SECOND LIEN FINANCING ISSUES IN BANKRUPTCY CASES

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© January, 2007
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SECOND LIEN FINANCING ISSUES IN BANKRUPTCY CASES

I. Introduction.

A. Second Lien Financing Transaction.

1. Basic Transaction. Borrowers often enter into separate financing facilities with different lenders, secured by the same collateral. In a typical transaction, the borrower grants the senior lender a collateral package with a first lien on all or substantially all of the borrower's assets. A junior lender then loans money to the borrower, secured by a second lien on the same collateral.

2. Senior Lender's Benefits. Senior lenders typically agree to second lien financings for several reasons. First, the borrower will often use the proceeds from the second lien financing to pay down the first lien financing. Second, the second lien financing may limit what the senior lender has to loan the borrower. Third, the second lien financing may make the first lien financing easier to syndicate, ostensibly because the first lien is oversecured. Finally, the senior lender may expressly gain certain waivers and protection of its liens through an intercreditor agreement that it may not otherwise receive. We discuss those waivers and protections in section II.

3. Junior Lender's Benefits. Second lien financings are attractive to junior lenders. If the borrower defaults, the junior lender may still foreclose on the collateral, subject to the senior lender's liens, and collect ahead of the unsecured creditors. Moreover, if the borrower becomes a debtor in a bankruptcy case, the junior lender may still be entitled to a secured lender's rights and benefits, including:

   • An interest in the debtor's property as collateral. 11 U.S.C. § 506(a)(1)
   • Postpetition interest and reasonable fees, costs, or charges, if oversecured. 11 U.S.C. § 506(b)
   • Adequate protection. 11 U.S.C. §§ 361, 362(d), 363(e), 364(d).
   • Right to credit bid at an asset sale. 11 U.S.C. § 363(k)
   • Leverage in reorganization plan negotiations.

4. Intercreditor/Subordination Agreement. To govern their rights over the shared collateral, the senior lender and the junior lender enter into an intercreditor or subordination agreement subordinating the junior lender's debt or liens to the senior lender's debt or liens. If any of the shared collateral is sold in a foreclosure or other enforcement action, the first lien debt will ordinarily be paid in full out of the sale of the collateral before the junior creditor receives anything on account of its second lien. The junior lender also frequently waives
rights that it would receive in the borrower's bankruptcy, including rights in the following contexts:

- Adequate protection disputes;
- Automatic stay disputes;
- Debtor-in-possession financing disputes;
- Cash collateral disputes;
- § 363 asset sale disputes;
- Reorganization plan disputes; and
- Senior lender lien disputes.

5. Enforceability Of Subordination Agreements In Bankruptcy Cases. When a borrower becomes a debtor, subordination agreements between creditors remain enforceable to the extent they would be enforceable outside of bankruptcy. 11 U.S.C. § 510(a) ("A subordination agreement is enforceable in a [bankruptcy case] to the same extent that such agreement is enforceable under applicable nonbankruptcy law"). As section II of this outline notes, however, courts may decline to enforce certain provisions if the borrower commences a bankruptcy case. The law thus remains unsettled as to the enforceability of certain bankruptcy-related provisions (e.g., junior lender's waiving right to challenge senior lender's adequate protection request; waiving rights to seek relief from the automatic stay; advance consent to senior lender's relief from the automatic stay; waiving right to offer debtor-in-possession financing without senior lender's consent; waiving right to object to debtor-in-possession financing consented to by senior lender; consent to a debtor-in-possession's use of cash collateral approved by senior lender; and waiving plan voting rights).

B. Second Lien Financing Market. The second lien financing market has grown rapidly in recent years. Companies raised $3.2 billion in second lien loan proceeds in 2003. Neil Cummings, "Shroud of Silence -- Second Lien Creditors Who Agree to Have Their Hands Tied When it Comes to Voting on a Bankruptcy Reorganization Plan May Come to Regret that Decision Deeply," The Deal, Sept. 20, 2004. But second lien issuance has increased more than 500% since then. According to Standard & Poor's Leveraged Commentary & Data, second lien issuance was $16.3 billion for 2005 and $18.5 billion through the third quarter of 2006. Mary D'Souza, "High Yield Report for the Week of October 16 -- Second Liens Continue To Set New Records," REI Research Online, Oct. 16, 2006, http://www.reiresearch.com/public/2080.cfm. One explanation: in a market of low interest rates, second lien financing offers lenders a chance to receive a higher return on secured loans, albeit with greater risk. From the borrower's perspective, second lien financing is typically priced lower than unsecured financing, and borrowers can gain additional liquidity at lower cost. Second lien lenders frequently include hedge funds, insurance companies, distressed debt investors, banks, and other financial institutions.
C. **Scope.** This outline discusses the second lien financing market and the role of second lien lenders in a bankruptcy case. The second lien lender's impact in a bankruptcy turns on the bankruptcy provisions in its intercreditor agreement with the first lien lender and the value of the junior lender's collateral relative to the amount of its loan. We accordingly analyze the enforceability of the typical provisions if the borrower seeks bankruptcy relief under the Bankruptcy Code ("Code").

