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LIEN SUBORDINATION AND INTERCREDITOR AGREEMENTS

Second lien financings have become an increasingly prevalent alternative to other forms of junior financing, although the distinction between payment subordination and lien subordination has not always been well understood. After clarifying the distinction, the authors discuss four critical issues: "absolute" priority of security interests; composition of first lien obligations; cap on first lien obligations; and relative enforcement rights in the collateral.

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This article is intended to provide a framework for a basic understanding of second lien financing. While there are multiple important issues affecting first and second lien lenders that are insufficiently understood by practitioners, this article will focus on four of the critical issues that arise in negotiation of first lien/second lien intercreditor agreements, and place them within a broader conceptual frame.

The issues discussed herein are commonly the object of intense negotiations and, often, of some confusion, particularly since many businesspeople and perhaps some courts may confuse lien subordination and payment subordination. We suggest a range of reasonable outcomes for these issues based on a clear view of the function of the intercreditor agreement. In immediate practical terms, we hope this article will be of use both to practitioners charged with drafting or negotiating intercreditor agreements (by providing some "best practices" guidance),[1] and, even more acutely, to practitioners dealing with existing intercreditor agreements, drafted during the past few years and now possibly at the heart of disputes among different classes of creditors (by pointing out some common vulnerabilities and fracture lines). Over a somewhat longer time horizon, we hope that this and future

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[1] Notable in this context is the current trend allowing unsecured, even payment subordinated, creditors to move up the capital structure to senior, second lien creditor status (whether pursuant to an exchange offer or a negotiated refinancing) to avoid an imminent payment or covenant default under the existing debt. Such transactions can require the implementation of lien subordination intercreditor agreements on an expedited basis with little time for negotiation.

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articles, taken together with the continuing efforts and work product of the American Bar Association Model Intercreditor Agreement Task Force discussed below, will contribute to stabilizing market practice and creditor expectations, and perhaps also be helpful in informing the analysis of courts grappling with difficult issues in respect of lien subordination intercreditor agreements.

BACKGROUND: GROWTH OF THE SECOND LIEN MARKET

In recent years, and with marked acceleration starting around 2003 (*see* chart in the appendix) and deceleration as the overall debt market remains in crisis, second lien financings have become an increasingly prevalent alternative to other forms of junior financing, such as unsecured subordinated "mezzanine" debt, and to "high yield" debt. Second lien financing offered borrowers an additional source of capital that generally had lower interest rates, and therefore substantially reduced cash outflows for debt service, than with the payment subordinated and unsecured alternatives. First lien creditors obtained the usual benefits from a junior financing, including maintenance of a senior position at the top of the borrower's capital structure and a defined position of control over the exercise of remedies against collateral and to a great degree over the restructuring and bankruptcy process. The second lien creditors benefited from capturing the residual equity value in the collateral, which would otherwise have to be shared among all senior unsecured creditors of the borrower, and achieved many of the advantages available to secured lenders, but not to unsecured lenders, in the event of the borrower's bankruptcy.

The lower coupon on second lien financings, as compared to unsecured mezzanine financing generally, reflected the parties' assumption that the second lien creditors would obtain some value from their liens based on valuation of the collateral base at closing, and second lien lenders also assumed that they would not be in the same position as unsecured, payment subordinated mezzanine debt, though the intercreditor agreements initially prevalent in the market did not always support that assumption (indeed, in some cases the second lien lenders viewed and priced themselves as subordinated debt and treated the second lien as gravy). First lien lenders wanted to ensure that they had, for at least some defined period of time, exclusive rights to manage the common collateral and any foreclosure sale, and the use and disposition of common collateral, as well as the exercise of certain other material secured creditor rights, during a bankruptcy proceeding. Second lien lenders often sought backstop protections, such as a purchase option to acquire the first lien debt at par, though many purchase options in intercreditor agreements do not work from a practical standpoint. Strangely, very few intercreditor agreements provide the second lien lenders with the right to disclaim the lien entirely, terminate the intercreditor agreement, and eliminate the waivers of rights contained in the intercreditor agreement.

THE DISTINCTION BETWEEN LIEN AND PAYMENT SUBORDINATION

Central to a basic understanding of the implications and goals of second lien financing, and of several of the critical issues in intercreditor agreements, is the distinction between lien subordination and payment subordination. Lien subordination involves two senior creditors with security interests in the same collateral, one of which has lien priority over the other. To the extent of any value derived from the collateral (*e.g.*, its liquidation proceeds upon a sale), the senior lien lender is repaid first from collateral proceeds, and the junior lien lender collects only from any remaining collateral value. If the collateral proceeds are insufficient to repay the senior lender in full, then both the senior lien and junior lien lenders, and all other unsecured senior creditors, rank equally in their right to repayment of their remaining debt from the other assets or resources of the borrower. By contrast, in payment subordination, the senior lender enjoys the right to be paid first from all assets of the borrower or any applicable guarantor, whether or not constituting collateral security for the senior or subordinated lenders. Because payment subordination depends only on the amount owed and not on the value of any particular collateral, it is a more fundamental form of subordination and is generally more advantageous to a senior lender.

