SECOND LIENS

WATCHING THE SECONDS TICK AWAY: FINDING VALUE IN SECOND LIENS IN BANKRUPTCY

*By Glenn E. Siegel**

Until recently, senior lenders rarely consented to allowing their borrowers to raise additional funding by granting junior liens to new lenders. Such additional junior borrowings, despite their ability to add additional liquidity to borrowers, and arguably improve the likelihood of repayment of senior loans, were frowned upon because of the difficulties they were thought to create in maximizing recovery through liquidation of collateral in the event of a default.

In recent years, however, this has changed and second lien loans[1] have become a common component of the capital structure of many companies.[2] When their borrowers default, holders of second lien loans are faced with different challenges in their efforts to maximize their recoveries and may find their previous experience as either senior lenders or holders of unsecured debt provides little guidance in analyzing their situations.

This article will attempt to provide such guidance by first describing the benefits obtained by lenders in second lien transactions, second, describing typical structures for second lien positions, and third, highlighting the issues confronted by second lien holders in bankruptcy.

Benefits Available to Second Lien Creditors in Bankruptcy

Creditors who become second lienholders, instead of lending on an unsecured basis, obtain significantly greater rights than unsecured creditors.[3] The rights granted to secured lenders under security agreements

---

* *Glenn E. Siegel, a partner in Dechert LLP's corporate recovery and insolvency group, has more than twenty years of high-level bankruptcy experience. He represents indenture trustees, bondholders, creditor committees, acquirers of troubled businesses, secured creditors, debtors, shareholders, and other participants in bankruptcy and workout matters and has advised major stakeholders in numerous bankruptcy cases. Mr. Siegel can be contacted at glenn.siegel@dechert.com.*

1. This article will use the term second lien loan to describe this type of lending although the names such as Junior Secured Notes, Tranche B Loans, and Silent Liens have been used to describe the same product.

2. Issuance of Second Lien Debt has continued to rise dramatically over the past three years. In 2003, approximately $3 billion of second lien debt was issued. In 2004, the number had grown to $12 billion and in 2005, the number continued to rise to approximately $16.3 billion. Siegel and Nevins, Second Liens in Workout and Bankruptcy: Is Junior Safe From Danger?, Presentation at SRI Distressed Investing Conference (May __, 2006, London, England).

3. The following discussion assumes that the second lienholder is "in the money." In other words, the value of the collateral granted to the second lienholder exceeds the

allow recovery from specific borrower assets prior to the claims of general unsecured creditors. A debtor in bankruptcy may not affect these rights without providing specific protections granted under the Bankruptcy Code. The protections granted to secured lenders are required by the so-called "takings clause" of the Fifth Amendment to the United States Constitution.[4]

These protections are contained in several provisions of the Bankruptcy Code.

For example, Section 363(e) of the Bankruptcy Code[5] prohibits a debtor from using, selling, or leasing property encumbered by a lien (this would include requests by a borrower to use cash, negotiable instruments, securities, or other cash equivalents) unless the lienholder's interest is adequately protected.[6] Similarly, a lienholder may obtain relief from the automatic stay imposed by Section 362 of the Bankruptcy Code if its interests are not adequately protected.[7] A debtor cannot borrow money on a secured basis ahead of the lien of another secured lender unless the lender's interest in its collateral is adequately protected.

Section 361 of the Bankruptcy Code, which defines adequate protection, provides examples of how a debtor may provide adequate protection including providing periodic cash payments or substitute liens to compensate a secured creditor for the delay associated with bankruptcy. In the seminal case of *In re Murel Holding Corp.*,[8] Judge Learned Hand wrote:

> It is plain that "adequate protection" must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will hardly be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.[9]

In most instances, this right to adequate protection will provide a lienholder to the right to current payments of interest and fees and expenses as well as specific information rights about its collateral.

In addition to adequate protection rights, a debtor may only sell property encumbered by a lien, if: (1) the lienholder consents, (2) the

---

amount of the claims of all prior lienholders. If it does not, there is no secured claim. 11 U.S.C. §506(a).

4. AMENDMENT V, UNITED STATES CONSTITUTION ("private property [shall not] be taken for public use, without just compensation"). *See Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 594-595; 55 S.Ct. 854, 865-866 (1935).

5. 11 U.S.C. §363(e)

6. 11 U.S.C. §361

7. 11. U.S.C. §362(d) (1)

8. 75 F.2d 941 (2d Cir. 1935)

9. 75 F.2d at 942

property is sold for more than the lien, (3) the lien is in dispute, and/or (4) the lien attaches to the proceeds.[10] Moreover, a lienholder has the right to credit bid at any sale of property subject to its lien.[11]

A lienholder can receive post-petition interest (sometimes on a current basis as part of adequate protection) to the extent its collateral is worth more than its debt.[12] If its documents provide for payment of expenses[13] or prepayment premiums[14] or other liquidated damages,[15] these claims may also be paid if enforceable under state contractual law.