II. **Bankruptcy-Related Intercreditor Agreement Provisions.**

A. **Adequate Protection.**

1. **Code Provisions and Case Law.** The Code protects prepetition lenders' liens during the bankruptcy case. On an appropriate showing, the court may order "adequate protection" of a lender's lien by modifying the automatic stay, Code § 362(d) ("... the court shall grant relief from the stay ... for cause, including the lack of adequate protection of an interest in property ... "); conditioning the debtor's use of cash collateral, Code § 363(e) ("... on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court ... shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest"); and conditionally authorizing equivalent or priming liens to postpetition lenders. Code § 364(d)(1)(B) ("The court ... may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if ... there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted."). The concept of adequate protection is derived from the Fifth Amendment's protection of property interests. See H.R. Rep. No. 95-595, at 339 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6295. Code § 361 outlines what may qualify as "adequate protection." To the extent that the automatic stay; the use, sale, or lease of property under section 363 of the Code; or the debtor's granting of a priming lien to a postpetition lender impairs the value of a secured lender's interest in collateral, adequate protection may be provided by (i) cash payments or (ii) additional or replacement liens. Code § 361(1), (2); United Savs. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 372 (1988) ("... [T]he phrase 'value of [the lender's] interest' in § 361(1) and (2), when applied to secured creditors, means ... ['the value of the collateral.'].") Alternatively, a court may order other forms of adequate protection (but something more than a mere administrative priority claim) that will result in the secured lender's receiving "the indubitable equivalent" of its interest in its collateral. Code § 361(3); Timbers, 484 U.S. at 377 ("... the relief pending the stay need only be such 'as will result in the realization ... of the indubitable equivalent' of the collateral.") (emphasis in text of opinion) (held, "immediate payment" of principal not required, "but only upon completion of the reorganization"). Other forms of adequate protection referenced in Code § 361(3) may include, among others:

   • an "equity cushion",\(^1\)

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\(^1\) Some courts have found that when the value of the debtor's collateral exceeds the amount of the secured claim, the excess value or "equity cushion," without more, will adequately protect the secured lender's interest. In re Shaw Industries, Inc., 300 B.R. 861, 865 (Bankr. W.D. Pa. 2003) ("The existence of an equity cushion alone can constitute adequate protection"). See also In re Mellor, 734 F.2d 1396 (9th Cir.1984); In re Lane, 108 B.R. 6
• secured or unsecured third-party guarantee;
• reporting requirements and limitations on use of cash collateral;
• preservation of value of collateral.

Adequate protection is a flexible concept, and may take many forms. The types of protection that the debtor may offer are limited only by the debtor's imagination and resources. For example, in MBank Dallas, N.A. v. O'Connor (In re O'Connor), 808 F.2d 1393 (10th Cir. 1987), the Tenth Circuit authorized the debtor to use $721,000 of cash collateral to drill three new gas wells that were expected to produce revenues with present value of $3,674,000. Finding that the secured creditor was adequately protected by the debtor's excellent prospects of success and the potential value of the new revenues, and despite the inherent risk of drilling dry holes, the court held that "[i]n order to encourage the Debtors' efforts in the formative period prior to the proposal of a reorganization, the court must be flexible in applying the adequate protection standard." Id. at 1398 (citations omitted). Accord In re Pomodoro Restaurant, 251 B.R. 441 (B.A.P. 10th Cir. 1999) ("A bankruptcy court has considerable discretion in balancing the factors in awarding adequate protection and any such determination is to be done on a case-by-case basis"); In re Kline, 226 B.R. 284 (B.A.P. 10th Cir. 1998) (same); Shaw Industries Inc., 300 B.R. at 865 ("means of adequate protection provided by § 361 are not exclusive"). See also In re 495 Central Park Avenue Corp., 136 B.R. 626 (Bankr. S.D.N.Y. 1992) (projected property improvements constituted adequate protection when rental income from lease conditioned on improvements would increase value of real estate by at least $800,000); In re Sheehan, 38 B.R. 859 (Bankr. D.S.D. 1984) (court allowed cash collateral to be used in exchange for replacement lien on crops to be grown with the cash, relying on evidence that debtor's prospects for a profitable crop were good).
Regardless of the proposed form of adequate protection, however, the burden of proof is on the debtor-in-possession ("DIP")\(^4\) to show by competent evidence that the value of the lender's collateral is protected and will not be diminished by the DIP's use of the cash collateral. Conversely, the burden of proof as to the validity, priority, or extent of the secured creditor's interest in the cash collateral is on the secured creditor. Code § 363(p)(1), (2).

A secured creditor whose "interest" (i.e., its collateral value) was in fact not adequately protected but impaired may be given a later super-priority claim under Code § 507(b). To receive this super-priority, the creditor's claim must have arisen because of (a) harm caused by the automatic stay under Code § 362(a); (b) harm caused by the use of cash collateral under Code § 363; or (c) harm caused by the granting of a lien under Code § 364(d). Code § 507(b) ("If the trustee, under section 362, 363, or 364 of [the Code], provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim allowable under subsection (a)(2) of this section [administrative expenses allowable under Code § 503(b)] arising from the stay of action against such property under section 362 of [the Code], from the use, sale, or lease of such property under section 363 of [the Code], or from the granting of a lien under section 364(d) of [the Code], then such creditor's claim under such subsection shall have priority over every other claim allowable under such subsection.").

2. Intercreditor Agreement. Intercreditor agreements typically address adequate protection in several ways. A junior lender may waive its right to challenge the senior lender's adequate protection request in a bankruptcy case. The senior lender may thus enforce its rights to adequate protection of the shared collateral without the junior lender's challenging those rights, including the validity of the senior lender's liens. An intercreditor agreement may also provide that a junior lender's ability to seek adequate protection is conditioned on the senior lender's having already received adequate protection. But regardless of the intercreditor agreement's terms, the junior lender cannot receive adequate protection at the senior lender's expense. In re WestPoint Stevens, Inc., 333 B.R. 30, 49 (S.D.N.Y. 2005) (finding no authority that "an action in permanent derogation of a senior creditor's contractual rights can be forced upon that creditor for the purpose of providing 'adequate protection' to a junior creditor"). These adequate protection provisions often appear in intercreditor agreements, but a court may still find them unenforceable. Beatrice Foods Co. v. Hart Ski Mfg. Co., Inc. (In re Hart Ski Mfg. Co., Inc.), 5 B.R. 734, 736 (Bankr. D.Minn. 1980) (" . . . the right to seek Court ordered protection for [a creditor's] security . . . cannot be affected by the actions of the parties prior to the commencement of a bankruptcy case when such rights did not even exist.").