In a second lien financing, the lien subordination is effected contractually by means of an intercreditor agreement between the first lien and the second lien creditors or their representatives. Although the first lien creditors will often also insist on timing the filing of

perfection documents so as to ensure that they are first to perfect and thus enjoy statutory first-in-time priority, this serves merely as a backstop; the intercreditor agreement establishes the lien priority by agreement of the parties, and generally explicitly overrides the statutory result notwithstanding the timing of perfection of the liens of the two sets of creditors. In addition, the intercreditor agreement establishes multiple rights and obligations, and waivers of rights, among the creditors beyond those that would result from a simple statutory priority, and will often fundamentally and adversely affect rights that the second lien lenders would have as unsecured creditors in a bankruptcy proceeding. These provisions are generally intended to prevent the second lien creditors from interfering with the first lien creditors' pursuit of remedies against the common collateral and from exercising certain rights in a bankruptcy proceeding of the borrower that could adversely affect the lien priority of, or the value of the collateral to, the first lien lender. Thus, the second lien is said to be "silent" to a greater or lesser degree.[2]

The drafting of intercreditor agreements governing lien subordination was initially based upon the intercreditor and subordination agreements used in a payment subordination context, and often these agreements carried over several payment subordination concepts that may not be appropriate to pure lien subordination, resulting in a substantial erosion of what many practitioners would consider to be appropriate rights of second lien lenders.[3] Indeed, many early second lien intercreditor agreements were drafted by counsel for the first lien lenders with no separate counsel representing the interests of the second lien lenders. There is a movement to eliminate these payment subordination concepts from lien subordination intercreditor agreements by redefining the concept of "Common Collateral" as discussed below, by eliminating from the definition of "First Lien Obligations" certain default interest, post-petition interest or other amounts not allowed or allowable in a bankruptcy proceeding as discussed below, and by clarifying that enforcement action blockages are limited to actions against the Common Collateral.

Today, second lien lenders generally employ their own counsel and, as a result, a number of "hot button" issues in modern second lien intercreditor agreements are resolved, through often intense negotiation, in favor of the second lien lenders, resulting in more balanced agreements.[4] Reflecting, and to a certain extent shaping, this trend, the ABA Model Intercreditor Agreement Task Force[5] is developing a model first lien/second lien intercreditor agreement and issues list that bring into focus a number of issues between first and second lien lenders that have often been ignored in the past.[6] The

[2] This article addresses basic first-lien/second-lien arrangements of the kind described above. However, depending on the circumstances, the second lien debt might be payment subordinated, as well as lien subordinated. Another common scenario involves creditor A, often a revolving loan lender, having a first lien on certain assets (such as accounts receivable, inventory, and cash, as part of an asset-based financing), and creditor B, often a term loan lender, having a first lien on other assets (such as plant, property, and equipment), with each creditor having a second lien on the assets on which the other creditor has a first lien, resulting in greater balance in the negotiations between the two lender groups.

[3] Three of the common provisions that imposed payment subordination concepts on such lien subordination arrangements were:

A. Inclusion, in the "First Lien Obligations" definition, of "post-petition default interest, whether or not allowed as a claim" or equivalent language, which enabled the first lien creditor potentially to enjoy an advantage over the second lien creditor that was not based on its collateral. (*See* discussion of "Composition of First Lien Obligations" below).

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B. Having the enforcement blockage or standstill period apply to any enforcement action against the debtor, rather than being limited to enforcement against the shared collateral.

C. Defining "Common Collateral" to include all assets on which the first lien credit documents purport to impose a lien, without regard to whether the lien is perfected or even valid. (*See* discussion of "Common Collateral" below).

[4] *But see* Dana S. Armagno, Marie H. Godush, Kathryn L. Stevens & Michael M. Eidelman, *"Second Lien" Loans*, SPECIAL REPORT (Vedder Price Finance and Transactions Group, Chicago, Ill.), Winter 2008–2009, at 1 (contemplating that tight credit conditions may cause market terms to shift in first lien lenders' favor).

[5] The Model Intercreditor Agreement Task Force is a project of the ABA Syndications and Lender Relations Subcommittee (Commercial Financial Services Committee) of the American Bar Association.

[6] MODEL INTERCREDITOR AGREEMENT (Interim Draft 2008), *available at* http://www.abanet.org/buslaw/committees/CL190029pub/materials/mica/20081109-draft.pdf. *See generally* Gary D. Chamblee, *Reducing Battles Between First and Second Lien Holders Through Intercreditor Agreements: The Role of the New ABA Model Intercreditor Agreement Task Force*, 12 N.C. BANKING INST. 1 (2008) (discussing provisions of the draft ABA Model Intercreditor Agreement). The Model

themes in this article represent a portion of the ongoing work of the Model Intercreditor Agreement Task Force. It is important to note that the enforcement of intercreditor agreements is subject to various statutory, equitable, and other factors that may be considered by a court (typically a bankruptcy court). There is substantial literature discussing these considerations and analyzing relevant case law,[7] though this article, for reasons of space, does not explore those factors, and the reader is advised to consider the discussion herein against that backdrop.

