

Back to basics banking

As the financial crisis has unfolded, there have been demands for a return to simpler and more traditional lending structures. Here's how they work

Some market participants believe that traditional lending structures offer lower (or at least known or more predictable) risks for lenders. Traditional mezzanine loan or note financings, which have declined in popularity among borrowers in recent years, may be set for a resurgence. Another factor that points to potential for growth in the demand for mezzanine financings is the softening in the markets for second lien debt. This trend was noticeable even before the credit crisis took hold and has been accelerated by market conditions.

We expect to see a number of stand-alone mezzanine deals in which the mezzanine debt is the only debt for borrowed money in the capital structure. However, many mezzanine financings will be accompanied by senior debt financings. This structure is attractive both to senior lenders, whose risk is lowered by a junior tranche of capital that allows the borrower to reduce the amount of senior debt it needs, and to borrowers, whose blended cost of capital will be reduced by including senior debt in the capital structure.

Basics

Under a typical intercreditor agreement, mezzanine investors agree to two important types of limitations. The first

are payment blockage restrictions: in certain circumstances, with some exceptions, the borrower is blocked from paying the mezzanine debt. The basic premise of the intercreditor arrangements in mezzanine financings is that mezzanine debt is subordinated in right of payment to senior debt, as defined in the intercreditor agreement. Also, the intercreditor agreement customarily contains a remedies standstill provision that prohibits the mezzanine investors from exercising remedies for a period of time.

Specifics

What is senior debt?

Because mezzanine debt is subordinated to senior debt, the definition of senior debt, and a number of related questions, assume critical importance. Some definitions of senior debt are long, others short. But the intent is generally to cover all obligations under the senior loan documents, including hedging obligations that are secured by liens on the collateral securing the senior loans. Obligations under non-speculative hedge agreements provided by senior lenders or their affiliates to hedge against changes in interest rates, currency rates and commodities' prices are frequently included in senior debt. This is done, in part, as an accommodation to the borrower because hedge providers generally require collateral, and the borrower will likely have pledged substantially all of its assets to secure the obligations under the senior loan documents. Another reason to allow such hedge providers to share in the collateral for the senior debt is to incentivise the borrower to give its hedging business to the senior lenders and their affiliates.

Is there a cap on the amount of senior debt?

Yes. The cap is usually set at 100% of the committed senior debt at closing, plus a cushion of around 10% to 15%. The cushion allows the senior lenders to inject

a limited amount of rescue capital at a future date that will qualify as senior debt. Sizing the amount of rescue capital to meet the potential needs of the borrower is important for both senior lenders and mezzanine investors. Mezzanine investors rarely quibble at the notion of a cushion. They generally recognise that a future limited debt infusion by the senior lenders may be helpful, or necessary, to stabilise the credit, and that few senior lenders would be motivated to provide additional loans that were not protected by the intercreditor arrangements.

Are all types of senior debt included in the senior debt cap?

Often they are not. Senior lenders and mezzanine investors frequently have different views on the types of debt to be included in calculating the senior debt cap. Many senior lenders argue that the cap should apply only to the principal amount of senior loans and the face amount of letters of credit. In their view, other categories of senior debt should not be subject to the cap. Most importantly, from the perspective of most senior lenders, hedging obligations should be uncapped because forecasting the likely hedge exposure can be difficult, and the possible exposure may be large. Mezzanine investors, on the other hand, frequently counter that the cap should include hedging obligations. They argue that mezzanine investors bargain to subordinate mezzanine debt to a fixed amount of senior debt (plus an agreed cushion), but not to sit behind open-ended hedge exposure, particularly under hedging arrangements provided by senior lenders and their affiliates.

This is often one of the most heavily debated issues in intercreditor discussions. Whoever concedes on this point will often only do so in return for a material concession on another open point. Traditionally, more often than not, senior lenders have prevailed on this issue. However, an increasing number of mezzanine investors are focusing on this topic, and at least a few of them have learned the hard way that the potential hedge exposure can be great.

A middle ground we have seen is to include hedging exposure as senior debt up to an agreed amount. If the total hedging exposure exceeds that amount, the excess amount is allocated pro rata across the various hedges included in the senior debt definition, based on the respective net termination or settlement values of those hedges.

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Payment blockage

When do payments get blocked?

