This is the fourth installment in a series of articles that focus on the parties’ actual experiences in cases where second-lien financings have hit the bankruptcy courts. In the third installment printed in the May issue of the Journal, we explored the Atkins Nutritional, Inc., et al. chapter 11 cases.4 This fourth installment explores the Maxim Crane and New World Pasta chapter 11 cases. As a reminder, these reports are purely anecdotal.6 In the prior installments, we explored how Atkins resulted in a confirmed chapter 11 reorganization plan, a continuing business operation, and both first- and second-lien lenders participating in the reorganized company. In contrast, American Remanufactures cratered at the very start—unable to resolve the differences between first- and second-lien lenders on the terms of the debtor-in-possession (DIP) credit facility. The case was converted to a chapter 7 liquidation and the assets sold by the chapter 7 trustee. In our view, nobody benefited by the battle over rights between the first- and second-lien holders contained in the intercreditor agreement.

In this installment, we will see first how Maxim Crane highlights the potential benefits of a negotiated resolution via the bankruptcy process in contrast to the strict enforcement of the contractual rights found in intercreditor agreements. Then we will turn our attention to New World Pasta, which illustrates how the crucial early proceedings in the bankruptcy case may affect the ability of the parties to enforce the provisions of the intercreditor agreement at a later time in the case.

Maxim Crane Works

When first reviewing the Maxim Crane case, the initial question that comes to mind, and which has been posed to these authors, is this: What did the first-lien lenders do wrong in documenting the pre-petition credit facility? After all, the result of the Maxim Crane chapter 11 case was that the senior lenders gave up some of their contractual rights to seniority under the intercreditor agreement and their right to insist upon application of the absolute priority rule and allowed value to flow downhill not only to second-lien lenders (who, given the economics of the case, would have otherwise received nothing), but also to unsecured creditors. The answer surprises many bankers and nontraditional lenders, but should not surprise bankruptcy professionals who have experience with the practical realities of the bankruptcy process. Very simply, the answer is “nothing.” There was nothing “wrong” with the intercreditor document—nor was there any legal weakness in the position of the first-lien lenders. Conversations with counsel involved in the case confirm that the agreement by the first-lien lenders to allow value to trickle down to the second-lien lenders and unsecured creditors was instead driven by their desire to (1) see the case move along quickly, (2) participate in the DIP loan, (3) receive payment more quickly (and with more certainty as to amount) and (4) eliminate risk.

Feature

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To set the stage for this discussion: The debtors, headquartered in Pittsburgh, constituted North America’s largest crane-rental operation. They had an assumed enterprise value of approximately $475 million. Arrayed against that value was debt that totaled about $700 million. The debt was divided into four levels. The senior, or Tranche A lenders, were secured by a first lien on all assets and were owed approximately $475 million. Tranche B held a junior lien on all assets and was owed about $50 million. Tranche C, also secured by a lien on assets, was owed $9.1 million. A fourth level of secured notes was owed about $190 million. Clearly, given the reality of the value of the debtor’s assets and the costs of the reorganization process, no creditors besides those in Tranche A “should” have received anything.

A pre-negotiated plan had been agreed upon prior to the debtors’ bankruptcy filing. It provided that the first-lien lenders would receive a 90 percent recovery with some of that return represented by participation in a new secured credit facility and the balance in most of the equity of the reorganized debtor. The second-lien lenders would receive 9 percent of the common stock of the reorganized debtor plus warrants. Their recovery was represented in the disclosure statement as worth 43 percent of what they were owed. The third level of secured debt was to receive nothing, but that level was controlled by the first-lien lenders through an intercreditor agreement. The fourth level of secured debt was to receive warrants. All of the secured creditors were to receive releases. As the bankruptcy process evolved, the first-lien lenders were able to provide a DIP credit facility that allowed them to earn additional fees resulting in a greater than 90 percent overall recovery for the first-lien lenders. A cash recovery and litigation pool was structured for unsecured creditors that, depending on the litigation recoveries, would return between 24 and 50 percent of what the unsecured creditors were owed. The plan was confirmed six months after the chapter 11 filing, and the reorganized debtor emerged from chapter 11 shortly thereafter.

