Mezzanine Financing - Payment Subordination 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 overview – the third of a series on intercreditor arrangements – we examine the payment subordination agreement typical of "mezzanine" financing deals.

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Background – Mezzanine Financing

Mezzanine financing – so-called for being "in between" the equity and senior debt of the issuer – first became a significant product in United States corporate finance in the 1980s, concomitantly with the burgeoning of Leveraged Buyouts during the same period. Like high-yield bonds, mezzanine financing allowed for the incurrence of more debt than could be supported by the borrower's assets under the traditional senior secured loan model. Unlike high-yield bonds, mezzanine debt was often accompanied by an equity component, such as warrants, and the market players included more buy-to-hold capital providers, such as insurance companies, thrift institutions, and a host of dedicated mezzanine capital funds.

While mezzanine financing can take many forms, including preferred equity and (especially in the real estate mezzanine debt market) structurally subordinated debt, this overview focuses on the form of mezzanine debt common in the corporate finance context. This corporate mezzanine debt is typically unsecured senior subordinated loans or notes, subject to a contractual payment subordination in favor of one or more specified senior secured debt facilities.

Focus – Payment Subordination Agreement

There are a number of critical differences between a mezzanine subordination agreement and a first lien / second lien intercreditor agreement. Since mezzanine financing is typically unsecured, the numerous provisions of a first lien / second lien intercreditor agreement that are aimed at circumscribing the second lien creditor's rights as a secured creditor are not required in a mezzanine debt subordination agreement. Since the mezzanine financing's subordination applies to payments from any source, and not just from proceeds of collateral, there will customarily be a payment bar (a period or periods during which payments are prohibited, sometimes also called a payment standstill), and a liquidation subordination, in each case with specified exceptions.

Other provisions, though similar in content in both first-lien / second-lien intercreditor agreements and payment subordination agreement, may take somewhat different form or receive different emphasis. For example, a purchase right in favor of the junior creditor, allowing purchase of the senior creditor's position at par, is almost universal in second lien financings but somewhat less frequent (though still very common) in mezzanine debt subordination agreements.

Negotiating a Subordination Agreement

A typical payment subordination arrangement has "anchoring" provisions in the documentation of the subordinated credit facility (e.g., a credit agreement or note purchase agreement), to the effect that the facility is subject to the provisions of the subordination agreement. It is the subordination agreement itself, however – typically a standalone, separately negotiated document – that contains the provisions governing the intercreditor arrangement. The subordination agreement, while 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, usually modest, borrower input.

There is no “standard” mezzanine subordination agreement. Lenders often have their own forms, and transactions are often bespoke. Also, given the illiquidity of most mezzanine credit, and the unsyndicated nature of mezzanine facilities, the market’s pressure to develop terms that are consistent across deals is not strong. It is, however, possible to identify topics that draw most professionals’ attention during the negotiation of mezzanine subordination agreements. Below are some of the high value topics that arise in a mezzanine debt payment subordination agreement.

Definition of “Senior Debt Obligations” (and any cap thereon)

Identifies the obligations that are entitled to payment priority under the subordination agreement; discharge of these obligations will generally free the junior lenders from further undertakings under the intercreditor arrangement.

> **Senior 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.
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> **Junior Lender perspective:** seeks to establish a cap on senior debt, typically sized at an amount equal to the debt actually incurred under the senior documents, plus some cushion, minus the amount of permanent repayments of the senior debt. Note that in payment subordination agreements, post-petition interest, even where disallowed, is generally included in the senior debt obligations.

Payment Bar Provisions

Payment bar or blockage provisions prevent, for a designated period of time in the case of most events of default, and in perpetuity in the case of payment defaults, the junior creditor from demanding or receiving any payment from the borrower or guarantors. While these provisions are designed to ensure that a senior creditor has an exclusive seat at the table with respect to work-out discussions, they also must provide basic protections for a junior lender, typically as limitations on the number of blockages per year, and/or the number of blocked days per year, absent a payment default on the senior debt. (During a payment default on the senior debt, the payment bar is indefinite and endures so long as the payment default is continuing.) Other negotiated aspects of the payment bar provisions include the permissive carveouts – e.g., for interest paid in kind, or for reimbursement of expenses of the junior creditor (sometimes subject to a cap) – that allow certain types of payments to be made even during a payment bar.

Restrictions on Amendment of Senior and Junior Debt Documents

Agreement of the senior lender not to amend its credit documents in certain ways without the junior lender’s consent, and vice versa. These provisions implicate essentially the same interests as in a first-lien/second-lien intercreditor agreement.

> **Senior Lender perspective**: generally will not permit the junior debt’s maturity to be amended to be inside six months or one year following the senior debt’s maturity. The

senior lender may also seek to cap increases in the yield of the junior debt (especially, but not exclusively, to the extent representing cash outflow), and to prevent the junior credit documentation from becoming more restrictive vis-à-vis the borrower.

Junior Lender perspective: seeks to cap the amount of senior debt, and often to cap increases in the yield of the senior debt.

Various other restrictions are negotiated, commonly on a symmetrical basis, where applicable (e.g., if the senior lender has a consent right with respect to increases in junior yield, the junior lender will have a consent right with respect to increases in senior yield).

The borrower, to the extent it influences 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.

Purchase Right

Ability of the junior lender to purchase the senior lender's position. The dynamics here are analogous to the purchase right in first-lien/second-lien intercreditor agreements, but such purchase rights – while still common in payment subordination agreements – are not universal. Owing to different dynamics among the players in the mezzanine debt space, some mezzanine subordination agreements do not include purchase rights.

Senior Lender perspective: wants to establish a narrow, defined window for the exercise of the purchase right. An open-ended buyout right could act as an "option" in the hands of the junior lender, enabling it to reap the fruits of the senior lender's efforts by buying the senior lender's position at par if such circumstances materialize.

Junior Lender perspective: wants to ensure that the mechanics of the purchase 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 junior lenders, not all of whom desire to participate in the buyout right exercise. Also, the junior lender will want to firmly establish the scope of what is included in the purchase right – only true senior obligations (not in excess of the senior debt cap), and generally without prepayment or other premiums (i.e., a "par" purchase right). A purchase right that cannot be practically exercised may as well not be included.

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