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Does Your Intercreditor Agreement Properly Protect You? Common Mistakes and How to Fix Them — Lessons Learned From the *MPM Silicones* and *RadioShack* Cases

Properly drafted intercreditor agreements[1] are entered into to limit future disputes among secured parties by establishing relative priorities with respect to liens securing shared collateral and a clear set of operating rules governing the parties' respective rights and remedies. Given their purpose of avoiding disputes among secured creditors, it is ironic that a great deal of recent bankruptcy litigation has focused upon intercreditor agreements. Most recently, in the RadioShack bankruptcy, various secured creditors locked horns over whether the intercreditor agreement allowed certain of the secured creditors to credit bid in the auction of the debtors' assets.[2] Similarly, a fight over whether an intercreditor agreement allowed for one set of secured creditors to receive distributions in advance of another set of secured creditors was central to the MPM Silicones case.[3] A properly drafted intercreditor agreement could have possibly avoided these disputes. However, as usual, the devil is in the details — as these cases reveal, if not properly drafted, an intercreditor agreement may not provide the protection creditors desire, but rather, only serve to increase, not lessen, intercreditor conflict.

In order to avoid future intercreditor disputes, investors can learn from past mistakes and draft or revise their intercreditor agreements accordingly. As a result, in this article, after discussing the intercreditor disputes that arose in the RadioShack and MPM Silicones cases, we attempt to highlight a number of specific considerations that may improve intercreditor agreements, to better achieve their intended purpose of delineating the respective priorities and rights of senior and junior secured creditors while avoiding intercreditor conflict.

MPM Silicones

In *MPM Silicones*, various secured creditors were parties to a fairly standard pre-petition intercreditor agreement (the "*MPM Intercreditor Agreement*") setting forth the parties' respective rights to shared collateral. Pursuant to its terms, the liens of second lien noteholders were subordinated to the liens of senior noteholders, with the second lien noteholders agreeing that senior noteholders would be paid "in full and in cash" prior to any distribution from "common collateral" or the proceeds thereof being made available to second lien noteholders. The MPM Intercreditor Agreement also contractually restricted the actions of second lien noteholders with respect to the common collateral, prohibiting second lien noteholders from exercising any remedies with respect to the common collateral, interfering with senior noteholders' exclusive rights to enforce their remedies or taking any actions adverse to senior noteholders' liens. Significantly, as is typical, the MPM Intercreditor Agreement specifically exempted from such restrictions any actions taken by second lien noteholders in their role as an unsecured creditor.

Despite the terms of the MPM Intercreditor Agreement, the debtors proposed a chapter 11 plan, in accordance with a plan support agreement entered into with second lien noteholders, that distributed all of the reorganized entities' equity along with subscription rights to a $600 million rights offering to second lien noteholders, while senior noteholders received not cash, but rather, if they voted to reject the plan, only replacement notes bearing below market interest rates.[4]

Believing that the proposed plan violated their rights under the MPM Intercreditor Agreement, senior noteholders' trustees commenced two New York state court actions alleging violations of the MPM Intercreditor Agreement. Specifically, the trustees argued that the MPM Intercreditor Agreement had been breached as: (i) second lien noteholders were receiving a distribution under the plan prior to senior noteholders being paid *in full and in cash* and (ii) second lien noteholders had taken actions and positions that compromised senior noteholders' liens, including, among other things, contesting a make-whole payment, supporting a priming lien as part of debtor's DIP financing, opposing senior noteholders' request for adequate protection, executing plan support agreements and supporting the plan which provided for payments to them before senior noteholders were paid in full and in cash. Certain defendants sought removal to the District Court, and the two actions were subsequently transferred to the Bankruptcy Court.

Before the Bankruptcy Court, the defendants sought to dismiss the actions on grounds including that: (i) the plan provided for payment in full through the delivery of replacement notes; (ii) the MPM Intercreditor Agreement did not explicitly state that payment must be in cash following a bankruptcy cramdown, and (iii) actions were taken in their role as equity sponsor and unsecured creditor.

