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Reorganization Securities And Second-Lien Structures

Law360, New York (November 09, 2010) -- The threat of reinstatement or cram-up of senior creditors in restructurings in many cases is a function of the breadth of intercreditor terms. Reinstatement under 1129 and 1124 of the Bankruptcy Code requires a determination that the creditor whose debt is reinstated on exit is not impaired, which means that defaults under the facility have been cured (other than certain financial and other defaults) and all of the legal, equitable and contractual rights of the creditor have been preserved.

Cram-up occurs when a senior creditor receives securities, such as equity securities or secured or unsecured debt securities equal in value to its secured claim and secured by the same collateral or the "indubitable equivalent thereof."[1]

Many second-lien intercreditor arrangements contain provisions which may render difficult restructuring strategies for second-lien creditors that involve the reinstatement or cram-up of first-lien debt. These arrangements provide that a second-lien creditor may not receive any distribution in respect of collateral, from the enforcement thereof or in connection with any insolvency proceeding, until the payment in full in cash of the first-lien credit agreement.

Were the first-lien creditor to be reinstated or crammed-up, the first-lien creditor would have a claim to the turnover of distributions made to the second-lien creditor pursuant to the plan or reorganization.

Recently we have seen exceptions to the second-lien intercreditor arrangement turnover provisions similar to X clauses more commonly found in payment subordinated deals. These X clauses provide for an exception from the turnover provisions for permitted junior securities.

Second-lien intercreditor arrangements have historically included a clause dealing with "reorganization securities." These clauses should not be confused with an X clause because they do not typically include an exception from the payment turnover. An example of a "reorganization securities" clause is set forth below:

"If, in any insolvency or liquidation proceeding, debt obligations of the reorganized debtor secured by liens upon any property of the reorganized debtor are distributed, pursuant to a plan of reorganization or similar dispositive restructuring plan, on account of both the First Lien Obligations and the Second Lien Obligations, then, to the extent that the debt obligations distributed on account of the First Lien Obligations and on account of the Second Lien Obligations are secured by Liens upon the same assets or property, the provisions of this agreement survive the distribution of such debt obligations pursuant to such plan and will apply with like effect to the liens securing such debt obligations."

This clause provides that if debt obligations are distributed pursuant to a restructuring plan to both the first-lien and second-lien creditors and such debt obligations are secured by the same assets, then the liens securing those debt obligations will be subordinated pursuant to the terms of the intercreditor arrangements. Conspicuously absent is the right to receive and retain such debt securities if the first-lien creditor has not been paid in full in cash. Also absent is a clear right to receive equity securities or unsecured debt as a distribution in respect of the secured claim of the second-lien creditor.

As mentioned above, some recent-vintage second-lien X clauses are to some extent borrowed from X clauses in payment subordination transactions. The logic behind attempts to impose an X clause on the second-lien structure suggests that the relationship of the first-lien creditor and the second-lien creditor is similar to the relationship of a payment subordinated creditor to the extent of the value of the collateral.

The inheritance of the second-lien market of the X clause is not an undisputed bequest. The senior creditor regards the X clause as supporting its position by allowing junior creditors to receive equity securities only if such securities (whether debt or equity) are subordinated to any debt and equity securities that the senior creditor receives short of payment in full in cash of its claims. The junior creditor tends to think of the X clause in terms of negotiating leverage to support a plan that distributes equity securities to the junior creditor and reinstates or crams-up the senior creditor.

Courts have tended to favor the view of the senior creditor. In cases such as In re: Envirodyne Industries Inc.,[2] In re: PWS Holding Corp.,[3] In re: Metromedia Fiber Network Inc.[4] and In re: Dura Automotive Systems Inc.,[5] courts have found, and perhaps gone to lengths to find, that the X clause is intended to provide an administrative mechanism to address the turnover of securities by, and later return of securities to, the junior creditor in cases where the senior creditor receives payment other than cash.

In Envirodyne, the placement of a restrictive clause imposing subordination requirements on securities distributed to the junior creditor rendered the X clause somewhat unclear as to whether equity securities distributed to the junior creditor had to be subordinated to equity securities distributed to the senior creditor. The X clause in Envirodyne read:

"All Superior Indebtedness shall first be paid in full before the noteholders, or the trustee, shall be entitled to retain any assets (other than shares of stock of the company, as reorganized or readjusted or securities of the company or any other corporation provided for by a plan of reorganization or readjustment, the payment of which is junior, at least to the same extent as the notes, to the payment of all Superior Indebtedness which may at the time be outstanding)."[6]

The court found “shares of stock of the company, as reorganized or readjusted” to be modified by “the payment of which is subordinated to the payment of all Superior Indebtedness which may at the time be outstanding.”[7] Reading the scheme of subordination as a whole indicated to the court that the clause was not intended to allow pari passu sharing of the senior creditor with the junior creditor when the distribution in question was comprised of equity securities. The purpose of the X clause, the court concluded, was simple:

"[W]ithout this clause, the subordination agreement that it qualifies would require the junior creditors to turnover to the senior creditors any securities they had received as a distribution unless the senior creditors had been paid in full. Then, presumably, if the senior creditors obtained full payment by liquidating some of the securities that had been turned over, the remaining securities would be turned back over to the junior creditors."[8]

According to the court in Envirodyne, the X clause served to prevent a complicated circular flow of the securities distributed pursuant to the plan.[9] Although the use of two different terms “stock” and “securities” suggested, semantically, that the restrictive clause might be construed only to apply to “securities” the court did not see it as a plausible intention.