B. Relief from Automatic Stay.

1. Automatic Stay. The commencement of a bankruptcy case stays most actions by creditors against the debtor and its property. Code § 362(a) ("a petition [commencing a case] . . . operates as a stay, applicable to all entities . . . "). Litigation and lien enforcement are thus stayed, giving a trustee or chapter 11 debtor-in-possession a breathing spell from creditors by stopping all collection efforts, harassment, and foreclosure actions, and allowing the debtor to

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negotiate a reorganization plan. See e.g., In re Siciliano, 13 F.3d 748, 750 (3d Cir. 1994) (“[t]he purpose of the automatic stay provision is to afford the debtor a ‘breathing spell’ by halting the collection process. It enables the debtor to attempt a repayment or reorganization plan with an aim toward satisfying existing debt.”); Shaw v. Ehrlich, 294 B.R. 260, 267 (W.D. Va. 2003), aff’d, 99 Fed. Appx. 466 (4th Cir. 2004) (“stay protects debtors, as well as creditors, by providing debtors a ‘breathing spell’ from collection efforts”).

2. Relief From Stay. For the creditor seeking relief from the automatic stay so as to proceed against its collateral, the creditor must generally show (i) "cause, including the lack of adequate protection" of its collateral, or that (ii) the debtor lacks "equity" in the collateral, which "is not necessary to an effective reorganization." Code § 362(d)(1)-(2). Although there is no rigid test for determining whether cause exists to grant relief from the automatic stay, courts generally consider three factors: (i) prejudice suffered by the debtor and its estate if the stay is lifted; (ii) the balancing of hardships between the parties; and (iii) the probable success on the merits if the stay is lifted. In re Peregrine Systems, Inc., 314 B.R. 31, 47 (Bankr. D. Del. 2004) aff’d in part, rev’d in part on other grounds, 2005 WL 2401955 (D. Del. Sept. 29, 2005). As Code § 362(d)(1) expressly provides, cause to modify the automatic stay includes "lack of adequate protection." See, e.g., In re McGaughey, 24 F.3d 904, 906 (7th Cir. 1994) (“a court may lift an automatic stay if, in an appropriate hearing, an interested party can show a lack of adequate protections for creditors’ interests”); In re Yates, 332 B.R. 1 (B.A.P. 10th Cir. 2005) (held, creditor that had repossessed car violated automatic stay by withholding possession and refusing use of car after debtor tendered adequate protection payments); In re Sharon, 234 B.R. 676 (B.A.P. 6th Cir. 1999) (same); In re Rutherford, 329 B.R. 886 (Bankr. N.D. Ga. 2005) (creditor violated automatic stay when, based on its unilateral determination that it was not adequately protected, it refused to return debtor's repossessed vehicle after notification of debtor's bankruptcy filing); In re Coleman, 229 B.R. 428, 432 (Bankr. N.D. Ill. 1999) (held, creditor that repossessed estate property prepetition could not be held liable for damages for violating automatic stay “until and unless adequate protection is provided”). Courts have also found cause to modify the automatic stay for, among other things, the following:

(a) To annul stay retroactively in order to rehabilitate debtor’s stay violation, which was filing a notice of appeal after filing a bankruptcy petition. See In re Hoffinger Ind., Inc., 329 F.3d 948 (8th Cir. 2003).


(c) To lift automatic stay requested by potential judgment creditor seeking to proceed with her appeal in a state court malicious prosecution action when no other forum was available to her. See In re Wilson, 116 F.3d 87 (3d Cir. 1997).

(d) Misconduct by corporate officers was sufficient to allow derivative suit to continue in district court. See In re Highcrest Management Co., Inc., 30 B.R. 776 (Bankr. S.D.N.Y. 1983).
(e) General malfeasance is “cause” under 362(d). See, e.g., In re Newpower, 233 F.3d 922 (6th Cir. 2000) (cause existed to allow embezzlement victims to continue pre-petition state court action); In re Kolberg, 199 B.R. 929 (W.D. Mich. 1996) (debtor’s malfeasance in attempting to avoid creditor’s lien on crops “exempted” the creditor from the stay).

(f) Advanced stage of litigation or arbitration may weigh heavily in favor of stay modification. See In re Betzold, 316 B.R. 906 (Bankr. N.D. Ill. 2004) (modifying automatic stay to allow damages hearing to proceed before arbitrator, when parties had spent over a year and half before arbitrator to obtain decision on liability issues.)

Under Code § 362(d)(2), a court may modify the automatic stay as to property subject to 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.” Code § 362(d)(2) (emphasis added). See generally In re Indian Palms Associates, Ltd., 61 F.3d 197, 206 (3d Cir. 1995) (automatic stay “is thus intended to balance the interests of the creditors and the debtor’); Gateway North Estates, Inc. v. Bailey, 169 B.R. 379, 382 (E.D. Mich. 1994) (decision to lift stay under Code § 362(d) “is not purely discretionary because it must be based on the bankruptcy court’s findings of fact with respect to the statutory conditions’); Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303 (5th Cir. 1985) (held, relief from automatic stay did not apply because railroad cars, which made up less than 10% of debtor’s inventory, were not necessary to an effective reorganization); In re Cohen, 267 B.R. 39 (Bankr. D.N.H. 2001) (debtor’s real property was not necessary to an effective reorganization, and creditor was entitled to stay relief). If one of prong of Code § 362(d) is not met, a court will not grant relief. Bartucci v. O’Neil, 64 Fed.Appx. 344, 346 (3d Cir. 2003) (when debtor conceded it had no equity interest in subject property, bankruptcy court was required to determine whether property was necessary to effective reorganization); Matter of Holt County Grain Storage, Inc. 25 B.R. 271 (Bankr. D. Neb. 1982) (mortgagee not entitled to relief from automatic stay under § 362(d) even though debtor had no equity in the property when debtor’s property was necessary to reorganization); In re Harrington, 282 B.R. 637 (Bankr. S.D. Ohio 2002) (movant was not entitled to relief when it failed to show lack of equity in tractor; debtor not required to show that tractor necessary for effective reorganization). The party seeking relief from automatic stay under Code § 362(d) has the burden to prove the debtors’ equity, but the party objecting to the relief has the burden on all other issues. Code § 362(g). See, e.g., Bartucci v. O’Neil, 64 Fed.Appx. 344 (3d Cir. 2003) (creditor had burden to prove debtor had no equity interest in property; debtor opposing relief from stay bore burden of proving property necessary to effective reorganization); In re Harrington, 282 B.R. 637 (Bankr. S.D. Ohio 2002) (movant not entitled to stay relief because it did not introduce evidence to prove debtor lacked equity in tractor); In re Watts, 273 B.R. 471, 477 (Bankr. D.S.C. 2000) (held, creditor entitled to relief from automatic stay because debtor failed to carry her burden of proving that collateral “necessary to an effective reorganization”).

