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Intercreditor Agreements in Chapter 11: What's a Junior Lienholder to Do?

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An "intercreditor agreement" is a form of agreement between secured creditors of a common debtor that defines the priority, remedies and rights among such creditors as they pertain to their common debtor. Typically, an intercreditor agreement confirms or modifies the preexisting priority rankings of the senior and junior lienholders relative to each other and, additionally, modifies, waives or assigns various contract, statutory or common law rights or remedies against the debtor to which the junior lienholder otherwise would be entitled to assert. In the past, understandings between a debtor's creditors were more frequently governed by a subordination agreement due to the predominance of companies who financed their operations using both secured indebtedness and unsecured bond debt. In other words, the holders of the bond indebtedness agreed to condition their right of payment upon the prior repayment of the secured indebtedness. However, over the last 15 years, companies have utilized first/second lien debt structures with increasing frequency in order to take advantage of the lower borrowing costs that such structures afford and, therefore, the use of intercreditor agreements has become much more prevalent.

Intercreditor agreements are used not only to set forth the relative priorities of the debtor's creditors, but also to limit the remedies that would otherwise be available to the junior lienholder in the event of a default or a bankruptcy by the debtor. Indeed, intercreditor agreements often include a sundry of bankruptcy-related waivers, limitations and prohibitions both on the junior lienholder's rights to enforce its claims until the senior lienholder is paid in full, and on the junior lienholder's ability to interfere with the senior lienholder's exercise of various rights to collect its payment ahead of the junior lienholder. Section 510(a) of the Bankruptcy Code provides that "[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law."[1] Despite this rather straightforward edict, courts have varied in their willingness to enforce waivers, limitations and prohibitions on a junior lienholder's ability to act in a bankruptcy proceeding. The purpose of this article is to explore the extent to which intercreditor agreement waiver provisions are enforceable in bankruptcy and, if so, the type of

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conduct by a junior lienholder that may be prohibited. In other words, what are the limits on a junior lienholder's ability to act in the bankruptcy case to protect its lien rights without running afoul of the waivers, limitations and prohibitions contained in an intercreditor agreement?

It is not surprising that with the more frequent inclusion of these waivers, limitations and prohibitions in intercreditor agreements, their effectiveness has been tested in bankruptcy cases with increasing regularity. One of the first cases to address the enforceability of bankruptcy waiver provisions in intercreditor agreements was *In re Hart Ski Manufacturing*.[2] In *Hart Ski*, the senior lender moved for summary judgment in connection with the subordinated lender's motion seeking adequate protection. The court denied summary judgment, holding that "[t]here is no indication that Congress intended to allow creditors to alter, by a subordination agreement, the bankruptcy laws unrelated to distribution of assets."[3] The court went on to note that rights that are guaranteed to creditors under the Bankruptcy Code and have nothing to do with the priority of distribution "cannot be affected by the actions of parties prior to the commencement of a bankruptcy case when such rights did not even exist."[4]

Subsequent to *Hart Ski*, courts varied as to their enforcement of bankruptcy waiver provisions. In *In re 203 North LaSalle Partnership*,[5] the bankruptcy court continued *Hart Ski*'s narrow interpretation of Bankruptcy Code §510(a). In *203 North LaSalle*, the court held that a provision in an intercreditor agreement that authorized the senior lienholder to vote the claim of the junior lienholder was unenforceable, despite express language in the agreement granting such right. The court found that the right to vote affirmatively granted by §1126(a) of the Bankruptcy Code could not be waived in a prepetition contract, notwithstanding Bankruptcy Code §510(a).[6]

The bankruptcy court's decision in *In re Aerosol Packaging*[7] in 2006 represented a departure from the narrow interpretation of Bankruptcy Code §510(a) promulgated by the courts in *Hart Ski* and *203 North LaSalle*. There, the court upheld a provision in an intercreditor agreement that authorized the senior lienholder to take certain actions on behalf of the junior lienholder, including to vote the junior lienholder's claims. In its opinion, the court focused not on whether the right being waived was a right provided under the Bankruptcy Code, but on whether the subordination agreement was enforceable under applicable nonbankruptcy law, as required by §510(a).[8]

