# THE EVER-CHANGING LAYER CAKE OF JUNIOR CAPITAL FINANCING AND INTERCREDITOR AGREEMENTS

**With the surge of junior capital growth in recent years, providers have had to become more creative than ever in structuring their loan documents and intercreditor relationships.**

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Ten years ago, the only junior capital product readily available in the market was the mezzanine loan (subordinated debt). Things have changed dramatically. In the past five years alone, there has been an explosion of new products offered between senior debt and common equity. These products are commonly referred to as junior capital. As an asset class, junior capital has grown exponentially over the past several years.

The robust M&A and buyout markets have helped fuel this growth as hedge funds, CLOs (collateralized loan obligations), BDCs (business development companies) SBICs (small business investment companies) and mezzanine funds, among others, have competed to find and finance the most attractive deals. This competition has forced junior capital providers to become more creative in structuring their loan documents and intercreditor relationships. Junior capital is no longer a one-trick pony, but rather a layer cake of financing options. To describe junior capital as mezzanine debt and second lien debt ignores the reality of the complex and diverse structures that now exist.

We will describe below some of the more commonly seen layers in the junior capital cake as well as some of the more exotic structures. For brevity's sake, we will not discuss a number of other products that regularly cross our desks such as holdco notes, toxic holdco notes, redeemable preferred stock, convertible preferred stock and the like. While some of the layers have now become permanent fixtures in the market, we expect that structures and terms will continue to evolve as competition in junior capital market increases and lenders and their lawyers look for a competitive advantage to win deals.

## The Traditional Mezzanine Layer

The traditional unsecured mezzanine loan remains an active and robust part of the junior capital world. Mezzanine loans have been around for a long time, and the intercreditor agreements in these deals have become "market" on many basic terms. A mezzanine loan is unsecured and subordinated to the senior lender's loan with respect to the right to receive payments. A mezzanine loan has a cash coupon of 10 to 18 percent, and often has an additional noncash coupon of two to four percent that is paid-in-kind (PIK) by the issuance of additional notes. It is sometimes accompanied by warrants to purchase common or preferred stock of the borrower. The significant components of the intercreditor agreement for this layer are:

- *Payment subordination.* Upon the occurrence of an event of default under the senior credit documents, payments on the subordinated debt are typically blocked for 180 days (and typically blocked permanently if there is a payment default). During this blockage period, the subordinated lender cannot receive payments on the subordinated debt.
- *Remedies standstill.* Another cornerstone of the mezzanine structure is the remedies standstill. During the remedies standstill (typically 120 to 180 days), the subordinated lender is prohibited from exercising remedies or taking enforcement action against the borrower for breach of the mezzanine loan agreement.
- *Cap on senior debt.* From the subordinated lender's perspective, probably the most important provision in the subordination agreement is the cap on senior debt. In these agreements,

there is typically a cap on the amount of senior debt that can be piled on top of the subordinated debt—usually consisting of the amount of senior debt committed at closing plus a 10 percent cushion.

- *Restrictions on amendments.* The subordination agreement also contains restrictions on amendments to the senior and mezzanine documents with respect to, among other things, interest rates, extending maturity dates and tightening covenants.
- *Freedom to act in bankruptcy.* In a bankruptcy the unsecured mezzanine creditor is free to pursue its rights as an unsecured creditor and to object to actions taken by the senior lender (with the exception of attacking the senior lender's lien or claim).

## The Secured Mezzanine Layer (The Silent Second)

A secured mezzanine loan is the same as a traditional mezzanine loan except that the mezzanine lender receives a lien on the assets of the borrower. This lien is essentially no different from the lien that the senior lender obtains against the assets of the borrower. The subordinated lender has its own security agreement. Its lien is perfected by UCC filings, mortgages, control agreements and the like. The security agreements provide for all the rights and remedies that you would find in the first lien security agreements.

The differences are found in the intercreditor. The second lien is "silent" because the mezzanine lender agrees to limit its rights and remedies under its security agreements. A mezzanine lender with a silent second lien typically cannot take foreclosure actions against the collateral until the senior debt is paid in full. All of the rights and remedies set forth in the security agreements that allow the mezzanine lender to take collateral, foreclose on collateral, liquidate collateral, etc. are limited under the terms of the intercreditor agreement.