Back to the initial question posed in this discussion: If the Tranche A lenders were truly senior to the other lenders and their position was slightly underwater, and the intercreditor agreement was enforceable, why would the Tranche A lenders agree to any recovery at all for the junior lenders and unsecured creditors? The answer lies in the first-lien lenders’ recognition of how the bankruptcy process works: Time is short, resources are limited, assets are what they are worth, and, as the American Remanufactures case demonstrates, sometimes it does not make sense to stand on your rights and fight for the sake of fighting. The disclosure statement reveals the first-lien lenders’ dilemma. While the enterprise value of $475 million meant that the senior lenders were just a bit underwater, a chapter 7 liquidation was projected to result in a substantial loss of value where the first-lien lenders would recover only 45 percent of what they were owed. It was obvious that the first-lien lenders wanted—and needed—to find a way to realize a going-concern value and avoid liquidation. To accomplish this goal, the first-lien lenders made the decision to distribute some of that enterprise value to other constituencies but secured to themselves a sure return of substantial proportion. This made the case a relatively brief one, maintained the going-concern value of the business, eliminated any risk that a greater value might have been found by the court in a contested valuation dispute at confirmation, and left them in a position to enhance that recovery if the reorganized debtors’ equity should increase in value. “[A]bsolute priority is often merely a theoretical starting point from which the intercreditor negotiations depart.”7 More often than not, as the Atkins case highlights, parties fare much better when they work together with a recognition of a common goal of maximizing recovery as a whole.

There was simply no reason to believe that the intercreditor agreement in Maxim Crane was anything other than iron-clad and fully enforceable. However, the Maxim Crane first-lien lenders were faced with the same quandary that most senior lenders face when they do not enjoy a recognized and substantial equity cushion in collateral. Absent a negotiated agreement, junior secured and unsecured creditors could use the chapter 11 forum to argue about the validity, priority and amount of the first-lien lenders’ secured claims, contest the terms of the DIP credit facility, contest the valuation of the reorganized debtors, and otherwise cause the chapter 11 case to be expensive, time consuming and bitter. After all, if the junior creditors are not allowed to share in the recovery, there is little for them to lose and much to be gained if they are ultimately successful (even marginally). Certainly, the first-lien lenders might be able to fight back by trying to stand on their rights to absolute priority and seek to enforce the terms of the intercreditor agreement. However, it is not clear that a bankruptcy court will take jurisdiction of disputes between secured creditors over the enforceability of an intercreditor agreement and that would leave the senior lenders with nothing more than a state court breach of contract claim to pursue. Furthermore, unsecured creditors are not party to the intercreditor agreement and are therefore free to raise any of these issues without fear of reprisal from the senior lenders. An enlightened first-lien lender will often be eager to limit the length of the chapter 11 proceeding, cut down on the resultant legal and other professional fees associated with a long and contentious chapter 11 case, and produce a result that exceeds what would happen in a liquidation. The first-lien lenders also might secure to themselves the fees that flow from the DIP credit facility, avoid a costly valuation fight, obtain post-petition releases and secure to themselves the vast majority of the upside represented by control of the equity of the reorganized business.

**New World Pasta, a.k.a. Ronzoni**

New World Pasta8 presents a different story. It’s another Pennsylvania case begun about the same time as Maxim Crane, but this one was in the Middle District of Pennsylvania. No pre-negotiated plan was pursued. Instead, the debtor came into the chapter 11 proceeding with a proposed DIP credit facility to be provided by the first-lien lenders. However, the proposed DIP order contained a clause to which the second-lien lenders objected. It provided:

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8 In re New World Pasta, No. 04-02817 (M.D. Pa. filed May 10, 2004).
The rights and remedies of the pre-petition junior lenders, with respect to the subordinate obligations, if any, shall only be exercised in a manner consistent with and subject to the pre-petition credit agreement and pre-petition participation agreements.

Clearly, the first-lien lenders wanted the bankruptcy court to order the second-lien lenders to abide by the terms of the intercreditor agreements. The second-lien lenders were astute, picked up on the goals of the first-lien lenders and sought to avoid that result. Objections were filed by the junior lienholders to the motions requesting approval of the DIP financing, the use of cash collateral and the adequate protection finding (the “Objections”). In the Objections, the junior lienholders acknowledged that the debtor needed the post-petition financing on a super-priority basis, but requested that the court strike certain provisions of the DIP order as “offending language” since, in the objecting creditors’ opinion, that language “potentially deprives the pre-petition junior lenders of fundamental bankruptcy rights and protections that cannot be traded away in pre-petition agreements to the extent that [such agreements] purport to do so.” The “offending language” had been crafted by the first-lien lenders and placed into the DIP order in order to enforce provisions of the inter-creditor agreement—namely, a waiver from the pre-petition junior lenders of the rights to adequate protection and to vote on the chapter 11 plan. The Objections acknowledged the cases previously cited by these authors concerning the enforceability of certain provisions of the intercreditor agreement and argued that any order approving the DIP financing and authorizing cash collateral should not be used to obtain declaratory or injunctive relief on these unsettled issues of the enforceability of waiver provisions by junior lienholders in bankruptcy cases. The Objections further argued that the enforceability of the “offending language” can only be properly decided as part of an adversary proceeding.

