"Don't Look Back…"

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In the first installment of this article, which was entitled "CreditorWars In The New Millennium," I discussed some of the changes in the "nature and motivations" of creditor constituencies in bankruptcy cases that I have experienced during some 35 years of practice. I spoke of the emergence of new issues and battlegrounds as a result of these changes. I will address these battlegrounds and issues in greater detail now.

About Baseball and Bankruptcy

I sat down to write this article about two weeks before the start of the 2009 Major League Baseball season. It seemed particularly coincidental and appropriate that, when I was considering the overall theme of this article, inter-creditor disputes in bankruptcy, my thoughts immediately turned to the words of the legendary Satchel Paige, one of the greatest pitchers of all time, who was prevented by racial segregation from playing in the Majors Leagues until the twilight of his career. Like another legendary baseballer, Yogi Berra, Paige was a fountain of quotable suggestions and remarks. His most famous words of advice were almost certainly – "Don't look back. Something might be gaining on you."

While this advice may be especially applicable to track stars who lose a potentially decisive step when they turn their heads to look over their shoulders at mid-race, or aging pitchers who sacrifice the necessary psychological edge when they consider the enhanced skills of rookie phenoms, it is decidedly *not good advice* for lenders that are lining up and taking their respective places on the right-hand side of a borrower's balance sheet. Too often, creditors that rely solely upon the seemingly diamond-hard terms of a pre-bankruptcy subordination or inter-creditor agreement to secure their place in the creditor pecking order find that the provisions of that agreement do not protect them or cannot do so in the event of a bankruptcy. For creditors, the better advice would be something like – "Look both ways. Somebody may be closing in on you."

My Mezzanine Lender Clients

Consider, for the example, a situation in which certain of my clients recently found themselves. They had made an $60 million unsecured "mezzanine" term loan to a company that manufactures and supplies products to residential builders. The loan was made several years ago, at a time when the housing industry was peaking and when no end to the real estate boom was anywhere in sight. The loan was, of course, junior in priority to the loans of a traditional bank group that had funded some $300 million of secured revolving and term loans to the borrower. Those bank loans were secured by duly perfected liens upon all or substantially all of the assets of the borrower. My clients' mezzanine loan was sandwiched between this secured debt and several tranches of subordinated debt, aggregating about $450 million. The subordinated debt was funded largely by hedge and private equity funds.

The mezzanine lenders had considered and knowingly assumed, or thought they had considered, *all* of the risks associated with their mezzanine position. Their rights were governed by both the inter-creditor agreement among the parties and applicable law. Among other things, they understood that, during the pendency of any default by the borrower of its obligations to the senior secured lenders, the seniors could block further payments of principal and interest on the mezzanine loan and could prevent the mezzanine lenders from initiating actions to collect the amount of their claim. They understood also that, in the event of a diminution in the value of the borrower, foreclosure, bankruptcy or forced liquidation, the realizable value of the assets might not exceed the amount of the senior secured debt.

They did not worry about the rights of the subordinated lenders, however. Under an inter-creditor/subordination agreement among the mezzanine lenders and the subordinated lenders, the former had received a host of protective rights and powers, including but not limited to "blocking" rights of the kind described above, the right to be paid in full before any payments were made to the subordinated debt holders, and the right essentially to control the conduct of the subordinated lenders in any bankruptcy case, including but not limited to the right to complete and cast the subordinated lenders' ballots in favor of or opposition to any proposed plan of reorganization. The enforceability of a number of

BANKRUPTCY

these kind of provisions has been called into question by bankruptcy courts in recent litigation arising from the attempted enforcement of such inter-creditor agreements. But the mezzanine lenders did not know this at the time they entered into the inter-creditor agreement.

Moreover, as a separate class of debt, with a unique package of rights, the mezzanine lenders assumed that they would be entitled to constitute their own separate class of claims in the event of a bankruptcy and that they could effectively insist that, unless they were paid in full, no junior class could receive anything under the plan of reorganization. This valuable right, which belongs to each class of creditors in bankruptcy, is called either the "fair and equitable" rule or the "absolute priority" rule.

The Disappearing Mezzanine Loan

Then, the world of these mezzanine lenders changed. First, a group comprised of the same hedge and private equity funds that had acquired the subordinated debt, and certain of their affiliates, acquired the claims of the senior secured lenders. Second, the residential housing market hit the skids. Third, the senior secured credit facility went into default, entitling the holders of the senior debt immediately to foreclose on their collateral at a time when the realizable value of the business was at low ebb. Fourth, the senior secured lenders threatened to foreclose and acquire the business at a price that would be inadequate to repay the mezzanine lenders unless the latter agreed to surrender their mezzanine level notes in exchange for a *pro rata* share of the subordinated debt. In short, the senior secured lenders threatened the mezzanine lenders that, unless the latter abandoned their rights as mezzanine lenders and agreed to exchange their notes for less than a 12% share of the subordinated debt, they would be utterly wiped out in a foreclosure. With this miniscule share of the subordinated debt, the former mezzanine lenders would not only *not* be entitled to constitute their own separate class in the event of a bankruptcy, but they would *not* have a sufficiently large share of the subordinated debt to veto any proposed plan of reorganization.

It was at the time of this threat when I first received a call for help from the mezzanine lenders. I wish I could say that I came to their utter and complete rescue, but that happy ending can come only with the recovery of the economy and housing market. I was able to help however. With carefully veiled and worded allusions to lender liability litigation and a more direct calling of the senior secured lenders' bluff (because even the senior secured lenders feared the effect of a bankruptcy upon the business), I was able to negotiate an interest rate enhancement, "liquidation preference" for the old mezzanine lenders, and a modification of the financial covenants in the senior credit agreement to make it more difficult for the senior secured lenders to declare a default and threaten to foreclose in the future. At the end of the day, the mezzanine class was not eviscerated, despite the best efforts of the senior secured lenders and subordinated lenders.

Satchel Paige's Advice Revisited

The mezzanine class had encountered some non-traditional lenders who were playing the game in accordance with a completely new and different set of rules. The hedge and private equity funds had exploited their dual roles as senior secured lenders and subordinated lenders in an attempt to wipe out, or at least seriously dilute, an entire class of mezzanine lenders.

The "takeaway" lesson for mezzanine or subordinated creditors – "Look both ways, consider some of the *non-traditional* ways in which competing creditor groups can attack your rights, and document the deal protectively."

The "takeaway" lesson for all other parties that get involved in bankruptcy and insolvency situations – "Get good legal counsel. This is a complex world involving many intersecting and, at times, competing, bodies of law."

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