Enforceability of the "Bankruptcy Waiver": Where Are We Now?

Rick Hyman and Jane Kang of Mayer Brown LLP

We are now exiting a three-year period of unprecedented bankruptcy activity as the return of low interest rates and heated bond markets have allowed borrowers access to liquidity that was unavailable until only recently. For many bankruptcy practitioners, this is an opportunity to take a breath and consider the consequences of the many financing structures that gained prominence leading up to the last bankruptcy wave. The series of bankruptcy cases filed during this three-year period provided the courts with an opportunity to address issues raised by many of these structures. This article provides an overview of the so-called "bankruptcy waivers" that were typically granted by junior lienholders and examines how they have held up through the economic crisis.

Birth of the Second Lien Market and Bankruptcy Waivers

The second lien market first began expanding rapidly in 2003. The loans were often used for financing recapitalizations, dividends payments, and leveraged buyouts—typically as a replacement to mezzanine loans. Because these loans were collateralized, albeit on a subordinated basis, they offered borrowers a cheaper alternative to unsecured mezzanine debt. At the height of the market, more than $15 billion of second lien loans were issued in the second quarter of 2007 alone.[1]

The common perception about second lien loans was that the rights of the senior lenders would not be compromised by the new structure. During the birth of the market, second lien loans were often described as "silent seconds" because, in order to "silence" the junior lenders, the intercreditor agreements that were the centerpieces of these financings generally included a number of waivers by the second lien lenders of certain bankruptcy-related rights.

The second lien lenders usually agreed to waive, during any bankruptcy proceeding of the borrower, certain rights that they had as secured creditors. Through these waivers, the first lien lenders sought assurance that they would be able to exercise their rights and remedies with little interference from second lien lenders. Of course, the use of the term "silent second" quickly became a misnomer, as it became clear that the second lien lenders would have some rights by virtue of their secured status (e.g., junior lien lenders can exploit the potentially disruptive effect of a legal challenge in order to negotiate concessions from senior lien lenders and avoid strict performance of the intercreditor agreement).

Some of the most important waivers negotiated by first lien lenders include limitations on the rights of junior lienholders to demand adequate protection,

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contest DIP financing, object to the use of cash collateral, object to an 11 U.S.C. § 363 sale of the borrower's assets, and vote for non-conforming plans of reorganization. Initially, these waivers were broadly drafted and construed firmly in favor of first lien lenders. However, as the market developed, second lien lenders gained more bargaining power and negotiated less restrictive waivers. While the exact terms of the waivers vary across the different second lien financing transactions, the key characteristics of some of these waivers are:

- *Right to object to use of cash collateral or proposed DIP financing.* During a bankruptcy proceeding, a borrower will often need to use cash collateral or seek additional funds through DIP financing in order to continue its operations. Junior lenders often waived the right to object to the use of cash collateral or DIP financing subject to certain conditions (e.g., an agreed upon cap on the amount of DIP financing).

- *Right to demand adequate protection.* Secured creditors in a bankruptcy are entitled to adequate protection to protect against any erosion in the value of their collateral position. Second lien lenders often waived the right to seek such adequate protection.

- *Right to object to sale of collateral.* Junior lenders often waive the right to object to sales of collateral that are approved by first lien lenders. Generally, these waivers provide that the liens will attach to the sale proceeds and that the sale will be on commercially reasonable terms.

- *Right to vote against a plan of reorganization.* In an effort to control the plan confirmation process, the first lien lenders often seek to restrict junior lenders from voting in favor of any plan that is inconsistent with the intercreditor agreement.

After experiencing a sharp contraction during the financial crisis in late 2008 and 2009, the second lien market is slowly picking up. According to S&P LCD, $3.77 billion in second lien loans were issued in 2010, twice the amount issued in 2009.[2] As the credit markets continue to open up in 2011, it is expected that second lien lending will continue to grow. It is crucial for lenders seeking to enforce existing intercreditor agreements and those beginning to negotiate new credit facilities to understand the current trend in the case law regarding the interpretation of these waivers.

Enforceability of Pre-Petition Waivers

The growth in second lien financings was exponential, occurring during a period noted for the near-absence of new bankruptcy filings. Accordingly, there was relatively little precedent with regard to the legal enforceability of such waivers during the birth of the market.

