

Introduction.

The basic documents for privately placed debt securities in venture capital financings are the purchase agreement and the note. (By convention, if the instrument has a term to maturity of more than five years, it is generally called a debenture and if it is secured, it is often called a bond.) The purchase agreement contains virtually all of the terms so that the note, which is usually a negotiable security, is of reasonable length. The note, however, entitles its holder to the benefits of the purchase agreement.

In venture capital transactions, notes are often convertible into common stock or issued together with warrants exercisable to purchase common stock. The principal difference is that with a convertible, the investor must surrender his position as a creditor to obtain the equity; notes issued together with warrants, however, unless the warrants are non-detachable, may be retained if the warrants are exercised. From the investor's perspective, it is always advisable in transactions structured as notes with warrants to provide for the payment of the exercise price of the warrants with notes at the option of the holder, so that the investor is not required to spend additional cash should he wish to exercise the warrants. The principal issues in convertible notes and notes with warrants are antidilution protection, term, mandatory conversion or redemption, and registration rights. These subjects are covered elsewhere in this volume under the topics "Planning For the Investment" and "Equity Securities."

There are two principal legal distinctions between preferred stock and a note (other than the basic difference between equity and debt). First, preferred stock creates a payment priority, generally as to dividends and in liquidation, while a note creates an obligation, generally as to interest and principal. The second distinction is a result of the first: upon default, the holder of a note may enforce payment, but the holder of preferred stock may do so only if payment is being made to a person with a payment priority junior to its position. With regard to the second distinction, acceleration of maturity is almost always provided for in the documentation for notes as a remedy if default occurs, but mandatory redemption of preferred stock in the event of a default is rare. In addition, dividends paid on preferred stock are eligible for the dividends received deduction for federal income tax purposes if paid to an eligible recipient and not deductible by the issuer, while interest paid on notes is taxable in full to the recipient and deductible by the issuer.

The principal business terms of a debt instrument are:

- (a) Principal - When and in what installments is it payable? Are there any circumstances (other than default) which will require that principal be prepaid?
- (b) Interest - What is the rate, when is it payable and what is the medium of payment (cash or in kind)? Is the rate to be calculated on a 365-day year or a 360-day year?
- (c) Premium - Will there be a prepayment premium? If so, will it be fixed or will it decline over the life of the note? If it is a "make-hole," what is the formula?

- (d) Collateral - If there is collateral, what will it be?
- (e) Guarantees - Who will the guarantors be? What is their relationship to the issuer? Will the guarantees be collateralized?
- (f) Other fees - Will there be a closing fee, late payment fees, annual administration fee or other fees and charges? Will the issuer pay the legal fees incurred by the investor for documenting the transaction or to enforce its rights in the event of default?
- (g) Subordination - Will the notes be subordinated to any other obligations of the issuer? If so, on what basis? These issues are discussed below.
- (h) Covenants - What affirmative and negative covenants are desired? Some examples are described below.
- (i) Default - What will the events of default be? Will there be any grace periods? Under what circumstances will acceleration of maturity occur? These issues are discussed below.
- (j) Investors - Will there be more than one investor? Regardless of the answer, because transfers of less than the entire principal amount may occur, what percentage of the outstanding principal amount of the notes will be required for waivers, consents, calling defaults, etc.? If there is collateral, how will it be held and administered?

In addition to the business terms, the principal topics covered by the purchase agreement are representations and warranties, closing conditions, covenants, restrictions on transferability, and default. The representations and warranties and closing conditions generally refer to the investor. The covenants, restrictions on transferability and default provisions refer to noteholders because they affect and may be enforced by transferees as well as the original investor. The provisions commonly found under these topics in a purchase agreement are as follows:

I. Representations and Warranties.

A. Organization and Qualification.

This warranty establishes that the issuer exists and is able to conduct its business.

B. Capital Structure.

This warranty sets forth the position of the notes in the capital structure of the issuer.

C. Subsidiaries.

If there are subsidiaries, they are generally identified and the nature and percentage of ownership by the issuer are set forth. Also, the material representations and warranties generally cover subsidiaries as well as the issuer.

D. Authorization.

This warranty gives assurance that the issuer has the power and authority to carry out the transaction; that appropriate corporate action, pursuant to applicable law and the issuer's charter and bylaws, has been taken to authorize the purchase agreement, notes and other documentation, if any; and that all documentation is valid, binding and enforceable with respect to the issuer.

E. Title.

This warranty sets forth the status of the issuer's title to its various properties and assets. Depending upon the issuer's business, separate representations are used to specifically cover subsidiary stock, real estate, patents and trademarks, and leases.

F. Licenses and Permits.

This warranty deals with authorization required from governmental agencies and authorities. These are particularly important for issuers in regulated industries.

G. Consents.

This warranty deals with two types of consents or approvals, those required from stockholders, other parties to agreements, other creditors, etc., and those required from governmental agencies and authorities for the making or performance of the purchase agreement, notes or other documentation.

H. Financial Statements.

This warranty should be obtained with respect to the annual and interim financial statements relied on, even those covered by an audit report. It should also cover the absence of undisclosed liabilities, actual or contingent.

I. Litigation.

This warranty should describe all material pending or threatened legal proceedings and the effect of existing judgments.

J. Taxes.

This warranty should cover payment and also the adequacy of reserves for taxes being contested. Investors should be aware that liability for the payment of certain taxes, notably

federal withholding taxes not properly remitted, can be asserted against directors and certain stockholders.

K. Contracts; Law.

Two concepts should be covered: (1) that the issuer is in compliance with all contracts, its charter, its bylaws and applicable law, and (2) that making or performing the purchase agreement, notes or other documentation will not violate any of the foregoing. Depending on the business of the issuer, the provision regarding compliance with applicable law may list specific statutes, or additional representations regarding specific areas of law (e.g., ERISA, environmental) may be added.

L. Confidentiality Agreements.

This representation is especially important if the issuer's business is dependent on a proprietary technology or process and states that all employees important to the technology or process have agreed to keep it confidential during and after the period of employment.

M. Insider Transactions.

This representation discloses transactions between the issuer and directors, officers or stockholders.

N. Broker's Commissions.

This representation sets forth broker's commissions or finder's fees payable by the issuer in connection with the transaction.

O. Extent of the Offering.

This representation is an important component of the basis for not registering the notes under the Securities Act of 1933. The issuer represents that the notes have not been offered or sold in a manner that would require such registration, and that it will not subsequently offer or sell any securities in a manner that would require registration of the notes by operation of the Security and Exchange Commission's ("SEC's") doctrine of integration.

P. Veracity of Offering Materials.

The issuer should warrant that no written material furnished to the investor in connection with the transaction contains any material untruths or omissions, and that all material facts concerning the issuer have been disclosed to the investor.

Q. No Material Adverse Changes.

This representation ties to the date of the most recent financial statements warranted and, if an offering memorandum was used, to the date of the memorandum, and states that, in the

interim, there have been no material adverse changes in the business or financial condition of the issuer.

R. Other.

Specific representations and warranties should be added to address particular concerns. For example, an issuer with a large number of employees might be asked for a representation concerning labor relations.

II. Closing Conditions.

A. Delivery of the Notes.

The notes should be in the possession of the investor prior to delivery of the purchase price.

B. SBA Forms.

If any investor is a Small Business Investment Company ("SBIC"), the issuer must complete the Small Business Administration's ("SBA's") Assurance of Compliance (Form 652D) and Size Status Declaration (Form 480), and the investor must complete the SBA's Portfolio Financing Report (Form 1031).

C. Bring-Down Certificate.

This certificate is usually given by a senior executive officer and the chief financial officer of the issuer and certifies that the representations and warranties are correct, that the issuer has performed all acts required by the purchase agreement, and that no events of default exist.

