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Memorandum

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Can Second Lien Lenders Be Heard In Connection With A 363 Sale? The Answer In *Boston Generating* Is A Resounding "Yes."

By Ancela R. Nastasi and Keith N. Sambur

In the absence of an express waiver, a second lien lender may object to proposed bid procedures and to the 363 sale itself.

Years ago, second lien lenders adhered to the truism about children -- they were seen but not heard. As our children have grown more vocal in recent years, so too have second lien lenders. A spate of recent bankruptcy cases demonstrate that second lien lenders have been both seen and heard at many critical junctures in the chapter 11 timeline -- at the sale of the debtor's assets under section 363 of the Bankruptcy Code,[1] in seeking the appointment of an examiner,[2] when voting on a chapter 11 plan,[3] and in connection with the confirmation hearing.[4]

The judiciary's response to the louder voice of second lien lenders has been varied and somewhat unpredictable. Recent decisions in *In re Boston Generating, LLC*, No. 10-14419 (SCC) (Bankr. S.D.N.Y.), however, are of singular mindset -- second lien lenders can be seen and heard in the context of a 363 sale so long as the intercreditor agreement does not specifically provide otherwise.

THE DEBTORS' CAPITAL STRUCTURE AND PROPOSED 363 SALE

In *Boston Generating*, the debtors financed their pre-petition operations with two tranches of secured debt -- a $1.45 billion facility secured by first priority liens on substantially all of the debtors' assets, and a $350 million facility secured by second priority liens on the same assets.[5]

Contemporaneously with the filing of their chapter 11 petitions, the debtors filed a motion seeking approval to sell substantially all of their assets. The debtors fast-tracked the sale, and requested authorization to conduct the auction within 72 days and to hold the sale hearing promptly thereafter.

The sale proposed by the debtors was to a stalking horse bidder at a price slightly less than the amount of the first lien debt. Pursuant to the proposed sale order, proceeds from the sale would be paid directly to the first lien lenders, less amounts

1 *See, e.g., In re Westpoint Stevens, Inc.*, 333 B.R. 30, 45-54 (S.D.N.Y. 2005), *rev'd in part*, 600 F.3d 231 (2d Cir. 2010).
2 *See, e.g., In re Erickson Retirement Communities, LLC*, 425 B.R. 309 (Bankr. N.D. Tex. 2010).
3 See, e.g., *In re 203 North LaSalle Street Partnership*, 246 B.R. 325 (Bankr. N.D. Ill. 2000).
4 *See, e.g., In re TCI 2 Holdings, LLC*, No. 09-13654, 2010 WL 1540115 (Bankr. D. N.J. April 12, 2010).
5 The debtors also financed their operations with unsecured mezzanine debt in the amount of $422 million.

withheld to establish certain reserves.[6] The proposed sale order provided that none of the sale proceeds would be used for the fees, expenses or the debt of the second lien lenders.

OBJECTIONABLE BID PROCEDURES? SECOND LIEN LENDERS HAVE A RIGHT TO BE HEARD.

The first lien lenders supported the proposed sale, including the timeframe for conducting the auction. The second lien lenders did not. They filed an objection to the bidding procedures, claiming that the proposed procedures would not allow for a robust sale process and would essentially ensure that they would receive no recovery.

In response, the first lien lenders argued that the prepetition intercreditor agreement between them and the second lien lenders prohibited the second lien lenders from objecting to the sale procedures. In support of their argument, the first lien lenders cited this provision of their intercreditor agreement:

> Until the Discharge of First Lien Obligations has occurred, whether or not any Insolvency or Liquidation Proceeding has been commenced… the First Lien Collateral Agent, at the written direction of the Required First Lien Secured Parties, shall have the exclusive right to enforce rights, exercise remedies and make determinations regarding the release, sale, disposition or restrictions with respect to the Collateral without any consultation with or the consent of the Second Lien Collateral Agent or any Second Lien Secured Party or any Second Lien Secured Debt Representative in respect thereof.
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> [The Second Lien Agent may] file any pleadings, objections, motions, or agreements which assert rights or interests available to unsecured creditors … arising under any Insolvency or Liquidation Proceeding... in each case not inconsistent with the terms of this Agreement… (emphasis added)

