June 29, 2021

Not for You, Second Lien Creditor: Delaware Bankruptcy Court Reaffirms First Lien Intercreditor Right to Carve Out Collateral

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The liquidity-fueled lull in restructuring activity provides both an interesting historical echo of the late 1990s and a useful opportunity for market participants to take note of a deceptively interesting opinion in *Giuliano ex rel. Consolidated Bedding, Inc. v. L&P Financial Services Co.* (*In re Consolidated Bedding, Inc.*), Case No. 19-50727, 2021 WL 2638594 (Bankr. D. Del. June 25, 2021) (Shannon, J.).

Despite *Consolidated Bedding*'s innocuous facts, it is a helpful guidepost for future intercreditor disputes where the disposition of shared collateral is at issue. In particular, *Consolidated Bedding* strongly reaffirmed a first lien creditor's rights to dispose of shared collateral over the objection of—and without any notice to—a subordinated second lien creditor through an otherwise vanilla intercreditor agreement.

More interestingly, *Consolidated Bedding* may be applied to enforce a senior secured creditor's rights to dispose of shared collateral by "carving out" recoveries for unsecured creditors and circumventing distributions to a junior secured creditor in the process. An otherwise market-standard intercreditor agreement may then be invoked to limit or eliminate a junior secured creditor's rights to dispute a chapter 11 plan that, for example, provides meaningful recoveries to general unsecured creditors (but not second lien creditors) through such a carve-out. Such a plan may also silence objections from that second lien creditor by recourse to the "silent second" provisions of that same agreement.

And, although questions of absolute priority and cramdown were not directly at issue in *Consolidated Bedding*, that case still provides a roadmap as to how senior secured creditors, together with plan proponents, may use shared collateral as currency to fund a separate peace with other stakeholders in a given case.

Admittedly, intercreditor disputes and questions of absolute priority, like dial up modems, AOL accounts, and Grunge music, may all seem rather quaint for the present. The seemingly relentless expansion of valuation multiples and overall leverage, as well as a rather late-1990s approach by the Federal Reserve towards asset prices (not to say "bubbles"), perhaps mean that refinancings are inevitable and that intercreditor disputes are a thing of the past—along with the relevance of Seattle-based rock bands, Netscape, and single-digit leverage multiples.

But we tend to think the current trend of '90s nostalgia may yet manifest itself in its post-March 2000 form,[1] even if the notion of "impairment" for senior secured creditors seems almost quaint under present conditions. In that scenario, secured creditors and plan proponents will inevitably be obliged to make hard calls on their rights in collateral and their ability to structure an efficient disposition of that collateral along the way.

Consolidated Bedding's Facts

Consolidated Bedding's facts are not remarkable. The debtor, a bedding company, filed chapter 7 with first lien debt (totaling approximately $231 million) and second lien debt (totaling approximately $14.4 million) encumbering substantially all its assets. The chapter 7 trustee entered into a proceeds-sharing agreement with the first lien creditor where, in simplified form: (i) the first lien creditor was entitled to receive 75% of all recoveries; (ii) the chapter 7 trustee would receive 25% of all recoveries; and (iii) no recoveries were allocated for the second lien creditor. *See generally Consolidated Bedding*, slip op. at 3–5.

After nearly a decade of collections, the chapter 7 trustee held approximately $2.3 million after paying off the first lien creditor per that agreed 75/25 split. *Id*. at 5. The second lien creditor then argued it was entitled to the entire, $2.3 million balance on account of its rights as a secured creditor, claiming its previously junior liens attached to that balance. *Id*. The second lien creditor further argued that the entire proceeds-sharing arrangement was void as it had received no notice of the arrangement when originally entered into by the chapter 7 trustee and the first lien creditor. *Id*. at 6.

Significantly, the second lien creditor was subject to an intercreditor agreement that provided, among other things:

- "In connection with any such disposition of Collateral . . . Junior Creditor shall (i) be deemed to have automatically and without further action released and terminated any Liens it may have on the Collateral (as and to the extent that Senior Creditor shall release and terminate its Liens);"

- the second lien creditor was required to hold any proceeds of collateral "in trust, as trustee, for the benefit" of the first lien creditor; and

- the second lien creditor "waive[d] notice of, and hereby consent[ed] to . . . (ii) the taking, exchange, surrender and releasing of Collateral or guarantees now or at any time held by or available to Senior Creditor for the Senior Debt, [and] (iii) the exercise of, or refraining from the exercise of any rights against any Debtor or any other obligor of any Collateral . . . ." *Id*. at 9–11.

As students of intercreditor agreements will quickly observe, these provisions are neither particularly controversial nor particularly unique.

