PREDICTIONS FOR INTERCREDITOR ARRANGEMENTS IN 2015 AND BEYOND

# The Devil Really is in the Details

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Intercreditor arrangements are one of the most challenging aspects of transactions, yet they have become increasingly prevalent in recent years. Changes in law, the regulatory environment, the credit markets, the economy, and the way that companies do business can all trigger new developments in intercreditor arrangements. This article examines five areas where we anticipate developments in intercreditor arrangements in 2015 and beyond and describes the reasons for the developments.

“The devil is in the details” is appropriate cautionary advice for anyone tasked with documenting the relationships among different lenders.

Intercreditor arrangements exist in circumstances where more than one group of lenders has a claim against the same loan parties and some or all of the lenders have a claim as secured creditors against their assets. A variety of different types of intercreditor arrangements are common in the market today -- first lien/second lien, split collateral, unitranche, senior/mezzanine and others – and they exist in every market, across industries, and in both asset-based and cash-flow transactions. Intercreditor agreements are designed to set forth the ground rules for lenders playing in the same sandbox with the same toys at times when the stakes are high and incentives may not be aligned. With multiple claims against the same loan parties and common collateral, come overlapping and competing rights and differing incentives. As a result, each intercreditor negotiation represents a series of compromises among competing lenders.

Additionally, intercreditor arrangements have grown more complex in recent years. There are a variety of reasons for this. With supply exceeding demand, steep competition among lenders in the markets has required lenders to be creative in structuring deals and flexible on terms in order to win deals. Therefore, it is common today for financing transactions to involve multiple tranches of debt, multiple liens and the flexibility to fold in additional debt and liens over the term of the credit facility. It is also more common today for asset pools and revenue streams to be more finely sliced and diced and allocated with different priorities among different lenders in different tranches of debt. Moreover, the underlying operations of loan parties have become more and more complex over the years. For example, businesses are becoming increasingly global every day. This means that multiple legal regimes may have an impact on lenders to that business. Also, the underlying assets of businesses are becoming more complex – intangible asset classes like intellectual property are more important in every business today and are intertwined with other traditional asset classes. The foregoing raises unique and increasingly complex intercreditor considerations.

In light of the overlapping and competing rights of lenders and increasingly complex intercreditor arrangements, intercreditor arrangements are – not surprisingly — one of the most challenging aspects of transactions. This is unlikely to change. However, past experience has shown that changes in law, the regulatory environment, the credit markets, the economy, and the way that companies do business, can all trigger new developments in intercreditor arrangements. This article examines five areas where we anticipate developments or changes in intercreditor arrangements in 2015 and beyond. Of course, we remain in the midst of change in many of these areas.

1) **Second Lien/Junior Creditors Will Press for More Favorable Intercreditor Terms:**
   The U.S. loan market is in the process of adjusting to a more restrictive regulatory environment, with, among other things, increased regulatory scrutiny over banks’ leveraged loan underwriting standards. Regulatory scrutiny is expected to limit bank lending activity compared to levels over the past several years. Nonbank lenders have jumped on this opportunity, with a slew of new nonbank lenders raising capital and positioned to fill the void. As a result, a greater number of transactions will involve nonbank lenders in one or more roles in the debt structure going forward.

Many nonbank lenders have more latitude in their underwriting approach, have higher cost of funds, and have greater risk tolerance than traditional banks. Consequently, the increase in the number of these players in the market is likely to lead to an increase in deals involving privately negotiated second lien term loans. As this occurs, we anticipate that many of those second lien lenders will press for greater control over the credit compared to the intercreditor arrangements that would be in place in circumstances where the second lien is provided through a high yield bond issuance or other issuance involving more passive investors. In addition, tightening credit markets generally give second lien and mezzanine lenders more negotiating leverage.

Under circumstances in the past involving a greater concentration of privately negotiated second lien term loans with nonbank lenders or tighter credit markets, we saw more negotiation around restrictions relative to amendments to senior debt, caps on senior debt (including accordions and post-petition financing), and shorter standstill periods. This trend has already begun to reemerge and we anticipate more to come.