Considering the relevant provisions of the intercreditor agreement, Judge Chapman upheld the right of the second lien lenders to object to the bidding procedures. [Bid Procedures Transcript, p. 55].[7] In the absence of specific language in an intercreditor agreement prohibiting second lien lenders from objecting to the sale process, Judge Chapman held that such agreement could not be used as a basis to silence the second lien lenders. [Bid Procedures Transcript, pp. 53-54].[8]

In rendering her opinion, Judge Chapman referenced *Ion Media Networks, Inc. v. Cyrus Select Opportunities Master Fund, Ltd. (In re Ion Media Networks, Inc.)*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009). In *Ion Media*, the court declined to entertain the junior lender's objection to the debtors' plan based on, among other things, the fact that the junior lender had expressly waived that right in the intercreditor agreement, and on the fact that the junior lender was "woefully out of the money." *Ion Media*, 419 B.R. at 590.

Judge Chapman also referenced *In re Erickson Retirement Communities, LLC*, 425 B.R. 309 (Bankr. N.D. Tex. 2010), wherein the court considered a motion by certain mezzanine lenders to appoint an examiner. In *Erickson*, the operative subordination agreement barred the mezzanine lenders from filing any actions or pursuing any remedies to collect on their claims until the senior lenders were paid in full. Relying on these provisions, the court held that the mezzanine lenders were not parties in interest in the debtor's chapter 11 case, and accordingly had no standing to seek the appointment of an examiner. *Erickson*, 425 B.R. at 314.

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6 The proposed reserves included amounts for professional fees, the fees of the United States Trustee, chapter 7 trustee fees, amounts required to pay holders of priority and administrative claims in full, and 5% of the gross purchase price to be paid to the first lien lenders upon the effective date of a plan of liquidation.

7 Attached to this article is a copy of the transcript from the bid procedures hearing held on October 4, 2010. To access this transcript, please click on this link.

8 Judge Chapman noted that prepetition intercreditor agreements are enforceable in accordance with their terms and applicable contract law. [Bid Procedures Transcript, p. 52].

Judge Chapman distinguished *Ion Media* and *Erickson* for two primary reasons: *first*, the intercreditor agreement did not specifically prohibit objections to the bidding procedures by the second lien lenders, [Bid Procedures Transcript, pp. 54-55], and *second*, the second lien lenders were "very close to the money." Based upon the facts before her, Judge Chapman determined that the second lien objection was not obstructionist in nature. [Bid Procedures Transcript, p. 55]. Rather, allowing the second lien lenders the right to object to the bidding procedures ensured that the debtors properly exercise their fiduciary duties to all creditors of the estate. [Bid Procedures Transcript, p. 55]

OBJECTIONABLE SALE? SECOND LIEN LENDERS HAVE A RIGHT TO BE HEARD.

In connection with the hearing to approve the sale of substantially all of the debtors' assets to the stalking horse bidder, the second lien lenders argued in favor of their right to object to the sale. Not surprisingly, the first lien lenders opposed the notion that the second lien lenders had a right to be heard. Both sides relied on provisions of the same intercreditor agreement to support their contrary positions.

On November 17, 2010, Judge Chapman heard approximately two hours of oral argument from counsel on the intercreditor issues, and reserved decision. One week later, on November 24, she issued a draft opinion.[9] Judge Chapman concluded that the second lien lenders had a right to object to the sale as both *secured and unsecured creditors* -- but as she put it, this was a "hollow victory" because she went on to approve the sale. [Sale Opinion, p. 27].