After noting that the MPM Intercreditor Agreement contained "really bad drafting,"[5] Bankruptcy Judge Drain dismissed the actions and confirmed the plan over senior noteholders' objections. Among other things, Judge Drain held that senior noteholders: (i) retained their lien on the common collateral, (ii) had been paid in full under the plan in accordance with the cramdown procedures of § 1129 of the Bankruptcy Code, (iii) the MPM Intercreditor Agreement did not expressly require payment in full in cash following a cramdown, and (iv) the equity being distributed was not "proceeds" of the common collateral. The Bankruptcy Court also held that certain of the alleged actions taken in violation of the MPM Intercreditor Agreement had been taken by second lien noteholders in their role as unsecured creditors, a role which had been specifically carved out of the MPM Intercreditor Agreement's restrictions.

RadioShack

RadioShack's assets were the subject of a contentious four day sale hearing, which pitted the debtor's two top creditors as bidders against one another. Much of the conflict between the parties did not center on competing valuations of their bids, but rather, on the specific terms of their intercreditor agreement and their respective rights thereunder.

By way of background, on December 10, 2013, RadioShack obtained an $835 million financing package consisting of (i) $250 million term loan provided by Salus, acting in its capacity as agent for a group of lenders (the "*Salus Loan*"),[6] and (ii) $585 million provided by a syndicate of asset-based lenders in the form of (a) a $50 million term loan (the "*ABL Term Loan*") and (b) $535 million in asset-based revolving loan commitments (the "*ABL Revolving Loan*" and together with the ABL Term Loan, the "*ABL Loans*"). Both the Salus and ABL Loans were secured by liens on the same collateral pool, substantially all of RadioShack's assets.

To establish their relative priority, upon entering into the loans, Salus and General Electric Capital Corp., then serving as agent for the ABL Loans, entered into an intercreditor agreement (the "*RS Intercreditor Agreement*").[7] The RS Intercreditor Agreement provided that the ABL Loans were secured on a first-lien basis on the company's liquid collateral (principally accounts receivable, certain deposit accounts and inventory) and the Salus Loan was secured by the liquid collateral on a second-lien basis.

In October 2014, the initial ABL lenders assigned all of their loans and obligations to a new group of ABL lenders, which included Standard General and its affiliates. Subsequently, RadioShack and the new ABL lenders agreed to amend the terms of their credit agreement to, among other things: (i) substantially reduce the amount of asset-based revolving loan commitments and (ii) convert the revolving loans into term loans. After converting the ABL Revolving Loans to term loans, RadioShack repaid approximately $129 million of the amounts outstanding under the new term loans. Standard General and the other ABL lenders did not receive Salus' consent to amend the ABL Loans' underlying documents and no amendments were made to the RS Intercreditor Agreement.

RadioShack filed for bankruptcy on February 5, 2015 and quickly sought the approval of bidding procedures to sell its assets pursuant to § 363 of the Bankruptcy Code. In connection with the bidding procedures, RadioShack accepted a stalking-horse bid from Standard General's affiliate, General Wireless, of approximately $145.5 million. Importantly, $117.5 million of this amount was in the form of a credit bid. Salus made a competing bid at the auction. Importantly, neither of the proposed bids would result in all of the debtors' secured debt being paid in full.

Prior to the sale hearing, Salus filed an adversary proceeding against General Wireless and the other ABL lenders which focused on the language of the RS Intercreditor Agreement. Among other things, the complaint alleged that the October 2014 amendments to the ABL Loans altered their secured status. In addition, Salus sought a declaratory judgment that, pursuant to the RS Intercreditor Agreement, the only amounts senior to the Salus Loan, and thus entitled to be used as part of a credit bid, was that portion of the ABL Loans' remaining asset-based revolving loans (approximately $61 million) and the ABL Term Loan (approximately $50 million). Salus alleged that all other amounts outstanding under the ABL Loans were subordinated to Salus' claims.[8] Salus also sought a determination that because the RS Intercreditor Agreement specifically prohibited any repayment of junior debt with the proceeds of debtors' liquid collateral prior to repayment in full of the Salus Loan, the $129 million paid to the ABL lenders was improper and must be disgorged.