D. Copies of Important Documents.

The issuer is generally required to provide certified copies of its charter, bylaws and resolutions authorizing the execution and performance of the purchase agreement, notes and other documentation of the transaction, and copies of consents, approvals and requisite filings with government agencies.

E. Collateral.

If the notes are secured, documentation is provided which will enable the investor's security interest to be perfected.

F. Opinions of Counsel.

An opinion is usually required of issuer's counsel regarding the issuer's due incorporation, valid existence and good standing (appropriate authorizations having been secured and consents

obtained); the due execution, delivery and enforceability of the purchase agreement, notes and other documentation; the exemption of the notes from the registration requirements of the Securities Act of 1933 and state securities laws; and, if the notes are secured, the creation, perfection and priority of the investor's security interest. Some investors also require an opinion of their own counsel as to certain of such matters.

III. Covenants.

A. Affirmative Covenants.

Affirmative covenants (promises by the issuer to perform certain actions either automatically or at the request of the noteholders) are specified to provide the noteholders with information with respect to the financial condition of the issuer. The purchase agreement should specify whether or not these covenants are to apply to the subsidiaries as well as to the parent company.

1. Financial Statements. Issuers are generally required to provide various financial statements to keep the noteholders informed as to the financial condition of the issuer throughout the loan period. Typically, annual financial statements are required to be accompanied by a report of independent accountants, and interim statements, certified by the issuer's chief financial officer, are prepared and delivered quarterly or, in some cases, monthly.

2. Budget. Start-up and early stage issuers (almost always) and later stage issuers (sometimes) are required to prepare and deliver annual budgets. If so, when financial statements are delivered, there is also a requirement to deliver a comparison of the results reported to the budget.

3. Periodic Certificates. Periodic assurances that the issuer is complying with the terms of the purchase agreement in the form of periodic certification by an appropriate officer of the issuer that the covenants set forth in the purchase agreement have been complied with, and that no default has occurred. Such certificates may be called for by the purchase agreement in order to insure that such occurrences are brought to the attention of the noteholders.

4. Access to Information. This provision gives the noteholders the right to inspect the records and premises of the issuer to ascertain the issuer's condition, and to discuss its business, results and prospects with officers of the issuer. Such access may be limited to occasions when such condition is in reasonable question.

5. Notice of Default. A requirement that the issuer give notice of default assures the noteholders of notice of breach of any other contract entered into by the issuer. This ties in with the default provisions.

6. Stockholder and Other Reports. The issuer is usually required to provide the noteholders with copies of shareholder reports and reports to governmental agencies in order to furnish the noteholders with information. Most of this information, however, is often otherwise available, making this provision one of convenience.

7. Maintenance of Plant. This provision requires that plant, property and equipment of the issuer be maintained in good operating condition.

8. Compliance with Contracts; Payment of Indebtedness. By this provision, the issuer agrees to comply with the terms of all contracts to which it from time to time is a party and to pay indebtedness other than the notes when due.

9. Payment of Taxes. The issuer agrees to pay taxes, assessments and other governmental charges when due or, in the case of a contested item, to contest the item by appropriate proceedings and to create a reserve for the contested amount. Investors should be aware that liability for the payment of certain taxes, notably federal withholding taxes not properly remitted, can be asserted against directors and certain stockholders.

10. Compliance with Laws. The issuer covenants to comply with all applicable laws.

11. Insurance. The provision requiring that adequate insurance be maintained for plant replacement and damage claims, as necessary. Often, key man life insurance is also required.

12. Corporate Existence. Through the provision requiring the maintenance of corporate existence, the issuer affirms that it will not voluntarily relinquish its right to do business as a legal entity until termination of the agreement and payment of the notes.

13. Confidentiality Agreements. If the issuer's business is dependent on a proprietary technology or process, the issuer is often required to have employees important to the technology or process execute agreements to keep it confidential during and after the period of employment.

14. Use of Proceeds. This provision specifies how the purchase price, net of transactional expenses, may be used by the issuer.

15. Other. Specific affirmative covenants are created to fit the circumstances. For example, a regulated issuer would be required to keep its licenses and permits in full force and effect.

B. Negative Covenants.

Negative covenants provide the noteholders with some control over the actions of the issuer, particularly preventing a dissipation of assets. The purchase agreement should specify the extent, if any, to which negative covenants will apply to subsidiaries.

1. Fixed Asset Expenditures. Expenditures for fixed assets are sometimes restricted to further insure the availability of funds to repay the noteholders.

2. Working Capital. The purchase agreement often requires the issuer to maintain working capital, as defined, at a minimum agreed amount which will be adequate for its operations.
3. Net Worth. The purchase agreement may require the issuer to maintain a minimum amount of net worth. Defining net worth in the purchase agreement can eliminate later confusion as to the inclusion in net worth items of intangible value such as good will, patent rights, etc.
4. Additional Indebtedness. Additional borrowings of a term nature from other sources may be restricted or prohibited except under specified circumstances or for certain purposes, as may be modifications of the terms of existing indebtedness.
5. Guarantees and Contingent Liabilities. Guarantees and contingent liabilities are frequently limited as to amount, and are sometimes prohibited.
6. Rental Obligations. Restrictions on rental obligations are intended to prevent an issuer from making commitments for rental payments in an amount which could strain its working capital.
7. Sale and Leaseback Restrictions. Restrictions on sale and leasebacks preserve the issuer's equity in capital assets of substantial value.
8. Restrictions on Loans. Loans, investments, and other advances are generally prohibited, particularly to insiders; however, investment in U.S. government securities is often allowed for short-term employment of funds.
9. Purchase of Stock. Generally the issuer is restricted from using its funds for purchasing its own stock or the stock of a subsidiary or affiliate. Repurchases from employees on termination of employment at not more than fair market value are often permitted.
10. Dividend Restrictions. This restriction prohibits the payment of dividends from cash needed in the business until the notes are paid.
11. Restrictions on Liens. The purchase agreement usually states that the issuer will not allow any liens or mortgages to exist on all or certain specified assets of the issuer. Certain exceptions, however, are made which are considered necessary in the normal course of the issuer's business, particularly taxes.
12. Mergers and Consolidations. Mergers or consolidations with unrelated companies are usually prohibited. This gives the noteholders the opportunity to consider the merits of the proposal.
13. Sale of Subsidiaries. For obvious reasons, the noteholders may wish to limit the issuer's right to dispose of part or all of the capital stock of any subsidiary or of any part of indebtedness owing to the issuer by such subsidiary. This provision is designed to insure

maintenance of control or the continuation of complete stock ownership and also to avoid having non-affiliated parties acquire debt which is owed by a subsidiary.

14. Sale of Assets. The sale of assets is generally prohibited with respect to all or substantially all of the issuer's assets. Exceptions might include sales if the proceeds are to be applied to the payment of the notes.

15. Salary Increases and Bonuses. A restriction on salary, salary increases and bonuses is commonly included among the covenants.

16. Changes in Management. A clause prohibiting changes in management is frequently included when particular reliance is being placed on those persons who constitute the management of the issuer. In these cases, the investor may wish to reserve the right of accelerating the debt if the management is changed without the prior approval of the noteholders.

17. Change in Business. This clause prevents the issuer from entering into a new type of business without the prior approval of the noteholders.

IV. Restrictions on Transfer.

Restrictions on transfer are a component of the basis for not registering the notes under the Securities Act of 1933.

A. Restrictive Legend.

Each note should bear a legend that states that it has not been registered under the Securities Act of 1933 and that transfers may be made only if in transactions exempt from such registration or following such registration.

