Sit Down, Shut Up and Mind Your Own Business: Controlling Subordinate Lenders in Bankruptcy

BY ROCCO I. DEBITETTO

As the senior lender, your rights to recoup your funds should be top priority during bankruptcy proceedings. But those pesky subordinate lenders often get in the way. Rocco I. Debitetto explains the best way to craft an intercreditor agreement that forces subordinate lenders to "sit down, shut up and mind their own business" until you get paid.

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Growing up, our family abided by the mandate, "sit down and shut up." For example:

"But Mom, I don't want *meatloaf* for dinner!"

"Sit down and shut up."

"Mind your own business" seldom lagged far behind. Case in point:

"Mom, you should tell your friend to stop smoking Pall Malls around her oxygen tank."

"Mind your own business."

Ultimately, the mandates weren't bad. I've gone further in life just by sitting down, shutting up and minding my own business than by doing virtually anything else. Not surprisingly, the mandates apply to asset-based lending, particularly when you're forced to share a borrower with subordinate lenders. Controlling these meddlesome bedfellows is critical, especially in bankruptcy where those emboldened with a "nothing-to-lose" attitude can undermine you. A good intercreditor agreement goes a long way toward getting these folks to sit down, shut up and mind their own business.

Intercreditor agreements come in all shapes and sizes. Just when lawyers think they've seen the most draconian one ever, some grizzled loan officer conjures up new and innovative terms to shock the conscience (Believe me; law firms aren't driving this sort of progress in financial neutering). Here are the essentials you'll want in your intercreditor agreement when the bankruptcy soiree gets underway.[1]

Automatic Stay/Adequate Protection

Intercreditor agreements should forbid subordinate lenders from seeking relief from the bankruptcy stay or from seeking adequate protection of their collateral through avenues like replacement liens on post-petition collateral or periodic payments. At a minimum, they should provide that your prior consent is required for any such undertaking.

Restricting subordinate lenders' ability to seek relief from the automatic stay or adequate protection helps ensure that you don't have to incur the expense of defending your rights, which they already agreed are superior to theirs. It also undercuts a common tactic for secured lenders to exert control over a debtor and its exit strategy, and helps keep cash in the estate for other uses, namely paying you.

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Chapter 11 Plans

To confirm a plan under which one or more classes of claims is impaired (not paid in full), at least one impaired, non-insider class must accept it.[2] This is Congress's way of saying, "It's okay to short *everybody* as long as *somebody* getting shorted is OK with it." Recognizing this, intercreditor agreements should provide that you have the authority to vote subordinate lenders' claims for (or against) any plan or, alternatively, direct subordinate lenders to vote however you instruct. Thus, if you find yourself with a plan under which you're unimpaired (paid in full), your subordinate lender — who's getting two cents on the dollar, by the way — nevertheless will have to help deliver that impaired, consenting class necessary for confirmation.

Controlling voting is just the start. A debtor has the exclusive right to propose a plan of reorganization during the first 120 days of a Chapter 11 filing,[3] after which almost *anybody* can propose one. Intercreditor agreements should prohibit subordinate lenders from proposing their own plans or only allow this with your consent to the terms of the plan itself. Intercreditor agreements also should contemplate the possibility of you proposing a plan (even one conveying the simple message, "I get everything," through 50 pages of masterful legalese), by providing that subordinate lenders will support — with a smile — any plan you propose.

Proofs of Claim

Intercreditor agreements should authorize you to file proofs of claim on behalf of subordinate lenders and provide for their full cooperation in the process. This is important. If a subordinate lender drops the ball on filing a proof of claim, then > >

1 These are in addition to standard debt and lien subordination provisions, which are not unique to bankruptcy.

2 11 U.S.C. § 1129(a)(10)

3 11 U.S.C. § 1121(b)

it might not be entitled to vote on the plan, nullifying any right you have to cast or control that vote.

No Pursuit of Claims

When a borrower files for bankruptcy, all parties' liens and claims, including those of senior lenders, are subject to scrutiny by the debtor and all other creditors and interested parties, such as creditors' committees. You can preemptively restrict at least one of these parties by forbidding subordinate lenders from investigating or challenging the nature, extent, validity or priority of your liens and claims, including by financing, joining in, supporting or accepting any benefit from any such investigation or challenge. You similarly should forbid asserting any claim or cause of action against you in the bankruptcy, such as avoidance actions (preference claims) under Chapter 5 of the Bankruptcy Code.

Desperate subordinate lenders often recruit unlikely allies to fight wars for them. This includes Chapter 11 trustees or examiners who might not share a debtor's philosophy that one's sole mission in life is to pay senior lenders (particularly those holding personal guaranties) in full.

