SUBORDINATED DEBT

I. INTRODUCTION

A. General. This outline is written from the perspective of counsel to senior lenders, though the points raised and their suggested resolutions can be modified and/or used by counsel to borrowers or subordinated lenders with little difficulty. No attempt has been made in this outline to bias the characterizations of market practice in favor of senior lenders.

B . Focus of Outline. This outline concentrates on issues raised in drafting subordination agreements or subordination provisions for inclusion in debt instruments. The outline begins, however, with an overview of methods of obtaining priority of payment over competing creditors because it is important always to be aware of alternate methods of achieving the same goal--getting paid first.

II. METHODS OF OBTAINING PRIORITY OF PAYMENT OVER COMPETING CREDITORS

A. Contract. The basis for enforcing subordination agreements is that a creditor and a debtor (or two creditors of a common debtor) can by contract agree that a specified creditor of the debtor will, upon the occurrence of certain contingencies, receive from the debtor (or, in the case of an agreement between two creditors, from the creditor agreeing to be subordinate) payments that the creditor agreeing to be subordinate would otherwise be entitled to receive from the debtor. The subordinated creditor agrees that it will have no right to receive or retain payment from the debtor until after the designated "senior" creditor has been paid in full. See, e.g., In re Credit Industrial Corporation, 366 F.2d 402, 407 (2d Cir. 1966) ("Attention . . . must be focused on the contract upon the basis of which the noteholders loaned various amounts to CIC. If the terms of the contracts are clear and unambiguous, as they are here, it is unnecessary to resort to strained theories of third-party beneficiary, estoppel or general principles of equity to evaluate and determine the proper respective positions of the parties involved").

B. Contract Theory. The Court of Appeals for the Ninth Circuit set forth the contract theory as follows: "The Bankruptcy Court has undoubted power to subordinate a general claim to other claims in the same category where for any reason legal or equitable, it ought to be subordinated. The court may administer the estate and order its distribution conformably to the rights of creditors as fixed by their own contracts, if these are lawful." Bank of America Nat'l Trust & Sav. Ass'n v. Erickson, 117 F.2d 796, 798 (9th Cir. 1941). Additionally, Section 510(a) of the Bankruptcy Code specifically provides that "a subordination agreement is enforceable in a case under

[the Bankruptcy Code] to the same extent that such agreement is enforceable under applicable nonbankruptcy law." Furthermore, in order to enforce a subordination agreement, senior lenders do not have to plead or prove that they relied upon such subordination agreement when deciding whether to extend credit to the debtor. See In re Credit Industrial Corp., 366 F.2d 402, 410 (2d Cir. 1966).

1. "Ab initio" subordination is typically found in public debt securities; the debtor agrees to terms of subordination in the indenture or in the terms of the securities to be issued prior to issuance. The terms of the securities state on their face that the holder accepts the terms of the subordination by acceptance of the securities and that holders of present and future "senior debt" (as defined in the indenture or in the securities) are relying on the terms of the subordination in extending credit to the debtor.

2. "Subsequent" subordination is typically found in situations where affiliates of the debtor have extended credit and a new lender (typically a bank or an insurance company) is unwilling to extend credit unless the debt owed to affiliates is subordinated. The affiliate creditors and the new lender will enter into a contract pursuant to which payments received by the affiliates will, in certain situations, be turned over to the new lender. The best practice is to have the debtor also sign such a subordination agreement so that provision can be made for direct payment to the new lender rather than relying exclusively on the affiliate creditors to turn over certain payments to the new lender. (The terms "ab initio" and "subsequent" subordination are borrowed from Reade H. Ryan, Jr., "Subordination of Debt--Drafting Considerations" in Resource Materials: Banking and Commercial Lending Law.)

3. In acquisition financings, senior lenders extending credit to an acquiring company to purchase securities of a target will always require that any subordinated debt incurred to purchase securities of the target be subject to ab initio subordination; they will also require that any long term subordinated debt used to refinance the initial subordinated "bridge" debt be subject to ab initio subordination. Existing third party lenders to the target will almost never sign subsequent subordination agreements; such lenders hope that any merger following the stock acquisition will violate the terms of their debt instruments so they will have a right to be repaid or extract concessions for requisite waivers. Senior lenders may, however, successfully negotiate the subordination of obligations owed by the acquisition company or the surviving company to its affiliates. Such obligations are typically in the form of service contracts, advisor fees and management or consulting agreements. Occasionally affiliates of the acquiring company will lend funds for the acquisition which could also be subordinated to senior debt.

a. Though senior lenders will require that any subordinated acquisition debt be

subordinated "ab initio", senior lenders will often sign commitment letters with potential acquiring companies to advance funds prior to agreement with the subordinated lenders on the terms of subordination. The senior lenders protect themselves in these commitment letters by conditioning their obligation to advance funds on the subordination language "being acceptable to the senior lenders in their sole discretion". The subordinated lenders will often similarly condition their commitment to lend, thus setting the stage for a negotiating session in which the would-be borrower typically ends up as "moderator". In today's market, however, the terms of subordination are fairly standardized with only a few marginal issues actively negotiated.

