"All Assets" First-Lien/Second-Lien Intercreditor Agreements

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Overview

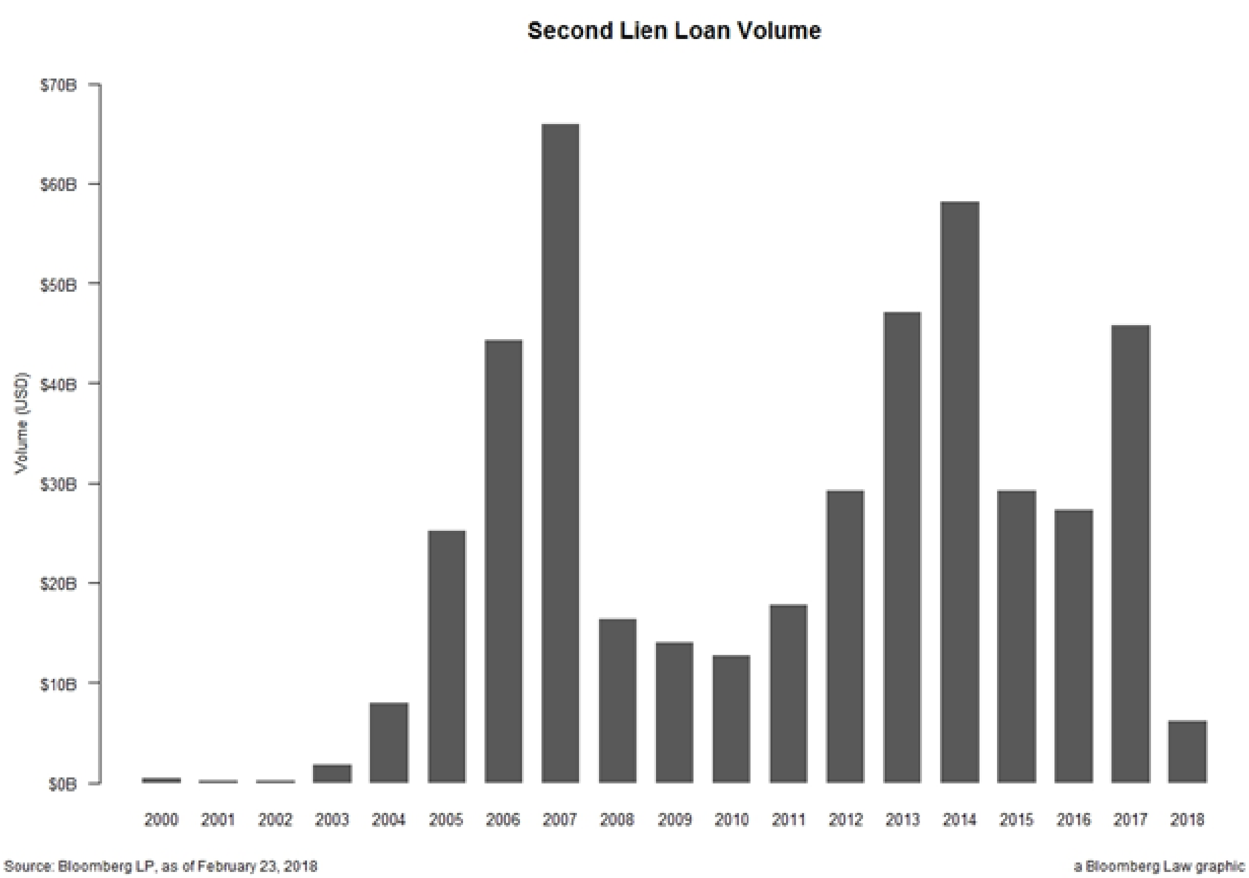
Whenever a borrower incurs debt under more than one facility, the parties to the credit transactions face the question of ranking the different facilities – which one will be repaid first, in the event the borrower cannot repay all of its debts? There are many circumstances under which it is appropriate or desirable to allocate different priority to different credit facilities. For example, an asset-based lender might be given priority over the pool of assets that it is primarily lending against – its borrowing base. Or higher- and lower-priority debt might be marketed to different segments of the financial markets, with different expectations and orientations along the risk/reward curve. Or a particular ranking within the borrower's capital structure might be available, under existing contractual obligations, for the issuance of new debt, whether to raise cash or to use as currency in an exchange offer.

