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Client Alert

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September 2005

Answers To Some Of The Less Frequently Asked (But Important) Questions In Second Lien Term Loan Financings

Second lien term loans sold in the institutional term loan markets have emerged in recent years as one of the most popular financing products in the senior debt world. Reduced to its basics, in a second lien term loan financing, the first lien lenders agree to allow a junior lien securing the second lien debt on all or part of the collateral securing the first lien debt. In return for their junior lien, the second lien lenders enter into an intercreditor agreement with the first lien lenders, designed to put the first lien lenders firmly in control (at least for a time) when it comes to dealing with, and exercising remedies against, the shared collateral.

As the second lien term loan market has developed, there is growing agreement among first and second lien lenders on the answers to some of the more frequently asked questions in the intercreditor discussions. However, there are a number of important questions that are far less frequently raised in the negotiations between first and second lien lenders. This Client Alert discusses some of those questions, and some of the answers may come as a surprise, particularly to first lien lenders.

Are there restrictions on what can be included in the "first lien debt"?

First Lien Debt Cap. In a second lien term loan deal, "first lien debt" is generally broadly defined to cover all obligations under the first lien debt documents, including principal, interest, premium and hedging obligations, subject to a cap on the amount of the first lien debt. As typically formulated, any outstanding principal and accrued interest on that principal in excess of a dollar amount is expressly excluded from the definition of "first lien debt." As discussed below, this distinction can have important consequences.

Type of Debt. Some deals, often at the prompting of second lien lenders, restrict the type of first lien debt to indebtedness incurred under a credit facility. There is general agreement among second lien lenders that a borrower needs the ability to refinance its existing first lien credit facility with a new credit facility at some future date. That may be challenging, if not impossible, unless that new credit facility can slot into the capital structure as first lien debt. As a result, there is broad agreement that first lien debt should include indebtedness under a refinancing credit facility. However, some second lien lenders reason the borrower should be able to access other debt markets, such as the Rule 144A high yield market, in order to refinance its existing first lien credit facility without having to give that refinancing debt first lien debt status. In those other markets, takeout financing may be available either on a junior secured basis that ranks behind the second lien debt or on an unsecured basis, albeit at greater financing cost to the borrower. In that situation, some second lien lenders are not inclined to allow that "new" (refinancing) debt to occupy the first lien slot. In many deals, though, second lien lenders are indifferent to the type of first lien debt they are sitting behind.

Identity of the Borrower. In some holding company transactions in which both the first and second lien loans are made to the same holding company, some second lien lenders have pushed to include a requirement that any debt incurred to refinance the initial first lien debt must be incurred by the initial borrower in order to qualify as "first lien debt." The goal of these second lien lenders is to avoid the structural subordination that would follow for the second lien debt if the refinancing first lien debt was incurred by a subsidiary of the initial borrower. These second lien lenders want to make sure that future first lien lenders don't lend "closer to the assets" than the second lien lenders. Most deals have not included this requirement. The prevailing view among most second lien lenders appears to be that they can protect themselves against changes in the identity of the first lien borrower by getting a guarantee from the subsidiary that incurs the refinancing first lien debt. Another practical difficulty with locking in the identity of the borrower is that the corporate structure of the loan parties often is not locked-in going forward. Under a typical covenant package in a first lien loan agreement, subject to some restrictions, new entities can often be formed, existing entities can sometimes be reorganized and at least some assets can usually be transferred among, and investments made in, members of the borrower credit group. In short, the entity that holds the key assets can change over time. As a result, the "right" borrower today from the second lien lenders' standpoint may be the "wrong" borrower tomorrow.

If the amount of first lien debt exceeds the first lien debt cap, what are the holders of the "excess" first lien debt left with?

Intercreditor agreements frequently provide that only "first lien debt" (as defined) is entitled to the benefit of the intercreditor arrangements with the holders of the second lien debt. "First lien debt" is often defined as debt incurred under the first lien debt documents, subject to a cap on the principal amount of the debt that qualifies as first lien debt. If this is the case, debt up to the first lien cap, which we will refer to as "qualified first lien debt," qualifies for first lien debt status. On the other hand, the principal amount of any debt in excess of the first lien debt cap (and interest on that excess amount) are disqualified from treatment as first lien debt. Any such "disqualified first lien debt" gets none of the contractual benefits given to "qualified" first lien debt under the intercreditor agreement.

