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"SECOND LIEN" LOANS

Executive Summary: Second Lien lenders used to review only a chosen borrower's enterprise value or asset value to determine if it will exceed the value advanced against by a senior secured lender. Today, Second Lien lenders create a broad range of structured finance products to meet the needs of a borrower's circumstances and capital structure, rather than adhering to a strict borrowing formula. This article discusses Second Lien financing structures in detail.

Special Report

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SECOND LIEN LOANS

In today's competitive finance market, creative, complex financing structures give rise to many different classes and types of lien priorities. Because of desired market flexibility, secured lenders are often approached by borrowers with a request to allow another lender into the deal with a secured lien on some or all of the borrower's assets. One relatively new layer of debt, known as a "tranche b" or "second lien" loan, has become a recognized part of the capital structure of sophisticated financings. The second lien loan stems from the concept that a borrower's enterprise value or asset value will exceed the value of what typical senior secured lenders ("First Lien Lenders") are comfortable advancing against for that borrower. Second lien financing differs from traditional subordinated financing in that the second lien lender ("Second Lien Lender") typically subordinates only its lien position and not its right to receive payment on the debt. From the borrower's perspective, there are often advantages to having access to second lien loans, such as having an additional source of capital and access to interest rates typically lower than those found in more traditional subordinated or mezzanine debt deals, which often outweigh the potential disadvantage of having multiple layers of secured financing.

In general, the First Lien Lender provides a working capital loan secured by a first priority lien on, and security interest in, all of the borrower's assets. The Second Lien Lender usually provides a term loan secured by a second priority lien on, and security interest in, all or substantially all of the borrower's assets.[1] A Second Lien Lender does not typically demand warrants or other equity incentives as part of its terms, but this feature may be negotiated as part of the structure. A second lien on all of the borrower's assets provides the Second Lien Lender with the benefits of having secured creditor rights, the most critical being its position ahead of trade creditors. For First Lien Lenders, this collateral positioning is at the crux of the negotiations of the intercreditor agreement–determining the secured creditor rights of the Second Lien Lender in relation to the First Lien Lender, and what rights the Second Lien Lender will waive, subordinate or stall, and for what period of time.

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After an initial period of fluctuation and settling, a range of "market" terms for this category of second lien loans has gradually evolved and is becoming more standardized. First and Second Lien Lenders must familiarize themselves with this range of "market" terms, summarized below, in order to practically and effectively structure and negotiate a transaction with multiple layers of secured financing.

Separate Loan Documents

The First Lien Lender should always demand that it maintain its own set of loan documents separate from the loan documents of the Second Lien Lender, including separate UCC financing statements evidencing its separate lien. Maintaining separate loan documents will ensure the First Lien Lender that it does not have a "single secured claim" along with the Second Lien Lender. Specifically, if a bankruptcy court concludes that the security interest in the assets of the borrower covers both the First Lien Lender and the Second Lien Lender, a bankruptcy court could characterize the claims as a "single secured claim." As a consequence, the First Lien Lender risks a bankruptcy court determining that it is undersecured and collaterally impaired, and the court may deny post-petition interest, fees and costs to the First Lien Lender, and diminish the level necessary to provide the First Lien Lender with adequate protection. Moreover, by distinguishing its secured claim from that of the Second Lien Lender, the First Lien Lender:

- avoids having to act as the Second Lien Lender's "agent" during a bankruptcy;
- averts complicated voting issues with respect to the borrower's plan of reorganization;
- avoids certain equitable subordination risks in transactions where the Second Lien Lender receives equity in the borrower or the ability to affect decision-making concerning the borrower; and
- minimizes the risk of being "crammed down" (*i.e.*, forced to unwillingly accept a plan of reorganization).

With respect to the Second Lien Lender's loan documents, to the extent they contain provisions that track those in the First Lien Lender loan documents (which they typically do), First Lien Lenders typically require that any default trigger in the Second Lien Lender loan documents must have a cushion of at least 10% to 20% with respect to covenants and grace periods. This ensures that the covenants and grace periods under the second lien loan documents are triggered after, or no sooner than, the covenants and grace periods under the First Lien Lender loan documents. Moreover, First Lien Lenders often take the position that the second lien loan documents should not contain automatic cross-defaults to the First Lien Lender's loan documents, which requires that appropriate cushions and grace periods be built into these provisions as well.

