

# Bankruptcy Implications of Second Lien Loans

By: Gordon L. Su

The Wharton School of the University of Pennsylvania  
306 Governors Court, Philadelphia, PA 19146; 240.476.2228; [gordonsu@wharton.upenn.edu](mailto:gordonsu@wharton.upenn.edu)

**ABSTRACT** The second lien loan market has grown rapidly in the past few years, rising from an issuance of \$300 million in the late 1990s to over \$22 billion in 2005. This article examines the impact that second lien loans may have on future bankruptcies by studying sixteen bankruptcies that have involved second lien loans. Based on a careful study of most or all of the recent bankruptcy cases involving second lien loans, this article finds that intercreditor agreements between first and second lien loans have had a limited impact smoothing conflicts between first and second lien lenders. Intercreditor agreements have been used primarily as a negotiating lever rather than the determinant of reorganization results. My research also reveals that bankruptcies with second-lien loans mostly involve debtors with over-encumbered balance sheets. In these cases, second lien loans have become the fulcrum of impairment. The result is that second lien loans have created significant barriers to reorganizations by: 1) limiting free assets to operate in bankruptcy and collateralize Debtor-In-Possession (DIP) financing; 2) limiting reorganization options by making cram-downs more difficult and; 3) introducing new hedge fund related complexities in the reorganization process. Professionals have used a number of tactics to work around these problems. Tactics include pre-negotiated plans, creative DIP financing solutions, asset sales, first lien loan buyouts, rights offerings, valuation litigation, and cross-lien ownership. The article surveys each of these developments and speculates about the future significance of these lending arrangements.

**AUTHOR** Gordon L. Su is a student at the Wharton School concentrating in Finance and Management. He is a Joseph Wharton Scholar, Benjamin Franklin Scholar, and member of the Tau Beta Pi Engineering Honors Society. He is on the Wharton School's Dean's list. The author is grateful for the support, guidance, and mentoring of Professor David A. Skeel Jr. at the University of Pennsylvania Law School; the academic approval of Professor Martin Asher at the Wharton School; and the perspective and resources provided by the Matt Ehmer, Roger Higgins, Stephen Lerner, Suneel Mandava, Alan Miller, Harvey R. Miller, Stephen Sieh, Michael Walsh, and the University of Pennsylvania.

## I. Introduction

### A. Background

The second-lien loan market has exploded in the past few years. While second liens were used in the late 1990s as small bridge loans with total volume around \$300 million<sup>1</sup>, second lien loans today have become a fixed part of the corporate debt market. Issuance has grown exponentially, rising to \$7.7 billion in 2003, \$22 billion in 2005<sup>2</sup> and is on pace to exceed \$24 billion in 2006<sup>3</sup>. In Europe, issuance has also grown rapidly, with €1.88 billion in 2004 and €5.75 billion in 2005.<sup>4</sup>

Driving this growth has been the demand for second-lien loans from hedge funds, high yield funds, business development companies, prime funds and collateralized loan obligation vehicles (CLOs). In a low interest environment, investment vehicles are attracted to the additional yield second lien loans provide relative to first lien loans. Simultaneously, the supply of second lien loans has been robust as private equity firms have used second lien debt to leverage buyouts. Private equity funds have been attracted to second lien loans' greater flexibility and cheaper pricing relative to traditional high-yield and mezzanine products.<sup>5</sup> Perhaps one of the most notable achievements of the second lien market was the \$2.25 billion second lien syndicated loan financing for Koch Industries Inc's acquisition of Georgia Pacific, which was rated at B+ and priced at LIBOR plus 300 bps.<sup>6</sup>

The growth of second lien loans has come at the expense of high yield bonds and unsecured debt. Much of the capital that was formerly raised as unsecured credit is today secured through second liens. These developments sour the outlook for unsecured debt as the increase in new second lien

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<sup>1</sup> Cross, Collins, *The Evolution of Second Lien Notes*, Bank of America CapitalEyes, November 2004.

<sup>2</sup> *Strong Second Lien Issuance Persists, But Road Bumps are Forming*, Bank Loan Report, July 17, 2006.

<sup>3</sup> Kiesel, Mark, *US Credit Perspectives*, PIMCO Bonds, September 2006.

<sup>4</sup> Bedell, Denise, *Second Lien Financing: Untapped Resource or risk?*, Euromoney, March 2006.

<sup>5</sup> Burke, Kevin, *Second Lien Market Likely to Maintain '04s Heated Pace*, Bank Loan Report, February 7, 2006.

<sup>6</sup> See Miller, Steven, *Why Investors and Borrowers Continue to Tap Second Lien Loans*, Bank of America CapitalEyes, April 2006.

secured bank debt will decrease unsecured debt recoveries. Furthermore, debtors have been attracted to second lien loans' cheaper financing cost relative to fixed obligations in a low interest environment. Issuance of high-yield corporate bonds fell to \$97 billion 2005 from \$141.8 billion in 2004 according to Thomson Financial.<sup>7</sup>

Although second liens are a relatively new product and have not been tested in a declining credit cycle, the market infrastructure for the product has developed rapidly. Mirroring the broader syndicated loan market, trading in second lien loans has grown rapidly in the past couple years. The Bank Loan Report notes that "in the last two years, trading and liquidity in the second lien market has grown significantly."<sup>8</sup> An even more important trend has been the growth and participation of hedge funds, which have provided most of the liquidity in second lien secondary markets, especially in distressed debt markets.<sup>9</sup>

The second lien loan market can be bifurcated into two distinct markets: large, broadly syndicated second lien loans and middle market second lien loans. The large, syndicated second lien loans are generally used for companies with EBITDA greater than \$50 million, and for which a large, liquid secondary market exists. In contrast, middle market second lien loans are smaller and are relatively illiquid, although some loans are still traded.<sup>10</sup>

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<sup>7</sup> Leary, Christopher, *Why Second Liens Could Fall out of Favor*, Bank of America CapitalEyes, August 2006.

<sup>8</sup> *Id.*

<sup>9</sup> See *Structured Complacency*, Grant's Interest Rate Observer, June 2, 2006 and Cantrell, Amanda, *How hedge funds make money now*, Cnn/Money, (August 4, 2006) <http://money.cnn.com/2005/08/04/markets/fastmoney/index.htm>.

<sup>10</sup> D'Souza, Mary, *Second Lien Bank Loan Report*, Bank Loan Report, February 6, 2006.

## B. Research Focus

With a slowing housing market, declining consumer prices, and continued inflation pressure, credit has already begun tightening and second lien products could soon be tested in a slowing market. Given the prevalence of second lien loans in corporate capital structures and in anticipation of the credit cycle, this paper addresses the impact second lien lenders and loans have on the reorganization process and discusses the main tools that have and will likely be used to reorganize multiple-lien debt. Sixteen recent bankruptcies that contained second-lien debt were reviewed.<sup>11</sup> The sixteen cases investigated should be close to the universe of recent bankruptcies involving second lien loans as of the end of October 2006. In August 2006, Standard and Poor's (S&P) reported that there were only 10 bankruptcies involving second lien loans in the past three years.<sup>12</sup> Interviews with the lawyers, investment bankers, and creditors involved with the cases were used to supplement the bankruptcy documents studied.

| Number | Company                                  | Filing Date | Second Lien Debt (\$ mil) | Outcome               | Exit Date |
|--------|--|-------------|---------------------------|-----------------------|-----------|
| 1      | Dura Automotive Systems                  | 30-Oct-06   | 225                       | In Chapter 11         | N/A       |
| 2      | Aerosol Packaging LLC                    | 21-Jun-06   | 1.95                      | In Chapter 11         | N/A       |
| 3      | Werner Co.                               | 12-Jun-06   | 100                       | In Chapter 11         | N/A       |
| 4      | JL French Automotive Castings Inc.       | 10-Feb-06   | 170                       | Reorganized           | 30-Jun-06 |
| 5      | Performance Transportation Services Inc. | 25-Jan-06   | 35                        | Still in Chapter 11   | N/A       |
| 6      | Nellson Nutraceuticals Inc.              | 28-Jan-06   | 75                        | Still in Chapter 11   | N/A       |
| 7      | Pliant Corp.                             | 4-Jan-06    | 250                       | Reorganized           | 19-Jul-06 |
| 8      | Calpine Corp.                            | 20-Dec-05   | 650                       | Still in Chapter 11   | N/A       |
| 9      | American Remanufacturers Inc.            | 7-Nov-05    | 40                        | Chapter 7 Liquidation | 6-Jan-06  |
| 10     | Atkins Nutritional Inc.                  | 31-Jul-05   | 78.5                      | Reorganized           | 10-Jan-06 |
| 11     | New World Pasta Co.                      | 10-May-05   | 168                       | Reorganized           | 7-Dec-05  |
| 12     | Meridian Automotive Systems Inc.         | 26-Apr-05   | 179.8                     | Reorganized           | N/A       |
| 13     | EaglePicher Corp.                        | 11-Apr-05   | 115                       | Reorganized           | 1-Aug-06  |
| 14     | Tower Automotive Inc.                    | 2-Feb-05    | 155                       | Still in Chapter 11   | N/A       |
| 15     | Maxim Crane Works Holdings               | 14-Jun-04   | 51                        | Reorganized           | 31-Jan-05 |
| 16     | Westpoint Stevens Inc                    | 1-Jun-03    | 165                       | 363 Asset Sale        | 10-Aug-05 |

<sup>11</sup> A review of the bankruptcy cases involved studying the disclosure statement for each case, if available, gathered from PACER and certain law firms including Weil Gotshal, & Manges LLP, Kirkland & Ellis LLP, Squire, Sanders, & Dempsey LLP, and Lazard Ltd. Disclosure statements were available for Meridian, Eagle Picher, JL French, EaglePicher, Maxim Crane Works Holdings & Westpoint Stevens. Information from disclosure statements was supplemented with coverage of all cases as reported on The Deal's Bankruptcy Insider Database. Case developments are discussed as of the end of October 2006.

