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ION Media: Second Lien Terms Enforced

Law360, New York (January 08, 2010) -- Despite the prevalence of first lien-second lien structures in the loan market over the course of the recently ended leveraged transaction cycle, a fully-litigated case interpreting the provisions of a first lien-second lien intercreditor agreement remains something of a rarity.

In particular, a case providing guidance on the extent to which customary waivers included in such intercreditor agreements would be enforced would be welcome to finance practitioners.

On Nov. 24, 2009, the U.S. Bankruptcy Court for the Southern District of New York issued an opinion in just such a case, In re ION Media Networks Inc. et al.[1]

The Bankruptcy Court in ION Media dismissed the standing of a second lien creditor to challenge the debtor's proposed plan of reorganization by broadly enforcing the second lien creditors' waiver, contained in an intercreditor agreement, of any right to claim that the first lien creditors' liens were unperfected.

But because the court did so in the context of a species of property — FCC broadcast licenses — as to which all parties acknowledged uncertainty as to what extent a lien is possible, the court's opinion raises interesting questions as to the lessons to be drawn from the case.

ION Media Networks Inc. (formerly Paxson Communications Corporation), a broadcast company, issued $725 million of secured first lien debt and $405 million of secured second lien debt in 2005.

Both tranches of debt were secured by liens on substantially all of the assets of the company pursuant to a Pledge and Security Agreement.

The Pledge and Security Agreement expressly included "FCC Licenses" in its description of "collateral," but separately excluded from the security interest grant certain "special

property" defined as "any permit, lease, license agreement or other personal property ... to the extent that any requirement of law ... prohibits the creation of a security interest therein."[2]

The first lien creditors and the second lien creditors also entered into intercreditor provisions (the "Intercreditor Agreement")[3] relating to the security interests in the shared collateral which provided, among other agreements, that the priorities of the parties as to the collateral would not affected by "any nonperfection of any lien purportedly securing" any of the obligations.

The FCC licenses, although included within the ambit of "collateral" under the Pledge and Security Agreement, arguably were also "special property" excluded from the grant of the security interest because of limitations imposed by the FCC on the encumbrance of FCC licenses.

And it was this apparently unencumbered chunk of ION Media's assets that Cyrus Select Opportunities Master Fund Ltd., a holder of second lien debt, attempted to exploit when ION Media went into bankruptcy.

Throughout the ION Media debtors' bankruptcy case, Cyrus repeatedly voiced objections to value being ascribed to the first lien creditors' liens in the FCC licenses.

Cyrus resisted the debtors' DIP financing arrangements on the grounds that they improperly rolled up first lien obligations into the DIP financing on the strength of the first lien creditors' liens on the FCC Licenses.

Cyrus later objected to the debtors' proposed disclosure statement and plan of reorganization — which would have allocated most of the enterprise value in the reorganized debtors to the first lien creditors by distributing 95 percent of the new stock to them — on the same grounds, asserting that the plan was unconfirmable because the FCC Licenses were unencumbered and the disclosure statement did not contain adequate information to permit the creditors to make an informed decision on the plan.[4]

Cyrus's argument was simple: The Intercreditor Agreement created a priority scheme that was limited to the collateral in which a security interest was successfully granted under the Pledge and Security Agreement; it created a lien subordination, in other words, but did not create a debt subordination that affected the second lien debt beyond the collateral.

Some or all of the rights related to the FCC licenses were excluded from the collateral grant.

To the extent the second lien debt was underwater and the second lien lenders' claims were unsecured claims, Cyrus's argument would continue, the second lien debt, along with other unsecured creditors, should capture the benefit of the unencumbered FCC licenses.

The waiver under the Intercreditor Agreement of the second lienholders' right to attack the perfection of the first lien debt's lien on the collateral was inapplicable, Cyrus contended, because the FCC licenses were simply not collateral.

Much of the back-and-forth in the parties' briefs in the case probed the contour of permissible security interests in the rights inherent to FCC broadcast licenses.

But the Bankruptcy Court declined to become enmeshed in the nature and scope of the security interest in the FCC licenses.

Noting that the language in the Intercreditor Agreement prohibited the second lien creditors from challenging perfection of a lien "purportedly securing" any of the secured obligations, the court concluded that the FCC licenses were properly covered by the waiver as "purported" collateral, regardless of the extent to which the niceties of the FCC lien analysis may have removed the FCC Licenses from the security grant.

Indeed, the Bankruptcy Court's reasoning moved quickly off the FCC analysis.

The court instead focused on two competing public policy interests: that in favor of certainty in the enforcement of contracts between creditors, versus that for the maintenance of the Bankruptcy Code's scheme of settling claims among creditors (and the reluctance of some courts to permit advance waivers at variance with that scheme).

In weighing these competing interests, the Bankruptcy Court came down clearly on the side of deferring to the bargained-for terms of pre-bankruptcy intercreditor agreements (although the court's evident annoyance with Cyrus, as the lone remaining plan objector, may have flavored its language):

". . . [P]lainly worded contracts establishing priorities and limiting obstructionist, destabilizing and wasteful behavior should be enforced and creditor expectations should be appropriately fulfilled. The Intercreditor Agreement is an enforceable contract under section 510(a) [of the Bankruptcy Code], and the court will not disturb the bargained-for rights and restrictions governing the second lien debt currently held by Cyrus."[5]

In fact, the Bankruptcy Court seems to imply that the case law questioning the enforceability of such intercreditor waivers should be limited to waivers of creditors' voting rights on reorganization plans.

Notably, it seems clear that In re ION Media Networks does not teach that a clever intercreditor agreement will fill the gaps of a flawed collateral grant; although the first lien creditors in ION Media ultimately received the benefit of the "purported" collateral consisting of FCC licenses, the court also noted that this was not a case where a lien perfection was mistakenly neglected.

Rather, where the Cyrus argument fell short was in its expectation that a first lien-second lien intercreditor agreement would be strictly construed as pure lien subordination.

The ION Media court took a more practical, commercial view, and evinced its willingness to enforce the Intercreditor Agreement in accordance with its terms as bargained for among the creditor parties — without regard to whether those terms imposed lien subordination concepts, debt subordination concepts, or gradations of both.

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The opinions expressed are those of the author and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] In re ION Media Networks Inc., -- B.R. --, 2009 WL 4047995 (Bankr. S.D.N.Y., Nov. 24, 2009).

[2] Compare Declaration of Jonathan S. Henes in Support of Debtor's Motion for Summary Judgment, Exhibit A — Pledge and Security Agreement at 10, In re Ion Media (Bankr. S.D.N.Y., Nov. 24, 2009) (No. 09–13125) (including "all FCC Licenses" in the description of "Collateral") with Declaration of Jonathan S. Henes in Support of Debtor's Motion for Summary Judgment, Exhibit A — Pledge and Security Agreement at 8 (definition of "Special Property").

[3] The Intercreditor Agreement consists of the "Collateral Agent and Secured Party Acknowledgments", Annex 1 to the Pledge and Security Agreement.

[4] ION Media, 2009 WL 4047995, at *5. Notably, Cyrus appears to have been the only objecting creditor; the other second lien lenders and unsecured creditors accepted an agreement, embodied in the ION debtors' plan, whereby the second lien and unsecured creditors would receive a $5 million cash distribution and 5% of the stock of the reorganized debtors.

[5] ION Media, 2009 WL 4047995, at *6.
