Flashpoints for Intercreditor Disputes

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INTERCREDITOR FLASH POINTS PANEL DISCUSSION:

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Intercreditor Hypothetical: Premise

- ABC Co. is valued at $1 billion. ABC issues $400 million in first lien debt and $200 million in second lien debt secured by all-asset liens. Over time, ABC's prospects dim and its valuation declines to roughly $500 million – enough to repay 1Ls in full, but to leave 2Ls impaired.

- As ABC approaches bankruptcy, it negotiates the terms of an in-court restructuring with the 1Ls, with the following terms: 1Ls will provide DIP financing; and ABC will conduct a quick 363 sale of substantially all going concern assets, with 1Ls acting as stalking horse and credit bidding their $400 million facility with no cash premium.

Intercreditor Hypothetical: Premise

- Milestones and credit terms are strict. 1Ls want ABC out of bankruptcy within six months.

- These arrangements would leave the 2Ls with no expected recovery. The 2Ls would like, in theory, to present a DIP with more favorable terms that would allow ABC to extend its marketing process and achieve better sale value. And, in any event, they would want the milestones loosened so as to enhance the odds that a higher bidder will appear.

- Another complicating variable: 2Ls comprise funds that cannot hold equity. There is accordingly no appetite to present a competing credit bid.

II. Intercreditor Arrangements

- Two scenarios worthy of discussion:

- 1Ls and 2Ls are parties to a standard intercreditor and subordination agreement and hold separate issuances with separate agents.

- 1Ls and 2Ls hold unitranche debt subject to an agreement among lenders. (We will continue using the terms '1L' and '2L' here for ease of reference.)

A. Traditional Intercreditor

- In the traditional intercreditor scenario, 2Ls' rights in collateral are subordinated to 1Ls. This is a 1L-friendly document:
- 2L Agent deemed to have consented to any use of cash collateral or provision of DIP financing if 1L Agent consents.
- No 2L holder may provide DIP financing that primes the 1Ls.
- 2L Agent deemed to have consented to any 363 free-and-clear sale of collateral if 1L Agent consents, provided that 2Ls' liens attach to proceeds of sale.
- Provided, however, that "Second Lien Claimholders may object to any Disposition of Collateral that could be raised in an Insolvency Proceeding by unsecured creditors generally."

A. Traditional Intercreditor

- 2Ls cannot seek relief from the automatic stay unless 1Ls have been paid in full, and cannot oppose 1Ls' seeking stay relief.

- 2Ls cannot seek adequate protection unless 1Ls do so, and cannot oppose 1Ls' request for adequate protection. To the extent 2Ls receive adequate protection payments while 1Ls are not being paid timely and in full, 2Ls agree to turn over payments received.

- 1Ls are authorized to vote 2Ls' claims in bankruptcy.

- Finally, "the Parties acknowledge that this Agreement is a 'subordination agreement' under section 510(a) of the Bankruptcy Code, which will be effective before, during, and after the commencement of an Insolvency Proceeding."

B. Unitranche / Agreement among Lenders

- Alternatively, lenders are part of a unitranche facility. Under unitranche, lenders' claims are secured by a single, first-priority, all-asset lien. The junior holders – or last-out holders – are contractually subordinated in right of payment to first-out holders. Unlike with a traditional intercreditor, ABC Co. is not a party to the AAL.

- Key terms of the AAL in this case include:

  - Payment waterfall for proceeds of collateral, however such proceeds are realized.

  - Prior to EOD (including bankruptcy filing), requisite LO lenders participate in decision-making, including directing agent to enforce remedies. However, after filing, only requisite (50%) FO lenders may direct the agent.

B. Unitranche / Agreement among Lenders

- LO lenders have a right to buy-out 100% of FO lenders' stake after EOD upon 10 days' written notice.

- FOs have exclusive right to direct agent to consent to priming, DIP financing and asset sales; however, LOs are not prohibited from objecting in their individual capacities.

- All lenders agree not to prime the unitranche lien absent Agent's consent.

III. Topics for Discussion
A. Traditional Intercreditor

- 2Ls offer an improved DIP financing package that would prime 1Ls notwithstanding prohibition in intercreditor. What is 1L Agent's recourse? Will bankruptcy court refuse to entertain the offer, or will 1L Agent have to seek damages in another forum?

- What if ICA provides for exclusive jurisdiction of NY state courts?

- Can 2Ls roll up 1L debt into a 2L-funded DIP facility?

III. Topics for Discussion
A. Traditional Intercreditor

- 2Ls object to proposed 363 sale terms, seeking looser milestones and a more aggressive marketing process. 1Ls seek to enjoin the objection because it is prohibited under the ICA. Where will they do this, and can they prevail?

- Assume injunction is not granted. As a result of 2Ls' objection milestones are loosened, new bidders come forward, and a third party prevails at auction with a cash bid for $500 million. 1Ls are paid in full and 2Ls receive a 50% recovery. Can 1Ls assert a claim for breach of contract?

- Can 2Ls try to have limitations on their activities declared unenforceable by Bankruptcy Court? What effect, if any, does the acknowledgment that the entire agreement is subject to 510(a) have?

III. Topics for Discussion
B. Unitranche / AAL

- If LO lenders object to FO-proposed DIP financing and sale process but Agent consents, what weight will be accorded to LO lenders' objections?

- What if the LO lenders propose a competing DIP? FO lenders will direct Agent not to consent to priming. Can FO lenders and/or Agent persuade the Bankruptcy Court not to consider the alternative DIP? What is their recourse otherwise?

- Under what scenarios might LO lenders wish to exercise buyout right?

- What are the jurisdictional implications of the fact that debtor ABC Co. is not a party to the AAL?