FOUR CRITICAL ISSUES

1. "ABSOLUTE" PRIORITY OF SECURITY INTERESTS IN COLLATERAL

The Concept of "Common Collateral". As noted above, the typical first lien/second lien intercreditor agreement is intended to effect a "pure" lien subordination, in which the second lien lender does not subordinate its debt claim but only its lien on certain specified assets on which both the first and second lien lenders have a security interest (which we will refer to as "Common Collateral"). In typical transactions, both parties are intended to have valid, perfected liens on the Common Collateral, the priority of the first lien lenders' liens is intended to be absolute regardless of the timing or manner of perfection, and once the value of the Common Collateral is exhausted upon liquidation, and assuming a deficiency in recovery by the first lien lenders, both the first lien and the second lien lenders typically become senior unsecured creditors ranking equally in rights to payment, together with all other senior unsecured creditors, from the debtor's remaining assets.[8]

However, the definition of Common Collateral, as is often the case with definitions of core terms, raises a conceptual question: Does Common Collateral include all assets in which the security documents of the first lien lender purport to create a lien, whether or not perfected or valid (the "First Lien Absolute Priority Approach")? Alternatively, is it limited to the assets in which the first lien lender and the second lien lender each has a valid, perfected lien at the time of determination (the "First Lien Relative Priority Approach")? The First Lien Absolute Priority Approach, initially the more common arrangement, forces what amounts to payment subordination if the first lien creditor's lien is, as a result of such creditor's negligence or otherwise, unperfected or invalid, with the result that the second lien lenders become, in effect, insurers of the validity in bankruptcy of the first lien lenders' liens. We have asked second lien clients whether they view their coupon as the equivalent of an insurance premium for their insurance, against their expectations, that the first lien lenders will not be negligent in effecting or maintaining the perfection of their liens, and no client has so far understood their role as one of insurer in these circumstances. A typical definition reflecting the First Lien Absolute Priority Approach might read as follows:

> "'Common Collateral' means any property described in the definition of 'Collateral' as set forth in any First Lien Collateral Document."

Or in the alternative:

> "'Common Collateral' means any property in which a lien is purported to be granted pursuant to any First Lien Collateral Document."

The critical defect in such a definition is that there is no requirement that the first lien lenders' lien in fact ever be perfected or that it remain perfected.

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Intercreditor Agreement Task Force maintains a website at http://www.abanet.org/dch/committee.cfm?com=CL190029.

[7] *See generally* David Line Batty & Jo Ann J. Brighton, *"Silent" Second Liens — Will Bankruptcy Courts Keep the Peace?*, 9 N.C. BANKING INST. 1 (2005) (analyzing enforceability of several intercreditor agreement provisions); William W. Bratton, Jr., *The Interpretation of Contracts Governing Corporate Debt Relationships*, 5 CARDOZO L. REV. 371 (1983–1984) (discussing interpretation of debt contracts in light of various contract law doctrines); Neil Cummings & Kirk Davenport, *How to Structure US Second Lien Financings*, INT'L FIN. L. REV., June 2004, at 26 (discussing mechanics of second liens and enforceability of provisions); Kimberly S. Winick, Mayer Brown LLP, Presentation at Los Angeles County Bar Association Commercial Law and Bankruptcy Section Program: Subordinated Secured Financing and Intercreditor Agreements in Bankruptcy (Jan. 23, 2008) (surveying implications of recent court decisions for intercreditor agreements).

[8] It is, of course, possible that one or both of the lenders (most likely solely the senior lender) will have access to liens on additional assets, but in any event the lien subordinating intercreditor agreement will generally not apply to such extraneous assets. However, as mentioned above, there are crossover arrangements in which each creditor has a first lien on designated assets, and a second lien on the other's designated assets. In such a case, there would be two separate, defined pools of Common Collateral, with the terms of the intercreditor agreement typically applying, *mutatis mutandis*, to both.

On the other hand, a definition of Common Collateral that maintains the first lien lenders' expectation of priority regardless of the timing or method of perfection, but that does not render the second lien lenders insurers of that perfection, and payment subordinated, to the extent the first lien lenders are negligent in perfecting, or maintaining perfection of, their liens might read as follows:

> "'Common Collateral' means any property in which, at any time of determination, both the First Lien Lenders and the Second Lien Lenders have a valid and perfected security interest not subject to avoidance as a preferential transfer or otherwise by the debtor or a trustee in bankruptcy, other than avoidance based on a theory equally applicable to the liens of both the First Lien Lenders and the Second Lien Lenders."