Within context of automatic stay relief provision, "equity" is defined as difference between value of subject property and encumbrances against it. See In re Prestwood, 185 B.R. 358 (M.D. Ala. 1995).
3. **Automatic Stay Waivers.**

   (a) **Right To Seek Relief From Stay.** A junior lender may waive its right in an intercreditor agreement to seek relief from the automatic stay so as to proceed against its shared collateral with the senior lender. At least one bankruptcy court, however, found this waiver unenforceable. In re Hart Ski Mfg. Co., Inc., 5 B.R. at 736 (subordination agreement provided junior creditor would not "assert collect, enforce or release the indebtedness . . . or realize [on] any collateral securing the indebtedness or enforce any security agreements, real estate mortgages, lien instruments, or other encumbrances securing . . . indebtedness . . . " without senior lender's consent; held, junior creditor could seek modification of automatic stay; " . . . the right to have a stay lifted under proper circumstances . . . cannot be affected by the actions of the parties prior to the commencement of a bankruptcy case when such rights did not even exist").

   (b) **Advance Agreement To Consent To Senior Lender's Request For Relief From Stay.** A junior lender may agree in advance to consent to a senior lender's later motion for relief from the automatic stay to foreclose on the shared collateral. This provision is probably enforceable pursuant to the enforceability standard under section 510(a) of the Code. See Code § 510(a) ("A subordination agreement is enforceable . . . to the same extent that such agreement is enforceable under applicable non-bankruptcy law.").

C. **DIP Financing.**

   1. **Code Provisions.** Code § 364 permits trustees or debtors in possession\(^6\) to borrow money after commencing the bankruptcy case -- often referred to as debtor-in-possession, or "DIP," financing. The DIP must ordinarily seek court approval before borrowing outside its ordinary course of business.

      (a) **Priming Liens.** The Code permits the DIP to prime prepetition secured lenders, incurring debt secured by equal or senior liens on the prepetition lender's collateral, if the DIP (i) cannot "otherwise" obtain credit, and (ii) the prepetition secured lender's collateral is adequately protected. Code § 364(d)(1); In re Snowshoe Co., 789 F.2d 1085, 1088 (4th Cir. 1986) (held, trustee was not required to seek credit from every possible source; showing good faith efforts to obtain credit on more favorable terms was sufficient). As discussed in section II.A.1 above, prepetition secured lenders will ensure that they receive adequate protection should a DIP lender seek to prime the prepetition lender's liens. See In re Swedeland Dev. Group, Inc., 16 F.3d 552 (3d Cir. 1994) (en banc) (held, to constitute adequate protection of preexisting lender's collateral, replacement liens must be on newly-created unencumbered assets); In re First South Sav. Ass'n, 820 F.2d 700, 710 (5th Cir. 1987) (held, district court abused discretion in denying "primed" creditor's motion for stay pending appeal; "given the fact that super priority financing displaces liens on which creditors have relied in extending credit, a court that is asked to authorize such financing must be particularly cautious when assessing whether the creditors so displaced are adequately protected"). The order approving the DIP financing usually grants the adequate protection.

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(b) **Non-Priming Equal Liens.** Non-priming "equal" liens (i.e., liens pari passu to existing liens) for new money may be granted only when credit is not otherwise available, and only when the pre-existing lienholders' collateral value is adequately protected. Code §364(d)(1)(A).

(c) **Liens On Unencumbered Assets.** The court may grant liens on unencumbered assets when unsecured credit is not otherwise available. Code § 364(c)(2). In re Phase-1 Molecular Toxicology, Inc., 285 B.R. 494 (Bankr. D. N. Mex. 2002) (application denied when debtor failed to show no alternative financing available; required to show reasonable effort to find other financing). See In re Calore Exp. Co. Inc., 288 F.3d 22, 48-49 (1st Cir. 2002) (relying on section of Massachusetts Uniform Commercial Code (UCC) applicable to assignment of accounts receivable, held, federal government's setoff rights in debtor's accounts receivable had priority over creditor's lien granted under Code § 364(c)(2) against debtor's property, including its accounts receivable). As with priming liens, the DIP must show some effort to find alternative financing. Code § 364(c)(2). Unsecured creditors are not entitled to adequate protection when a lien is granted under Code § 364(c)(2). In re Garland Corp., 6 B.R. 456, 463 (B.A.P. 1st Cir. 1980) ("Congress has chosen to exercise its substantive bankruptcy power so as not to require 'adequate protection' of the interests of the holders of unsecured claims under the Bankruptcy Code in circumstances where the debtor obtains postpetition credit on the strength of a lien on previously unencumbered property of the estate theretofore available in whatever measure for the satisfaction of unsecured claims").

(d) **Junior Liens.** The court may also grant junior liens, subject to an existing lien, on assets for new money advanced when unsecured credit is otherwise unavailable. Code § 364(c)(3).

(e) **Unsecured Financing.**

(i) **New Money Super-Priority.** Code § 364(c)(1) allows the granting of a super-priority unsecured claim for new money advanced when unsecured credit is not otherwise available. Careful drafting of the financing order should resolve any later contest of the super-priority of the DIP lender's unsecured claim. These unsecured claims can prime all other administrative expenses under Code § 503(b) and inadequately protected claims under Code § 507(b), even those for professional fees. In re Flagstaff Foodservice Corp., 739 F.2d 73, 75 (2d Cir. 1984) (held, fees of professionals for debtors in possession and creditors' committee subordinate to lender's Code § 364(c)(1) priority claim and first lien on all of debtor's assets previously granted to lender in financing order).