Conclusion & Questions

- Are Intercreditor Agreements and Agreements Among Lenders Enforceable under 510(a)?

- Should Bankruptcy Courts enforce these agreements?

- How does a senior lender prove damages?

OUTLINE FOR ABI INTERCREDITOR FLASH POINTS DISCUSSION

By Pamela Corrie, Epiq Systems and Madlyn Primoff, Kaye Scholer

Traditional Financing Structure

- 1st Lien/2nd Lien Debt
  - 2 separate groups of lenders with 2 agents, loan documents and liens
  - 1 collateral pool
  - Lien subordination

Post-Petition Financing/Adequate Protection

- DIP Financing
  - Intercreditor agreements often fix creditor rights relating to post-petition financing – modifying, or eliminating subordinated creditor rights to object to, propose or consent to DIP or use of cash collateral, seek adequate protection or relief from automatic stay
  - Subordinated creditor may not be permitted to propose DIP absent consent of 1st lien lenders
  - "Fundamental bankruptcy rights, including right to object as unsecured creditor", often upheld by courts
  - Cap on allowed senior indebtedness may limit ability of senior creditor to provide a DIP of adequate size to allow the debtor to successfully reorganize

- Use of Cash Collateral/Adequate Protection
  - Intercreditor agreements often "deem" a subordinated creditor to consent to use of collateral and waive right to adequate protection, or limit right to of juniors to challenge senior creditor's liens
  - Limited case law, although some cases suggest such provisions may be unenforceable, based on finding that secured creditor is guaranteed "the right to seek Court ordered protection for its security . . ." (In re Hart Ski Co., Inc., 5 B.R. 734, 736 (Bankr. D. Minn. 1980))

- Post-Petition Interest
  - Is tranche over-secured?
  - Can interest payments go to 2nd lien, or must they first be used to pay off 1st lien
  - Should junior creditor pay interest directly to under-secured senior creditor until interest is PIF – under rule of explicitness (rejected in 1st Circuit, recognized under applicable non-bankruptcy law by 11th Circuit), subordination agreement must clearly show that general rule that interest stops on filing date is to be suspended as between the 1st and 2nd lien lenders
  - These issues can complicate and slow negotiations regarding post-petition interest and plan treatment

- Automatic Stay
  - Subordinated creditor may waive right to seek stay relief or to object to senior creditor's request for stay relief

- Motion to Appoint Examiner
    - Can be seen as a pursuit of remedy by junior claimant otherwise precluded by intercreditor agreement
    - Appointment is mandatory unless creditors lack standing or had waived right
    - Courts likely will look to state law to determine if waiver of right to enforce remedies under intercreditor agreement extends to appointment of examiner

- Sale Process
    - Subordinate creditor often waives right to challenge sale, especially if 1st lien creditor agrees to sale
    - Typically, subordinated creditor's lien must attach to sale proceeds consistent with priority provisions of intercreditor agreement
    - Intercreditor agreement / waterfall may require that proceeds first apply to senior creditor indebtedness
    - Intercreditor agreement may preserve right of 2nd liens to object in capacity as unsecured creditor
    - Courts typically look to express release of this right and clarity in drafting

- Remedies, including Credit Bidding
    - Typically, senior creditors have exclusive right to exercise remedies
        - Forbearance agreement by senior creditors may be viewed as an extension of credit in violation of, or necessitating required lender or junior creditor consent under, intercreditor agreement
    - Intercreditor may allow junior debt to credit bid as long as senior debt is paid in full in cash at closing
    - Majority lenders to direct collateral agent to credit bid
    - Taking title and managing the assets going forward
        - Tag-alongs, drag-alongs and supermajority voting provisions

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- Chapter 11 Plan
    - Intercreditor agreements may require junior creditors to support (or not object to) plan supported by seniors
    - Courts have upheld intercreditor agreement prohibition against junior creditor objecting to adequacy of disclosure statement and challenging senior lien
    - Courts generally have been willing to enforce "stay silent" provisions, but some find them to be in violation of bankruptcy policy (see below for expanded discussion)
    - Cases are split on whether subordinate creditor can be deemed to have transferred its right to vote its claim to senior creditors
    - Valuation disputes and other tactics pursued by out-of-the money creditors

Unitranche Loan Structures

- Have become more prevalent in middle market over past 5 years or more

- Merge 1st lien/ 2nd lien or senior/mezzanine credit facilities into single facility

- Documented pursuant to single set of loan documents
  - Single credit agreement, set of loan covenants, security agreement and set of ancillary loan documents

- Single collateral pool
  - Single agent administers loan for both tranches of lenders

- Advantages: Speed of Transaction
  - Reduce time to negotiate and close, costs, complexity
  - Blended interest rate
  - Post-closing – administratively, relatively less complex

- Rights among lenders set forth in Agreement Among Lenders ("AAL")
  - Create first out and last out payment streams for 2 tranches of lenders
  - Rarely executed by borrower

- One rate of interest, in single note or credit agreement, blended to result in desired stream of payments to each lender group pursuant to payment waterfall, detailed in AAL
  - Payments made ratably pursuant to debt agreement, until trigger event such as default or bankruptcy, after which 1st out lenders get payment priority until P&I paid in full
  - Trigger events – highly negotiated
    - Often include payment default, bankruptcy, financial covenant default, commencement of exercise of remedies
    - Upon trigger event, majority of 1st out lenders may control future amendments

- Typically contain detailed voting arrangements
  - Single agent required to take action on behalf of all unitranche lenders based on voting results
  - Amendments generally based on Required Lenders (subject to sacred rights)
  - Voting not necessarily pro-rata: one lender often has veto rights over significant actions