B. Notice.

To effect a transfer, the noteholder should be required to notify the issuer, specifying the facts of the proposed transfer. Usually, an opinion of counsel to the noteholder is required unless the transfer is to a "qualified institutional buyer" as defined in Rule 144A under the Securities Act of 1933. The issuer should be required to effect the transfer unless its outside counsel furnishes an opinion indicating why such transfer would violate applicable securities laws.

C. Rule 144.

The issuer should covenant to comply with the filing requirements of Rule 144 under the Securities Act of 1933 at all times subsequent to becoming a reporting company under the Securities Exchange Act of 1934.

V. Default.

It is customary to provide that a default will, under certain circumstances, or may, at the option of the holders of notes of a specified amount, accelerate the maturity of all of the notes. Customary provisions are:

A. Nonpayment of Principal or Interest.

Nonpayment is always an event of default. In the case of principal, grace periods are not customary; in the case of interest, a short (i.e., three to five days) grace period is sometimes provided.

B. Violation of Covenants.

Violations of covenants adversely affect the credit-worthiness of the loan. The usual grace period is thirty days. Sometimes, the grace period commences on the date that the issuer becomes aware of the violation or on the date of notice to the issuer by the holders of a requisite percentage of principal amount of notes rather than on the date that the violation commences.

C. Breach of Representation or Warranty.

Because the representations and warranties do not cover periods subsequent to the closing, issuers often object to breach being an event of default. However, if it is not, the noteholders will have parted with their funds on the basis of misrepresentation, yet may not have an adequate remedy. A possible compromise is to provide that a default premised on breach of representation or warranty must be brought within one or two years after closing; it is important that the period selected permit at least one post-closing annual audit of the issuer's financial statements as breaches of representations and warranties may often be discovered during the audit process. Because the event at issue is one that occurred in the past, a grace period is not appropriate.

D. Default Under Other Indebtedness.

Customarily referred to as a "cross-default clause," this mechanism permits the noteholders to call a default if a default exists under other indebtedness (giving effect to any applicable grace period in the other indebtedness). Variants are premised on other creditors actually taking action as opposed to having the right to take action, and an acceleration as opposed to default having occurred.

E. Insolvency.

If legal proceedings involving insolvency, reorganization, bankruptcy, creditors' proceedings, or appointment of a trustee or receiver are commenced against the issuer and are not vacated within a stated number of days (generally thirty to sixty), they generally become events of default. If the proceeding is instituted by the issuer, the default normally will be automatic. Acceleration and payment, however, can be blocked by the bankruptcy court.

VI. Miscellaneous.

A. Amendment and Waiver.

Generally requires written approval by the issuer and the holders of a requisite principal amount of notes.

B. Notices.

This provision establishes what constitutes valid notice and sets forth the addresses at which notices are to be given. Currently, notices by facsimile are becoming acceptable in many transactions.

C. Assignment.

Generally, the issuer is not permitted to assign its rights or delegate its obligations.

D. Usury.

This provision does not waive application of usury laws (because such waiver is normally unenforceable by the terms of such laws). Instead, it provides that in the event of a challenge premised on violations of an applicable usury law, the parties will make a good faith effort to reconstruct the transaction to make it non-usurious, e.g., by reducing the interest rate to the highest rate permissible by law.

E. Severability.

If a court finds a portion of the documentation to be invalid, this provision states that the balance shall remain valid. In the absence of such a provision, partial invalidity brings all of the documentation into question.

F. Governing Law.

Generally, the law of the state in which the lead investor's principal office is located is selected (unless that state has a usury statute that would be violated by the transaction). Other selections could be the state in which the issuer's principal office is located or in which the issuer is incorporated. Frequently, this provision also specifies where litigation regarding the transaction must be brought and contains a waiver by all parties of the right to request a jury trial. The law selected should bear a reasonable relationship to the location of the parties.

G. Expenses.

The fees and disbursements of counsel to the investor(s) in connection with the transaction, amendments, or waivers requested by the issuer after closing, and enforcement of the noteholders' rights after the occurrence of default, are customarily borne by the issuer. In

addition, some investors charge the issuer fees for administering the loan, for closing the loan, and for late payments.

VII. Contractual Subordination.

A. Priority of Payment and Liens.

Investors purchasing notes often agree to subordinate their right to payment to the right of the issuer's primary lenders to get paid. If the notes are secured, the noteholders often expressly subordinate their lien to the liens of senior debtholders. Among the reasons why subordination may be required are (1) there are existing primary lenders who can declare an event of default if new debt is incurred without their consent and the price of obtaining their consent is subordination, or (2) other potential lenders are only willing to allow the investors a higher rate of return if they bear more risk because of subordination. For privately placed debt securities, these agreements regarding priority appear in the purchase agreement and/or the intercreditor or subordination agreements.

B. Other Intercreditor Provisions.

Intercreditor and subordination agreements also can address matters such as:

1. Rights to Declare Events of Default
2. Cure Periods/Rights to Cure
3. Modifications of Loan Documents
4. Extensions of Loan Maturities
5. Advances of Additional or New Funds
6. Rights to Accelerate
7. Rights to Exercise Remedies
8. Sharing of Proceeds
9. Rights to File an Involuntary Petition
10. Rights to File Proofs of Claim/Vote in Bankruptcy Case

C. Enforceability in Bankruptcy.

Section 510(a) of the Bankruptcy Code specifically provides that agreements regarding priority are enforceable in bankruptcy to the same extent that they are enforceable under state law. It is unclear whether agreements among creditors on matters other than priority will be enforced by a bankruptcy court. If not, creditors may have remedies against other creditors in a state law contract action in another forum. A creditor may be deemed to have waived its rights under an intercreditor or subordination agreement when it accepts a different treatment of its claim under a bankruptcy plan. Where there are a number of creditors in a class of similar claims in a bankruptcy, that class can accept a bankruptcy plan if more than one-half in number and two-thirds in amount of those class members actually voting accept the plan, and such a vote binds dissenting class members to the plan. It has been argued that this ability to bind dissenters includes the ability to waive the dissenter's rights under an intercreditor or subordination agreement.

D. Levels of Subordination.

1. Complete Subordination. Complete subordination exists when the subordinated debt does not receive any payments until the senior debt is paid in full. In privately owned borrowers, complete subordination is typically given only by insiders or other parties dependent on the borrower.

2. Contingent, Subsequent or Inchoate Subordination. This kind of subordination is contingent on a future event of default such as insolvency or bankruptcy, and permits payments to the noteholders until the designated event occurs.

E. Intercreditor Provisions That Are Commonly Negotiated.

1. Definition of Indebtedness. In defining what constitutes senior debt and subordinated debt, the senior debtholders want to define debt as broadly as possible to maximize the amount of their claims which are superior. Specific items that should be considered are:

- a. Principal
- b. Interest (Pre-Bankruptcy and Post-Bankruptcy)
- c. Reimbursement of Letter of Credit Draws
- d. Fees and Expenses
- e. Indemnities
- f. Extensions, Renewals and Refinancings

The specific inclusion of post-bankruptcy interest, especially where the senior debtholders are or become undersecured and thus are not entitled to accrue interest or be reimbursed for their costs, fees and expenses under the Bankruptcy Code, should be carefully considered. Senior debtholders usually insist on such provisions because they want to receive post-petition interest from amounts received by the noteholders if they cannot get such interest from the bankruptcy estate directly. Noteholders fear that such interest may eat up much of their recovery, especially in a prolonged bankruptcy, but rarely can avoid it because senior debtholders view it as part of their essential economic bargain.

