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Ten key issues that the loan market association failed to address in their new intercreditor agreement

BY MICHAEL CROSBY

The new model intercreditor agreement recently released by the Loan Market Association (LMA) failed to address several issues of key importance to mezzanine lenders. While presented as a suggested form for multi-tranche financings, mezzanine lenders should resist embracing this document as a standard form until several inequities are addressed through redrafting. Not surprisingly, the form is very senior-lender favourable and exacerbates many of the difficulties mezzanine lenders are experiencing in today's restructurings. Mezzanine lenders are entitled to a seat at the table in a restructuring and should fight to include the following issues in their next intercreditor agreement.

1. Providing that a sale of collateral meets certain minimum standards

With the prevalence of cross-border transactions, there should be certain minimum standards for dispositions of collateral that apply across all applicable jurisdictions to ensure that mezzanine lenders are not forced to release their liens in a situation where value is being destroyed. Different countries have different laws relating to the disposition of collateral. Mezzanine lenders should not rely solely on these laws to provide them with the procedural protections they need to ensure a fair process. For example, it should be made clear that the lien release provisions do not apply to sales to affiliates. A private equity house should not be able to team up with a senior lender to squeeze out mezzanine lenders at a below market valuation. Also, all aspects of the sale process should be commercially reasonable, including the price and the process. By including these basic protections, mezzanine lenders will establish minimum standards of conduct for dispositions of collateral.

2. Preserving the primary borrowing obligations

Often the security release provisions in intercreditor agreements provide that in connection with a disposition of collateral, not only is the security released but the obligations of the borrower to repay the debt are also discharged. It should go without saying that the only way that a borrower should be able to discharge its debt is to repay the debt or to restructure the debt either consensually or through an insolvency process. Clearly, a mezzanine lender would suffer irreparable harm if its debt were discharged without appropriate compensation.

3. Terminating the standstill upon a sale of assets

Invariably mezzanine loan agreements contain restrictions against sales of assets other than certain permitted exceptions. However, these provisions may prove to be ineffective at a time when their protection is most needed. To illustrate, if the mezzanine lenders are prevented from taking action because of the standstill, the borrower will be able to sell assets to a third party (or even worse, to the equity sponsor or the senior lenders) without seeking the consent of the mezzanine lenders. By using the standstill as a shield, the borrower is able to deprive the mezzanine lenders from a seat at the table and a voice in determining valuation. By the time the standstill expires the assets have been sold and the mezzanine lenders are left with whatever proceeds remain and a claim for breach of contract.

4. Carving out expenses from the 'lock-up'

One of the major obstacles for mezzanine lenders in a restructuring is often their inability to recover costs and expenses for advisers. Without professional advisers, mezzanine lenders may not fully explore their contractual and statutory rights. The LMA precludes mezzanine lenders from recovering their costs and expenses while a stop notice is in effect. Following the occurrence of an event of default, mezzanine lenders should have the ability, like senior lenders, to instruct lawyers and other professional advisers at the expense of the borrower.

5. Securing the right to remove the agent

During a workout, time is often of the essence and having an agent that represents your interests is critical. Mezzanine lenders should not be forced to work with the same agent that represents the senior lenders. While the conflict is obvious, many agents do not resign, or do not resign as quickly as they should. This results in mezzanine lenders not having as loud, responsive or persistent a voice in a workout as they could. In a fluid and fast moving process, it is critical to have an agent who is willing to be a robust and reliable advocate for mezzanine lenders. A majority of mezzanine lenders should have the express right to remove the agent (or to appoint a sub-agent) after an event of default.

6. Preserving the right to take independent action upon a senior acceleration

If the senior lenders accelerate their debt, mezzanine lenders should be free to take enforcement action. An acceleration is a game-changing event and often precedes a disposition of collateral or an insolvency proceeding. Mezzanine lenders should not be limited to taking the same enforcement action as the senior lenders. If the senior lenders are not pursuing certain types of collateral (e.g., real estate or intellectual property), mezzanine lenders should be free to do so, subject, of course, to the turnover provisions and the priorities established in the intercreditor agreement.

7. Limiting the number of days that stop notices are in effect

It is well settled that if a payment default exists, mezzanine lenders are restricted from receiving payments on their debt until the payment default is cured or waived or the senior debt is paid in full. What's not commonly understood is that without an aggregate limit on the number of days that stop notices are in effect, a series of covenant defaults may produce the same result. For example, if a borrower breaches one of its covenants (e.g., leverage), the senior lenders can issue a stop notice barring future payments on the mezzanine debt for a period of time, typically 120 (sometimes 150) days.

If prior to the expiration of the stop notice, the borrower breaches another covenant (e.g., interest coverage), the senior lenders can issue another stop notice to prevent payment for another 120 days. The only limit on issuing successive notices are for notices that are related to the same event or set of circumstances. In this case where the circumstances are different, the senior lenders would be entitled to impose a second stop notice. This is an odd result. Mezzanine lenders should address this issue by including an aggregate limit on the number of days that stop notices may be in effect (for example 150 days in any 360 day period). Additional limits such as restricting the number of stop notices that may be given over the life of the deal should also be considered.

8. Preserving the right of individual lenders to vote in an insolvency

One of the most sacred rights that a mezzanine lender has is the right to vote on matters concerning its investment. In its model intercreditor agreement, the LMA proposes to strip away the mezzanine lenders' individual right to vote on any proposal in an insolvency or similar proceeding by delegating it to the security agent. This provision should be strongly resisted as it deprives mezzanine lenders of their right to vote at precisely the time when it's most needed.

9. Establishing a waterfall for senior debt in excess of the cap

From the mezzanine lender's perspective, a key component of the intercreditor agreement is the cap on senior debt. If the senior lenders advance funds in excess of the permitted headroom, those excess amounts (and any interest or fees thereon) should be paid only after the mezzanine loan is paid in full. However, as currently proposed, the LMA's intercreditor agreement permits the senior lenders to recover the full amount of their claim (even amounts in excess of the cap), before payments may be made to the mezzanine lenders. This occurs because the senior lenders' priority lien on the collateral secures its entire claim, even amounts in excess of the cap. The mezzanine lenders are left with a mere breach of contract claim, which could be expensive and time consuming to pursue. A better result would be to establish a clear waterfall of payment priorities for amounts under and over the cap.

10. Securing parallel restriction on amendments

Once the deal closes, the senior and mezzanine lenders should not be able to change the key terms of a deal without the consent of the other group of lenders. The restrictions on amendments should largely be reciprocal, with the exception that the senior lenders should be free to impose more restrictive covenants and events of default after the occurrence of a default. In this case, however, the mezzanine lenders should be entitled to adopt parallel restrictions, subject to any agreed upon stepbacks.

Conclusion

Mezzanine lenders are frequently finding themselves hamstrung with few weapons in today's restructurings, saddled with intercreditor agreements from the past five years that do not adequately protect them against a softening economy. Mezzanine lenders should resist adopting the LMA's proposed form of intercreditor agreement until the issues set out above are adequately addressed. Without these protections, mezzanine lenders risk being sidelined during a workout, left to watch their recovery rates diminish even further. ■

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