- Typically contain remedy standstill and purchase option

Bankruptcy Issues arising based on structures of unitranche facilities

- Jurisdiction: Will the courts enforce AALs
  - Must be independent jurisdiction under Bankruptcy Code section 157(b) or (c)
  - Borrowers are typically not parties, so given Stern v Marshall decision, bankruptcy courts may determine more easily than with typical intercreditor agreement that they lack jurisdiction, and lenders may need to proceed in non-bankruptcy forum
    - Stay relief required prior to commencement of enforcement action?
    - Should a law suit filed in state court been seen to deprive the bankruptcy court of jurisdiction to rule on plan issues?
    - Bankruptcy courts must enforce non-bankruptcy court judgment resolving disputes where bankruptcy court lacked jurisdiction (or declined to exercise discretionary jurisdiction) over controversy
  - Bankruptcy courts may be more likely to find jurisdiction over intercreditor disputes brought later in the case (around plan negotiations or confirmation) than earlier in the case
  - If bankruptcy court declines to rule on contested AAL provision or confirms plan that conflicts with AAL, what remedies are available to the aggrieved creditor?
  - Bankruptcy courts interpreting AALs (as with any intercreditor agreement) must apply state (or international) law, as applicable
  - Confirmed plan that conflicts with AAL could subject aggrieved lenders to cumbersome, time-consuming, expensive litigation in non-bankruptcy forum to enforce their rights

- Unsecured Creditor Clause
  - Intercreditor agreements (and courts) frequently allow second lien lenders to retain right to take actions that could be taken by unsecured creditors
  - But in AALs, only agent, acting for all lenders, can pursue enforcement actions against borrower
  - All lenders bound by results of voting between 1st and last out lenders under AAL
  - Stronger argument with AALs than traditional intercreditor agreements that last out lenders can't take any action inconsistent with actions of agent or contrary to vote taken pursuant to AAL voting procedures

- DIP Financing/Use of Cash Collateral
  - Last out lenders may waive ability to object and/or propose their own DIP, unless 1st out lender consents

- Adequate Protection/Post Petition Interest, fees and expenses
  - Right to adequate protection generally turns on whether creditor is over-secured
  - Since unitranche loan is single legal obligation, value of collateral likely would be compared to amount of debt under entire facility, without reference to waterfall priority of 1st out lender group
  - ***Oversecured 1st lien creditor runs risk of being held to be undersecured when viewed in light of entire facility, and denied adequate protection***

- Claims Classification and Voting
    - Claims arising under single set of documents, administered by single agent, likely not susceptible to separate classification for 1st and last out lenders under Section 1122
    - ***Claims placed in same class may lead to a result contrary to lenders' voting rights under AAL. If last-out lenders control more than 1/3 of unitranche loan, they can block the class vote, despite possible prohibition in AAL, and gain more leverage than in traditional 1st lien/2nd lien structure***

- Release of Liens/Credit Bidding
    - In a sale under Section 363(f), if 1st out lenders don't have sufficient votes under the AAL to direct agent to release liens, and court requires secured party to be paid in full or release liens to have sale take place, last out lender can block sale

<u>In re RadioShack Corporation, Case No. 15-10197 (Bankr. D. Del. March 2015)</u>

- No decision, but provides some insight into how court might rule on unitranche issues
    - Doesn't squarely address jurisdiction issue, as both lenders had consented to jurisdiction
    - 2 separate unitranche facilities involved (1 ABL, 1 Term)
    - Issue: Right of 1st out lender to be paid in full under AAL prior to last out lenders receiving any recovery thorough credit bid of their last out debt. Court concluded that right to be paid in full must include first out lenders' valid contingent indemnification claims related to on-going litigation with the U.C.C. (issue of validity not reached)
    - Bankruptcy Court construed and enforced the terms of the 2 AALs
    - Bankruptcy Court stated that 1st out lenders had "bargained for rights" that must be respected, suggesting that AAL's should be enforceable in chapter 11
    - Court was willing to enforce AAL provision restricting the last out term lender from objecting to the sale on grounds that could be asserted only by a secured creditor, but upheld the creditor's objections otherwise available to an unsecured creditor
    - Court specified that first out lenders would retain all remedies under the AAL

<u>Some other issues potentially worth discussing in context of sales/plan confirmation:</u>

- <u>Baker Hughes</u> decision on interaction between section 1111(b) election and credit bid rights under section 363 – especially concurrence "best practices" for sale process

- Will courts allow for waiver of rights granted under the Bankruptcy Code through an intercreditor agreement

    - Ability to exercise remedies, including credit bidding or consent to sale by agent
        - Credit bid by junior creditor if senior creditor paid in full

    - Stay silent provisions
        - Will intercreditor agreement to transfer right to vote claim be enforced / does Bankruptcy Code or intercreditor agreement determine voting rights?

        - Some courts are reluctant to allow private contract to alter right to vote under Bankruptcy Code, finding the Bankruptcy Code, not the intercreditor agreement, governs determination of voting rights in bankruptcy
        - Some courts find that while section 510(a) recognizes enforceability of subordination agreements in bankruptcy, it does not trump voting rights under the Section 1126(a) of the Code and Bankruptcy Rule 3018 does not allow for the voting of a junior creditor's claim by a senior creditor – rather, the rule allows for voting by an agent
        - Other decisions have come out the opposite way – Section 1126(a) doesn't prevent creditors from delegating or bargaining away rights and Rules 3018 and 9010 recognize that agents or representatives may vote on behalf of other parties where intent of parties is clear
        - Bankruptcy policy – even though creditor is subordinated, it has substantial interests in treatment of its claim
        - Trend seems to be to allow constructive participation by stakeholders, assuming they are not being obstructionist in 2 key areas of voting and enforcing rights and remedies as unsecured creditor
    - Does subordination apply only to priority of payment or also right to vote?

