Private Equity

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SECOND LIEN DEBT:

A Guide to Key Terms and Inter-Creditor Issues

Borrowers and private equity funds have increasingly turned to second lien financing as an alternative to unsecured, subordinated, mezzanine financing to fund leveraged buyouts, recapitalizations, stock repurchases and other transactions. According to Standard & Poor's/Leveraged Commentary & Data, in the first six months of 2004, second lien loans raised more than $7.4 billion, compared with only $3.2 billion for all of 2003, and compared with less than $600 million for 2002.

Why Get Second Lien Debt?

Borrowers and equity sponsors are turning toward second lien loans for various reasons. One, even though pricing varies widely based on the risk of the loan, the average price for second lien loans in the second quarter of 2004 was only LIBOR + 697 basis points, and the price is expected to drop as new lenders continue to enter this market. Compared to 16% to 20% returns plus an equity kicker for traditional mezzanine debt, second lien financing is relatively cheap.

Two, second lien loans are often viewed as transitional capital, allowing the borrower time to improve its performance in order to gain access to traditional senior credit facilities. Accordingly, most second lien facilities allow prepayment at par or with a nominal premium. Mezzanine loans, on the other hand, generally are non-callable for two to three years, and sometimes still carry premiums thereafter.

How Are Inter-Creditor Issues Typically Resolved

The main disadvantage to borrowers and private equity funds in getting second lien financing is the additional complexity and related costs it adds to the transaction. These complications are largely the result of the fact that while in today's market the terms of inter-creditor agreements between senior secured lenders and junior unsecured lenders are largely standardized with only a few minor issues actively negotiated, the market for lien subordination agreements between first and second lien holders has not matured to that point. Instead, the current state of the market is best understood by focusing on the following two principles:

1. Until first lien creditors are paid in full, they have almost complete control over the shared collateral.

This is the main reason why first lien lenders allow junior lenders to have security interests. This arrangement is agreeable to junior creditors for several reasons. One, a secondary security interest still gives them priority over trade creditors and other unsecured creditors. Two, under UCC Section 9-610, the first lien lender has a duty to the borrower and to all lien holders to act in a commercially reasonable manner in disposing of collateral, and this duty cannot be waived. Three, standard 90- or 180-day inter-creditor agreement standstill provisions still force first lien lenders to take enforcement actions within a reasonable period of time.

There are a couple of practical implications of this principle. Until the first lien lenders are paid in full, second lien lenders generally agree not to exercise any remedies against collateral, nor challenge any exercise of remedies against such collateral by the senior lenders. Also, in the event of a sale, if the first lien lender agrees to release its security interest in collateral, the second lien holder also agrees to release its liens in such collateral.

2. In bankruptcy, second lien lenders refuse to relinquish control if the two lenders' interests are not sufficiently aligned.

In the event of the borrower's bankruptcy, one area of contention is that first lien holders often try to restrict junior lenders from voting their claims in a plan of

reorganization (giving them fewer rights than unsecured creditors). One compromise that has been reached is that the senior lender can vote the junior lender's claims, provided that the junior lien holder continues to receive current interest on its debt and continues to accrue additional interest.

Another subject of pushback is that senior banks generally ask second lien lenders to waive their right to ask the bankruptcy court for "adequate protection" against declines in the value of the junior creditor's collateral. One suggested compromise is to limit adequate protection rights to replacement liens and cash payments.

Fortunately, there are several areas in which the market is starting to settle. Second lien lenders generally give advance consents to (i) the sales of collateral approved by the first lien lenders and the bankruptcy court (so long as the second liens continue to attach to the sale proceeds); (ii) the use of cash collateral approved by the first lien holders; and (iii) debtor-in-possession (DIP) financing approved by the first lien creditors (often with a cap, and so long as the DIP loans are senior or pari passu with the first lien holder's debt).

Hybrid Loans

In some cases, senior banks have given junior lenders liens in hard assets (such as property, plant and equipment) only under the condition that they waive their rights to the marshalling of assets. Marshalling assets occurs when (i) there are two or more creditors, one of whose debt is secured by multiple sources of collateral (in our case, hard and soft assets), and the other's is secured by only one of those sources of collateral (in our case, the hard assets only); and (ii) a court of equity compels the creditor whose debt is secured by the multiple sources of collateral first to resort to the non-shared collateral to collect on its debt. This can lead to confusion and disagreement among junior lenders and the unsecured creditors over which assets satisfied the senior banks' claims.

It is important to note that under these conditions, the cash-flow based lender's and the asset-based lender's interests are opposed. The cash-flow based lender is more inclined to give the borrower time to work out its problems, since businesses are generally worth more as going concerns than they are when liquidated, while the asset-based lender's collateral is often losing value over time. Accordingly, while senior lenders (with pressure from the borrower) occasionally convince the junior lien holder not to take any enforcement action against collateral in which they have a first lien, junior security interest holders often only agree to a 90- or 180-day standstill period before they may foreclose.

Conclusion

The second lien financing market is dynamic and growing with many unsettled inter-creditor terms. Private equity buyout and mezzanine funds need to remain aggressive in negotiating against each other, while at the same time being able to reach consensus to get deals done. The above principles should provide the parties some guidance in these discussions.

If you are interested in discussing the issues addressed herein, please contact:

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