<sup>12</sup> Kerr, Steven, *Second-Lien Pricing May Not Fully Recognize Risk of Loss Given Default*, Standards & Poor Ratings Direct, August 7, 2006.

Based on anecdotal evidence, outside research, and the sixteen cases examined for this research, second lien loans appear to be and could become a major impediment to successful reorganizations. The issue lies in the aggressive financing that second lien debt provides. Several commentators have noted that second lien loans are simply unsecured loans that have been secured to decrease financing costs.<sup>13</sup> While second lien loans provide companies with cheaper debt, they over-encumber debtors' assets. This makes reorganizations substantially more difficult without free assets for bankruptcy restructuring costs, such as DIP financing. Furthermore, most second liens are significantly undersecured and impaired, which has allowed second lien lenders to put a stranglehold on the reorganization process despite intercreditor agreements that may exist to alleviate inter-lien issues.

Indeed, market participants have become openly concerned with the aggressive terms of second lien loans. Marc Hanrahan, co-head of the global banking practice group at Latham & Watkins explains, "It's still a new product; many of the intercreditor agreements have not been tested through the bankruptcy process. The details of the product still vary from deal to deal and institution to institution."<sup>14</sup> Many have also expressed their concern that with inexperienced investors, second-lien markets have gotten too far ahead of themselves and will likely experience a steep drop when hidden risks reveal themselves.<sup>15</sup> One investor states, "I think when one [second-lien loan] starts to go bad, pricing will drop from 102 to 70 in the secondary market overnight and its going to spook some of the investors."<sup>16</sup> S&P recently published a report which suggests that, based on ten

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<sup>13</sup> Based on discussions and views of bankruptcy lawyers Alan Miller and Roger Higgins.

<sup>14</sup> *Second Liens will Ride in '05, but 'Growing Pains' Expected*, Bank Loan Report, February 7, 2006.

<sup>15</sup> Based on the authors' discussion with several portfolio managers and unnamed investors including Steven Schwartz of Prudent Capital LLC.

<sup>16</sup> See *Second Liens will Ride in '05... supra* note 14.

bankruptcies involving second lien loans, current pricing may not fully reflect the expected loss and probability of default of second lien loans.<sup>17</sup>

### **C. Literature Review**

Although there has been substantial coverage of second lien markets in commercial literature such as S&P, Bank Loan Report, and various law firm publications, to the author's knowledge, there has not been any academic coverage of the growth of second lien loans and its impact on the bankruptcy process. Nonetheless, the research covered in this paper does touch on recent developments that impact current academic discussions on absolute priority violation, the balance of power between creditors and debtors, claims trading and the relevance of Chapter 11.

First, this paper's findings may provide supporting evidence for Professor Douglas G. Baird and Donald S. Bernstein's recent paper highlighting valuation uncertainty as a possible cause for absolute priority violations.<sup>18</sup> Baird and Bernstein argue that absolute priority violations are a natural byproduct of corporate reorganization bargaining under the shadow of uncertainty. Tactics observed in this research to solve problems with second-lien lenders such as the use of asset sales, pre-negotiated and pre-packaged reorganization plans, and valuation litigation may support the idea that absolute priority violations could be the result of uncertainty in valuation appraisals and the enforceability of intercreditor agreements.

Second lien loans have also had an impact on the balance of power between creditors and debtors. Several authors including Professor David A. Skeel Jr. and Harvey R. Miller have discussed the shift

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<sup>17</sup> See Kerr, *supra* note 12.

<sup>18</sup> See Baird, Douglas G. & Bernstein, Donald S. *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*. The Yale L.J. 1930-1970 (2006).

of power from debtors to creditors in the past several years.<sup>19</sup> Although the complexities associated with reorganizations involving second lien loans may have increased creditors' power in Chapter 11 in a general sense, the split between first and second lien secured creditors may have decreased the power of individual creditors. In other words, unlike bankruptcies described by Professor Skeel's *Creditor's Ball*, first lien secured creditors no longer dominate reorganizations and exit financing but now must share control with second lien lenders. This has reduced any one party's control over the reorganization process. As a result, second lien loans have also changed the role of DIP financing. While DIPs have often been used by first lien lenders to control the reorganization process, the involvement of second lien loans combined with new lenders in the marketplace has reduced first lien lenders' control over DIP financing, which in turn has both reduced the cost and changed the structure of DIP loans.<sup>20</sup>

For more than a decade, increased claims trading has been widely noted in bankruptcy literature.<sup>21</sup> While this paper's findings do not find specific evidence of a change to claims trading, the importance of claims trading with second lien claims in bankruptcy does provide another example of the growing market for distressed assets and the rising importance of hedge funds.

Finally, there has been an ongoing debate in recent bankruptcy publications about the future role of Chapter 11, which began with Professors Douglas G. Baird and Robert K. Rasmussen's

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<sup>19</sup> See Skeel Jr., David A. *Creditors Ball: The New New Corporate Governance in Chapter 11*, 153 University of Pennsylvania Law Review 917 (2003); Miller, Harvey R. & Waisman, Shai Y. *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty First Century?*, 78 American Bankruptcy L.J. (2004); and Miller, Harvey R. & Waisman, Shai Y. *The Erosion of Debtor Protections in the Face of Expanding Creditors Rights and Control*, Remarks at the NYU Workshop on Bankruptcy and Business Reorganization (September 2, 2003).

<sup>20</sup> See Skeel Jr., David A. *The Past, Present, and Future of Debtor-in-Possession Financing*, Cardozo Law Review Volume 25, number 5 (2004).

<sup>21</sup> See Tung, Frederick, *Confirmation and Claims Trading*, 90 Northwestern Undergraduate Law Review 1684 (1996) and Miller and Waisman, *supra* note 19.

controversial publication about the end of bankruptcy.<sup>22</sup> Professors Baird and Rasmussen argue that given the evolution toward a service-based economy, the contraction of hard assets, and the fungibility of assets, the importance of Chapter 11 and the existence of value as a going concern has greatly diminished.<sup>23</sup> Their argumentation has touched off a number of responses from other experts including Professor Lynn Lopucki<sup>24</sup>, Harvey R. Miller, and Shai Y. Waisman<sup>25</sup>. While this paper does not directly address this debate, the increased use of asset sales and pre-negotiated and pre-packaged reorganization plans reinforces many of the trends observed in these publications. This paper, however, does not attempt to make any general conclusions regarding the meaning of these trends on the future of Chapter 11. I focus instead on a particular development, the use of second lien financing.

#### **D. Outline**

To further discuss the issues involved with reorganizing companies with second lien loans, this paper will:

- Section II: describe the current discussion on the impact of intercreditor agreements in Chapter 11
- Section III: consider the main implications of second liens in bankruptcy reorganizations
- Section IV: explore some solutions that have been employed to alleviate second lien impediments to reorganizations

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<sup>22</sup> See Baird, Douglas G. and Rasmussen, Robert K., *The End of Bankruptcy*, 55 Stanford Law Review 751 (2002).

<sup>23</sup> *Id.*

<sup>24</sup> See Lopucki, Lynn, *The Nature of the Bankrupt Firm: A Reply to Baird and Rasmussen's "The End of Bankruptcy"*, 56 Stanford Law Review 645-71 (2003).

<sup>25</sup> See Miller & Waisman *supra* note 19.

- Section V: weigh the impact of the second lien bankruptcy developments and consider the future impact that second liens may have on Chapter 11

Although second lien issuance may slow in a tighter credit environment, second lien loans appear to have become a permanent part of capital markets. When default rates rise, second lien loans will probably complicate bankruptcy negotiations. Future reorganizations will likely use more pre-negotiated and pre-packaged bankruptcy plans, asset sales, and rights offerings to deal with some of these complexities. Liquidations may also increase because of the difficulties reorganizing second lien loans.

## II. Intercreditor Issues of Second Liens

Much of the commercial bankruptcy literature on second lien loans has focused on the intercreditor issues between first and second lien creditors. Second lien loans have not grown independent of the first lien loan market. All second lien loans are underwritten with intercreditor agreements that attempt to anticipate and mitigate some of the issues that may arise out of bankruptcies with second lien debt. This section reviews the current discussion on intercreditor agreements and the limited impact that they have had on smoothing the bankruptcy process with second lien loans.

### A. Evolution of Intercreditor Agreements

Since second lien debt is so new, a standard intercreditor agreement has not emerged and terms in the agreements have been evolving with the second lien loan market.<sup>26</sup>

At the inception of second lien growth in 2003, intercreditor agreements were primarily designed to align second lien interests with first lien lenders. The most salient features of these early intercreditor agreements were the provisions requiring second lien lenders to waive rights they were entitled to and vote along with the first lien lenders. These types of agreements were often dubbed “silent second liens”. Typical terms that have “silent features” include:<sup>27</sup>

- Waivers of the right to challenge the validity, enforceability or priority of first liens
- Waivers to adequate protection
- Advance consents to the use of cash collateral
- Advance consents to the sale of collateral
- Advance consents to DIP financing

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<sup>26</sup> Kerr, Steven, *Second Lien Evolution Creates Higher Recovery Prospects – At First Lien Lender's Expense*, Ratings Direct, August 22, 2005.

<sup>27</sup> Cummings, Neil, *A Primer on Second Lien Term Loan Financing*, Commercial Lending Review, September 2004.