2) **There will be an Increase in Split Collateral Intercreditor Arrangements and More Focus on Valuation Methods:**
Over the past few years there has been a marked uptick in the number of transactions involving split-collateral intercreditor arrangements. Fewer and more flexible covenants, coupled with extremely competitive pricing, have proven attractive –- resulting in private equity funds and borrowers seizing upon the benefits of asset-based loan facilities. In addition, the presence of flexible debt provisions (refinancing facilities and side-car incremental provisions) and lenient covenant packages, which are more and more prevalent in market loan documentation today, work together to make it feasible for borrowers to be more creative in how they use their debt and lien baskets going forward. This flexibility invites even greater use of split collateral arrangements in the future – from traditional splits between working-capital assets and fixed assets, to carve-outs secured by asset classes like intellectual property and other intangibles.

Increased complexity in the allocations of collateral among competing creditors invites potential valuation battles. Some lenders have already placed provisions in split collateral intercreditor agreements which specify valuation methodology under certain circumstances, such as provisions setting forth the allocation of proceeds of sales that involve mixed collateral (meaning priority collateral of both classes of lenders). However, many split collateral arrangements do not include such provisions today. We expect increased attention and negotiation around valuation methods and allocations in split collateral intercreditor arrangements going forward. In addition, with the increase in split collateral arrangements, we expect to see more litigation in split collateral transactions in the context of Section 363 sales and plan confirmations (and the issues involved will likely be relative to the valuation and allocation of the collateral pools).

3) **There will be Increased Sophistication Around Access, Use and License Rights Related to Intellectual Property in Split Collateral Deals:**
The importance and value of intellectual property in commerce today cannot be overstated. In many split collateral transactions, intellectual property is the priority collateral of the term lenders. Yet, the asset-based lenders very likely need access, use and/or license rights to realize upon, and preserve the value of, their priority collateral. Given the importance and value of intellectual property today, ensuring adequate access, use, and license rights relating to intellectual property assets is increasingly important and requires specialized expertise. Crafting adequate access, use, and license around intellectual property assets requires a real understanding of what assets are in a given business and how they need to be used in order to extract value in an exit scenario. We expect that practitioners and lenders will increasingly focus on these provisions to bring them in line with the level of sophistication of how intellectual property assets are used by businesses today.

4) **Intercreditor Arrangements Will Evolve to Address Cross-Border Considerations:**
The prevalence of cross-border financing transactions and more complex capital structures continues to grow. Consequently, we expect that standard intercreditor agreements will evolve to address the complexities raised by the overlay of different legal frameworks applicable to entities and assets located in other jurisdictions. Below are a few examples of provisions that we expect will become more prevalent in intercreditor arrangements:
• contractual frameworks to replicate a two-lien structure in jurisdictions where obtaining two liens is not feasible, and
• preservation of expectations relative to the right of a junior creditor to exercise remedies after a standstill period in jurisdictions where junior lien creditors are not statutorily entitled to such remedies while senior creditors are unpaid.

5) **In Light of Recent Case Law, Senior Lenders Will Negotiate For Broader and Clearer Chapter 11 Protections:**
At least two recent court decisions indicate a trend towards courts narrowly interpreting intercreditor agreements' restrictions on junior lenders' actions in bankruptcy proceedings: *In re Boston Generating, LLC*, 440 BR. 302 (Bankr. S.D.N.Y. 2010) ("Boston Generating") and *In re MPM Silicones, LLC*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014) ("*Momentive*").