4. Subordination agreements do not create security interests governed by Article 9 of the Uniform Commercial Code.

a. Both the history and the text of Article 9 are clear that Article 9 was not intended to apply to subordination agreements. In general, Article 9 is a filing and notice statute: one acquires security interests usually by public filing and, generally, without a public filing one cannot defeat a subsequent creditor who publicly files notice of its own security interest. Concerns that Article 9 might apply to subordination agreements arise because in the bankruptcy of a common debtor dividends otherwise payable to the subordinated creditor are turned over to the senior creditor. This "turn over" practice has been explained by some courts as an equitable lien, an equitable assignment or a constructive trust. Nevertheless, the practice is essentially an equitable remedy and does not mean that there is a transaction intended to create a security interest or in which a security interest is created by contract within the meaning of Section 9-109. See Official Uniform Comment, Section 1-209.

(i) New York has adopted optional Section 1-209 of the Uniform Commercial Code which expressly states that subordination agreements "do not create a security interest as against either the common debtor or a subordinated creditor".

D. Security Interests. Senior lenders may also obtain priority over other creditors by receiving a valid first priority perfected security interest in collateral of the debtor.

1. Senior lenders should avoid permitting subordinated lenders to acquire a "second lien" on their collateral. A second lienholder may interfere with a senior lender's disposition of collateral and the senior lender may, by virtue of having permitted a second lien, incur liability to the second lienholder for a sale of collateral at an inadequate price. See e.g. Uniform Commercial Code Section 9-625(c). Often the subordination language or terms of senior debt will require that the subordinated debt remain unsecured or the terms of the senior debt will provide that the granting of a security interest to the subordinated debt will be an event of default. Such provisions

should be included because of potential problems created by second liens.

2. If subordinated debt is secured by collateral, a senior lender may get the benefit of this security interest even if the senior debt is unsecured so long as the subordination language clearly states that the subordination applies to payments received from collateral. Nevertheless, reliance on security interests granted to secure subordinated debt is less certain and should be avoided: the subordinated debtholders could release the collateral, and their liens could be unperfected or subject to defenses. Typically, senior lenders would take an independent security interest in the collateral and require subordinated lenders to subordinate their security interest to that of the senior debt.

E. Debt incurrence at varying levels of corporate structure. Debt incurred at a parent company is, in effect, structurally subordinate to the debt incurred by its subsidiaries. If a senior lender advances funds directly to an acquisition company and other lenders advance funds to the parent company which downstreams the advances to the acquisition company in the form of equity, the senior lender will have a prior claim on the assets of the acquisition company and any surviving company in the event of a merger between target and acquisition company and the other lenders will have a claim (along with other parent company creditors) only in respect of the parent's residual equity interests in the acquisition company.

1. Risks of substantive consolidation. See, e.g., Consolidated Rock Prods. Co. v. Dubois, 312 U.S. 510 (1941).

2. Risks of action taken by debtor (e.g., merger of debtor into parent).

F. Judicial Action/Equitable Subordination. In addition to the contract terms that control priority, the noncontractual actions of a party to a reorganization may affect the priority of the creditors. Bankruptcy courts have the "equitable power" to subordinate claims of one creditor to those of another and to disallow claims all together. See 11 U.S.C. Section 510(c). Both debt claims and security interests can be equitably subordinated. However, a debt claim typically is not subordinated to an equity claim, regardless of whether the debt may have acted in an inequitable manner to the equity's detriment.

1. It is well established that courts will subordinate the claim of a guarantor or surety to the competing claim of a creditor in a class intended to be protected by the surety bond or guarantee. See, e.g., American Surety Co. v. Sampsell, 327 U.S. 269 (1946).

2. A court may also subordinate the claim of a creditor if the court does not like the way in which the creditor has acted. Generally, equitable subordination will be effected only if a creditor has exercised control over the debtor in a manner detrimental to other creditors' interests.

a. The Deep Rock Doctrine. The "Deep Rock doctrine" was formulated in Taylor v. Standard Gas Co., 306 U.S. 307 (1939), in which the Court subordinated the claims of Standard Gas against its subsidiary, Deep Rock Oil Corporation, upon proof that Standard had established Deep Rock as an undercapitalized entity and had thereafter mismanaged Deep Rock for the benefit of Standard Gas.

b. In Pepper v. Litton, 308 U.S. 295 (1939), the Court disallowed entirely the claim of a controlling stockholder against his bankrupt corporation where the stockholder had used his controlling position to defeat the efforts of the only other general creditor of the corporation to collect a claim.

c. "The lower federal courts have applied the Deep Rock doctrine, which thus far has been employed only in business bankruptcies, to subordinate or disallow claims for reasons ranging from findings that the claims had been acquired in violation of the antitrust laws and to the injury of other claimants, through findings that the claims had been concealed from other creditors, to findings that [a] claimant newspaper publisher had converted its subsidiary debtor from a profitable manufacturer of various paper products into an unprofitable supplier of newsprint for the claimant." Countryman, The Use of State Law in Bankruptcy Cases (Part 1), 47 N.Y.U.L. Rev. 407, 429-430 (1972).