These waivers gained attention within the bank loan literature, as many questioned whether these terms were too onerous or may even leave second-lien lenders worse off than unsecured creditors. However, intercreditor agreements generally contain provisions that protect second-lien lenders from abuse. For example, the above-mentioned waivers usually only pertain to a standstill period of 180 days, after which second lien lenders can exercise their secured creditor remedies.<sup>28</sup> Intercreditor agreements also rarely contain waivers to vote on the plan of reorganization and often include provisions that prevent the priming of the second lien loan and caps on the incurrence of additional debt or increased interest rates. These provisions are important because they force first lien lenders to negotiate with second lien lenders for any debt workout.<sup>29</sup> For example, often a debt restructuring may require an increase in the interest rate on the first lien debt. However, most intercreditor agreements cap the interest rate on the first lien loan, which means first lien lenders would need to negotiate with second lien lenders for the workout.<sup>30</sup>

As a tool of last resort, intercreditor agreements also typically contain call options that allow second-lien lenders to buy out first lien lenders at par.<sup>31</sup> Given the typical 2-3 year length of many reorganizations and the importance of voting on the plan of reorganization, these provisions collectively suggest that even silent second liens would unlikely be silent in a work out or reorganization.

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<sup>28</sup> *Id.*

<sup>29</sup> Goodison, Eric, *Second Liens Create Tougher Workouts*. Investment Dealers Digest (September 25, 2006).

<sup>30</sup> *Id.*

<sup>31</sup> Vedder Price Finance & Transaction Group, *Nature of Tranche B or "Second Lien" Loans*, Special Report, May 2004.

## B. Enforcement of Intercreditor Agreements

Courts have been ambiguous and reluctant to rule on the enforceability of second-lien waivers. While section 510(a) of the bankruptcy code provides that subordination agreements are enforceable in a case under this title and bankruptcy courts regularly enforce payment subordination provisions, bankruptcy voting provisions have not always been enforced.<sup>32</sup> Most notably, the court held *In re 203 North Salle Street Partnerships* that Section 1126(a) of the Bankruptcy Code, which provides that the “holder of a claim or interest allowed under section 502 of this title may accept or reject a plan,” means that only the actual holder of the claim may vote and that an agreement giving the right to the senior lender is not enforceable.<sup>33</sup> Since the decision, courts have been ambiguous on the enforceability of voting provisions outlined in intercreditor agreements.

Based on the sixteen investigated bankruptcies, courts only ruled on intercreditor issues in four of the cases (Aerosol Packaging, American Remanufacturers, Westpoint Stevens, and New World Pasta). While court decisions in American Remanufacturers and Westpoint Stevens regarded specific provisions not seen in many other intercreditor agreements<sup>34</sup>, the court decision in New World Pasta effectively deferred any judgment on intercreditor issues and ruled that intercreditor issues should not be altered or dealt with in DIP financing provisions. Although the New World Pasta decision has put some ambiguity into the automatic enforcement of intercreditor waivers and

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<sup>32</sup> See 11 U.S.C. § 510(a).

<sup>33</sup> See 11 U.S.C. § 502 and *In Re 203 North LaSalle Street Partnership*, 246 B.R. 325 (Bankr. N.D. Ill. 2000).

<sup>34</sup> American Remanufacturers’ court decision addressed an unusual provision in the intercreditor agreement that would allow the second lien to share proceeds *pari passu* with the first lien upon the priming of the second lien with a DIP. The courts ruled that the provision held. As a result, the first lien creditor decided to file Chapter 7 rather than provide a DIP that would trigger the *pari passu* provision. At the end, the second lien lender walked away with nothing (Berman, Mark, Brighton, *jo Ann, Second Lien Financings*, ABI Journal, March 2006)

Westpoint Stevens’ court ruling dealt with the appropriate distribution of proceeds from the sale of Westpoint Stevens. The issue was over whether the intercreditor agreement allowed for the first-lien recovery to be in non-cash securities. While the bankruptcy court ruled that the intercreditor agreement would allow the first lien recovery to be in non-cash securities even against the first lien creditors’ will, the courts of appeals have recently overruled the bankruptcy court decision. (Murray, Shannon, *WestPoint’s ownership wrinkles*, theDeal.com, June 12, 2006)

raised questions of whether certain bankruptcy rights (such as adequate protection) can even be waived in bankruptcy, it did not explicitly debunk the waivers.

The lack of court decisions on intercreditor agreements has drawn attention to the decision in *In re Aerosol Packaging, LLC*, issued by a bankruptcy court in Atlanta in late December 2006. In that case, Wachovia Bank had signed an intercreditor agreement with Blue Ridge Investors, II, L.P., the second lien lender. In its Chapter 11 bankruptcy, the debtor filed a plan of reorganization acceptable to Wachovia. When votes were solicited, both Wachovia and Blue Ridge submitted competing ballots voting Blue Ridge's claim, with Wachovia's ballot accepting the plan's primary treatment of Blue Ridge's claim and Blue Ridge's ballot rejecting that proposed treatment.<sup>35</sup> Blue Ridge then filed a motion seeking a determination of its voting rights and allowance of its ballot instead of the one Wachovia submitted. Wachovia opposed the motion, relying on a section in the subordination agreement that made it, as the lender, "irrevocably authorized and empowered (in its own name or in the name of the Subordinated Creditor)" to "take such other action (including without limitation voting the Subordinated Debt. . .)" as it "deemed necessary or advisable."<sup>36</sup> Wachovia also argued that the *In re 203 North LaSalle Street Partnership* case, relied on by Blue Ridge, was wrongly decided and that the bankruptcy rules allowed agents to vote another party's claim.<sup>37</sup>

In siding with Wachovia, the bankruptcy court held that Wachovia was the agent of Blue Ridge, that under the subordination agreement Blue Ridge assigned its right to vote to Wachovia, and that Section 1126(a) of the Bankruptcy Code does not prohibit the enforcement of such provisions. The court therefore accepted Wachovia's ballot and rejected the one submitted by Blue Ridge. The court

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<sup>35</sup> See *In Re Blue Ridge Investors, II, LP, vs. Wachovia Bank, N.A. and Aerosol Packaging, LLC*, No. 06-67096 (MHM) (Bank. N.D. Ga 2006).

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

also pointed out that Blue Ridge is not without a remedy: it "may free itself from the ongoing effect of the Subordination Agreement by paying the Wachovia claim in full in cash." Blue Ridge has appealed the decision, so a higher court may have a chance to rule on the issue.<sup>38</sup>

Since it is only one bankruptcy court ruling, the *Aerosol Packaging* decision does not settle the issue of whether bankruptcy voting provisions will be enforced. Still, it's interesting that the court considered and rejected the reasoning of the *In re 203 North LaSalle Street Partnership* decision. Given that this subordination agreement involved both lien and payment subordination, it's unclear whether the voting provision would have been enforced if the lender's agreement had involved only lien and not payment subordination, which is the more typical second lien arrangement.

As second lien loan markets and intercreditor agreements evolve, the possibility that there will be more definitive court rulings on these "silent" waivers has diminished. Over the past two years, there has been well-documented evidence that second lien lenders are negotiating more favorable intercreditor agreements and becoming less silent. Some of the trends that have been noted are:

- Shorter standstill periods: in bankruptcy, first liens will increasingly need to negotiate with second lien lenders. The utility of waivers is dramatically reduced with the growth of 45 to 90 day standstill periods, which is not long enough for first liens to dictate and complete the reorganization process.<sup>39</sup>
- The existence of second-lien financial covenants: Standard & Poor's has noted that an increasing number of second lien loans have begun to include their own separate credit agreements, which almost all feature some form of financial covenants such as total leverage and interest coverage covenants. These covenants force debtors and first lien lenders to

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<sup>38</sup> *Id.*

<sup>39</sup> See Kerr, *supra* note 26.

negotiate with second lien lenders for relief on both first and second lien covenants for any debt to be restructured.<sup>40</sup>

### **C. Impact of Intercreditor Agreements**

Based on the bankruptcy cases examined, it appears that intercreditor agreements have only played a marginal role in the reorganization process. According to discussions with bankruptcy lawyers, intercreditor agreements are important negotiating levers but have not been used as the yardstick to determine bankruptcy proceedings or proceeds distributions.

The costs associated with litigation may have deterred creditors from trying to strictly enforce prepetition agreements. This point should not be overstated though since the costs to litigate in bankruptcy are not extremely high. Perhaps a stronger reason creditors have avoided intercreditor litigation revolves around the costs associated with an unfavorable but definitive ruling. Both parties may feel that the costs of a settlement are worth avoiding the possible loss of an unfavorable ruling. Second lien lenders may feel that the risk of the agreements being enforced and recovering nothing in a restructuring outweigh settlement costs. Concurrently, first lien lenders may be willing to settle in order to avoid losing their priority claims over the second liens. Creditors only directly litigated over the provisions of intercreditor agreements in the Aerosol Packaging and American Remanufacturers bankruptcies, with the American Remanufacturers bankruptcy ending unfavorably for all parties involved with liquidation. The willingness of creditors to negotiate has probably been enhanced by the ambiguity over waiver enforcement in Chapter 11, especially in light of the non-uniformity in agreement provisions.

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<sup>40</sup> *Id.*

Creditor demographics also support limited future intercreditor litigation. A large amount of the second lien loans were underwritten and are held by creditors who hold both first and second lien loans. The involvement of these cross-lien creditors decreases the probability of extended intercreditor litigation. Additionally, creditors who trade into their positions may be hesitant to challenge intercreditor agreements in court due to their lack of expertise in courts and the length and resources necessary to litigate the issue. This is particularly true given the lack of uniformity and court ambiguity over intercreditor agreements (this will be discussed in greater detail in section III).