In light of Salus' objections regarding the amount of its credit bid, prior to the sale hearing, General Wireless amended its bid by, among other things, reducing its credit bid to $112 million, or the amount not subject to Salus' challenge.[9] Ultimately, the Court approved the sale to General Wireless. The adversary proceeding, however, remains pending.

Lessons Learned From the *MPM Silicones* and *RadioShack* Cases

The *MPM Silicones* and *RadioShack* cases both reveal that an intercreditor agreement will not serve its intended purpose of properly protecting the parties' relative interests and avoiding later disputes among the parties if not tightly drafted. For example, in *MPM Silicones*, while the MPM Intercreditor Agreement prohibited payment of the common collateral or the proceeds thereof from being distributed to junior lenders in cash, it did not specifically address distributions of other types of currency, such as equity to junior creditors. This same restrictive language regularly appears in many intercreditor agreements — prohibiting distributions consisting of collateral or its proceeds, but few intercreditor agreement contain broad language to prohibit other types of distributions.[10]

Moreover, while intercreditor agreements may properly establish and limit the amount of a later credit bid, the RS Intercreditor Agreement did not expressly delineate the parties' rights to credit bid or was ambiguous at best. In its various objections, Salus argued (citing only minimal precedent), that only senior secured debt, rather than subordinated secured debt, could be used as part of a credit bid. The Bankruptcy Code does not contain any such express limitation, and § 363(k) allows parties to credit the full face amount of their claim. If the intercreditor agreement had specifically addressed this issue, the parties could have avoided this dispute. While, in the end, the court did not need to address this issue in light of General Wireless' reduced credit bid, RadioShack stands as a reminder to creditors that parties to intercreditor agreements should always be clear as to: (i) what amount of secured debt can credit bid and (ii) whether senior secured debt must first be paid in full prior to any credit bid being made by secured (but subordinated) creditors.

Further, while the *MPM Silicones*' intercreditor agreement contained restrictions on the actions that could be taken by second lien noteholders following a bankruptcy filling, it contained an exception for actions taken in the role of an unsecured creditor. Gaps such as this, while often seemingly innocuous at first glance, can often be taken advantage of later, especially as the claims of subordinated secured creditors are often bifurcated pursuant to § 506 of the Bankruptcy Code. Small exceptions that can seem innocent at first can later arise to swallow more specific prohibitions.

What You Can Do to Ensure Your Intercreditor Agreement is Upheld According to Its Terms

As can be seen in these two instances, the failure of an intercreditor agreement to be explicit and unambiguous with regard to the parties' pre-petition bargain ultimately may result in a bankruptcy case ending with a very different result than the parties may have initially intended. Intercreditor agreements tend to be strictly interpreted by courts to enforce the bargained-for rights of the parties. *Ion Media Networks v. Cyrus Select Opportunities Master Fund (In re Ion Media Networks)*.[11] Because the MPM Intercreditor Agreement was unclear, the claims of MPM's senior noteholders were paid using below market rate replacement notes rather than being paid "in full in cash." In deciding this issue, Judge Drain acknowledged that a different result may have occurred where the applicable intercreditor agreement "contained very tight language."[12]

In order to ensure that your subordination agreement is more effective, below are a number of potential drafting points all creditors should consider:

- *Prohibitions on Distributions to Junior Lenders Must be Explicit*: In *MPM Silicones*, the court found that the MPM Intercreditor Agreement only prohibited distributions of common collateral or the proceeds thereof prior to senior noteholders being paid in full and in cash.[13] As the agreement was silent on the definition of "proceeds" of the common collateral and similarly did not restrict the distribution of other forms of currency, second lien noteholders were able to receive the reorganized company's equity prior to senior noteholders being paid in cash. If parties wish to prohibit distributions to junior creditors from any source prior to senior lenders being paid in full in cash, the agreement must explicitly and unambiguously say so.

- *Cramdowns Should be Addressed*: In *MPM Silicones*, the Bankruptcy Court held that even though the MPM Intercreditor Agreement prohibited distributions to second noteholders prior to senior lien noteholders receiving payment in full and in cash, it did not address payment following a cramdown pursuant to § 1129 of the Bankruptcy Code. This failure allowed the court to essentially negate the restrictions contained in the MPM Intercreditor Agreement. Parties should therefore provide that such payment restrictions specifically apply in any and all situations, including any cramdown event.