Finally, a debtor may not confirm a bankruptcy plan over the objection of a secured creditor class unless the plan provides, among other things, either: (a) that the holder of such claim retains its liens and receives payments of a present value equal to the smaller of the value of the property or the amount it is owed; or (b) for the sale of the encumbered property, free and clear of such liens, with such liens to attach to the proceeds of such sale.[16]

In contradistinction, the most an unsecured creditor for borrowed money may be entitled to is representation on an official unsecured creditors committee,[17] the right to vote on and oppose a plan which either: (1) fails to give it what it would receive in a liquidation,[18] (2) prefers similarly situated creditors,[19] or (3) allows equity to be paid before creditors are paid in full.[20]

Obtaining Consent of Senior Lienholders to Junior Liens: The Intercreditor Agreement

In exchange for allowing other creditors to share in their right to have repayment protected by a lien on the borrower's assets, senior lenders will require that junior lenders restrict or limit some of their rights in the event of a borrower bankruptcy. These restrictions will be contained in an Intercreditor Agreement, frequently because secured creditors will hold their lien through a collateral trustee to avoid priority and control issues. The limitations on junior creditor rights are not designed to protect the borrower but rather are designed to assure that a senior lender retains maximum control over its collateral during the course of a bank-

10. 11 U.S.C. §363(f)

11. 11 U.S.C. §363(k). It should be noted that in the case of a second lien, a credit bid would require either the consent of the first lienholder or a cash bid sufficient to pay off the senior indebtedness.

12. 11 U.S.C. §506

13. *See, e.g., In re Kord Enterprises II,* 139 F.3d 684 (CA9,1998)

14. *See, e.g., In re CP Holdings, Inc.,* 332 B.R. 380 (W.D. Mo. 2005)

15. *See, e.g. In re Direct Transit, Inc.*, 226 B.R. 198 (8th Cir. BAP,1998)

16. 11 U.S.C. §1129(b)(2)(A)

17. 11 U.S.C. §1102(a)

18. 11 U.S.C.§1129(a)(7)

19. 11 U.S.C. §1129(b)

20. 11 U.S.C. §1129(b)(2)(B)

ruptcy, particularly in instances where a junior lienholder would be entitled to adequate protection or to object to its treatment under a plan.

Earlier agreements contained severe restrictions on the rights of junior creditors including a total ban on requests for adequate protection payments (or alternatively a turnover of all adequate protection payments to senior lienholders), consent to any lien priming or sales supported by senior lenders or even restrictions on opposing plans supported by senior lenders. These provisions, while not fully tested in bankruptcy court, may be subject to challenge as an abrogation of secured creditor rights in bankruptcy.

More recent Intercreditor Agreements will show more give and take. For example, there will be a limit on the size of first lien debt, typically tied to the original amount committed, and allowance for refinancing but not unlimited increases in senior debt. Junior lienholders will insist on consent rights to DIP financing, sales of collateral under Section 363 of the Bankruptcy Code and only limited forbearance of their right to enforce their liens, generally 90 to 180 days. Junior holders will be allowed to defend challenges to their liens, join in enforcement actions and bid at foreclosure sales. Another important right typically granted to junior holders is the option to buy senior debt out at par either at specific times during the case or alternatively at any time.

Most Intercreditor Agreements only restrict second lienholders from receiving the proceeds of collateral upon liquidation; in the absence of a default in the senior debt obligations, junior lienholders will receive current payments on their debt even when senior debt remains outstanding. In the event of a default in the senior debt, junior holders may not be paid but will typically have the right to bring enforcement actions frozen (*i.e.,* a stand still agreement) for a limited time.

Some Intercreditor Agreements will appear more equitable in that the "first" lienholder will only maintain its first lien on the borrower's more liquid assets such as inventory and accounts receivable while taking a second on assets such as intangibles and property, plant and equipment. The "second" lienholders will have a second on inventory and accounts receivable with a first on intangibles and property plant and equipment. This kind of division of collateral means a second lienholder will also need to expect that, to realize maximum value on its collateral, it will need to support the business in order to avoid a fire sale of its collateral.

Thus, the Intercreditor Agreement is the most important agreement to review when determining the value of lien rights granted to a junior lienholder. The panoply of rights granted to a secured creditor in bankruptcy (see discussion in previous section) is meaningless if they have been bargained away in an overly restrictive Intercreditor Agreement. Accordingly, if involved at the inception of the loan, holders should be vigilant in protecting themselves in such negotiations or alternatively, if purchasing the debt, the price should reflect the true value of the second

lien position. One more point – valuation of collateral is essential. The purchaser should be confident that collateral values will support the additional rights granted to second lien holders.

