

# New ABA Model First Lien/Second Lien Intercreditor Agreement

By Gary D. Chamblee

As defaults increase, the strengths and weaknesses of these existing agreements are being tested both inside and outside of bankruptcy.

After more than three years of work, a task force formed under the auspices of the Commercial Finance Committee of the American Bar Association (ABA) recently completed a Model First Lien/Second Lien Intercreditor Agreement (the model agreement<sup>1</sup>). When the first draft was published in March 2007, so-called second lien financing was still at its height. This type of financing typically involves a first lien loan secured by a first priority lien in substantially all of the assets of the borrower and a separate *pari passu* second lien loan secured by a second priority lien in the same collateral. Second lien structures have enjoyed increased popularity in recent years because of the increased liquidity provided by second lien lenders, who might not have provided financing on an unsecured basis, and because of the relatively narrow interest rate spreads available in the second lien market before the financial crisis. In the second quarter of 2007, second lien loans reached \$15.21 billion, the highest quarter recorded for second lien issuance since its inception. Since that time, second lien financing, like other forms of leverage finance, has been hit hard by the credit crisis; the volume of second lien financing has fallen sharply. By the third quarter of 2009, second lien issuance was approximately \$500 million.<sup>2</sup>

This type of lending is highly leveraged and is usually part of a syndicated loan facility with two separate groups of lenders. In a typical second lien

transaction, one syndicated group of lenders has a first lien on all of the assets of the borrower and its subsidiaries, and the second syndicated group holds a second lien on the same collateral.<sup>3</sup> The issuers of the second lien financing piece may be a group of banks and other institutional investors or may be a group of bondholders. The second lien lenders subordinate their lien on those assets to the lien of the first lien lenders but typically do not subordinate their right to payment. In other words, these transactions involve lien subordination but not payment subordination. The first lien credit facility is usually structured as a revolving loan (or a revolving facility and a term loan facility), while the second lien facility is usually a term loan. The interest rate on second lien loans has historically been higher than first lien loans but less than comparable mezzanine loans. Unlike mezzanine loans, second lien loans have historically not included an equity component. Variations on that structure exist, such as an asset-backed loan tranche secured by a first lien on current assets with a term loan tranche secured by a first lien on fixed assets of the borrower and a second lien on the borrower's current assets.

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*No single form of intercreditor agreement can address all of the concerns of both first and second lien lenders.*

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While certain issues are present in almost all intercreditor arrangements between first and second lien creditors, including lien subordination, standstill provisions and waivers of certain bankruptcy rights, there has been a great deal of variety in how different lenders and their counsel deal with these issues. There is also a considerable divergence of views between first and second lien lenders on what constitutes a “fair” intercreditor agreement. Because no single form of intercreditor agreement can address all of the concerns of both first and second lien lenders, and because the bargaining power of the two groups of syndicated lenders will vary depending on the particular transaction, the task force designed the model agreement to include optional and alternative provisions addressing the concerns of both first and second lien lenders. The model agreement also includes extensive commentary and footnotes explaining the key issues and provisions in detail. Although some suggestions are made for dealing with specific issues (for example, how to treat the “excess amount” above a first lien cap for priority purposes), the task force’s guiding star was always that the model agreement should reflect market expectations and standard practices among the most knowledgeable practitioners drafting and negotiating such agreements on behalf of both first lien creditors and second lien creditors. The model agreement with commentary was completed in January 2010 and is available on the task force Web site.<sup>4</sup>

Interest in intercreditor issues involving first and second lien loans remains high despite the decline in the overall volume of new transactions. One reason is that there are thousands of intercreditor agreements still in place for outstanding loans. As defaults increase, the strengths and weaknesses of these existing agreements are being tested both inside and outside of bankruptcy. Another factor creating interest is that many unsecured creditors in the present environment are attempting to improve their position relative to senior secured creditors by obtaining second priority liens on the collateral held by the senior creditors. This type of transaction includes bond exchange deals in which formerly unsecured bondholders exchange their unsecured debt for secured debt with a second lien on the borrower’s assets behind the first lien

lenders. Other forms of debt, including mezzanine debt, are also being restructured to grant the lenders a junior lien on collateral.

