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Delaware Bankruptcy Court Weighs In on Intercreditor Agreements

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In a recent noteworthy decision, the U.S. Bankruptcy Court for the District of Delaware weighed in on two issues that frequently arise in bankruptcy sales of overencumbered property: (1) whether a junior lienholder has standing to object to a sale notwithstanding the terms of an intercreditor agreement, and (2) whether a court may authorize a sale of property free and clear of junior out-of-the-money liens where the junior lienholders do not consent to the sale.

In *CyberDefender Corp.*,[1] GR Match LLC (GRM), the first-lien lender, was owed more than $16 million on an undisputed secured basis on account of pre-petition debt plus an additional $4 million on a post-petition secured basis as the debtor-in-possession (DIP) lender. The debtor also owed approximately $5 million to individual noteholders on account of two secured note issuances (the "junior lienholders"). The debtor, GRM and the junior lienholders were parties to intercreditor agreements that, *inter alia*, contained broad subordination provisions and language preventing the junior lienholders from interfering with GRM's rights and remedies.

When no other bidders came forward to purchase the debtor's assets despite an extensive marketing process, the debtor sought to sell its business to GRM for a $12 million credit-bid plus $500,000 in cash, cancellation of all first-lien indebtedness and the assumption of various cure obligations. Although the subordinated notes were issued on a secured basis, given the value of the debtor's business and the sale of the debtor to GRM in exchange for a credit-bid, the junior lienholders were completely undersecured, and hence unsecured within the meaning of § 506(a) of the Bankruptcy Code.

Nonetheless, the junior lienholders objected to the debtor's proposed sale, arguing that§ 363(f) of the Code did not permit a sale free and clear of their liens unless they consented or their liens were paid in full.

Did the Junior Lienholders Lack Standing to Object to the Sale?

Before it could reach the question of whether the proposed sale satisfied the requirements of § 363(f)(3), Judge **Brendan Shannon** considered whether the junior lienholders had standing to object to the sale. GRM argued that the junior lienholders lacked standing to object to the sale based on the terms of the intercreditor agreements. Under the intercreditor agreements, the junior lienholders agreed to (1) subordinate their liens on the debtor's assets to the pre-existing liens of GRM, (2) refrain from taking any actions to enforce their rights against the debtor and (3) refrain from exercising any remedies to which they might otherwise be entitled until GRM's senior loans are paid in full.

Section 510(a) of the Bankruptcy Code provides that "[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law."[2] *In re Ion Media Networks Inc.* was the first in a series of bankruptcy court decisions ruling on the enforceability and parameters of waivers found in pre-petition intercreditor agreements among lenders. Judge **James Peck** of the U.S. Bankruptcy Court for the Southern District of New York found that the intercreditor agreement constituted an enforceable contractual waiver of standing to challenge the validity of senior liens on FCC licenses. As the court put it, "[a]t bottom, the language of the Intercreditor Agreement demonstrates that the Second-Lien Lenders agreed to be 'silent' as to any dispute regarding the validity of liens granted by the Debtors in favor of the First-Lien Lenders and conclusively accepted their relative priorities regardless of whether a lien ever was properly granted in the FCC Licenses."[3]

In *In re Erickson Retirement Communities LLC*, the agent for the senior secured lender argued that the subordinated entities "lack standing and/or have waived their right" to pursue a motion for appointment of an examiner "because they essentially agreed to stand still, be 'silent seconds' and yield in all respects to the senior, secured lenders until the senior secured lenders are paid in full."[4] The agent further argued that the request for an examiner was "an indirect demand for payment" in violation of the parties' subordination agreement.[5] Because "subordination agreements are interpreted and enforced in accordance with general contract principles," the

1 Case No. 12-10633 (BLS) (Bankr. D. Del).

2 11 U.S.C. § 510(a). *See also In re Electrical Components International Inc.*, 2010 Bankr. LEXIS 5797, at * 26 (Bankr. D. Del. April 27, 2010); *In re Erickson Retirement Communities LLC*, 425 B.R. 309, 314 (Bankr. N.D. Tex. 2010); *In re Ion Media Networks Inc.*, 419 B.R. 585, 595 (Bankr. S.D.N.Y. 2009).