DIP Financing/Cash Collateral

Perhaps the most opportune time for senior lenders to set the right tone for a Chapter 11 proceeding is in connection with a debtor's request for post-petition financing or ability to use cash collateral. At this point, a senior lender can secure critical protections and concessions in connection with the bankruptcy, such as releases and milestones for asset sales or plan confirmation. Intercreditor agreements should provide that subordinate lenders will not object to the terms, conditions or amounts of any DIP financing by you or to an agreed upon use of your cash collateral. Similarly, intercreditor agreements should prevent subordinate lenders from offering, extending or participating in DIP financing or allowing (or seeking to prohibit) use of their own cash collateral unless you agree.

Conversion/Dismissal

Believe it or not, you might find yourself in a position where you're better off with a borrower safely ensconced in Chapter 11. Consider the alternatives: Chapter 7, where a sharp trustee might want nothing more than a pound of your flesh (and that's after lunch) or outside of bankruptcy, where your borrower finally is free to commit all those financial sins it sorely missed while under the bankruptcy court's watchful eye. Accordingly, intercreditor agreements should prohibit subordinate lenders from seeking to convert a bankruptcy from one chapter to another or to dismiss filing altogether.

Asset Sales

Many bankruptcies entail sales of substantially all of the debtor's assets. Intercreditor agreements should prohibit subordinate lenders from supporting or contesting any use, sale or lease of assets (including bid and sale *procedures*) without your consent. On the other hand, upon your request, you should require their support of any such use or disposition. Further, you should acquire control over subordinate lenders' rights to credit bid their secured claims.[4] These restrictions help ensure that subordinate lenders, who might be facing a significant air ball after an underwhelming sale, cannot impede a transaction that otherwise generates a meaningful return for you.

Shut Down the Allies

Desperate subordinate lenders often recruit unlikely allies to fight wars for them. This includes Chapter 11 trustees or examiners who might not share a debtor's philosophy that one's sole mission in life is to pay senior lenders (particularly those holding personal guaranties) in full. Intercreditor agreements accordingly should prohibit subordinate lenders from seeking or supporting the appointment of Chapter 11 trustees or examiners of any kind.

No 1111(b) Elections

Subject to limited exceptions, an under-secured creditor may elect to have its *entire* claim treated as fully secured under a plan.[5] Without belaboring what's infamously known as the "1111(b) election," suffice it to say that, if exercised, it can dramatically alter the landscape of what otherwise should be a confirmable plan (and potentially a plan you support). Pluck this arrow from your subordinate lender's quiver by prohibiting 1111(b) elections.

Payment Termination and Turnover

Should you find yourself in a situation where you have to swallow hard and allow a subordinate lender to receive some sort of payments to book a deal, your intercreditor agreement nevertheless should provide that this charity stops in bankruptcy. It also should provide that any payments received by a subordinate lender in violation of the agreement, for example adequate protection payments or collateral proceeds, are held in trust by them for your benefit and bear interest.

A trust relationship generally cannot be created unless the borrower also is a party to your agreement. If you cannot secure the borrower as a party, then your agreement should provide that prohibited payments will be applied by the subordinate lender to its debt and then turned over to you. The subordinate lender should then be subrogated to your rights under your loan for exercise only after you are paid in full.

A Note on Enforceability

In bankruptcy, "[a] subordination agreement is enforceable . . . to the same extent that such agreement is enforceable under [state] law."[6] This is significant because "subordination agreement" doesn't necessarily mean "intercreditor agreement with subordination provisions [*and* a buffet of pro-senior terms]." Should that stop you from including them? Probably not. But at least know that these terms, which are "ancillary" to traditional debt and lien subordination, have been questioned and, in some cases, not enforced by bankruptcy courts.

To help enhance the enforceability of your intercreditor agreement, do three things: First, make sure the agreement contains choice-of-law provisions, selecting the state law most favorable for enforcement, particularly as it relates to those "ancillary" terms nearest and dearest to you. Second, if possible, make the borrower a party to the agreement. Finally, ensure that the agreement is clear and unambiguous. Ambiguity is a way subordinate lenders commonly escape the enforcement of the agreement in bankruptcy court.

Hopefully now you'll have no problem getting subordinate lenders to sit down, shut up and mind their own business in bankruptcy. If they don't, just call my mom. She'll hit them on the head with a spoon for you.

I love that woman. abfj

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4 11 U.S.C. § 363(k).

5 11 U.S.C. § 1111(b)(1)(A)(i).

6 11 U.S.C. § 510(a)