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Debt Payments to Second Lien Lender

The First Lien Lender should not always expect the Second Lien Lender to subordinate scheduled payments on the outstanding debt owed to the Second Lien Lender by the borrower. Permitting a borrower to make payments of scheduled interest (both pre-default and post-default) to a Second Lien Lender is gaining widespread acceptance, and interest payment blockages are no longer customary in these deal structures. In certain cases, the Second Lien Lender may even have scheduled amortization prior to the maturity of the First Lien Lender's loan, or be entitled to participate with the First Lien Lender in excess cash flow sweep payments. Even though these terms are becoming more customary, any requests by a Second Lien Lender for such concessions must be carefully analyzed by the First Lien Lender. If the First Lien Lender permits any principal payments to the Second Lien Lender, the First Lien Lender should have the ability in a default scenario to "block" such payments. Often, any payments that are blocked may later be permitted in circumstances where pre-established hurdles are met by the borrower, with any hurdles measured after giving effect to payments made to the Second Lien Lender. Examples of these hurdles include:

- borrower maintaining a minimum level of liquidity;
- no events of default under the First Lien Lender loan documents; and
- scheduled payments to the First Lien Lender are current or made in full.

Priority of Security Interests

The First Lien Lender's lien must have priority in right and time over the Second Lien Lender's lien, except for instances where different collateral packages are negotiated and the Second Lien Lender is granted certain priority collateral. Where there are two secured lenders, the First Lien Lender would prefer that the Second Lien Lender have a "silent" second lien. As a general matter, a second lien is silent if the lien holder contractually agrees not to exercise some or all of its secured creditor rights until the First Lien Lender is paid in full. The four primary elements of a "silent second" lien include:

- prohibiting or limiting the right of the Second Lien Lender from taking enforcement actions with respect to its lien;
- agreement by the Second Lien Lender not to challenge enforcement or foreclosure actions taken by the First Lien Lender (possibly subject to time limitations);
- prohibiting the right of the Second Lien Lender to challenge the validity or priority of the first lien; and
- certain other waivers (or limitations) of other secured creditor rights, such as certain waivers in bankruptcy or waivers concerning "adequate protection."

Today's Second Lien Lenders are no longer willing to agree to remain completely silent, and there will likely be at least some negotiation by Second Lien Lenders on the above points. It is typical and customary for the First and Second Lien Lenders to agree that, until the obligations owed to the First Lien Lender are indefeasibly paid in full in cash, the First Lien Lender will have the exclusive right to manage and dispose of the collateral without interference (at least for a significant period of time) from the Second Lien Lender.

"In general, Second Lien Lenders will usually agree to a 180-day standstill period, depending on the nature of the deal."

Standstill Provisions

The period of time in which the Second Lien Lender agrees to forbear from exercising its rights and remedies as a secured creditor is referred to as a "standstill" period. An enforcement standstill period is critical to providing the First Lien Lender with the opportunity to determine whether it wants to accelerate and exercise rights and remedies against the collateral, or permit the Second Lien Lender to exercise such rights and remedies. The First Lien Lender should require that the standstill period commence upon receiving notice from the Second Lien Lender of the Second Lien Lender's actual acceleration of the borrower's obligations, rather than just relying upon the Second Lien Lender's "intent" to accelerate. In general, Second Lien Lenders will usually agree to a 180-day standstill period, depending on the nature of the deal. In addition, the Second Lien Lender should not be permitted to commence any enforcement action if the First Lien Lender is diligently pursuing, in good faith, the exercise of its lien enforcement rights against all, or a material portion, of the collateral. Second Lien Lenders have been successful, however, in negotiating the ability to exercise rights available to unsecured creditors, such as:

- the right to request appointment of a trustee or examiner;
- the right to request dismissal or conversion of the borrower's bankruptcy case;

- the right to vote against and object to plan confirmation or to propose a creditor's plan; and

- a limited right to reclaim goods sold to the debtor or to stop the transit of the goods.