III. SUBORDINATION BY CONTRACT

A. Definition of Senior Debt. "Senior debt" must be carefully defined; the definition will likely be strictly construed against the senior lenders, particularly if the senior lenders participated in drafting the terms of the subordination.

1. Principal. The subordination language should make clear that all principal of the senior debt is included.

a. Future advances. The language should make clear whether and to what extent future advances from the senior lenders will be included in the definition of senior debt.

(i) In an acquisition context, the senior lenders will often want to advance additional funds to the debtor to help the debtor over a period of financial difficulty; a senior lender might not advance additional funds unless the new advances are considered senior debt. If it is important to the senior lender that future advances be considered senior debt this provision should be included at the outset; it will be particularly difficult to amend any public subordinated debt to allow such "workout" money to be considered senior debt.

(ii) It is to the distinct advantage of senior lenders (and not objectionable from a

subordinated debt point of view) to limit the definition of senior debt to their own debt, so that they get the full benefit of any payments made to the subordinated debt required to be turned over to senior debt rather than having to share payments with other senior lenders. The senior debt should also prohibit subordinated debt from agreeing in the future to subordinate to other indebtedness. A borrower may view this as impairing its ability to raise new indebtedness, although that ability would typically be severely curtailed by senior debt covenants in leveraged acquisitions.

b. Future Purchases of Indebtedness. If any debt acquired or purchased by the senior lenders is to be included in senior debt the language should clearly provide for its inclusion.

c. Existing Indebtedness. If the senior lenders hold any existing debt of the debtor, whether created by an advance or obtained by a purchase, if this debt is to be included in the definition of senior debt, it should be specifically listed and described (including whether interest, fees and other amounts related to such indebtedness are to be considered senior debt).

2. Interest. The subordination language should clearly specify accrued interest as senior debt. Often subordination language will limit senior debt to a specified amount. The subordination language should clearly state that any such limit is a limit on the principal amount of senior debt only and that, even if the sum of the principal and accrued interest exceeds the specified limit, the combined amount all counts as senior debt.

a. Increases in interest rates or changes to method of calculation. If the subordinated lenders are attempting to narrowly limit the scope of senior debt, they will often ask that the terms of the senior debt not be amended without the consent of subordinated lenders. This is overly broad as it prohibits technical amendments to covenants and the like. The senior lenders could consider limitations on their ability to increase interest rates, fees or changes to the methods of calculating interest; however, such changes will limit the senior lenders' flexibility. In a workout situation, a senior lender might postpone acceleration in exchange for a higher rate of interest or increased fees--an option that may be unavailable (or available only at a price) if a subordinated lender consent is required.

b. "Post-petition" interest. Absent "absolutely clear" language stating that a senior lender is entitled to post-petition interest at the expense of the subordinated lender, the general rule that interest stops accruing on the date of the filing of the bankruptcy petition will prevent the senior lender from receiving post-petition interest. Often a subordinated lender will propose language that provides the senior lender with post-petition interest "to the extent such interest is an allowable claim under the

Bankruptcy Code." While sounding fair enough, this language is essentially meaningless to a senior unsecured lender because post-petition interest is not an allowable claim in a bankruptcy proceeding. See 11 U.S.C. Section 502(b)(2). Because this language has found its way into a significant number of debt agreements, to avoid any confusion, if all post-petition interest is intended to accrue at the expense of the subordinated lender, the subordination language should expressly provide for post-petition interest "whether or not such interest is an allowable claim under the Bankruptcy Code." See, In re Times Sales Finance Corp., 491 F.2d 841 (3d Cir. 1974). ("If a creditor desires to establish a right to post-petition interest and a concomitant reduction in the dividends due to subordinated creditors, the agreement should clearly show that the general rule that interest stops on the date of the filing of the petition is to be suspended, at least vis-a-vis these parties"). The Model Simplified Indenture expressly provides for post-petition interest but does not include the phrase "whether or not such interest is an allowable claim"; however, this phrase should be used in subordination language to avoid ambiguity. See In re Ionosphere Clubs, Inc., 134 B.R. 528 (Bkrtcy, S.D.N.Y. 1991). (The clause in Ionosphere held insufficiently clear was virtually identical to the clause contained in the Model Simplified Indenture. This decision underscores the importance of using the "whether or not . . . " language stated above).

c. At the time the Model Debenture Indenture was drafted in 1965, it also arguably provided for post-petition interest, although no specific language was needed to achieve this result under the law in effect at that time. Under the Bankruptcy law in effect in 1967, claims for postpetition interest were not "provable" and since only provable claims were dischargeable, a claim for post petition interest survived a bankruptcy discharge, see e.g., Matter of Paley 260 App. Div. 632 (New York 1940) (interpreting Section 63 of Federal Bankruptcy Act). Therefore post-petition interest clearly would have been considered in the computation of senior debt required to be satisfied, if necessary, out of dividends received by the subordinated lender through the turnover provisions of the subordination language. Existing case law, however, would not permit postpetition interest under the language of the Model Debenture Indenture. Occasionally, a senior lender will agree to limit accumulation of post-petition interest to one or two years.