### **III. Primary Issues with Reorganizations involving Second Lien Loans**

Intercreditor agreements have had a limited role in reorganizations involving second lien loans. Instead, the main impact of second lien debt has been on DIP approval and reorganization negotiations. Due to overly ambitious second lien lending, all of the second lien loans in the bankruptcies studied were significantly undersecured. Without any free assets, debtors have had difficulty securing DIP financing, paying for bankruptcy costs, and negotiating a satisfactory plan of reorganization. Furthermore, with their collateral impaired, second lien lenders have been able to use their status as secured creditors to put a stranglehold on the reorganization process.

#### **A. Free Assets for Bankruptcy Operations: Cash Collateral and DIP Financing**

With the debtors' balance sheets overly-encumbered, the use of cash collateral and DIP financing approval were the most contentious issues creditors faced with second lien lenders. Despite provisions in intercreditor agreements that address the use of cash collateral and approval of DIP financing, approval of both were issues in 10 of the 16 cases examined (Dura Automotive, Aerosol Packaging, Werner, Calpine, Performance Transportation Systems, American Remanufacturers, New World Pasta, Meridian Automotive, Tower Automotive, and Westpoint Stevens). Second lien lenders have not been hesitant to challenge cash collateral and DIP financing waivers on the basis of the enforceability of these waivers, adequate protection of their collateral and the priming of their debt.<sup>41</sup>

The American Remanufacturers bankruptcy best illustrates the potential downside to second lien loan conflicts with DIP financing. In American Remanufacturers, negotiations with second lien lenders reached an impasse when Black Diamond's DIP financing package triggered a provision in

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<sup>41</sup> This point has been confirmed by a number of bankruptcy lawyers including Roger Higgins of Kirkland & Ellis LLP and Alan Miller of Weil, Gotshal, and Manges LLP.

the intercreditor agreement that would put the second lien lenders pari passu to the Black Diamond's first lien debt. Instead of negotiating with the second lien lenders, Black Diamond pulled its DIP loan and opted for liquidation.<sup>42</sup>

Operating under Chapter 11 is more difficult when second lien lenders are involved because there often are not any free assets to secure the DIP loan or cash to use to continue operations. Before second lien loans, first lien lenders often provided the DIP in order to maintain their seniority in the capital structure and control the bankruptcy process.<sup>43</sup> However, if there are second liens on the assets, a super-priority DIP becomes complicated because first lien lenders will be priming the second lien lenders with the DIP loan. Second lien lenders can often object to the DIP loan on the basis of adequate protection and various provisions in intercreditor agreements that restrict second lien priming and limit the debtors' ability to incur additional debt. For example, in the Calpine bankruptcy, an ad hoc committee of second lien lenders strongly objected to Deutsche Bank and Credit Suisse's DIP loan. The DIP was a \$2 billion loan which included a \$250 million first lien term loan and a \$650 million second lien term loan. The first lien lenders and debtors had unilaterally decided to repay the first lien debt with the \$650 million second lien term loan that was part of the DIP financing.<sup>44</sup> In order to prevent the repayment of the first lien lenders and stop the DIP loan, the second lien lenders and unsecured creditors wanted to pursue multiple causes of action and sue the first lien lenders to void the security of the first lien note. The creditors claimed that the notes did "not fall within any reading of the definition of the term priority lien debt."<sup>45</sup> In November, Calpine, the committee and trustee of the first lien note agreed to delay litigation over the security of first lien notes until May 15, 2007 in order to prevent any disruption of Calpine's

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<sup>42</sup> Berman, Mark & Brighton, Jo Ann, *Second Lien Financings*, ABI Journal, March 2006 at 24.

<sup>43</sup> See Skeel, *supra* note 20.

<sup>44</sup> Lipschultz, Rhonda, *DIP dimensions: Calpine Corp.*, theDeal.com, January 18, 2006.

<sup>45</sup> Brennan, Terry, *Calpine Creditors Challenge Liens*, theDeal.com, November, 9, 2006.

business.<sup>46</sup> Nonetheless, Calpine's experience illustrates the trouble that second lien lenders can cause with DIP financing even with strong intercreditor agreements. The Tower bankruptcy encountered similar DIP financing issues when second lien lenders objected against the DIP loan on the grounds that it primed their debt.<sup>47</sup>

The difficulty of securing DIP approval from second lien lenders is compounded by the fact that often an opportunistic hedge fund is the first lien lender providing the DIP, and the hedge fund will subject the debtor to onerous and punitive covenants that reduce the possible recovery of second lien lenders. For example, second lien lenders objected to expensive DIP financing provided by Black Diamond Capital in both the Werner<sup>48</sup> and New World Pasta<sup>49</sup> bankruptcies, and second lien lenders objected to the costs of DIP financing provided by first lien lender Credit Suisse in the Meridian bankruptcy.

## **B. Reorganization Negotiations**

Reorganizations have and will likely continue to be more difficult to negotiate given the leverage that second lien lenders have over the process. Traditionally, with just one class of secured lenders, negotiations were clearly delineated by secured claims and unsecured claims and secured debt was often able to be made whole through exit financing, leaving the majority of equity to unsecured lenders. However, with second lien lenders, the point of impairment has clearly shifted in the cases examined from unsecured lenders to second lien debt. Julia Frost-Davies of Bingham McCutchen

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<sup>46</sup> Brennan, Terry, *Calpine battle delayed six months*, theDeal.com, November 16, 2006.

<sup>47</sup> Moser, Eric, *DIP dimensions: Tower Automotive Inc.*, theDeal.com, April 15, 2005.

<sup>48</sup> Elman, David, *Werner talked to Ableco for weeks*, theDeal.com, August 2, 2006.

<sup>49</sup> Berman, Mark & Brighton, Jo Ann, *Second-Lien Financings: Good, Bad, and Ugly*, ABI Journal, June 2006 at 1.

has noted, “In the worst of circumstances, supposedly secured second lien loans are increasingly becoming the fulcrum securities.”<sup>50</sup>

With over-encumbered debtor balance sheets, second lien loans are soaking up all the remaining value behind first lien loans, rarely leaving any residual value for unsecured creditors. The impairment of second liens has given second lien lenders a stranglehold over the reorganization process. Normally, a restructuring (as opposed to a liquidation) will incorporate some conversion of debt to equity. However, problems arise when second lien lenders are impaired and unwilling to take equity. Most authorities agree that reorganizations can not force secured lenders to take equity. The US District Court of the Southern District of New York reinforced this consensus in the Westpoint Stevens bankruptcy by nullifying the bankruptcy courts’ decision to force secured lenders to receive equity.<sup>51</sup> Therefore, as a secured lender, second lien lenders can not be crammed down, which removes an important negotiating lever for debtors and first lien creditors to use against second lien lenders. This makes reorganizations much more difficult.

The negotiating and capital structure position of second lien loans are the primary reasons why hedge funds have bought into second lien distressed debt when possible. Second lien lenders’ dominance of debtor’s residual value has meant that second lien lenders can often control the debtor’s exit financing. Furthermore, the inability to cram down and the need to negotiate with second lien lenders has granted the hedge funds who own second lien loans additional leverage for reorganization negotiations and has made it easier for hedge funds to block reorganization plans or liquidate debtors.

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<sup>50</sup> Belinsky, Russ & Flaschen, Evan, *North American Distressed Debt Market Outlook 2007*, DebtWire North American, (January 2007).

<sup>51</sup> See *Contrarian Funds, LLC v. Westpoint Stevens*, No. 05-6860 (S.D.N.Y. 2006).

### **C. Hedge Funds and Second Lien Loans**

The involvement of hedge funds in bank loan and distressed markets has had a particularly important impact for bankruptcies with multi-lien debt. Michael Kramer, a restructuring adviser who recently left Greenhill and Co. states, “Hedge funds acting in this market are dramatically changing the landscape of bankruptcy filings.”<sup>52</sup>

While investment banks will often retain first lien debt even in bankruptcy in order to maintain their relationship with the debtor, hedge funds have become the primary holders of distressed second lien debt.<sup>53</sup> Institutional investors have tended to be cautious retaining distressed second-lien loans, given the untested and highly-leveraged nature many of these loan arrangements. Many traditional lenders are quick to sell their claims in order to obtain cash out of their position, stem future costs associated with participation in the case, and move debt off their books for regulatory and other lending purposes. On the other hand, distress debt investment vehicles and hedge funds have been actively buying distressed positions in order realize quick investment gains from either acquiring the assets of the company, taking over the company or providing high-interest exit financing.

Hedge funds and distressed debt funds were involved in all of the bankruptcies examined for this research and were the dominant secured creditors in 10 of the 16 cases reviewed. When the distressed debt-specialized affiliates of large investment banks are included, such as Goldman Sachs Credit Partners and Credit Suisse’s Cayman-Island affiliate, 15 of the 16 all the cases involved distress debt focused investment vehicles holding secured credit.

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<sup>52</sup> Sender, Henny, *Hedge-Fund Lending to Distressed Firms Makes for Gray Rules and Rough Play*, Wall Street Journal, July 18, 2005.

<sup>53</sup> Conclusion is based on the composition of holders of second-lien claims in the 16 cases studied. See also Miller and Waisman *supra* note 19.

The tradability of second lien claims means that the second lien creditors may be constantly changing, which may complicate and exacerbate already difficult reorganizations of second lien loans. The tradability of claims can force companies to negotiate with a constantly changing creditor body, which aggravates an already overly-complex situation.