### Lien Priority

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From the point of view of the typical first lien lender, an intercreditor agreement has one primary purpose: to make sure that the first lien remains a first lien on all assets of the borrower inside or outside of bankruptcy. The first lien lender also wants the second lien lender to be a silent second, with no significant ability to challenge the priority of the first lien or to throw up procedural obstacles to the enforcement of the first lien following a default. The first lien lender is likely to insist that its lien on the common assets should remain superior even if the first lien lender fails to properly perfect its lien or allows its lien to lapse or its lien is avoided in bankruptcy or otherwise. The first lien lender will argue that this type of “absolute” priority provision implements one of the basic purposes of an intercreditor agreement, which is to agree in advance on the relative lien priority of the parties in order to avoid expensive and protracted litigation. In practice, the vast majority of intercreditor agreements to date have adopted the first lien lender’s position on this issue and, consistent with this practice in the marketplace, the model agreement provides in its standard provisions for absolute lien priority for the first lien lender regardless of perfection, lack of perfection or avoidance up to the amount of any first lien cap:

#### **Seniority of Liens Securing First Lien Obligations**

A Lien on Collateral securing any First Lien Obligation up to but not in excess of the First Lien Cap will at all times be senior and prior in all respects to a Lien on such Collateral securing any Second Lien Obligation ...

Except as otherwise expressly provided herein, the priority of the Liens securing First Lien Obligations and the rights and obligations of the Parties will remain in full force and effect irrespective of

- (a) how a Lien was acquired (whether by grant, possession, statute, operation of law, subrogation, or otherwise),
- (b) the time, manner, or order of the grant, attachment, or perfection of a Lien,
- (c) any conflicting provision of the UCC [Uniform Commercial Code] or other applicable law,
- (d) any defect in, or non-perfection, setting aside, or avoidance of, a Lien or a First Lien Loan Document or a Second Lien Loan Document,
- (e) the modification of a First Lien Obligation or a Second Lien Obligation,
- (f) the modification of a First Lien Loan Document or a Second Lien Loan Document,
- (g) the subordination of a Lien on Collateral securing a First Lien Obligation to a Lien securing another obligation of a Grantor or other Person,
- (h) the exchange of a security interest in any Collateral for a security interest in other Collateral,
- (i) the commencement of an Insolvency Proceeding, or
- (j) any other circumstance whatsoever, including a circumstance that might be a defense available to, or a discharge of, a Grantor in respect of a First Lien Obligation or a Second Lien Obligation or holder of such Obligation.

The second lien lender and its counsel are likely to argue, particularly in a negotiated middle-market transaction, that giving the first lien lender absolute priority even if its lien is not perfected or is subsequently avoided in bankruptcy is unfair and may result in a windfall to the unperfected first lien lender to the disadvantage of the second lien lender. If a first lien agent fails to perfect, or maintain perfection of, its lien, an agreement to treat the second lien lender as subordinate to an unperfected first lien lender may have the effect of converting lien subordination into payment subordination to unsecured indebtedness.<sup>5</sup> Therefore, second lien lenders and their counsel will

often take the position that only collateral in which, at any time, both first and second lien lenders have a valid and perfected security interest not subject to avoidance as a preferential transfer or otherwise by the debtor or a trustee in bankruptcy should be subject to the lien priority provisions. The model agreement contains an alternative priority provision favorable to second lien lenders that provides that the second lien lender will be subordinate only to the extent that the first lien lender maintains a valid and perfected first priority lien in the common collateral.