Just as there are different business rationales for establishing credit facilities with different rankings, there are also different ways of documenting intercreditor arrangements. A thorough understanding of intercreditor agreements is vital to any practitioner dealing with finance transactions, especially leveraged finance, as well as bankruptcy and restructuring practitioners. In this article – the first of a series on intercreditor arrangements – we examine the now-traditional "all assets" first-lien/second-lien intercreditor agreement.

Access the Bloomberg Law Precedent Database of Intercreditor Agreements used in real transactions.

Background – Second-Lien Financing

Since the turn of the century – with a marked uptick starting in 2003, followed by a downturn at the time of the financial crisis, and a sporadic renaissance beginning in 2011 (See Second Lien Loan Volume Chart below) – second-lien financings have become a mainstream form of junior financing, partially edging out other types of junior financing such as subordinated "mezzanine" debt.



Though having economic antecedents in payment-subordinated debt, second-lien financing offers the junior lender security, and compared to the payment subordinated and unsecured alternatives offers lower downside risk. As such, second-lien financing offers borrowers a capital source that demands a lower yield than subordinated and unsecured alternatives. Notably, second lien lenders typically do not require an equity kicker or co-invest right, which many payment-subordinated mezzanine lenders expect as risk compensation. The first lien creditor retains its senior position at the top of the capital structure, with a suite of contractual rights to control the exercise of remedies and, to a large degree, the restructuring and bankruptcy process. The second lien creditor, meanwhile, obtains the benefit of the residual value in the collateral after payment of the first lien creditor, which would otherwise have to be shared among all senior unsecured creditors of the debtor, and gains many of the advantages available to secured creditors, but not to unsecured creditors, in the event of a bankruptcy.

Focus - "All Assets" First-Lien/Second-Lien Financing

Within the second lien loan market, the most common, and simplest, form of financing is the "all assets" first-lien/second-lien arrangement, in which substantially all of the assets of the borrower are encumbered by a first-priority lien in favor of the first-lien lenders, and a second-priority lien in favor of the second-lien lenders. Structurally, this is the form that most closely resembles the earlier payment-subordination arrangements, in that, because there are no unencumbered prepetition assets, no value from prepetition assets can flow to the junior creditor until the senior creditor has been paid in full in cash. In the absence of material post-petition assets, such arrangements behave much like payment subordination, which require turnover of payments received from any source (not just collateral).

Indeed, experience with payment-subordination arrangements informed documentation for such first-lien/second-lien arrangements – and, as a result, the documentation incorporates principles and provisions that are often more consistent with payment-subordination than with lien-subordination. For example, almost all first-lien/second-lien intercreditor agreements provide that the first lien obligations include post-petition interest whether or not allowed, and most also provide that the first lien obligations maintain their lien priority on the collateral notwithstanding any invalidity, avoidability or non-perfection of their liens.

Despite their origins in payment-subordination arrangements, first-lien/second-lien arrangements have shifted to a more second-lien-favorable norm, as second-lien creditors argued for treatment that (a) is consistent with the lien-subordination concept (i.e., removing payment-subordination elements), and (b) protects the second-lien creditors from outcomes worse than in the absence of a junior lien altogether. Concomitantly, certain market norms have begun to develop around the degree to which the first-lien creditors are entitled to control the exercise of remedies – e.g., the duration of the enforcement standstill period, the carveouts from the enforcement actions blocked by the standstill, the list of bankruptcy rights waived by the second-lien creditor and the carveouts from those waivers (e.g., the waiver of the right to object to a DIP financing proposed by the first-lien lenders, but only if that financing has certain attributes).

Negotiating an Intercreditor Agreement

A typical first-lien/second-lien arrangement has "anchoring" provisions in the documentation of the underlying credit facilities (e.g., a first lien credit agreement and a second lien note purchase agreement), to the effect that the credit facilities are subject to the provisions of the intercreditor agreement. It is the intercreditor agreement itself, however – a standalone, separately negotiated document – that contains the provisions governing the intercreditor arrangement. The intercreditor agreement, while developed and entered into as part of the credit documentation for the underlying credit facilities, is mostly the product of negotiations among the creditors, albeit with some borrower input.

Though a "standard" first-lien/second-lien intercreditor agreement never did fully emerge – despite attempts such as the Model First Lien / Second Lien Intercreditor Agreement published by the American Bar Association in 2010 – it is possible to identify certain high value topics that draw most professionals' attention during the negotiation of such intercreditor agreements.

Definitions of "Shared Collateral" and "First Lien Debt Obligations" (and any cap thereon)

- **"Shared Collateral"** determines the pool of assets, the liens on which are subject to the intercreditor agreement.