The involvement of hedge funds also increases the likelihood that the debtor may be stuck in a fight for control between several hedge funds. For example, Westpoint Stevens was not able to reorganize and ultimately elected for a Section 363 sale since the company needed to raise additional cash to move its operations offshore. The company was not able to secure the necessary financing in a traditional reorganization because its assets were overly-encumbered and hedge funds were viciously fighting for control of the company. In the sale auction, Carl Icahn, who owned a majority of the second lien debt and was the largest first lien debt holder, contested with the hedge funds on the first lien steering committee for control of the company. Carl Icahn ultimately prevailed in the auction, but the company today is still in limbo without the needed investment for off-shoring from Icahn. Icahn has not invested in the company since his ownership has been put into question by the opposing hedge funds' appeal to the district courts. The opposing hedge funds challenged their receipt of minority shares in an Icahn controlled company as adequate protection for their secured claims. The district court invalidated the distribution of shares to secured creditors on the basis that the shares and rights distribution did not satisfy the secured creditors claim, and that the secured creditors had to be paid in cash (as discussed in section III.A).<sup>54</sup>

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<sup>54</sup> Based on conversations with Alan Miller, debtor counsel in Westpoint Stevens. See also Murray, Shannon, *WestPoint's ownership wrinkles*, theDeal.com, June 12, 2006 and Murray, Shannon, *Icahn wins WestPoint*, theDeal.com, June 30, 2006.

Another complication introduced by hedge funds is that many funds who buy into distressed second lien positions may not fully understand the subtleties that govern the intercreditor agreements since they did not participate in its issuance. For example, many of the lenders who acquired their positions via trading in the Atkins Nutritional bankruptcy had a perception that they enjoyed the benefits of debt subordination of the second lien loans as opposed to only lien subordination. As Mark Berman describes, “the waterfall provision in the intercreditor agreement only addressed distributions from collateral and not payments that the first or second lien lenders might obtain outside of collateral liquidation.”<sup>55</sup> The agreements explicitly left open the possibility of equal treatment of the first and second liens outside of the context of liquidation.<sup>56</sup> Another example is American Remanufacturers, where Black Diamond ultimately chose to liquidate the company because they did not realize that there was a provision in the intercreditor agreement that would put the second lien lenders *pari passu* to first lien lenders if there was a DIP loan that primed the second lien debt.<sup>57</sup> Both these examples show the danger of hedge funds trading into positions that may not match their expectations, especially given the complexity involved with second lien debt structures.

Finally, hedge fund involvement has introduced potential conflicts of interests. While traditional creditors have reputation and long-term interests to consider, hedge funds are primarily concerned with maximizing returns. Jeff Stengenga, a senior managing director with FTI Consulting says that, “Borrowers know they are making a pact with someone who may lack a long-term investment horizon.” The conflicting interest of hedge funds could potentially create situations where hedge funds hold positions where there is a conflict of interest. For example, lenders say hedge funds

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<sup>55</sup> Berman, Mark & Brighton, Jo Ann, *Second Lien Financings: Part III: Anecdotes – the Good, the Bad, and the Ugly: Atkins – the good.*, ABI Journal, May 2006 at 14.

<sup>56</sup> *Id.*

<sup>57</sup> See Berman & Brighton, *supra* note 42.

often resist amending loan agreements to force companies into Chapter 11. Some bankers have expressed concern that hedge funds may trigger Chapter 11 filings to make their short positions worth more.<sup>58</sup> These concerns were directly raised when Harvey R. Miller, vice-chairman of investment bank, Greenhill & Co. investigated an allegation that Silver Point Capital traded on confidential information it obtained as a member of Fibermark's creditors' committee. The report did not reveal any insider trading by Silver Point Capital.<sup>59</sup>

Since hedge funds buy into positions with the goal of optimizing the return of their portfolio instead of the returns of a particular class of securities, conflicts of interest have also arisen due to hedge funds' various cross class positions. Although there has not been any explicit evidence of hedge funds undermining a specific classes' interest in order to maximize their own return, there was litigation in two cases examined involving second lien lenders' conflicts of interest. For example, in the Meridian bankruptcy, Milbank was removed as the counsel to the ad hoc committee of first lien holders due to a conflict of interest the law firm had with its initial retention by Stanfield Capital, a large second lien holder.<sup>60</sup> In the New World Pasta bankruptcy, the unsecured creditors objected to JLL Partner's ownership of the second lien debt. JLL Partners, a private equity firm, owned a majority of the company's equity and 100% of the company's second lien debt. The company had acquired the second lien debt when it made an agreement with the Bank of Nova Scotia to purchase 100% of the debt Bank of Nova Scotia underwrote to New World Pasta. JLL had pursued this lending agreement as a way to avoid covenant breaches. Unsecured creditors, however, argued that JLL had classified the investment as a loan in an attempt to leapfrog unsecured creditors in the recovery scale and the loan was a fraudulent conveyance. The disagreement between JLL and the

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<sup>58</sup> *Id.*

<sup>59</sup> Lattman, Peter, "The Creditor's Ball," *Forbes Magazine*, July 5, 2005.

<sup>60</sup> *See In re Meridian Automotive Systems, Inc.*, No.05-11168 (MFW) (Bankr. D. Del 2006)

unsecured creditors was ultimately settled, but both these cases show that the involvement of hedge funds, given their tendency to acquire various classes of claims and the unique strangle-hold that second lien loans have on the reorganization process, can lead to significant conflicts of interest.

#### **IV. Solutions to Reorganizations Involving Second Liens**

Bankruptcy professionals have used several tactics to work around the difficulties of under-collateralized second lien loans. These strategies have revolved around preemptively settling bankruptcy and reorganization issues, avoiding the traditional reorganization process, and taking advantage of liquidity in distress debt markets.

##### **A. Pre-Negotiated Plans**

Pre-negotiated plans are an effective way to avoid the reorganization issues that second lien loans raise. Although it can not be determined how many reorganizations attempted to negotiate pre-negotiated plans, Atkins Nutritional, JL French Automotive, and Maxim Crane were all successful in securing a lock-up agreement for a pre-negotiated plan before entering bankruptcy. In all three cases, the debtor approached the creditors about a pre-negotiated plan in order to avoid the potential obstacles that a bankruptcy involving second lien debt can encounter. Professionals may also seek to use pre-packaged plans in the future to achieve similar results.

Pre-negotiated plans are easiest to negotiate when the second-lien debt is controlled by a few parties, the first lien debt is largely unimpaired, and second lien lenders are able to control the process. For example, in the JL French<sup>61</sup> and Maxim Crane bankruptcies<sup>62</sup>, the majority of the second lien debt was held by institutional lenders who originated the debt and were familiar with the operations of the debtor. In both cases, the debtor was able to open their books to the lender and work out a pre-arranged plan because of the debtor's familiarity with the lenders and the lenders' familiarity with the debtor.

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<sup>61</sup> See *In re* New World Pasta Company, No. 1-04-02817 (MDF) (Bankr. M.D. Pa 2005).

<sup>62</sup> See *In re* ACR Management, LLC, No. 04-27848 (MBM) (Bankr. W.D. Pa 2004).

In JL French, Goldman Sachs Credit Partners was the agent for the second lien debt at issuance. Goldman Sachs agreed to a pre-negotiated plan where they were the only class eligible to vote and where they would ultimately end up with a majority of the company. Goldman Sachs provided exit financing to repay \$295 million of the first lien debt and had most of their second lien debt converted into equity and warrants. Through the arrangement, JL French was able to quickly emerge from bankruptcy with substantially less debt.<sup>63</sup> Maxim Crane had a similar pre-negotiated plan. Fleet Bank and Bain Capital held the majority of the second and third lien debt at issuance and upon bankruptcy. Fleet bank was the second lien agent at issuance.<sup>64</sup>

A pre-negotiated plan is much more difficult when the second lien debt is highly syndicated and tradable. The logistics of managing the various claims of multiple debt holders make negotiating a 100% satisfactory plan problematic. Furthermore, when the claims are actively traded, they often end up with different distressed debt funds that may be vying for control of the company.

As mentioned in section III, cross-class ownership may make some pre-negotiated plans possible for companies with tradable debt. For example, although there were multiple debt holders in the Atkins Nutritional bankruptcy, a lock-up agreement was able to be negotiated due to the significant cross-ownership of first and second-lien positions. In fact, creditors' cross-lien ownership was to the degree that there was not any significant party that did not hold both positions.<sup>65</sup> Cross-lien ownership simplifies negotiations by aligning first and second lien lenders as largely one secured debt class, which most bankruptcy professionals have experience working through.

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<sup>63</sup> See *In re* JL French Automotive Castings, Inc., No. 06-10119 (Bankr. D. Del. 2006).

<sup>64</sup> See *In re* ACR Management, LLC. *supra* note 62.