Certain material credit events trigger automatic blockage of payments on the mezzanine debt. Other events give the senior lenders the option of delivering a payment blockage notice. Once delivered, the credit parties are prohibited from making payments on the mezzanine debt for the duration of the payment blockage period. Automatic payment blockage is typically triggered by: (i) a bankruptcy or insolvency proceeding involving a credit party; or (ii) a payment event of default under the senior loan documents. A payment blockage notice can often be served upon the occurrence of any non-payment default under the senior loan documents. In some deals, the mezzanine investors have bargained for a materiality standard: only certain agreed-upon considerable non-payment defaults can be invoked as the basis for a payment blockage notice. These defaults often include judgment defaults, as well as defaults tied to the invalidity of the senior lenders' security interests and the unenforceability of the intercreditor agreement.

Which payments get blocked?

In a mezzanine deal, once the payment blockage provisions kick in, the borrower and the other credit parties are typically prohibited from using any funds available to them to pay the mezzanine debt. The source of those funds is irrelevant. This contrasts with the typical approach to payment blockage in an intercreditor agreement governing a second lien deal, in which the turnover provisions apply only to the proceeds of the shared collateral that secures the first and second lien debt (lien subordination as opposed to payment subordination).

For how long do payments get blocked?

If there is an automatic payment blockage, it generally remains in effect until the senior debt is repaid in full, unless the credit party emerges from bankruptcy or insolvency protection sooner or the payment event of default on the senior debt is cured or waived. Payment blockage notices, on the other hand, are not permanent. They are typically effective for 180 days, unless the underlying senior event of default is cured or waived sooner.

Are there other limits on payment blockage notices?

Generally, intercreditor agreements contain at least one additional limitation

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on the issuance of payment blockage notices. Although the wording varies among intercreditor agreements, payment blockage notices can invariably be issued only twice in any 12-month period. In some deals, usually those where the mezzanine investors have strong bargaining power, senior lenders will agree to cap the total number of blockage notices (generally in the range of four to six notices) that can be issued over the life of the intercreditor agreement.

Are there exceptions to payment blockage?

Generally, intercreditor agreements include exceptions from payment blockage for: (i) the issuance of permitted junior securities; and (ii) certain specified expense and other payments, often covered in a defined term, such as permitted subordinated debt payments. Though there is general agreement that these carve-outs should be included, there is less agreement on how broadly to define permitted junior securities, and on what items should be included as permitted subordinated debt payments.

Generally, what are permitted junior securities and when are they issued?

Permitted junior securities are securities or other instruments (such as loans) that are issued to the holders of mezzanine debt in substitution (in whole or in part) for, or in addition to, the mezzanine debt, typically in connection with a bankruptcy or insolvency proceeding or other dispositive restructuring of the credit parties. They may be debt, equity or convertible debt securities. They may be senior debt, senior subordinated debt or subordinated debt. They may be secured or unsecured, or supported with guarantees or not. They may be issued by the borrower, an affiliate of the borrower, a successor entity to the borrower or an affiliate. Their terms may be the same as, or more or less favourable than, the terms of the mezzanine debt. Understandably, senior lenders want to

protect their bargained-for seniority over the mezzanine debt. As a result, senior lenders insist on limiting the types and terms of permitted junior securities that mezzanine investors can receive.

What limitations are placed on permitted junior securities?

From the standpoint of the senior lenders, the most important point is to make sure that the mezzanine investors do not receive a permitted junior security that gives mezzanine investors more rights vis-à-vis the senior lenders and the senior debt than the rights provided for in the intercreditor agreement with respect to the mezzanine debt. The senior lenders want to make sure that any permitted junior securities are subordinated to the senior debt to at least the same degree as the mezzanine debt is subordinated to the senior debt. Senior lenders often have other concerns, such as the maturity date, the mandatory prepayment or redemption provisions or other core economic terms of, or the credit support (including in the form of liens or guarantees) provided with respect to, the permitted junior securities.

Virtually every definition of permitted junior securities focuses on the attributes of the securities: only securities that have those attributes can be distributed to mezzanine investors. Some definitions focus on specific attributes, such as the maturity date (often, it cannot be inside the maturity date of the mezzanine debt), the mandatory redemption provisions (often, there cannot be any until the senior debt is fully repaid) or the issuer of the security (frequently, this is limited to the issuer of the mezzanine debt). Other definitions take a more general approach and include a broad requirement that the permitted junior securities be subordinated to the senior debt to at least the same degree as the mezzanine debt is subordinated to the senior debt. Many definitions combine such a broad requirement with a laundry list of required features for a permitted junior security.