*In Boston Generating*, the bankruptcy court permitted the second lien lenders to object to a debtor's bid procedures approved by the first lien lenders despite the terms of an intercreditor agreement which gave the first lien lenders the "exclusive right to…make determinations regarding the…sale" of the collateral. In its decision, the court found that the intercreditor agreement did not expressly preclude the second lien lenders from objecting to bid procedures and thus the court permitted the second lien lenders to object to the bid procedures. In *Momentive*, the bankruptcy court rejected the first lien lenders' efforts to recoup their losses by obtaining a recovery from *Momentive's* second lien lenders under an intercreditor agreement that (a) prohibited the second lien lenders from receiving any recovery from the "common collateral" until the first lien lenders are "paid in full in cash" and (b) permitted the second lien lenders to "exercise rights and remedies as an unsecured creditor". The bankruptcy court dismissed the first lien lenders' primary claims, holding that (i) the equity distributed to second lien lenders under the plan of reorganization did not constitute "proceeds" of common collateral and (ii) the second lien lenders' actions in intervening in the make-whole dispute and supporting the debtors' cramdown plan did not violate the intercreditor agreement because the second lien lenders were acting as unsecured creditors and disputing the amount of the first lien lenders' claims and the adequacy of their proposed distribution, not their entitlement to collateral.

The courts' holdings in the *Boston Generating* and *Momentive* decisions mean that overly broad waivers of junior lenders' rights and/or overly broad language preserving junior lenders' rights to participate in the bankruptcy proceedings as "unsecured creditors" can negate the effectiveness of restrictions on actions by junior lenders in bankruptcy proceedings. Therefore, to preserve prohibitions on actions by junior lenders, senior lenders must negotiate and contract for broad and clear bankruptcy protections which prohibit junior lenders from taking positions in opposition to senior lenders' interests.

Senior lenders and their counsel are aware of the *Boston Generating* and *Momentive* decisions (as well as many other recent decisions that are suggestive of the same trend) and are likely to increase their focus on intercreditor documentation in order to tailor them to address these concerns.

**Conclusion**

This article provides insight into changes on the horizon in the intercreditor arena and identifies several of the key factors driving the evolution. Several of the developments that we discussed above will present themselves as changes to intercreditor agreements that may appear on their face to be subtle. However, as we previously cautioned – the devil really is in the details in areas as complex as intercreditor arrangements and subtle changes can have significant consequences. **TSL**

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# BORROWERS AS DISTRIBUTORS OF TRADEMARKED INVENTORY:

## SUGGESTIONS FOR THE ASSET-BASED LENDER


**BY ANTHONY CIANCIOTTI**

Distributors of inventory frequently sell products bearing a third party's trademark. Trademark law and the distributor's agreement with the trademark owner may limit the sale of trademarked inventory after termination of the distribution agreement. An asset-based lender should understand both when considering financing trademarked inventory.

In today's world of off-shore manufacturing, an asset-based lender's portfolio of borrowers most likely includes entities that purchase finished goods for resale. Some of these borrowers may purchase goods on the open market. Others may be authorized distributors of a manufacturer (the "supplier") who supplies goods bearing the supplier's trademark (the "Trademarked Inventory"). In such cases, the parties' relationship typically is memorialized in a distribution agreement, which agreement may contain an express grant of a license to use the supplier's trademark in connection with the marketing, promotion and sale of the Trademarked Inventory. Lending against Trademarked Inventory involves questions of trademark law and contract interpretation. It is important for the lender to understand whether applicable law or the underlying contract restricts the borrower's ability to sell the Trademarked Inventory if the agreement is terminated. The lender should consider any limitations that may exist when it evaluates whether it will extend loans against the value of the Trademarked Inventory.[1]

**Trademark Law**

The Lanham Act[2] is the applicable federal law governing federally registered trademarks. One of the primary objectives of the Lanham Act is to protect trademark owners against third parties, creating confusion among consumers regarding the origin of a product bearing a registered trademark.[3] However, such protections have limits. Case law interpreting the Lanham Act provides that a trademark owner's right to control the sale of licensed products ceases after a "first sale" of "genuine goods" has occurred.

*First Sale.* The "first sale" doctrine provides that the trademark owner's right to control the distribution of a product bearing its trademark does not extend beyond the first sale of its product. In other words, "a purchaser who does no more than stock, display, and resell a producer's product under the producer's trademark violates no right conferred upon the producer by the Lanham Act."[4] This limitation preserves competition, which would otherwise be stymied if the trademark owner could dictate the terms of subsequent resales of a trademarked product.

