

Morgan Lewis

insight

# The Lien at the End of the Distressed Tunnel

presented by:

**Moderator**

Leonard Klingbaum, Morgan, Lewis & Bockius LLP

**Panelists**

Jeffery T. Rose, Wells Fargo Bank, N.A.

Wendy S. Walker, Morgan, Lewis & Bockius LLP

Kris Wigness, Morgan, Lewis & Bockius LLP

Dennis Stogsdill, Alvarez & Marsal LLC

David Kirsch, Alvarez & Marsal LLC

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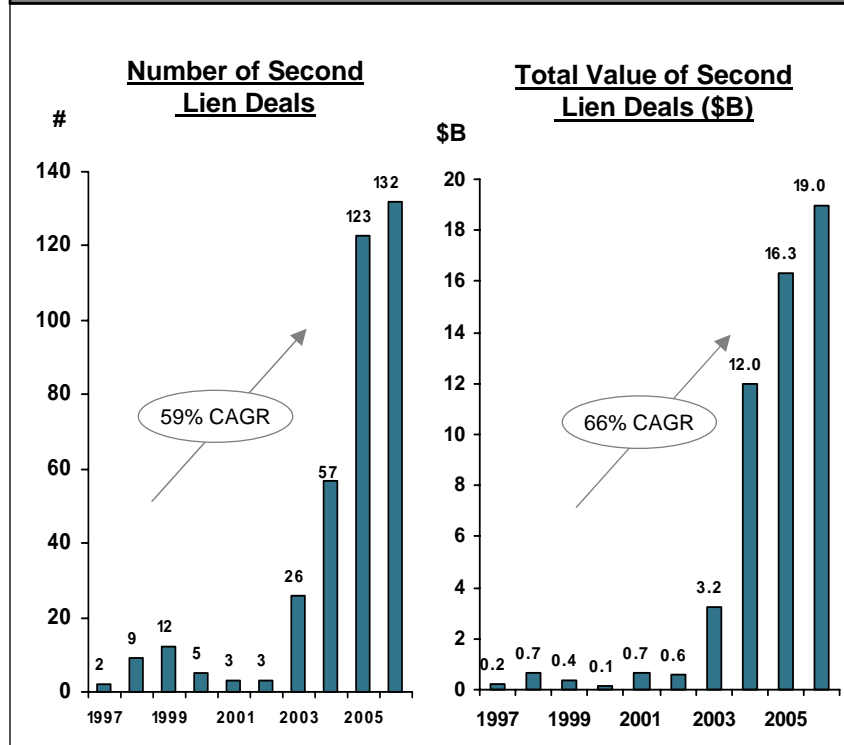
  
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# What is “Second Lien Financing”?

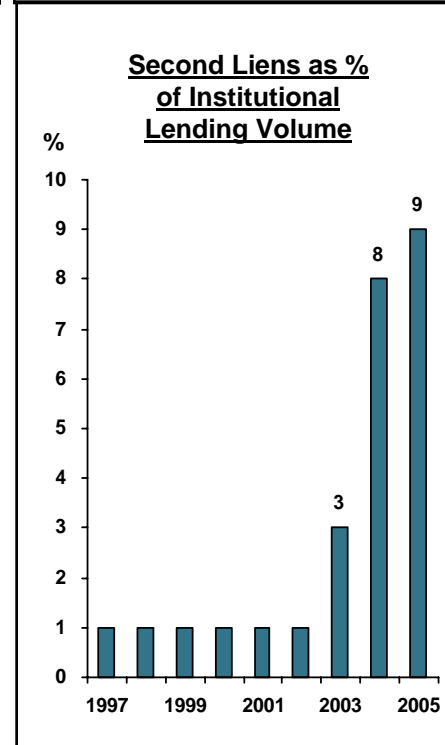
- Under Subordination and/or Intercreditor agreements, one lender or group of lenders agrees to have a second or subordinated claim and/or security interest in collateral to be repaid only after the senior lender(s) have been paid in full
- Pursuant to Bankruptcy Code Section 510(a), pre-bankruptcy subordination agreements are generally enforceable
- Second lien financing has grown dramatically in originations and in a workout context as borrowers look for cheaper, more available capital

