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Client Alert

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Bankruptcy Court Enforces First Lien/Second Lien Intercreditor Agreement to Bar Second Lien Lender from Challenging Validity of Security Interest and Objecting to Plan of Reorganization

"The *Ion Media* decision provides an example how such agreements can prove invaluable to first lien lenders, and provides some comfort that they will be enforced in the context of a bankruptcy case."

One of the common features of intercreditor agreements in first lien/second lien transactions is the waiver by the holders of the second lien obligations of certain rights in the borrower's bankruptcy case. The rights that the second lien lenders waive almost always include the right to challenge the validity of the lien granted to secure the first lien claims, and sometimes include the right to object to a plan of reorganization that the first lien lenders support. The parties to these agreements no doubt intended that such waivers be effective; however, given that these agreements had never been tested in a bankruptcy case, there was no certainty that a bankruptcy court would in fact enforce the waivers. Now, for the first time, a bankruptcy court has addressed the issue head on and given an answer.

On November 24, 2009, the Bankruptcy Court for the Southern District of New York issued a ruling in *In re Ion Media Networks et al.* enforcing an intercreditor agreement between first lien and second lien lenders to bar the second lien lender from (i) challenging the validity of the first lien lenders' purported lien on certain property of the debtors, (ii) challenging the priority scheme established by the governing loan documents and (iii) objecting to confirmation of a plan of reorganization that was consistent with such priority scheme and did not satisfy the first lien lenders' claims in full. While this is only one decision (albeit by an important bankruptcy court) and there is no assurance that it will be followed by other bankruptcy courts, nonetheless the decision should help assuage concerns over whether bankruptcy courts will enforce a junior lender's prospective waiver of standing to contest the validity of a senior lender's purported security interest and the priority scheme established by the governing loan documents.

Background

In the last deal era, from 2005 to 2008, companies who accessed the financial markets frequently divided interests in their property among secured lenders by granting first and second lien interests to separate lender groups. Intercreditor agreements typically govern the relationship between first and second lien lenders. From the first lien lender's perspective, the intercreditor agreement functions as, among other things, (i) the second lien

lender's acknowledgement that its right to the collateral securing the borrower's obligations is fully subordinated to that of the first lien lender and (ii) the second lien lender's waiver of the right to argue otherwise in a legal proceeding, including a bankruptcy. Accordingly, the first lien/second lien intercreditor agreement often contains broad language precluding second lien lenders from contesting the respective lenders' priority in the collateral and from challenging the validity of the first lien lender's interest in the collateral.

To further protect the integrity of the first lien lender's interest in the common collateral, intercreditor agreements frequently provide that the second lien lenders waive their right to raise certain issues in the borrower's bankruptcy. For example, it is common that the second lien lenders waive their right to object to certain types of priming debtor-in-possession financing, and waive their rights to the receipt of adequate protection by the first lien lenders. At times those waivers go further, and can include a waiver of the right to object to a sale of assets under section 363 of the Bankruptcy Code supported by the first lien lenders and even the right to object to a plan of reorganization supported by the first lien lenders.

In December of 2005, Ion Media Networks and certain of its affiliates (collectively, Ion Media) entered a first lien/second lien financing, with a Security Agreement and an Intercreditor Agreement governing the relationship between the first and second lien lenders (respectively, the First Lien Lenders and the Second Lien Lenders). The Intercreditor Agreement contained an acknowledgment that the First Lien Lenders' first priority interest in the collateral was senior to the Second Lien Lenders' second priority interest and an acknowledgement that such priority scheme would not be affected or impaired by the nonperfection of a lien purportedly securing the obligations. The agreement stated, in relevant part, "Each of the Secured Parties acknowledges and agrees (x) to the relative priorities as to the Collateral (and the application of the proceeds therefrom) as provided in the Security Agreement . . . and acknowledges and agrees that such priorities (and the application of proceeds from the Collateral) shall not be affected or impaired in any manner whatsoever including, without limitation, on account of . . . (iii) any nonperfection of any lien purportedly securing any of the Secured Obligations (including, without limitation, whether any such Lien is now perfected, hereafter ceases to be perfected, is avoidable by any bankruptcy trustee or otherwise is set aside, invalidated, or lapses)."

Additionally, the terms of the Intercreditor Agreement prohibited the Second Lien Lenders from contesting the validity, priority or enforceability of the liens granted to the First Lien Lenders in the event of a Chapter 11 filing by any of the parties granting security interests and from objecting to a plan of reorganization the terms of which were consistent with the priority scheme established by the Security Agreement.

