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Cross-Collateral/Cross-Default Loans: Structuring and Documenting Transactions

Negotiating Intercreditor Agreements, Resolving Priority Disputes, Overcoming Enforcement Challenges Post Default or Bankruptcy

WEDNESDAY, FEBRUARY 11, 2015

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Cross-Collateral/Cross-Default Loans: Structuring and Documenting Transactions

February 11, 2015

R. Todd Ransom and Craig S. Unterberg haynes boone

Setting precedent

This material does not constitute a legal opinion or advice related to any of the subjects or topics mentioned herein.

It is only an informative overview of the subject matter.

Cross-Collateral/Cross-Default Loans: Structuring and Documenting Transactions
Overview of Topics

- Structuring and documenting cross-collateralization and crossdefault loans
- Enforceability of cross-collateral provisions after default
- Enforceability of cross-collateral provisions in bankruptcy

Structuring and Documenting Cross-Collateralization and Cross-Default Loans

Overview of Different Cross-Collateralization and Cross-Default <u>Structures</u>

- Cross-collateralization and cross-defaults of different assets of same debtor for multiple obligations
- Cross-collateralization and cross-defaults between Parent Company and Subsidiary
- Cross-collateralization and cross-defaults among affiliated entities

<u>Cross-Collateralization and Cross-Defaults of Different Assets of Same Debtor for Multiple Obligations</u>

- In these situations, Debtor enters in a loan with Lender A secured by a specific piece
 of property, and the security agreement or deed of trust contains broad language
 regarding the secured obligations that is intended to pick up all other debt owed to
 that secured party.
- Debtor then obtains a second loan from Lender A secured by a different piece of property, and that security agreement or deed of trust also contains broad language regarding the secured obligations that is intended to pick up all other debt owed to that secured party.
- In addition, both of the loans made by Lender A contain cross-default provisions that are triggered if any loan made by Lender A to that Debtor is in default.

Cross-Collateralization and Cross-Defaults Between Parent Company and Subsidiary

- In these situations, Debtor A enters into a loan with Lender A.
- Debtor A's subsidiary, Debtor B, also enters into a financing relationship with Lender A (e.g., treasury management, letter of credit facility).
- Debtor A guarantees Debtor B's obligations to Lender A, and Debtor B guarantees Debtor A's obligations to Lender A. Here, both of those guaranties are secured by the assets of Debtor A and Debtor B, respectively.
- In addition, the financing documents for Debtor A and Debtor B are also crossdefaulted to each other.

Cross-Collateralization and Cross-Defaults Among Affiliated Entities

- These structures are more bespoke, but could be between a principal and his company or between two affiliated companies.
- These structures need to be analyzed carefully due to fraudulent transfer concerns

Primary Issues when Structuring Cross-Collateralized Facilities

<u>Cross-Collateralization and Cross-Defaults of Different Assets of the Same Debtor for Multiple Obligations</u>

The Dragnet Clause

- These clauses are used to pick up additional obligations owed to a creditor that are outside the specific loan facility.
- We will discuss the effectiveness and enforceability of these provisions in more detail later in the presentation.

<u>Intercreditor Issues</u>

Types of Collateral

- It is important to be aware that there are different issues that arise in relation to different types of properties:
 - Personal Property
 - Property excluded by the U.C.C.
 - Real Property

Due Diligence

- It is necessary to conduct proper due diligence on potential collateral to see if there are existing cross-collateralization rights.
- Certain types of collateral should be flagged for additional due diligence (e.g. deposit and securities accounts).

Collateral Due Diligence

- Request perfection certificate
- Determine if any unpledged assets exist
- Determine the current perfection status, and whether any defects in perfection exist by running U.C.C. searches and real property records

Types of Cross-Default

- Payment vs. covenant defaults
- Threshold amounts
- Cross-defaults with affiliates of lender
- Cross-acceleration
- Swap agreements
- Grace periods and waivers when underlying default cured



Cross-Collateralization Among Multiple Debtors

- Differences between upstream, downstream and cross-stream guaranties/pledges
- Structuring issues related to Fraudulent Transfer
- Covenants and provisions to prevent additional exposure on structural issues
- Potential fiduciary duty concerns regarding cross-collateralization and cross-defaults

<u>Differences Between Upstream, Downstream and Cross-Stream</u> <u>Guaranties/Pledges</u>