<sup>65</sup> Berman, Mark, Brighton, Jo Ann, *Second-Lien Financings: Part III: Anecdotes – the Good, the Bad, and the Ugly – Atkins*, ABI Journal, May 2006

## B. Solutions to DIP Financing

If the debtor is unable to negotiate a pre-negotiated plan, the first problem that debtors immediately face with second lien lenders is securing a DIP loan. DIP financing with second lien loans has become increasingly problematic because of the lack of free assets to securitize the loan.

| Number | Company                                  | DIP Solutions   |
|--------|--|---|
| 1      | Dura Automotive Systems                  | Adequate Protection Multi-Lien DIP, Outside Lenders   |
| 2      | Aerosol Packaging LLC                    | Outside Lenders                                       |
| 3      | Werner Co.                               | Outside Lenders                                       |
| 4      | JL French Automotive Castings Inc.       | -   |
| 5      | Performance Transportation Services Inc. | Adequate Protection, Multi-Lien DIP, Outside Lenders  |
| 6      | Nellson Nutraceuticals Inc.              | -   |
| 7      | Pliant Corp.                             | -   |
| 8      | Calpine Corp.                            | Multi-Lien DIP, Outside Lenders - still in litigation |
| 9      | American Remanufacturers Inc.            | Liquidation   |
| 10     | Atkins Nutritional Inc.                  | -   |
| 11     | New World Pasta Co.                      | Adequate Protection                                   |
| 12     | Meridian Automotive Systems Inc.         | Outside Lenders                                       |
| 13     | EaglePicher Corp.                        | -   |
| 14     | Tower Automotive Inc.                    | Multi-Lien DIP, Backstop Agreement                    |
| 15     | Maxim Crane Works Holdings               | -   |
| 16     | Westpoint Stevens Inc                    | -   |

### B.1 Multi-Lien DIP Loans

To side-step the lack of collateral, 4 of the 16 bankruptcy cases examined used DIPs with multi-lien term loans. DIP financing with multi-lien term loans appears to be a new trend in bankruptcy proceedings as the majority of DIP loans have traditionally been structured as facilities with very tight covenants due to the risk involved with lending to distressed companies.<sup>66</sup>

In the Calpine, Performance Transportation Systems, and Tower Automotive bankruptcies, the DIP loans with multi-lien term loans were partially used to repay first lien lenders. The development of DIP loans with multi-lien loans is a clear indication of the amount of liquidity in distressed markets

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<sup>66</sup> *Id.*

and the willingness of hedge funds to provide financing to bankrupt companies. The multi-lien DIP loans have used the second lien term loan to repay first lien lenders, while the DIP loans' facilities and first lien term loans were used for operational purposes. This structure has allowed debtors to effectively prime and borrow against the second lien lenders' collateral by arguing that the DIP is senior to the second lien because it is used to repay first lien lenders. This argument has not been tested in bankruptcy courts. Second lien lenders have reluctantly gone along with the DIP loans after being compensated with adequate protection payments and increased interest rates on their loans. Furthermore, the repayment of first lien lenders has allowed the second lien lenders to control the bankruptcy proceedings.

### *B.2 Outside Lenders*

The problem with securing DIP financing and approval with second lien lenders has also been solved by taking advantage of the number of hedge funds willing to lend to distressed companies. For example, in the Werner<sup>67</sup>, New World Pasta<sup>68</sup>, and Meridian<sup>69</sup> cases, second lien lenders were able to get Black Diamond Capital and Credit Suisse respectively to revise the terms of their DIP loan by bringing in third party hedge funds willing to provide more favorable terms. Second lien lenders used financing provided by Ableco Finance LLC against Black Diamond Capital in the Werner and New World Pasta cases, while Deutsche Bank was brought in to provide cheaper DIP financing to force Credit Suisse to adjust their DIP terms. Furthermore, the number of hedge funds has also enabled the structuring of more aggressive DIP loans, which has enabled distressed companies to raise capital even with limited collateral bases. In the Calpine bankruptcy, a \$2 billion DIP loan was provided even though there were and still are outstanding collateral issues with the

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<sup>67</sup> See Elman, *supra* note 48.

<sup>68</sup> See Berman & Brighton, *supra* note 49.

<sup>69</sup> See *In re Meridian Automotive Systems Inc.*, *supra* note 60.

second lien lenders and court petitions that may invalidate \$650 million of the DIP loan being used to repay first lien lenders. Calpine had JP Morgan, Goldman Sachs, Lehman Brothers, and Morgan Stanley all bid for the DIP largely based on the size and attractive pricing of the deal relative to other opportunities.<sup>70</sup>

### *B.3. Adequate Protection Payments*

Despite the fact that many intercreditor agreements include provisions that waive second lien lenders' rights to adequate protection payments (as mentioned above in section B.1), several reorganizations have used adequate protection payments to solve DIP financing conflicts. In the Performance Transportation Services bankruptcy, the debtor was able to negotiate a DIP loan that was partially used to refinance \$50 million of first lien debt, by agreeing to pay adequate protection to the remaining second lien lenders.<sup>71</sup> Similar payments were made to JLL Capital in the New World Pasta bankruptcy.<sup>72</sup>

Beyond DIP approvals, similar consent payments have been made to second lien lenders to smooth the reorganization process. Pliant Corp paid its second lien lenders a \$4 million fee for consenting to the plan of reorganization.<sup>73</sup> Wilbur Ross also offered \$10 million in adequate protection to second lien lenders in his bid for Westpoint Stevens.<sup>74</sup> Despite limitations to adequate protection payments in intercreditor agreements, debtors and creditors still appear to be using these payments to avoid potential conflicts with second liens. This strategy appears to have been effective and will likely be a popular tool for side-stepping DIP conflicts involving second liens.

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<sup>70</sup> See Lipschultz, *supra* note 44.

<sup>71</sup> Elman, David, *DIP dimensions: Performance Transportation Services Inc.*, theDeal.com, April 24, 2006.

<sup>72</sup> See *In re New World Pasta Company*, *supra* note 61.

<sup>73</sup> Blakeley, John, *Pliant emerges from bankruptcy*, theDeal.com, July 19, 2006.

<sup>74</sup> See *In re Westpoint Stevens Inc.*, No. 03-132532 (RDD) (Bankr. S.D.N.Y. 2005).

### C. Asset Sale

After securing the DIP financing, the next big hurdle debtors face is reorganizing the company. As discussed in section III, second lien loans have become an impediment to the reorganization process because of the lack of unencumbered assets. To avoid difficulties with restructuring second lien lenders, 5 of the 16 cases studied used or contemplated section 363 asset sales.

Westpoint Stevens and Eaglepicher were both able to restructure by selling their assets in bankruptcy. Although there are still outstanding issues with the sale proceeds, Westpoint Stevens was able to avoid reorganizing its capital structure by selling the company to Carl Icahn, who held the majority of the company's second lien debt, in a bankruptcy auction.<sup>75</sup> Eaglepicher was also able to work out an agreement with its primary bondholders where the unsecured creditors provided the exit financing, repaid all the secured creditors and effectively took over the company. Many of the assets were then sold off to the various unsecured creditors' subsidiaries or affiliated companies.<sup>76</sup>

Maxim Crane and Atkins Nutritional also both explored asset sales. Maxim Crane held an auction, but its competitor Amquip-Bove was the only company to submit a bid. Amquip-Bove's \$325 million offer was deemed unsatisfactory.<sup>77</sup> Atkins Nutritional, which entered bankruptcy with a pre-arranged plan, openly contemplated a sale; however no buyer appeared.<sup>78</sup>

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<sup>75</sup> *Id.*

<sup>76</sup> See *In re EaglePicher Holdings Inc.*, No. 05-12601 (Bankr. S.D. Ohio 2006).

<sup>77</sup> See *In re ACR Management, LLC*, *supra* note 62.

<sup>78</sup> See *Berman & Brighton*, *supra* note 55.

Asset sales are an effective and efficient method of avoiding the reorganization issues brought by second lien loans. Several of the bankruptcy lawyers interviewed predict that asset sales will increase as more companies face difficulties reorganizing with second lien debt.

#### **D. First Lien Buyouts**

If the debtor is unable to arrange a pre-negotiated plan or find a suitable buyer, the second lien lenders will often buyout the first lien position to expedite reorganization negotiations. With the fulcrum of impairment lies firmly in the second lien range, second lien creditors are primarily hedge funds who trade into their positions looking to take control of the company. For example, Carl Icahn bought into the second lien loans when he was trying to acquire Westpoint Stevens.<sup>79</sup> Similarly, the private-equity firm Yucaipa acquired a substantial amount of Performance Transportation System's \$35 million second lien term loan in what many people speculate is an attempt to merge Performance Transportation Systems with its competitor Allied Holdings, which is also in bankruptcy. Yucaipa owns about two thirds of Allied Holdings' unsecured notes.<sup>80</sup>

To control the bankruptcy process, second lien lenders have bought out or repaid first lien lenders in 6 of the 16 cases investigated. The Werner bankruptcy is the only case where second lien lenders purposefully used the buyout provision in the intercreditor agreement to replace the first lien lenders.<sup>81</sup> In the remaining first lien buyout cases, second lien lenders took control of the bankruptcy process by either providing the DIP or exit financing and using the proceeds to repay first lien lenders.

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<sup>79</sup> See *In re Westpoint Stevens Inc.*, *supra* note 74.

<sup>80</sup> Fidler, Ben, *Yucaipa deepens PTS role with DIP loan*, theDeal.com, October 19, 2006.

<sup>81</sup> See Elman, *supra* note 48.

Like pre-negotiated plans, replacing the first lien debt is an effective way for second lien lenders to avoid intercreditor issues and expedite the reorganization process. In fact, two of the three cases that had pre-negotiated plans had hedge funds buying out the first lien lenders. First lien buyouts, however, only make sense when valuations are high enough so that hedge funds are willing to replace first lien lenders. First lien replacement can become impossible when first lien lenders are clearly impaired but second lien lenders still want some recovery on their investment.

### **E. Rights Offerings**

Rights offerings appear to be a popular tool to complement pre-negotiated plans, asset sales and first lien buyouts in reorganizations. Rights offerings are usually an offering of stock to creditors which entitles them to acquire new shares, usually at discounted rates. The offering occurs during the bankruptcy proceedings and is for new shares of the reorganized company. 6 of the 16 companies examined used a rights offering to reorganize the company.

Given the over-securitization and complexity that second lien loans introduce to debtor capital structures, rights offerings are an effective method for companies to raise the funds they need to exit bankruptcy. As one bankruptcy lawyer commented, “Financially troubled companies now have more encumbered assets, and as part of de-leveraging, they need to raise some additional cash.”<sup>82</sup> Rights offerings have been particularly popular with hedge funds holding second lien debt. Another bankruptcy lawyer comments, “There’s a lot of liquidity in the marketplace, and I think a lot of hedge funds want to put money to work and that’s a way to do it.”<sup>83</sup> JL French, Meridian, and Maxim Crane all used rights offerings to increase their liquidity and expedite the reorganization process. For example, Goldman Sachs backstopped JL French’s rights offerings, guaranteeing the

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<sup>82</sup> Fidler, Ben, *Rights of Passage*, TheDeal.com, July 20, 2006.