Dura Automotive was decided by the U.S. Bankruptcy Court for the District of Delaware with like results. The relevant language in Dura Automotive was perhaps more challenging than the language in Envirodyne. The term “Permitted Junior Securities” was defined as:

"'Permitted Junior Securities' means: (1) equity interests in the company, DASI or any guarantor; or (2) debt securities that are subordinated to all senior debt and any debt securities issued in exchange for senior debt to substantially the same extent as, or to a greater extent than, the notes and the guaranties are subordinated to the senior debt under this indenture."[10]

With clauses (1) and (2) enumerated, the argument was stronger that the restrictive clauses “that are subordinated to all senior debt and any debt securities issued in exchange for senior debt to substantially the same extent as, or to a greater extent than, the notes and the guaranties are subordinated to the senior debt under this indenture” did not apply to clause (1). Nevertheless, reading the whole of the agreement and looking to extrinsic evidence the court in Dura Automotive construed the restrictive clause to apply to the equity securities referred to in clause (1) as well as clause (2).[11]

Turning to the second-lien context, there are many possible ways to articulate an X clause, depending on the intentions of the parties when the bargain is struck. A basic formulation is an exception to the payment turnover for “Permitted Junior Securities” such as:

"([E]xcept that the second-lien lenders may receive Permitted Junior Securities)."

The substance of the X clause is then embedded in the definition of permitted junior securities. For example, “Permitted Junior Securities” could be:

“'Permitted Junior Securities' means: (1) debt securities that are unsecured or that are secured, provided that to the extent secured by liens upon the same assets or property securing debt securities that are distributed on account of the First Lien Obligations, the provisions of this Intercreditor Agreement survive such distribution and apply with like effect to the liens securing such debt securities or such liens are otherwise subordinated to substantially the same extent, or to a greater extent than, as provided in this Intercreditor Agreement, or (2) equity interests in the company or any guarantor or any successor thereof."

This would clearly allow the second-lien creditor to benefit from a plan of reorganization in which equity securities or unsecured debt were distributed to the second-lien creditor on account of its secured claims while the first-lien debt is reinstated or crammed up. It also would allow the retention by the second-lien creditor of distributions, in respect of the secured claim of the second-lien creditor, of equity securities which are pari passu to the equity securities distributed in respect of the secured claims of the first-lien creditor.

“Permitted Junior Securities” could also be:

“'Permitted Junior Securities' means: (1) debt securities that are unsecured or that are secured, provided that to the extent secured by liens upon the same assets or property securing debt securities that are distributed on account of the First Lien Obligations, the provisions of this Intercreditor Agreement survive such distribution and apply with like effect to the liens securing such debt securities or such liens are otherwise subordinated to substantially the same extent, or to a greater extent than, as provided in this Intercreditor Agreement, or (2) equity interests in the company or any guarantor or any successor thereof; provided that in the case of clauses (1) and (2) to the extent that payments in respect of such unsecured debt securities and equity interests, to the extent distributed in respect of the interest of the Second Lien Obligations in the collateral shall, until the discharge of the First Lien Obligations, be subject to the turnover provisions of this Intercreditor Agreement as though such payments were payments in respect of collateral."

A broad approach could track the suggestion in the Model Simplified Indenture[12] which incorporates a broad X clause that includes:

“[O]r (ii) distributions under any plan approved by the court in any proceeding.”[13]

This allows a second-lien creditor to retain any securities it receives pursuant to a plan, whether consented to by the class or classes of first-lien creditors or whether obtained through the exercise of hold-up value. Along similar lines, the ABA’s recently published Model First Lien/Second Lien Intercreditor Agreement[14] recommends an X clause and includes language permitting the retention of distributions pursuant to an insolvency proceeding, but qualifies this (in an example of first-lien creditor favorable language) that the distribution be made pursuant to a plan consented to by the class or classes of first-lien creditors.[15]

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[1] Keep in mind that under the Bankruptcy Code a secured creditor is entitled only to the full value of its secured claim, not payment in full in cash. As a result, a secured claim can be crammed up by delivery of debt securities having a present value equal to the amount of the claim that is secured by the same collateral or the "indubitable equivalent" thereof.

[2] 29 F.3d 301 (7th Cir. 1994).

[3] 228 F.3d 224 (3rd Cir. 2000).

[4] 416 F. 3d 136 (2d Cir. 2005).

[5] 379 B.R. 257 (Bankr. Del. 2007).

[6] 29 F.3d 301, 306.

[7] Id. at 305-06.

[8] Id. at 306.

[9] Id.

[10] 228 F.3d 224, 261.

[11] Id.

[12] American Bar Association, Model Simplified Indenture (1983).

[13] Id. at §11.03.

[14] American Bar Association, Model First Lien/Second Lien Intercreditor Agreement (2010).

[15] Id. at § 6.7.