Section 510(a) of the Bankruptcy Code states that a "subordination agreement is enforceable in a [bankruptcy case] to the same extent that such agreement is enforceable under applicable nonbankruptcy law." This means that a subordination agreement will be governed by principles of contract law, and that the same rules of construction used to interpret contracts should be used to interpret subordination agreements. As second lien financings became more prominent, it was generally understood that bankruptcy courts regularly enforced subordination provisions to the extent that the provisions direct the priority of claims. Less clear was how far the courts would extend § 510(a) beyond payment subordination (e.g., to pre-petition bankruptcy waivers).

The uncertainty was largely based on the two bankruptcy cases most often cited by junior lienholders:

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203 North LaSalle[3] and *Hart Ski.*[4] The subordination agreement in *203 North LaSalle* provided that the senior creditor could vote the junior creditor's claims in connection with any bankruptcy proceeding. The court struck down this provision, holding that the second lien lender's right to vote on the confirmation of a reorganization plan could not be waived or assigned in a pre-bankruptcy intercreditor agreement. In *Hart Ski*, the second lien lenders requested adequate protection and lifting of the automatic stay despite having signed pre-bankruptcy waivers prohibiting this behavior in the subordination agreement. The court refused to enforce the waivers and overruled the first lien lender's objections. In both instances, the court reasoned that while the lien subordination provisions were enforceable under § 510(a), the scope of § 510(a) did not extend to the bankruptcy waivers.

More recent cases, however, indicate a trend away from the reasoning in *203 North LaSalle* and *Hart Ski.* Courts today appear more willing to enforce intercreditor agreements, including the pre-petition bankruptcy waivers. For instance, in the subordination agreement at issue in *Aerosol Packaging*,[5] the second lien lender expressly assigned its right to vote in any bankruptcy proceeding to the first lien lender. The court rejected the second lien lender's reliance on *203 North LaSalle* and held that the second lien lender, by assigning its voting rights, had agreed to allow the first lien lender to act in its best interests even if the vote would be contrary to the second lien lender's interests.

In another example, the court in *TOUSA*[6] enforced the second lien lender's waiver of its right to object to the use of cash collateral. Even though the second lien lender had raised a limited objection to the use of cash collateral, the court approved the cash collateral order as consensual because the second lien lender could not raise any objections. Moreover, because the cash collateral order was deemed consensual, the second lien lender lacked standing to sue under the order.

In *Erickson Retirement Communities*,[7] the court found that the junior lender had properly bargained away certain bankruptcy rights in the subordination agreements. Specifically, the court decided to strictly enforce the standstill provision in the subordination agreements by denying the junior lender's motion seeking the appointment of an examiner. Also, the court noted that there were no allegations of fraud and mismanagement, which typically are found in motions for the appointment of an examiner. This led the court to view the junior lender as self-serving and engaging in obstructionist behavior in order to gain negotiating leverage.

An underlying theme in this line of cases is that the second lien lenders are sophisticated commercial entities that should understand the full effects of bankruptcy-related waivers and that are less in need of the courts' protection.

Perhaps the most aggressive enforcement of a bankruptcy waiver was made in *ION Media*.[8] In this case, the court broadly enforced two different bankruptcy waivers. First, the second lien holders argued that certain assets should not be considered collateral and should therefore not be included as part of the first liens. In ruling against the second lien holders, the court broadly interpreted the terms of the intercreditor agreement to find that the second lien holders had waived any right to object to the validity or perfection of the liens. Second, the court read the second lien holders' waiver of their right to contest a plan of reorganization to bar them from challenging a proposed reorganization plan even as a general unsecured creditor. In reaching its conclusions, the court noted that the second lien holder was a distressed debt investor that had bought the second lien at a steep discount and perceived the second lien holder to be using aggressive litigation tactics.