(ii) **Administrative Expense Claims.** Section 503(b) of the Code grants priority to administrative expense claims, including claims arising from post-petition credit obtained in the ordinary course of business under Code § 364(a), and interest resulting from such credit. Code § 364(a) ("If the trustee is authorized to operate the business of the debtor... unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of [the Code] as an administrative expense.") Claims arising from post-petition extensions of credit outside the ordinary course of business, if approved by the court under Code § 364(b), also have priority. Code § 364(b) ("The court, after notice and a hearing, may authorize the trustee to
obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of [the Code] as an administrative expense.). See In re Club Dev. & Management Corp., 27 B.R. 610, 612 (B.A.P. 9th Cir. 1982) (Code § 364(b) order must contain specific finding that credit is for one of purposes specified in Code § 503(b)(1)(A), (B) or (C) to obtain administrative expense priority; reversed order authorizing payment of corporate salaries when debtor had no ongoing business operations).

In the context of Code § 364, "ordinary course of business" is narrowly construed to include trade credit and payments for utility services. See In re Dant & Russell, Inc., 853 F.2d 700, 704-06 (9th Cir. 1988) (applying creditor's expectation test and comparing conduct of debtor to industry-wide practices, court rejected bankruptcy court's holding that execution of post-petition renewal leases was not within DIP's ordinary course of business); In re Blumer, 95 B.R. 143, 147-8 (B.A.P. 9th Cir. 1988) (applied "creditor's expectation" test and compared debtor's business to industry-wide practices in determining debtor's "ordinary course of business" for purposes of Code § 364(a); In re Johnson Bros. Truckers Inc., 9 Fed. Appx.156, 164 (4th Cir. 2001) (held, insider failed to show that post-petition transfers from debtor to herself, though not authorized by court, were payments made in ordinary course of debtor's business under Code § 364(a) despite claim that she had purchased assets from debtor and leased them back; other than self-serving statements of insider and her husband, no evidence in record showed that insider had purchased assets from debtor; financial records offered through testimony of debtor's accountant did not reflect any accounting entries supporting contention that she did so). But see In re Ockerlund Constr. Co., 308 B.R. 325, 328 n.1 (Bankr. N.D. Ill. 2004) (rejecting "horizontal dimensions test" that requires DIP to show that terms of financing were consistent with industry practice).

Generally, if court approval is required under Code § 364 but is not obtained, the party extending credit will have no super-priority claim against the estate. William B. Schnach Retirement Trust v. Unified Capital Corp. (In re Bono Development Corp.), 8 F.3d 720, 722 (10th Cir. 1993) (held, amounts expended in excess of amount that bankruptcy court order had authorized for preservation of Chapter 11 debtor's property not entitled to super-priority status); Bezanson v. Indian Head Nat'l Bank (In re J. L. Graphics, Inc.), 62 B.R. 750, 754 (Bankr. D.N.H. 1986), aff'd sub. nom. In re Cross Banking Co., Inc., 818 F.2d 1027 (1st Cir. 1987) (court declined to exercise equitable power to authorize borrowing and attachment of floating lien agreement to postpetition receivables retroactively when debtors and creditors proceeded under tentative agreements without obtaining court order). But see In re Photo Promotion Assoc., Inc. (Sapir v. C.P.Q. Colorchrome Corp.), 881 F.2d 6, 10-11 (2d Cir. 1989) (held, creditor who obtained funds in violation of Code § 364(c) was required to remit funds to debtor's estate, but was allowed to assert administrative claim pursuant to Code §503(b) for value of post-petition services rendered to debtor's estate); In re Cybridge Corp., 312 B.R. 262 (D.N.J. 2004) (court affirmed grant of summary judgment on avoidance action to chapter 7 trustee in which trustee sought to recover collections on post-petition receivables from pre-petition factoring lender but court also upheld grant to lender of credits for post-petition advances, thereby eliminating trustee's recovery on avoidance action).

2. Waivers. Intercreditor agreements may include a junior lender's waiver of its right to offer DIP financing without the senior lender's consent. Junior lenders may also waive their right to object to DIP financing consented to by the senior lender. In negotiating
these provisions, the junior lender may insist on capping DIP financing that would prime the junior lender's liens. Junior lenders may further condition their consent to DIP financing approved by the senior lender on the new loan's priming or ranking equally with the senior lender. These waivers should be subject to the enforceability standard stated in Code § 510(a).

D. Cash Collateral.

1. Definition of Cash Collateral. Code § 363(a) defines cash collateral as follows:

[C]ash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels or other lodging properties subject to a security interest as provided in [Code § 552(b)], whether existing before or after the commencement of a [bankruptcy case].

Code § 363(a). Code § 552(b), cited in the above definition, creates two exceptions to the Bankruptcy Code's general rule, found in §552(a), that property acquired by the DIP postpetition is not subject to a lender's prepetition security interest. Code § 552(a) ("Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case."). First, § 552(b)(1) provides an exception for the "proceeds, products, offspring, or profits" of the lender's prepetition collateral, to the extent permitted under the prepetition security agreement and non-bankruptcy law. Second, a lender's prepetition security interest in rents (including hotel room charges) is extended postpetition by § 552(b)(2) whether or not the security interest was perfected under "applicable non-bankruptcy law." Accordingly, the definition of "cash collateral" includes cash and cash equivalents in existence as of the commencement of the bankruptcy case, as well as the proceeds of property subject to a prepetition security interest (as provided in Code § 552(b)).

2. Restrictions On Trustee/DIP's Use Of Cash Collateral. The trustee/DIP "may not use, sell, or lease cash collateral . . . unless -- (A) each entity that has an interest in such cash collateral consents; or (B) the court, after notice and a hearing, authorizes such use, sale, or lease . . . ." Code § 363(c)(2). Thus, the Code provides for either the agreed-upon or contested use of cash collateral subject to court approval.