*Genuine Goods.* A reseller of goods bearing a trademark owner's trademark can avail itself of the first sale doctrine only if the goods are "genuine." In the distributor context, questions can arise as to whether goods are "genuine" if they have been repackaged or otherwise modified prior to resale. Courts addressing the issue examine whether the goods sold by the reseller are "materially different" from the goods sold by the trademark owner. Materiality is not based on the size or number of changes. Instead, the analysis is a fact-based, case-by-case examination that aims to determine whether the changes generate consumer confusion about the source and quality of the goods in question.[5] For example, the removal of batch codes or other markings from packaging could be sufficient to find that the packaged goods are not genuine.[6] In addition, repacking the Trademarked Inventory or splitting the Trademarked Inventory into smaller lots or components could also be deemed to render the goods to be materially different.[7]

*Due Diligence.* The lender should first review the underlying distribution agreement to determine whether the first sale doctrine shields the borrower from claims of trademark infringement. The passage of title is a logical reference as to when a first sale has occurred.[8] Ideally, the terms of the agreement set forth when title to the Trademarked Inventory passes from the supplier to the borrower. Assuming that title passes no later than the time the Trademarked Inventory is received by the borrower, the supplier would be hard-pressed to assert that a first sale has not occurred upon the borrower's receipt of the Trademarked Inventory.

A lender's due diligence should also include confirming whether the Trademarked Inventory purchased by the borrower is altered in any manner prior to its resale. Any physical modification of the Trademarked Inventory should raise a potential "red flag," as the fact-specific analysis used to determine whether the Trademarked Inventory is genuine could prevent a lender from having a clear answer whether the borrower's actions might support a claim of trademark infringement.

Severe consequences can result if a first sale has not occurred or the borrower's actions are found to result in the sale of materially different goods. A court could order injunctive relief prohibiting further sales of the Trademarked Inventory. If the Trademarked Inventory constituted primary collateral supporting the lender's asset-based loans, an injunction could transform the lender's secured loan to an unsecured loan.

Holding Out as an "Authorized" *Distributor*. Distribution agreements may also contain a license authorizing the use of the trademark owner's trademarks in connection with the marketing, sale and promotion of the Trademarked Inventory. Although the contract's language regarding the license will vary by agreement, the provisions typically require that the licensee cease using the trademarks upon termination of the distribution agreement and that the licensee return all promotional material to the trademark owner. A license of this type raises the question whether the termination of the license restricts the borrower's ability to sell the goods.

Although a license may assist the borrower in its conduct as an authorized distributor, the termination of the license (and the rights granted pursuant to it) should not prevent the borrower from continuing to sell the Trademarked Inventory on the grounds of trademark infringement. As noted earlier, once a "first sale" has occurred, the first sale doctrine dictates that the borrower should be able to resell freely the Trademarked Inventory in an unaltered state without restriction.

The license allows the borrower to use the supplier's trademark to hold itself out as the supplier's authorized distributor in its promotional material. In this limited context, the borrower should alter its promotional material and cease to represent itself as an authorized distributor. The failure to do so could constitute both a breach of contract as well as trademark infringement, based on possible confusion among consumers regarding the supplier's perceived endorsement of the borrower as a seller of the Trademarked Inventory.[9]

**Due Diligence**

In addition to the passage of title and trademark license considerations noted previously, the lender's review should also include an examination of the distribution agreement provisions regarding the agreement's term and the parties' rights upon termination. Restrictions on post-termination sales can arise as a result of an agreement between the parties. Understanding what restrictions exist, if any, will assist the lender in evaluating whether the Trademarked Inventory is a suitable asset against which the lender can advance loans.

*Contract Review:* Distribution agreements come in all shapes and sizes. In their most basic form, distribution agreements will address (a) the goods subject to the agreement, (b) the borrower's distribution territory, and (c) the circumstances under which the agreement can be terminated by either the borrower or the supplier. More detailed distribution agreements may also address (i) potential minimum purchase obligations or performance standards to which the borrower must adhere, (ii) the supplier's right or obligation to repurchase (or the borrower's right to require the supplier to repurchase) the Trademarked Inventory upon the expiration or termination of the agreement, and/or (iii) the borrower's ability to sell the Trademarked Inventory after termination or expiration.

