is made binding upon any assignee, an unfavorable intercreditor arrangement might deter third parties from purchasing the First Lien Lender Debt in a distress situation. Hence, the First Lien Lender must carefully negotiate the intercreditor agreement with a view towards its potential impact (especially in the context of an insolvency proceeding) on its exit strategy in discounting its loan to a third party.

- To ensure that a successor or assign has actual notice of the existence of the intercreditor agreement, the assigning party should be required by the intercreditor agreement to give notice of the existence of the intercreditor agreement to the proposed assignee, concurrently

80. See Carter v. Gibbs, 909 F. 2d. 1450, 1451 (Fed. Cir. 1990) (voluntary disclosure to an adversary in litigation defeats the policy underlying the work-product doctrine). Unlike the attorney-client privilege, waiver of work-product protection normally does not occur simply by disclosure to a third party. For a waiver to result, the disclosure generally must be made to the party’s adversary or in such a way that the party’s adversary likely can obtain the document. See, e.g., Bank of America, N.A. v. Terra Nova Insurance Co., 212 F.R.D. 166, 169-70 (S.D.N.Y. 2002); see also, e.g., Meoli v. American Med. Service of San Diego, 287 B.R. 808, 817 (S.D. Cal. 2003).
with the assignment. To bolster that covenant, in the case of the Second Lien Lender, the UCC-1 financing statements and other perfection documents filed by the Second Lien Lender should specifically state that the priority of liens perfected by such perfection document is subject to the intercreditor agreement. The purpose of inclusion of such language in the perfection documents is to impart public notice to potential assignees from the Second Lien Lender that the Second Lien Lender's liens are junior in priority to those of the First Lien Lender. The inclusion of such language is especially important if the liens of the Second Lien Lender are reported prior to those of the First Lien Lender and, therefore, enjoy first priority status based upon the public record.

XII. CONSENT OF BORROWER AND SYNDICATE LENDERS

Because the consent of the borrower is likely required for the effectiveness of certain provisions in the intercreditor agreement in which the consent or agreement of the borrower is mentioned, it is prudent to have the borrower acknowledge and consent to the terms of the intercreditor agreement and agree to be bound by those terms. However, the intercreditor agreement should be subject to amendment without any consent or agreement of the borrower, unless the amendment directly and adversely affects the rights or liabilities of the borrower. In addition, in a syndicated transaction, the intercreditor agreement is often executed by the administrative agent on behalf of all of the members of the lender group. If those lenders are not also parties to the intercreditor agreement (which may not be practical in a large syndicate), the administrative agent should ensure that the First Lien Credit Documents specifically authorize the agent, on behalf of all First Lien Lenders, to enter into the intercreditor agreement and that each lender, by becoming a party to the First Lien Credit Documents, consents to and agrees to be bound by all of the terms of the intercreditor agreement.

XIII. CONCLUSION

Over time, as the market for second lien transactions evolves and continues to mature, many of the negotiating points discussed in this article will become standardized, especially in larger, syndicated trans-

81. If the First Lien Lender is part of a syndicated transaction, the First Lien Lender must be attentive to the consequences of a syndicate member's sale of its position to the Second Lien Lender. Consideration should be given to the insertion of a provision in the First Lien Credit Documents that would exclude the Second Lien Lender (as well as any of its affiliates) from the class of "eligible assignees" to which syndicate members may otherwise assign their claims.
actions. Second Lien Lenders that attempt to escape the strictures that they voluntarily undertook in the intercreditor agreement will precipitate significant clashes in bankruptcy cases that may spawn judicial decisions on the enforceability of these strictures.

To the extent that a Second Lien Lender attempts to disavow its undertakings in an intercreditor agreement, it may find itself short on second lien financing opportunities in the future. To the extent that a Second Lien Lender is successful in convincing a court that some or all of the pre-bankruptcy waivers are ineffective, the market will adjust and counsel for first lien lenders will no doubt invent creative alternatives.