Invoking these intercreditor provisions, the chapter 7 trustee commenced an adversary proceeding arguing that, among other things, its 25% interest in proceeds was held "free and clear of any lien, claim, or interest" asserted by the second lien creditor. *Id*. at 5. The second lien creditor, in turn, argued that any senior liens were released as part of the "carve out" arrangement and, therefore, the second lien creditor had a lien attaching to the proceeds at issue. *Id*. at 6. Notably, the record was also clear that the first lien creditor at issue would be paid significantly less than par, perhaps a distinguishing factor between this case and situations where a first lien creditor might otherwise recover in full. *Id*. at 10–11.

The *Consolidated Bedding* Ruling

The Delaware bankruptcy court strongly concurred with the chapter 7 trustee's position and, by extension, an undersecured creditor's rights to dispose of its collateral as it sees fit. In the court's words: "[The first lien creditor] enjoyed the right to carve funds out from the proceeds of its collateral to incentivize the Trustee to pursue claims on behalf of the Debtors' estate[s], and that is precisely what happened here." *Id*. at 8; *see also id*. ("In sum, 'a secured creditor may consent to the use of its collateral as its chooses.'" (quoting Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 Am. Bankr. L.J. 445, 448 (2002)).

The second lien creditor, in turn, was prohibited from objecting to the trustee's retention of proceeds as a result of those intercreditor agreements, noted above: "The Intercreditor Agreement provides [the first lien creditor] with broad authority to release liens in any collateral in connection with a sale or disposition of the collateral and simultaneously curtails [the second lien creditor]'s rights to oppose or interfere with those actions." Id. at 9. And, although the court found the alleged lack of notice "troubling," the court also found that the second lien creditor "had already voluntarily waived any right to interpose an objection." Id. at 10.

Implications of *Consolidated Bedding*

Consolidated Bedding, in itself, is neither a remarkable fact pattern nor a surprising conclusion. Similar proceeds sharing agreements as between secured creditors and chapter 7 trustees are commonplace. It would have been a strange outcome indeed that permitted a junior secured creditor to leapfrog ahead and recover where the senior secured creditor is not paid in full and a "standard" intercreditor agreement is in effect.[2]

Of much more interest is the extent to which *Consolidated Bedding*'s principles can be applied in the context of a chapter 11 plan, rather than a chapter 7 liquidation. That is, a senior secured creditor could structure a plan where:

- the senior secured creditor will recover less than par;

- the junior secured creditor will recover zero; and
- general unsecured creditors will receive a pool of value through a "carve out" of shared collateral

Assuming the existence of an intercreditor agreement similar to the one at issue in *Consolidated Bedding*, and a valuation consisting wholly of encumbered value, a second lien creditor would be hard-pressed to challenge this structure without also breaching its intercreditor agreement. Thus, *Consolidated Bedding* reinforces the proposition that a plan proponent has substantial flexibility to use collateral proceeds as currency in a plan that otherwise crams down a dissenting junior secured creditor by enforcing an intercreditor agreement.

To be sure, a junior secured creditor may still have defenses to this structure. The Third Circuit's recent opinion in *In re Tribune Co.*, 972 F.3d 228 (3d Cir. 2020), may perhaps be cited to that effect: "[S]ubordination agreements need not be strictly enforced for a court to confirm a cramdown plan." *Id*. at 239. *Consolidated Bedding* similarly leaves open the question as to whether enforcing an intercreditor agreement may constitute "unfair discrimination" under section 1129(b) in light of *Tribune*.[3] Furthermore, "Rights as Unsecured Creditors" provisions of a particular intercreditor agreement, or narrowly (or expansively) tailored language in that agreement more broadly, may provide an alternative gap for the junior secured creditor to make its case.

Still, the fact remains that a junior secured creditor would be in the delicate position of trying to circumvent the potentially substantial limits imposed by an intercreditor agreement rather than being free to maneuver at all. That junior secured creditor may also face the potential risk for its own liability should it be found to have breached an intercreditor agreement in that process.

It certainly bears repeating that the operative facts will matter a great deal in any given situation—including the specific language of any intercreditor agreement at issue. But *Consolidated Bedding* is a useful reminder as to how plan proponents and their senior secured creditors can efficiently utilize intercreditor agreements to drive outcomes. With this in mind, the lessons of the late '90s suggest that market participants are better served by thoroughly analyzing their own intercreditor arrangements in advance, rather than relying too heavily on a perpetual state of love and trust in the capital markets.

We encourage you to contact your Ropes & Gray team to discuss these matters more fully.

1. Students of history, or at least members of Generation X, will recall the peak of the so-called "dot com bubble" that occurred in March 2000.
2. A more complicated question could have arisen if the first lien creditor was, at least arguably, fully secured or if there were substantial pockets of unencumbered value. Those facts were not at issue in *Consolidated Bedding*.
3. Of course, *Tribune* did not necessarily <u>prohibit</u> a plan proponent from enforcing an intercreditor through a plan of reorganization, either. *Cf. In re La Paloma Generating Co.*, 609 B.R. 80, 100-01 (D. Del. 2019) (enforcing turnover provisions of intercreditor agreement with respect to distributions of collateral and proceeds of collateral under chapter 11 plan).