2. Limitation of Amount of Senior Debt. The noteholders will often insist on a cap on the total amount of senior debt claims to which they are subordinated. The noteholders will also want the cap on the amount of senior debt to decline as the senior debt gets paid down, so that they can protect themselves from a larger senior refinancing later.

3. How Senior Debt Gets Paid in Full. The senior debtholders will want to specify that they must be paid first in cash before the noteholders get paid anything, and that until such time anything the noteholders receive will be turned over to the senior debtholders.

4. Who Keeps New Debt or Equity Securities. The senior debtholders will want to receive any equity or debt securities and other non-cash value which the noteholders receive, without crediting such securities against their loan balances. Noteholders will vigorously fight

for the right to keep those securities or at least assure that they get them back once the senior debt is paid off. In a bankruptcy case of the issuer, noteholders may argue that (a) the senior debtholders should not receive more than the bankruptcy court determines is the full value of their senior claims, (b) the senior debt should not care if the securities received are equally subordinated, and (c) senior debtholders should not receive the securities issued to subordinated debt under the bankruptcy plan if that is prohibited by the bankruptcy court. The senior debtholders will counter that this invites the bankruptcy court to meddle in intercreditor issues which should not concern it.

5. Events Causing Payment Blockages. Subordination or intercreditor agreements generally provide that payment on subordinated debt is blocked upon the happening of certain events, including the following:

a. Payment Default on the Senior Debt. This usually results in an automatic payment blockage without notice to the issuer or noteholders. It is usually unlimited in duration. Defaults in paying fees, expenses or other such items owed to the senior debtholders may not necessarily result in a payment blockage, unless clearly defined as senior debt.

b. Acceleration of the Senior Debt. Similar to a payment default. The senior debtholders may also seek to have a payment blockage when the notes are accelerated (if the notes can even be accelerated in the first place).

c. Other Defaults. The noteholders will often seek to limit other payment blockages to the occurrence of a few specified material events of default such as defaults in financial covenants or major negative covenants. Written notice by the senior debtholders of such defaults is usually required.

6. Length of Payment Blockage. Certain payment blockages, especially blockages based on nonpayment defaults, will typically be limited to somewhere between 90 and 180 days. If the default is cured or waived during this period, then payments with respect to the notes must be resumed at that time.

7. Number of Payment Blockages. Noteholders do not want a new payment blockage period to begin each time the previous one ends. They therefore try to limit such blockages to one per year or a specified number of days out of a year. Senior debtholders want to protect themselves from the scenario in which a payment blockage covenant default occurs, is cured quickly, and then when a more serious payment blockage covenant default occurs the senior debt has used its only payment blockage for that year.

8. Standstill. The senior debtholders generally want to prevent the noteholders from exercising remedies or taking other enforcement actions unless the senior debtholders consent. Enforcement actions include acceleration, judicial remedies, filing an involuntary bankruptcy petition against the issuer, or sending default notices. The senior debtholders may also seek extended grace periods on the subordinated debt. The noteholders may seek extended grace periods and opportunities to cure defaults on the senior debt.

9. Remedies Upon Senior Debt Default. The senior debtholders generally will resist any limitations on their ability to exercise remedies in the event of a default on their debt. They will seek to disclaim any obligation to marshal assets or otherwise exercise remedies in a manner which protects the interests of the noteholders. They may also seek a provision which automatically rescinds acceleration of the notes upon rescission of acceleration by the senior debt.

10. Control Over Remedy Process. The senior debtholders may request a power of attorney to enforce or collect the notes while the senior debtholders exercise their remedies, or may otherwise seek to assure that the noteholders exercise remedies in lock-step with the senior debtholders. This may include the right to vote the noteholders' claims in any bankruptcy.

11. Proof of Claim. Since the senior debtholders may benefit from items received by the noteholders in a bankruptcy proceeding, the senior debtholders will want the right to prepare and file a proof of claim on the noteholders' behalf when the bar date for filing proofs of claim is approaching.

12. Limitations of Amendments. The noteholders will have an interest in trying to limit the senior debtholders' ability to modify their documents, especially with regard to increases in the principal balance, the interest rate and other monetary terms or changes in covenants which can result in a payment blockage. The senior debtholders will want to have a veto right over changes in the noteholders' documents, especially changes which reduce the issuer's available cash flow.

13. Multiple Layers of Debt. Where there are multiple layers of senior debt or noteholder obligations, the issues discussed above must be worked through for each layer.

14. Subrogation. The noteholders may seek to become subrogated to the rights of the senior debtholders so that they can recover before payment is made to trade, tort and other claimants.

VIII. Other Subordination and Priority Issues.

A. Equitable Subordination.

Quite apart from any contractual subordination, bankruptcy courts have the power under Section 510(c) of the Bankruptcy Code to subordinate part or all of a claim where it is equitable to do so. The generally accepted elements which must be specifically pleaded and proved by the party seeking to equitably subordinate are:

1. Claimant engaged in inequitable conduct;
2. The misconduct resulted in injury to creditors of the issuer or conferred unfair advantage on the claimant; and
3. Equitable subordination must not be inconsistent with the provisions of the Bankruptcy Code.

For some types of lower priority claims such as tax penalties, a showing of misconduct may not be required. Claims which are particularly susceptible to be challenged on equitable subordination grounds include the claims of (a) insiders and their affiliates, (b) a creditor who influenced the day-to-day operations of an issuer, or (c) a creditor who may have engaged in fraudulent misrepresentation or other similar acts to the detriment of other creditors. Noteholders, general unsecured creditors and/or insiders may seek (or threaten to seek) equitable subordination of the senior debtholders when it is likely that those junior to the senior debtholders will receive little or nothing in the bankruptcy case. Likewise, several noteholders may be subject to equitable subordination challenges from general unsecured claimants or insiders who want to recover prior to or at least pro rata with those noteholders. The party being challenged must weigh its exposure under the particular facts of the case and the potential delay such claims could cause against the recovery for which the parties challenging are willing to settle.

B. Automatic Subordination of Securities Rescission Claims.

Claims for rescission of a purchase or sale of a security (e.g., a suit for the return of the purchase price of notes based on allegations of fraud in the offering memorandum or elsewhere) are automatically subordinated by Section 510(b) of the Bankruptcy Code. Thus, debt security rescission claims are beneath general unsecured claims but prior to equity claims.

C. Priority and Priming Lien Claims

The Bankruptcy Code provides that certain claims (such as certain employee, tax and bankruptcy case administration claims) must be paid in full in order to confirm a Chapter 11 plan. As a practical matter, secured creditors often consent to payment of these claims as part of a consensual overall deal and allow payment of certain employee related claims early in the case to maintain employee morale. Other types of claims, such as (i) mechanics lien claims, (ii) liens issued to a debtor-in-possession lender, (iii) reclamation claims of trade suppliers with respect to merchandise delivered around the time of the bankruptcy filing and (iv) certain tax claims, may recover before existing secured and unsecured claims to the extent permitted by applicable state law or the Bankruptcy Code.

Appendix A

Sample Pro-Senior Creditor Provision

1. Definitions.

"Borrower" means [describe borrower].

"Bankruptcy Code" means 11 U.S.C. §§ 101 et seq., as from time to time amended, and any successor or similar statute.

"Guarantor" means [describe if applicable].

"Indebtedness" with respect to any Person means, without duplication, (i) all indebtedness of such Person for borrowed money, (ii) any obligation incurred for all or any part of the purchase price of property or services, other than accounts payable and accrued expenses included in current liabilities and incurred in respect of property or services purchased in the ordinary course of business, (iii) indebtedness or obligations evidenced by bonds, debentures, notes or similar written instruments, (iv) the face amount of all letters of credit issued for the account of such Person and all drafts drawn thereunder, (v) any obligation (whether or not such Person has assumed or become liable for the payment of such obligation) secured by a Lien on any property of such Person, (vi) any obligations of such Person under leases which should be capitalized in accordance with generally accepted accounting principles, and (vii) all guarantees of such Person.