- Cramdown: Since Section 1129(b) is "notwithstanding Section 510(a)": will courts ignore intercreditor rights in cram downs?
    - Regardless of whether plan breaches intercreditor agreement, court can nonetheless confirm under cram down provisions
    - *Momentive* decisions: Ability of 2^{nd} lien creditors to enter into an RSA with the debtors and propose plan over objection of 1^{st} lienholders and in violation of intercreditor agreement upheld
        - Court dismissed intercreditor actions, highlighting broad retention of unsecured creditor rights and remedies against the debtors
        - Since actions by 2^{nd} lien creditors didn't directly relate to senior creditors' interest in shared collateral or rights expressly precluded in intercreditor agreement, Court found no contractual breach
        - Take away: courts may not read provisions into intercreditor agreements restricting junior creditors' right to contest senior creditors' asserted claims, and junior creditors have unfettered right to act as unsecured creditors

    - Anomalous result: Subordination agreements need to be enforced in consensual plans, but not cramdown plans

    - Leaves open issue of whether senior creditor can pursue separate breach of contract action in state court

- Classification: Will courts enforce junior creditor agreement not to oppose separate classification?
- Distributions: Can junior creditor keep securities issued under a plan

Claims Chat

By James J. Henderson[1]

Caulkett: Debtors May Not Strip Off Wholly Unsecured Junior Mortgages in Chapter 7

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Editor's Note: *For ABI media teleconferences on Supreme Court decisions entered this term, visit abi.org/newsroom/supreme-court-opinions.*

A unanimous U.S. Supreme Court has held that a debtor in a chapter 7 case cannot strip off a junior mortgage under § 506(d) of the Bankruptcy Code where the lien is an allowed secured claim, even if the junior mortgage is completely underwater. *Caulkett*[2] tested the limits of the Supreme Court's previous decision in *Dewsnup v. Timm*, in which the Court decided that a chapter 7 debtor could not strip off a junior lien that was partially underwater.[3] The *Caulkett* Court found that because *Dewsnup* controlled the interpretation of "secured claim" in § 506(d), it was obliged to find that a chapter 7 debtor could not strip off a completely underwater junior mortgage.[4]

While the Court stated that its prior decision in *Dewsnup* compelled it to find for the junior mortgageholder, Justice Clarence Thomas, and most of the justices who joined his opinion, were clearly dissatisfied with *Dewsnup*'s interpretation of a "secured claim" as it relates to § 506(d).[5] The debtors insisted that they were not asking the Supreme Court to overrule *Dewsnup*, but rather to limit that decision to junior liens that were only partially underwater. However, the Court declined to do so, and determined that *Dewsnup*'s interpretation of the phrase "secured claim" in § 506(d) controlled regardless of whether the junior lien was partially or completely underwater.

In and Out of the Money

Before examining *Caulkett*, it is necessary to understand how the value of real property affects multiple mortgages encumbering the property. To illustrate, imagine that you own JN Farm. It is valued at $200,000 and encumbered by a first mortgage held by Green Bank, securing an obligation in the amount of $100,000, along with a second junior mortgage held by Brown Bank, securing an obligation in the amount of $50,000. If JN Farm is sold for $200,000, the proceeds would be sufficient to fully pay the liens of both Green Bank and Brown Bank.

However, if JN Farm is only worth $125,000, the proceeds from a sale would be sufficient to fully satisfy the $100,000 mortgage of Green Bank, but would only be sufficient to partially satisfy the $50,000 mortgage of Brown Bank. In this situation, Brown Bank's lien is considered "partially underwater." This was the situation in the earlier *Dewsnup* case.

If JN Farm is only worth $90,000, the proceeds from a sale would be insufficient to fully satisfy the $100,000 first mortgage and there would be no proceeds available to satisfy the junior mortgage, making it completely underwater. This was the situation facing the Supreme Court in *Caulkett*.

In *Caulkett*, the debtors asserted that their cases were fundamentally different from *Dewsnup* because the junior mortgages encumbering their homes were completely underwater. As a result, they argued that *Dewsnup* did not control and that they should be entitled to strip off the junior liens under § 506(d).

Background

Caulkett involved the consolidated cases of debtors David Caulkett and Edelmiro Toledo-Cardona. At the time that the debtors filed their respective chapter 7 petitions, they both owned homes, each of which was encumbered by multiple mortgages. In both instances, the junior mortgage was completely underwater and as a result, the debtors filed motions in their respective bankruptcy cases seeking to strip off the junior mortgages encumbering their homes under § 506(d). The junior mortgageholders in both cases objected to the debtors' motions to strip off their respective liens.[6] The bankruptcy courts in both cases determined that § 506(d) permitted the debtors to void a junior mortgage that was completely underwater. The rulings were upheld on appeal,[7] and the Supreme Court granted *certiorari*.[8]

1 The author thanks Andrew L. Turscak, Jr. of Thompson Hine for his assistance with this article.
2 *Bank of Am. NA v. Caulkett*, 135 S. Ct. 1995; 192 L. Ed. 2d 52; ___ U.S. __ (2015).
3 *Dewsnup v. Timm*, 502 U.S. 410 (1992).
4 *See Caulkett*, 192 L. Ed. 2d at 59.
5 Six of the nine justices joined a footnote, which strongly hinted that they would have been open to overruling *Dewsnup* had the debtors asked the Court to take that step.

