A Primer on Second Lien Term Loan Financings

By Neil Cummings and Kirk A. Davenport

One of the more noticeable developments in the debt markets in the last year has been the exponential increase in the number of second lien financings in the senior bank loan market. Standard & Poor's/Leveraged Commentary & Data Team reports that second lien financings raised more than $7.8 billion in the first seven months of 2004 alone, compared with about $3.2 billion for all of 2003.

In this article, we discuss second lien term loans marketed for sale in the institutional loan market, with a goal of providing both an overview of the product and an understanding of some of the key business and legal issues that are often at issue.

In a second lien loan transaction, the second lien lenders hold a second priority security interest on the assets of the borrower. Their security interest ranks second to the liens in those assets securing the first priority lien debt. In the event of a foreclosure on the shared collateral that secures the first and second lien debt, the first lien creditors will be entitled to be paid in full from the enforcement proceeds before any payments are made to the second lien lenders out of those proceeds.

Typically, the first priority lien debt is a senior working capital facility, usually consisting of a revolving loan facility, sometimes coupled with a term loan facility. Senior working capital lenders will generally insist on holding a first priority lien on the borrower's assets; however, in a number of transactions, they have been willing to permit second lien lenders to hold a lien on the borrower's assets.

There are a few reasons for this. First, the proceeds of the second lien loans may be used to prepay the first lien debt or to reduce the amount of first lien debt otherwise needed. In addition, there may not be a market for the borrower to borrow the funds it needs on a first lien basis. As a result, allowing junior liens on their collateral may be the price that the first lien lenders have to pay to make a deal happen. Finally, first lien lenders are increasingly comfortable that they can protect their interests in the collateral by requiring second lien lenders to agree to a "silent second" lien.

Second lien lenders can often be persuaded to agree to this arrangement because a silent second lien is better than no lien at all. In addition, under the intercreditor agreement, in most deals, the second lien lenders expressly reserve all of the rights of an unsecured creditor, subject to some important exceptions.

All of this sounds very simple, and first and second lien investors may be tempted to ask why it takes pages of heavily negotiated intercreditor terms to document a silent second lien. The answer is that a "silent second" lien can span a range from completely silent to fairly quiet, and where the volume control is ultimately set varies from deal to deal, sometimes significantly. A standard package of intercreditor terms has yet to emerge in the second lien term loan market, although a consensus is developing on many of the key issues and how they ought to be resolved.

Before we discuss those issues, it is helpful to review some key background information since that information is important to understanding what is at stake in the intercreditor negotiations.

Background

In a bankruptcy proceeding, secured creditors hold a series of significant rights that unsecured creditors don't enjoy. As a result, secured creditors have significantly higher recovery rates in bankruptcies and other reorganizations than unsecured creditors.

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Priority Vis-À-Vis *the Trade and Other Unsecured Creditors*

Under the bankruptcy code, creditors' claims generally can be divided into three basic classes: secured claims, priority unsecured claims and general unsecured claims. A second lien creditor's claim is treated as a secured claim to the extent of the value of its interest in the collateral. As a result, a creditor that is undersecured (that is, the value of its collateral is less than the amount of its prepetition claim) will hold both secured and unsecured claims. Under the bankruptcy code, secured claims are entitled to receive value equal to the full value of their interest in the collateral before any value is given to holders of unsecured claims, and any priority unsecured claims are entitled to receive the full value of their claims before any general unsecured claims receive any value. To the extent a secured creditor is undersecured, that undersecured creditor will share ratably with other general unsecured creditors (including trade creditors) in the amount, if any, remaining after repayment in full of both secured claims and priority unsecured claims.

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Post-Petition Interest

A secured creditor is entitled to post-petition interest under the Bankruptcy Code to the extent the value of its interest in the collateral securing its claim is greater than the amount of its pre-bankruptcy claim. An undersecured creditor is not entitled to post-petition interest. The amount of post-petition interest can be significant in practice given that the bankruptcy proceedings may run for several years.

Adequate Protection Rights

Under the bankruptcy code, a secured creditor has the right to be protected against declines in the value of its interest in the collateral following the date of the bankruptcy filing. This is a very broad right and entitles a secured creditor to a voice in any actions taken in a bankruptcy proceeding that could affect the value of its collateral (including the use of cash collateral, sales of collateral, substitutions of collateral or the grant of a priming lien on collateral to secure a debtor-in possession, or DIP, financing). Upon request to the bankruptcy court, secured creditors are entitled to assurance that their collateral is adequately protected if there is a serious risk of its diminution in value. The "adequate protection" may take the form of a court-ordered grant of additional or substitute collateral or the provision of periodic cash payments to the secured creditor. Adequate protection is an extremely valuable right for a secured creditor.

Harder to Be Crammed Down

The bankruptcy code gives the creditors in each class the right to vote on any proposed plan of reorganization. In certain circumstances, however, a plan of reorganization can be confirmed over the objections of a particular class of creditors. A class of creditors that is forced to accept the terms of a plan that it voted against is said to be "crammed down." Under the tests applied under the bankruptcy code, it is generally much harder for a class of secured creditors to be crammed down in a bankruptcy than a class of unsecured creditors, which can give a secured creditor significantly more leverage in the plan or restructuring negotiations.