(i) A senior lender that is secured will receive payment of post-petition interest to the extent of its security; a partially or undersecured creditor will not receive post-petition interest. See 11 U.S.C. § 506(b); see also United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd., 56 U.S.L.W. 4108 (U.S. Jan. 20, 1988).

(ii) In the rare situation in which assets remain after the payment of all allowed claims in a bankruptcy proceeding, interest at the legal rate from the date of the filing of the

petition will be paid on any allowed claim before remaining assets are turned over to the debtor. See 11 U.S.C. § 726(a)(5).

3. Fees and Other Amounts. The senior lender must consider what additional amounts should be included in senior debt.

a. Administrative, commitment, participation, L/C, etc.

b. Attorneys' fees.

c. Costs of collection; taxes; other.

4. Extensions, Renewals and Substitutions. If the senior lenders want the flexibility to have any refinancing or substitution of the senior debt also be considered senior to the subordinated debt this must be expressly provided. If any extension or renewal of the senior debt is intended to constitute senior debt this also must be expressly provided. This latter possibility may be particularly important in a work-out situation in which the senior lenders believe it is to their advantage to extend the maturity of the senior debt.

B . Definition of Subordinated Debt. The same issues arise in the definition of subordinated debt as in the definition of senior debt. Ambiguities in the definition of subordinated debt may result in a narrow interpretation, reducing the size of the bankruptcy dividend payable to the subordinated lenders that may be turned over to the senior lenders.

C. Events of Subordination. This section outlines so-called "events of subordination". The events of subordination describe the situations in which a payment that would otherwise be made to, or retained by, the subordinated creditor is instead made, or paid over, to the senior creditor or is blocked altogether. At one extreme is strict or "stand-by" subordination in which no payments may be made on the subordinated debt until the senior debt has been paid in full. At the other extreme is bankruptcy subordination in which a payment that would otherwise be made to or retained by the subordinated creditor is paid to the senior creditor only if a voluntary or involuntary bankruptcy proceeding has commenced against the debtor. Strict subordination is almost never found outside of obligations owed to affiliates. Major institutional lenders will not be content with simple bankruptcy subordination because they want to be able to manage a deteriorating credit situation. The occurrence of these events may also trigger the prohibition of certain actions that could otherwise be taken by the subordinated lenders, such as acceleration of the subordinated debt or commencement of judicial proceedings. A more detailed outline of the effects of the occurrence of an event of subordination appears in subpart D of this outline.

1. Bankruptcy. The list of bankruptcy events should be broadly drafted to include any voluntary or involuntary petition, appointment of a receiver, assignment for the benefit of creditors, marshalling of assets, dissolution, liquidation, etc., whether pursuant to a state or Federal proceeding or otherwise. The subordinated creditor may wish to omit marshalling of assets, an equity rule under which a court may compel a creditor who has a right to collect his debt out of two sources to resort to one source which will not diminish the rights of another creditor who has a claim on only one source. This situation would exist if the senior creditor was secured and the subordinated creditor was unsecured.

2. Judicial Proceedings by Senior Lenders. If the senior lenders commence judicial proceedings against the debtor based on a default under the senior loan documents, payments on subordinated debt should be blocked and any payments made over the block should be turned over to the holders of senior debt.

3. Acceleration of Senior Debt. If the senior debt has been accelerated, payments on the subordinated debt should be blocked and any payments made over the block should be turned over to the senior lenders. Since acceleration typically occurs prior to commencement of judicial proceedings, use of acceleration as a subordination event would generally result in an earlier block than simply relying on the commencement of judicial proceedings (although both acceleration and commencement of judicial proceedings are typically specified as events of subordination).

4. Senior Debt Payment Defaults. If the debtor misses a payment of principal or interest on senior debt, payments on the subordinated debt should be blocked and any payments made over the block should be turned over to the holders of senior debt. Generally payments on subordinated debt will also be blocked if the debtor fails to pay fees or other amounts due to the holders of senior debt. One issue in this area is whether the block is effective immediately upon the failure to make a payment when due or only after the expiration of any applicable grace periods. Most senior bank credit agreements require subordination upon the failure to pay, not upon the failure to pay coupled with the expiration of any applicable grace periods. This is the theoretically correct result because the subordinated lenders should not be allowed to receive or retain payments on account of a grace period. Though this seems to be the correct result, the Model Debenture Indenture and the Model Simplified Indenture institute a block only after the expiration of grace periods. The Model Debenture Indenture achieves this result by instituting a block upon the occurrence of an "event of default" rather than upon either a "default" or a "default which with the giving of notice or passage of time or both would constitute an event of default". The Model Simplified Indenture achieves the same result by instituting the block upon the

occurrence of a "default on Senior Debt . . . that permits the holders of such Senior Debt to accelerate its maturity". Another issue in this area is whether a block is triggered by a default on any senior debt or only by a default on Designated Senior Debt (the latter is preferable from the subordinated debtholder's point of view).