The silent second lien lender agrees to discharge its lien if the first lien lender is discharging its lien, regardless of whether the underlying sale provides any proceeds to the mezzanine lender. In a bankruptcy, a secured mezzanine lender typically agrees to waive all of the enhanced protections that it is entitled to receive as a result of its status as a secured creditor, such as the right to seek adequate protection or postpetition interest with respect to its secured claim. All of the other bells and whistles in a traditional mezzanine intercreditor are in effect—the standstill, the blockage periods, the limits on senior debt, etc.

To get the benefits of the lien, the mezzanine lender must accept a fundamental premise: it will not use its lien as a sword against the senior lender. The value is purely downside protection. To the extent the borrower liquidates or is sold, the mezzanine lender with the silent second lien is a secured creditor that must be paid in full before any unsecured creditors are paid. So, by obtaining a silent second, a mezzanine lender leapfrogs the unsecured creditors (including trade creditors) and ensures that it will be paid before them in a sale or liquidation.

## The Private Second Lien Layer

The rise of the second lien market is well documented, and the second lien, virtually unheard of five years ago, now occupies a significant (and permanent) portion of the layer cake. But what you may hear or read about the second lien market often does not tell the full story.

There are two second lien markets: the private or "club" market and the syndicated market. The private market is dominated by traditional junior capital investors and hedge funds. The syndicated market is dominated by CLOs, prime funds, and ratings oriented investors.

The terms of the intercreditor agreements in these two markets vary dramatically. The easiest way to determine if you're faced with a syndicated second lien is whether you have leverage in negotiating the intercreditor agreement. To the extent that the issues discussed below are not well received—in fact, it is common in the syndicated market that they will be rejected in total—you know you're in the syndicated market. The reason: in the syndicated market the deals are oversubscribed and many lenders do not even read the documents. Hence, there is little or no negotiating leverage. In contrast, in the private market there are typically a handful of lenders in a deal (typically two or three) and these lenders aggressively negotiate the terms of the intercreditor agreement.

In the private market, the major friction points in the intercreditor agreement are:

- *"Plumber Rights"—Preserving Unsecured Creditor Rights.* A second lien lender doesn't want to be treated worse than an unsecured creditor (e.g., a plumber with an overdue invoice). The plumber issue is one that ripples through the intercreditor agreement—often there are waivers of the right to object to asset sales, foreclosure actions, debtor-in-possession financings, etc. A plumber has the right to object to all of these actions; so should second lien lenders. A second lien lender should only waive its right to object to these matters in its capacity as a secured creditor.
- *Cap on First Lien Debt.* Similar to a mezzanine loan, a second lien loan typically has a cap on the amount of the first lien debt. The cap is usually the amount of first lien debt committed at closing plus a 10-percent cushion. The cap is then reduced by payments on the term loans (amortization, prepayments, etc.) and by permanent reductions in the revolving commitments. There is also typically a "waterfall" that subordinates payments on the first lien debt in excess of the cap until the second lien is paid in full. Other negotiated items include whether there are separate caps for hedges and bank products and whether changes can be made to the borrowing base that would increase the amount of credit available to the borrower.
- *The Scope of the Standstill.* The heart of a second lien intercreditor is the standstill. The standstill prevents the second lien lender from pursuing

its remedies against the collateral. The standstill period runs anywhere from 3 to 180 days, depending on the type of collateral (e.g., collateral that declines rapidly in value, such as produce, typically has a shorter standstill). The standstill generally commences upon an event of default. Then the second lien lender must refrain from pursuing any secured creditor remedies against the borrower's assets until the standstill expires.

One major distinction between a second lien intercreditor agreement and a mezzanine intercreditor agreement is that there is no payment subordination in a second lien intercreditor. Also, no general remedies standstill prevents the second lien lender from demanding payment or accelerating its debt.

