

It takes two to tango... or does it? The enforceability of intercreditor agreements in bankruptcy | BY DAVID W. MORSE

Section 510(a) of the US Bankruptcy Code could not be terser: “a subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable non-bankruptcy law.” The brevity of this single sentence leads to any number of questions and has led different courts in the US down different paths in understanding the comprehensive intercreditor agreements commonly used in today’s sophisticated financing transactions.

Some courts have taken the view that a ‘subordination agreement’ means literally only the agreement of one creditor to subordinate its right to payment, in the case of debt subordination, or to subordinate its lien in common collateral, in the case of lien subordination, implicitly concluding that the balance of the terms and conditions that are customarily part of any subordination agreement are not the subject of Section 510(a).

After all, the intercreditor agreement is a contract between two lenders or groups of lenders that are ‘non-debtor parties’, that is parties that are not themselves subject to a bankruptcy case. Therefore, it is reasonable to suggest that any dispute between them relating to the terms of such contract should properly be addressed in the applicable state court, like any other contract dispute, and not in a federal bankruptcy court. Nonetheless, as a practical matter, forcing the parties to turn to the state courts could substantially undermine the benefits of the intercreditor agreement since, by the time the litigation was concluded in the state court action, it may be too late for an effective remedy given events in the bankruptcy case itself. To require such litigation in the forum of the

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state courts would, in most cases, require that the extensive provisions in the intercreditor agreement concerning the rights of the creditors in the context of the bankruptcy of the debtor be ignored and in so doing, defeat the intent of the parties as to how their relationship should be governed during a bankruptcy.

Fortunately, most bankruptcy courts have not adopted this narrow understanding with respect to the provisions of intercreditor agreements in a bankruptcy case. The prevailing and better perspective that is reflected in the more significant majority of cases is that the provisions in the intercreditor agreement dealing with the events within a bankruptcy case of the debtor will be enforced by the bankruptcy court.

Two cases decided last year nicely illustrate the workings of the intercreditor agreement in a bankruptcy.

On 29 January 2008, Touse Inc. and its affiliates filed a petition for relief under Chapter 11 of the US Bankruptcy Code. On the date of the petition, the debtors filed a motion seeking to obtain secured post-petition financing on a super-priority and priming lien basis and authority to use cash collateral of the lenders under its pre-petition credit facilities. There was some negotiation around the terms of the cash collateral order. The creditors’ committee in the case wanted the right to seek disgorgement of certain payments received by the pre-petition lenders, as part of the order and wanted to be allowed to use the proceeds of the cash to fund professional fees for actions seeking to avoid the liens of the pre-petition lenders. Eventually, such matters were resolved and Citicorp North America, Inc., as administrative agent for the pre-petition first lien lenders, consented to the terms of the cash collateral order.

Meanwhile, Wells Fargo as administrative agent for the pre-petition second lien lenders had objected to the cash collateral order. It did not want any of the cash collateral to be used to pursue actions against the second lien lenders. Unfortunately for Wells Fargo and the second lien lenders, Section 5.2 of the Intercreditor Agreement said that if the holder of the first-priority lien consented to the use of cash collateral, then the second lien lenders would be deemed to have consented to the use of cash collateral.

In addition to various procedural arguments, the United States District Court for the Southern District of Florida, in its decision on 5 February 2009, in *Aurelius Capital Master, Ltd. v. Touse Inc.*, held Wells Fargo to the terms of the Intercreditor Agreement. Finding that Wells Fargo had no standing to pursue its appeal of the cash collateral order because it was deemed to have consented to it, the District Court said: “pursuant to Article 5.2 of the Intercreditor Agreement, Wells Fargo is barred from ‘request[ing] any form of adequate protection or any other relief in connection with the use of the cash.’ Put differently, Wells Fargo has bargained away its right to object by entering into the Intercreditor Agreement.”

The District Court recognised Wells Fargo’s argument that the Inter- ▶▶

creditor Agreement could not be used in the case to reflect its consent because only the agent for the first lien lenders was entitled to enforce the applicable provision of the Intercreditor Agreement, but found this reasoning unpersuasive because the District Court was not relying on the enforcement of the agreement per se, but merely using it to support the legal conclusion that the cash collateral order was consensual. Notwithstanding that this reasoning by the District Court may not be absolutely clear, its conclusion that Wells Fargo would be bound by the agreement certainly was.

In re ION Media Networks, Inc., the issue under the Intercreditor Agreement arose because the assets of the debtors included broadcast licences granted to them by the Federal Communications Commission. As a result of the federal law that governs them, such FCC licences have generally been held to not constitute property that may be subject to the lien of a creditor. On this basis, Cyrus Select Opportunities Master Fund Ltd., as a second lien creditor, argued that the FCC licences were not 'collateral' within the meaning of the term in the Intercreditor Agreement. Cyrus said that, although the Intercreditor Agreement prohibited Cyrus from commencing any action to challenge the liens of the first lien lenders in any 'collateral,' such provision did not apply to the FCC licences.

Just as the district court did in *Tousa*, the bankruptcy court in *ION* turned to the provisions of the Intercreditor Agreement. The Intercreditor Agreement said that the lien priorities, as between first lien lenders and second lien lenders, would not be affected or impaired on account of any non-perfection of any lien 'purportedly securing' any of the secured obligations. On this basis, the bankruptcy court concluded that the FCC licences 'purported' to secure the first lien debt and therefore constituted 'collateral' within the definition.

Cyrus also objected to the plan of reorganisation agreed to by the debtors and the first lien lenders. Here again, the bankruptcy court pointed to the specific sections of the Intercreditor Agreement that said that the second lien lenders may not oppose, object to or vote against any plan of reorganisation, which was consistent with the rights of the first lien lenders.

Based on the provisions of the Intercreditor Agreement, as to both the challenge to the liens of the first lien lenders on the FCC licences and the objection to the plan, the bankruptcy court concluded that Cyrus lacked standing.

The decision noted that some courts have refrained from enforcing a creditor's waivers of bankruptcy rights in a pre-bankruptcy intercreditor agreement. But the bankruptcy court judge gave resounding support for the enforcement of intercreditor agreements in a bankruptcy case stating that the Intercreditor Agreement is strictly enforceable in accordance with its terms and is an enforceable contract under Section 510(a). "Giving effect to the plain language of the Intercreditor Agreement in this manner also reinforces general principles of public policy. 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."

The decisions in *Tousa* and *ION* provide further comfort to lenders that the express terms of their intercreditor agreements will be enforced by the bankruptcy court as part of a bankruptcy case. ■

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