Despite this trend of enforcing pre-petition bankruptcy waivers, a few courts have chosen to enforce intercreditor agreements and their waivers much more narrowly, either by limiting the applicability of

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such agreements—as in *TCI 2 Holdings*[9]—or by strictly limiting the waivers to their specific terms—as in *Boston Generating*.[10]

In *TCI 2 Holdings*, the court found the intercreditor agreement to be inapplicable in the context of confirming a cramdown reorganization plan. In this case, the first lien lenders objected to the confirmation of the plan proposed by the second lien lenders in part because it violated the intercreditor agreement. While acknowledging that intercreditor agreements are enforceable contracts under § 510(a), the court found an exception to this rule in 11 U.S.C. § 1129(b)(1), which provides that "[n]otwithstanding Section 510(a)," the court "shall" confirm a plan if it meets the cramdown requirements of 11 U.S.C. § 1129. As a result, the second lien lenders' plan could be confirmed as long as it met the cramdown statutory requirements, even if it was inconsistent with the terms of the intercreditor agreement. Notably, the court declined to address whether or not the second lien lenders had breached the intercreditor agreement, which leaves open the possibility that first lien lenders could pursue a contractual claim in these circumstances.

In *Boston Generating*, the bankruptcy court ruled that the second lien lenders were not prohibited from objecting to the proposed bidding procedures for the sale of the borrower's assets. Although the second lien lenders had expressly waived their right to object to any sale of collateral in the intercreditor agreement, the agreement was silent regarding the right to object to the bidding procedures. Furthermore, the court appeared more willing to enforce a strict reading of the agreement because it did not perceive the second lien lenders to be engaging in any obstructionist behavior.

Conclusion

The series of bankruptcy court decisions over the last few years has taught us that bankruptcy courts are willing to treat the intercreditor agreement as an enforceable contract negotiated between two sophisticated commercial entities. While this may give parties negotiating intercreditor agreements some greater certainty, the extent to which courts will enforce pre-petition bankruptcy waivers remains unresolved. We expect that courts will continue to construe bankruptcy waivers in the context of the facts at hand, discouraging self-interested gamesmanship and encouraging the preservation of going-concern value of the borrower. Courts then can be expected to continue conducting fact-intensive inquiries, and the court's perception of the parties' underlying motivations may play a large role in the ultimate outcome on the enforceability of a contested bankruptcy waiver.

Rick Hyman is a partner in the Restructuring, Bankruptcy & Insolvency practice at Mayer Brown. He focuses his practice on bankruptcies and reorganizations. He primarily represents institutional creditors and lending groups in connection with their exposure in large and middle-market credit facilities. Rick has represented major financial services clients and creditors in many complex chapter 11 reorganizations, out-of-court restructurings and recapitalizations, and debtor-in-possession and exit financings. Rick is based in Mayer Brown's New York office and can be reached at +1 212 506 2664 or fhyman@mayerbrown.com.

Jane Kang is an associate in the Restructuring, Bankruptcy & Insolvency practice at Mayer Brown. Jane is based in Mayer Brown's New York office and can be reached at +1 212 506 2311 or jkang@ mayerbrown.com.

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[1] *See* Gary D. Chamblee, "Reducing Battles Between First and Second Lien Holders through Intercreditor Agreements: The Role of the New ABA Model Intercreditor Task Force," 12 N.C. Banking Inst. 1 (Mar. 2008).

[2] *See* Emre Peker, "Carlyle Leads Buyers 'Hungry for Yield' in Second-Lien Opening," Bloomberg Businessweek, Oct. 29, 2010, *available at* http://www.businessweek.com/news/2010-10-29/carlyle-leads-buyers-hungry-for-yield-in-second-lien-opening.html.

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[3] *In re 203 North LaSalle St. P'ship.,* 246 B.R. 325 (Bankr. N.D. Ill. 2000).

[4] *In re Hart Ski Mfg. Co.*, 5 B.R. 734 (Bankr. D. Minn. 1980).

[5] *In re Aerosol Packaging, LLC*, 362 B.R. 43 (Bankr. N.D. Ga. 2006).

[6] *Aurelius Capital Master, Ltd. v. TOUSA Inc.* (S.D. Fla. Feb. 6, 2009).

[7] *In re Erickson Retirement Cmtys., LLC*, 425 B.R. 309 (Bankr. N.D. Tex. 2010).

[8] *In re Ion Media Networks, Inc.*, 419 B.R. 585 (S.D.N.Y. 2009), *appeal docketed*, No. 09-10596 (S.D.N.Y. Dec. 30, 2009).

[9] *In re TCI 2 Holdings, LLC*, 428 B.R. 117 (Bankr. DN.J. 2010).

[10] *In re Boston Generating, LLC*, No. 10-14418 (SCC) (Bankr. S.D.N.Y. Oct. 4, 2010).

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