    First-lien lender perspective: seeks an expansive definition, including all assets on which either the first-lien lender or second-lien lender is granted, or is "purported" to be granted a lien by the credit documentation for the respective facility, regardless of invalidity or lack of perfection.

    Second-lien lender perspective: seeks a narrower definition – either limiting to assets on which both sets of lenders actually are granted liens, or inserting protective provisions to limit, under certain circumstances, the degree to which the second-lien lender must pay the price for the first-lien lender's failure to obtain valid, perfected liens.

- **"First Lien Debt Obligations"** identifies the obligations that are entitled to lien priority under the intercreditor agreement; discharge of these obligations will generally free the second-lien lenders from further undertakings under the intercreditor arrangement.

    First-lien lender perspective: seeks to include any obligations that might arise under its credit documents (including pursuant to incremental facilities) or any refinancing thereof, as well as ancillary obligations that are customarily secured on a pari passu basis (such as hedging or cash management arrangements), as well as building in a cushion for incurring additional first-ranking debt.

    Second-lien lender perspective: seeks to establish a cap on first lien debt, typically sized at an amount equal to the debt actually incurred under the first-lien documents, plus some cushion, minus the amount of permanent repayments of the first-lien debt.

Enforcement Standstill Provisions

Enforcement standstill provisions prevent, for a designated period of time, sometimes in perpetuity, the junior lien creditor from taking certain actions with respect to collateral. While these provisions are essential to ensure that a senior lien creditor has an exclusive seat at the table with respect to work-out discussions, they also must provide basic protections for a junior lender.

Turnover Provision

Turnover provisions provide the mechanism for ensuring that the priorities established by the intercreditor agreement are not evaded by the making of payments to the junior creditor that are not permitted by the intercreditor agreement or are inconsistent with the ranking of the claims or liens. Payments received in violation of the intercreditor agreement are held in trust and turned over to the senior creditor in accordance with the priorities.

Bankruptcy Waivers and Automatic Release Provisions

Bankruptcy can have a dramatic impact on the priority of lenders, even where an enforceable intercreditor agreement has been agreed. The rights of junior lenders to object to post-petition financing provided by the senior lender are often circumscribed, as are the rights of junior lenders to seek adequate protection for the diminution in value of their liens. In addition, junior creditors are often asked to consent in advance to a sale under Section 363 of the U.S. Bankruptcy Code.

> **First-lien lender perspective:** often include provisions regarding release of liens in a sale approved by the senior lenders.
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> **Second-lien lender perspective:** insist on the protection of their covenants restricting asset sales and are wary of provisions that could produce low sale prices.

Restrictions on Amendment of First-Lien and Second-Lien Debt Documents

Agreement of the first-lien lender not to amend its credit documents in certain ways without the second-lien lender's consent, and vice versa.

> **First-lien lender perspective**: generally will not permit the second-lien debt's maturity to be amended to be inside the first-lien debt's maturity (plus a cushion). The first-lien lender may also seek to cap increases in the yield of the second-lien debt (especially, but not exclusively, to the extent representing cash outflow), and to prevent the second-lien credit documentation to become more restrictive vis-à-vis the borrower.
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> **Second-lien lender perspective:** seeks to cap the amount of first-lien debt, and often to cap increases in the yield of the first-lien debt.

Various other restrictions are negotiated, commonly on a basis of symmetry, where applicable (such that if the first-lien lender has a consent right with respect to increases in second-lien yield, the second-lien lender will have a consent right with respect to increases in first-lien yield).

The borrower, to the extent it can exert influence over the negotiations, has an interest in ending with a very short list of consent-necessitating amendments, to give it as free a hand as possible in negotiating amendments with either lender.

Buyout Right

Ability of the second-lien lender to buy out the first-lien lender's position.

First-lien lender perspective: wants to establish a narrow, defined window for the exercise of the buyout right. The concern is that, under some circumstances – especially if most of the equity is awarded in a reorganization to the first-lien lender – the first-lien lender might end up with value in excess of par. An open-ended buyout right could act as an "option" in the hands of the second-lien lender, enabling it to reap the fruits of the first-lien lender's efforts by buying the first-lien lender's position at par if such circumstances materialize.

Second-lien lender perspective: wants to ensure that the mechanics of the buyout right are logistically feasible – e.g., without exercise windows that are too narrow to allow for raising the necessary capital, and with appropriate handling of syndicates of second-lien lenders, not all of whom desire to participate in the buyout right exercise. Also, the second-lien lender will want to firmly establish the scope of what is included in the buyout – only true first lien obligations (not in excess of the first lien cap), and generally without prepayment or other premiums (i.e., a "par" buyout right).

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