"Lien" means any security interest, mortgage, pledge, lien, claim, charge, encumbrance, title retention agreement, or lessor's interest under a capitalized lease or analogous instrument, in, of or on any of the Borrower's, the Guarantor's or any of their respective subsidiaries' assets or property (whether held on the date hereof or hereafter acquired).

"Person" means and includes an individual, a partnership, a joint venture, a corporation, a trust, a foundation, an unincorporated organization and a government or governmental authority or any department or agency thereof.

"Reorganization Securities" means securities of the Borrower or the Guarantor or any other Person provided for by a plan of reorganization, composition, arrangement, adjustment or readjustment of the Borrower or the Guarantor, and issued or distributed in any bankruptcy or other proceeding referred to herein, consisting of (a) shares of common stock, or warrants or rights to purchase shares of common stock, of the Borrower or the Guarantor or such other Person, or (b) debt securities of the Borrower or the Guarantor or such other Person, provided that (i) such debt securities shall mature no earlier than the current maturity date of the subordinated notes, (ii) the rates of interest, prepayment charges, fees, expenses and other amounts payable under such debt securities or under the agreements, instruments and documents executed pursuant to or in connection therewith shall not be greater than those provided for under the Subordinated Note Documents as in effect on the date hereof, (iii) the covenants, events of default, representations, warranties and other provisions contained in such debt

securities and in any agreements, instruments and documents executed pursuant to or in connection therewith shall be substantially similar to, and not more burdensome to the Borrower and the Guarantor than, the corresponding provisions contained in the Subordinated Note Documents as in effect on the date hereof, (iv) such debt securities and such agreements, instruments and documents shall provide that no cash payments of principal, prepayment charges, interest or other amounts shall be payable thereunder until all Senior Indebtedness at the time outstanding, and all securities issued in exchange therefor to the holders of such Senior Indebtedness at the time outstanding, shall have been paid in full in cash, and (v) in all other respects, the payment of such debt securities shall be subordinate and subject, at least to the extent provided in this Agreement with respect to the Subordinated Indebtedness, to the payment of all Senior Indebtedness of the Borrower and the Guarantor at the time outstanding, and to the payment of all securities issued in exchange therefor to the holders of such Senior Indebtedness at the time outstanding.

"Senior Indebtedness" means (a) the principal amount of Indebtedness now or hereafter incurred by the Borrower under the Senior Loan Documents, (b) prepayment charges, if any, payable with respect thereto, (c) interest thereon (including, without limitation, any such interest accruing subsequent to the filing by or against the Borrower or the Guarantor of any proceeding brought under the Bankruptcy Code, whether or not such interest is allowed as a claim pursuant to the provisions of the Bankruptcy Code), (d) all obligations of the Guarantor or any other person under any Guarantee of any of such Indebtedness now or hereafter executed, (e) all fees (including without limitation, attorneys' fees), costs, expenses, indemnities or other amounts payable pursuant to the terms of or in connection with any of the Senior Loan Documents and (f) any other obligations owed by Borrower to the Senior Lender.

"Senior Lender" means [describe Senior Lender].

"Senior Loan Documents" [list all applicable senior loan documents and include a catch-all provision].

"Subordinated Indebtedness" means (a) the principal amount of Indebtedness and interest thereon now or hereafter incurred by the Borrower under the Subordinated Note Documents, (b) prepayment charges, if any, payable with respect thereto, (c) all obligations of the Guarantor or any other person under any guarantee of any of such Indebtedness now or hereafter executed, (d) all fees (including, without limitation, attorneys' fees), costs, expenses, indemnities or other amounts payable pursuant to the terms of or in connection with any of the Subordinated Note Documents, (e) any other obligations owed by Borrower to the Subordinated Lender and (f) any obligation or claim (whether for rescission or damages and whether based on contract, tort, duty imposed by law, or any other theory of liability) related to or arising out of the offer, sale or purchase of any of the subordinated notes.

"Subordinated Lender" means [describe Subordinated Lender].

"Subordinated Note Documents" [list all applicable note related documents and include a catch-all provision].

2. Subordination.

2.1 Subordination of Indebtedness. Each of the Borrower and the Guarantor, for itself and its successors or assigns, covenants and agrees, and each holder of a subordinated note, by its acceptance of the subordinated note, shall be deemed to have agreed, that the payment of the Subordinated Indebtedness shall be subordinate and subject in right of payment, to the extent and in the manner set forth herein, to the prior payment in full in cash of all Senior Indebtedness, and that each holder of Senior Indebtedness, whether now outstanding or hereafter created, incurred, assumed or guaranteed, shall be deemed to have acquired Senior Indebtedness in reliance upon the provisions contained in this Agreement.

2.2 Subordinated Indebtedness Subordinated to Prior Payment of All Senior Indebtedness on Dissolution, Liquidation Reorganization, Etc. Upon any payment or distribution of the assets of the Borrower or the Guarantor of any kind or character, whether in cash, property or securities from any source whatsoever (including any collateral, whether the proceeds thereof or in kind, at any time securing the Subordinated Indebtedness, and including any payment or distribution that is payable by reason of the payment of any other Indebtedness of the Borrower or the Guarantor being subordinated to the payment of the Subordinated Indebtedness), to creditors upon any dissolution, winding up, total or partial liquidation, reorganization, composition, arrangement, adjustment or readjustment of the Borrower or the Guarantor or their respective subsidiaries (whether voluntary or involuntary, or in bankruptcy, insolvency, reorganization, liquidation or receivership proceedings, or upon an assignment for the benefit of creditors, or any other marshalling of the assets and liabilities of the Borrower or the Guarantor, or otherwise), then in such event:

(a) the holders of the Senior Indebtedness shall be entitled to receive payment in full in cash of all amounts due or to become due on or in respect of all Senior Indebtedness, before any payment is made on account of or applied on the Subordinated Indebtedness;

(b) any payment or distribution of assets of the Borrower or the Guarantor of any kind or character, whether in cash, property or securities from any source whatsoever (including Reorganization Securities), to which the holders of the Subordinated Indebtedness would be entitled except for the provisions of this Section 2, shall be paid or delivered by any debtor, custodian, liquidating trustee, agent or other person making such payment or distribution, directly to the holders of such Senior Indebtedness, or their representative or representatives, ratably according to the aggregate amounts remaining unpaid on account of the principal of and interest on such Senior Indebtedness held or represented by each, for application to the payment of all such Senior Indebtedness remaining unpaid, to the extent necessary to pay all such Senior Indebtedness in full in cash after giving effect to any concurrent payment or distribution to the holders of such Senior Indebtedness; and

(c) in the event that, notwithstanding the foregoing provisions of this Section 2.2, any payment or distribution of assets of the Borrower or the Guarantor of any kind or character, whether in cash, property or securities from any source whatsoever (including

Reorganization Securities), shall be received by any holder of Subordinated Indebtedness before all such Senior Indebtedness is paid in full in cash, such payment or distribution shall be held in trust for the benefit of, and shall immediately be paid or delivered by such holder to, as the case may be, the holders of such Senior Indebtedness remaining unpaid, or their representative or representatives, for application to the payment of all such Senior Indebtedness remaining unpaid, ratably according to the aggregate amounts remaining unpaid on account of such Senior Indebtedness held or represented by each, to the extent necessary to pay all such Senior Indebtedness in full in cash after giving effect to any concurrent payment or distribution to the holders of such Senior Indebtedness.

