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The dilemma of the second lien lender

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In less than two years, second lien loans have transformed from a relatively unknown financing alternative in the United States to the fastest growing, and most commonly misunderstood, junior capital solution. According to Standard & Poor's Leveraged Commentary data, over $12bn in second lien loans were made in 2004. Recent reports show that the volume of second lien loans is continuing to accelerate, with over $5bn of second lien loans completed through March of this year.

Competition is increasing

As the volume of second lien loans continues to grow, so does the competition. This competition is placing tremendous downward pressure on the anticipated yield of second lien lenders. The primary driver of this competition has been the flood of new entrants to this space. Business development companies, hedge funds, mezzanine funds and banks looking for more deal flow have joined the market with "one-stop" shops that provide senior debt, second lien debt, mezzanine debt and preferred equity at the same time and often in the same set of documents.

At the same time, it is becoming more difficult for second lien lenders to find quality product. Total leverage is continuing to increase, and the percentage of second lien deals with full asset coverage is rapidly declining. In fact, many second lien deals these days are cash flow deals, or deals with a significant "airball" component. While second lien lenders are commonly thought of as asset based lenders looking for collateral coverage above and beyond the first lien credit, many second lien lenders, in fact, are enterprise value lenders who are looking for some asset coverage but are evaluating the value of the enterprise as a whole to make their credit decisions.

The dilemma

Once the second lien lender finds a loan it likes from a credit and asset coverage standpoint, it is then confronted with a first lien lender who is becoming increasingly more difficult in intercreditor negotiations. While term sheets for second lien deals spell out the economics in reasonable detail, they often gloss over the terms of the intercreditor agreement, providing simply that the intercreditor will be "customary". Some day there may be customary terms for second lien intercreditors, but we are not there yet.

As a result of the increasing demands of first lien lenders, second lien lenders are faced with a dilemma. On the one hand, the yield on second lien loans, while declining, still remains attractive. On the other hand, if the second lien lender acquiesces to some or all of the demands of the first lien lender, it is taking mezzanine financing risk (or possibly worse) on normal creditor right issues without receiving a mezzanine like return.

Second lien intercreditors generally

To put the recent demands of first lien lenders in perspective, it is useful to understand the terms that are typically included in second lien intercreditors. Second lien lenders generally only agree to subordinate their liens and their rights as secured creditors. In a nutshell, lien subordination involves subordinating the rights of the second lien lender to receive proceeds from the common collateral to the rights of the first lien lender. The second lien lender also agrees to "stand still" for a period of time (typically 90 to 180 days) and not to pursue its rights to foreclose upon or otherwise exercise remedies against the common collateral. The standstill period allows the first lien lender time to work through the problem with the borrower before the second lien lender is ▸▸

permitted to pursue its rights against the collateral. The second lien lender is otherwise free to pursue its other rights as a creditor to seek payment and to enforce the terms of its agreements (such as declaring a default, accelerating the loan and commencing litigation to enforce its other rights and remedies).

In a typical second lien financing, there is only lien subordination, not payment subordination. In a mezzanine transaction, payment subordination is customary and requires the junior lender to turnover to the senior lender any payments received in respect of the junior debt after the occurrence of an event of default, regardless of the source. The period of payment subordination varies, but in a typical mezzanine transaction, it is often 120 to 180 days for non-payment defaults and permanent for a payment default. During the payment block, the mezzanine lender is restricted from pursuing its rights as a creditor to seek payment and to enforce the terms of its agreements (such as declaring a default, accelerating the loan and commencing litigation to enforce its other rights and remedies).

Recent demands

In recent months, first lien lenders have become increasingly more aggressive in demanding that second lien lenders waive some of their key rights as unsecured creditors and agree to terms more typically found in mezzanine intercreditor agreements. Some recent demands by first lien lenders include:

- payment subordination
- permanent standstills on exercising remedies under junior lien documents upon a first lien payment default
- a block on the second lien lender's ability to accelerate its loan upon a default
- automatic amendments and waivers to the second lien agreements, to correspond with amendments and waivers to the first lien agreements
- waiver of rights to object to actions undertaken by the first lien lender, placing the second lien lender in a worse position than if it were an unsecured creditor (e.g., cannot object to dispositions of collateral or debtor in possession financing by the first lienholder on any grounds)
- turnover of adequate protection payments received by the junior lienholder in an insolvency proceeding (i.e., payment subordination)
- significant step-backs on financial covenants and baskets in restrictive covenants, such as dollar caps on asset sales
- limits on amendments to the second lien agreements other than those that are immaterial and ministerial
- control over all pleadings and motions filed in connection with an insolvency proceeding
- eliminating the ability of the second lien lender to commence an insolvency proceeding or appoint a trustee or receiver.

In many cases, acceding to the list of demands of the first lien creditor will leave the second lien lender in a worse position than if it were a mezzanine lender and often worse than an unsecured creditor with a small claim – such as a plumber with an overdue invoice. There are circumstances in which the second lien lender should, and often does, concede rights that unsecured creditors are free to pursue (such as the right to challenge the lien and claim of the first lien lender). As a general proposition, however, second lien lenders should retain the rights afforded to unsecured creditors, including the rights to object to actions taken by the first lien lender, and agree only to forego the additional rights that they receive as a result of receiving a lien. Second lienholders must draw the line to preserve the rights that, at a minimum, an unsecured creditor would have, resist any payment subordination, and retain the right to act as a secured creditor after a certain standstill period. Absent these protections, the lower pricing of these loans does not match the subordination risk.

Conclusion

The recent demands of first lien lenders have created a dilemma for second lien lenders. In the search for yield, second lien lenders are increasingly facing provisions in intercreditor arrangements that could leave them in a worse position than if they did not have a lien. Most second lien lenders are resisting the urge to participate in a race to the bottom. Given the tight spreads on second lien loans and the lack of complete asset coverage in many deals, second lien lenders should continue to resist a further erosion of their rights as creditors.

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