The second, narrower approach – which limits the Common Collateral to assets that are the subject of valid and perfected liens in favor of both parties – has enjoyed a period of increasing acceptance as practitioners became more familiar with lien subordination, and the inequities that can result from the former approach. A second lien lender forced to agree to the First Lien Absolute Priority Approach should take cognizance of the risks and of the payment subordination element implicit in it. A second lien creditor's counsel may find it prudent in such circumstances to scrutinize the perfection process of the first lien creditor and to point out any flaws for the first lien creditor to correct; however, invalidity and non-perfection may also result from steps taken, or omitted to be taken, after the transaction has closed, beyond the practical scope of counsel's review.[9]

Examples. Two simple examples will show the different results under the two approaches:

Example 1. Assume that a borrower has $110 million of asset value upon liquidation, all of which assets are intended to constitute Common Collateral, and that the borrower has $50 million of first lien debt, $50 million of second lien debt, and $50 million of additional unsecured creditors.

Full Perfection of all Liens. In this example, consistent with the expectations of the parties, the first lien lenders and the second lien lenders would each recover 100% of their secured claims, leaving $10 million to satisfy the claims of unsecured creditors.

Perfection of Second Liens; Non-perfection of First Liens. In this example, under the First Lien Relative Priority Approach the first lien lenders' liens would be avoided and the second lien lenders, as a matter of law, would have the only secured claims and would ordinarily be entitled to a full recovery, leaving the unsecured first lien creditors to share recovery of 60% of their claims with the other unsecured creditors. However, under the First Lien Absolute Priority Approach, the second lien lenders would receive a recovery of $50 million and would be required under the terms of the intercreditor agreement to turn over that entire recovery to the unsecured first lien lenders, receiving by subrogation[10] an unsecured claim in bankruptcy entitling them to a recovery of only 60% of their claim in subrogation, in lieu of the 100% recovery they would have had if the first lien creditors had maintained perfection of their liens. The second lien lenders, as effective insurers of the first lien's validity, are victims of the negligence of the first lien lenders. It is important to note that in this example, had the second lien lenders been unsecured lenders not subject to an intercreditor agreement, they would have recovered 73.33% of their unsecured claim, a far better recovery than they receive as secured creditors under the First Lien Absolute Priority Approach.

Example 2. Assume that a borrower has only $75 million of asset value upon liquidation, all of which assets are intended to constitute Common Collateral, and that the borrower has $50 million of first lien debt, $50 million of second lien debt, and $50 million of additional unsecured creditors.

Full Perfection of all Liens. In this example, consistent with the expectations of the parties, the first lien lenders would recover 100% of their secured claims and the second lien lenders would recover 50% of their secured claims, leaving no assets to satisfy the unsecured claims of the second lien lenders and the other unsecured creditors.

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[9] There are several recent cases in which questions have arisen regarding the proper validity and/or perfection of liens, or in which perfected liens were potentially subject to avoidance as preferential transfers. These cases underscore that this issue is not a vanishingly rare occurrence. Also, even ambiguity as to whether a lien is valid can sap a party's bargaining leverage in a workout or other high-intensity negotiating framework.

[10] Lien subordination intercreditor agreements invariably have a payment-over provision that requires the second lien creditor to turn over to the first lien creditor any proceeds it may obtain of the shared collateral, until the first lien debt is paid in cash.

Perfection of Second Liens; Non-perfection of First Liens. In this example, under the First Lien Relative Priority Approach, the first lien lenders' liens would be avoided and the second lien lenders, as a matter of law, would have the only secured claims and would ordinarily be entitled to a full recovery, leaving the unsecured first lien creditors to share recovery of 25% of their claims with the other unsecured creditors. However, under the First Lien Absolute Priority Approach, the second lien lenders would receive a recovery of $50 million and would be required under the terms of the intercreditor agreement to turn over that entire recovery to the unsecured first lien lenders, receiving by subrogation an unsecured claim in bankruptcy entitling them to a recovery of only 25% of their claim in subrogation, in lieu of the 50% recovery they would have had if the first lien creditors had maintained perfection of their liens. The second lien lenders, as effective insurers of the first lien validity, are again victims of the negligence of the first lien lenders. Again, it is important to note that in this example, had the second lien lenders been unsecured lenders not subject to an intercreditor agreement, they would have recovered 50% of their unsecured claim.

A reasonable argument can be made that the First Lien Relative Priority Approach results in a windfall to the second lien lenders in Example 2 above, in that they would recover more than they would have if the first lien lenders had perfected their liens as anticipated. This issue can be addressed fairly by a provision stating that the second lien lenders are only required to turn over any amount received by them in excess of the amount they would have received and been entitled to retain had the first lien creditors maintained valid, perfected liens, provided that the second lien lenders will be entitled to exercise valid subrogation rights in respect of the unsecured claims of the first lien lenders. An exception to this alternative would be a situation in which the first lien is avoided or avoidable for a reason that would not apply equally to the second lien creditors' liens.

Note that an avoidance of the first lien creditor's lien under section 552 of the Bankruptcy Code may allow the bankruptcy trustee to assume claims of the first lien creditor for the benefit of the estate at the expense of the second lien creditor, and care should be taken to ensure that no trustee in bankruptcy or other third party can derivatively assert the rights of the first lien creditors under the intercreditor agreement.