5. Senior Debt Covenant Defaults. A main issue in this area is also whether a block is effective upon a default or only after the expiration of any applicable grace periods. It is fairly typical to give the benefit of grace periods for nonpayment covenant defaults, particularly if no grace is provided for important covenants (e.g., financial covenants for which grace periods are generally inapplicable).

a. Structure of Senior Debt Covenants. Covenants are typically more restrictive in senior loan documents than in subordinated loan documents. To the extent that the senior lender has a voice in the structure of the subordinated lender's loan documents, the senior lender should require that any financial ratio covenants for the senior debt are more restrictive than those of the subordinated debt and that the subordinated debt does not have any additional financial covenants that could be triggered at a time when no default exists on the senior debt. If the covenants are tiered in this fashion, in theory, the senior lenders may have an opportunity to work out problems with the debtor without having the subordinated lenders at the negotiating table. As supplemental protection, senior loan documents may include a cross-default to subordinated loan documents as discussed below.

(i) The senior debt should include as a covenant default any amendment of the subordination terms of the subordinated debt without the consent of the senior lenders. This default should result in an immediate block on payments to the subordinated debt and should not require that any notice be given or be subject to any grace period.

b. Senior Debt cross defaults to other agreements. The senior debt should cross default to other significant indebtedness of the debtor, particularly to the subordinated debt, to ensure that the senior lenders are included in any workout negotiations. This type of provision is often objected to because it elevates the senior lender to a "most favored nations" status, giving the senior lender the benefit of any covenants negotiated in the future or past. If the "defaults" in other agreements are not required to have matured into "events of default" in the other agreements before the cross-default is triggered, the senior lender will be able to accelerate and to block payments on the subordinated debt prior to acceleration by the very lenders who negotiated the defaulted provision.

c. Senior Debt cross acceleration to other agreements. If the senior lender cannot negotiate a cross default, it should at a minimum have a cross acceleration in its

agreement to other significant indebtedness of the debtor (which should include any subordinated debt).

6. Subordinated Debt Covenant Defaults

a. Structure of Subordinated Debt Covenants. The subordinated debt covenants are typically more lenient than the senior debt covenants. The senior debt will get the benefit of these covenants and may use them as a basis for a block if the senior debt cross defaults to the subordinated debt.

(i) The senior lenders should get the subordinated lenders to agree in the terms of the subordinated debt not to amend the subordination provisions without the consent of the senior lenders.

b. Subordinated Debt cross defaults to other agreements. The senior lenders should not allow the subordinated debt a cross default to the senior debt. If a cross default is allowed, it has the effect of incorporating the senior covenants into the subordinated loan documents and destroys any timing advantages the senior lender might gain by negotiating tighter covenants.

c. Subordinated Debt cross acceleration to other agreements. The subordinated debt will likely have a cross acceleration to other significant indebtedness of the debtor, including the senior debt. The senior lender should make sure that the amount of indebtedness specified as "significant" is higher in the subordinated debt than in the senior debt. If for some reason the amount specified is lower, the senior debt will be on a parity with the subordinated debt if it contains an adequate cross default to the subordinated debt which can serve as a basis for a payment block.

7. Subordinated Debt Payment Defaults. The subordinated lenders will typically not allow a cross default in the senior debt to serve as a block if the cross default is a failure to make a payment on the subordinated debt. If this cross default is allowed to block payments, the debtor will never be able to cure a failure to make a payment on the subordinated debt.

D. <u>Effect of Occurrence of Event of Subordination.</u>

1. Immediate "blockage" versus notice. The most favorable treatment of events of subordination from the senior lender's perspective is to provide that upon the occurrence of any such event payments on the subordinated debt are automatically blocked. The Model Debenture Indenture contains an optional provision which distinguishes between payment defaults on senior debt and covenant defaults on senior debt; in the later case, notice of the default must be given to the debtor and to the trustee for the subordinated debt before a blockage period commences. The Model

Simplified Indenture requires that notice be given for any default unless it is the subject of judicial proceedings. It is the rule, not the exception, under current market practice to provide that notice must be given to the subordinated lenders or their trustee before a senior debt covenant default may form the basis for a block. On the other hand, notice is rarely required of a payment default to trigger a block. However, under no circumstances should notice be a requirement to trigger a block based upon a bankruptcy event, judicial action or acceleration of senior debt--in each of these cases the debtor will have notice from the senior lender that action is being taken to collect the debt so any payment on the subordinated debt would be wrongful and should be capable of recovery by the senior lenders. Limitations on the ability to give notices instituting blockage periods are discussed in subpart E below.