Since *Aerosol Packaging*, courts have been more willing to look to the particular language of the intercreditor agreement under applicable contract law in determining whether a junior lienholder properly waived a particular right. In addition, when deciding whether the waiver provisions are enforceable, courts may consider the conduct of the parties and the circumstances surrounding intercreditor disputes. For example, the court in *In re Ion Media Networks*[9] looked to the terms of the intercreditor agreement in deciding whether the junior lienholder was permitted to object to confirmation of a proposed plan under which the senior lienholders were to recover the value of an asset the junior lienholders alleged was unencumbered. The court concluded that the junior lienholder did not have standing to object to the plan because the intercreditor agreement expressly prohibited lien challenges, including challenges to "purported" liens. Although the court's decision was based upon its interpretation of the language in the agreement, notably the court criticized the conduct of the junior lienholder, describing it as an "activist distressed investor" that used "aggressive bankruptcy litigation tactics" to create leverage and "earn outsize returns on its bargain basement debt purchases."[10]

Similarly, the court in *In re Erickson Retirement Communities*[11] found that the motion of the junior lienholders to appoint an examiner to investigate the allocation of value among the debtors' estates was "tantamount to both a pursuit of a remedy and the commencement of an action" and was therefore prohibited by the stand-still provisions of the intercreditor agreement. The intercreditor agreement prohibited the junior lienholders from engaging in the exercise of rights or remedies or from taking any action or proceeding to collect or enforce any of the subordinated obligations without the consent of the senior lienholders. The court also noted that the junior lienholders' motion was "unmistakably aimed at slowing down the confirmation process and gaining leverage to enhance or create recoveries for the [junior lienholders]," the "very type of obstructionist behavior that the [intercreditor] agreements are intended to suppress."[12]

The court in *In re Boston Generating*[13] also looked to the terms of the intercreditor agreement to determine whether the junior lienholders had standing to pursue their objection to the sale of the debtors' assets. The intercreditor agreement contained a waiver by the junior lienholders of the right to object to an "exercise of remedies" by the senior lienholders. The court noted that while it might have found that the senior lienholders' consent to the sale of the collateral was an "exercise of remedies" to which the junior lienholders were prohibited from objecting, at the sale hearing, counsel to the senior lienholders stipulated that the actions taken by the senior lienholders in connection with the sale was not an exercise of remedies.[14] Given this stipulation, in the absence of an explicit waiver of the right to object to the sale in the intercreditor agreement, the court held that the junior lienholder did in fact have standing to object.[15] The court noted that the decision was a "close call" in as far as the intercreditor agreement clearly set forth that the senior lienholders had the right to make the determinations regarding sales or dispositions of shared collateral.[16] The court further noted, however, that while not dispositive, additional facts that entered into its analysis were that the junior lienholders were "on the 'cusp' of recovery and [were] not engaging in the obstructionist behavior identified by the court in *Ion Media*."[17]

The various rights and remedies afforded to parties in interest by the Bankruptcy Code are designed to foster negotiation amongst the parties. Indeed, negotiation and compromise are fundamental tenets of the reorganization process. Thus, it is not surprising that a junior lienholder will seek to gain negotiating leverage by engaging in a variety of strategies designed to frustrate and/or obstruct the rights and remedies of the senior lienholder. These may take the form of affirmative actions by the junior lienholders or objections by such lienholders to actions that the senior lienholders are taking. Some of the standard lienholder remedies intended to hamper the senior lienholder are readily identifiable (e.g., moving for relief from stay and foreclosure; seeking to enforce its claim or demanding adequate protection; objecting to a proposed sale of collateral, cash collateral use, debtor in possession financing or plan supported by the senior lienholder; filing a competing plan of reorganization; receiving distributions under a plan if the senior lienholder has not been paid in full; or challenging the senior lienholder's liens). Other efforts by the junior lienholder to hinder the senior lienholder are not as apparent (e.g., a motion to transfer venue of the bankruptcy case; a motion to appoint an examiner; a motion to appoint a trustee; an objection to asset sale bidding procedures; a motion for substantive consolidation of two debtors' bankruptcy estates; or a challenge to the bankruptcy court's jurisdiction to determine intercreditor issues in light of the U.S. Supreme Court's decision in *Stern v. Marshall*[18]).

