"Trumping" Seniority: Recent Decisions in *Westpoint Stevens* and *Trump Entertainment* Allow Bankruptcy Process to Undermine Intercreditor Terms Between First-Lien and Second-Lien Lenders

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"First-lien" and "second-lien" financing structures developed over recent years have allowed borrowers to increase leverage and have allowed lenders to expand their investment options in the secured debt markets. These layered-lien financing structures depend on intercreditor agreements between the first-lien lenders and the second-lien lenders to establish the relative priorities and rights of the two tiers of debt. In turn, these intercreditor agreements rely upon Section 510(a) of the Bankruptcy Code[1] to ensure that the rights of the first-lien lenders will be respected in a bankruptcy of the borrower.

However, two recent decisions provide a basis for questioning whether Section 510(a) fully protects first-lien lenders in all circumstances. In *Westpoint Stevens*,[2] the Second Circuit Court of Appeals held, based on the principle of mootness, that first-lien lenders could not appeal a ruling that shifted value to second-lien lenders and thereby breached an intercreditor agreement. In *Trump Entertainment*,[3] the New Jersey Bankruptcy Court held that the "cram-down" provisions of Section 1129(b) of the Bankruptcy Code[4] provide an exception to Section 510(a), such that intercreditor terms need not be satisfied if a Chapter 11 plan is otherwise confirmable under the "cram-down" requirements.

Together, these two decisions suggest that the enforceability of an intercreditor agreement in bankruptcy cannot be assumed, and first-lien lenders may be required to act carefully and strategically to protect their contractual seniority.

The *Westpoint Stevens* Decision and Statutory Mootness

Bankruptcy Code Section 363(m) provides that the "reversal or modification on appeal" of a sale approved under Section 363 "does not affect the validity of a sale" to a good-faith purchaser, unless the sale was stayed pending appeal.[5] This rule of "statutory mootness" protects consummated bankruptcy sales from challenge on appeal, enhancing sale values for the estate. But, as demonstrated in the *Westpoint Stevens* decision, Section 363(m) can also adversely affect the rights of first-lien lenders who have not expressly preserved their intercreditor rights with respect to second-lien lenders.[6]

The *Westpoint* case involved a contest between two groups of secured lenders for control of the debtor's business. The first group, led by Wilbur L. Ross, Jr., held a majority of the debtor's first-lien debt of $488 million. The second group, led by Carl C. Icahn, held a majority of the second-lien debt of $165 million, and 40% of the first-lien debt. When it appeared that a consensual plan was unattainable, the debtor proposed a Section 363 sale of its assets. Following a bidding war between the groups at an auction, the Icahn group emerged the winner and obtained approval from the bankruptcy court to purchase the debtor's assets under Section 363(b). Under the terms of the Icahn group purchase, a new Icahn entity would purchase the Westpoint assets, the first and second liens would be released, and the equity in the new entity would be shared among the first-lien lenders (which would receive shares valued at $489 million, the value of their first liens as determined in the sale order), the second-lien lenders (which would receive shares valued at $95 million), and the Icahn group (which would purchase a stake in the new entity for $187 million in cash). This sale structure assured that the Icahn group would obtain majority control of the debtor's business, through the equity in the new entity distributed to it on account of its first-lien and second-lien positions, combined with the equity interest it purchased with cash.

The Ross group of other first-lien lenders opposed the Icahn group transaction and sought a greater stake in the sale proceeds. After appealing to the district court, those first-lien lenders moved to stay the sale. However, rather than litigate the stay and attempt to prevent the closing, the Ross group agreed by stipulation to allow the sale to close so long as the distribution of the equity to the second-lien lenders was delayed pending further litigation regarding the relative rights of the first-lien lenders and second-lien lenders.

The sale closed, and on appeal the district court held that the distribution of equity to the second-lien lenders violated the intercreditor agreement between the first-lien lenders and the second-lien lenders, because the agreement provided—as most intercreditor agreements do—that the second-lien lenders were not entitled to any distribution unless the first-lien lenders were paid in full in cash.[7] The district court then ordered the sale of the equity that had been allocated to the second-lien lenders, with the cash proceeds of the sale to be paid to the first-lien lenders.