2.3 No Payments With Respect to Subordinated Indebtedness in Certain Circumstances; Remedies; Redemption of Subordinated Indebtedness and Equity.

(a) No payment on account of the Subordinated Indebtedness or any judgment with respect thereto shall be made by or on behalf of the Borrower or the Guarantor if, at the time of such payment or immediately after giving effect thereto,

(i) (x) a default in the payment when due of all or any portion of the principal of, prepayment charges or interest on, or fees in respect of unused commitments relating to, the Senior Indebtedness shall have occurred, and such default shall not have been cured or waived in accordance with the applicable provisions of the Senior Loan Documents; or (y) any other default in respect of the payment when due of all or any portion of the Senior Indebtedness shall have occurred and the Borrower and the holders of Subordinated Indebtedness shall have received written notice of such default from any holder of Senior Indebtedness or Person duly acting as representative of the holders of Senior Indebtedness, and such default shall not have been cured or waived in accordance with the applicable provisions of the Senior Loan Documents; or

(ii) the Borrower and the holders of Subordinated Indebtedness shall have received written notice (each a "Payment Bar Notice") from the holders of Senior Indebtedness or Person duly acting as representative of the holders of Senior Indebtedness of the occurrence of a default or event of default under the terms of any of the Senior Loan Documents (other than a default described in clause (i) of this Section 2.3(a)), and such default or event of default shall not have been cured or waived in accordance with the applicable provisions of the Senior Loan Documents.

(b) Following any acceleration of the maturity of any Senior Indebtedness and as long as such acceleration shall continue unrescinded and unannulled, such Senior Indebtedness shall first be paid in full in cash before any payment is made on account of or applied on the Subordinated Indebtedness.

(c) Following any acceleration of the maturity of any Subordinated Indebtedness (including, without limitation, any automatic acceleration pursuant to the provisions of the Subordinated Note Documents), and as long as such acceleration shall

continue unrescinded and unannulled, all Senior Indebtedness shall first be paid in full in cash before any payment is made on account of or applied on the Subordinated Indebtedness.

(d) If, at any time when the maturity of both Senior Indebtedness and Subordinated Indebtedness shall have been accelerated and such acceleration of Senior Indebtedness and Subordinated Indebtedness shall be continuing, the acceleration of such Senior Indebtedness shall be rescinded and annulled in accordance with the applicable terms of the Senior Loan Documents, then (except in any case where the holders of Subordinated Indebtedness would at the time have a right to accelerate the maturity of the Subordinated Indebtedness under the provisions of clause (z) of Section 2.3(f)), automatically and without any action on the part of the holders of Subordinated Indebtedness, such acceleration of the maturity of the Subordinated Indebtedness shall likewise be deemed rescinded and annulled in accordance with the applicable terms of the Subordinated Note Documents, effective as of the effective date of such rescission and annulment of the acceleration of Senior Indebtedness; and thereupon the provisions of this Section 2.3 shall be applicable in the same manner and to the same extent as was the case immediately prior to such acceleration of Senior Indebtedness as though such acceleration had not occurred.

(e) In the event that, notwithstanding the foregoing provisions of this Section 2.3, any payment or distribution of assets of the Borrower or the Guarantor of any kind or character, whether in cash, property or securities, from any source whatsoever, shall be received by any holder of Subordinated Indebtedness contrary to the foregoing provisions of this Section 2.3, such payment or distribution shall be held in trust for the benefit of, and shall be immediately paid or delivered by such holder to, as the case may be, the holders of such Senior Indebtedness remaining unpaid, or their representative or representatives, for application to the payment or prepayment of all such Senior Indebtedness remaining unpaid, ratably according to the aggregate amounts remaining unpaid on account of the Senior Indebtedness held or represented by each, to the extent necessary to pay all such Senior Indebtedness in full in cash after giving effect to any concurrent payment or distribution to the holders of such Senior Indebtedness.

(f) So long as any Senior Indebtedness shall remain outstanding, no holder of Subordinated Indebtedness shall take any action to (i) accelerate the maturity of all or any of the Subordinated Indebtedness or (ii) exercise any other rights or remedies under the provisions of the Subordinated Note Documents or at law or in equity (including, without limitation, the filing of an involuntary petition under the Bankruptcy Code against the Borrower or any of the Guarantor or the commencement or maintenance of any other judicial or administrative action against the Borrower or the Guarantor, or either of them, or against any of their property or assets), unless and until (x) the maturity of the Senior Indebtedness shall have been accelerated in accordance with the terms thereof, (y) a voluntary or involuntary petition under the Bankruptcy Code shall have been filed by or against the Borrower or the Guarantor, or (z) with respect to any particular Event of Default, such Event of Default shall have continued without cure or waiver thereof for a period of 180 consecutive days, but no such action shall be taken by reason of or with

respect to any other Event of Default unless and until such other Event of Default shall have continued without cure or waiver for a period of 180 consecutive days.

(g) Notwithstanding anything to the contrary set forth in the Subordinated Note Documents, so long as any Senior Indebtedness shall remain outstanding, (i) except as expressly permitted by the provisions of the Senior Loan Documents as in effect on the date hereof, no payment of all or any portion of the principal amount of or prepayment charges (if any) or interest on the Subordinated Indebtedness shall be paid prior to the scheduled maturity date or scheduled payment date for such payment under the provisions of the Subordinated Note Documents, (ii) except as expressly permitted by this Section 2.3, no acceleration of the maturity of all or any portion of the Subordinated Indebtedness shall occur or be deemed to occur, whether automatically under the terms of the Subordinated Note Documents or by action of the holders of Subordinated Indebtedness or their representatives, (iii) neither the Guarantor nor the Borrower, nor any of their subsidiaries, shall, or shall be permitted to, redeem, repurchase or otherwise acquire for value any of the Subordinated Indebtedness or any shares of preferred stock or common stock issued or sold by the Borrower or the Guarantor to the holders of the Subordinated Indebtedness, and (iv) no Subordinated Indebtedness shall be accelerated automatically or by action of the holders thereof, and no other remedy under the Subordinated Note Documents or at law or in equity shall be available in respect of the Subordinated Indebtedness, by reason of any failure of the Borrower, the Guarantor or their subsidiaries to comply with any provision of the Subordinated Note Documents.

(h) The Borrower shall give prompt written notice to each holder of outstanding Subordinated Indebtedness of any default or event of default in respect of Senior Indebtedness referred to in paragraph (a)(i) of this Section 2.3 and of any acceleration or deceleration of the maturity of any Senior Indebtedness; but no failure or delay by the Borrower in giving any such notice shall affect the rights hereunder of the holders of Senior Indebtedness.

2.4. Obligations of the Borrower and the Guarantor Unconditional. Nothing contained in this Section 2 or elsewhere in this Agreement or in the Subordinated Note Documents is intended to or shall impair, as between the Borrower or the Guarantor and their creditors other than the holders of Senior Indebtedness, the obligations of the Borrower and the Guarantor to the holders of the Subordinated Indebtedness to pay the Subordinated Indebtedness as and when it shall become due and payable in accordance with its terms, or is intended to or shall affect the relative rights of the holders of the Subordinated Indebtedness and creditors of the Borrower or the Guarantor other than the holders of Senior Indebtedness, nor shall anything herein or therein (except as provided in Sections 2.3(d), (f) and (g) hereof) prevent any holder of Subordinated Indebtedness from exercising all remedies otherwise permitted by applicable law upon the happening of an event of default under the Subordinated Note Documents, subject to the rights, if any, under this Section 2 of the holders of Senior Indebtedness in respect to assets, whether in cash, property or securities, of the Borrower or the Guarantor received upon the exercise of any such remedy. In the event that any payments or distributions shall be paid or delivered by the holders of Subordinated Indebtedness to the holders of Senior Indebtedness, or their representative or representatives, in accordance with the provisions of Section 2.3(e) then the

holders of Subordinated Indebtedness shall, for purposes of determining whether an Event of Default has occurred with respect to the Subordinated Indebtedness, be deemed never to have received such payment or distribution. In the event that the Borrower fails to make any payment on account of the Subordinated Indebtedness by reason of any provision of this Section 2, such failure shall, notwithstanding such provision, constitute an event of default with respect to the Subordinated Indebtedness if and to the extent such failure would otherwise constitute such an event of default in accordance with the terms of the Subordinated Indebtedness and the Subordinated Note Documents.