- Upstream
- Downstream
- Cross-stream Guaranties/Pledges

Structuring Issues Related to Fraudulent Transfer

Overview of Fraudulent Conveyance Actions

- A fraudulent conveyance is the fraudulent transfer of property. The term transfer encompasses every mode of parting with an asset or interest in an asset, including:
 - Payment of money
 - Taking new collateral
 - Guaranteeing an obligation
 - Analyze specific state laws

Effect of a Fraudulent Conveyance

- Set aside transfer
- Judgment for value of transferred asset
- Other relief as required by the circumstances

Constructive Fraudulent Conveyance

There is no requirement to show intent to commit fraud

Elements

- Transfer is for less than "reasonably equivalent value;" and
- The transferor:
 - Was insolvent or rendered insolvent by the transfer;
 - Intended to incur or believed it would incur debts beyond the transferor's ability to pay as they matured; or
 - Was engaged in business or a transaction, or was about to engage in business or a transaction, that left transferor with unreasonably small capital.

How to Determine "Reasonably Equivalent Value"

- Minority per se rule: The transfer of an interest in collateral to secure an antecedent debt constitutes a transfer for reasonably equivalent value. The value of the collateral is therefore irrelevant since the collateral only secures the amount of the debt.
- Majority fact-driven analysis: a majority of courts use factual analysis to determine whether reasonably equivalent value has been given in exchange for collateral securing antecedent debt. These courts typically:
 - compare the value of the collateral transferred by the debtor to the value received by the debtor for the transfer; or
 - compare the value of the collateral transferred by the debtor to the amount of the antecedent debt.

Covenants and Provisions to Prevent Additional Exposure on Structural Issues

- Change of control
- Savings clause
- Solvency representations

Potential Fiduciary Duty Concerns Regarding Cross-Collateralization and Cross-Defaults

 Potential issues may arise when cross-collateralization or cross-default occurs among debtors with different investors and/or owners.

Key Provisions of Intercreditor Agreements

February 11, 2015



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Biography

Mark B. Joachim

Experience

Mark B. Joachim is a Partner in the Washington, D.C. and New York offices of Arent Fox LLP. Mark regularly advises a variety of financial institutions, including specialty finance companies, business development companies, investment banks, commercial banks, asset-based lenders, funds, private equity firms, and other parties in structuring and implementing complex corporate and financing transactions. In addition, he has extensive experience representing lenders, bondholders, official and unofficial committees of creditors, indenture trustees and debtors in connection with bankruptcy cases and out-of-court restructurings. His multifaceted experience also includes the purchase and sale of distressed businesses, and the financing of such transactions.

Representative Matters

- -- A Second Lien Indenture Trustee in the Caesars Entertainment chapter 11 cases
- -- The Official Committee of Unsecured Creditors in the Cengage Learning chapter 11 cases
- -- The First Lien Term Lenders to The Newark Group in its recent successful refinancing transaction
- -- A major bondholder and DIP lender in the Spectrum Brands cases
- -- The senior secured lenders in the successful out-of-court restructuring of American Media
- -- The second lien lenders in international insolvency proceedings for TOUSA, Inc., a leading home builder and financial services company
- -- An ad hoc committee of bondholders in the restructuring and exit financing of Tembec, a leading Canadian-based international forest products company
- -- The second lien lenders in international insolvency proceedings for Dura Automotive, the world's largest independent designer and manufacturer of driver control systems



Biography

Mark B. Joachim

Education

- -- J.D., with distinction, Hofstra University School of Law, 1992
- -- B.A., State University of New York at Stony Brook, 1989

Bar Admissions

- -- New York
- -- District of Columbia
- -- California
- -- Massachusetts

Noteworthy

- -- New York/Washington, D.C. Super Lawyer, 2006, 2007, 2011-2015
- -- Managing Editor, Hofstra Law Review, Hofstra University School of Law, 1991-1992