<sup>83</sup> *Id.*

purchase of every share even if they have to buy it themselves.<sup>84</sup> Tower Automotive is currently considering a rights offering to help with its reorganization effort. The company is in discussions with several senior bondholders and other third parties regarding the backstopping of a rights offering.<sup>85</sup>

Rights offerings have also been effective at alleviating some of the difficulties with bankruptcy valuations, allowing players to invest in the debtor if they believe in the company's value. This tool has been useful in avoiding conflict with unsecured creditors and equity holders, giving players further down the capital structure an opportunity to stay involved with the company even if they do not receive any direct equity or options in the reorganization.

With the difficulty reorganizing debt structures that involve second lien debt, rights offerings will likely be part of a substantial amount of bankruptcies with second lien loans since they are an effective method for companies to de-leverage while allowing creditors to retain an interest in the company.

## **F. Valuation Litigation**

Given the difficulty reorganizing companies with second lien debt, valuation litigation is an interesting strategy to preemptively solve intercreditor issues early in the bankruptcy process. Thus far, this strategy has only been employed by Nellson Nutraceuticals. The debtors and creditors in the Nellson Nutraceutical bankruptcy are litigating over the debtor's value even before a DIP package has been secured.<sup>86</sup> While the creditors had similar valuations of \$315 to \$350 million,

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<sup>84</sup> See *In re JL French Automotive Castings, Inc.*, No. 06-10119 (Bankr. D. Del. 2006).

<sup>85</sup> Fidler, Ben, *Tower Auto wins 2 in Court*, theDeal.com, October 26, 2006.

<sup>86</sup> Murray, Shannon, *Nasty Fight at Nellson?*, theDeal.com, September 18, 2006.

Nellson Nutraceuticals' controlling shareholder Fremont Investors had a significantly higher valuation of \$405 million.<sup>87</sup> The difference most likely comes from Fremont Investors' desire to keep some value for its equity, and the valuation fight illustrates the potential conflicts of interest between controlling shareholders, who are increasingly influential private equity firms, and creditors. This topic is beyond the scope of this research paper. Instead, the main issue with Nellson Nutraceuticals' valuation fight is that if the valuation of the collateral determines that the second lien lenders are significantly undersecured or unsecured, their entitlement to adequate protection in the form of professional fees and other payments may be reduced or eliminated. The litigation fight also illustrates all parties' desire to resolve inter-lien issues at the beginning of the bankruptcy process.

### **G. Hedge Fund Involvement and Cross-Lien Ownership**

Hedge funds buy loans opportunistically. Therefore, unlike traditional lenders, hedge funds, depending on their goal, will buy loans across different classes of debt. For example, Black Diamond Capital has often acquired first lien positions in order to provide the DIP and exit financing for the debtor. This indicates that a hedge fund's intentions can often be divined by its claims holdings.

Since many hedge funds buy distressed debt for control, hedge funds have acquired second-lien positions to control the debt to equity conversions. If some of the first-lien position is impaired, hedge funds will often buy both first and second lien positions to solidify their control position. When hedge funds own a portfolio of different class debt, they are focused on maximizing their

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<sup>87</sup> Cronin, Maureen, & To, My Chi, *Second-Lien Financing Update: Strategic Timing of Collateral Valuation in Chapter 11*, Debevoise & Plimpton LLP Client Update, June 1, 2006.

overall portfolio return, which is not always the same as maximizing their recovery on a specific debt paper.

Straddle, cross-lien ownership has been cited by lawyers to be one of the primary determinants of successful, multi-lien reorganizations.<sup>88</sup> When hedge funds have a cross-lien position, it is usually an indication that the hedge fund is pursuing equity control, which suggests that the hedge fund has a serious interest in reorganizing the debtor. For example, Carl Icahn purposefully added first lien positions to his majority second lien position in Westpoint Stevens when the company's business fundamentals began to deteriorate and it became clear that the first lien loans would be impaired.<sup>89</sup>

Experienced hedge funds have also often been integral at negotiating with other hedge funds to expedite the reorganization process. As hedge funds are discovering, acquiring second lien positions for post-petition control is often difficult given the problem introduced by reorganizing secured loans and over-encumbered balance sheets. Therefore, hedge funds with second lien loans in the bankruptcies studied have been open to creative solutions to reorganize secured debt. For example, Silver Point Capital helped JP Morgan break an impasse with the second lien lenders in the Tower Automotive bankruptcy. During the Tower bankruptcy, JP Morgan was planning to provide a \$725 million DIP loan. \$425 million of the loan was a tranche B term loan that would be used to refinance the first lien debt. Many second lien holders, however, objected to the DIP on the grounds that the tranche B component primed their debt although it was being used to refinance the first lien debt.

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<sup>88</sup> See Berman & Brighton *supra* note 55.

<sup>89</sup> See *In re* Westpoint Stevens Inc. *supra* note 74.

The DIP looked like it would not go through until Silver Point Capital, which had bought out a substantial portion of the second lien debt to prevent other hedge funds from securing Tower’s post petition equity, was elected to be the agent for the second lien loans. As the second lien agent, Silver Point solved the DIP priming problem by providing a back stop for all second lien debt, effectively guaranteeing second lien lenders against any losses for a period of time. With the back stop in place, the DIP passed and Tower’s operations were not disrupted. Today, Tower is currently exploring outside equity investments.<sup>90</sup>

The founding Silver Point Partners Ed Mule and Bob O’ Shea commented in the Wall Street Journal that Silver Point’s involvement should be contrasted with,

*“debtors in other recent automotive bankruptcies where Silver Point was not involved, including Collins & Aikman and Meridian Automotive, [which] had difficulty obtaining the appropriate DIP financing due to dissent among the bank debt holders.”<sup>91</sup>*

The table below shows the reorganization solutions used in each bankruptcy. DIP financing solutions were given in a separate table in section B.

| Number | Company                                  | Reorganization Solutions                   |
|--------|--|--|
| 1      | Dura Automotive                          | Still in negotiations                      |
| 2      | Aerosol Packaging                        | Potential Asset Sale                       |
| 3      | Werner Co.                               | First Lien Buyout & Cross-Lien Ownership   |
| 4      | JL French Automotive Castings Inc.       | Pre-Negotiated Plan                        |
| 5      | Performance Transportation Services Inc. | First Lien Buyout                          |
| 6      | Nellson Nutraceuticals Inc.              | Valuation Litigation                       |
| 7      | Pliant Corp.                             | Consent Payment                            |
| 8      | Calpine Corp.                            | First Lien Buyout                          |
| 9      | American Remanufacturers Inc.            | Liquidation                                |
| 10     | Atkins Nutritional Inc.                  | Pre-Negotiated Plan & Cross-Lien Ownership |
| 11     | New World Pasta Co.                      | Cross-Lien Ownership                       |
| 12     | Meridian Automotive Systems Inc.         | Rights Offering                            |
| 13     | EaglePicher Corp.                        | Cross-Lien Ownership                       |
| 14     | Tower Automotive Inc.                    | Rights Offering                            |
| 15     | Maxim Crane Works Holdings               | Pre-Negotiated Plan                        |
| 16     | Westpoint Stevens Inc                    | Asset Sale & Cross-Lien Ownership          |

<sup>90</sup> Letters to the Editor, *Hedge Fund Generalization Doesn’t Fit Silver Point*, Wall Street Journal, July 29, 2005.

<sup>91</sup> *Id.*

## V. Conclusion

Although second lien issuance may certainly decline in a tightening credit and rising interest rate environment, it is unlikely that the product will disappear given the size of the market, which exceeds \$50 billion<sup>92</sup> and the growing liquidity in second lien secondary markets. Furthermore, the supply and demand fundamentals for second lien loans will likely persist. Though second lien debt may make work outs more difficult, companies seldom consider restructuring implications when issuing debt. Instead, companies will continue to use second liens as long as the product remains cheaper than other subordinated debt alternatives, which they still have.

On the supply side, the growing importance of hedge funds combined with the amount of liquidity available suggests that even in a down-cycle, there will still be willing second-lien lenders. One mezzanine debt portfolio manager concurs, explaining that even in a tightening credit environment, liquidity should not significantly decrease. Furthermore, current second lien recoveries have been decent. Moody's reported a 40% recovery rate for second lien lenders without debt below them and a 75% recovery for second liens with junior debt below them in the capital structure.<sup>93</sup> These recoveries are comparable to the median historical recovery rates based on data from 1989 to 2003 of 71.50% and 50.50% for senior secured and senior unsecured bank loans respectively.<sup>94</sup>

### A. Future Impact of Hedge Funds

In the coming years, the impact of second lien loans on reorganizations will likely be dominated by hedge funds and distressed debt funds. Soaking up most of the value of bankrupt companies, second lien loans are a particularly attractive security for hedge funds to take control of distressed

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<sup>92</sup> \$50 billion estimate is based on \$7.7 billion, \$22 billion and close to \$24 billion in second lien issuance in 2004, 2005, and 2006 alone.

<sup>93</sup> Stein, Gabrielle, *Rise in Second Liens Prompts Evaluations*. Bank Loan Report, November 27, 2006.