The problems for the holders of disqualified first lien debt do not end there. In addition to being stripped of all the contractual benefits assigned to qualified first lien debt in the intercreditor agreement, holders of disqualified first lien debt may also find themselves stripped of their intended status as secured creditors, depending on the wording of the granting clauses in the security documents for the first lien debt. This is because the security agreements that create the first liens often state that the first liens secure "first lien debt." If disqualified first lien debt does not fall within the definition of "first lien debt," those first liens will not secure the disqualified first lien debt.

If the amount of intended first lien debt exceeds the first lien debt cap, how does the intercreditor agreement allocate the excess among the holders of first lien debt?

This point is rarely, if ever, addressed in the intercreditor agreement. The issue is typically left to the holders of first lien debt to decide among themselves at a later date. At first blush, it may appear surprising that this issue is not tackled head-on in the intercreditor agreement. This is probably because first and second lien lenders, to their credit, have tended to limit intercreditor discussions to "real world" issues. In practice, it is unlikely that first lien lenders will ever cross the first lien debt cap threshold because first lien lenders can generally be relied on to carefully monitor the amount of their committed and funded first lien debt. Also, in many cases, the first lien debt cap includes a cushion over and above the committed and funded first lien debt at closing, which provides at least a partial safety net for first lien lenders and permits some flexibility when refinancing the borrower's debt in the future.

If the amount of intended first lien debt exceeds the first lien debt cap, what are some of the possible allocation mechanisms?

There are a variety of possible allocation methods. We suspect that the issue will be addressed on a deal-by-deal basis and that different solutions may be appropriate for different deals. In this area a one-size-fits-all solution is unlikely to be found.

One approach would be a pro rata allocation across the total amount of intended first lien obligations. The first lien lenders would bear the burden proportionately, regardless of when and how the first lien debt cap was crossed. This approach has the benefit of simplicity. However, at least in some situations, this type of no-fault allocation technique may not sit well with non-offending first lien lenders. Those lenders may argue that it produces an unjust result, allowing the offending lenders to earn all of the economic benefits of exceeding the first lien debt cap, while spreading the risks of that activity across the first lien lender group.

The following example illustrates their concerns. Assume that the first lien debt cap is $10 million and, on day one, the borrower borrows $7 million under a first lien debt facility. Five years later, a second group of lenders (or a subset of the original group) funds another $5 million of what it believes is first lien debt.

Faced with these facts, the lenders under the initial first lien debt facility may well favor a fault-based allocation mechanism, in which the disqualified first lien debt is allocated solely to the debt facility or tranche that caused the first lien cap to be exceeded, in this case, the second $5 million debt issuance. Otherwise, from their perspective, they will end up paying for someone else's mistake.

How this issue is resolved in a given deal may have far-reaching consequences for the members of the first lien lender group. In some deals, if the credit deteriorates, the difference between holding secured qualified first lien debt versus disqualified (and possibly unsecured) first lien debt may be the difference between getting paid in full (or close to it) and being forced to settle for a small fraction of the amount of debt that is owed.

How can first lien lenders protect themselves against the risk that the amount of their debt exceeds the first lien debt cap?

One way for lenders to tackle the problem is to include a clause in the intercreditor agreement that allows first lien lenders to conclusively rely on an officer's certificate from the borrower stating that the principal amount of the debt in question, together with the amount of any existing outstanding or committed first lien debt, falls below the first lien debt cap. This provision is sometimes, but not usually, included in intercreditor agreements.

If second lien lenders foreclose on the shared collateral, who gets the foreclosure proceeds?

The answer to this question may depend on the wording of the turnover clause that is usually included in an intercreditor agreement. At its most basic, a typical "turnover clause" requires second lien creditors to turn over funds received by them to first lien creditors in certain situations.