Key Provisions of Intercreditor Agreements



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Issue	Second Lien Position	First Lien Position
 Definition of "Collateral" or "Common Collateral"? Determines which assets the subordination and standstill provisions apply to Some Alternatives: Anything in Firsts' granting clause (whether or not valid, perfected) Anything in Firsts' granting clause in which Firsts' have "at any time" a security interest Anything in Firsts' granting clause in which Firsts' have "at any time" a perfected security interest Anything in which, at any time of determination, both Firsts and Seconds have a valid and perfected security interest Anything in which, at any time of determination, both Firsts and Seconds have a valid and perfected security interest not subject to avoidance as a preferential transfer or otherwise by the debtor or a trustee in bankruptcy 	 Only collateral in which, at any time of determination, both Firsts and Seconds have a valid and perfected security interest not subject to avoidance as a preferential transfer or otherwise by the debtor or a trustee in bankruptcy (Preferred Definition) Consider "Meridian Problem" (First's mistakenly fail to maintain perfection; Seconds effectively "insured" validity of Firsts' lien, creating payment subordination) If Firsts' lien avoidable, subrogation rights of Seconds are effectively to an unsecured claim All property that is not subject to a valid, perfected and unavoidable lien of the Firsts or the Seconds, the value of which would be shared <i>pari passu</i> with general unsecured creditors, should be likewise shared <i>pari passu</i> with the Seconds All collateral that is not subject to a valid, perfected and unavoidable lien of the Firsts, but is subject to a valid, perfected and unavoidable lien of the Seconds (but not as a result of a breach of the Intercreditor Agreement) should not be subject to the payment turnover, and in any event the payment turnover should not require the Seconds to receive less than they would have received if the Firsts had properly created and perfected their liens 	 Many current forms include anything in Firsts' granting clause from time to time (whether or not valid or perfected or unavoidable) Lien priority not affected by avoidability in bankruptcy (the "Meridian Problem")



Issue	Second Lien Position	First Lien Position
2. Impact on lien subordination of avoidance or disallowance of claims of Firsts (e.g., disallowed interest (particularly default interest), fees, expenses)	 Priorities only apply to allowable claims (avoids Seconds inheriting a worthless or non-existent subrogation claim for things like disallowed post-petition or default interest) not in excess of any applicable First Lien Cap Allow exception (i.e., interest still "accrues as against the Seconds") where disallowance of interest results from Firsts and Seconds being deemed to hold a common lien resulting in Firsts being deemed undersecured, but only to the extent of interest which would have been allowed if Firsts had been awarded non-default interest as oversecured creditor 	Subordination applies to all amounts specified in First Lien documents, regardless of allowability in bankruptcy (i.e., "the deal is that we are paid before you are"). Creates payment subordination, which can be substantial issue.



Issue	Second Lien Position	First Lien Position
3. How are payments outside common collateral proceeds treated and applied? (lien subordination vs. payment subordination)	 Allow scheduled payments of interest (standard) and principal (negotiated, depending on scope of Common Collateral and source of payments) Payments not restricted other than from enforcement actions against Common Collateral or from Common Collateral following Event of Default on Firsts Add express override provision that agreement does not create payment subordination Eliminate all payment subordination provisions (e.g., eliminate provisions such as for recovery of interest "whether or not allowed in bankruptcy") 	 With deepest subordination, no payment of interest or principal on Second's debt until Firsts paid in full (payment subordination) Generally, Firsts will permit scheduled interest payments on Seconds' debt If payment of principal is permitted, tie to certain financial thresholds for extra cushion If proceeds of Common Collateral received from sale of Common Collateral, turnover to Firsts provided that Firsts have a perfected and unavoidable Lien



Issue	Second Lien Position	First Lien Position
4. Standstill with respect to Seconds' exercise of remedies against and payment blockage from Common Collateral on an Event of Default under Firsts' loans.	 Limit Seconds' standstill period to set period of time (usually 90-180 days) unless Firsts' have commenced (and are diligintly pursuing) enforcement of remedies against a material portion of the Common Collateral (exclude enforcement by set-off from this) Standstill only occurs upon certain "serious" defaults (i.e., payment) No payment blockage, but turnover only for payments from Common Collateral Standstill ends once default is cured Limit multiple standstill periods based on "different" defaults 	 Should seek no time limitation or other restrictions on payment blockage from Common Collateral following a default on, or acceleration of, Firsts' loans Often try to block all post-default payments (which becomes payment subordination)



Issue	Second Lien Position	First Lien Position
5. Restrictions on Seconds' enforcement rights in respect of Common Collateral	 Insist upon right to take actions with respect to Common Collateral to preserve and protect the value of recovery therefrom to the extent it does not interfere with or harm Firsts during standstill Include a "use-it-or-lose-it" provision that forces Firsts to make election of remedies within specified time or forfeit the right to take exclusive future remedial actions Require that Firsts' enforcement actions be against a material portion of the Common Collateral (exclude enforcement by set-off from this) Exclude from restrictions commencement of an involuntary proceeding joined in by Seconds, and other unsecured creditor remedies 	 Similar concerns as in payment blockage standstill period above; Firsts want exclusive right to manage and enforce collateral rights. This is usually fair for a defined period. Include in restriction commencement of an involuntary proceeding joined in by Seconds Proceeds of Seconds' enforcement actions against Common Collateral must be paid over to Firsts (up to any applicable "cap") Reinstate standstill period (i) if bankruptcy petition filed with respect to any debtor, (ii) so long as Firsts are diligently pursuing remedies against any Common Collateral, or (iii) if Seconds' default waived