- *Lenders Can Provide for Recovery Outside of Bankruptcy*: In *MPM Silicones*, second lien noteholders argued that because senior noteholders were deemed paid in full under the cramdown provisions of § 1129 through the receipt of below market replacement notes, any additional distributions from debtors' estates would violate the absolute priority rule — which prohibits creditors from receiving more than the value of their claim. In making such argument, second lien noteholders acknowledged that while the absolute priority rule cannot be violated, this prohibition only applies to distributions made by debtors, and does not restrict the ability of non-debtor third parties to agree to pay another party. As a result, to the extent that senior creditors wish to ensure that they are paid the entire face principal and interest amount outstanding on the debt, notwithstanding any distribution deemed to be payment in full by the court, the applicable intercreditor agreement provision should explicitly state that any recovery by junior creditors following a bankruptcy filing must first be paid to the senior creditors until they are paid in full (minus any amounts received from the debtors on account of their claim). This would assure that there are no disputes about what payment in full constitutes.

- *Restrictions on Junior Creditors Must be Specific and Without Exemption*: Restrictions on junior creditors following a bankruptcy proceeding must also be explicit. In *MPM Silicones*, the intercreditor agreement specifically exempted actions taken by second lien noteholders when serving in their role as an unsecured creditor. The court also held that certain other actions were taken in second lien noteholders' role as backstop creditor.[14] To the extent that senior creditors wish to restrict a party's actions, there should be no exceptions to the restrictions. Language should also be included that prohibits any action even as unsecured creditors, to the extent such actions would violate or contravene the intended purpose of the applicable intercreditor agreement.

- *Restrictions on Future Financings*: Not only should the parties' relative priorities be established with respect to any common collateral, but the ability of junior creditors to participate in alternative forms of financing, especially following a bankruptcy filing, such as a rights offering or a priming DIP loan, should be addressed in the intercreditor agreement as well.

- *Credit Bidding Must Be Considered*: In *RadioShack*, the parties respective right to credit bid was not explicit. Parties should consider all options regarding a sale of assets following a bankruptcy filing, including any limits to the amount of a credit bid and whether other secured debt must be paid in full prior to subordinated, but secured, claims being used to credit bid.

As the *MPM Silicones* and *RadioShack* cases show, intercreditor agreements that fail to properly define the parties' rights will not protect the parties interests vis-à-vis one another and only lead to disputes the agreements were designed to avoid. When drafting an intercreditor agreement, parties should consider all possible scenarios.

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1 Intercreditor agreements are subordination agreements enforceable under § 510(a) of the Bankruptcy Code. The term "intercreditor agreement" broadly refers to an agreement between creditors that determines their competing rights and obligations with respect to a common obligor and/or its assets. The term encompasses both lien and payment subordination agreements.

2 *In re RadioShack*, Case No. 15-bk-10197 (Bankr. D. Del.).

3 More recently, in *Caesars Entertainment Corp.*, the agent for the holders of the first lien bank debt instituted litigation in New York state court against holders of the second lien notes alleging that defendants breached the intercreditor agreement by, among other things, filing an involuntary bankruptcy case and seeking the appointment of an examiner in the bankruptcy case.

4 Senior noteholders objected to certain provisions of the plan, claiming, among other things, that any refinancing of the senior notes would require payment of a make-whole amount. As a consequence, the plan provided for a so-called "deathtrap" provision; if senior noteholders voted to accept the plan, they would receive cash for the full amount of their claim, but had to waive their claim to certain make-whole amounts. If, on the other hand, senior noteholders did not accept the plan, and determined to pursue the make-whole amounts, they would instead receive replacement notes still secured by the common collateral but bearing interest rates well below prevailing market rates. We have previously reported how, after senior noteholders rejected the plan, Judge Drain allowed their claims to be cramdowned, finding that the distribution of the replacement notes under the plan in full satisfaction of the claims of senior noteholders was "fair and equitable" pursuant to § 1129 of the Bankruptcy Code. *See* Make-Whole Provisions Continue to Cause Controversy: What You Can Do to Avoid Litigation, July 2014 http://www.chapman.com/media/publication/398_Chapman_Make-Whole_Provisions_Continue_to_Cause_Controversy_What_You_Can_Do_to_Aviod_Litigation_071814.pdf