Release of Collateral

A Second Lien Lender should agree in advance to release its lien on the collateral, at the First Lien Lender's request, upon the occurrence of certain "Release Events," which may include:

prior to an insolvency proceeding,

- the occurrence of an event of default under the First Lien Lender loan documents; and

- the First Lien Lender's exercise of rights and remedies against collateral.

after an insolvency proceeding,

- a sale pursuant to a confirmed plan of reorganization or liquidation;

- a sale in a bankruptcy proceeding of one or more assets, free and clear of all liens, claims and encumbrances (a "Section 363 sale"); and

- an order by the bankruptcy court to vacate the automatic stay under Section 362 of the Bankruptcy Code to allow the First Lien Lender to exercise its enforcement rights against the collateral.

If the Second Lien Lender is permitted to release collateral, it is important to note that the intercreditor agreement should direct that all proceeds from the sale of the collateral must be used to (i) permanently pay down the First Lien Lender loan, or (ii) pay it down pursuant to the previously negotiated "waterfall" provisions in the intercreditor agreement. In addition, under the Uniform Commercial Code, every aspect of a disposition of collateral must be "commercially reasonable."

Modifications to Credit Agreements

The intercreditor agreement between First and Second Lien Lenders typically includes a cap on the amount of indebtedness owed to the First Lien Lender in order to prevent the First Lien Lender from arbitrarily adding debt ahead of the Second Lien Lender's lien priority. Specifically, any cap on the First Lien Lender's debt is usually the maximum amount of the first lien revolving loan facility, plus a "cushion" (often 10%), or the lesser of (a) the maximum revolving loan amount under the first lien loan documents, and (b) 110% of the borrowing base availability, *plus* the amount of any first lien term debt (less any permanent deductions), *plus* treasury function (such as hedging) indebtedness, *plus* an additional amount for advances required for collateral protection. The parties will often negotiate provisions regarding the consequences of exceeding the senior debt cap, but possible allocation methods must be dealt with at the First Lien Lender level among the syndicate members on a deal-by-deal basis.

The current trend relating to interest rates is to limit their increases under the loan documents to 200 basis points. It is also customary for the First Lien Lender to agree with the Second Lien Lender not to amend its loan documents to change borrower's covenants in a way that would accelerate the scheduled dates of permitted principal payments on the second lien loans, or extend the maturity date of the first lien loan. In addition, it is customary for the First Lien Lender to agree not to waive a default by its borrower under the First Lien Lender's loan documents, where such default is triggered solely by a nonpayment default under the second lien loan documents. This concession is typically made under the theory that "technical" defaults by the borrower may not rise to the level that requires triggering the intercreditor standstill provisions.

We also believe the current trend is for the First Lien Lender to refuse limitations on its ability to otherwise amend its loan documents and limitations on its ability to:

- shorten the final maturity;
- accelerate or change the amount of payments (in a non-default situation);
- release or implement reserves;
- change the borrowing base or eligibility criteria;
- increase or add fees; and
- waive a payment default.

Retaining the ability to amend its loan documents protects the First Lien Lender from changes or events that could impact a borrower's condition and performance in a credit, or any changes or material events which could impact the collateral. Alternatively, Second Lien Lenders are generally prohibited from modifying their loan documents in any manner adverse to the First Lien Lenders or in any respect that makes the provisions less restrictive or more burdensome on the borrower.

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Bankruptcy

In order to maximize repayment of the borrower's obligations, a First Lien Lender must have flexibility to restructure the debt in a bankruptcy situation. In this respect, it is typical for the First Lien Lender to substantially curtail the Second Lien Lender's rights to participate in a bankruptcy proceeding. It is also typical, within the context of the intercreditor agreement, for the First Lien Lender to grant the Second Lien Lender the ability only to file a proof of claim. However, the Second Lien Lender does not want to be forced into a position behind unsecured creditors if it gives the First Lien Lender certain contractual up-front bankruptcy-related consents or waivers in the intercreditor agreement. The most common intercreditor waivers and consents provided by a Second Lien Lender in an intercreditor agreement include adequate protection waivers and advance consents concerning:

- use of cash collateral;
- sales of collateral; and
- debtor-in-possession ("DIP") financing by the First Lien Lender.