Issue	Second Lien Position	First Lien Position
6. Reservation of rights of Seconds to exercise rights and remedies as unsecured (or undersecured) creditors (either generally, in accelerating, filing involuntary bankruptcy petition, seeking a judgment or foreclosing on property not constituting "Common Collateral", and other key issues)	 Extremely important Consider issue of conflict between "No challenge of First's lien" and need to determine and resolve scope of Common Collateral If limited, try to be specific as to limitations, not general reference to consistency with intercreditor To the extent possible, seek to preserve right to seek adequate protection, to file competing DIP, propose competing plan, etc. 	 Examine closely, but market is to give this (some forms place filing of bankruptcy into bucket of "collateral actions"; may negotiate limited standstill in this case) More favorable to Firsts is language such as unsecured rights preserved where exercise is in a manner consistent with intercreditor agreement



Issue	Second Lien Position	First Lien Position
7. Restrictions on Seconds' enforcement rights in respect of Seconds' loans (other than with respect to Common Collateral)	 Waiver of enforcement rights only with respect to Common Collateral and only during negotiated standstill period 	 Waiver of enforcement rights only with respect to Common Collateral and only during negotiated standstill period
	 Seconds can obtain judgment and enforce it against assets other than Common Collateral Seconds have ability to accelerate 	 Seconds can obtain judgment and enforce it against assets other than Common Collateral Seconds have ability to accelerate



Issue	Second Lien Position	First Lien Position
8. Scope of First Lien Obligations	 First Lien Obligations should exclude: Amounts not allowed or allowable in an Insolvency Proceeding (failure to exclude this creates payment subordination and loss of subrogation rights of the Seconds) Amounts in excess of any applicable First Lien Cap (capped either at a fixed dollar amount or by reference to a maximum leverage ratio, the Borrowing Base, or other financial test) Where appropriate, Hedging Obligations other than those relating to interest on First Lien Principal Obligations not in excess of any applicable First Lien Cap First Lien Cap should be reduced by the amount of any voluntary or involuntary principal payments (excluding revolver debt in the ordinary course) 	 Any First Lien Cap should include a reasonable amount of flexibility to deal with an emergency situation (including a cushion to allow "protective advances"), or to accommodate a borrower request. Ensure any reinstated First Lien obligations increase First Lien Cap, if cap reduced by prior payment



Issue	Second Lien Position	First Lien Position
9. Implications of a First Lien Cap without any provision for treatment of the excess.	 Expressly exclude from "First Lien Obligations," and subordinate Firsts' lien securing, all interest, fees and other amounts attributable to principal of first lien debt in excess of the First Lien Cap, and any excluded categories, such as hedging obligations Excess over cap to be expressly lien subordinated to the Seconds, creating a third lien tranche and rights comparable to Firsts to be given expressly to Seconds against the excess debt Seconds need adequate protection rights in the event of a DIP financing in excess of the First Lien Cap 	 Merely excluding excess over cap from definition of "First Lien Obligations" does not prevent subordination – the excess first lien debt will still have priority as a matter of law assuming the first lien perfected first. Consider impact of extensions, renewals, financings and upsizing of Second Lien Obligations on third lien status of excess First Lien Obligations over applicable First Lien Cap



Issue	Second Lien Position	First Lien Position
10. Amendments to Seconds' loan documentation without waiver from Firsts	 Firsts' consent not required to restrict increases in interest, fees, etc. on Firsts' debt Firsts' consent not required to restrict grant of additional collateral on Firsts' debt Firsts' consent not required to restrict covenant/default tightening on Firsts' debt Firsts' consent not required to increase amount or type of non-collateral asset dispositions, the proceeds of which are required to be applied to reduce Seconds' obligations (to the extent consistent with Firsts' loan documents) Firsts' consent not required to change 	 Ability to restrict increases in interest, fees, etc. on Firsts' debt without consent from Firsts should be limited Ability to increase interest, fees, etc. on Seconds' debt without consent of the First should be limited Seconds should have no ability to tighten covenants/defaults on Seconds' debt Seconds should have no ability to strengthen mandatory prepayments on Seconds' debt, to shorten the maturity on Seconds' debt or shorten the amortization period of Seconds' debt Seconds have no ability to lower First Lien Cap
	the definition of Borrowing Base or loosen covenants/defaults	Zion Cup