<sup>94</sup> Altman, Edward, Hotchkiss, Edith, *Corporate Financial Distress and Bankruptcy*, Wiley Finance, 2006.

companies. Hedge fund involvement should not intensify reorganization efforts but may actually, on net, alleviate potential inter-creditor conflicts. The cross-lien ownership and return-driven time constraints faced by hedge funds have encouraged them to be cooperative in bankruptcies. Furthermore, although there are a large number of hedge funds who trade distressed debt, only a handful of them actively participate in the workout process. These funds are known to take a private-equity type approach to their investments and include funds such as Oaktree Capital Management, Apollo Management, Fortress Investments, Black Diamond Capital Management, MatlinPatterson Asset Management, and DE Shaw Laminar Portfolios among others.<sup>95</sup> The hedge funds that are active participants have been involved with most of the recent bankruptcies and have been gaining more and more experience with the negotiating process.

Anecdotal evidence suggests that these “active” distressed debt funds are becoming more sophisticated in navigating Chapter 11 and when defaults rise, their experience should help smooth and expedite the inter-lien negotiating process.

An illustrative example is the experiences of Black Diamond Capital, who was a major debt holder in the Werner Co., New World Pasta, and American Remanufacturer bankruptcies. As mentioned above, Black Diamond often acquires a secured position in order to provide DIP and/or exit financing to the debtor. In the distressed debt world, Black Diamond Capital is known for playing rough. In fact, two unnamed sources independently mentioned rumors that some newly-issued intercreditor agreements include provisions that prevent the sale of debt to Black Diamond. Although Black Diamond has a reputation for and has played rough, it appears that through its three bankruptcies with second lien debt, they have become more sophisticated negotiators. In their first

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<sup>95</sup> *Distressed-debt investors anticipating defaults*, Private Equity Intelligence, (March 13, 2006) <<http://www.preqin.com/article.aspx?articleid=98>>

second lien bankruptcy experience, American Remanufacturers, Black Diamond refused to negotiate with second lien lenders when their lien priority was challenged when Black Diamond's DIP triggered a provision in the intercreditor agreement that would put the second lien lenders *pari passu* to the first lien lenders. Instead of negotiating with the second lien lenders, Black Diamond pulled its DIP and opted for liquidation.

The American Remanufacturers experience should be contrasted with Black Diamond's current involvement with Werner Co. While there was again some contention over Black Diamond's DIP with an ad hoc committee of second-lien claimants, Black Diamond was able to negotiate amicable terms with the second lien group and even got the lenders to buy out the first lien lenders, eliminating any future disputes between the two classes.<sup>96</sup>

As these hedge funds gain more experience participating in the bankruptcy process, hedge funds should become more sophisticated and cooperative Chapter 11 participants. Although hedge-funds often do not have a long-term investment horizon, Chapter 7 liquidation is a slow, detailed, and time-intensive process. Hedge funds are focused on maximizing their return in a short time-horizon with the least risk possible. Therefore, hedge funds should not be fundamentally interested in spending money on litigation, contesting lien subordination, dragging the bankruptcy process out, and facing potentially negative court rulings. Although there are some activist hedge funds, such as Eliot Associates, that have the legal expertise to engage in lengthy litigation, most hedge funds are lean operations with a few employees and are sensitive to time-adjusted returns of their investments. Given the time-sensitivity of reorganizations, distressed debt funds will more often than not be aligned with other stakeholders, wanting quick, conflict-free reorganizations.

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<sup>96</sup> See Elman *supra* note 48.

Finally, some loans have recently been underwritten with terms that restrict who can hold the loans on a name-by-name basis. For example, Apollo Management L.P. and JLL Partners have tried to exclude from certain deals specific hedge funds known to be tough negotiators. Black Diamond Capital has been one hedge fund rumored to be blacklisted from some loans.<sup>97</sup> This type of blacklisting should provide another incentive for hedge funds to be cooperative bankruptcy constituents.

Nonetheless, potential problems may still develop in the future where different hedge funds have acquired different classes of the debt and contest for control. In the end though, the impairment of assets and time-sensitivity of reorganizations should limit hedge fund conflict.

## **B. The New Face of DIP Financing**

Given the over-securitization associated with second lien loans, DIP financing in reorganizations involving second lien debt will inevitably be more complicated. Although there have been provisions in intercreditor agreements attempting to side-step this problem, the unwillingness of creditors to litigate intercreditor agreements means that first and second lien lenders will likely continue to use negotiations to settle DIP financing terms. The complexity and time needed to settle DIP financing issues with second liens, however, will probably encourage debtor and creditors to seek alternative financing channels and may decrease the use of DIP financing. In the future, DIP loans in reorganizations involving second-lien loans could therefore be substantially different from the strict loans described in Professor Skeel's overview of DIP lending in 2004.<sup>98</sup>

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<sup>97</sup> Sender, Henny, *Debt Buyers vs. The Indebted*, Wall Street Journal, October 17, 2006.

<sup>98</sup> See Skeel, *supra* note 20.

Potential problems and hold-ups with the DIP loan will also increase the pressure and urgency for debtors to settle intercreditor issues, since DIP financing is usually critical to the continued operation of the debtor. Therefore, pre-negotiated plans and asset sales should become more popular when the DIP loan impediments appear to be too great to surmount on a timely basis. While DIP complications may ultimately give creditors more control of the bankruptcy process, control will not lie in any one creditor's hands. This suggests that if there is a serious and prolonged creditor dispute, the debtor may be stuck in limbo. In the future, there may be increased instances where debtors that may have been able to be reorganized as a going-concern are ultimately liquidated.

The use of cash collateral may also increase as a result of DIP complications posed by second lien loans. Nellson Nutraceutical, for example, sought the use of its cash collateral to fund operations while its creditors are currently locked into valuation litigation. Some people have noted that recently the number of cash collateral requests has increased while DIP loan hearings have decreased.<sup>99</sup> Although this trend is not solely a result of second-lien financing, the complications that second lien loans introduce to DIP financing may make the use of cash collateral more attractive in the future. The use of cash collateral should not significantly displace DIP financing though since many debtors will not have enough cash collateral to fund their businesses.

When DIP financing is used, second lien lenders will likely continue to decrease financing costs for debtors. Financing costs are likely to be lower because second lien lenders can provide or find alternatives to first lien DIP loans, introducing more competition to the DIP lending process. Furthermore, second lien lenders' ability to challenge first lien lenders will also serve as a check

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<sup>99</sup> Fidler, Ben, *Finding Cash Close to Home*, theDeal.com, February 10, 2006.

against potentially exploitive DIP financing terms. Mark Joachim of Bingham McCutchen notes, “the DIP marketplace has become sufficiently crowded such that the traditional high fees and spreads are compressing due to highly competitive bidding when large financings are involved.”<sup>100</sup>

### **C. Future Reorganizations**

Second lien loans may amplify several trends that have been observed with reorganizations in recent years. Most of these trends are driven by hedge funds’ increasing involvement in reorganizations. First, several bankruptcy lawyers agree that second lien loans should accelerate the recent increase in assets sales and liquidations.<sup>101</sup> Asset sales and liquidation will become more popular to avoid the difficulty caused by second lien loans’ monopoly over debtors’ residual value. They will also gain popularity since hedge funds favor assets sales and liquidation as a liquidity event, which means hedge funds may use second lien loans to force more sales or liquidations.

In the reorganizations that do occur with second lien loans, rights offerings and first lien buyouts will probably be the prevailing tactics used to expedite the reorganization process. Rights offerings will likely be popular because of the flexibility that they provide both to creditors and debtors. Many distressed debt funds support rights offerings because they allow other investors who believe in the value of the company to continue their interests in the company while increasing the financial flexibility of the debtor. First lien buyouts are also popular with hedge funds since they allow hedge funds to dictate the reorganization process without any impediments from senior lenders.

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<sup>100</sup> See Belinsky & Flaschen, *supra* note 50.

<sup>101</sup> Baird, Douglas & Rasmussen, Robert, *Chapter 11 at Twilight*, Stanford Law Review, December 12, 2003.

#### **D. The Future of Chapter 11**

The likely impact of second lien loans on future reorganizations should be thought of in context of broader developments in reorganizations. In recent years, reorganizations in Chapter 11 have relied much more on market-mechanisms. This development has largely been driven by hedge funds. For example, Private Equity Intelligence notes that \$6 billion in new distressed debt funds was raised in 2005 and estimated that private equity and hedge fund managers could raise \$15 billion in 2006.<sup>102</sup> The control that second-lien loans provide to claims traders suggest that second-lien loans should contribute to the growing impact that hedge funds have in reorganization processes. The growth of sophisticated claims holders focused on short-time horizons should only provide increasing liquidity and market mechanisms to distress asset markets.

The complexities of reorganizing second-lien loans has driven debtors to seek alternative mechanisms for financial restructurings beyond the tools provided by traditional Chapter 11 proceedings. Even the tactics used in bankruptcy such as rights offerings and first lien buyouts indicate difficulties professionals are having with restructuring companies in Chapter 11.

Although these hurdles may be the result of increasingly complex or perhaps irrational capital structures instead of a manifestation of changing business economics, these results do provide some supporting evidence that Professor Baird and Rasmussen may be correct noting the increasing irrelevance of Chapter 11 given the growth of distress asset markets.<sup>103</sup> In fact, the difficulties with reorganizing with second-lien loans may also dilute some Baird and Rasmussen's critics. For example, Harvey R. Miller's argument that Chapter 11 still has benefits in its ability to properly marshal claims and sell assets free and clear of claims is not consistent with the stranglehold that

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<sup>102</sup> See *Distressed-debt investors...*, *supra* note 95

<sup>103</sup> See Baird & Rasmussen *supra* note 23.

second-liens have on certain reorganizations noted in this paper.<sup>104</sup> This suggests that the twilight of Chapter 11 may indeed be closer than we think.

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<sup>104</sup> See Miller *supra* note 19.