# *Musicland* offers cautionary note for intercreditor agreements in second lien financings

By: Sean T. Scott

In the second lien financing market, one of the most hotly-contested issues in negotiations between first lien and second lien lenders is typically the "hard cap" — that is, to what extent, and under what circumstances, additional first lien debt may be incurred without second lien lender consent. First lien lenders typically seek flexibility to amend their loan documents to increase the amount of the first lien debt and to bring in new, or replace existing, lenders. Meanwhile, second lien lenders often negotiate for dollar or percentage caps on the amounts by which first lien loans can be increased, whether in the context of a new money facility, a refinancing, or a debtor-in-possession facility.

A recent decision from the **U.S. Bankruptcy Court, Southern District of New York** highlights why lenders and their counsel should carefully consider whether amendment and assignment provisions of loan documents affect any hard cap. *See In re Musicland Holding Corp.*, 2007 WL 2405658 (Bankr. S.D.N.Y. August 24, 2007). Although *Musicland* did not involve a typical second lien financing, the decision demonstrates the importance of understanding the terms of key intercreditor provisions in any distressed financial scenario.

## Musicland's prepetition lending arrangements

*Musicland* stemmed from an intercreditor agreement between certain revolving facility lenders and a consortium of secured trade creditors. The first lien lenders made loans to Musicland and its affiliates, secured by substantially all of Musicland's assets, pursuant to a $200 million revolving credit line. At the time the first lien lenders entered into the facility, the secured trade creditors agreed under an intercreditor agreement to subordinate what otherwise would have been their first-priority liens on certain inventory collateral to the liens of the first lien lenders. The intercreditor agreement also contained a negative pledge barring Musicland from obtaining any new secured loans.

In the fall of 2005, while facing financial distress, Musicland asked the first lien lenders to increase availability under the revolving credit agreement. The existing lenders declined to do so. Instead, **Harris NA**, which was not then one of the first lien lenders, agreed to make a $25 million term loan on "materially different terms from the Revolving Credit Agreement." In particular, the Harris loan had a short-term maturity and was guaranteed by Musicland's parent. If the Harris loan had been documented as a stand-alone facility, Harris' lien on any inventory collateral would have been subordinate to the liens of the secured trade creditors.

Consequently, the first lien lenders and Harris structured the Harris loan as an amendment to the revolving credit agreement. In late 2005, Musicland repaid the Harris loan in full. Musicland then filed a Chapter 11 case in January 2006, during which it sold substantially all of its assets. Although the first lien lenders were paid in full from the proceeds of the sale, the secured trade creditors were left "substantially undersecured."

## A windfall to the term lender?

In 2007, a number of the secured trade creditors brought an adversary proceeding in the bankruptcy case against the first lien lenders. Their complaint asserted claims for breach of contract, various torts and unjust enrichment on the basis that the intercreditor agreement did not allow the first lien lenders to amend the revolving credit agreement "to bring the Harris Term Loan within its priority and protection." The first lien lenders moved to dismiss the complaint, arguing that the plain language of the revolving credit agreement permitted such amendment.

The bankruptcy court ultimately agreed, finding that the intercreditor agreement "unambiguously authorized" the first lien lenders to bring in Harris as a term lender. In reaching this decision, the court made its way through several definitions in the intercreditor agreement, "the net effect of which provided that the [first lien lenders'] priority extended to the debts under … any amended agreement, including any new loans of any type made under any amended agreement." In particular, the court noted that "Revolving Loan Debt" was not limited to the existing revolving credit facility, but


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instead was defined as "any and all obligations, liabilities and indebtedness of every kind, nature and description" owed by Musicland, "whether now existing *or hereafter arising*" under the revolving credit agreement (emphasis added). The court also emphasized that "Revolving Loan Creditors" who could benefit from the intercreditor agreement were not limited to the initial lenders under the revolving credit agreement, but also included "any other lender or group of lenders that at any time refinances, replaces or succeeds to all or any portion of" the first lien debt or "is otherwise a party to the Revolving Creditor Agreements." In reaching this conclusion, the court also relied on the fact that the only express limitation in the revolving credit agreement on assignments was a contractual limitation on the ability of affiliates of Musicland to become first lien lenders. In the court's view, the "absence of a similar limitation concerning term loans lends additional support to the [first lien lenders'] interpretation" of the applicable agreements.

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Based on these and other provisions, the court concluded that the first lien lenders had the contractual right under the intercreditor agreement to include the Harris Loan, despite the fact that the Harris Loan included a new lender and was materially different in structure from the existing facility. Consequently, the court granted the first lien lenders' motion to dismiss all counts of the secured trade creditors' complaint.

### Lessons for documenting second lien transactions

The *Musicland* decision illustrates the importance of negotiating and carefully documenting the precise instances in which first lien lenders will be permitted to increase the size of their facility. It also illustrates how broadly written amendment provisions and boilerplate definitions in the relevant transaction documents could give rise to potential inconsistencies with such provisions. Indeed, if the intercreditor agreement in *Musicland* had included a hard cap on increases in debt thereunder, it is unclear how the court would have reconciled that with the broad definitions and amendment provisions.

Consequently, lenders and their counsel should ensure that to the extent an intercreditor agreement is intended to limit the ability of first lien lenders to increase the size of the facility or to bring in new lenders, such limits are expressly and clearly set forth in the loan and collateral documents. Moreover, lenders should be careful to delineate when such provisions can themselves be amended, including requisite percentages for second lien lender consent. Otherwise, as the *Musicland* decision demonstrates, second lien lenders risk that unanticipated new first lien debt may come in at the worst possible time — when a borrower is in financial distress — and significantly affect their collateral coverage and ultimate recoveries. ■

## CONFERENCE CALENDAR

### NOVEMBER

**Nov. 7-9**
63rd Annual Convention
Phoenix
Presented by: Commercial Finance Association
Information: *www.cfa.com*

**Nov. 8-11**
87th New York Meeting
New York
Presented by: Commercial Law League of America
Information: *www.clla.org*

### DECEMBER

**Dec. 6-8**
19th Annual Winter Leadership Conference
Rancho Mirage, Calif.
Presented by: American Bankruptcy Institute
Information: *www.abiworld.org*

**Dec. 7-8**
The 32nd Annual Alexander L. Paskay Seminar on Bankruptcy Law and Practice
Clearwater Beach, Fla.
Presented by: Stetson University College of Law
Information: *www.law.stetson.edu/conferences/Bankruptcy/*

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