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## INTERCREDITOR AGREEMENTS: CEMENTING PRIORITIES AND SILENCING OBJECTIONS

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### **Intercreditor Agreement in *ION Media* requires Second Lien Lenders "Be Silent" — precludes challenge to validity of liens; deprives junior creditors of standing to object to plan of reorganization.**

Corporate capital structures now commonly incorporate multiple tiers of secured debt. First-, second-, and third-lien secured tranches take the place of traditional, single-layer secured debt followed by varying tiers of unsecured and subordinated instruments. Absent a contractual arrangement allocating rights across the capital structure, the lien priorities of the various classes of secured creditors will determine their relative rights. This presents an opportunity for conflict when an issuer enters bankruptcy: by successfully challenging the security interests of creditors senior to it, a junior secured creditor can potentially boost its recovery. Indeed, a successful lien-avoidance action by a junior creditor can completely reshuffle

the payout at each level of the secured debt structure. The question then becomes whether—and to what extent—creditors can allocate rights among themselves pre-bankruptcy. In that regard, groups of creditors frequently execute intercreditor agreements defining the rights available at each level of the debt hierarchy, and restricting the actions of lower-tier debt holders, including within bankruptcy proceedings. The benefit of enforcing such intercreditor agreements as written is simple: economic efficiency and commercial certainty.

In a recent decision, Judge James M. Peck of the Bankruptcy Court for the Southern District of New York confirmed the chapter 11 reorganization plan of ION Media Networks, Inc. ("ION") over the objection of a minority holder of second-lien debt subject to a restrictive intercreditor agreement.<sup>2</sup> The objecting debtholder, Cyrus Select Opportunities Master Fund Ltd. ("Cyrus"), a distressed-debt fund, purchased approximately \$47 million of ION's deeply

discounted second-lien debt in the secondary market. Cyrus then aggressively sought to challenge the first-lien lenders' asserted secured claims against certain ION entities on the basis that the entities could not legally grant liens in the underlying assets due to restrictions imposed by the Federal Communications Commission and applicable federal statutes. The Court held that under the intercreditor agreement, Cyrus lacked standing (a) to challenge the first-lien lenders' liens and the priority of their claims and (b) to object to plan confirmation.

### **The Intercreditor Agreement Governs**

The respective rights and duties of ION's first- and second-lien lenders are set forth in an intercreditor agreement that prohibits the holders of second-lien debt from, among other things, challenging first-lien lenders' liens and claims,

and from taking any action opposed to first-lien lenders' rights. In addition, the intercreditor agreement specifically provides that the hierarchy of interests defined by the first- and second-lien structure would govern, even if a particular lien "ceases to be perfected, is avoidable by any bankruptcy trustee or is otherwise set aside, invalidated, or lapses."

Cyrus argued that because the FCC prohibits license holders from granting liens on broadcast licenses, the licenses held by certain of ION's special-purpose subsidiaries were unencumbered as of ION's filing for Chapter 11. The first-lien lenders' claims against those subsidiaries, Cyrus argued, therefore were unsecured, entitling the first- and second-lien debtholders to share *pari passu* in the enterprise value of the licenses (the intercreditor agreement was premised on subordination of liens and not payment subordination). On the contrary, if the liens were valid, the first-lien lenders would receive all of the value of the licenses left over after paying off the DIP lenders. This is precisely what the ION plan provided: DIP lenders were to receive 62.5% of the equity in reorganized ION in full satisfaction of DIP financing, with the remaining 37.5% going to the first-lien lenders in full satisfaction of ION's first-lien debt. The plan treated the second-lien lenders' claims as fully unsecured.

The Court found that the plain language of the intercreditor

agreement evidenced the parties' intent to establish their relative legal rights "in respect of the Collateral" generally, instead of relying solely on the validity and proper perfection of each of the underlying property interests. This solved the broadcast-license lien challenge without the Court having to reach it on the merits: even if the first-lien creditors' security interests in broadcast licenses were wholly invalid or unperfected, the intercreditor agreement nonetheless subordinated the junior creditors' right to payment.

The ION intercreditor agreement also expressly precludes second-lien holders from taking any action to contest: "the validity, priority, or enforceability" of any liens or "the relative rights and duties" of the first-lien holders. The Court described the restrictions as "plain and purposeful," recognizing also that the intercreditor agreement expressly prohibits second-lien lenders from objecting to any chapter 11 plan that is consistent with the first-lien lenders' rights. Thus, not only was Cyrus precluded from challenging the validity of any liens granted in favor of the first-lien lenders, but it also was contractually deprived of standing to object to ION's plan of reorganization.

### **Conclusion**

Judge Peck's decision in *ION* is a step toward crystallizing the unsettled body of law governing the pre-bankruptcy contractual

allocation of rights between different classes of secured creditors. By enforcing the intercreditor agreement to preclude any re-ordering of anticipated priorities in bankruptcy, the Court reinforced the concept of commercial certainty through unambiguous contract construction. As the Court found, "[a]t 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 ...." Moreover, "Cyrus, by purchasing second lien debt that was expressly subject to the Intercreditor Agreement, agreed to remain silent in the event of a chapter 11 case."

As seen in *ION*, an intercreditor agreement may go so far as to strip a junior secured creditor of legal standing to speak at all, even if the actions of the senior lender negatively impact its wallet. This outcome may be disfavored by buyers of junior debt subject to contractual restrictions.

Nevertheless, bankruptcy courts likely will continue to uphold the unambiguous intent of contracting creditors to cement their priorities in bankruptcy, and to preclude attempts by junior creditors to move up the capital structure through lien-avoidance actions. Like Judge Peck, Courts will

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recognize that: “[a]ffirming the legal efficacy of unambiguous intercreditor agreements leads to more predictable and efficient commercial outcomes.” Thus, holders of all tranches of secured debt subject to intercreditor agreements must be aware of the terms of any clear intercreditor restrictions, and should consider the likelihood of their strict enforcement in bankruptcy when valuing the debt.

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<sup>2</sup> *In re ION Media Networks, Inc.*, --- B.R. ---, 2009 WL 4047995 (Bankr. S.D.N.Y., Nov. 24, 2009).

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