# Recent Growth of Second Lien Financing

Second lien loan deals showing strong rise in volume & value since 2003...<sup>(1)</sup>



...and increasing their share of total institutional lending

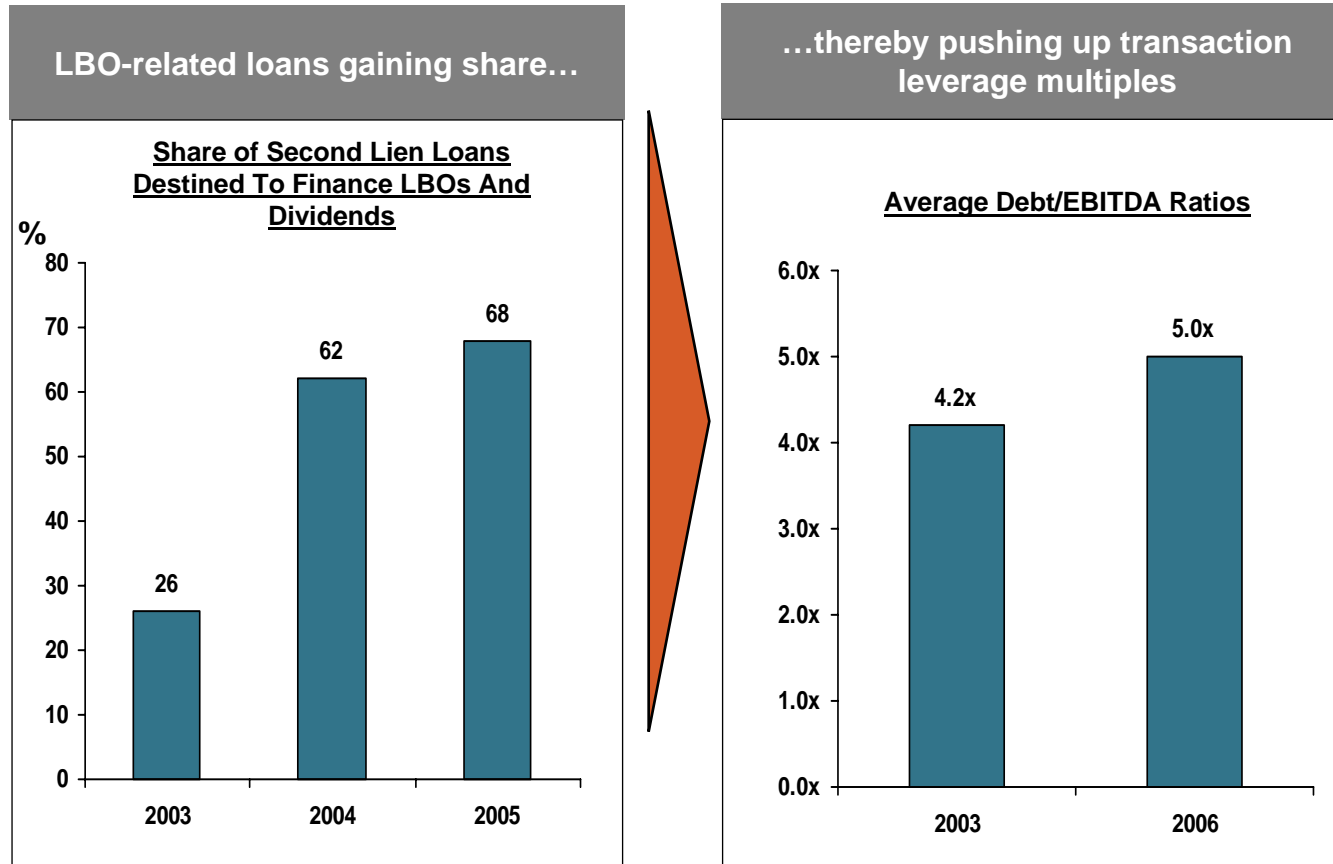


Note: 2006 data only available until Oct. 2006.