Note that this same issue – absolute priority vs. priority to the extent of valid, perfected unavoidable liens – also arises in the body of the intercreditor agreement, in the "Relative Priorities" provision. A typical first lien creditor-favorable provision might read:

> "Relative Priorities. Notwithstanding the date, time, method, manner, or order of grant, attachment, or perfection of any Liens securing the Second Lien Obligations granted on the Collateral or of any Liens securing the First Lien Obligations granted on the Collateral and notwithstanding any provision of the UCC, or any other applicable law or the Second Lien Loan Documents, the Second Lien Agent, on behalf of itself and the Second Lien Claimholders, hereby agrees that … any Lien on the Collateral securing any First Lien Obligations now or hereafter held by or on behalf of the First Lien Agent or any First Lien Claimholders, or any agent or trustee therefor, regardless of how acquired, whether by grant, possession, statute, operation of law, subrogation, or otherwise, shall be senior in all respects and prior to any Lien on the Collateral securing any Second Lien Obligations …."

It is possible to modify this provision to import the "solely to the extent of valid, perfected, unavoidable liens" concept – *e.g.*, "all Liens on the Collateral granted under or pursuant to the First Lien Collateral Documents in favor of the First Lien Agent securing any First Lien Obligations … shall, so long as such Liens are valid, perfected, and unavoidable, be and remain senior in all respects and prior to all Liens on the Collateral that are held by the Second Lien Agent…." However, if the second lien creditor succeeds in obtaining agreement on this concept, it is better to incorporate it in the definition of Common Collateral, which is used throughout the intercreditor agreement and affects a number of other provisions.

Challenges to Priority. Limiting the Common Collateral to assets in which the first lien creditors and second lien creditors both have valid, perfected, unavoidable liens, or alternatively restricting the Relative Priorities provision to the first lien creditor's valid, perfected, and unavoidable liens, raises a further question: What courses of action are available to the second lien creditors if the first lien creditors' liens are not valid, perfected, and unavoidable? Most intercreditor agreements provide that the parties will not challenge each other's liens and priority – *e.g.*, "[each of] Second Lien Agent … and First Lien Agent …

agrees that it will not (and hereby waives any right to) contest or support any other Person in contesting, in any proceeding (including any Insolvency Proceeding), the validity, enforceability, perfection, or priority … of a Lien held by or on behalf of any of the First Lien Claimholders in the First Lien Collateral or by or on behalf of any of the Second Lien Claimholders in the Second Lien Collateral, as the case may be ….”

On the one hand, first lien creditors will react negatively to an agreement that permits the second lien creditors to attack the first priority liens without limit. On the other hand, the First Lien Relative Priority Approach inherently requires some methodology for a legal determination of whether assets are or are not included in the common collateral pool (to which the lien subordination applies) and therefore whether the first lien creditors’ lien on the assets in question is invalid or unperfected. Denying the second lien creditors the ability to contest the validity or perfection of the first priority liens will render the First Lien Relative Priority Approach ineffective.

One possible resolution to this conundrum allows the second lien creditors to challenge lien priorities as a shield but not as a sword, *i.e.,* as a defense against a claim of breach of contract brought by the first lien creditor. So, if the second lien creditor believes a certain asset is not subject to a valid lien of the first lien creditor, and accordingly the intercreditor agreement’s enforcement standstill period[11] does not apply to that asset, it can pursue its remedies against the asset, and, if the first lien creditor objects on the basis that the asset is part of the Common Collateral, the second lien creditor is entitled to defend itself by challenging the first lien creditor’s lien. Most intercreditor agreements do not, by their terms, terminate if there is no “Common Collateral,” and such a provision would have to be added to the intercreditor agreement to cause the second lien lenders’ waivers to become ineffective in a bankruptcy if all of the first lien lenders’ liens are invalid at the time of filing in bankruptcy.

2. COMPOSITION OF FIRST LIEN OBLIGATIONS

First Lien Obligations – Excluded Elements. Given their lien subordinated position, second lien creditors’ recovery prospects may decrease materially if there is any increase in the amount of the first lien obligations secured by the Common Collateral. Accordingly, second lien creditors typically insist on defining explicitly the types of first lien obligations that may have the benefit of the intercreditor agreement’s lien subordination provisions – and the types that will not. Once the scope of the composition of eligible First Lien Obligations is determined, the two classes of creditors set a cap on the overall principal amount thereof, as discussed in the next section.

Second lien creditors typically seek to exclude from the composition of first lien obligations any elements that might be disallowed by a bankruptcy court, such as unaccrued original issue discount, default interest, and certain fees and expenses, in each case to the extent so disallowed. Since these claims are disallowed, the second lien creditors’ succession to those claims by subrogation – if they are required to turn over the proceeds of the Common Collateral to the first lien creditors on account of such claims – will not give the second lien creditors a valid claim against the debtor, and accordingly will permanently reduce the second lien creditors’ effective recovery.