- *"Big Boy" Risk.* First lien lenders often seek to add a mezzanine concept to the intercreditor agreement that provides which, if the first lien is avoided, subordinated or otherwise set aside in a bankruptcy or otherwise, the second lien lender is still required to turn over any proceeds it receives from the collateral, as if nothing happened. Second lien lenders generally take the position that the lenders are all "big boys" and each is responsible for ensuring that their liens are valid and enforceable. A number of compromises to settle this issue have grown out of battles between first lien and second lien lenders over the years.
- *Amendments to Documents.* First lien lenders and second lien lenders agree that certain amendments to their documents are not permitted without the other's consent. First lien lenders typically agree not to exceed the first lien debt cap or increase interest rates beyond a certain number of basis points. But other limitations are usually discussed, such as limits on extending or accelerating maturity dates or amortization payments, caps on recurring fees, subordination of the first lien debt to other debt, tightening or adding covenants or events of default. The second lien lender often insists that limits on amendments be reciprocal; that is, no tighter restrictions on the second lien than the first lien.
- *Release of Liens.* First lien lenders would like second lien lenders to discharge their liens if the first lien lenders are prepared to do so. Second lien lenders certainly agree that their liens will be released to the extent the release is permitted under the second lien documents. Where they stop short, however, is when the first lien debt is foreclosing after event of default or where the borrower decides to sell its assets after the event of default. The first draft of an intercreditor agreement often provides that the second lien is automatically discharged. Second lien lenders object to this provision desiring the ability to determine the "commercial reasonableness" of the sale before their liens are discharged.
- *Adequate Protection.* Second lien lenders want to retain the right to seek adequate protection in a bankruptcy proceeding like all other secured creditors. To the extent they are allowed to seek protection, the issue becomes what happens when they receive it. If the adequate protection is in the form of cash, the parties then negotiate how the cash is to be applied. If the adequate protection is in the form of a lien on post-petition assets, the second lien lenders generally agree to subordinate their lien to the lien of the first lien lender.
- *Bankruptcy Issues.* Several bankruptcy issues arise in second lien intercreditor agreements. These issues may relate to retaining "plumber rights," the ability to object to debtor-in-possession financing and 363 sales; whether the second lien lenders can seek relief of the automatic stay, etc.
- *Purchase Options.* Almost all private second lien deals contain a purchase option. It allows the second lien lender to purchase the first lien debt at par. The issues that frequently arise in negotiating purchase options are the triggers for the option, the scope of the option and the time period the option is exercisable. Triggers for the option typically include one or more of the following: a first lien default, a payment default on the first lien or the second lien, a first lien acceleration event or an exercise of remedies by the first lien lender. The parties also negotiate whether the second lien lenders are required to compensate the first lien lenders for prepayment penalties, bank product obligations and amounts in excess of the first lien debt cap. Often, the par-

**FIRST LIEN LENDERS OFTEN SEEK TO ADD A MEZZANINE CONCEPT TO THE INTERCREDITOR AGREEMENT THAT PROVIDES WHICH, IF THE FIRST LIEN IS AVOIDED, SUBORDINATED OR OTHERWISE SET ASIDE IN A BANKRUPTCY OR OTHERWISE, THE SECOND LIEN LENDER IS STILL REQUIRED TO TURN OVER ANY PROCEEDS IT RECEIVES FROM THE COLLATERAL, AS IF NOTHING HAPPENED.**

ties also discuss whether the purchase option will be "evergreen" or whether it terminates after a certain period of time (a "use it or lose it" option).

- *Voting on a Plan of Reorganization.* The second lien lender will insist on having the unfettered right to vote on a plan on reorganization. This is generally nonnegotiable.
- *Removal of Agent.* In first lien-second lien structures, the agent of the first lien is often the agent for the second lien. The second lien lenders will want to make sure that they have the ability to remove the first lien agent as their agent after an event of default. The concern is a practical one. Will the first lien agent pursue remedies on their behalf, especially if the second lien lenders are exercising "plumber rights" and objecting to actions of the first lien lenders? Given that time is often of the essence, any delays in exercising the right could prove detrimental to the second lien lenders.

