

X Clauses: Meaning and Mutations

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In corporate restructurings, plan negotiation dynamics often turn on two basic fundamentals: hold-up value and the scope of possible restructuring outcomes. Hold-up value arises from the power to obstruct or delay process, leading to a transfer of value to that party as a price for consent. Possible restructuring outcomes arise from what is permitted by the Bankruptcy Code and the terms of intercreditor arrangements. The fewer possible restructuring outcomes for a junior creditor, the less there is for the junior creditor to discuss or dispute, reducing negotiating leverage.

From a senior creditor's point of view, if junior creditors are not permitted to receive any payment in a liquidation or insolvency proceeding until the payment in full in cash of the senior debt, then there is only one possible outcome for junior creditors without senior creditor consent: zero recovery for junior creditors. Generally speaking, this is the rule set forth in the intercreditor terms for payment of subordinated debt. This rule is often subject to a customary qualification known as the "X clause." The X clause usually permits the junior creditors to receive and retain "permitted junior securities" even though the senior debt has not been paid in full in cash. These permitted junior securities are typically defined as equity or debt securities that are junior to any securities received by the senior creditors in the restructuring to at least the same extent as provided in the intercreditor terms governing the junior and senior debt.

An example of an X clause, taken from the 1983 ABA Model Simplified Indenture,¹ is set forth below:

Until the Senior Debt is paid in full in cash, any distribution to which Securityholders would be entitled but for this Article shall be to holders of Senior Debt as their interests may appear, except that Securityholders may receive securities that are subordinated to Senior Debt to at least the same extent as the Securities.²

Competing views exist as to what is intended by the X clause. The typical senior creditor view is that the X clause represents a rule of convenience: it allows the junior creditor to receive and retain junior securities rather than turn-over securities received until the senior creditor can liquidate the securities for a full recovery and round trip the excess securities back to the junior creditor.

The typical junior creditor view is that the X clause allows the junior creditor a hope of recovery and negotiating leverage to propose or support a restructuring that distributes equity securities to the junior creditor and crams-up the senior creditor under 11 U.S.C. § 1129(b) (or reinstates the senior creditor under 11 U.S.C. §§ 1129 and 1124). This creates the possibility of an alternative plan outcome and, accordingly, the potential to negotiate leverage for the junior creditor.

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Courts have generally agreed with the typical senior creditor view. In *In re Envirodyne Inc.*,³ the Seventh Circuit interpreted the following X clause:

All Superior Indebtedness shall first be paid in full before the Noteholders, or the Trustee, shall be entitled to retain any assets (other than shares of stock of the Company, as reorganized or readjusted or securities of the Company or any other corporation provided for by a plan of reorganization or readjustment, the payment of which is junior, at least to the same extent as the notes, to the payment of all Superior Indebtedness which may at the time be outstanding).⁴

In connection with the plan of reorganization of *Envirodyne*, the junior noteholders argued that the X clause entitled them to be treated equally with the senior creditors with respect to distributions of common equity of the reorganized enterprise. The court, however, determined that the phrase “the payment of which is subordinated to the payment of all Superior Indebtedness which may at the time be outstanding” modified the phrase “shares of stock of the Company, as reorganized or readjusted” and not merely the term “securities.”⁵ This analysis was based in part on the conclusion that:

[W]ithout this clause, the subordination agreement that it qualifies would require the junior creditors to turn over to the senior creditors any securities they had received as a distribution unless the senior creditors had been paid in full. Then, presumably, if the senior creditors obtained full payment by liquidating some of the securities that had been turned over, the remaining securities would be turned back over to the junior creditors.⁶

According to the court in *Envirodyne*, the X clause serves only to shortcut “this cumbersome procedure.”⁷ While the appellants argued that there was no reason to distinguish “stock” from

“securities” if the limiting clause applied to both words, the court in *Envirodyne* ultimately did not agree with this view.

In a subsequent and recent case, *In re Dura Automotive Inc.*,⁸ the United States Bankruptcy Court for the District of Delaware took a similar position, interpreting language that did not easily admit of such a reading. Specifically, the court took the view that the plain language of the X clause did not trump the overall context of the subordination agreement. The X clause in *Dura Automotive* read:

(except that the Holders of the notes may receive (i) Permitted Junior Securities . . .)⁹

In turn, the term “Permitted Junior Securities” was defined as:

Permitted Junior Securities” means: (1) Equity Interests in the Company, DASI or any Guarantor; or (2) debt securities that are subordinated to all Senior Debt and any debt securities issued in exchange for Senior Debt to substantially the same extent as, or to a greater extent than, the Notes and the Guaranties are subordinated to the Senior Debt under this Indenture.¹⁰

Despite the syntax including enumerated clauses (1) and (2), the court in *Dura Automotive* concluded, citing *Envirodyne*, that the purpose of the subordination provisions of the subordinated notes indenture in question was to assure payment in full of the senior notes *before there was any* recovery on the subordinated notes. As such, the clause, “that are subordinated to all Senior debt and any debt securities issued in exchange for Senior Debt to substantially the same extent as, or to a greater extent than, the Notes and the Guaranties are subordinated to the Senior Debt under this Indenture,” was construed to apply to clause (1) as well as clause (2).¹¹ It is important to note that the court in *Dura Automotive* relied on extrinsic evidence in coming to this conclusion and relied on its interpretation of commentaries to the Revised

Model Simplified Indenture (2000) and Commentaries on Model Debenture Provisions (1971). It did so somewhat apologetically, despite the fact that the semantics of this particular X clause favored the junior lender.