In analyzing the equities of excluding various types of disallowed claims, it is helpful to note that as a practical matter, the extent and scope of the lien subordination arrangements are far less relevant when the reason for the disallowance is insufficiency of the value of the overall collateral package (*e.g.*, when a bankruptcy court disallows first lien post-petition interest on the basis that the first lien obligations are undersecured). In such cases, the second lien creditors would not be expected to have any recovery from the Common Collateral, so the lien subordination does not come into play in respect of any second lien creditor recovery (presumably from other, non-collateral assets). The tough discussions revolve around disallowances of first lien claims under circumstances in which the second lien creditors still have some prospects of recovery from the Common Collateral.

A broad exclusion for claims that are not allowed or allowable in a bankruptcy proceeding offers a clean way to resolve the issue of disallowed claims. However, there should arguably be an exception from this exclusion for any disallowance based on a theory equally applicable to both first and second lienholders. To the extent the disallowance arises from external factors applicable to both the first and second lien debt (*e.g.,* due to a secured guaranty of both being avoided as a fraudulent transfer), rather than from the conduct of, or other factors applicable solely to, the first lien creditors,

[11] Normally, a lien subordination intercreditor agreement will require the second lien creditor to forbear from any enforcement actions against the Common Collateral until the expiration of a “standstill period” or until one of certain enumerated events occurs. *See* discussion of the enforcement standstill below.

the original bargain between the first lien and second lien creditors is preserved.

3. CAP ON AMOUNT OF FIRST LIEN OBLIGATIONS

Determination of First Lien Obligations Cap. As mentioned in the prior section, second lien creditors – after negotiating the composition of the first lien obligations that will enjoy the benefits of the intercreditor agreement's subordination provisions – typically negotiate a cap on the overall principal amount thereof. The setting of this cap is complicated by the fact that the agreed composition of the debt subject to the cap may include, in addition to loans and other typical extensions of credit under the first lien facility (*e.g.*, letters of credit), the principal amount of which can be controlled, items such as hedging obligations entered into by the borrower with the first lien creditors and cash management obligations (*e.g.*, intra-day overdrafts), the amounts of which can vary wildly, and may be beyond the control of the first lien lenders, making establishment of an absolute cap impossible. In addition, first lien obligations may include incremental or "accordion" facilities that expand the original first lien credit facilities, refinancings of the first lien credit facility and debtor-in-possession (DIP) facilities in bankruptcy to the extent based on priming liens (having court-sanctioned priority over both first lien and second lien creditors) on the Common Collateral.

First lien creditors will typically insist that various accumulations of interest, fees, costs, indemnities, and other miscellaneous amounts payable under the terms of the first lien facility, as well as items such as hedging and cash management obligations, not be subject to the cap (or, equivalently, that the cap be automatically increased by the aggregate of such accumulating payable amounts). The second lien lenders will insist on limiting the interest, fees, expenses, and other amounts (including interest rate hedging obligations) included in the First Lien Obligations cap to those items that relate to principal amounts included in the First Lien Obligations, and on an overall cap on interest rate and fee increases under the first lien documents, and will often allow unlimited cash management obligations.[12] The cap should generally ignore currency fluctuations, and should automatically be increased by any recoveries from the first lien lenders of prior payments in respect of first lien obligations to the extent the cap was reduced by such prior payments. Note that in asset-based loan (ABL) transactions, overadvances constituting principal amounts incurred in excess of permitted borrowing base limits may be treated as exceeding the "cap," in order to protect the "equity" cushion in the Common Collateral on which the second lien lenders may be relying.

Once the treatment of these issues is agreed, the creditors need to determine the size of the cap. It is generally in the interests of the second lien creditors to agree to some additional debt capacity under the cap, since the first lien creditors will often be the best (cheapest and quickest) source of additional liquidity in time of need. A typical intercreditor agreement will provide for a "cushion" of 10–15% of the initial principal amount in a non-bankruptcy context, perhaps with an additional cushion of 10–15% to provide priming DIP financing if insolvency proceedings have commenced. In some cases these additional baskets are combined. Second lien creditors will often request that the cap be automatically reduced by any permanent repayments of the first lien credit facility (including any permanent reductions in revolving credit commitments).

A typical formulation for the cap applicable to the principal amount of first lien obligations might be:

> "'**First Lien Cap' means** [[(A)]% of [(B)-(C)-(D)]] plus (E), where (A) is ___%,[13] (B) is $[__________],[14] (C) is the amount of all repayments and prepayments of principal applied to any term loans constituting First Lien Obligations, (D) is the amount of all repayments and prepayments of any revolving loans or reimbursement of drawings under letters of credit constituting First Lien Obligations, to the extent accompanied by a corresponding permanent reduction of commitments under the applicable revolving facility or letter of credit commitment amount (excluding reductions in sub-facility commitments not accompanied by a corresponding permanent reduction in the revolving facility or letter of credit commitment

[12] Concomitantly, and for the same reasons, the second lien creditors will typically want to limit the imposition of any additional interest or fees under the first lien credit documents above negotiated levels. Limiting any such increase in non-default rate interest to 200–300 basis points has been common, but the increased realization of the need to deal with potential future refinancings in the current market environment (as a result of defaults, liquidity problems, and the like) may push this range higher in new deals.