6 *See Caulkett*, 192 L. Ed. 2d at 56.
7 *Id.* The Eleventh Circuit had previously examined this issue and determined that a chapter 7 debtor could use § 506(d) to void a junior mortgage that was completely underwater. *See McNeal v. GMAC Mortg. LLC*, 735 F.3d 126 (11th Cir. 2012).
8 *Id.*

Caulkett

The question before the Supreme Court was whether a chapter 7 debtor may strip off a junior mortgage under § 506(d) when the debt owed on a senior mortgage exceeds the present value of the property. Two Bankruptcy Code provisions are implicated: § 502 (which governs the allowance of claims) and § 506(d) (which states that a claim is void if it is not an allowed secured claim).[9]

The Court spent little time on the relevant provisions of § 502 because the parties in both cases agreed that the junior lienholder's claims were "allowed claims." Thus, the Court focused its analysis on the meaning of "secured claim" in § 506(d), which provides, in relevant part, "[t]o the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void."[10] Under this section, a debtor may void or "strip down" a lien that is not an allowed claim.

The Supreme Court noted that the phrase "secured claim" is used in other sections of the Bankruptcy Code, including § 506(a)(1). According to the Court, § 506(a) dictates that if a creditor's interest in a property is worthless, then the creditor does not hold a "secured claim" within the meaning of the statute.[11] Under the rules of statutory construction, the Court noted, if the same words or phrases are used in different parts of a statute, a court will interpret such words or phrases as having the same meaning.[12] The Court thus acknowledged that under the common rules of construction, the Debtors would prevail.[13] However, the Court had previously adopted another meaning of the phrase "secured claim" in the context of § 506(d) in *Dewsnup*.[14] As a result, *Dewsnup*'s construction of the phrase "secured claim" foreclosed any employment of textual analysis in *Caulkett*.

In *Dewsnup*, the chapter 7 debtor sought to reduce a junior lien that was partially underwater. The Supreme Court rejected the debtor's position and determined that the phrase "secured claim" in § 506(d) means a "claim [that is] supported by a security interest in property, regardless of whether the value of that property would be sufficient to cover the claim."[15] As Justice Thomas explained in *Caulkett*, under the *Dewsnup* interpretation, § 506(d) can only be used to void a claim that has not been allowed.[16]

Recognizing that the Supreme Court's prior decision in *Dewsnup* presented a serious challenge to their attempts to strip off the mortgages held by the junior lenders, the debtors' principal argument was that *Dewsnup* was distinguishable because the junior lien at issue in *Dewsnup* was only partially underwater, whereas the junior mortgages at issue in the current cases were completely underwater. This meant that unlike the junior lien in *Dewsnup*, which had some value, the junior mortgageholders in the cases before the Court in *Caulkett* would receive no proceeds from the sale of the debtors' homes.

The debtors advanced several arguments in support of this distinction, each of which the Court rejected. First, the debtors observed that *Dewsnup* explicitly stated that it was not addressing all factual situations. The *Caulkett* Court rejected this argument, noting that the *Dewsnup* Court had already determined of § 506(d).[17] The debtors were similarly unsuccessful in their attempts to convince the Court to apply its previous holding in *Nobelman v. American Savings Bank*, in which the Court construed the meaning of "secured claim" as used in § 506(a) in the context of a chapter 13 case.[18]

The Court found that *Nobelman v. American Savings Bank* provided no guidance since it did not address § 506(d), but rather dealt with § 506(a).[19] Finally, the debtors argued that the policy concerns that led the *Dewsnup* Court to find that a debtor could not strip off a junior lien that retained some value did not apply in the situation in which a junior mortgage was completely underwater. Justice Thomas explained that even if the debtors were correct, these policy concerns did not provide sufficient justification to give different meaning to § 506(d) based solely on the value of the collateral.[20]

Ultimately, the Supreme Court refused to accept the debtors' argument that *Dewsnup* could be distinguished from their cases. Justice Thomas explained that to do so would create an "odd statutory framework" since whether a junior lien could be voided under § 506(d) would then depend on the value of the real property. The Court observed that in such a situation, if a piece of real property was valued for $1 less than the value of the senior mortgage, then the junior mortgage could be voided, but if that same property was valued at $1 more than the senior mortgage, then the junior lien could not be stripped off under § 506(d). Since the value of real property is ever-shifting, the Court was concerned that this interpretation could lead to arbitrary results.[21] It acknowledged that $1 could make a profound difference under other Bankruptcy Code sections, but that those distinctions had been set by Congress.[22]

Notably, the debtors did not request that the Supreme Court overrule *Dewsnup*. A majority of the justices hinted that they would have been amenable to overruling *Dewsnup* had the debtors requested it. This is most clearly seen in the opinion's lone footnote that points out that *Dewsnup* has been the target of criticism from its inception, but further notes that "[d]espite this criticism, the debtors have repeatedly insisted that they are not asking us to overrule *Dewsnup*."[23]

In the end, the Court concluded that *Dewsnup*'s construction of "secured claim" under § 506(d) answered the question of whether the junior mortgages encumbering the debtors' property could be voided under § 506(d). Justice Thomas noted that the parties agreed that the junior mortgages were allowed claims under § 502. As a result, the Supreme Court determined that *Dewsnup* compelled it to find that the junior mortgages could not be voided.[24]