Issue	Second Lien Position	First Lien Position
11. Automatic application to Seconds' security documentation of waivers, consents and amendments (other than releases of collateral or guarantees) given by Firsts under their security documentation	 No, represents an abdication of control over Seconds' security interest Firsts should not be able to disenfranchise Seconds 	Firsts control Common Collateral at both levels, even if it adversely affects Seconds without their consent



Issue	Second Lien Position	First Lien Position
12. Option of Seconds to buy out Firsts (price (at par or premium) and timing (anytime; upon default; upon event of default; upon acceleration))	 Very important right to minimally safeguard Seconds' interests No limit on timing of exercise after trigger event Exclude prepayment premiums from buyout price, perhaps with incremental price if a prepayment premium received by Seconds within some defined time frame (i.e., clawback) Many "form" buyout provisions don't work and fail to address (i) process for multi-party Second lien holders and (ii) L/C's, hedges and bank products exposure: use a well thought out provision Permit buy-out combined with credit bid for excess 	 Firsts should not care if procedure is fast and if enforcement standstill has escape clause for material disadvantage to Firsts Include detailed logistics provisions similar to loan payoffs re: disposition of outstanding letters of credit, cash collateral, etc. upon buy out Consider how to treat hedges and bank products exposure



Issue	Second Lien Position	First Lien Position
13. Ability of Seconds to veto a proposed sale of all or substantially all of the borrower's assets	 Yes, very important, since alternative allows Firsts to negotiate a "give away" of the Seconds' collateral value for a quick deal that pays off the Firsts Fall-back: buy-out rights Seconds preserve right to be heard, and credit bid (subject to buy-out of Firsts), in bankruptcy context 	Often resisted



Issue	Second Lien Position	First Lien Position
14. Waiver by Seconds of right to object to a sale of collateral under § 363(b) of the Bankruptcy Code (outside of the ordinary course) approved by Firsts	 Can disenfranchise Seconds May limit to sales where proceeds go either to Firsts to permanently reduce or to Seconds (with carveout for professional fees if granted in DIP/adequate protection order) Try to preserve unsecured creditor rights to object to sale or process, waive rights only in capacity as holder of lien on Common Collateral (i.e., maintain the right to object to the process, but not the price) Preserve right to credit bid subject to payment in full of Firsts Condition waiver on attachment of Second's liens to (excess) net proceeds with same priority and validity as Seconds' other liens on Common Collateral 	Desire to control process; otherwise, Seconds could just play hold-up and reject any offer that does not pay the Seconds off as well, effectively undoing the lien subordination



Issue	Second Lien Position	First Lien Position
15. Right of Seconds to act separately as proponent of a plan of reorganization	 Very important right Generally, Seconds must have plan proponent right to have maximum value Firsts are protected anyway by § 510(a) of the Bankruptcy Code (which gives force to subordination agreements) and the "absolute priority rule" of § 1129(b)(2) of the Bankruptcy Code 	 Firsts prefer to control plan structure Seconds' plan proponent right must not permit Seconds to challenge status or priority of First's liens if one plan alternative is a First Lien cram-down or plan challenges, or preserves right to challenge, validity of Firsts' lien



Issue	Second Lien Position	First Lien Position
16. Right of Seconds to vote separately on a plan of reorganization	Extremely important to preserve separate voting right; Firsts are protected anyway by § 510(a) of the Bankruptcy Code (which gives force to subordination agreements) and the "absolute priority rule" of § 1129(b)(2) of the Bankruptcy Code	 Firsts' prefer control over plan Seconds' voting rights should not permit Seconds to challenge status or priority of First's liens if one plan alternative is a First Lien cram-down or plan challenges, or preserves right to challenge, validity of Firsts' lien