2. Blockage of Payments on subordinated debt. At a minimum, the occurrence of an event of subordination should result in the blockage of payments on the subordinated debt and require that any payments made over the block be turned over to the senior lender.

3. Prohibition on acceleration. Senior lenders should also consider prohibiting acceleration of the subordinated debt during a blockage period. The block itself will typically result in an eventual payment default on the subordinated debt which would otherwise permit its acceleration. The subordinated debt can cause trouble for the debtor and the holders of senior debt by accelerating the subordinated debt during a blockage period, particularly if the senior lenders instituted the block specifically to gain time to work out problems with the debtor. For example, acceleration by the subordinated lenders could trigger cross-acceleration of many of the debtor's other credit agreements. The subordinated debt may use this ability as a bargaining chip to extract concessions from the senior debt. The ability to accelerate is particularly troubling if the vote required to accelerate the subordinated debt is lower than the vote required to rescind a notice of acceleration, as often is the case in public subordinated debt. One way of dealing with the issue (but not necessarily cross-default problems) would be to provide for automatic rescission of acceleration if the payment default giving rise to acceleration is cured at the end of the blockage period.

4. Prohibition on exercise of remedies. The senior lenders may wish to prevent the subordinated lenders from filing a bankruptcy petition, commencing a lawsuit, filing an attachment or lis pendens or taking similar action during a blockage period, again on the theory that such actions will put pressure on the debtor and may inhibit any rehabilitation efforts. The threat to take such action may also be used as a bargaining chip. Senior lenders may also attempt to impose a standstill period on subordinated debt enforcement or collection actions after any acceleration of the subordinated debt, regardless of whether during a blockage period. In the case of senior secured lenders,

a sufficiently long standstill will provide time prior to a bankruptcy filing for disposition of collateral and repayment of the senior debt.

E. "Fish or cut bait" Provisions. It is fairly common for the subordinated lenders to request that the blockage of payments (and other prohibitions on subordinated lender action, if any) be lifted, at least with respect to blocks instituted for certain types of defaults, after a specified period of time. The Model Simplified Indenture contains such a provision, though it is not found in the Model Debenture Indenture. Such a provision represents an accommodation between the senior lenders who would prefer to block any payments to the subordinated lenders during a deteriorating credit situation and the subordinated lenders who do not want the senior lenders to remain idle at their expense rather than actively working with the debtor to resolve a deteriorating credit situation. Typically these provisions require that the block be removed after a certain period of time unless the default giving rise to the block has resulted in the acceleration of the senior debt or is the subject of litigation. If the parties have agreed to include such a "fish or cut bait" provision, the issue always arises as to whether it should apply to all defaults or only nonpayment defaults. Resolution of this issue varies.

1. Time periods. Blockage periods are typically specified by time periods that range from 90 days to a year or more. The most common periods are 120 days (included in the Model Simplified Indenture) and 180 days.

a. Specified by days. If days are specified for the blockage period, the parties should focus on when the period begins--upon notice to the debtor and the subordinated lender given by the senior lender, upon the occurrence of the default that permits blockage or upon the senior lender receiving notice of the default.

b. Specified by number of payments blocked. Though less common, it makes sense to specify the blockage period by computing the number of scheduled payments that can be blocked. In any event, the senior debt should determine how many scheduled payments can be blocked even if the period is specified in terms of the number of days.

c. Limitations on blockage periods. Subordinated lenders will often request that the senior lenders be prohibited from stringing together blockage periods and to accomplish this they suggest that no two notices may be effective if given in a set time period (240 days, nine months, etc.) This approach is followed in the Model Simplified Indenture but has the serious disadvantage of preventing the senior lenders from tacking a new blockage period onto an old one if a new default has occurred. It is far preferable for the senior lender to agree that no default existing on the date of the notice triggering the first blockage period (and known to it) may serve as the basis

for a subsequent blockage period unless such default has been cured or waived for a specified period of time following the first notice (use a period of time not greater than the blockage time period). This will at least stop the senior lenders from "saving up" defaults and should satisfy most subordinated lenders.

d. Relevance of delivery of financial statements. The length of the blockage period should not be negotiated as a simple numbers game in which the parties "split the difference". Often the senior lenders will be faced with a decision of whether to accelerate the senior debt and/or start judicial proceedings (thus typically instituting a permanent block) or allow the subordinated lenders to receive a payment. If the blockage periods are too short to permit the receipt and evaluation of financial statements for a period or periods deemed relevant to the senior lenders, the senior lenders may be forced to make a decision in a vacuum. In determining what periods are appropriate, the senior lender should keep in mind that quarterly financial statements are usually delivered during the midpoint of the following quarter; thus, even if the senior lenders forced the debtor to institute certain procedures to remedy a deteriorating credit situation immediately upon receipt of quarterly financial statements indicating a breach of a financial covenant, the effects of those steps would only appear in results for half of the quarter reflected in the next set of financial statements delivered.