Also, many definitions go beyond the attributes of the permitted junior securities and provide that securities can only be permitted junior securities if: (i) they are issued under a confirmed plan of reorganisation or another dispositive restructuring arrangement; and (ii) the senior lenders voted as a class in favour of issuing the securities. Mezzanine investors will often try, with mixed results, to delete the second requirement during the negotiations, arguing that the senior lenders are sufficiently protected by the other elements of the definition of permitted junior securities.

What limitations are placed on permitted subordinated debt payments?

Senior lenders rarely object to allowing mezzanine investors to collect reasonable out-of-pocket expenses owed by the credit parties, sometimes subject to a cap. In addition, if the mezzanine debt is subject to US tax rules dealing with applicable high yield discount obligation instruments, there will often be an exception that allows the borrower to make catch-up payments to ensure that the borrower does not lose a federal income tax deduction. In addition to pushing back on a cap on reimbursable expenses, mezzanine investors will often seek to be able, during the payment blockage period, to: (i) collect regularly scheduled interest payments; and (ii) accrue (but not receive payment of) default interest.

Remedies standstill

During the standstill period, which remedies are prohibited?

The short answer is that virtually all remedies are prohibited during the standstill period. There are a handful of exceptions that are sometimes included. These exceptions are rarely controversial and allow mezzanine investors to, among other things: (i) sell their mezzanine positions to unaffiliated third parties; (ii) charge default interest; and (iii) take limited actions to preserve their legal rights, such as issuing payment demands or reservation of rights letters.

When does the remedies standstill fall away?

Typically, no later than a specified time period (usually 150 to 180 days) after an event of default has occurred under the mezzanine debt and the mezzanine investors have delivered a notice to the senior lenders stating that they intend to take enforcement actions. Some deals go further and provide that the standstill

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terminates on the earlier of the lapse of this time period and the first to occur of various negotiated trigger events. These trigger events can consist of, among other things, any or all of: (i) the acceleration of the senior debt; (ii) the commencement of a bankruptcy or insolvency proceeding involving a credit party; and (iii) the scheduled final maturity date of the mezzanine debt.

Are there any other timing restrictions on remedies enforcement?

Sometimes. A number of intercreditor agreements contain what is termed an x clause. This is intended to prevent senior lenders being taken by surprise when a remedies standstill period would otherwise expire. Under an x clause, mezzanine investors need to give senior lenders some advance notice (typically five to 10 days) before exercising remedies. This is true even if the remedies standstill would otherwise have expired. Because the x clause is intended to fulfil a notice function rather than to delay an exercise of remedies by mezzanine investors, many x clauses permit the notice to be delivered during the standstill period. As a result,

“Despite occasional posturing, both sides tend to be willing to compromise”

mezzanine investors can time delivery of the notice to dovetail with the expiration of the standstill.

Do the mezzanine investors waive rights generally available to them as creditors?

Typically, the answer is no. Intercreditor arrangements in mezzanine transactions are different to those in second lien deals, where the second lien investors will generally give broad waivers of a variety of rights available to them as secured creditors. This is the case in both unsecured and secured mezzanine financings.

Do mezzanine investors have the right to purchase the senior debt?

Typically, no, although we have seen some deals that allow mezzanine investors to purchase senior bank debt in certain circumstances, invariably at par. These types of purchase options are much more common in intercreditor agreements governing second lien financings. In those deals, many second lien lenders view a right to purchase the first lien debt as a must-have provision. It seems that mezzanine investors appear to place a lower value on this provision than their counterparts in second lien transactions.

Can senior lenders and mezzanine investors freely amend their debt documents?

Generally, no. Certain types of amendments to the mezzanine documents, usually those affecting core economic terms such as interest rate, fees and amortisation, require senior lender consent. Typically, the intercreditor agreement will contain similar, although often not as far-reaching, restrictions on amendments to the senior loan documents. The frequent lack of symmetry is often a source of frustration to mezzanine investors.

There is substantial agreement between senior lenders and mezzanine investors on many of the provisions that are routinely included in intercreditor agreements governing mezzanine financings. However, there remain a number of areas where the two constituencies often disagree. The good news is that, despite occasional posturing, both sides tend to be willing to compromise to reach a satisfactory resolution. It is rare for intercreditor discussions to derail a deal.

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