3 *Ion Media*, 419 B.R at 594.

4 *Erickson*, 425 B.R. at 314.

5 *Id.*

court determined that a reasonable person in the position of the subordinated party would understand the meaning of the subordination agreement to be that until the senior lenders are paid in full, the subordinated parties must "stand still."[6] The subordination agreement at issue in *Erickson* provided that the subordinated creditors could not "exercise any rights or remedies or take any action or proceeding to collect or enforce any of the Subordination Obligations" without prior written consent from the agent for the senior secured lenders until the senior loan was satisfied in full.[7]

In *Boston Generating*, Judge **Shelley Chapman** determined that an intercreditor agreement did not prohibit second-lien lenders from objecting to a § 363 sale process where the intercreditor agreement did not contain an "express or intentional waiver of [such] rights."[8] The bankruptcy court distinguished *Ion Media* and *Erickson*, noting that the facts before it required a different outcome because the proposed 363 sale would effectively deprive the second-lien lenders of the opportunity to vote, in "an economically meaningful way, on a plan"; in addition, the second-lien lenders were on the "cusp" of a recovery and were not engaging in the type of obstructionist behavior displayed in *Ion Media*.[9] The court further stated that second-lien lenders do retain certain rights under a typical intercreditor agreement, including the right to appear and be heard in a bankruptcy case as unsecured creditors.[10]

More recent cases, such as *In re Centaur LLC, et al.*[11] and *Boston Generating*, trend toward disfavoring standing arguments in light of the Bankruptcy Code's inclusiveness of all parties in interest and the bankruptcy court's use of the "bankruptcy imperative" to guard certain core rights such as the right to vote on a reorganization plan and, in some instances, the right to be heard as a creditor. Both *Centaur* and *Boston Generating*, however, focused on whether there had been an explicit waiver of a right.

GRM argued that a reasonable person would understand the intercreditor agreements to categorically prevent the junior lienholders from (1) objecting to the sale as an action to enforce the debtor's obligations to the junior lienholders, (2) an attempt to exercise remedies and (3) a prohibited effort to interfere with the disposition of GRM's collateral. At bottom, GRM argued that the junior lienholders' objections were improperly aimed at slowing down the sale process and "gaining leverage to enhance or create recoveries" for themselves—"the very type of obstructionist behavior that the agreements are intended to suppress."[12]

Judge Shannon was intrigued by these issues and commented that it was a very close call whether to entertain the junior lienholders' objections to the sale. On the one hand, Judge Shannon commented that the debtor, being a party to the intercreditor agreement, was important and provided a nexus to the bankruptcy estate to permit enforcement under § 510(a). On the other hand, he struggled with the constitutional due-process implications of denying a creditor the right to be heard in the bankruptcy case and drew a distinction in the case law between waiver and standing. Judge Shannon ultimately allowed the junior lienholders to be heard in connection with their objection to the sale, but stressed that his determination was only for purposes of the sale hearing and that it may not be his ultimate conclusion if the matter was raised in another context or in another case. Judge Shannon's willingness to let the junior lienholders be heard was likely also influenced by his decision to overrule their substantive objections and authorize the sale over their objections.