(i) Problems created by year end statements. Usually year-end financial statements are delivered three months after the end of the fiscal year. If a covenant default were demonstrated by year end financial statements, no effects of remedial efforts instituted by the senior lenders would be reflected in the next quarter's financial statements.

F. <u>Turnover of Property to Senior Debt.</u> Every subordination provision will provide that upon the bankruptcy, liquidation or dissolution of the debtor all property distributed to the subordinated lenders will be turned over to the senior lenders until the senior debt has been repaid in full.

1. The "X" clause. The "X" clause is an exception to the general rule that all property distributed to the subordinated lenders will be turned over until the senior debt is repaid in full. It is an optional provision in the Model Debenture Indenture, is included in the Model Simplified Indenture and is generally found in public subordinated debt in some form. The "X" clause provides that the subordinated lender gets to keep any securities distributed to it in a reorganization proceeding of the debtor "to the extent that the securities received are subordinated to the senior debt at least to the extent of the subordinated debt". There are numerous methods of drafting this provision. The key issue is whether the subordinated lenders get to keep any

equally or more deeply subordinated securities if the plan of reorganization results in an "impairment" of the senior debt. Most subordination provisions either do not address the issue, creating the implication that the subordinated lenders will keep any newly issued subordinated securities regardless of impairment of the senior debt, or do not refer specifically to "impairment", thus creating an ambiguity. The "X" clause can be effectively neutered if the absence of an impairment to the senior debt is expressly made a condition to receipt of securities by the subordinated lenders.

a. Impairment of Senior Debt. The concept of impairment under a plan of reorganization is technical but generally the senior debt will be impaired if the principal amount of the debt, the interest rate or the fees paid are reduced in the reorganization proceeding or if the maturity of the senior debt is extended. See 11 U.S.C. section 1124. Note that the senior debt will not be deemed impaired if the plan of reorganization provides for a cash payment equal to the amount of the senior debt's "allowed claim"--i.e., no postpetition interest if the senior debt is unsecured or undersecured.

b. Problems with receipt of equity securities. If the subordinated debt were replaced with equity securities, by definition the equity securities would be more deeply "subordinated" than the original subordinated debt. However, the receipt of equity securities would eliminate the possibility of the senior lender receiving payment in the event of a second bankruptcy of the reorganized company equal to the amount that would have been paid to the subordinated lenders because no bankruptcy dividends are paid to holders of equity securities until after all other claims are paid in full. See paragraph 3 below, Column C.

2. Multiple Layers of Subordinated Debt. If a transaction contains several layers of subordinated debt, the senior lenders will need to make certain that they benefit from any turnover of property by junior subordinated lenders to senior subordinated lenders.

a. The Model Debenture Indenture recommends inserting the following clause in the section specifying the property that the subordinated lenders shall turn over to the senior lenders: ", including any such payment or distribution which may be payable or deliverable by reason of the payment of any other indebtedness of the [debtor] being subordinated to the payment of the [senior subordinated debt]."

3. Example of Property Distribution

	Case A	Case B	Case C
Assets of Debtor:			
Liquidation Value of Plant, Property and Equipment	$500	$750	$500
Liabilities of Debtor:			
Senior unsecured debt	$400	$400	$400
Subordinated debt	$300	$300	-0-
Trade debt	$300	$300	$300
Bankruptcy Dividends:			
Senior unsecured debt	$200	$300	$285
Subordinated debt	$150	$225	-0-
Trade debt	$150	$225	$215
Amount Retained by Creditor Classes:			
Senior unsecured debt	$350	$400	$285
Subordinated debt	-0-	$125	-0-
Trade debt	$150	$225	$215

a. Column A illustrates the "double dividend" benefit received by the senior lenders from the subordinated lenders. The entire subordinated debt dividend of $150 is applied to the senior debt because the senior debt has not been paid in full, leaving the subordinated lenders with no proceeds from the bankruptcy dividend.

b. Column B also illustrates the double dividend but, in addition, shows that when the senior debt is paid in full, the subordinated lenders retain the balance of their bankruptcy dividend.

c. Column C illustrates the outcome of a bankruptcy distribution if there is no subordinated debt because it has been replaced by equity securities. Note that while this increases the initial bankruptcy dividend payable to the senior debt from the amount in column A, the amount ultimately received by the senior debt is less because no bankruptcy dividend is paid on equity securities which may in turn be paid over to the senior lenders.

G. <u>Subordination via Timing of Payments.</u> Senior lenders gain considerable comfort from a debt structure in which no principal payments are made on the subordinated debt until the senior debt has been repaid in full (or, if the senior debt amortizes, until after a substantial portion of the senior debt has been retired). Many acquisition financings are structured so that the senior debt matures prior to the subordinated debt; however, the subordinated debt may often be optionally redeemed prior to the maturity of the senior debt. The senior lenders might consider use of a negative covenant prohibiting an optional redemption of the subordinated debt. Similarly, the senior lenders might consider requiring payment of the senior debt prior to payment of the subordinated debt upon a "change of control" or other event that requires the debtor to make on offer to purchase the subordinated debt. A change of control "put" does not result in a technical acceleration of the subject debt but has a similar practical effect. The subject debt is not "repaid" but is, instead, "repurchased."