9 *Id.*
10 11 U.S.C. § 506(d).
11 *Caulkett*, 192 L. Ed. 2d at 56.
12 *Id.* (quoting *Desert Palace Inc. v. Costa*, 539 U.S. 90, 101 (2003)).
13 *Id.*
14 *Id.* at 56-57.
15 *Id.* at 57 (quoting *Dewsnup*, 502 U.S. at 416).
16 *Id.*
17 *Id.* at 58.
18 508 U.S. 324, 113 S. Ct. 2106 (1993). Unlike in chapter 7, most courts have construed *Nobelman* to allow debtors to strip down wholly unsecured junior mortgages in chapter 13 cases pursuant to §§ 506(a) and 1322(b). *See, e.g., In re Lane*, 280 F.3d 663 (6th Cir. 2002).
19 *Caulkett*, 192 L. Ed. 2d at 58 (citing *Nobelman v. Am. Savs. Bank*, 508 U.S. 324, 113 S. Ct. 2106 (1993)).
20 *Caulkett*, 192 L. Ed. 2d at 58 (citing *Pasquantino v. United States*, 544 U.S. 349, 358, 125 S. Ct. 1766 (2005)).
21 *Id.* at 58-59.
22 *Id.*
23 *Id.* at lone, unnumbered footnote (citing a number of authorities including dissents and concurrences from Justices Thomas and Antonin Scalia). Justices Anthony Kennedy, Stephen Breyer and Sonia Sotomayor did not join the decision with respect to the footnote.
24 *Id.*

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Consequences and Future Issues

Caulkett unquestionably represents a significant victory for junior mortgageholders. After *Dewsnup*, it was clear that a junior lien that was partially underwater could not be stripped off under § 506(d). However, it remained uncertain whether the Supreme Court would construe § 506(d) to allow a chapter 7 debtor to void a junior lien that was completely underwater. That issue has, at least for the time being, been resolved in favor of junior mortgageholders.

However, it is possible that the victory could prove to be temporary. Even though the Supreme Court unanimously held that a chapter 7 debtor could not void a completely underwater junior mortgage, it is apparent that a significant number of the justices are dissatisfied with *Dewsnup*'s interpretation of § 506(d). While the Court was compelled to follow that precedent since it was not being asked to overrule it, a majority of justices telegraphed their displeasure with *Dewsnup*, leaving the door at least partly open for another chapter 7 debtor to seek to use § 506(d) to void a junior mortgage that is partially or fully underwater, and to directly ask the Court to overrule *Dewsnup*. abi

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Secured Creditors Must Insist on Credit-Bidding Rights; Otherwise Waivable

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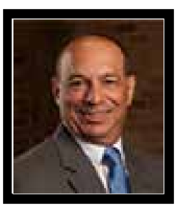

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What happens if an undersecured creditor makes an election under 11 U.S.C. § 1111(b) but does not otherwise participate in the bankruptcy process? The Fifth Circuit Court of Appeals addressed this question in *In re R.L. Adkins Corp*. [1] In *In re Adkins*, the debtor filed a plan of reorganization recognizing the lien of Bakers Hughes Oilfield Operations, Inc. (BHO) on four mineral leases and one well. The total amount due to BHO far exceeded the value of its collateral.

Prior to the confirmation hearing, BHO filed an election for treatment of its claim under § 1111(b), which allowed its claim to be fully secured while giving up rights to any unsecured portion. BHO did not appear at the confirmation hearing, nor did BHO file any objection to the debtor's plan. The plan proposed a sale of numerous mineral leases and several wells to a third party in a bulk sale. The bankruptcy court confirmed the plan. Following confirmation, BHO pursued its § 1111(b) election, arguing that it had a right to credit-bid at the sale of its collateral, or to be considered fully secured in its collateral up to the debt amount. The bankruptcy court and district court rejected BHO's arguments.

BHO then appealed to the Fifth Circuit Court of Appeals, reasserting its arguments that the plan did not allow for BHO to credit-bid and that it did not recognize BHO's election under § 1111(b). The Fifth Circuit found that the plan did, in fact, permit BHO to credit-bid its debt pursuant to § 363(k), but held that BHO never attempted to credit-bid and that any credit bidding would only be to the amount of the value of the secured claim before the § 1111(b) election. The Fifth Circuit further held that any objection to the bidding process or any impairment to BHO's ability to credit-bid could have been resolved at the confirmation hearing, but that BHO chose not to participate in the confirmation and never objected to the plan.

The concurring opinion by Judge Jones goes beyond the majority's holding and addresses the argument that BHO waived its § 1111(b) election by failing to pursue it at the confirmation hearing. It emphasizes three points for proper protection of a creditor's interests. *First*, if a creditor properly asserts a § 1111(b) election, then the bankruptcy court must dispose of that issue prior to the confirmation hearing. The bankruptcy court's decision on this issue will affect the amount of the creditor's secured claim and treatment under the plan. *Second*, if the plan proposes the sale of the collateral under § 363 or under the plan, and if the protections and sale provisions are found not to properly protect the creditors' secured claims, then the creditor will be allowed an election under § 1111(b). *Third*, a plan should provide for bid procedures that promote broadly publicized auctions that test the market for valuations, which will test a secured creditor's sincerity in stating a desire to credit-bid.

The ruling of both the majority and the concurring opinions appears to be that in the Fifth Circuit, at least, a secured or partially secured creditor cannot simply rely on an election under § 1111(b) to protect its position. Instead, the creditor needs to actively object to a plan and participate in the process in order to protect its interests. Otherwise, a secured creditor may be precluded from asserting its right to credit-bid in a sale under § 363 of the Code.

[+] Feedback

[1] No. 14-10768, 2015 WL 1873137, at *1 (5th Cir. Apr. 23, 2015)

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Financial Statements

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The Unitranche Facility: Implications

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Middle-market loans have grown in size and often provide for first- and second-lien tranches—each documented with a separate set of credit documents knitted together with an intercreditor agreement. In an effort to increase efficiencies and to reduce documentation costs, middle-market lenders have developed—and are actively offering—"unitranche facilities" to borrowers searching for simpler and faster access to credit.