## First Lien Caps and Loan Modification Provisions

What can happen if a second lien lender fails to negotiate a ceiling on the maximum amount of first lien debt or fails to effectively control material modifications of the first lien loan documents in the intercreditor agreement? Unfortunately, for many second lien lenders, the answer has been that such lenders end up with a lien that is partially or entirely underwater when the first lender increases the amount of its loan, raises the interest rate significantly or imposes substantial fees over the objection of the second lien lender.

The case of *In re Musicland Holding Corp.*<sup>6</sup> demonstrates how boilerplate provisions in an intercreditor agreement may effectively permit a first lien lender to increase the amount of the senior loan at the expense of the second lien lender. The plaintiffs in this case were a group of secured trade creditors who had a second lien position on inventory. That lien was subordinated by an intercreditor agreement to a first lien on all of the assets of the borrowers securing a \$200 million revolving credit loan. Under the terms of the intercreditor agreement, the trade creditors consented in advance to “any amendment, modification, supplement, extension, renewal or restatement of any of the Revolving Loan Debt ... .” The term revolving loan debt was defined broadly to refer to “any and all obligations, liabilities and indebtedness of every kind, nature and description” owed by the borrowers at any time to the senior lenders. In other words, the term revolving loan debt was defined so that it also included nonrevolving debt.

The borrowers asked the first lien revolving lenders to provide additional funds that the revolving

lenders were unwilling to provide. If the term revolving loan debt had been defined narrowly, that would have ended the matter, although the lack of any cap on revolving debt would have left the second lien lenders with a continuing risk of being pushed further down if the revolving lenders increased the revolving loan. However, recognizing the opportunity offered by the loose provisions in the intercreditor agreement, the borrowers turned to a third-party lender who agreed to make a \$25 million term loan. If made independently, the term loan would have been third in priority behind the first lien lenders and the second lien trade creditors. However, the borrowers and first lien lenders amended the revolving credit agreement to bring the term lender into the syndicate of lenders as a first lien lender and to provide for a \$25 million term loan.

Because of the essentially unlimited right to amend the revolving credit agreement and the broad definition of revolving loan debt, the senior lenders argued that the term loan qualified as revolving loan debt as defined in the intercreditor agreement and that the intercreditor agreement clearly permitted any and all amendments to the revolving credit agreement. The trade creditors argued that they had an expectation or understanding that they “bargained for a lien that was subordinate only to obligations under the borrower’s existing revolving credit facility.” Pointing to what it called the “unambiguous” provisions of the intercreditor agreement, the bankruptcy court held that the provisions of the intercreditor agreement were sufficiently broad on their face to allow the senior lenders to amend the revolving credit agreement to bring in a term lender.

One lesson from this case for second lien lenders is that, in addition to requiring approval rights over material modifications to the first lien loan documents, they should always insist on having a first lien cap. The model agreement provides for a first lien cap in an agreed-upon maximum principal amount and provides that the second lien lender will be subordinate only to the extent that the principal amount of the first lien loan does not

exceed the first lien cap. The model agreement also provides that any principal amount in excess of the agreed-upon first lien cap will not be considered first lien obligations for purposes of the intercreditor agreement. This means, for example, that the agreement by the second lien lender to subordinate the lien of its loan applies only to the extent that the first lien lender does not increase its loan in excess of the first lien cap. Similarly, the buyout provisions of the agreement that permit the second lien lender to purchase the first lien loan at par following the occurrence of an event of default only apply to

the portion of the first lien loan that does not exceed the agreed-upon cap. The standard definition of first lien cap in the model agreement applies only to the principal outstanding under the first lien loan. The second lien lender may argue that the cap should also apply

to accrued and unpaid interest, default interest, fees and expenses, hedging obligations and cash management obligations. In the absence of a cap on expenses and fees, the second lien lender may also argue that the first lien lender has an incentive to run up expenses and fees following an event of default in order to make it more difficult for the second lien lender to bid at the foreclosure sale or to purchase the first lien debt. The model agreement includes an alternative definition of first lien cap that favors the second lien lender and includes these items in addition to principal.