Some of these actions are often specifically addressed to varying degrees in the intercreditor agreement. Others might come within the more general prohibitions contained in the intercreditor agreement. Moreover, most intercreditor agreements require the junior lienholder to stand still and not object to an "exercise of remedies" by the senior lienholder. Some senior lienholder remedies that require the junior lienholder to stand still are obvious, such as the enforcement of liens on shared collateral. Others of the actions described above are less obvious (e.g., Is a senior lienholder's support of asset sale bidding procedures an exercise of remedies by the senior lienholder?).

While refusing to return to the position that prepetition waivers of bankruptcy rights are unenforceable (e.g., *Hart Ski* and *203 North LaSalle*), the court in *Boston Generating* strictly construed the senior/junior lienholder rights and remedies under the intercreditor agreement that was at issue. In fact, whereas the courts in *Ion Media* and *Erickson Retirement* focused on whether the junior lienholders' actions were aimed at frustrating the priorities and repayment scheme embodied in the intercreditor agreement, the court in *Boston Generating* focused on the language of the intercreditor agreement and permitted the junior lienholder to proceed because its actions were not expressly waived or limited by the terms of the intercreditor agreement.

The lesson to be gleaned from the foregoing is straightforward: The parties should be very explicit when drafting exactly what the junior lienholders can and cannot do in a bankruptcy proceeding. The benefit of clear and unambiguous drafting is illustrated by at least two other cases. See *Aurelius Capital Master v. Tousa*[19] (holding that a waiver of the right to object to a cash collateral order that was supported by the senior lienholders was enforceable against the junior lienholder); *In re Musicland Holding*[20] (holding that an increase in the amount of senior debt from an outside source was permissible where the new investment was funded as a part of the existing senior credit facility because the junior lienholders had agreed to be subordinated to additional loans made under such facility).

Drafting guidance can be found in the model form intercreditor agreement promulgated in May 2010 by the Intercreditor Agreement Task Force created by the Committee on Commercial Finance of the Business Law Section of the American Bar Association. Indeed, the court in *Boston Generating* utilized the model intercreditor agreement in its analysis of whether the intercreditor agreement in question contained a waiver of the junior lienholder's right to object to a sale of shared collateral. The court observed that the model form of intercreditor agreement contained an express waiver of the right to object to a sale pursuant to §363 of the Bankruptcy Code, while the intercreditor agreement in question fell short of such clarity.[21]

The model intercreditor agreement expressly prohibits a variety of conduct by the junior lienholder including lien challenges, appraisals or other valuation rights.[22] The model intercreditor agreement form language provides the senior lienholder with the right to make all decisions regarding the disposition of collateral, the enforcement of rights with respect thereto and/or the right to commence and maintain an "Enforcement Action" (including, among many others, the right to: set off or credit bid the debt, solicit bids for the collateral or receive the collateral with a deed in lieu of foreclosure)—all without complaint or objection by the junior lienholder.[23] Finally, the model intercreditor agreement provides that the junior lienholder, among other things, waives any claim it may have against any senior lienholder arising out of any cash collateral or financing arrangement or any grant of a security interest in connection with an insolvency proceeding, waives any right to assert or enforce any claim under §§506(c) or 552 of the Bankruptcy Code, and agrees that it will not seek to be treated as part of the same class of creditors as the senior lienholders.[24]