5 Transcript of Hearing held on September 30, 2014 in Case No. 14-22503 ("Tr.") at 57:2.

6 With respect to the Salus Loan, it appears that approximately $100 million was held by Cerberus and its affiliates while the remaining $150 million was held by Salus and its affiliates. Pursuant to an agreement between these parties, which established their relative priorities, Cerberus was the "first-out" lender and Salus was the "last-out" lender. The agreement also provided that Cerberus retained certain rights relative to Salus, including in connection with a possible future § 363 sale. Specifically, the agreement provided if Cerberus consented to a sale of assets, then Salus, as a "last-out" lender, would not object or oppose such sale on certain grounds. Unlike Salus, Cerberus generally supported the sale to General Wireless, and in fact, argued in a filing before the Court that in accordance with their agreement, Salus' objections should be disregarded and stricken. Case No. 15-10197 (Bankr. D. Del.) [D.I. 1551].

7 It is important to note that at the time the RS Intercreditor Agreement was entered into, RadioShack was already experiencing extreme financial distress, so the RS Intercreditor Agreement's terms likely received higher levels of scrutiny than they would otherwise have received. Notwithstanding this fact, numerous issues emerged between the parties over perceived ambiguities in the agreement.

8 It is important to note that Salus and Standard General were among the parties to a DIP financing agreement in this case. Salus did not raise any of the issues raised in the adversary proceeding at the DIP hearings nor at the time the bidding procedures were approved. As a result, Standard General argued that Salus should be judicially estopped from thereafter raising such issues.

9 It should be noted that Standard General acknowledged that it could not credit bid without first paying off the claims of the "first-out" ABL lenders.

10 Certain intercreditor agreements have attempted to solve this problem by requiring, for instance, that any securities received by junior creditors from a reorganized debtor must be turned over to the senior creditors until the senior liens are fully discharged. However, while such language does address the holding of *MPM Silicones*, it fails to go far enough. The MPM Intercreditor Agreement specifically provided that junior creditors could not receive any distribution until senior lenders were paid in full and in cash. Notwithstanding such restriction, the Bankruptcy Court approved a distribution to second noteholders even though senior noteholders had not received cash because the MPM Intercreditor Agreement did not specifically prohibit such distributions under a cramdown plan. Consequently, unless an intercreditor agreement specifically prohibits such distributions or requires that such securities be turned over to senior creditors in a cramdown and all other possible situations, any restriction of distributions of securities or any other type of currency may prove to be ineffective.

11 First lienholders need to be aware that distributions of equity interests of a debtor would not, under *MPM Silicones,* and even in the instance of a blanket lien, be captured under the broad UCC definition of "proceeds" as construed by the court.

12 Tr. at 112:1-7.

13 The Ad Hoc Committee of Second Lienholders made this point by stating that "… nothing in the [intercreditor Agreement] purports to prohibit the Debtors' recourse to cramdown or to impose negative consequences on the Second Lien Noteholders in the event Senior Lien Noteholders are crammed down." If the Senior Noteholders wished to receive more than allowed pursuant to the absolute priority rule, "[u]nder applicable law, such extraordinary results would have to be explicitly stated in the [Intercreditor Agreement]." See *Supplemental Memorandum of Law in Support of Reply of Ad Hoc Committee of Second Lien Noteholders to (I) Objection of BOKF, NA, as First Lien Successor Trustee, to Debtors' Joint Chapter 11 Plan and (II) Objection of Wilmington Trust, National Association, as Indenture Trustee, to Confirmation of Debtors' Proposed Joint Chapter 11 Plan of Reorganization* [D.I. 896], ¶¶ 2,4.

14 Tr. at 114:17-23.

For More Information

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