2.5 Authorization To Take Action to Effect Subordination. Each holder of any Subordinated Indebtedness by his acceptance thereof (i) irrevocably authorizes and empowers (but without imposing any obligation on) each Senior Lender at the time outstanding, and such Senior Lender's representatives, to demand, sue for, collect, receive and receipt for such holder's ratable share of payments or distributions in respect of the Subordinated Indebtedness which are required to be paid or delivered to the Senior Lenders as provided in Section 2.2, and take all such other action, in the name of such holder or otherwise, as such Senior Lender or Senior Lender's representatives may determine to be necessary or appropriate for the enforcement of the provisions of Section 2.2. In any proceeding under the Bankruptcy Code in which any holder of Subordinated Indebtedness has not filed any claim, proof of claim or other instrument of similar character necessary to enforce the obligations of the Borrower in respect to the Subordinated Indebtedness of such holder within 30 days before the expiration of the time to file the same, any holder of the Senior Indebtedness or representative thereof may, as attorney-in-fact for such holder of the Subordinated Indebtedness, file any claim, proof of claim or other such instrument of similar character on behalf of such holder of the Subordinated Indebtedness, and each holder of the Subordinated Indebtedness hereby appoints such holder of the Senior Indebtedness or representative thereof as an attorney-in-fact for such holder of the Subordinated Indebtedness, to so file any claim, proof of claim or such other instrument of similar character. Each holder of Subordinated Indebtedness agrees to execute and deliver to each Senior Lender, and such Senior Lender's representatives, all such further instruments confirming the authorization hereinabove set forth, and all such powers of attorney, proofs of claim, assignments of claim and other instruments, and to take all such other action, as may be requested by such holder or such holder's representatives in order to enable such holder to enforce all claims upon or in respect of such holder's ratable share of payments or distributions in respect of the Subordinated Indebtedness.

Each holder of Subordinated Indebtedness by its acceptance thereof acknowledges and agrees that each holder of Senior Indebtedness (whether such Senior Indebtedness is now or hereafter incurred) shall have acquired or will acquire such Senior Indebtedness in reliance upon the covenants and provisions contained in this Agreement.

3. Miscellaneous .

3.1 Reinstatement. To the extent any payment of Senior Indebtedness (whether by or on behalf of the Borrower or any of the Guarantor, as proceeds of security or enforcement of any right of setoff or otherwise) is declared to be fraudulent or preferential, set aside, rescinded or required to be paid to a trustee, receiver, debtor in possession or other similar party under any

bankruptcy, insolvency, receivership or similar law, then to the extent such payment is recovered by, or paid over to, such trustee, receiver, debtor in possession or other similar party, the Senior Indebtedness or part thereof originally intended to be satisfied shall be deemed to be reinstated and outstanding as if such payment had not occurred. All Senior Indebtedness shall be and remain Senior Indebtedness for all purposes of this Agreement, whether or not subordinated, in a bankruptcy, insolvency, receivership or similar proceeding.

3.2. No Waiver of Subordination Provisions. No right of the Senior Lenders to enforce subordination as herein provided shall at any time in any way be prejudiced or impaired by any act or failure to act on the part of the Borrower or the Guarantor or by any act or failure to act by any Senior Lender, or by any noncompliance by the Borrower or the Guarantor with the terms, provisions and covenants of the Subordinated Note Documents regardless of any knowledge thereof which the Senior Lenders, or any of them, may have or be otherwise charged with.

Without in any way limiting the generality of the foregoing paragraph, the Senior Lenders, or any of them, may, at any time and from time to time, without the consent of or notice to the holders of the Subordinated Indebtedness, without incurring any liabilities to any such holder and without impairing or releasing the subordination and other benefits provided in this Agreement or the obligations hereunder of the holders of Subordinated Indebtedness to the Senior Lenders, even if any right of reimbursement or subrogation or other right or remedy of any holder of the Subordinated Indebtedness is affected, impaired or extinguished thereby, do any one or more of the following:

(a) change the manner, place or terms of payment or change or extend the time of payment of, or renew, exchange, amend, increase or alter, the terms of any Senior Indebtedness, any security therefor or guaranty thereof or any liability of the Borrower or any Guarantor to such holder, or any liability incurred directly or indirectly in respect thereof (including, without limitation, any extension or increase in the amount of any Senior Indebtedness), without any restriction as to the amount, tenor or terms of any such extension or increase, provided that no such increase may increase the outstanding principal amount of the Senior Indebtedness to an amount in excess of \$ _____;

(b) settle or compromise any Senior Indebtedness or any other liability of the Borrower or any Guarantor to such holder or any security therefor or any liability incurred directly or indirectly in respect thereof and apply any sums by whomsoever paid and however realized to any liability (including, without limitation, Senior Indebtedness) in any manner or order; and

(c) fail to take or to record or otherwise perfect, for any reason or for no reason, any lien or security interest securing Senior Indebtedness by whomsoever granted, exercise or delay in or refrain from exercising any right or remedy against the Borrower or any security or any Guarantor or any other Person, elect any remedy and otherwise deal freely with the Borrower and any security and any Guarantor or any

liability of the Borrower or any Guarantor to such holder or any liability incurred directly or indirectly in respect thereof.

All rights and interests under this Agreement of the Senior Lenders, and all agreements and obligations of the holders of Subordinated Indebtedness, the Borrower and the Guarantor hereunder, shall remain in full force and effect irrespective of (i) any lack of validity or enforceability of the Senior Loan Documents, or of any provision of any thereof, or (ii) any other circumstance that might otherwise constitute a defense available to, or a discharge of, the Borrower or any Guarantor in respect of the Senior Indebtedness.

3.3 Legend. The Borrower covenants to cause each subordinated note now or hereafter issued to have affixed upon it a legend which reads substantially as follows:

"This instrument is subject to the Subordination Agreement dated as of _____, among _____, which, among other things, contains provisions subordinating the obligations of the maker hereof to the payee to the maker's obligations to the holders of the Senior Indebtedness (as defined in said Agreement), to which provisions the holder of this instrument, by acceptance hereof, agrees."

3.4 Amendments to Subordinated Note Documents. Without the prior written consent of the holders of a majority of the aggregate outstanding principal balance of the Senior Indebtedness, no provision of the Subordinated Note Documents shall be amended, supplemented, modified or waived if the effect of such amendment, supplement, modification or waiver would be to (a) increase the amount of, or advance to an earlier date the scheduled maturity date or payment date of, any required payment or prepayment of the principal of the Subordinated Indebtedness, (b) increase the rate of interest, prepayment charges, fees, expenses or other amounts payable with respect to the Subordinated Indebtedness, (c) amend, modify or supplement any existing covenant, agreement, default, event of default, representation, warranty, condition or requirement contained in the Subordinated Note Documents, or the definition of any term used in any of such provisions, in a manner that make such provision more restrictive or burdensome in any respect to the Borrower, the Guarantor or their subsidiaries than such provision as in effect on the date hereof or (d) add any new or additional covenant, agreement, default, event of default, representation, warranty, condition or requirement not contained in the Subordinated Note Documents as in effect on the date hereof (exclusive of any such addition that relates exclusively to the common stock or preferred stock of the Guarantor and that is not inconsistent with the provisions of this Agreement).