The key distinctions between a unitranche facility and a first-/second-lien facility arise because the unitranche facility is provided under a single credit agreement, utilizes a single set of security documents and is administered by a single agent for the lenders. Instead of an intercreditor agreement among the first-lien agent, the second-lien agent and the borrower, the intercreditor arrangements for a unitranche facility are set forth in the "agreement among lenders" (AAL), which includes the lenders but not the borrower. The AAL creates "first-out" and "last-out" payment streams for the two sets of lenders.

The enforcement of the competing rights of the two sets of lenders under an AAL has not yet been tested in a bankruptcy proceeding. The unique structure of the unitranche facility raises commercial issues that market participants should be aware of when negotiating the AAL.

Terms of the AAL

The AAL divides the loans made under a unitranche facility into "first-out" and "last-out" tranches, effectively creating senior and junior tranches of loans. There are no "market-standard" resolutions of the issues arising between the first-out and last-out lenders in a unitranche facility, and the scope and resolutions of the issues involved largely depend on the negotiating power between the first-out and last-out lenders.

Blended Interest Rate

Unlike a first-lien/second-lien facility, where each loan carries a different rate of interest, a unitranche loan carries a single "blended" rate of interest. In order to provide last-out lenders with a higher effective interest rate than the first-out tranche, the AAL provides that interest payments collected by the agent will be paid over to the first-out and last-out lenders on a disproportionate basis in accordance with the agreed-upon allocation.

Payment Waterfall

The AAL also provides that mandatory and optional principal payments are paid ratably to the first-out and last-out lenders until the occurrence of certain "waterfall trigger events." Upon the occurrence of events, the first-out lenders will receive payment priority on their principal until any payment is distributed to the last-out lenders. Waterfall trigger events usually include (1) a payment default under the credit agreement; (2) failure of the borrower to comply with all or certain financial covenants, usually within a percentage range; (3) bankruptcy and insolvency events; and (4) the borrower failing to conduct all or a material portion of its business, usually following a certain cure period. The payment waterfall typically only applies with respect to payments and proceeds received by the agent from the collateral, meaning that any other proceeds received by the agent would be distributed ratably to the lenders.

Voting Rights Modified by the AAL

While intercreditor agreements for first- and second-lien facilities usually do not include any arrangements with respect to voting, most AALs contain voting arrangements. Under these arrangements, the first-out and last-out lenders will agree that amendments requiring the consent of "required lenders" under the credit agreement will, notwithstanding any other provision in the credit agreement, require both "required first-out lenders" and "required last-out lenders." Depending on the number of lenders of a particular tranche, the AAL may define "required first-out lenders" or "required last-out lenders" to require more than one lender. In addition, the AAL may provide for cross-over voting restrictions (for example, if a last-out lender acquires a first-out loan, the last-out lender cannot vote with respect to its first-out tranche).

Last-Out Lenders May Direct Enforcement Actions and the Agent

While intercreditor agreements for first- and second-lien facilities usually provide that second-lien lenders must "stay silent" during a first-lien enforcement action maintained by the first-lien agent acting at the direction of first-lien lenders, the same may not be true with respect to last-out lenders in unitranche facilities. Although some AALs provide that following an event of default the "required first-out lenders" can direct the agent to take enforcement actions (and any such direction is binding on all lenders), some AALs fail to specify who is able to direct the agent following an event of default. To

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the extent that the AAL is silent on the issue of direction, the lenders will generally be bound by the direction provision in the credit agreement, which usually provides for majority or requisite lenders being able to direct the agent. In such cases, in the event the last-out lenders comprise the majority of requisite lenders or if they comprise a blocking position preventing the first-out lenders from being able to direct the agent, last-out lenders may have greater rights than their second-lien counterparts with respect to directing the agent on issues such as collateral disposition, release of liens in connection with a sale under Article 9 of the Uniform Commercial Code or a sale of assets under § 363 of the Bankruptcy Code, or generally maintaining standing to enforce loan obligations.

Enforcement of AALs in Bankruptcy

The enforceability of key provisions of the AAL has not yet been tested in bankruptcy. Just as intercreditor agreements raised questions about the rights of the first-lien lenders and the second-lien lenders in the event of a borrower's bankruptcy, AALs are likely to raise a number of unique issues in bankruptcy courts. While the authors expect that recent case law involving intercreditor agreements will prove instructive when interpreting and determining the enforcement of AALs, the results may not always be the same given the structural differences between a first-lien/second-lien facility and a unitranche facility.

Can a "First-Out" or "Last-Out" Lender Object as an Unsecured Creditor?

Intercreditor agreements typically provide that second-lien lenders retain their rights to take certain actions in the borrower's bankruptcy case as unsecured creditors. AALs generally contain similar provisions. Bankruptcy courts have generally upheld second-lien lenders' ability to object as unsecured creditors except with respect to certain matters expressly waived by junior lenders.[1]

However, it remains to be seen how courts will interpret and apply the provisions of the AAL. If courts focus on the terms of the unitranche facility without reference to the AAL (to which the debtor is not a party), they may conclude that where an agent is acting at the direction of a required group of lenders under a credit agreement, the only party that can take action in the bankruptcy case is the agent, and therefore it need not entertain objections of lenders that have contractually agreed with a borrower that only the agent could take action for the benefit of the lenders in the event of a bankruptcy.[2] In this regard, a court may view any dispute that a subgroup of lenders wishes to raise as an intra-creditor dispute that it need not resolve. On the other hand, if courts focus on the terms of the AAL and analogize those provisions to those of intercreditor agreements, they will likely be more willing to uphold the provisions of the AAL and the rights of first-out lenders and last-out lenders under the AAL.

Are First- or Last-Out Lenders Entitled to Adequate Protection/Post-Petition Interest?