3. Advance Consent To Uses Of Cash Collateral. Junior lenders may consent to a DIP's use of cash collateral approved by the senior lender. This consent, however, is a minor concession because the senior lender's and junior lender's interests are aligned. The senior lender will typically insist on the DIP's following a strict operating budget concerning the cash collateral, preserving the junior lender's lien in the cash collateral as well as its own.
E. Code § 363 Asset Sales. DIPs often sell their assets under Code § 363(b) and retain the proceeds for distribution to creditors. The DIP must seek court approval before selling its assets outside its ordinary course of business. Code § 363(b). These asset sales may be conducted through a private or public auction.

1. Liens Attach To Proceeds. Code § 363(f) permits DIPs to sell property "free and clear of any interest in such property of an entity other than the estate, only if -- (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest; (2) such entity consents; (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property; (4) such interest is in bona fide dispute; or (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest." Thus, even if the debtor sells collateral securing a junior lender's claim, the junior lender will retain its lien on the sale proceeds.

2. Credit Bidding. When the DIP seeks to sell collateral securing a lender's lien, the secured lender may purchase the collateral by bidding its claims against the purchase price of the collateral. Code § 363(k) ("At a sale . . . of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property."). A secured creditor may bid the full face value of its secured claim. In re SubMicron Systems Corp., 432 F.3d 448, 459, 460-61 (3d Cir. 2006) ("§ 363(k) speaks to the full face value of a secured creditor's claim, not to the portion of the claim that is actually collateralized as described in § 506."); In re Radnor Holdings Corp., Adversary No. 06-50909, 2006 WL 3346191, at *20 (Bankr. D. Del. Nov. 17, 2006) (Walsh, J.) (held, secured creditor could bid full amount of allowed claim, plus allowed post-petition interest and expenses constituting obligations under pre-petition credit agreement). No valuation of the collateral is necessary before the sale because section 363(k) "is premised on the notion that the market's reaction to a sale best reflects the economic realities of the assets' worth." SubMicron Systems, 432 F.3d at 461. Thus, assuming that it does not waive credit bidding rights in an intercreditor agreement, a junior creditor remains free to bid the value of its secured claim without first having to value the underlying collateral.

F. Control Over Acceptance Or Rejection Of Chapter 11 Plan.

1. Plan Process. In a typical chapter 11 case, the debtor files a plan, classifying and governing payment to creditors and equity holders. Classes of creditors and equity holders then vote on whether to accept or reject the plan. Code § 1126(c), (d). The vote determines whether the court will, in the first instance, even consider confirming the plan. Code § 1129(a).

2. Waivers Of Right To Vote On Plan. A junior creditor may waive its right to vote on a plan by assigning its vote to the senior creditor through the subordination agreement. Courts are split as to whether the junior creditor may waive its plan voting rights in a subordination agreement. Compare In re Inter Urban Broadcasting of Cincinnati, Inc., Nos. 94-
2382, 94-2383, 1994 WL 646176, at *1, 2 (E.D. La. Nov. 16, 1994) (junior creditor entered prepetition subordination agreement assigning right to vote debtor's claim in connection with any reorganization plan; held, senior lender's voting junior lender's claim was enforceable), appeal dismissed, 74 F.3d 1238 (5th Cir. 1995); Broadcast Capital, Inc. v. Davis Broadcasting, Inc. (In re Davis Broadcasting, Inc., EIN: 58-1914685), 169 B.R. 229, 230-31, 234 (Bankr. M.D. Ga. 1994) (junior creditor gave senior creditor right to vote on plan on junior creditor's behalf through subordination agreement; held, junior creditor was bound by confirmed chapter 11 plan when senior creditor voted in favor of plan on junior creditor's behalf and senior creditor did not object to plan or appeal confirmation), rev'd on other grounds, 176 B.R. 290 (M.D. Ga. 1994); In re Curtis Ltd. P'Ship, 192 B.R. 648, 659-60 (Bankr. E.D. Pa. 1996) (junior creditor entered subordination agreement authorizing senior creditor to vote junior creditor's claims if borrower sought bankruptcy relief; held, subordination agreement was clear and fully enforceable under Code § 510(a), absent any argument to the contrary) with In re 203 N. LaSalle St. P'ship, 246 B.R. 325, 227-28, 330-31 (Bankr. N.D. Ill. 2000) (junior creditor granted senior creditor right to vote its claim in reorganization case through intercreditor agreement; held, subordination agreement was unenforceable as to voting rights because section 1126(a) of the Bankruptcy Code governs voting on plan; "the fact that [junior creditor] agreed that [senior creditor] could vote its claim as part of a subordination agreement does not provide a basis for disregarding § 1126(a)"); In re Hart Ski Mfg. Co., Inc., 5 B.R. at 736 ("... the right to participate in the voting for confirmation or rejection of any plan of reorganization, the right to object to confirmation, and the right to file a plan... cannot be affected by the actions of the parties prior to the commencement of a bankruptcy case when such rights did not even exist.").