The New World court issued a final order approving the DIP financing, the use of cash collateral and the adequate-protection finding (the “order”). It specifically approved the subordination of payment of the junior creditors to the senior creditors. However, the final order dropped the “offending language” and replaced it with:

38. Pre-petition Participation Agreement. Notwithstanding anything in this order to the contrary, the pre-petition participation agreements are in full force and effect, and nothing herein shall alter, modify, amend or effect the terms and conditions of the pre-petition participation agreements, and nothing herein is or shall be deemed a waiver of any rights or remedies of the pre-petition agent or pre-petition senior lenders thereunder. Nothing in this order shall be deemed to alter, amend, prejudice or waive the rights of the pre-petition senior lenders or the pre-petition junior lenders with respect to the subordinate obligations under the pre-petition credit agreement and the pre-petition participation agreements, provided, however, that in the event a court of appropriate jurisdiction finds that the pre-petition junior lenders’ and/or JLL’s agreements and waivers contained in the pre-petition credit agreement and/or the pre-petition participation agreements are enforceable, the pre-petition agent preserves its rights to enforce such agreements and waivers retroactively to the petition date, including revoking any protections previously granted to the pre-petition junior lenders and/or JLL (including, without limitation, those protections contained in that certain stipulation and Agreed Interim Order entered by this court on May 10, 2004, and any final order entered with respect thereto), which protections upon such revocation shall be deemed void ab initio and of no force and effect.

There is no reported decision that explains the basis for the court’s order.

Counsel involved in the dispute have shared that the objections filed by the second-lien lenders were resolved consensually. Specifically, the “offending language,” and any appearance of approval of the underlying waivers or injunctive or declaratory relief, was removed and replaced with reservations of rights by all. In other words, the fight was reserved for a later day.

While the New World Pasta case does not answer the question of the enforceability of the waivers and other concessions typically found in the intercreditor agreements that accompany silent second liens, it is instructive in many ways. First, the order confirms that there are no clear answers to the question at hand. Second, the objection filed by the second-lien lenders suggests that approval of DIP financing, cash collateral and adequate protection in bankruptcy cases involving pre-petition facilities with second liens may be construed as a blessing of the underlying loan documents and the waivers they contain. The ultimate change in the language seems to imply that such a conclusion is possible and may in fact act as an estoppel against raising the issues later.

Finally, New World Pasta reveals why the issue of the enforceability of various provisions in intercreditor agreements of bankruptcy cases may never be resolved in a reported decision. These issues are often consensually resolved in the early days of the case while the debtor hangs precariously awaiting its DIP financing or resolved in the context of a larger settlement allocating value amongst the various levels of debt. As discussed earlier, once a bankruptcy case is filed, time is short: DIP financing and permission to use cash collateral need to be in place essentially before the case is filed. In a majority of cases, the borrower/debtor is so highly leveraged that there is no ability to wage a successful priming fight, and DIP credit facilities provided by the pre-petition senior lenders are the only real game in town. Issues need to be resolved quickly, and no one benefits, not the least of which the junior lenders, if precious time is lost and the borrower’s money is spent on litigating valuation or intercreditor issues. Settlement is often in everyone’s best interest. It may

1 Id. at 9, 25-26.

9 See 2004 WL 1484987 at 2.
10 Id. at 3.
11 Id.
12 Id.
be worthwhile for junior lenders to litigate waivers or assignments of their right to vote their claims at plan confirmation time and to engage in a valuation fight at that time, but in the meantime, all issues of the enforceability of intercreditor provisions concerning DIP financing, the use of cash collateral, the right to adequate protection, the release of liens on sales of collateral and the right to seek relief from the automatic stay have faded into the past. In the meantime, waivers or assignments of the right to vote the claims of the second-lien lenders are becoming increasingly less common in intercreditor agreements used in second-lien financings. It is simply likely that by the time most plans are presented for confirmation, most of these issues will have also been resolved consensually by the parties.

Conclusion

In the end, Maxim Crane was a simple balance-sheet restructuring in which the parties, as in Atkins, agreed to work together. The Tranche A lenders’ recovery of more than 90 percent is not bad for any bankruptcy case and avoided the disaster of a liquidation. The second lienholders and unsecured creditors happily received a recovery they would not otherwise be entitled to based on the assumed enterprise value. Even more impressive, Maxim Crane was in and out of bankruptcy in approximately six months.

New World Pasta also demonstrates the advantages of settlement. However, first-lien lenders would be wise to try to “shore up” their positions in DIP and cash collateral pleadings (although query whether such beneficial language would be enforceable if it is buried in the hundreds of pages of first-day pleadings and the bankruptcy judge has not been made aware of the implications of the specific language blessing the intercreditor agreement). Second lienholders should carefully review all DIP, cash collateral and adequate-protection motions made early in the case, as well as the proposed orders submitted by debtors and first-lien lenders acting in concert. At the very least, junior lienholders should file a limited objection reserving all rights to raise enforceability issues under the provisions of the intercreditor agreement.

Stay tuned. We pledge to scour the horizon for other bankruptcy cases that involved second-lien financings and report to you on the resultant intercreditor issues.


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