While a first lien cap is designed to protect the second lien lender from unanticipated increases in the first lien debt, the first lien lender will want to make sure that it has a sufficient cushion under the first lien cap to increase its loan by a reasonable amount to deal with additional cash needs by the borrower as part of a loan workout or otherwise. In the absence of unusual provisions in the first lien credit agreement (for example, delayed draw term loans or accordion features), the typical amount of a first lien cap is in the range of 110 percent to 115 percent of the aggregate loan amount of the first lien obligations with 110 percent being the most common percentage used.

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A first lien lender should also strongly consider including an additional cushion for debtor-in-possession (DIP) financing to be provided by the first lien lender in the event of bankruptcy. The definition of first lien cap in the model agreement includes optional provisions for including DIP financing under the first lien cap.

While many intercreditor agreements include a cap on first lien debt, they often fail to address how amounts in excess of the first lien cap will be treated. Even if the intercreditor agreement states that obligations in excess of the first lien cap will not be considered to be first lien obligations, the liens securing the first lien obligations (including UCC financing statements and mortgages or deeds of trust) are usually filed before the second lien UCC financing statements and mortgages or deeds of trust and would therefore arguably remain first priority liens under the “first to file” rule. A common alternative in intercreditor agreements in which the parties and their counsel have actually considered this issue is to assign third lien priority to all first lien obligations in excess of the first lien cap. This most closely aligns with the parties’ expectations and assigns a specific waterfall of priorities. The model agreement adopts that approach in dealing with this issue.

### Standstill Provisions

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A key part of any intercreditor agreement between first and second lien lenders is a so-called standstill provision. A first lender will want the power in the event of a default to control the enforcement process so that it has the time to reach a workout arrangement with the borrower or, if a workout fails, to enforce its lien and complete the foreclosure process.

On the other hand, the second lien lender will be concerned that the borrower’s financial position and the collateral may deteriorate if the first lien lender delays taking action to enforce its lien. The typical solution to this problem in an intercreditor agreement is to give the first lien lender a set standstill period (typically 120 to 180 days), in which the first lien lender will have the exclusive right to pursue remedies against the collateral. If the first lien holder fails to act during the standstill period, then the junior creditor may pursue its own remedies, including initiating a foreclosure proceeding on the shared

collateral. However, the intercreditor agreement typically provides that if the first lien lender initiates its remedies during the standstill period, then it will continue to have an exclusive right to exercise those remedies so long as it diligently pursues the exercise of its rights and remedies with respect to all or any material portion of the shared collateral. The standstill provisions in the model agreement follow this pattern.

If a second lien lender agrees to a standstill period, the second lien lender will still want to make sure that it is not worse off in terms of its remedies than it would be if it were an unsecured creditor. The model agreement gives the second lien lender the right to take certain specific actions to avoid losing its enforcement rights or lien rights during the standstill period. Those rights include the right of the second lien lender to file a claim in any insolvency proceeding; to take actions to create, perfect or preserve its lien on the collateral; to file a proof of claim in any bankruptcy proceeding; and to vote on any plan of reorganization.

### Intercreditor Issues in Bankruptcy

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The first lien lender will usually insist that the second lien lender waive certain of its rights in any bankruptcy proceeding. For example, in most intercreditor arrangements the first lien lender will require that the junior lien holder agree that it will not contest any request by the first lien holder for adequate protection and that it will not object to the first lien lender’s use of cash collateral or to any DIP financing under Section 364 of the U.S. Bankruptcy Code.

Despite the inclusion of these types of bankruptcy waivers in most intercreditor agreements, there have been only a relatively few cases addressing the enforceability of such provisions in bankruptcy and those cases have reached differing results.

Section 510(a) of the Bankruptcy Code acknowledges the continued effectiveness in bankruptcy of a subordination agreement. However, bankruptcy courts have reached different conclusions when the rights waived by the second lien lender in the intercreditor agreement involve basic bankruptcy rights beyond lien subordination or payment subordination.