G. Rights To Postpetition Interest.

1. Postpetition Interest From Estate. Once a debtor commences a bankruptcy case, the Code generally denies unsecured creditors recovery of interest accruing after the petition date. Code § 502(b)(2) ("if... objection to a claim is made, the court... shall determine the amount of such claim... as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that... (2) such claim is for unmaturated interest"). But to the extent that a secured creditor's collateral exceeds the amount of its claim, it may recover postpetition interest and reasonable fees, costs, or charges from the estate. Code § 506(b) ("To the extent that an allowed secured claim is secured by property the value of which... is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose."); Timbers, 484 U.S. at 372-73 ("Since [Code § 506(b)] permits postpetition interest to be paid only out of the 'security cushion,' the undersecured creditor, who has no such cushion, falls within the general rule disallowing postpetition interest."). Code § 506(b) codifies the long-standing policy that "[i]t was considered unfair to allow an undersecured creditor to recover interest from the estate's unencumbered assets before unsecured creditors had recovered any principal." Id. at 373 (citing Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 164, 166 (1946); Ticonic Nat'l Bank v. Sprague, 303 U.S. 406, 412 (1938)). In the second lien financing market, the senior lender should clearly document that it holds a separate lien from the junior lender in the shared collateral to increase its chances of being oversecured. Compare First Fidelity Bank, Nat'l Assoc., New Jersey v.
Midlantic Nat'l Bank (In re Ionosphere Clubs, Inc.), 134 B.R. 528, 531-32 (Bankr. S.D.N.Y. 1991) (Debtor granted one lien to cover three tranches of debt; collateral value exceeded debt to first tranche but was less than total debt to all three tranches; held, first tranche not entitled to postpetition interest because one lien secured all three tranches and first tranche was part owner of undersecured claim); with In re Plymouth House Health Care Center, Case No. 03-19135, 2005 WL 2589201, at *2, *10 (Bankr. E.D. Pa. Mar. 15, 2005) (junior and senior lenders took separate security interests in same collateral; collateral value exceed debt to senior lender but was less than total debt to both lenders; held, senior lender was oversecured and entitled to recover fees and costs under Code § 506(b)). Thus, the senior and junior lenders should either have separate loan documents governing their loans or otherwise clearly document that the senior and junior lenders hold separate liens.

2. Postpetition Interest From Junior Creditor -- Rule of Explicitness. The value of the collateral may be insufficient for the senior and junior lenders to recover postpetition interest from the debtor under Code § 506(b), but senior lenders may try to recover postpetition interest from junior lenders under their intercreditor agreement. Prior to the enactment of the Code, most circuits held that the intercreditor agreement must explicitly entitle the senior lender to recover postpetition interest before any recovery by the junior lender. Continental Illinois Nat'l Bank & Trust Co. of Chicago v. First Nat'l City Bank of New York (In re King Resources Co.), 528 F.2d 789, 791 (10th Cir. 1976) (Intercreditor agreement provided: "Upon any distribution of assets of the Company upon . . . reorganization of the Company . . . (a) The holders of all Senior Indebtedness shall first be entitled to receive payment in full of the principal thereof (and premium, if any) and interest due thereon before the holders of the Debentures are entitled to receive any payment on account of the principal (or premium, if any) or interest on the Debentures"; held, senior lender could not recover postpetition interest from junior debenture holders because subordination provisions made no specific reference to postpetition interest); Bankers Life Co. v. Mfrs. Hanover Trust Co. (In re Kingsboro Mortgage Corp.), 514 F.2d 400, 401 (2d Cir. 1975) (per curiam) (subordination agreement did not expressly refer to post-petition interest; held, district court properly denied senior creditors postpetition interest out of dividend to junior creditors absent express provision in subordination agreement); In re Time Sales Finance Corp., 491 F.2d 841, 844 (3d Cir. 1974) ("If a creditor desires to establish a right to post-petition interest and a concomitant reduction in the dividends due to subordinated creditors, the agreements should clearly show that the general rule that interest stops on the date of the filing of the petition is to be suspended . . ."). See also In re Ionosphere Clubs, 134 B.R. at 533 ("The holding in both Kingsboro and Time Sales is that where the subordination provisions are unclear or ambiguous as to whether post-petition interest is to be allowed a senior creditor, the general rule that interest stops on the date of filing of the petition in bankruptcy is to be followed"; held, Kingsboro remains controlling law in Second Circuit after enactment of 11 U.S.C. § 510(a)). But more recent decisions have looked to state law in determining whether to apply the Rule of Explicitness to a senior lender's entitlement of postpetition interest under a subordination agreement. HSBC v. Branch (In re Bank of New England), 364 F.3d 355, 360, 365-66, 368 (1st Cir. 2004) (Indenture made no reference to senior lender's entitlement to postpetition interest; held, " . . . the Rule of Explicitness has no application in the context of bankruptcy where . . . the state has not adopted the rule as one of general applicability": New York law did not require strict enforcement of subordination provisions), cert. denied, 543 U.S. 926 (2004); In re Southeast Banking Corp., 179 F.3d 1307, 1310-11 (11th Cir. 1999) (intercreditor agreement did not expressly grant senior lender postpetition interest; held, senior
lender was not entitled to postpetition interest because New York law recognized Rule of
Explicitness) (analysis rejected by first circuit in Bank of New England). To avoid unnecessary
litigation, a senior lender wishing to recover postpetition interest before a junior lender recovers
anything should explicitly provide for its entitlement to postpetition interest in the intercreditor
agreement (i.e., assume that the Rule of Explicitness still applies).

H. Stand-Stills. When a borrower defaults, the credit agreement generally grants the
secured lender remedies against its collateral. But in a second lien financing, junior creditors
often waive their right to exercise these remedies for a period of time. These waivers are known
as "stand-stills." Stand-stills grant the senior lender the right to control the disposition of the
collateral while the junior lender waits for the stand-still to expire. The stand-still period can be
either until the senior debt is paid in full or for a specified period, usually 90-180 days.

I. Purchase Option Provisions. A senior lender may convince a junior lender to
accept an option to purchase the first lien debt at par value plus accrued interest in exchange for
the junior lender's waiving its bankruptcy rights. The junior lender may typically exercise its
purchase option once the borrower commences a bankruptcy case. Whether junior lenders
should accept these purchase options will turn on the risk accompanying each deal. Junior
lenders must evaluate the likelihood of the borrower's seeking bankruptcy relief and whether
holding the senior debt in the bankruptcy outweighs the rights they are waiving.