Issue	Second Lien Position	First Lien Position
17. Limit on type of adequate protection Seconds can receive	 No limitation, provided any lien given is subordinate to any lien of Firsts on same collateral and any administrative priority is subordinate to Firsts administrative priority Seconds likely will have to agree, with such agreement incorporated into the court's adequate protection order, not to require payment in full in cash of administrative claim on confirmation and to allow payment over time (equal to present value of administrative claim); under the Bankruptcy Code, administrative claimants can agree to take less than payment in full, in cash, on confirmation Unlimited right to seek adequate protection (including cash payment of interest and expenses including professional fees) can vastly increase leverage at the outset of a case and at plan confirmation 	 Yes, any lien given Seconds to be subordinate to lien on same collateral given to Firsts No administrative priority since it gives Seconds right to block a Plan unless paid in full in cash, even if subordinated Consider impact of post petition cash interest and expense payment to Seconds – allows payment from the estate prior to Firsts being paid in full Limit Seconds' ability to seek adequate protection to subordinate replacement Liens and subordinate Liens on additional collateral



Issue	Second Lien Position	First Lien Position
18. If Intercreditor Agreement contains advance consent to DIP financing/use of cash collateral (whether provided by Firsts or third parties), what conditions or exceptions to that consent exist	 Is DIP subject to First Lien Cap? Separate DIP cap? If First Lien cap is reduced by paydowns does this block the DIP, if used in roll up? Is DIP covered in First Lien refinancing in a roll up? Exception for provisions in DIP dictating Plan terms Exception for provisions in DIP governing "sale of collateral" terms (to prevent a quick sale that just pays off the Firsts) 	 Firsts likely to push back on each of these issues Firsts will seek broad advance consents from Seconds



Issue	Second Lien Position	First Lien Position
19. Waiver by Seconds of right to accrue postpetition interest (i.e., to extent it is deemed "oversecured")	 Seconds should resist granting such a waiver Alternate - May seek to accrue postpetition interest if Firsts seek or obtain 	Often requested, and usually received to the extent that the Seconds have an equity cushion after giving effect to the Firsts' principal and accrued obligations



Issue	Second Lien Position	First Lien Position
20. Discharge of First Lien Obligations definition - Is it express that distributions pursuant to § 1129(b)(2) of the Bankruptcy Code (i.e., "cram up") do not constitute payment in full?	No, Seconds retain right to proceeds of secured claim even if Firsts are "crammed-up"	Yes



Issue	Second Lien Position	First Lien Position
21. Treatment of Reorganization Securities, debt and/or equity (the "X Clause")	Reorganization Securities to be expressly excluded from "proceeds" of Common Collateral, and permitted to be retained by Seconds	 Reorganization Securities are "proceeds" of Common Collateral to the extent of the value of the Seconds' interest in Common Collateral Reorganization Securities in any event to be subject to Intercreditor Agreement if secured by "Common Collateral" on bankruptcy exit Reorganization Securities received by Seconds on account of Seconds' obligations that constitute a secured claim to be paid to Firsts unless distribution is made under Plan consented to by affirmative vote of all classes composed of the secured claims of Firsts



Key Provisions of Intercreditor Agreements

II. Split-Collateral Intercreditor Agreements



II. Split-Collateral Intercreditor Agreements

Typically, ABL Lender has first lien on working capital assets (such as receivables and inventory) and Term Lender has first lien on fixed assets (such as real estate, equipment and possibly IP and investment property)

Each Lender has corresponding second lien against the other Lender's priority collateral



II. Split-Collateral Intercreditor Agreements

First issue is defining collateral pools (and determining which Lender is first on "other" assets, such as tax refunds, business interruption insurance and other extraordinary receipts)

Other issues unique to split-collateral deals include:

- -- Allocation of proceeds in sale of entire business
- --Standstill period re: exercise of remedies on each other's priority collateral



II. Split-Collateral Intercreditor Agreements

- --Access period during which ABL Lender can enter upon the fixed assets and use IP rights in order to liquidate working capital collateral
- -- Caps in order to limit amount of debt on working capital and fixed assets
- --Typically, ABL Lender presumed to be DIP lender in the event of a bankruptcy, and Term Lender preconsents thereto (subject to customary limitations)
- -- Corresponding buy-out rights are also common



Cross-Collateral/Cross-Default Loans: Structuring and Documenting Transactions

Enforceability of Cross-Collateral Provisions After Default

Treatment of Personal Property

Prior to 2001 and the implementation of the revised Article 9

Courts generally construed dragnet provisions narrowly.

Under U.C.C. §9-204(c)

 A security agreement may provide that collateral secured, or that accounts, chattel paper, payment intangibles, or promissory notes are sold in connection with, future advances or other value, whether or not the advances or value are given pursuant to commitment.

