Subordination And Intercreditor Issues (With Forms)

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A. Debt Subordination

1. Contractual Subordination. Contractual subordination is an agreement whereby one or more creditors of a common debtor agree to defer payment of their claims until another creditor of the same debtor is “paid in full.” Contractual subordination is specifically recognized under U.S. bankruptcy laws as enforceable in a debtor’s bankruptcy (to the extent enforceable outside of bankruptcy), 11 U.S.C. §510(a).

   a. Essential Purpose. When one group of creditors (the “Subordinated Creditors”) provides certain protections to another group of creditors (the “Senior Creditors”) in the event of the bankruptcy of the common debtor.

      i. In the event of a common debtor’s bankruptcy Senior Creditors are entitled to receive the bankruptcy distributions allocable to Senior Debt plus the bankruptcy distributions allocable to the Subordinated Debt, until the Senior Debt is paid in full.

      ii. Senior Creditors may want to prohibit forgiveness or modification of Subordinated Debt, conversion of Subordinated Debt, and payments of principal on Subordinated Debt (because there will be less principal upon which to receive distributions).

      iii. Senior Creditors want to ensure that the Subordinated Creditors act in a manner to preserve the Senior Creditors’ rights in a bankruptcy (or be authorized to take such actions on the Subordinated Creditors’ behalf).

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A complete set of the course materials from which this outline was taken can be purchased at www.ali-aba.org.
b. **Subordination Terms Must Be Explicitly Drafted**

   i. “Subordination of debt” itself has no meaning; terms must state how the Subordinated Debt is subordinated.

   ii. Important to be explicit as courts will often construe terms against the Senior Creditor who drafts the subordination terms.

c. **Maintain Control And Flexibility For Senior Creditors**

   i. Subordination terms should be drafted to retain the maximum amount of control and flexibility for the Senior Creditors (e.g., to permit refinancings of Senior Debt, to give Senior Creditors control and flexibility in workout situations, to permit corporate reorganizations that would cause repayment of Senior Debt but not of Subordinated Debt, and to give Senior Creditors time to decide what course of action to follow).

   ii. Much of negotiation is a give and take in determining how much control and flexibility Senior Creditors will have and what rights the Subordinated Creditors will retain.

d. **Types Of Subordinated Creditors**

   i. High-yield debt holders agree to subordinate in exchange for a higher-risk return (typically in publicly placed offerings).

   ii. Corporate insiders (e.g., officers and directors). (See Annex A for a form of a “deep” subordinated note.)

   iii. Sellers in acquisitions that need to provide seller financing to allow the purchaser to obtain primary financing from financial institutions. (See Annex A for a form of a “deep” subordinated note.)

   iv. In workouts and restructurings (whether as a way of avoiding, or as an exit from, bankruptcy) where “new money” is required and existing creditors agree to subordinate to attract financing.

   v. Type of subordinated creditor will determine the extent of contractual subordination.

e. **Definitions**

   i. **Senior Debt** should be defined broadly to include future financings, other financial products extended by Senior Creditors and all amounts due under the Senior Credit Agreement whether existing or future, matured, unmatured, fixed or contingent.

      (1) Should in most cases include:

         (A) Principal, interest, premiums and all amounts payable under the Senior Credit Agreement and other loan documents. Should not be limited to indebtedness for borrowed money or evidenced by a note, but should include specific references to expenses, fees, reimbursements, letter of credit liabilities and indemnities.

         (B) Amounts payable in respect of interest rate protection and foreign currency exchange agreements.
(C) Amounts payable to financial institutions in respect of ancillary financial services (e.g., overdrafts on deposit accounts, fees and amounts due under custodial accounts, cash management or funds transfer agreements).

(D) All post-petition interest at the contract rate (including the default rate), whether or not allowed as a claim in a bankruptcy proceeding. U.S. case law requires that this be specifically mentioned.

(E) Possibly an additional amount to permit Senior Creditors to lend additional money when the debtor has a cash crunch.

(2) Reinstatement of Senior Debt previously paid if payment is set aside or declared fraudulent or preferential.

(3) Refundings, refinancings and extensions of Senior Debt and amendments (including increases and deferrals) of tenor and terms of Senior Debt should be included to avoid lock-in of Senior Debt.

ii. Subordinated Debt

(1) Must include principal, interest and premium under Subordinated Notes and the indenture, deposits for defeasance, sinking fund and mandatory and optional redemption payments, payments and recoveries relating to offer, and sale or purchase of the subordinated debt (e.g., rescission rights under securities laws).

(2) Include “all other amounts payable in respect of the Subordinated Debt.”

f. Contractual Subordination Provisions. (See Annex B for certain provisions from a typical high-yield indenture.)

i. Bankruptcy. In a bankruptcy proceeding of a debtor, the Senior Creditors are entitled to receive payment in full in cash before the Subordinated Creditors can receive any payment. For publicly traded subordinated debt, the Subordinated Creditors may be entitled to receive certain securities (usually called “Reorganization Securities” or “Permitted Junior Securities”) if such securities are equity securities or debt securities that are subordinated to the same extent as the Subordinated Debt. Senior Creditors usually require that principal and interest on such debt securities become due no earlier than principal and interest on the existing Subordinated Debt and that the Senior Creditors are not impaired in, or have approved, the applicable plan of reorganization.

ii. Absolute Payment Bar. No payment is due on Subordinated Debt so long as the triggering event exists; no limitation as to time.