Sources: Standard & Poor's Leveraged Commentary & Data; Factiva

Strong growth expected to continue into 2007

# Second Liens Increasingly Utilized For LBO Transactions



Source: BofA Business Capital, Standard & Poor's Leveraged Commentary & Data

# Common Provisions & Issues to be Considered

Prospective consents to (i) sale of collateral by first lien lender, (ii) incurrence of post-petition debt, (iii) use of cash collateral, (iv) form/waiver of adequate protection, (v) no challenge to liens

## Issues to be Considered:

- **First Lien Lenders:** Enforceability in sale context could be an issue if second lien creditors are secured; drafting of subordination provisions should protect first lien lender in event of a failure to perfect security interests
- **Second Lien Lenders:** Sale of collateral/incurrence of post-petition debt may be just enough to take out senior debt but leave nothing for junior lienholder; preservation of adequate protection right may preserve seat at the table when plan negotiations start
- **Borrowers:** Prospective consents can ease post-petition financing process

# Common Provisions & Issues to be Considered

Voting on reorganization plan by first lien lender of second lien debt claim pursuant to intercreditor agreement

## Issues to be Considered:

- **First Lien Lenders:** Intercreditor agreement provisions held unenforceable in N.D. Illinois Bankruptcy Court; E.D. Pennsylvania Bankruptcy Court held that they are enforceable
- **Second Lien Lenders:** No leverage in plan negotiations in absence of right to vote
- **Borrowers:** Plan formulation becomes more complex; risks posed by non-consenting creditors
- Easing of plan negotiation process benefits all parties via reduced administrative costs

# Common Provisions & Issues to be Considered

“X” Clause: permitting second lien lenders to receive a distribution under a reorganization plan, usually of securities and often with the requirement that the securities be subordinated to the same extent as the pre-bankruptcy securities

## Issues to be Considered:

- **First Lien Lenders:** Exception to subordination which can be more or less meaningful depending on the provision; does not require that second lien lenders receive distribution
- **Second Lien Lenders:** Seat at the table in plan negotiations and, even though usually subordinated, potential upside
- **Borrowers:** Intercreditor disputes can prolong plan process

# Business Implications

- Increased liquidity to fund LBO activity and recapitalizations
- However, there are several negative financial implications:
  - Higher levels of debt exacerbate and accelerate company's slide into bankruptcy
  - More difficulty with respect to obtaining financing and developing restructuring alternatives
  - Incremental costs and additional administrative burdens
  - Complicated multi-party negotiation and litigation dynamics such as valuation fights
- Consider the relative size of the second lien facility as a company enters bankruptcy
  - The “2<sup>nd</sup> lien sandwich”

# Best Practices Going Forward

- Don't set yourself up for trouble: Intercreditor provisions should be clear and unambiguous and should accurately reflect the business agreement
- Don't start a fight you cannot finish: All lenders and agents should understand the business agreement as well as the intercreditor agreement's strengths and weaknesses
- Be Proactive: All lenders and agents should do the necessary to preserve and enforce their respective rights while remaining practical
- Be Practical: While sometimes necessary, litigation can prolong cases and increase administrative costs to the detriment of all parties

# Appendix - Sample X Clauses

- **Envirodyne** (7<sup>th</sup> Cir. 1994) (although Court found the provision was poorly drafted, X Clause was upheld in accordance with its intent and stock distributed under the plan had to be subordinated)

*“all Superior Indebtedness . . . shall first be paid in full before the Noteholders . . . shall be entitled to retain any assets (other than shares of stock of the Company . . . or securities . . . provided for by the plan of reorganization . . . the payment of which is subordinated, at least to the same extent as the Notes, to the payment of all [outstanding] Superior Indebtedness)”*