Treatment of Personal Property (Continued)

Official Comment 5 to U.C.C. § 9-204(c)

- Under subsection (c) collateral may secure future as well as past or present advances if the security agreement so provides.
- The parties are free to agree that a security interest secures any obligation whatsoever.
- Determining the obligations secured by collateral is <u>solely a matter of construing the</u> <u>parties' agreement under applicable law</u>.

Treatment of Real Property and Property Excluded by the U.C.C.

Historical Treatment of Dragnet Clauses

- Many courts have expressed a general dislike for dragnet clauses, but will generally
 enforce them if properly drafted.
- Courts, often narrowly construe dragnet clauses in order to avoid unfairness or oppressiveness, especially with respect to consumer borrowers.
- The guiding principal in determining the enforceability of dragnet clauses in most jurisdictions is the determination of the parties' intent.

The Dragnet Clause Intent Analysis

- The intent analysis often comes down to the language itself. Two things to consider are (1) whether the language used was clear and unambiguous, and (2) whether the borrower was aware of and/or acknowledged the provision.
- Generally, boilerplate provisions are not favored by courts because of the likelihood the borrower is not aware of the provision or the provision's potential ramifications.
- A broadly worded dragnet clause may be ambiguous and enforceability may be challenged; however, even a broadly worded clause will be enforced if the court determines the parties intended to cross-collateralize.

The Dragnet Clause Intent Analysis Continued

- Where ambiguity exists, courts will consider the actual expectations of the parties. Factors that have been relevant to various courts in making such determination are:
 - Language and specificity
 - Awareness of borrower
 - Type of loans cross-collateralized
 - Reliance by lender in determining whether to enter into loan agreement

Cross-Collateral/Cross-Default Loans: Structuring and Documenting Transactions

Enforceability of Cross-Collateral Provisions in Bankruptcy

Recent Cases

Arvest Bank v. Empire Bank, 13-6014 (8th Cir. 2014)

Peoples National Bank, N.A. v. Banterra Bank, 719 F.3d 608 (7th Cir. 2013)

Universal Guaranty Life Ins. Co. v. Coughlin, 481 F.3d 458 (7th Cir. 2007)

Arvest Bank v. Empire Bank, 13-6014 (8th Cir. 2014)

- Arvest Bank involves a lien priority dispute in which a couple executed an unsecured guaranty in favor of Empire Bank. They then took a subsequent loan from Empire Bank subject to a deed of trust, which included a dragnet clause defining secured debt to include, among other things, obligations under any guaranty.
- Arvest Bank was a judgment lien creditor and challenged the enforceability of the dragnet clause by claiming it was ambiguous.
- The United States Bankruptcy Appellate Panel for the Eighth Circuit reversed a
 holding by the bankruptcy court that there was a latent ambiguity. The court found
 that the language could not be rendered ambiguous by the statement in the earlier
 guaranty that it was unsecured.

Excerpts

- "The clear purpose of the broad cross-collateralization clause is to cover all debt with that single security interest, without having to list each debt separately. It would defeat the clear purpose of the clause to declare the document ambiguous for failure to specifically identify the debt."
- "Mr. Cook's testimony that he was unaware that the deed of trust might secure other obligations also does not make the language in the deed of trust uncertain or subject to more than one meaning. The language is what it is, whether he was unaware or not."

Takeaways

- The Arvest Bank case evidences the power of the dragnet clause to elevate the priority of an unsecured debt.
- This case also shows how easy it is to miss the dragnet clause.

Peoples National Bank, N.A. v. Banterra Bank, 719 F.3d 608 (7th Cir. 2013)

- People's National Bank involves a lien priority dispute.
- In 2004, Peoples made a loan to debtors secured by a mortgage with a dragnet clause.
- In 2008, a second mortgage was made by Banterra, with knowledge of the first mortgage.
- Banterra was unaware that in 2007, another loan was made by Peoples to the same debtors, secured by a different tract of property, and the mortgage in that transaction made no reference to the 2004 loan from Peoples.

- The court in *Peoples Bank* found that the junior lienholder, Banterra, had <u>actual</u> notice of the dragnet clause and that such clause was <u>unambiguous</u> and contemplated future advances.
- Banterra therefore was on inquiry notice, and obligated to conduct a reasonable investigation as to other loans which may exist and be subject to the dragnet clause.