These provisions, and in particular the acknowledgment of priority notwithstanding the validity of liens "purportedly securing" Ion Media's obligations, proved invaluable to Ion Media's First Lien Lenders in light of the unique nature of certain Ion Media property. Ion Media held FCC broadcast licenses, and though the Security Agreement purported to grant the lenders a lien on Ion Media's FCC licenses, applicable law limits the extent to which a security interest in FCC licenses may be granted. Thus, while the Security Agreement expressly included "FCC Licenses" within the definition of "Collateral," it expressly excluded any "license agreement" to the extent applicable law "prohibited the creation of a security interest therein." Yet the aforementioned provisions of the Intercreditor Agreement helped the First

Lien Lenders combat an argument by a Second Lien Lender that the collateral package did not include the FCC licenses.

In Ion Media's Chapter 11 Cases, Second Lien Lender Attacks Validity of Liens on FCC Licenses

Viewing the legal limitation on grants of security interests in FCC licenses as a potential hole in the First Lien Lenders' collateral package, Cyrus Select Opportunities Master Fund, Ltd. (Cyrus) purchased deeply discounted second lien debt on the theory that it would share, on a *pari passu* basis, the value of the FCC licenses — unencumbered assets — with the First Lien Lenders and any other creditors of the entities holding the licenses. Ion Media filed for Chapter 11 protection in the Southern District of New York on May 19, 2009, and Cyrus voiced its theory early in the case, objecting to Ion Media's motion for debtor-in-possession financing on the grounds that the financing contained an improper roll-up of liens on the FCC licenses.

On August 19, 2009, Ion Media filed a plan of reorganization (the Plan), which provided a roughly 50 percent recovery to the First Lien Lenders and a modest payoff to Second Lien Lenders and general unsecured creditors. On the date it filed the Plan, Ion Media also commenced an adversary proceeding seeking to enjoin Cyrus from (i) contesting the validity of any security interest granted to the First Lien Lenders in any of Ion Media's property, (ii) contesting the priority scheme established by the Security Agreement or (iii) objecting to confirmation of the Plan. On September 19, 2009, Cyrus moved to dismiss the Ion Media complaint and filed its own adversary proceeding against Ion Media and parties to the Security Agreement, seeking a declaratory judgment as to whether the FCC licenses were encumbered by any valid and enforceable security interests. The court consolidated the adversary proceedings, heard oral argument on cross-motions for summary judgment on October 28, 2009 and heard arguments on confirmation of the Plan on November 3, 2009.

Pursuant to Intercreditor Agreement, Cyrus had Waived Standing to Contest Validity of Purported Liens, Priority Scheme and Plan of Reorganization Consistent with Priority Scheme

On November 24, 2009, the bankruptcy court denied relief to Cyrus and confirmed Ion Media's Plan. Most importantly, the court held that Cyrus lacked standing to challenge either the validity of the First Lien Lenders' security interests in the FCC licenses or the priority of the First Lien Lenders' claims *vis-a-vis* those of the Second Lien Lenders. Additionally, it held that Cyrus lacked standing to object to the Plan.

The holding was based on the premise that the Second Lien Lenders provided loans to Ion Media and entered the Security Agreement with full knowledge that the liens on the FCC licenses were arguably invalid, but nevertheless contractually waived their right to contest such validity by virtue of the Intercreditor Agreement. As the court put it, "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." That the lien on FCC licenses might have been invalid was of no moment to the relationship between the First and Second Lien Lenders with respect to purported collateral. The court

found that the Intercreditor Agreement constituted an enforceable contractual waiver of standing to challenge the validity of the liens on FCC licenses and the priority scheme with respect to purported collateral.

Similarly, the court found that Cyrus lacked standing to object to the Plan. As discussed previously, the Intercreditor Agreement directly prohibited such an objection by the Second Lien Lenders, providing, in relevant part: "None of the [Second Lien Lenders] shall . . . (vi) oppose, object to, or vote against any plan of reorganization or disclosure statement the terms of which are consistent with the rights of the [First Lien Lenders] under the Security Agreement" unless the First Lien Lenders have been paid in full. Because the Plan did not satisfy the First Lien Lenders' claims in full, the Second Lien Lenders were contractually obligated to remain silent. The court acknowledged conflicting case law on the issue of whether contractual waivers of the right to vote ones' claim are enforceable, but distinguished those cases from the one at bar, which merely dealt with a contractual waiver of the right to object to a plan. The court determined that the prospective waiver of a right to *object* was fully enforceable. In effect, the court held that Cyrus was free to vote against the plan but could not oppose the confirmation of the plan that it had voted against.

Conclusion

First lien/second lien intercreditor agreements have traditionally included provisions aimed at precluding the second lien lender from later contesting the first lien/second lien priority scheme or the validity of the security interests granted, and sometimes contain broader waivers of the rights that the second lien lenders would otherwise have in a bankruptcy case. The *Ion Media* decision provides an example how such agreements can prove invaluable to first lien lenders, and provides some comfort that they will be enforced in the context of a bankruptcy case.

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