# Appendix - Sample X Clauses

- **Metromedia** (2<sup>d</sup> Cir. 2005) (distribution of warrants that would enable noteholders to purchase stock in same class as that distributed to senior debtholders violated X clause)

*“any payment or distribution of assets of the Company of any kind or character, whether in cash, property or securities (other than securities . . . provided for by a plan of reorganization . . . junior, or the payment of which is otherwise subordinate, at least to the extent provided in this Article 12, with respect to the Notes, to the payment of all Senior Indebtedness), to which the Holders . . . would be entitled . . . shall be paid . . . to the holders of the Senior Indebtedness”*

# Appendix - Sample X Clauses

- **Adelphia Communications** (noteholders commenced litigation seeking proportionate share of common stock distributed to senior noteholders; proceeding will be resolved in conjunction with the reorganization plan)

*“Upon . . . any distribution of assets of the Company upon any . . . reorganization of the Company . . . (1) the holders of all Senior Debt shall first be entitled to receive payment in full . . . before the [Noteholders] are entitled to receive payment . . . except payments comprised solely of Permitted Junior Securities; (2) any payment or distribution of . . . Securities (other than Permitted Junior Securities), to which the [Noteholders] . . . would be entitled . . . shall be paid . . . to the holders of Senior Debt . . .”*

*“Permitted Junior Securities” means (1) shares of stock of any class of the Company other than Disqualified Stock; or (2) securities of the Company other than Disqualified Stock that are subordinated in right of payment to all [outstanding] Senior Debt . . . to substantially the same extent as, or to a greater extent than, the [Notes] are so subordinated pursuant to the terms of this Indenture.”*

# Panel Members



**Wendy Walker, Partner**

Wendy S. Walker is a partner in the Bankruptcy and Financial Restructuring Practice. Ms. Walker's practice focuses on bankruptcy, commercial lending, debt restructuring and creditors rights, including the representation of lending institutions, trade creditors, and other secured and unsecured creditors (both US-based and international) in connection with loan restructuring transactions, debtor-in-possession financing, trading in distressed debt, Chapter 7 and Chapter 11 bankruptcy cases and commercial litigation.



**Kris Wigness, Partner**

Kris C. Wigness is a Partner in the Bankruptcy and Financial Restructuring Practice. His practice focuses on debt restructurings, loan workouts, secured and unsecured lending transactions, debtor-in-possession financing, creditors' rights and insolvency.



**Leonard Klingbaum, Associate**

Leonard Klingbaum is an associate in both the Bankruptcy and Financial Restructuring Practice and the Derivatives Practice. Mr. Klingbaum's practice focuses on debt restructuring, loan work-outs, secured and unsecured lending transactions, debtor-in-possession financing, creditors rights and insolvency, as well as over-the-counter derivatives involving interest rate, foreign currency, credit default and weather derivatives, and including transactions such as total return, interest rate and commodity swaps.

# Panel Members



## **Jeffery Rose, Vice President**

Jeffery Rose is a Vice President in the Customized Fiduciary Services Group of Wells Fargo's Corporate Trust Department. Mr. Rose administers a portfolio of contract agency and specialized trust transactions. He manages administrative agency transactions for various lending groups, including first lien, second lien and DIP and exit facilities.



## **Dennis Stogsdill, Managing Director**

Dennis Stogsdill is a Managing Director and serves as co-head of Alvarez & Marsal's Creditor Advisory Group. Mr. Stogsdill specializes in advising troubled companies, lenders, unsecured creditors and equity sponsors in distressed and non-distressed situations by devising creative solutions, including the development of workout, restructuring and refinance plans tailored to suit an individual client or creditor's needs.



## **David Kirsch, Director**

David Kirsch is a Director with Alvarez & Marsal's Creditor Advisory Group in New York. Mr. Kirsch specializes in advising lenders, unsecured creditors and equity holders in distressed and non-distressed situations.