When reviewing the possible contract terms, the lender should consider:

1. Distribution Territory: Is the stated distribution territory consistent with the lender's liquidation plan? If it is not, then the lender may need to adjust its advance rates if its recovery would be adversely impacted by limits placed on the markets into which the Trademarked Inventory can be sold.
2. Contract Termination: Does the distribution agreement contain minimum purchase requirements or must the borrower satisfy financial covenants? If so, has the borrower satisfied those requirements and covenants historically and what is the likelihood of satisfying them in the future? A track record of poor performance may raise the possibility that the supplier could terminate the contract during the term of the lender's financing to the borrower.
3. Repurchase Obligation/Right: Is the supplier obligated (or does it have the right) to repurchase the Trademarked Inventory upon termination or expiration of the license? If so, how is the purchase price calculated and could the payment be reduced by amounts owing by the borrower to the supplier? Repurchase obligations can be an effective method for a lender to unwind its relationship with the borrower after a default. However, the purchase price should not be lower than the lender's advance rate against the Trademarked Inventory. The lender should also monitor the amount of payables owing to the supplier to determine what effect, if any, the supplier's right to offset amounts could have on the net purchase price to be paid by the supplier in the event it repurchases any Trademarked Inventory.
4. Post-Termination Sales: Does the distribution agreement expressly permit the borrower to sell the Trademarked Inventory after termination or expiration of the agreement? If so, does the agreement set forth a specific time period during which sales may occur? If post-termination sales are permitted within a stated period, the lender should confirm that its liquidation timetable is no longer than the allotted period; otherwise, its ability to realize on the collateral could be adversely impacted.

What if the agreement is silent regarding post-termination sales? A number of courts have examined this issue when the prospective seller is a manufacturer – not a distributor – of Trademarked Inventory. Several federal court decisions have held that silence regarding post-termination sales should be interpreted to prohibit post-termination sales of previously manufactured goods.[10] The general focus of these decisions is that a "first sale" has not occurred when a manufacturer is involved, and that allowing future sales by the manufacturer would be akin to a *de facto* extension of the license, the effect of which would be to render the license's termination date irrelevant.

An important distinction exists when the borrower is a distributor of the Trademarked Inventory, and not a manufacturer. A first sale would have already occurred from the supplier to the borrower. Any trademark license from the supplier to the borrower would likely be in connection with the borrower holding itself out an authorized distributor of the supplier. As a result, silence regarding post-termination sales should not preclude future sales so long as the borrower ceases to refer to itself as an authorized distributor, removes such references from its marketing materials, and otherwise complies with the post-termination requirements under the distribution agreement.[11]

*Agreement between Supplier and Lender.* The lender may still have a sound credit basis to lend against the Trademarked Inventory even if the distribution agreement contains unfavorable terms regarding post-termination sales or the supplier's rights after termination. The lender can address such terms or adverse rights by pursuing an agreement directly with the supplier. Although the scope of the lender's agreement will depend on the terms of the underlying distribution agreement, common components of such an agreement with the supplier include:

1. Acknowledgment and Consent: The supplier's acknowledgement of, and

consent to, the borrower's grant of a security interest to the lender in the borrower's rights under the distribution agreement and the Trademarked Inventory.

2. Term: The supplier's agreement that the lender has the right to sell the Trademarked Inventory after termination of the distribution agreement.
3. Territory: The supplier's agreement regarding the territory into which the Trademarked Inventory may be sold.
4. Notice and Cure Right: The supplier's agreement to provide notice to the lender of any default by the borrower under, or termination by the supplier of, the distribution agreement, and the lender's right to cure the default, if the lender elects to do so.
5. Repurchase Right: The supplier's agreement to repurchase the Trademarked Inventory. The lender may also want to specify the methodology used to calculate the purchase price and to obtain the supplier's agreement to pay the purchase price directly to the lender without offset of any amounts owing by the borrower to the supplier.