## The Syndicated Second Lien Layer

In the syndicated world, there are typically a number of second lien lenders interested in a particular credit. It is a competitive process. If a second lien lender decides to argue about the terms of the intercreditor agreement, generally other lenders are willing to step in and take their allocation. Competition for deal flow is intense, and this competition limits the ability of prospective second lien lenders to negotiate the terms of intercreditor agreements. In these agreements second lien lenders provide extensive waivers of their rights. Many issues that they found successful in negotiating in private deals are lost in these negotiations; for example: the ability to object to a release of collateral, a debtor-in-possession financing or a sale of assets, and the ability to retain "plumber rights" both prior to and during a bankruptcy.

In a syndicated deal, the second lien lenders are often worse off than unsecured creditors. The standstills are typically longer than in private deals and typically cannot be commenced until the second lien debt is accelerated. No limits exist on the ability of the first lien lender to make amendments to its documents, other than amendments that would result in a breach of the first lien debt cap or an increase in the interest rate beyond a negotiated number of basis points. In a syndicated second lien transaction, the second lien lenders are treated more like equity than debt. This is completely different from a private second lien deal. Thus, an investor considering a purchase of a syndicated second lien loan should be cognizant of the obligations that it is stepping into under the intercreditor agreement. This is especially important for distressed investors.

## The Split or Reciprocal Collateral Layer

The split collateral deal has become more common as different types of lenders with different risk profiles team up to get deals done. Where one lender is a working capital lender and the other is an enterprise value lender, a split collateral deal makes sense. These deals are typically structured in the following manner: The working capital lender takes a first lien on the working capital assets—cash, receivables and inventory. The enterprise value lender takes a first lien on the remaining assets—typically hard assets such as real estate and equipment. Then, each takes a junior lien on the other's assets. To illustrate: the working capital lender with a first lien on the liquid assets takes a second lien on the hard assets. Similarly, the enterprise value lender with a first lien on the hard assets takes a second lien on the liquid assets.

The intercreditor negotiations in these types of deals are limited. The parties typically agree to leave the other party's collateral alone. The working capital lender generally has the ultimate right to proceed against the liquid assets without any blocks or limits from the enterprise value lender, and the enterprise value lender has a similar right to proceed against the hard collateral without any interference from the revolving lender. The intercreditor agreement primarily deals with lien subordination. The key issue in these deals is access to the collateral. The working capital lender needs access to the premises, equipment and books and records to complete work in process, and to liquidate inventory and receivables. The enterprise value lender wants to ensure that it is adequately indemnified for any damage to its collateral from the use by the revolving lender and adequately compensated for any costs and expenses that occur, such as keeping the lights on or maintaining security.

## The Last-out Layer

The last-out structure has been around for a long time. Unlike the previous layers, this layer simply has one credit agreement with a payment waterfall that provides that one tranche of the debt within the credit facility will be paid out last, after a senior "first-out" tranche is paid in full. All mandatory prepayments and liquidation proceeds are paid to the first-out lender before the last-out lender receives any proceeds.

In these structures, an agreement often notes how the various tranches of lenders are to interact with each other. Sometimes it is a simple agreement where lenders which hold a requisite percentage of the loan will control all matters (e.g., lenders who hold more than 50% of the outstanding principal amount of the loan will control waivers and amendments). Other times, a complex intercreditor or interlender agreement will specify the rights associated with each tranche of debt (e.g., which class of lenders control enforcement actions and which class of lenders are subject to a standstill, which lenders control amendments and which lenders have consent rights over certain items, etc.).

The parties must work through the credit documents and decide who has control and veto rights with respect to specific issues. The control of the issues may also flip back and forth as leverage of the company goes up and down or as the amount of the debt each lender

holds goes up and down. Negotiating these agreements is often the most difficult part of the transaction.