The Second Circuit reversed, holding that Section 363(m) barred the district court from modifying the sale order. The Ross group of first-lien lenders argued that Section 363(m) did not moot their appeal, asserting that they were not challenging the validity of the sale of the debtor's assets, but rather that they were challenging separate provisions distributing the proceeds of that sale among the debtor's secured lenders in satisfaction of their liens. Rejecting that argument, the Second Circuit stated that "we lack jurisdiction to review the entire Sale Order—not just the actual sale transaction."[8] It emphasized "the uniquely important interest in assuring the finality of a sale" in bankruptcy, and concluded that the challenged provisions fell within the scope of Section 363(m) because they were integral to the Icahn group's bid to purchase the debtor's business. It reasoned that what was being sold was a "sale for control of the Debtor's business," and, accordingly, the court could only revisit the sale order to the extent that the Icahn group's control would be preserved. Nonetheless, the Second Circuit agreed with the district court that the intercreditor agreement prohibited distribution of the equity to the second-lien lenders. As a partial remedy for the Ross group, the Second Circuit ordered that 11% of the equity otherwise distributable to the second-lien lenders should be allocated to the first-lien lenders, leaving the rest of the second-lien distribution with the Icahn group (to preserve control) and the non-Icahn group of minority second-lien lenders (who had not consented to the stipulation staying distribution of the equity pending appeal).[9]

The *Trump Entertainment* Decision and Subordination Rights in "Cram-Down" Plans

The *Trump Entertainment* case involved another contest between first-lien and second-lien lenders for control of the Trump casinos in Atlantic City, New Jersey. A group led by Icahn, holding a majority of the debtor's first-lien debt ($488 million), proposed a plan of reorganization that would convert the first-lien debt into 100% of the reorganized debtor's equity and wipe out the second-lien debt and the bulk of the unsecured debt and shareholders. A group holding a majority of the debtor's second-lien debt ($1.25 billion) proposed a competing plan that would satisfy the first-lien debt with cash ($125 million) and a secured loan ($334 million), and provide for the second-lien lenders to invest $225 million through subscription rights and receive 75% of the reorganized debtor's equity.

The bankruptcy court performed a confirmation analysis of both plans under each clause of Section 1129, concluding that both plans met the requirements for confirmation. It noted that the first-lien plan deleveraged the debtor and had better financial prospects, and that the first-lien lenders could properly take over the debtors while leaving nothing for other creditors, because the debtors were worth less ($459 million) than the first-lien debt ($488 million). But it exercised its discretion to confirm the second-lien plan, finding it superior because it was favored by more creditors, provided the first-lien lenders the value of their secured claim, and gave the second-lien lenders a chance to participate in the upside potential of the debtors' reorganization.

The bankruptcy court overruled objections by the first-lien lenders that the plan breached an intercreditor agreement by giving value to the second-lien lenders before full cash payment of the first-lien lenders. The court acknowledged that subordination agreements are generally enforceable in consensual plans confirmed under Section 1129(a), because Section 1129(a)(1) "requires a plan to conform to the provisions of Title 11, including § 510(a)." Section 510(a) provides, in turn, that a "subordination agreement is enforceable in a [bankruptcy] case ... to the same extent that such agreement is enforceable under applicable nonbankruptcy law."[10] But the court nevertheless held that an exception to this rule applies when a party seeks to confirm a "cram-down" plan, because Section 1129(b) provides that "[n]otwithstanding Section 510(a)," the court "shall" confirm the plan if it complies with the "cram-down" requirements.

The cram-down provisions of the Bankruptcy Code generally require the court to determine that the plan does not discriminate unfairly and is fair and equitable with respect to the dissenting class, including requirements that secured creditors receive the value of their secured claims and that unsecured creditors receive full payment before junior interests receive any value. Accordingly, the court held the plan could be confirmed under Section 1129(b) even if it breached the intercreditor agreement—so long as the statutory cram-down standard was met, the contractual intercreditor agreement need not be met. The court's analysis did not require it to decide whether the intercreditor agreement was actually breached—whether it was breached or not, the plan could be "crammed down" on the first-lien lenders under Section 1129(b).[11]

While the *Trump* ruling has been appealed, if it is upheld on appeal, it could establish a significant precedent that parties to subordination agreements should be aware of when navigating in the plan confirmation context, and in negotiating intercreditor agreements at the outset.