Stepping back, in a second lien term loan financing, second lien creditors will generally agree to a short remedies standstill of between 90 and 180 days. During that period, second lien creditors are barred from exercising remedies against the collateral they share with first lien lenders. However, once the standstill period expires, first lien lenders usually lose their monopoly on the exercise of remedies, and second lien lenders can move against the shared collateral (as long as the first lien creditors are not in the process of exercising their remedies against that collateral).

A turnover clause is intended as a true-up mechanism in the event that the second lien lenders receive funds they are not entitled to under the intercreditor arrangements. In some deals, the turnover clause states that *any* proceeds of a collateral sale by the second lien debtholders have to be turned over to the first lien lenders. In that case, if the second lien lenders foreclose, they will still have to turn over to the first lien lenders any foreclosure proceeds they receive upon a sale of collateral. But, in other deals, the turnover clause is more ambiguously worded and only requires the second lien lenders to turn over any collateral proceeds received by them *"in violation of the intercreditor agreement."*

The question then becomes: if the second lien lenders foreclose on the collateral once the standstill period ends, do the sale proceeds received by the second lien lenders represent amounts received "in violation of the intercreditor agreement"? If the intercreditor agreement allows the second lien lenders to foreclose on the collateral at the end of a standstill period, the answer to this question is not clear, and may turn on the intent of the parties when they entered into the intercreditor agreement. In our experience, this issue has not generally been addressed in the intercreditor discussions.

If second lien lenders foreclose, who *should* get the foreclosure proceeds?

There are arguments on both sides. First lien lenders will likely argue that allowing second lien lenders to keep foreclosure proceeds is inconsistent with the spirit of the intercreditor arrangements in second lien deals, which traditionally puts first lien lenders ahead of second lien lenders when it comes to the shared collateral. The likely response of second lien lenders is that allowing second lien lenders to foreclose but not to keep the sale proceeds is tantamount to giving them a right without a meaningful remedy.

The practical answer to the question is that, in almost every case, first lien lenders will move against the collateral before the standstill period expires. Few first lien lenders will be willing to give second lien lenders first bite at the collateral apple (particularly if there is a chance that foreclosing second lien lenders can stake a claim on the sale proceeds), so in virtually all cases, this will be a moot point.

If second lien lenders get to keep the foreclosure proceeds when they sell collateral, what are first lien lenders left with?

Under the Uniform Commercial Code, unless the secured party agrees otherwise, a secured party's lien is unaffected by the sale of its collateral. That lien will remain in place until the debt it secures is paid off. But it matters to first and second lien lenders who gets first bite at the sale proceeds, which is why turnover provisions are important to first lien lenders. To illustrate, let's say that the value of the collateral sold by the second lien lenders is $100. The first lien debt and related first lien obligations come to $80, and the second lien debt and related second lien obligations amount to $60. Assume that the intercreditor agreement either does not contain a turnover clause or has a turnover provision which arguably allows the second lien lenders to keep foreclosure proceeds.

If second lien lenders are entitled to the sale proceeds, the second lien lenders will receive the first $60 of the $100 proceeds, which will pay off the second lien debt in full, and the remaining $40 will be applied against the $80 owed to the first lien lenders. This will leave the first lien lenders with an outstanding $40 claim secured by a lien on the sold property.

The outcome is reversed if the first lien lenders are entitled to the sale proceeds. In that case, the first lien lenders will receive the first $80, which will pay off the first lien debt in full, and the remaining $20 will be applied against the $60 debt owed to the second lien lenders. This will leave the second lien lenders with an outstanding $40 claim secured by a lien on the sold property.

For any lender, payment in full in cash is clearly preferable to holding a residual claim on an asset that is in the hands of a third party, and the value of which could decline potentially and erode the prospect of future payment in full.

Conclusions

While first and second lien lenders have made significant progress in identifying and resolving many of the key intercreditor issues, a number of important issues remain on the table, and it continues to be important for both first and second lien lenders to carefully scrutinize the language in their intercreditor agreements. Second lien loans are far from being a commodity product with standardized terms, and, to make matters worse, the devil is very much in the detail.

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