The practical significance of the adequate protection waivers varies depending on the facts of each case. The principal benefit of adequate protection is the right of a secured creditor to request additional or substitute collateral to protect against declines in value of the collateral after the commencement of the bankruptcy case. Second Lien Lenders typically waive any right to dispute actions taken by First Lien Lenders to seek adequate protection with respect to the collateral securing the First Lien Lender. Such a waiver is not particularly controversial and is not usually subject to any time limitation.

Second Lien Lenders also typically provide advance consent to any use of cash collateral approved by the First Lien Lender. Without such waiver, the Second Lien

Lender could restrict the borrower's activities and thereby force a liquidation. One condition that a Second Lien Lender may try to negotiate into the deal is to condition its waiver on receipt of a satisfactory operating budget from the borrower. Second Lien Lenders also typically agree not to object to any court-approved asset sale that is also approved by the First Lien Lender. A Second Lien Lender may try to condition its advance consent to such sale by requiring that all or a substantial portion of such sale proceeds are used to reduce the First Lien Lender debt.

To secure its ability to participate in a bankruptcy proceeding, a Second Lien Lender will often agree in advance that it will not object to any DIP financing by, or the use of cash collateral with the consent of, a First Lien Lender if:

- the DIP financing is on commercially reasonable terms;
- the pre-petition "status quo" is maintained relative to the terms of the First Lien Lender debt and the Second Lien Lender debt (e.g., interest rate, fees, advance rates, lending limits);
- the Second Lien Lender retains its pre-petition lien priority status (subordinated to the DIP lender);
- the Second Lien Lender receives a replacement lien on post-petition assets to the same extent as, but junior to, the liens of the DIP lender;
- the aggregate principal amount of loans, letter of credit obligations, and other post-petition credit extensions and accommodations, together with the outstanding pre-petition First Lien Lender debt, does not exceed the negotiated pre-petition cap on the First Lien Lender debt; and
- the terms of the DIP financing are subject to the intercreditor agreement.

Further, Second Lien Lenders commonly agree:

- not to object to a plan of reorganization supported by the First Lien Lenders or a bankruptcy court;
- not to object to a Section 363 sale; and
- to waive the Second Lien Lenders right to make an election under Section 1111(b) of the Bankruptcy Code.[2]

Waterfall – Application of Proceeds of Collateral

Absent any bankruptcy proceedings, any payments of proceeds from the sale of collateral should be applied first to the obligations owing to the First Lien Lender (subject to any negotiated caps and exceptions) until the First Lien Lender is paid in full, and next, to the obligations owing to the Second Lien Lender. The application of proceeds resulting from an enforcement action or bankruptcy are typically applied as follows:

- first, to the costs and expenses of the First Lien Lender;
- second, to the interest and fees (subject to certain exceptions, if agreed to by First Lien Lender, such as excluding termination fees) related to the First Lien Lender debt;
- third, to the principal due on the First Lien Lender debt, and to provide cash collateral for certain other obligations and cash management obligations;
- fourth, to the costs and expenses of the Second Lien Lender;

- fifth, to interest and fees on the Second Lien Lender debt;
- sixth, to principal on the Second Lien Lender debt;
- seventh, to pay all other obligations in respect of the First Lien Lender debt; and
- finally, to pay all other obligations in respect of the Second Lien Lender debt.

Enforcement

As a general matter, intercreditor agreements are enforceable in a court of law, including in a bankruptcy case. Section 510(a) of the Bankruptcy Code provides that subordination agreements (including intercreditor agreements) are enforceable to the same extent as they are enforceable under state law. While state contract law is the final authority, intercreditor agreements are usually enforced according to their terms. The terms of intercreditor agreements are upheld unless the provisions thereof are unclear or ambiguous.

Market terms will continue to develop for second lien loans, and their use and success in structured finance transactions will continue to be watched carefully by the business and legal communities.

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Notes

[1] While some transactions can involve First and Second Lien Lenders taking liens in different assets, this article presumes that the First and Second Lien Lenders will have liens on the same collateral.

[2] Such election would allow a Second Lien Lender, if undersecured, to be treated as a fully secured creditor under the plan of reorganization that provides for the debtor's post-bankruptcy retention of such creditor's collateral.

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