Judge Chapman believed that "the spirit of the subordination scheme" embodied in the intercreditor agreement was to prevent the second lien lenders from being "heard" and from attempting "to block the disposition" of the collateral; the terms of the intercreditor agreement, however, were less than clear. [Sale Opinion p. 26]. Judge Chapman held that under New York law, "[i]f a secured lender seeks to waive its rights to object to a 363 sale, it must be clear beyond peradventure that it has done so." [Sale Opinion, p. 24]. The intercreditor agreement did not contain "an unequivocal" and "express" waiver or prohibition on the second lien lenders' right to object as *either unsecured or secured creditors* as is set forth in the American Bar Association's model interecreditor agreement.[10]

Judge Chapman noted, however that her interpretation of the intercreditor agreement was "to say the least, a very close call. While not dispositive, additional facts that enter into the Court's analysis include: (1) the fact that the issue here is a 363 sale of substantially all of the assets…, which if approved will effectively deprive them of the opportunity to vote… on a plan of reorganization; and (2)…, the [second lien lenders] are on the 'cusp' of a recovery and are not engaging in… obstructionist behavior." [Sale Opinion, p. 26].

THE INTERCREDITOR AGREEMENT: SPECIFICALLY ADDRESSING BID PROCEDURES AND 363 SALES

The intercreditor agreement in *Boston Generating* was over sixty-five pages in length, and included waivers by the second lien lenders of many bankruptcy-related rights, including the right to seek relief from the stay, and the right to object to any request for adequate protection or post-petition interest made by the first lien lenders. Oddly, the intercreditor agreement in *Boston Generating* was silent about the right of the second lien lenders to object to bidding procedures or to a 363 sale of the debtors' assets.

In drafting intercreditor agreements, parties should consider including provisions which specifically address

9 Attached to this article is a copy of the relevant pages of the draft sale opinion rendered by Judge Chapman. To access these pages of the sale opinion, please click on this link.

10 Perhaps critical to Judge Chapman's ruling was the fact that the first and second lien lenders stipulated that consent to a Bankruptcy Code section 363 sale by the first lien lenders did not constitute an exercise of remedies under the intercreditor agreement as Judge Chapman noted: "This may have altered my conclusion herein regarding standing and whether or not the objections asserted by the Second Lien Agent and the Second Lien Lenders were a violation of the Intercreditor Agreement." [Sale Opinion, p. 22].

objections to bidding procedures. First lien lenders beware -- in the absence of a specific waiver, the ruling in *Boston Generating* may be relied upon to allow second lien lenders to raise objections to proposed bid procedures and to the sale.

Although Judge Chapman allowed subjective considerations, such as second lien lenders being on the "cusp" of recovery and their "non-obstructive" behavior, to influence her decision, the central focus of the Sale Opinion was the objective text of the intercreditor agreement. Going forward, first lien lenders wishing to keep second lien lenders "silent" during a 363 sale process should make sure that their intercreditor agreement tracks the language of the American Bar Association's model intercreditor agreement which provides:

> Second Lien Agent, as holder of a Lien on the Collateral and on behalf of the Second Lien Claimholders, will not contest, protest, or object, and will be deemed to have consented pursuant to section 363(f) of the Bankruptcy Code, to a Disposition of Collateral free and clear of its Liens or other interests under section 363 of the Bankruptcy Code if First Lien Agent consents in writing to the Disposition.

In addition to the foregoing, given the ruling in *Boston Generating*, the intercreditor agreement should also specifically address whether and to what extent subordinated lenders are entitled to object to proposed bid procedures.

CONCLUSION

In light of Judge Chapman's recent decisions in *Boston Generating*, the intercreditor agreement should clearly spell out those bankruptcy-related rights which a second lien lender is waiving. In the absence of such specific intercreditor provisions, a second lien lender -- particularly one "in the money" or one close to being "in the money" -- will have an easier time being both seen and heard in the chapter 11 process.

QUESTIONS

If you have questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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