### The Unitranche Layer

A unitranche deal is similar to a last-out deal in that it has one loan agreement. But unlike the last-out deal, a unitranche has one tranche of debt where the blended cost of capital is roughly equal to that in a multitranche transaction. Loans can be held by one lender, sold off in strips or sold off in first-out, last-out pieces. Similar to a last-out transaction, the intercreditor arrangements can range from no intercreditor (relying on the required lenders vote), to a very complex intercreditor agreement that may be negotiated behind the scenes (without the company or the sponsor's knowledge).

### The Synthetic Layer

Synthetic structures have most often been used to replicate the economics and intercreditor relationship of a traditional mezzanine loan. A synthetic structure is a one-loan agreement structure (a one-stop or unitranche loan). From the borrower's perspective, all of the lenders are participating in the same tranche with the same pricing. But behind the scenes a synthetic senior tranche is created by an intercreditor agreement. It is typically a complicated and highly negotiated intercreditor agreement. The agreement attempts to create synthetically a typical mezzanine structure. It may provide for remedy standstills and payment blocks as in a mezzanine agreement. It may provide the junior lender the ability to consent to amendments or waivers of the financial covenants if the deviation from the stated covenant is more than 10 to 15 percent. A mutual buyout option often exists where the senior and the junior lender can buy each other out upon certain triggering events.

The advantages of the synthetic structure are numerous. The junior lender has a first priority security interest in the borrower's assets. There is faster execution with a one-stop loan than with a series of multitranche financings. The junior capital lender has more ability to control changes to the first lien document than in traditional structures. The junior claim is classified together with the rest of the first lien in a bankruptcy, which allows for postpetition interest to the extent that the first lien is over-secured. The junior claim is also entitled to adequate protection payments, which is not customary in a traditional mezzanine transaction.

There are also serious disadvantages in a synthetic structure. There is only one loan agreement, and that agreement is unable to provide both sets of lenders with the rights that they are accustomed to receiving. For example, a junior lender's unilateral right to control its destiny with respect to calling defaults or agreeing to a waiver is curtailed. Instead, the intercreditor agreement specifies the circumstances in which the junior lender has influence. If the junior lender becomes a lender by assignment after the deal has been cut with the borrower, the junior lender has little-to-no leverage to amend the agreements with the borrower. In these structures, junior creditors typically do not have a separate agent for their tranche. Instead, they need to direct the first lien agent to take action, which may be impractical in a restructuring or default situation. Borrowers are typically unaware of the synthetic structure, which may result in contentious discussions, or perhaps litigation, as these synthetic structures unwind in a workout or bankruptcy proceeding.

### The Upside Down Layer

One of the newest and most exotic pieces of the layer cake is the "upside down" intercreditor or the "silent first lien." An upside down, silent first lien provides the senior lender with first-out rights with respect to payments and proceeds from collateral. The first-out lender often receives increased pricing in exchange for ceding control of the credit to the second lien lender until the occurrence of a triggering event (often a payment default or a material breach of a financial covenant). But otherwise, the first lien is silent; it has little covenant protection and also has limited control prior to a triggering event. The first lien may be "dragged" into amendments and waivers to the first lien documents, as long as a corresponding amendment or waiver is being made to the second lien documents. The upside down intercreditor agreement reverses the usual situation where the first lien lender has the most control over what happens when the borrower violates covenants. In this structure, senior lenders' rights are limited to those that are usually afforded to the second lien lender. This structure is not for every deal. In a typical deal, the second lien is much larger than the first lien and the first-out lender is often in a solid collateral position.

While we have done a number of these transactions, so far none of the traditional first-lien, regulated lenders have bought into a silent first deal. But it is clearly a product that has traction as lenders are trying to find new ways to compete for deals. Whether this upside down product will survive a pull back in the debt markets, is unclear. It may fall in the wake of the covenant-lite deals that seemed to be everywhere, and then all of sudden disappeared without trace.

The layer cake of junior capital has evolved to meet the needs of the market. Some of the layers we have discussed are growing while others are shrinking. Some are not changing; others are. The greatest opportunity for lenders who play in this space is understanding the complexities of junior capital layer cake and embracing this change. New layers will be added to the cake in the near future as the market conditions change and as distressed debt players look to junior capital as a fertile ground to feed their next wave of deal flow. TSL

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