1. Covenant in Senior Debt. The senior debt may include a provision making it an event of default on the senior debt if any principal of the subordinated debt is repaid before the senior debt is repaid in full.

2. Statement in Subordinated Debt. It is better to include a statement in the subordinated debt that no payments of principal may be made on the subordinated debt until the senior debt is paid in full, though underwriters typically object to including such a statement in publicly offered subordinated debt. A compromise would be to require the trustee for the subordinated debt to provide the senior lenders with advance notice of any principal payment on the subordinated debt so the senior lenders may institute a payment block if the principal payment would constitute an event of default or a cross-default.

3. Maturity of Bridge Notes. In acquisition financings the senior lenders should make sure that any short term "bridge" subordinated debt incurred to finance a tender offer does not mature prior to any short term senior debt. If the senior lenders provide post-merger debt, they will need permanent subordinated debt in place before they make long term post-merger advances or they will require that the subordinated bridge debt automatically convert to permanent subordinated debt if there is a failure to market long term subordinated debt. See paragraph 4 below. In every case the key issue is to make sure that the subordinated debt does not mature prior to the senior debt. If the subordinated debt comes due prior to the senior debt a bankruptcy could be triggered at an early stage, perhaps before the senior lenders have completed all arrangements to obtain security interests and/or increasing the chances of a successful challenge to any security interests actually obtained (cf. fraudulent conveyance time limits).

4. Exchange Notes. In tender offers, it has become common for subordinated lenders

(usually investment banking firms) to make short term bridge loans to the acquiring company and to attempt to get repaid via a public offering or private placement of long term subordinated debt. Because of uncertainty as to whether a public offering or private placement will be successful, the bridge notes may provide that, in the absence of a public offering or private placement, the bridge notes will convert into "exchange notes" by a certain date (typically one year after the initial bridge loan). The exchange notes often carry a high rate of interest (i.e., higher than the bridge notes and higher than the rate that the investment advisors to the acquiring company at the time of the tender offer had been forecasting for the long term subordinated debt to be subsequently issued in the public offering or private placement) and will contain significant covenants not present in the bridge notes. The senior lenders should make sure that the terms and conditions of the exchange notes are acceptable and are fixed at the time the senior lenders initially extend credit (even if they have not made a long term lending commitment that extends beyond the maturity of the bridge notes, because the senior lenders may not be repaid on schedule) and the senior lenders should have approval rights over any amendments to the terms and conditions to the bridge notes and the exchange notes and to the conditions of the conversion of the bridge notes into exchange notes. Similarly, senior lenders should approve a specific form for the public or private securities to be offered or, at a minimum, receive final approval rights over the form when it is established. If the senior lenders make a long term lending commitment prior to repayment of the bridge notes (on the theory that the relevant maturity is the maturity of the exchange notes) they must satisfy themselves that the conversion of bridge notes into exchange notes is automatic, and that no contingency exists in which the bridge notes could fail to convert, resulting in an un-refinanced maturity of the bridge notes prior to the scheduled maturity of the senior loans. The senior lenders must also consider the extent to which they are willing to permit the investment banking firms that hold the bridge notes to receive a cash payment at the time the bridge notes convert into exchange notes. The investment banking firms will try to negotiate a provision that entitles them to payment of an "exchange fee" upon conversion of the bridge notes into exchange notes. The exchange fee will be approximately equal to, and paid in lieu of, the underwriting fee that the investment banking firm would have received had it successfully placed long term subordinated debt (typically 2.5% to 3.0%). If this fee is paid in cash, rather than in additional exchange notes, such payment will almost certainly come at a time when the borrower's financial outlook has deteriorated (the likely reason for a failure of the planned public offering or private placement) and when the borrower is facing the prospect of increased debt service by virtue of the higher interest rate borne by the exchange notes.

H. Special Rights of Senior Debt in a Bankruptcy Proceeding.

1. Filing Proof of Claim. The subordination language should specifically authorize the senior lenders to file a proof of claim on behalf of the subordinated lenders. Absent such authorization a claim filed by the senior lenders may be disallowed under Bankruptcy Rule 3001.

a. Lack of incentive for subordinated lenders to file. In a "Column A" situation in which no dividend is expected to be paid to subordinated debt, the subordinated lenders may not file a proof of claim.

2. Voting Subordinated Debt. The senior lenders should ask that they be given the right to vote the subordinated debt's interest in any reorganization proceeding.

a. Creditor Classes. If a general proxy is not given by the subordinated lenders to the senior lenders, the senior lenders should ask for the vote only in a situation in which the senior and subordinated lenders are included in the same creditor class.

IV. SUBROGATION OF SUBORDINATED DEBT

A. Limitation of right until Senior Debt paid in full. The subordinated lenders should be expressly prohibited from exercising any rights of subrogation until the senior debt has been paid in full.