Clear and unambiguous drafting may, nevertheless, be for naught when the enforcement of intercreditor waivers is at issue in the context of a plan of reorganization. Indeed, in the case of in *In re TCI 2 Holdings*,[25] the junior lienholder proposed a plan of reorganization. The senior lienholders argued that the plan proposed by the junior lienholders could not be confirmed because it violated the intercreditor agreement and, therefore, was inconsistent with §510(a) of the Bankruptcy Code.[26] The court noted that the introductory language of §1129(b) of the Bankruptcy Code[27]—"notwithstanding §510(a) of this title"—and held in favor of the junior lienholders reasoning that a nonconsensual plan that meets all of the requirements of §§1129(a) and (b) is confirmable even though the plan may be inconsistent with an otherwise valid intercreditor agreement.[28] The holding in *TCI 2* has been cited with approval by courts in *In re Tribune*[29] and in *In re Croatan Surf Club*[30] but rejected by the court in *In re Consul Restaurant*,[31] which held that failure to enforce an otherwise valid intercreditor agreement would violate the discrimination and fair and equitable concepts of the cramdown section of the Bankruptcy Code.[32]

In sum, if an affirmative action or right to object in a bankruptcy proceeding by a junior lienholder is not addressed by the express terms of the intercreditor agreement, the parties should assume that such conduct or objection is permissible. However, even if not specifically addressed, junior lienholders proceed at their own peril because the more general prohibitions contained in the intercreditor agreement may be invoked against them if the junior lienholders are "out of the money" and are clearly attempting to frustrate the senior lienholders' legitimate exercise of rights and remedies. Moreover, as a result of such conduct or objection, the junior lienholder may be liable to the senior lienholder in litigation outside of the bankruptcy context whether or not the provisions are enforceable in bankruptcy.

1. See 11 U.S.C. §510(a).
2. *In re Hart Ski Manufacturing*, 5 B.R. 734 (Bankr. D. Minn. 1980).
3. Id. at 736.
4. Id. at 736 (the first published case to address the enforceability of intercreditor agreements under §510(a) of the Bankruptcy Code).
5. *In re 203 North LaSalle Partnership*, 246 B.R. 325 (Bankr. N.D. Ill. 2000).
6. Id. at 331.
7. *In re Aerosol Packaging*, 362 B.R. 43 (Bankr. N.D. Ga. 2006).
8. Id. at 47.
9. *In re Ion Media Networks*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009).
10. Id. at 588.
11. *In re Erickson Retirement Communities*, 425 B.R. 309 (Bankr. N.D. Tex. 2010).
12. Id. at 315 (citing *Ion Media*).
13. *In re Boston Generating*, 440 B.R. 302 (Bankr. S.D.N.Y. 2010).
14. Id. at 318.
15. Id. at 320.
16. Id. at 320.
17. Id. at 320.
18. *Stern v. Marshall*, 131 S. Ct. 2594 (2011).
19. *Aurelius Capital Master v. Tousa*, Case Nos. 08-61317-CIV, 08-61335-CIV, 2009 WL 6453077 (S.D. Fla. Feb. 6, 2009).
20. *In re Musicland Holding*, 374 B.R. 113 (Bankr. S.D.N.Y 2007).
21. *In re Boston Generating*, 440 B.R. 302, 319 (Bankr. S.D.N.Y. 2010).
22. See Model First Lien/Second Lien Intercreditor Agreement §1.8.
23. See id. at §§3.1(a), 3.2(c) and 8.1).
24. See id. at §§6.9, 6.10.
25. *In re TCI 2 Holdings*, 428 B.R. 117 (Bankr. D.N.J. 2010).
26. Id. at 139.
27. Section 1129(b) of the Bankruptcy Code permits a plan of reorganization to be confirmed over the objection of a dissenting class of claims provided that it is fair and equitable and that it does not violate the absolute priority rule.
28. *TCI 2 Holdings*, 428 B.R. at 141.
29. *In re Tribune*, 472 B.R. 223, 241 (Bankr. D. Del. 2012).
30. *In re Croatan Surf Club*, Case No. 11-00194-8-SWH, 2011 WL 5909199, *2 (Bankr. E.D.N.C. 2011).
31. *In re Consul Restaurant*, 146 B.R. 979, 988 (Bankr. D. Minn. 1992).
32. Senior lienholders often bring an action against the junior lienholders for breach of contract in venues other than the bankruptcy court when the intercreditor agreements have been determined unenforceable in bankruptcy.

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