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Comment | Ross Pooley

Acquisition trends: the new intercreditor battlefield

The frenetic activity surrounding the limited number of leveraged buyout (LBO) targets towards the end of 2009 and early 2010 has seen comparisons drawn to the pre-crunch years of 2006 and early 2007. While such comparisons are undoubtedly far too premature, it is clear that private equity investors and lending institutions are keen to start the year with a bang and put their money to work.

Despite the proliferation of financing 'trees' as certain financial institutions run multiple teams competing to offer loan, bond and/or hybrid structures to different bidders for strong LBO targets, there remains a continuing reluctance on the part of many traditional bank lenders to underwrite entire debt capital structures, including mezzanine debt. This has seen the emergence of non-bank investors who are willing to participate in transactions on a 'take and hold' basis, frequently in the subordinated debt classes but also across the capital structure.

As a result of this fragmentation of capital sources, recent bid processes have seen the elevation of the importance of agreed intercreditor principles governing the contractual relationship between senior and mezzanine creditors. The court sanctioning of the IMO Car Wash restructuring in the face of a challenge by the mezzanine lenders and mixed experiences through the downturn generally have focused the minds of mezzanine creditors on ensuring they have adequate contractual protections once borrowers become distressed. It had been hoped that the Loan Market Association (LMA) form of intercreditor agreement, revised in November 2009 to reflect mezzanine creditor input, would largely pre-empt the market and settle an agreed intercreditor position; however, mezzanine creditors are increasingly insisting on the appointment of independent legal advisers early in the commitment documentation process, sometimes despite sponsor preference that all creditors use the same law firm.

The key battle lines are being drawn and, not surprisingly, the primary focus is on the mechanism by which mezzanine creditor loan claims, guarantees and security can be released or discharged by the security agent in an enforcement scenario. This issue goes to the heart of the debate about what level of protection is appropriate for a subordinated class of creditors.

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Mezzanine creditors have been pushing for more objective valuation procedures including requirements for an auction process and/or that disposals only be made with a fairness opinion from an independent investment bank or accountancy firm, thus drawing on protections more commonly found in the context of subordinated high-yield issuances. Conversely, the LMA mandated position states that the security agent "use reasonable care to obtain a fair market price". A corollary to this debate is the ability of senior creditors to credit-bid their debt to acquire the assets of a distressed group. Mezzanine creditors are seeking to curtail this right, one which they associate with the worst of potential restructuring options, an opportunistic pre-pack of the distressed group by existing stakeholders leaving behind the mezzanine creditors.

The appropriate balance of rights and protections afforded to senior and mezzanine creditors in intercreditor agreements will no doubt be the subject of lively debate in the market for some time to come.

Ross Pooley is a partner at Latham and Watkins.

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