For example, the intercreditor agreement at issue in *Bank of America, Nat'l Ass'n v. North LaSalle St. Ltd. P'ship (In re 203 N. LaSalle St. P'ship)*,<sup>7</sup> granted the first lien lender the right to vote the junior lien holder's claims in bankruptcy. The bankruptcy court held that the subordination agreement could not affect the voting rights of the junior lienor in bankruptcy pursuant to Section 510(a) of the Bankruptcy Code, in disregard of Section 1126(a) of the Bankruptcy Code, which provides that the holder of a claim may vote to accept or reject a plan under Chapter 11.

In *Blue Ridge Investors, II, LP v. Wachovia Bank, N.A. (In re Aerosol Packaging, LLC)*,<sup>8</sup> on the other hand, the intercreditor agreement granted the first lien lender

the right to vote the claims of the second lien lender in any bankruptcy proceeding. When the debtor proposed a plan under Chapter 11 of the Bankruptcy Code, the second lien lender voted against the plan and claimed that the voting restriction in

the intercreditor agreement was invalid under the authority of *LaSalle* and similar cases. The first lien lender used the grant of voting rights by the second lien lender in the intercreditor agreement to vote in favor of the plan on behalf of the second lien lender. The bankruptcy court interpreted the scope of Section 510(a) broadly as permitting the enforcement of subordination agreements (including delegation of voting rights) so long as such agreements are enforceable under applicable nonbankruptcy law. Since the intercreditor agreement was enforceable under applicable Georgia nonbankruptcy law, the bankruptcy court upheld the right of the first lien lender to vote on behalf of the second lien lender pursuant to the delegation of authority in the intercreditor agreement.

In the current wave of bankruptcies, anecdotal evidence and a few reported decisions suggest that bankruptcy judges are more often than not recognizing and enforcing intercreditor agreements entered into between commercially sophisticated parties.

In a recent Chapter 11 proceeding in the U.S. Bankruptcy Court for the Southern District of New York, for example, the court in a memorandum decision enforced the terms of an intercreditor agreement

between the first lien lenders and the second lien lenders against a distressed debt investor that had purchased certain deeply discounted second lien debt for what the court characterized as "pennies on the dollar."<sup>9</sup> The intercreditor agreement included an express acknowledgment by the parties "to the relative priorities as to the Collateral ... as provided in the Security Agreement" and an agreement by the parties that such priority would not be affected or impaired by "any nonperfection of any lien purportedly securing any of the Secured Obligations." The distressed debt investor attempted an end run around these provisions by arguing in a motion objecting to confirmation of the debtor's plan of reorganization

that certain Federal Communication Commission (FCC) licenses owned by a special-purpose vehicle within the debtor's capital structure were immune from being encumbered due to their special character and that the licenses therefore did not consti-

tute "collateral" for purposes of the intercreditor agreement. The court found that the use of the term "purportedly securing" in the intercreditor agreement to describe the liens granted in the security agreement evidenced the intent of the secured parties to establish their relative legal rights *vis-à-vis* each other, regardless of the ultimate validity of each individual right granted by the debtors. The court concluded that "at bottom, the language of the Intercreditor Agreement demonstrates that the Second Lien Lenders agreed to be 'silent' as to any dispute regarding the validity of liens granted by the Debtors in favor of the First Lien Lenders and conclusively accepted their relative priorities regardless of whether a lien ever was properly granted in the FCC Licenses." The court went on to note that "affirming the legal efficacy of unambiguous intercreditor agreements leads to more predictable and efficient commercial outcomes and minimizes the potential for wasteful and vexatious litigation."

If the approach taken in the *Ion* decision is followed by other bankruptcy and appellate courts, it bodes well for the enforcement of intercreditor agreements negotiated between commercially sophisticated parties. In turn, if lenders and their

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counsel have some assurance that courts will enforce the terms of intercreditor agreements, that should encourage both lenders and their counsel to take the time to negotiate intercreditor agreements carefully and to avoid the waste of time and money that results when the parties either fail to carefully consider the business and legal issues presented by intercreditor arrangements or when the parties do consider those issues and the courts fail to enforce their agreements.