Other cases such as *In re PWS Holding Corporation*¹² and *In re Metromedia Fiber Network, Inc.*¹³ came to similar conclusions. As a result, the typical junior creditor's view of what an X clause is intended to effect is a view from a valley where the senior creditors hold the surrounding hilltops. In order to have an X clause that entitles junior creditors to receive the equity of the reorganized debtor while the senior creditor receives other securities requires one of two things: a more clearly drafted X clause or equity securities that incorporate the payment subordination terms of the intercreditor arrangements.

What language would persuade a court that the X clause is intended to allow a junior creditor to retain common equity when the senior creditor has received debt or equity securities? The answer may be as simple as reversing the order of the two clauses in the definition of the term "Permitted Junior Securities" in *Dura Automotive*. The X clause would then read:

(except that the Holders of the notes may receive (i) Permitted Junior Securities . . .)

With "Permitted Junior Securities" being defined as:

"Permitted Junior Securities" means: (1) debt securities that are subordinated to all Senior Debt and any debt securities issued in exchange for Senior Debt to substantially the same extent as, or to a greater extent than, the Notes and the Guaranties are subordinated to the Senior Debt under this indenture; or (2) Equity Interests in the Company or any Guarantor."

With the restrictive clause "that are subordinated . . ." safely encircled in clause (1), the junior creditor

should be able to receive equity securities without getting overrun by the payment turn-over clause. Compromises in between could carve out from "Permitted Junior Securities" common equity interests that are *pari passu* with any common equity interest distributed to the senior creditor. The important point is that given courts' tendencies to view the X clause as a rule of convenience, junior creditors wanting more from their X clause will need clear language allowing the retention of common equity in circumstances where the senior creditors do not receive payment in full in cash.

The revised Model Simplified Indenture¹⁴ recognizes this and incorporates an additional clause to the X clause as follows:

or (ii) Distributions under any plan approved by the court in any Proceeding.

This clause exempts any plan distribution from the payment turnover and allows a junior creditor to retain whatever it can obtain through the confirmed plan, *i.e.*, the greatest number of possible outcomes permitted under the Bankruptcy Code.

The notes to § 11.13 of the Revised Model Simplified Indenture contain interesting commentary. The notes state that:

The third exception (clause (b)(ii)) implements the accepted notion that, in bankruptcy, holders of Senior Debt will enforce their rights through the structuring of the distributions under the plan and Securityholders will be entitled to retain their distributions under the approved plan.

In a nod to the legitimacy of a junior creditor exercising hold-up power, the note further states:

In large part such provisions are the result of the perceived need in many bankruptcies to make some distribution to subordinated debt holders in order quickly to confirm a plan.

What the Revised Model Simplified Indenture does is eliminate the requirement that the senior creditor must have consented to the plan resulting in the distribution. The markets, however, do not appear to have adopted this convention.

Thinking more about X clauses has its value in the second lien (as opposed to subordinated note) world as well. The market for second lien loans grew tremendously from 2000 until the loan markets collapsed in 2008. Early on, arrangers and underwriters and first and second lien lenders and note holders battled over many terms and conditions for the second lien financings. By the close of the second lien rally in 2008, much of the smoke had cleared and many conventions had settled, including a concept similar to the X clause that can be identified as the “reorganization securities” clause. Below is an example from a typical intercreditor arrangement for a second lien transaction:

If, in any Insolvency or Liquidation Proceeding, debt obligations of the reorganized debtor secured by Liens upon any property of the reorganized debtor are distributed, pursuant to a plan of reorganization or similar dispositive restructuring plan, on account of both the First Lien Obligations and the Second Lien Obligations, then, to the extent that the debt obligations distributed on account of the First Lien Obligations and on account of the Second Lien Obligations are secured by Liens upon the same assets or property, the provisions of this agreement survive the distribution of such debt obligations pursuant to such plan and will apply with like effect to the Liens securing such debt obligations.

If not obvious, the above provides for the continuing lien subordination for the distribution of secured debt securities but does not provide for an exception to the payment-turnover provisions that effect the subordination in the first place.

Second lien intercreditor arrangements typically provide that the second lien creditor cannot receive any proceeds of or distributions in respect of collateral from enforcement of liens or in any insolvency proceeding unless the first lien creditor has been paid in full in cash. Because second lien intercreditor arrangements should, theoretically, not include payment subordination of the second lien debt (though surprisingly many do, directly or indirectly), X clauses, formulated as an exception to the subordination and payment turn-over for permitted junior securities, have been neglected in many instances on the grounds that they are irrelevant.