The Split of Authority under § 363(f)(3)

Section 363(f)(3) provides that property may be sold under § 363(b) free and clear of liens if "such interest is a lien and the price at which the property is to be sold is greater than the aggregate *value of all liens* on such property."[13] The junior lienholders' objection to the sale was based on the Ninth Circuit Bankruptcy Appellate Panel's (BAP) 2003 decision in *Clear Channel Outdoor Inc. v. Knupfer (In re PW LLC)*.[14] In *Clear Channel*, the Ninth Circuit BAP ruled that the debtor could not sell its assets free and clear of nonconsenting junior liens under § 363(f)(3) without satisfying the junior debt in full. The *Clear Channel* court reasoned that Congress's use of the phrase "aggregate value of all liens" as opposed to the "aggregate value of all claims secured by liens" in § 363(f) was significant and justified interpreting the statute to mean the face value, as opposed to the economic value of liens.[15]

The *Clear Channel* decision highlights a split of authority with the Southern District of New York and other jurisdictions. *In re Beker Indus Corp.*[16] and its progeny have held that "value" in § 363(f)(3) means the value of the collateral underlying the lien—*i.e.*, the "actual value"—rather than the face amount of such lien.[17] In determining actual value, the measuring stick is the market value of the underlying collateral, which dictates the value of the lien pursuant to § 506(a).[18]

Judge Shannon overruled the junior lienholders' objection when he ruled that "the Courts that have construed and followed the *Beker* analysis have it right...that the value of those liens is determined by reference to Section 506, and that it is in fact the value of the collateral, not the face value of the asserted lien."[19] Judge Shannon also ruled that a sale free and clear of the junior liens was authorized under § 363(f)(5) because the junior lienholders could be compelled to accept a monetary satisfaction of their claim, whether under a cramdown or a state court judicial foreclosure proceeding. The *CyberDefender* ruling is significant as it represents the decision of an influential bankruptcy court weighing in on the *Beker/Clear Channel* split. abi

6 *Id.* at 314-15.
7 *Id.* at 313.
8 *In re Boston Generating LLC*, 440 B.R. 302, 316-19 (Bankr. S.D.N.Y. 2010).
9 *Id.* at 320.
10 *See id.* at 317.
11 Case No. 10-10799 (Bankr. D. Del.) (KJC).
12 *Erickson*, 425 B.R. at 315; *see also Ion Media*, 419 B.R. at 595.
13 11 U.S.C. § 363(f)(3) (emphasis added).
14 391 B.R. 25 (9th Cir. B.A.P. 2008).
15 The objecting junior lienholders also relied on *Criimi Mae Servs. LP v. WDH Howell LLC (In re WDH Howell LLC)*, 298 B.R. 527, 532-34 (D.N.J. 2003), which was an earlier district court opinion that paralleled the *Clear Channel* decision on § 363(f)(3).
16 63 B.R. 474, 475-78 (Bankr. S.D.N.Y. 1985).
17 *See* 63 B.R. at 476 ("value" means "actual value as determined by the Court, as distinguished from the amount of the lien"). *See, e.g., In re Hatfield Homes Inc.*, 30 B.R. 353, 355 (Bankr. E.D. Pa. 1983); *In re Oneida Lake Dev. Inc.*, 114 B.R. 352, 356-57 (Bankr. N.D.N.Y. 1990); *In re Collins*, 180 B.R. 447, 451 (Bankr. E.D. Va. 1995) (holding that term "value" in § 363(f)(3) should be given same definition as "value" under § 506(a), and therefore "means actual value as determined by the Court, rather than the face amount of the lien"); *In re Netfax Inc.*, 335 B.R. 85, 92 (D. Md. 2005); *In re Boston Generating LLC*, 440 B.R. at 332-33.
18 *See In re Boston Generating LLC*, 440 B.R. at 332 ("Under *Beker* and the many decisions of other Bankruptcy Courts following its reasoning, I find that section 363(f)(3) is satisfied. To hold otherwise would effectively mean that most section 363 sales of encumbered assets could no longer occur either (a) absent consent of all lienholders (including those demonstrably out of the money) or (b) unless the proceeds of the proposed sale were sufficient to pay the face amount of all secured claims in full.").
19 May 2, 2012 Hearing Tr. at 67:14-18.