The hope of the task force is that the model agreement will provide guidance to lenders and their counsel through the thicket of business and legal issues that confront first and second lien lenders attempting to agree in advance on what their rights and obligations will be with respect to their respective liens in a borrower's assets if the borrower ends up in default or bankruptcy.

### Endnotes

- <sup>1</sup> Gary D. Chamblee is Chair of the ABA's Model First Lien/Second Lien Intercreditor Agreement task force (the task force). The vice chairs of the task force are Alyson Allen, Ropes & Gray LLP; Christian Brose, McGuire Woods LLP; Richard K. Brown, Winston & Strawn, LLP; Robert L. Cunningham Jr., Gibson, Dunn & Crutcher LLP; Randall Klein, Goldberg Kohn; and Jane Summers, Latham & Watkins LLP. The editor of the model agreement is Howard Darmstadter. The task force has more than 200 members.
- <sup>2</sup> See Quarterly Second Lien Issuance, 2Q02-3Q09 at [www.loanconnector.com](http://www.loanconnector.com) (membership and password required), Loan Pricing Corporation, a Reuters company.
- <sup>3</sup> As with most intercreditor agreements, the model agreement provides that the first and second lien collateral agents will be parties to the intercreditor agreement but the first and second lien lenders will not be parties. Therefore, the first and second lien credit agreements should each bind each lender to the terms of the intercreditor agreement; authorize the collateral

agent to enter into the intercreditor agreement on behalf of the lenders and to exercise all the agent's rights and comply with all its obligations under the intercreditor agreement; and specify what lender direction or authorization is required for the agent to agree to consents, waivers or amendments or to take or refrain from other actions under the intercreditor agreement. For convenience, the first lien collateral agent and the first lien lenders are sometimes collectively referred to in this article as the "first lien lender," and the second lien collateral agent and the second lien lenders are sometimes collectively referred to as the "second lien lender."

- <sup>4</sup> The task force Web site is at [www.abanet.org/dch/committee.cfm?com=CL190029](http://www.abanet.org/dch/committee.cfm?com=CL190029) (ABA membership required). Information about the task force and the model agreement can also be obtained from Gary Chamblee, [gchamblee@wcsr.com](mailto:gchamblee@wcsr.com).
- <sup>5</sup> Payment subordination can occur if (i) the lien securing first lien obligations maintains priority under the intercreditor agreement even if invalid, unperfected or avoidable or (ii) first lien obligations include amounts "whether or not allowable in an insolvency proceeding" and the amounts are not allowed. This can result in payment subordination of the claims of second lien lenders to the extent of first lien claims not allowed in an insolvency proceeding, which also leaves the second lien lenders with no enforceable subrogation rights in respect of such claims. On the other hand, application of proceeds to second lien claim holders from unperfected first lien collateral may result in a greater recovery than had the first lien collateral been perfected. For a detailed discussion of this issue, see Robert Cunningham and Yair Galil, *Lien Subordination and Intercreditor Agreements*, 25 REV. BANKING & FIN'L SERVICES 5 (May 2009).
- <sup>6</sup> *In re Musicland Holding Corp.*, 374 BR 113 (S.D.N.Y. 2007).
- <sup>7</sup> *Bank of America, Nat'l Ass'n v. North LaSalle St. Ltd. P'ship (In re 203 N. LaSalle St. P'ship)*, 246 BR 325, 331 (Bankr. N.D. Ill. 2000).
- <sup>8</sup> *Blue Ridge Investors, II, LP v. Wachovia Bank, N.A. (In re Aerosol Packaging, LLC)*, 362 BR 43 (Bankr. N.D. Ga. 2006).
- <sup>9</sup> *In re ION Media Networks, Inc.*, 2009 Westlaw 4047995 (Bankr. S.D.N.Y. Nov. 24, 2009).

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