Appendix B

Sample Pro-Noteholder Provision

1. Definitions.

Definitions of "Bankruptcy Code," "Borrower," "Guarantor," "Reorganization Securities," "Senior Lender," "Senior Loan Documents," "Subordinated Lender" and "Subordinated Note Documents" are same as in Appendix A.

"Senior Indebtedness" means all principal, interest, costs and expenses due under that certain senior note [describe further]; provided, however, that the aggregate amount of the Senior Indebtedness shall at no time exceed \$_____. After any payment of the principal amount of [the term loan portion of] the Senior Indebtedness has been made, the cap on the amount of Senior Indebtedness set forth herein shall be reduced by a like amount and such amount may not be readvanced without the express written consent of the holders of a majority in principal amount of the Subordinated Indebtedness.

"Subordinated Indebtedness" means all principal, interest, costs and expenses due under those certain subordinated notes [describe further].

2. Subordination.

2.1 Subordination of Indebtedness. Each of the Borrower and the Guarantor, for itself and its successors or assigns, covenants and agrees, and each holder of any Subordinated Indebtedness, by its acceptance of a subordinated note, shall be deemed to have agreed that the payment of the Subordinated Indebtedness shall be subordinate and subject in right of payment, to the extent and in the manner set forth herein, to the prior payment in full in cash of all Senior Indebtedness, subject to the limitations set forth herein.

2.2 Same as Section 2.2 of Appendix A but exclude reorganization securities from turnover obligation and add these provisions:

The Borrower shall give prompt notice to each holder of outstanding Subordinated Indebtedness of any dissolution, winding up, total or partial liquidation, reorganization, composition, arrangement, adjustment or readjustment of the Borrower or of the Guarantor; but no failure or delay by the Borrower in giving such notice shall affect the rights hereunder of the holders of Senior Indebtedness.

Upon any distribution of assets of the Borrower or the Guarantor referred to in this Section 2, the holders of the Subordinated Indebtedness shall be entitled to rely upon any order or decree made by any court of competent jurisdiction in which such bankruptcy, insolvency, reorganization, liquidation, receivership or other proceeding is pending, or a certificate of the debtor, custodian, liquidating trustee, agent or other Person making any distribution to such holders, for the purpose of ascertaining the Persons entitled to participate in such distribution, the

holders of the Senior Indebtedness, the amount thereof or payable thereon, the amount or amounts paid or distributed thereon and all other facts pertinent thereto or to this Section 2.

2.3 No Payments With Respect to Subordinated Indebtedness in Certain Circumstances: Remedies, Redemption of Subordinated Indebtedness and Equity.

(a) No payment on account of the Subordinated Indebtedness or any judgment with respect thereto shall be made by or on behalf of the Borrower or the Guarantor if, at the time of such payment or immediately after giving effect thereto,

(i) same as Section 2.3(a)(i) of Appendix A;

(ii) all of the following three conditions shall be satisfied:

(x) the Borrower and the holders of Subordinated Indebtedness shall have received written notice (each a "Payment Bar Notice") from any holder of Senior Indebtedness or Person duly acting as representative of the holders of Senior Indebtedness of the occurrence of a default or event of default under the terms of any of the Senior Loan Documents (other than a default described in clause (i) of this Section 2.3(a)),

(y) such default or event of default shall not have been cured or waived in accordance with the applicable provisions of the Senior Loan Documents, and

(z) not more than 180 days shall have elapsed after the date of receipt by the Borrower and the holders of the Subordinated Indebtedness of such Payment Bar Notice;

provided, however, that no further Payment Bar Notice may be given during any period during which payments are prohibited under the provisions of this Section 2.3(a)(ii) or within 90 days after the expiration of such period.

(b) Same as Section 2.3(b) of Appendix A.

(c) Following any acceleration of the maturity of any Subordinated Indebtedness (including, without limitation, any automatic acceleration pursuant to the Subordinated Note Documents), and as long as such acceleration shall continue unrescinded and unannulled, all Senior Indebtedness shall first be paid in full in cash before any payment is made on account of or applied on the Subordinated Indebtedness (provided that the holders of Subordinated Indebtedness shall be entitled to be paid and retain any overdue installments of interest, the payment of which is not then prohibited by any provision of this Agreement other than this paragraph (c)).

(d)-(h) Same as Sections 2.3(d) through (h) of Appendix A.

(i) The Borrower shall give prompt written notice to each holder of outstanding Subordinated Indebtedness of any default or event of default in respect of Senior Indebtedness referred to in paragraph (a)(i) of this Section 2.3 and of any acceleration or deceleration of the maturity of any Senior Indebtedness, and each Senior Lender or its representative shall give prompt written notice to each holder of outstanding Subordinated Indebtedness of any Payment Bar Notice pursuant to paragraph (a)(ii) of this Section 2.3; but no failure or delay by the Borrower in giving any such notice shall affect the rights hereunder of the holders of Senior Indebtedness.

2.4 Holders of Subordinated Indebtedness to be Subrogated to Rights of Holders of Senior Indebtedness. Subject to the payment in full of all Senior Indebtedness, the holders of the Subordinated Indebtedness shall be subrogated to the rights of the holders of Senior Indebtedness to receive payments or distributions of assets of the Borrower or the Guarantor applicable to the Senior Indebtedness until the Subordinated Indebtedness shall be paid in full, and for purposes of such subrogation, no payment or distribution to the holders of the Senior Indebtedness of assets, whether in cash, property or securities, distributable to the holders of Senior Indebtedness under the provisions hereof to which the holders of the Subordinated Indebtedness would be entitled except for the provisions of this Section 2, and no payment pursuant to the provisions of this Section 2 to the holders of Senior Indebtedness by the holders of the Subordinated Indebtedness shall, as between the Borrower or the Guarantor, their creditors other than the holders of the Senior Indebtedness and the holders of the Subordinated Indebtedness, be deemed to be a payment by the Borrower or the Guarantor to or on account of such Senior Indebtedness, it being understood that the provisions of this Section 2 are, and are intended, solely for the purpose of defining the relative rights of the holders of the Subordinated Indebtedness, on the one hand, and the holders of Senior Indebtedness, on the other hand.

2.5 Same as Section 2.5 of Appendix A but add the following proviso:

provided that in no event shall any Senior Lender or representative thereof have the right to vote any such holder's ratable share of the Subordinated Indebtedness in any proceeding under the Bankruptcy Code.

2.6 Holders of Subordinated Indebtedness Entitled to Rely on Representations. Each holder of Subordinated Indebtedness shall be entitled to rely on the delivery to it of a written notice by a Person representing itself to be a holder of Senior Indebtedness to establish that such notice has been given by a holder of Senior Indebtedness. In the event that such holder of Subordinated Indebtedness determines in good faith that further evidence is required with respect to the right of any Person as a holder of Senior Indebtedness to participate in any payment or distribution pursuant to this Section 2, such holder of Subordinated Indebtedness may request such Person to furnish evidence to the reasonable satisfaction of such holder of Subordinated Indebtedness as to the amount of Senior Indebtedness held by such Person, the extent to which such Person is entitled to participate in such payment or distribution and any other facts pertinent to the rights of such Person under this Section 2, and if such evidence is not furnished, such holder of Subordinated Indebtedness may defer any payment to such Person pending judicial determination as to the right of such Person to receive such payment.