There are, however, reasonable arguments for the inclusion of an X clause in second lien intercreditor arrangements. Not the least of these is that many second lien intercreditor arrangements include payment subordination (or payment subordination-like) terms in derogation of the second lien catechism that the second lien means lien subordination but not payment subordination. Also, the relationship of the *secured* claims of a first lien holder and *secured* claims of the second lien holder is similar to that of a senior and junior (*i.e.*, payment subordinated) creditor *to the extent of the value of, and distributions from, the collateral*. Could second lien creditors be as deserving of the protection that an X clause provides to junior creditors in a payment subordinated deal?

There are arguments on both sides. On the one hand, the logic of the Bankruptcy Code is sympathetic to an X clause in a second lien transaction. Section 1129 of the Bankruptcy Code entitles a secured creditor *only to the full value of its allowed secured claim*, not to payment in full in cash of its secured claim. As such, a fully secured first lien creditor could be reinstated or crammed-up under §§ 1129 and 1124 of the Bankruptcy Code and receive debt securities for its secured claim. On the other hand, a second lien intercreditor arrangement is a compilation of compromises having the logic of the trades that took place in the bargaining. The rebuttal may be as simple as, “That’s not the deal!”

Looking at the possibilities further, the Bankruptcy Code clearly contemplates that a fully secured first lien creditor could receive, for example, secured paper for the full value of its secured claim while a second lien creditor received equity for its secured and unsecured claims. Under many intercreditor arrangements, the second lien creditor would be forced to turn over the equity that it received for its secured claim to the first lien creditor because the first lien creditor was not paid in full *in cash* and the second lien creditor had no X clause to rely upon. Under such circumstances, the absence of an X clause could result in the second lien creditor recovering less than it would have if it had been unsecured or subordinated with an X clause.

How might an appropriate X clause for a second lien intercreditor be drafted? The answer is much like an X clause for a payment-subordinated transaction. It would start with an exception to the payment turn-over:

(except that the Second Lien Lenders may receive (i) Permitted Junior Securities . . .)

With “Permitted Junior Securities” being defined as:

“Permitted Junior Securities” means: (1) debt securities that are unsecured or that are secured, provided that to the extent secured by Liens upon the same assets or property securing debt securities that are distributed on account of the First Lien Obligations, the provisions of this Intercreditor Agreement survive such distribution and apply with like effect to the liens securing such debt securities or such liens are otherwise subordinated to substantially the same extent, or to a greater extent than, as provided in this Intercreditor Agreement, or (2) Equity Interests in the Company or any Guarantor or any successor thereof.

The ABA’s recently published Model First Lien/Second Lien Intercreditor Agreement¹⁵

recommends an X clause and includes the following language with a footnote (recommending the bracketed language be included in a “first-lien friendly” intercreditor agreement):

Nothing in this Agreement prohibits or limits the right of a Second Lien Claimholder to receive and retain any debt or equity securities that are issued by a reorganized debtor pursuant to a plan of reorganization or similar dispositive restructuring plan in connection with an Insolvency Proceeding [, *provided that any debt securities received by a Second Lien Claimholder on account of a Second Lien Obligation that constitutes a “secured claim” within the meaning of section 506(b) of the Bankruptcy Code will be paid over or otherwise transferred to First Lien Agent for application in accordance with section 4.1, “Application of Proceeds,” unless such distribution is made under a plan that is consented to by the affirmative vote of all classes composed of the secured claims of First Lien Claimholders*].¹⁶

Thus, the model ABA second lien intercreditor form generously acknowledges the possibility that a second lien creditor might be entitled to retain debt or equity securities received under a plan of reorganization in respect of their secured claim, even under circumstances where the senior creditor was not paid in full in cash. Whatever the markets say, this much is clear: the absence of an X clause in a second lien intercreditor arrangement calls into question the possibility of a first lien cram-up or reinstatement that is a victory for a second lien creditor.

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¹ American Bar Association, Model Simplified Indenture (1983).

² *Id.* at § 11.03(2).

³ 29 F.3d 301 (7th Cir. 1994).

⁴ *Id.* at 306.

⁵ *Id.* at 305-06.

⁶ *Id.* at 306.

⁷ *Id.*

⁸ 379 B.R. 257 (Bankr. D. Del. 2007).

⁹ *Id.* at 261.

¹⁰ *Id.*

¹¹ *Id.*

¹² 228 F.3d 224 (3d Cir. 2000).

¹³ 416 F.3d 136 (2d Cir. 2005).

¹⁴ American Bar Association, Model Simplified Indenture (1983) (revised 2000).

¹⁵ American Bar Association, Model First Lien/Second Lien Intercreditor Agreement (2010).

¹⁶ *Id.* at § 6.7.