Takeaways

The Peoples Bank case requires a subsequent lender to have received actual notice
of the contemplated cross-collateralization clause before it is placed on inquiry notice
of additional borrowings that may impact the relative priority of future loans

Questions Raised

- The Peoples Bank court put great weight on the fact that the dragnet clause was on the first page. What would the result have been if the dragnet clause was less prominently displayed clause?
- What constitutes reasonable investigation? What if the lien cannot be discovered by a record search?

Universal Guaranty Life Ins. Co. v. Coughlin, 481 F.3d 458 (7th Cir. 2007)

- Universal Guaranty held that a dragnet clause within a master security agreement was effective, even though a subsequent loan agreement remained silent as to whether pre-existing collateral secured the new advance thereunder.
- If the new loan agreement had affirmatively stated that it was not secured, then an ambiguity would have existed, but it did not.
- No ambiguity or contradiction arises solely as a result of the latter agreement's failure to reference the dragnet clause or restate the pre-existing collateral.

Automatic Stay Relief/Adequate Protection

Automatic Stay

- Section 362(a) of the Bankruptcy Code generally imposes the automatic stay in connection with the filing of a bankruptcy petition, the result of which is a limitation on the ability of a secured lender to exercise its rights and remedies under the applicable loan documentation.
- However, there are a number of instances in which relief from the automatic stay can be obtained by the secured lender, one of which is found in Section 362(d)(2) of the Bankruptcy Code.
- Section 362(d)(2) of the Bankruptcy Code states that the court shall grant relief from the stay if (A) the debtor does not have an equity in such property and (B) such property is not necessary to an effective reorganization.

Automatic Stay (Continued)

- In order to determine whether a debtor has equity in such property for purposes of Section 362(d)(2)(A), it is necessary to determine what obligations such property collateralizes.
- This in turn requires an analysis of the economic impact of any applicable dragnet clause contained in the loan documents creating a security interest in such property.

Adequate Protection

- Sections 362, 363 and 364 of the Bankruptcy Code authorize a court to grant "adequate protection" of a party's interest in property.
- Section 362(d)(1) of the Bankruptcy Code permits a party to seek relief from the automatic stay where its interest in property is not adequately protected.
 - Accordingly, a party is entitled to adequate protection of its interest if the automatic stay prevents it from enforcing such interest.
- Section 363(e) of the Bankruptcy Code permits a party to seek adequate protection of its interest in property when a debtor seeks to use, sell or lease such property.

Adequate Protection (Continued)

- Section 364(d)(1)(B) of the Bankruptcy Code requires a debtor to provide adequate protection to a creditor where the debtor obtains credit or other debt secured by a lien on estate property that is senior to the creditor's lien on such property.
- While what constitutes adequate protection is not specified within the provisions of the Bankruptcy Code, one form of adequate protection can be an equity cushion in the collateral.
 - Determining whether any such equity cushion exists requires an analysis of the economic impact of any applicable dragnet clause contained in the loan documents creating a security interest in such property.

<u>Preferences</u>

Overview of Preferences

- Certain benefits gained by lender may be subject to attack as <u>preferences</u> in a bankruptcy. This applies:
 - To <u>unsecured</u> creditors and <u>under-secured</u> creditors.
 - Only when borrower has declared bankruptcy.

Elements

- Transfer of an interest of the debtor in property.
- Transfer to or for the benefit of a creditor.
- Transfer for or on account of an antecedent debt.
- Transfer made while the debtor is insolvent.
- Time of the transfer was within 90 days before the filing of the petition (or 1 year if to an insider).
- Transfer enables the creditor to receive more than it would in a Chapter 7 Liquidation and had the transfer not been made.

Defending a Preference Action

- "New Value" defenses to a Preference Action:
 - Contemporaneous exchange for new value
 - Subsequent new value

Defending a Preference Action (Continued)

- Payments made in the ordinary course of business:
 - Transfers should not be avoidable as a preference to the extent the transfer:
 - Was made in the ordinary course of business or financial affairs of the debtor and the transferee; or
 - Was made according to ordinary terms.
 - The purpose of this defense is to allow the debtor to continue normal financial relations.
- Purchase Money:
 - Transfers should not be avoidable as a preference to the extent the transfer was made for new value, which is intended and actually used to acquire the property over which the lien was granted (and perfected within 30 days).

Cross-Collateral/Cross-Default Loans: Structuring and Documenting Transactions Further Information



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