[13] 110% to 115%.

[14] Base principal amount of the first lien obligations.

amount and reductions under (A) and (B) as a result of a Refinancing), [and (E) is an amount equal to all Second Lien adequate protection payments if and to the extent paid from any DIP Financing or Proceeds of Collateral.] [In the event of an Insolvency Proceeding, the First Lien Cap shall be increased by $___________.]"

Treatment of First Lien Obligations in Excess of Cap. Once the composition and amount of the cap are agreed, the parties still need to determine how to treat any amounts in excess of the cap. Some quite poorly drafted intercreditor agreements simply provide that first lien obligations in excess of the cap are not "First Lien Obligations" (or the applicable defined term) and do not benefit from the provisions of the agreement and are not otherwise covered by the intercreditor agreement. This approach leaves first lien creditors who have legal priority based on first-to-file or other perfection priority rules recovering ahead of the second lien creditors who have negotiated an ineffective "cap" in the intercreditor agreement. Depending on the drafting of the clause, such an occurrence might, or might not, be a breach of the intercreditor agreement, giving rise to an action for damages, but the goal of the second lien lenders should be to subordinate to the lien securing the second lien obligations the lien securing any principal amount of first lien obligations in excess of the cap, together with interest and other amounts ancillary thereto, by assigning third lien priority to all first lien obligations in excess of the cap. This approach most closely aligns with the parties' expectations and assigns a specific "waterfall" of priorities. However, first lien creditors need to confirm that a potential classification of some of their debt as "third lien" is permitted by their initial credit approval. Also, both parties need to consider the voting and other effects of such a reclassification in bankruptcy, as another class of liens is created.

Creditors agreeing on such "third lien" treatment for amounts in excess of the cap need to ensure that necessary modifications are made throughout the intercreditor agreement. For example, if the second lien creditors have negotiated a protective buyout right (granting them the right to buy out the first lien creditors' stake under specified circumstances), they will want to limit their purchase right only to amounts up to the first lien cap, not the excess, and the first lien creditors will need to consider what happens to their remaining debt in excess of the first lien cap. Additionally, the second lien creditors need to ensure that all interest, fees, and expenses on the amounts in excess of the first lien cap also become third lien priority obligations. Importantly, the first lien creditors will generally want to impose an analogous cap on the second lien obligations, so that the debt to which their third priority "tail" is lien subordinated is capped at a known amount. The intercreditor agreement should be drafted to ensure that the second lien lenders have, vis-à-vis the excess first lien obligations now treated as third lien obligations, mutatis mutandis, the same rights as the first lien obligations within the first lien cap have with respect to the second lien obligations.

4. RELATIVE ENFORCEMENT RIGHTS OF SECURITY INTERESTS IN COLLATERAL

Non-Interference with Enforcement by First Lien Creditors. In line with the basic understanding that, subject to minimal limitations, the first lien creditors have exclusive rights to control the maintenance and disposition of the Common Collateral, the second lien creditors normally agree not to enjoin or otherwise interfere with the first lien creditors' exercise of their remedies against the Common Collateral. In particular, the second lien creditors waive certain statutory rights they would otherwise have as junior secured lenders to second-guess the process by which such remedies are exercised.[15] These waivers are intended both to streamline procedurally the enforcement actions taken by the first lien creditors, and to protect their finality by cutting off an avenue of future challenges.

Standstill on Second Lien Enforcement. In addition to agreeing not to challenge Common Collateral maintenance and enforcement actions by the first lien creditors, the second lien creditors are usually barred for some period of time (commonly referred to as a "standstill period") from taking enforcement action of their own against the Common Collateral in response to a default under the second lien credit facility. This bar, or "standstill," is designed to give the first lien creditors an exclusive period in which to exercise their priority rights and remedies against the Common Collateral. The standstill applies to all liens of the second lien lenders, including judgment liens obtained against the borrower upon acceleration of the second lien obligations. The length of the standstill period is a matter of negotiation (and is based upon factors such as the nature of the collateral, the relative bargaining power of the first lien creditors and the second lien creditors, the relative size of the first lien obligations and the second lien obligations, and similar considerations), but a common

[15] Note, however, that some of these statutory rights are not waivable. *See* David Line Batty & Jo Ann J. Brighton, *"Silent" Second Liens — Will Bankruptcy Courts Keep the Peace?*, 9 N.C. BANKING INST. 1, 9 n.34 (2005).

standstill period would range from 90 to 180 days.[16] Moreover, if the first lien creditors commence their enforcement actions against any material portion of the Common Collateral within this standstill period, most intercreditor agreements provide for exclusivity to continue as long as those enforcement actions are diligently pursued.