Whether a lender can obtain the supplier's agreement on all or some of these points will depend on a number of factors, including the relative negotiating power of the borrower and the supplier as well as the potential costs and delays associated with pursuing an agreement. The lender should first examine the borrower's business to confirm whether the borrower is merely a purchaser and reseller of the Trademarked Inventory. The lender should then review the distribution agreement to confirm whether the agreement limits the borrower's right to sell the Trademarked Inventory after termination, or grants the supplier the right to repurchase the Trademarked Inventory under circumstances that undermine the loans that the lender may have made against the value of the Trademarked Inventory. If such limits or adverse rights exist, the lender has the option to pursue an agreement directly with the supplier to address those concerns to the lender's satisfaction. **TSL**

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1. It is unclear whether a lender's right to sell the Trademarked Inventory is derivative of the borrower's right. The most conservative approach for the lender is to assume that its right is derivative, and make a decision regarding lending against such inventory accordingly.
2. 15 U.S.C. § 1401 et seq. (2006).
3. *Bel Canto Design, Ltd. v. MSS HiFi, Inc.,* 837 F. Supp. 2d 208, 222-23 (S.D.N.Y. 2011).
4. *Sebastian Int'l, Inc. v. Longs Drug Stores Corp.*, 53 F.3d 1073, 1074 (9th Cir. 1995), cert. denied, 516 U.S. 914 (1995).
5. *Societe Des Produits Nestle, S.A. v. Casa Helvetia, Inc.*, 982 F.2d 633, 638 (1st Cir. 1992).
6. *See, e.g., Davidoff & CIE, SA v. PLD Int'l Corp.*, 263 F.3d 1297, 1242 (11th Cir. 2001) (removal of batch code from bottom of fragrance bottle created a material difference where removal left a small etching on bottle); *John Paul Mitchell Sys. v. Pete-N-Larry's Inc.*, 862 F. Supp. 1020, 1027 (W.D.N.Y. 1994) (removal of batch codes from bottles constituted a material difference where removal left noticeable marks on the bottles and erased certain printed information). But *see Graham Webb Int'l Ltd. P'ship v. Emporium Drug Mart*, Inc., 916 F. Supp. 909, 916 (E.D. Ark. 1995) (removal of batch codes from hair care products did not constitute infringement where bottle was not visibly altered).
7. *Enesco Corp. v. Price/Costco Inc.*, 146 F.3d 1083, 1087 (9th Cir. 1998) (repacking of porcelain figurines without disclosing they had been repackaged constituted trademark infringement); *Softman Products Co., LLC v. Adobe Systems*, Inc., 171 F.Supp. 2d 1075, 1093 (C.D. Cal. 2001) (repackaging of Adobe-brand software in manner that omitted registration card and invalidated software support constituted a material difference).
8. *Italverde Trading, Inc. v. Four Bills of Lading*, 485 F. Supp. 2d 187, 210 (E.D.N.Y. 2007); *McDonald's Corp. v. Shop at Home, Inc.*, 82 F. Supp. 2d 801, 812 (M.D. Tenn. 2000).
9. *Bel Canto Design*, 837 F. Supp. 2d at 221-222 (S.D.N.Y. 2011); *Stormor, a Division of Fuqua Indus., Inc. v. Johnson*, 587 F. Supp. 275, 280 (W.D. Mich. 1984).
10. *See, e.g., Bill Blass, Ltd. v. SAZ Corp.*, 751 F.2d 152 (3d Cir. 1984); *Ryan v. Volpone Stamp Company*, 107 F. Supp. 2d 369 (S.D.N.Y. 2000).
11. *See, e.g., Citizens of Humanity, LLC v. Costco Wholesale Corp.*, 89 Cal. Rptr. 3d 455, 464-65 (Cal. App. 2009) (manufacturer's ability to preclude post-termination sales by distributor must be based on contractual restrictions, not trademark law), *disapproved on other grounds, Kwikset Corp. v. Superior Ct. of Orange Cty.*, 120 Cal. Rptr. 3d 741 (Cal. 2011).