Whether a secured creditor is entitled to assert a claim for post-petition interest generally turns on whether such creditor is "oversecured." In a traditional first-lien/second-lien facility, because each facility is documented separately, which results in separate legal obligations of the borrower, the determination of whether the first-lien lenders are oversecured would measure the value of the collateral against the first-lien debt obligations and the determination of whether the second-lien lenders are oversecured would measure the value of the collateral against the aggregate of the first- and second-lien debt obligations.

However, since a unitranche facility represents a single legal obligation of the borrower for both the first-out and last-out debt, when determining if first-out lenders are over or undersecured and thus entitled to post-petition interest or adequate protection, the analysis under §§ 361, 363, 364 and 506 of the Bankruptcy Code should be on the value of the collateral supporting the entire unitranche facility, not simply the first-out or last-out lenders' loans as the case may be. In the case where the total first-out obligations represent a smaller portion of the entire unitranche facility, first-out lenders who would otherwise be considered oversecured in a first-lien/second-lien structure may find themselves undersecured in a unitranche facility for purposes of obtaining post-petition interest. Ultimately, although an AAL may require an agent to provide first-out lenders with the economic benefits of any post-petition interest or adequate-protection payments prior to disbursing funds to last-out lenders, without the benefit of court-ordered post-petition interest or adequate protection, as a practical matter, it may be difficult for first-out lenders to enforce these rights.

Are "Last-Out" Lenders Disadvantaged in Classification Disputes?

Similarly, while in a traditional first-lien/second-lien facility, the lenders under each facility comprise two distinct and separate classes of creditors for purposes of a debtor's reorganization plan, it is not clear that a bankruptcy court would recognize first- and last-out lenders as separate classes of creditors. Section 1122 of the Bankruptcy Code provides that "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class." While on its face placing first- and last-out lenders in separate classes would not violate § 1122, § 1122 has largely been interpreted to prevent debtors from placing substantially similar claims into

1 *See, e.g., In re Boston Generating LLC*, 440 B.R. 302, 316-21 (Bankr. S.D.N.Y. 2010); *In re Erickson Retirement Communities LLC*, 425 B.R. 309, 314-17 (Bankr. N.D. Tex. 2010); *Ion Media Networks Inc. v. Cyrus Select Opportunities Master Fund Ltd. (In re Ion Media Networks Inc.)*, 419 B.R. 585, 593-98 (Bankr. S.D.N.Y. 2009).

2 *See, e.g., In re GWLS Holdings Inc.*, 2009 Bankr. LEXIS 378, *13-15 (Bankr. D. Del. Feb. 23, 2009); *Ind. State Police Pension Trust v. Chrysler LLC (In re Chrysler LLC)*, 576 F.3d 108, 119-20 (2d Cir. 2009), *vacated*, 130 S.Ct. 1015, *remanded to* 592 F.3d 370 (2d Cir. 2010); *In re Metaldyne Corp.*, 409 B.R. 671-79 (Bankr. S.D.N.Y. 2009).

separate classes unless there is a reasonable business justification for separate classification.[3]

Because all of the lenders' claims emanate from a single loan agreement, a single agent is responsible for taking enforcement actions for both the first-out and last-out lenders and collecting amounts from the borrower, and the lenders vote as one group even following an event of default, it may be argued that separate classification of first-out and last-out lenders is impermissible. On the other hand, because § 510(b) of the Bankruptcy Code provides that subordination agreements—such as AALs—are enforceable, it may be argued that separate classification of first- and last-out lenders is permissible.

The issue of classification raises several significant implications with respect to plan formulation and confirmation. If first-out and last-out lenders are considered a single class of creditors, § 1123(a)(4) of the Bankruptcy Code provides that all claims in a single class must receive the same treatment. Although any plan recoveries will ultimately flow to the first-out lenders until they are repaid in full under the AAL's contractual waterfall and turnover provisions, having to provide all unitranche lenders with the same plan currency may make it more difficult for debtors to negotiate or formulate reorganization plans or obtain exit financing. Similarly, if the debtor is required to place all of the unitranche lenders in the same class, and the last-out lenders control more than one-third of the loans under the unitranche facility, the last-out lenders may have a plan blocking position.[4] Such a result could give last-out lenders greater leverage than they would have in a traditional first-lien/second-lien facility.

As indicated, depending on who may direct the agent under the unitranche facility and whether a court were to give effect to the AALs' provisions regarding enforcement and agent direction, first-out lenders may or may not be able to direct the agent to provide for a release of all liens under § 363(f) of the Bankruptcy Code the way that first-lien lenders could typically force second-lien lenders to consent to a release of liens under § 363(f).[5]

Conclusion

Unitranche facilities are an important new product in middle-market lending and offer many advantages to both lenders and borrowers. However, the nature and structure of a unitranche facility differs from the first-lien/second-lien facilities that courts have examined over the past decade. Although unitranche facilities and AALs raise novel legal issues, it remains to be seen whether bankruptcy courts will view AALs as materially different from intercreditor agreements and to what extent the legal analysis of the rights among first-out and last-out lenders will differ from the rights of lenders that are party to a standard first-lien/second-lien intercreditor agreement. abi

3 *See, e.g., Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274, 1279 (5th Cir. 1991).

4 *See* 11 U.S.C. § 1126(c).

5 *See, e.g., In re SW Boston Hotel Venture LLC*, 406 B.R. 38, 52 (Bankr. D. Mass. 2011); *Bank of America Nat'l Ass'n v. 203 N. LaSalle Ltd. P'ship (In re 203 N. LaSalle Ltd. P'ship)*, 246 B.R. 325, 331 (Bankr. N.D. Ill. 2000); *Beatrice Foods Co. v. Hart Ski Mfg. Co. Inc. (In re Hart Ski Mfg. Co. Inc.)*, 5 B.R. 734, 736 (Bankr. D. Minn. 1980).