Unsecured Creditor's Remedies of Second Lien Creditor. While the second lien creditors normally are subject to an enforcement standstill with regard to their remedies against the common collateral, they will usually seek to retain as many of their unsecured creditor's remedies against the borrower and any guarantors as possible. The typical argument made by second lien creditors in this regard is that they should not, by extending credit as a second lien lender, be placed in a worse position than an unsecured lender. As noted above, the counterargument in certain transactions is that, were these lenders unsecured, they would likely be required by the first lien lenders to be subordinated unsecured creditors, and would still be required to give up many of their unsecured creditor's rights as a result.

Among the unsecured creditor's remedies that the second lien creditors insist on retaining include the right to accelerate their loan on default; the right to demand payment from the borrower or any guarantor; the right to commence litigation and obtain a judgment against the borrower or any guarantor; and the right to commence an involuntary bankruptcy proceeding against the borrower or any guarantor. Nevertheless, if the second lien creditors are awarded a judgment lien against any of the Common Collateral in response to their exercise of unsecured creditor's remedies, that judgment lien normally will be subject to the enforcement standstill relating to the common collateral.

In the bankruptcy context, the desire of the second lien creditors to retain and exercise their unsecured creditor's remedies usually results in intense negotiations, as the first lien creditors will not want to leave the second lien creditors with rights and remedies that could encumber the first lien creditors' control over the Common Collateral, including among others consent rights to dispositions of the Common Collateral under Section 363 of the Bankruptcy Code, and the right to seek adequate protection in respect of the Common Collateral without interference from the second lien creditors. The issues that arise between the first lien lenders and the second lien lenders in bankruptcy proceedings against the borrower are numerous and complex, and a full discussion of those issues is beyond the scope of this article.

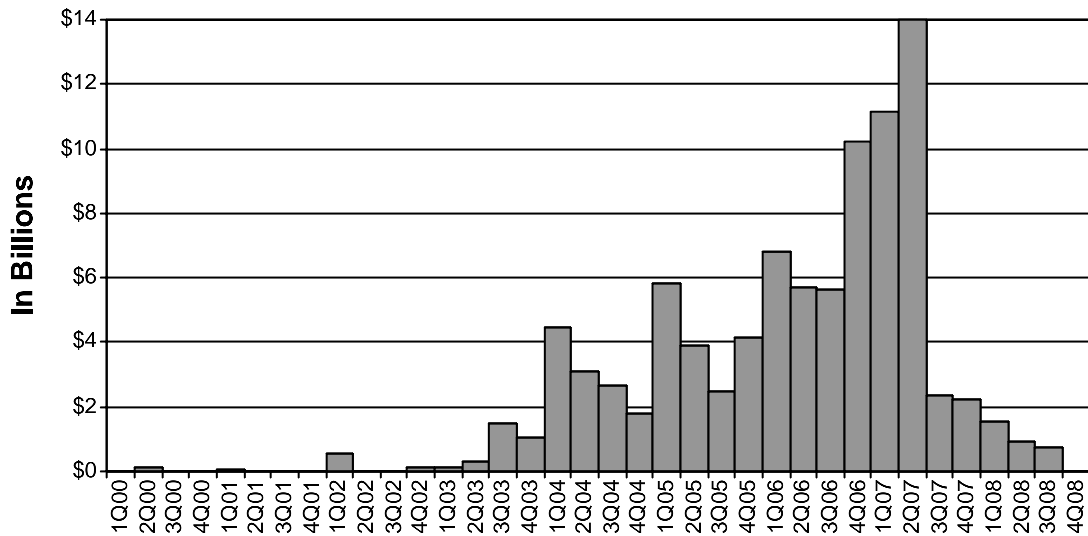
CONCLUSION

The lien subordination intercreditor issues discussed in this article represent a handful of the most important concepts negotiated between first lien and second lien creditors. In addition to the issues treated here, there are a number of other issues of vital importance to first and second lien lenders in this market, including those arising in the context of a bankruptcy proceeding of the borrower. Despite the current dearth of new second lien financings, an understanding of these issues is both timely and critical to any financial restructuring involving lien subordinated debt. As recent examples have shown, the manner in which some of these issues were resolved in the drafting of the governing intercreditor documentation can have decisive impact on the recovery available to different classes of creditors, resulting in unexpected losses to some and potential windfalls to others.

Going forward, a clearer view of the conceptual framework underlying lien subordination, and of the key issues that require close attention in the negotiation and drafting of intercreditor documentation, will be of practical benefit to transactional practitioners, as well as to other parties, such as courts, that may be called upon from time to time to interpret or implement intercreditor arrangements. It is our hope that this article will help advance both those goals. ■

[16] Although the borrower's economic interests are generally more closely aligned with the second lien position than with the first lien position, there are a few provisions in the intercreditor agreement in which the borrower will often want to support the first lien creditors, and this is one such. The borrower will generally prefer a longer (first lien-favorable) standstill period, since the first lien creditors will have an incentive to exercise their remedies prior to the standstill's expiration in order to act while still enjoying exclusivity.

APPENDIX



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