The Bottom Line

The *Westpoint* and *Trump Entertainment* decisions demonstrate that, in certain circumstances, intercreditor terms agreed between first-lien and second-lien lenders may not be enforced in bankruptcy. Although Section 510(a) provides a basis for the enforceability of intercreditor terms, other aspects of the bankruptcy case may override the effect of Section 510(a). Specifically, first-lien lenders should be cautious of losing the ability to assert intercreditor rights because those arguments have become moot, as occurred in *Westpoint Stevens*, or because the "cram-down" provisions of Section 1129(b) are deemed to "trump" the effects of Section 510(a).

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[1] 11 U.S.C. § 510(a).

[2] *In re Westpoint Stevens, Inc.*, 600 F.3d 231 (2d Cir. 2010).

[3] *In re TCI 2 Holdings, LLC*, No. 09-13654, 2010 WL 1540115 (Bankr. D.N.J. Apr. 12, 2010).

[4] 11 U.S.C. § 1129(b).

[5] 11 U.S.C. § 363(m).

[6] Courts have not been uniform in construing the scope of Section 363(m)'s bar against appellate review. A more expansive view extends its protection beyond the sale of assets to other terms of the sale that were integral to the buyer's decision to purchase. *See, e.g., In re Trism, Inc.*, 328 F.3d 1003, 1007-08 (8th Cir. 2003) (holding Section 363(m) mooted appeal of sale provision releasing third party from avoidance liability); *In re Stadium Mgmt. Corp.*, 895 F.2d 845, 848-49 (1st Cir. 1990) (holding Section 363(m) mooted appeal of sale provision assigning lease to purchaser under

Section 365). A narrower view, recently adopted by the Ninth Circuit Bankruptcy Appellate Panel in *Clear Channel*, moots only challenges to "changes of title or other essential attributes of a sale," but not to the "terms of those sales." *Clear Channel v. Knupfer (In re PW, LLC)*, 391 B.R. 25, 35-36 (B.AP. 9th Cir. 2008). The *Clear Channel* court thus reversed a sale provision cleansing the assets "free and clear" of liens, leaving the purchaser with unexpectedly encumbered assets after it had already closed the sale.

[7]*In re Westpoint Stevens, Inc.*, 333 B.R. 30, 45-54 (S.D.N.Y. 2005), *rev'd in part*, 600 F.3d 231 (2d Cir. 2010).

[8] 600 F.3d at 248.

[9] The limited appellate review of Section 363 sales is in contrast with the greater opportunity for appellate review of orders confirming plans of reorganization. Unlike Section 363, the Chapter 11 plan process does not impose a statutory bar on appellate review of plan-confirmation orders. Instead, courts have developed a similar, but distinct, doctrine known as "equitable mootness," a judge-made rule of appellate abstention, not a jurisdictional limitation, in which courts refrain from hearing bankruptcy appeals, even though relief could be provided, where it would be "inequitable" to do so. Had the *Westpoint* transaction occurred under a plan of reorganization, as originally contemplated, an appellate court might have had greater authority to exercise jurisdiction if it were persuaded review was warranted. But, as *Trump Entertainment* demonstrates, the courts may have reached a similar result, for different reasons, under a plan.

[10]*In re TCI 2 Holdings*, 2010 WL 1540115, at *11 (quoting 11 U.S.C. § 510(a)).

[11] In holding that a senior creditor cannot enforce a subordination agreement in a cram-down plan, the *Trump Entertainment* decision adopts a position on an issue that appears to have received little attention in the reported decisions. *See, e.g.*, 4 *Collier on Bankruptcy* ¶ 510.03[3] at 510-10 n.20 (16th ed. 2009) ("The courts have not yet resolved whether a plan may modify a subordination agreement through the cram-down mechanism of Section 1129(b)."). At least one prior decision reached the opposite conclusion, rejecting the "plain language" reading of Section 1129(b) later adopted in *Trump*, reasoning that subordination agreements are enforceable in a cram-down plan "under the discrimination and fair and equitable concepts of the statute." *In re Consul Restaurant Corp.*, 146 B.R. 979, 988 (Bankr. D. Minn. 1992).

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