In any event, if junior holders want to maximize their recovery they will need to be prepared to expend additional funds to protect their lien position. At the time of post-petition lending, a new lender may dilute the second's lien position, it may be better to provide the new lending. The senior lender's interests in the bankruptcy will not be to maximize the value of the collateral but rather to assure the conversion of their more liquid collateral to cash. The ability to take out the senior lenders at par will again prove to be a valuable right provided that junior holders are willing to provide additional funding. Finally, the nature of second lien collateral may also persuade lienholders to provide the on-going business with working capital in order to protect their position. However, those second lienholders who do not participate in the new lending will not benefit but will instead find their second lien position further compromised and their chances of repayment lessened.

Junior Lienholders' Ability to Enforce Rights to Collateral

As discussed above, junior liens may be held through a collateral trustee who also will have obligations to senior bondholders. Additionally, the junior position may be held through an administrative agent or an indenture trustee. In each instance, the agent or trustee will have the sole ability to act to recover the collateral and unified action on behalf of lienholders will be required. In the case of an indenture trustee, actions may require a direction from a specified plurality of holders (frequently twenty percent) and an indemnification running to the trustee against any liability that the trustee may face, or expenses which it may incur, in connection with the direction.

Additionally, a typical trust indenture will neither allow the trustee to bid on the collateral for the purpose of acquiring the company as an on-going business nor enable the lienholders to split the lien between different holders if there are different factions who wish to take different approaches. Moreover, if some of the second lienholders have provided additional funding and others have not, it may require that these lienholders reach an agreement on their disparate interests prior to acting in concert.

For example, the author had a recent experience where a sub group of second lienholders provided post petition debtor in position lending sufficient to retire the first lien as well as funds necessary for the on-going operations of the borrower. Later in the case, when it became obvious that the business needed to be sold, a majority of the holders provided a direction to the indenture trustee to credit bid at the auction of the business in concert with the DIP lenders in order to assure that the business was sold for maximum value. The agreement provided for a sharing arrangement between the holders with respect to the equity ownership of

the acquisition vehicle in the event of a successful credit bid. Negotiations between the holders over the sharing arrangement as well as negotiations with the holders and the indenture trustee over its direction and indemnification proved time-consuming to the point where agreement was not reached until the day of the auction. Ultimately, a satisfactory result was reached when a third party strategic bidder purchased the business at a price acceptable to the lienholders.

Other Issues Confronted by Second Lien Holders in Bankruptcy

Bankruptcy cases involving second liens have their own unique characteristics. The most obvious difference is need for lienholders and their indenture trustee to play an active role in the financing of the company from the outset of the case. Assuming that a company will require additional financing or even consent to use cash collateral, lienholders may need to be available to consent or negotiate conditions to the potential impairment of the lien position or alternatively, to act quickly to assure that consents may be given when an indenture trustee may not have the power to act under applicable documentation.

A corollary to the need to act quickly by junior lienholders is the possibility that second lienholders will not have the same interest in recovery once the case progresses. In particular, those holders who provide additional capital will have the ability to enhance their recoveries to the detriment of non-lending lienholders. Consequently, the ability of a second lienholder to act passively and rely on others to maximize its recovery will be severely limited.

Another difference will be the inability of noteholders holding collateral to serve on official unsecured creditors committees since secured creditors are not eligible to participate[21]. As a result, these committees can be controlled by out of the money trade creditors whose only interest will be in delaying resolution of the case in order to receive a distribution. Since the borrower pays for the fees and expenses of such a committee, additional administrative costs can be significant. Indeed, administrative costs in these cases can be significant since there is usually separate representation for first lienholders, the second lienholder indenture trustee, an ad hoc committee of second lienholders, and an unsecured creditors committee – all of whom may be entitled to payment from the borrower.

Protecting Your Interest as a Second Lienholder

The foregoing discussion illustrates the potential benefits that may be obtained from lending from a second lien position; however, in the event of a default and later workout or bankruptcy, second lienholders will need to be proactive in making sure that their position is protected.

---

21. In some instances, undersecured creditors may be entitled to serve on the committee when they possess a large deficiency claim but that is not always the case.

First, at the time of funding a second lien loan, second lienholders will need to review both the value of their collateral and the restrictions placed upon them under the applicable Intercreditor Agreement in order to determine whether the investment is worthwhile.

Second, in the event of a default, assuming a remedy short of foreclosure and sale is desirable, holders will need to organize into a group to assure that collective action can provide them with maximum flexibility in crafting a solution to the problem.

Third, once a case is filed, second lienholders need to be aggressive in protecting their rights from the inception of the case in order to avoid unfavorable post-petition lending arrangements or unwarranted use of their collateral. Given the limitations inherent in public indentures, holders may not be able to rely upon indenture trustees to fully protect their interests.

Finally, if things go wrong and the business does not thrive in bankruptcy, second lienholders may be required to lend into the situation to protect their position. If other second lienholders lend, those who do not should expect to have their recoveries impaired.