III. Second Lien Lenders In Bankruptcy Cases.

A. Second Lien Lenders' Impact On Bankruptcy Case. The impact second lien
financing will have on the direction and outcome of a bankruptcy case will depend on the facts
of each case, particularly the value of the lenders' collateral relative to the amount of senior and
junior debt and the extent the junior lender has waived its bankruptcy rights. The junior lender
may subordinate its position to a senior lender, but if the senior lender is oversecured and the
collateral at least partially covers the junior lender's claim, the junior lender will have a higher
priority than unsecured creditors. This greater priority will give the junior lender increased
leverage in plan negotiations. Moreover, if the junior lender is at least partially secured, it can
demand adequate protection of its lien, increasing its leverage in negotiations over DIP
financing, the debtor's use of cash collateral, and the debtor's sale of assets subject to the junior
lien. The junior lender may also credit bid its secured claim, increasing its leverage in an asset
sale. If the junior lender's collateral exceeds the total senior and junior debt, the junior lender
can also claim postpetition interest and reasonable fees, costs, and charges from the estate,
increasing its negotiating leverage with the priority and unsecured creditors. Of course, the
junior lender will reduce its leverage if it waives any of its bankruptcy rights in the intercreditor
agreement.

B. Strategies Employed By Second Lien Lenders In Bankruptcy Cases. What
strategy a junior lender decides to employ in a bankruptcy will depend on many facts, including
the extent of its liens and what rights it has waived in its subordination agreement with the senior
lender. A junior lender's leverage in the case diminishes as it waives more rights, discussed in
section II above. For example, if the junior lender waived its rights to vote on the plan, it will
lose significant leverage in negotiating any distribution that it may receive on account of its
claims. Moreover, if the collateral is insufficient to cover the junior lender's claim, it will lose leverage as a secured lender, placing it in a class with the general unsecured creditors.

C. Deepening Insolvency Claims. "Deepening insolvency" purports to be a claim under which a third party, usually the unsecured creditors, attacks a debtor's lenders, directors, and advisors for "the wrongful prolonging of an insolvent company's existence to the detriment of the company's creditors." James M. Peck, David M. Hillman, and Elizabeth L. Rose, "Deepening Insolvency" -- Litigation Risks for Lenders and Directors When Out-Of Court Restructuring Efforts Fail, NYU Journal of Law and Business, Fall 2004, at 293; In re Exide Techs., Inc., 299 B.R. 732, 750-52 (D. Del. 2003) (lenders extended debtors prepetition loan to acquire competitor; creditors' committee sued lenders alleging prepetition loan "caused debtors to suffer massive losses and become more deeply insolvent, costing creditors substantial value"; held, creditors' committee could pursue claim for deepening insolvency against lenders; "Delaware Supreme Court would recognize a claim for deepening insolvency when there has been damage to corporate property"). But recent case law has rejected the so-called "deepening insolvency" cause of action. Trenwick Am. Lit. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 204-07 (Del. Ch. 2006) (held, Delaware law does not recognize cause of action for so-called "deepening insolvency"); "If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy's success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather . . . the directors are protected by the business judgment rule"); In re CitX Corp., Inc., 448 F.3d 672, 674, 677-78, 681 (3d Cir. 2006) (accounting firm compiled financial statements to attract investors to insolvent internet company; trustee sued accounting firm for "deepening insolvency"); held, deepening insolvency is not a "theory of damages for an independent cause of action like malpractice"; deepening insolvency action requires showing of more than negligence; "a claim of negligence cannot sustain a deepening insolvency action"; deepening insolvency claim failed because trustee could not establish genuine factual issue to support allegation of fraudulent conduct); In re Radnor Holdings Corp., Adversary No. 06-50909, 2006 WL 3346191, at *16, *23 (Bankr. D. Del. Nov. 17, 2006) (Walsh, J.) (held, deepening insolvency claim, couched as breach of fiduciary duty claim, is not cause of action under Delaware law; "a board is not required to wind down operations simply because a company is insolvent, but rather may conclude to take on additional debt in the hopes of turning operations around"); damages model calculating difference between value unsecured creditors would have received if debtors filed for bankruptcy earlier and value available to them in actual bankruptcy case was impermissible because "deepening insolvency is not a recognized form of damages" (citing Trenwick, 906 A.2d at 204-07; In re CitX Corp., 448 F.3d at 677-78)). Accordingly, at least under current Delaware law, a junior lender should not be found liable on a "deepening insolvency" theory for lending to a distressed borrower already indebted to a senior lender.

D. Consequences Of Debt And Lien Subordination. As noted above, Code § 510(a) makes a subordination agreement enforceable in a bankruptcy case to the same extent it would be enforceable under applicable nonbankruptcy law. In the context of second lien financing, subordination agreements not only subordinate the junior lender's liens, but may also create a waterfall, providing that the borrower pay the senior lender before the junior lender.
1. **Lien Subordination.** As discussed above, the consequences of lien subordination in a bankruptcy case will turn on the value of the lender's collateral relative to the amount of senior and junior debt. By subordinating its lien to the senior lender, the junior lender will only have a secured claim to the extent the value of the collateral exceeds the total amount of senior debt. 11 U.S.C. § 506(a); see *In re Plymouth House Health Care Center*, Case No. 03-19135, 2005 WL 2589201, at *2, *10 (Bankr. E.D. Pa. Mar. 15, 2005) (junior and senior lenders took separate security interests in same collateral; collateral value exceeded debt to senior lender but was less than total debt to both lenders; held, senior lender was oversecured and entitled to recover fees and costs under Code § 506(b); junior lender remained undersecured). If the senior lender is able to recover postpetition interest from the estate, that recovery may diminish any current recovery to the junior lender. Further, if the debtor's assets are sold under Code § 363(b) and the estate's collateral is insufficient to cover the junior lender's claim, the senior lender may be in a stronger position to credit bid its secured claim. But to the extent the junior lender is at least partially secured, it will have more leverage over the unsecured and administrative claim creditors.

2. **Debt Subordination.** Debt subordination in a chapter 11 case will ultimately be embodied in the plan. As discussed above, the plan will classify claims and determine how the estate distributes assets to each class. Senior secured lenders typically have greater leverage in plan negotiations than other creditors. Thus, to the extent the senior lender seeks to enforce any waterfall provisions negotiated in its intercreditor agreement with a junior lender, the payout provisions in the plan will reflect the agreed upon waterfall.

IV. **Conclusion.**

As the second lien financing market continues to grow, litigation will follow. In the meantime, however, lenders should ensure that their intercreditor agreements clearly and explicitly define their rights.