(1) Usually triggered by payment default on Senior Debt (can be interest, principal installment or upon acceleration) or bankruptcy. Depending on the extent to which the Subordinated Debt is subordinated, this may be expanded to include any default under Senior Debt.

(2) Automatic. No notice to Subordinated Creditors is required.

iii. Limited Payment Bar. No payments on Subordinated Debt during “Blockage Period.”
(1) Usually triggered by default (other than a payment default) on Senior Debt. Usually effective only after written notice to Subordinated Creditors (or their representative).

(2) A blockage can usually only be invoked a limited number of times overall, and there generally are required intervals between consecutive Blockage Periods (i.e., no “tacking” of Blockage Periods). Important that the agent under the Senior Credit Agreement be the only Senior Creditor able to give notice (debt under the Senior Credit Agreement usually defined as “Designated Senior Debt”).

(3) The payment Blockage Period is subject to negotiation but should be long enough to structure a workout or plan strategy without interference from Subordinated Creditors. Generally in publicly traded high-yield debt the Blockage Period covers at least one interest payment to the Subordinated Creditors (e.g., if interest is payable quarterly, minimum Blockage Period, 89/90 days; if semi-annually, 179/180 days). If Borrower files bankruptcy or there is a payment default under Senior Debt the Absolute Payment Bar is effective.

iv. Standstill Of Remedies

(1) Bars enforcement of any remedy by Subordinated Creditors during a specified period (usually coextensive with Blockage Period on payments described above). Exceptions from enforcement bar if Senior Credit Agreement (or other Senior Debt of a specified amount) is accelerated or bankruptcy occurs.

(2) Standstills cannot prohibit public subordinated noteholders from suing to collect amounts then due and payable (Trust Indenture Act issue).

v. Turnover. Payments received by Subordinated Creditors (whether from the debtor, another party on behalf of the debtor or from the bankruptcy estate) in a bankruptcy or when a Payment Bar is in effect must by “turned over” to the Senior Creditors (or the agent or representative of the Senior Creditors).

vi. Other Issues

(1) Payment Bars usually do not prevent Events of Default under Subordinated Debt if payment or covenant default occurs (which it will if the interest payment date occurs while Payment Bar is effective). Unless a standstill is in effect (not the case in publicly traded subordinated debt), Subordinated Creditors can still pursue remedies (e.g., acceleration and suits for judgments).

(2) If there are a large number of Subordinated Creditors, provisions must be made to deal with a representative or trustee (Payment Bar Notices, etc).

(3) “Payment in full” of Senior Debt must be defined to mean payment in full and in cash.

vii. Subrogation And Other Waivers

(1) Subrogation allows Subordinated Creditors “to step into the shoes” of Senior Creditors to the extent Senior Creditors receive amounts or assets that would otherwise go to Subordinated Creditors.
(2) Subordinated Creditors must agree not to assert subrogation rights until Senior Creditors are “paid in full.”

(3) Some commentators analogize Subordinated Creditors to guarantors in that they agree to pay (albeit from a limited source) the Senior Creditors if the Borrower does not. Waivers should, therefore, include normal suretyship waivers.

g. Covenants; Representations And Warranties—Limited In Nature

i. No maintenance covenants or financial covenants.

ii. Typical indenture covenants would include restrictions on incurrence of debt, liens, investments and dividends, change of control, asset sales, layering of debt, encumbrances on the ability of subsidiaries to make dividends, transactions with affiliates and certain affirmative and reporting covenants.

iii. Limitations on amendments to subordination provisions without the consent of Senior Creditors.

h. Events Of Default In Subordinated Debt

i. Types

(1) Payment (at least 30 days’ cure for interest default; no grace period on principal defaults).

(2) Covenants (30-day cure after notice).

(3) Cross-acceleration of (not cross-default to) other Debt of specified amount (usually large enough so triggered only by Senior Debt).

(4) Bankruptcy (60-day cure if involuntary).

(5) Judgments exceeding specified amount not paid or stayed within 60 days.

ii. Procedure For Acceleration

(1) Bankruptcy default—automatic acceleration.

(2) Other defaults—by Trustee, or vote of majority bondholders.

(3) At least five days’ notice of acceleration required to be delivered to Senior Creditors before acceleration is effective (to allow Senior Creditors to invoke Payment Bar where notice is required).

(4) Rescission of acceleration usually requires majority of bondholders and cure of all defaults.

i. Issues In Senior Credit Agreement

i. Permitted Payments. So long as no triggering event or default occurs, certain payments on the Subordinated Debt may be permitted.

(1) Interest payments are permitted unless Payment Bar is in effect.