WILL SECOND LIEN LENDERS BE QUIET NOW?

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To Our Clients and Friends:

In a recent decision in the chapter 11 case of ION Media Networks, Inc., Judge James M. Peck of the United States Bankruptcy Court for the Southern District of New York upheld certain waivers of rights by second lien lenders in an intercreditor agreement. The court ruled that the plain language of the contract and creditor expectations required that the objecting second lien lender, Cyrus Select Opportunities Master Fund Ltd., be denied standing to challenge the first lien lenders' liens and priority and to oppose the debtors' plan of reorganization.

Last week, the United States District Court for the Southern District of New York denied Cyrus's motion for stay pending appeal of the bankruptcy court's order confirming the debtors' plan of reorganization. The Second Circuit Court of Appeals then temporarily stayed the confirmation order pending its review of the motion for stay, giving new life to Cyrus's attempts to block plan confirmation.

We will be monitoring and reporting on developments in this case. However, even if the Court of Appeals agrees with the lower courts' analysis, it remains to be seen what impact these decisions will have on intercreditor dynamics in cases involving second lien debt going forward.

BACKGROUND

In a 2005 financing, the debtors granted a security interest to their first and second lien lenders in certain of their assets, expressly including FCC broadcast licenses. However, the grant also excluded any property to the extent that applicable law prohibited the creation of a security interest therein. The intercreditor agreement governing the relationship between first and second lien lenders provided that second lien lenders could not challenge first lien lenders' priority as to the collateral (due to, among other things, non-perfection of any lien "purportedly" securing first lien debt) or object to a reorganization plan if its terms were consistent with the rights of first lien lenders.

The debtors commenced their chapter 11 cases to implement a restructuring that had the support of first lien lenders and the official committee of unsecured creditors. Under the proposed plan, first lien lenders were to receive nearly all of the equity in the reorganized company. The plan's sole objector was Cyrus, which had purchased second lien debt "for pennies on the dollar." During the proceedings, Cyrus repeatedly argued that the FCC licenses were not part of the collateral because applicable law prohibited the debtors from granting a security interest in the licenses and, therefore, their value should be shared *pari passu* among all first and second lien lenders.

BANKRUPTCY COURT DECISION

The bankruptcy court confirmed the plan of reorganization over Cyrus's objection, holding that the FCC licenses constituted "purported" collateral as the term was used in the intercreditor agreement. According to the court, the transaction documents clearly gave first lien lenders priority as to the economic value of the licenses, regardless of the validity of liens in the licenses. Giving effect to the "plain language" of the intercreditor agreement, the court found that Cyrus did not have standing to challenge the first lien lenders' liens or priority or to object to the proposed plan, which was consistent with first lien lenders' rights because it allocated substantially all of the debtors' value to them.

The court's frustration with Cyrus's aggressive litigation strategy is evident from the decision. The court emphasized that enforcing the clear terms of intercreditor agreements will minimize potential wasteful and vexatious litigation. Suggesting that the "high risk strategy" of deliberately ignoring the provisions of the intercreditor agreement made Cyrus potentially liable for breach of contract, the court noted that the increased administrative expenses caused by Cyrus might be a measure of damages to be claimed against Cyrus to the extent that these expenses are traceable to violations of the intercreditor agreement.

IMPLICATIONS

Faced with a similar intercreditor agreement and a more sympathetic objecting party, a court might come to a conclusion different than that reached by Judge Peck. In particular, a court might be reluctant to enforce provisions of an intercreditor agreement that would prevent second lien lenders from taking actions that would be in the best interest of the estate or from otherwise raising legitimate concerns about the proceedings.

Consequently, second lien lenders may still decide that they have little to lose by ignoring restrictions in their intercreditor agreements, particularly when their objections may benefit, and have the support of, unsecured creditors. But Judge Peck's allusion to the possibility of liability for damages in those circumstances should at least give second lien lenders reason to pause in the future.

In addition, Judge Peck commented that certain courts have refused to enforce, on public policy grounds, waivers of creditors' right to vote on a plan of reorganization. Distinguishing these decisions from the case at hand, the court observed that Cyrus's right to vote or to appear as an unsecured creditor was not limited by the intercreditor agreement. This observation suggests that waivers of these rights should be analyzed differently, leaving the door open for second lien lenders to argue that not all waivers should be equally enforceable. However, Judge Peck's view of unsecured creditors' right to appear in a case may be quite limited if, as his decision implies, such right does not include standing to object to a plan of reorganization.

Please click here to view the bankruptcy court's opinion.

For a detailed discussion of second lien financings in bankruptcy, please click here.

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