Structuring Issues

With that background discussion behind us, we will now turn to a series of specific questions about how to structure a second lien term loan transaction.

What Makes a "Silent Second" Silent?

A lien only becomes "silent" if the holder of the lien contractually agrees not to exercise some or all of the particular rights that it obtained by becoming a secured creditor. In a second lien term loan financing, the terms of the "silent second" are usually set out in an intercreditor agreement. There are usually four key elements to the intercreditor agreement:

- Prohibitions (or limitations) on the right of the second lien holders to take enforcement actions, with respect to their liens (possibly subject to time or other limitations)

- Agreements by the holders of second liens not to challenge enforcement or foreclosure actions taken by the holders of the first liens (possibly subject to time or other limitations)
- Prohibitions on the right of the second lien holders to challenge the validity or priority of the first liens
- Waivers of (or limitations on) other secured creditor rights by the holders of second liens

What Secured Creditor Rights Do the Second Lien Lenders Typically Waive During the Period Before a Bankruptcy Filing?

In a second lien term loan deal, the second lien is often more in the nature of a "quiet second" than a silent second. Generally, second lien term lenders will only agree to refrain from exercising their secured creditor rights for a limited period of time, typically 90 to 180 days. This period of time is often referred to as a "fish-or-cut-bait" or "standstill" period. At the end of the standstill period, the first lien lenders lose their monopoly on the exercise of secured creditor remedies. A few deals have taken an even more aggressive line and include a "use-it-or-lose-it" provision that forces the first lien lenders to make an election of remedies within the prescribed time period or forfeit the right to take remedial action in the future. In some of those deals, the impact of those provisions on the first lien lenders was mitigated by providing that an affirmative decision by the first lien lenders *not* to exercise remedies constitutes the required election of remedies. Second lien term lenders typically waive their right to challenge the validity, enforceability or priority of the first liens, sometimes (but often not) in exchange for a reciprocal waiver by the first lien lenders.

Adequate protection is an extremely valuable right for a secured creditor.

What Secured Creditor Rights Do the Second Lien Debt Holders Typically Waive in a Bankruptcy?

The short answer is all of the same rights they waive before bankruptcy (as discussed above), plus some others that arise as a result of the bankruptcy. The following post-bankruptcy waivers and consents are commonly found in intercreditor agreements in the second lien term loan market:

- Adequate protection waivers
- Advance consents to use of cash collateral
- Advance consents to sales of collateral
- Advance consents to DIP financings

Waiver of the Right to Oppose Adequate Protection for the First Lien Debt. Second lien term lenders typically waive any right to dispute actions taken by the first lien lenders to seek adequate protection with respect to the collateral securing the first lien debt. This waiver is not particularly controversial and is not usually subject to any time limitation.

Waiver of the Right to Seek Adequate Protection. In some cases, the term loan lenders will waive their adequate protection rights for so long as any first lien debt is outstanding. In most cases, however, there is strong resistance by institutional term loan lenders to agree to any blanket adequate protection waivers. In most recent deals, the term loan lenders have prevailed on this point, and blanket adequate protection waivers are increasingly rare.

Advance Consents. Second lien term lenders typically give an advance consent to the following:

- Any use of cash collateral approved by the first lien debt (effectively waiving their right to oppose the borrower's proposed use of cash collateral on adequate protection grounds)
- Any court-approved asset sale that is also approved by the first lien lenders as long as the second liens attach to the proceeds of the sale in accordance with the lien priorities agreed to in the intercreditor agreement
- DIP financings (which may take the form of an unconditional consent or may be conditioned on (1) a dollar cap on the amount of the DIP financing or (2) a requirement that the liens securing the DIP financing rank prior or equal to the liens securing the first lien debt to avoid DIP liens being layered between the first and second liens)

Are Intercreditor Agreements Enforceable?

Courts are generally willing to enforce intercreditor agreements between a borrower's creditors, even when the borrower is in bankruptcy. The Bankruptcy Code specifically states that a subordination agreement is as enforceable in a bankruptcy as it is outside of bankruptcy. As a general matter, an intercreditor agreement containing the types of provisions discussed above should be enforceable under state law, both before and during a bankruptcy. In practice, most bankruptcy courts will not police compliance with every aspect of the advance waivers and consents contained in an intercreditor agreement, but the final plan of reorganization will usually give effect to that agreement's priority waterfall provisions by treating first and second lien creditors as separate classes for plan purposes. If the first lien creditors want specifically to enforce the intercreditor agreement, they generally will need to make their case in state court in the state selected as the governing law in the intercreditor agreement.

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Does a "Silent Second" Lien Creditor Ever End up Worse off Than an Unsecured Creditor?

Typically, an intercreditor agreement expressly states that, both before and during a bankruptcy, the second lien lenders can take any actions and exercise any rights that they would have had if they were unsecured creditors, except any rights they expressly waived in the intercreditor agreement, such as with respect to adequate protection, use of cash collateral, sales of collateral, DIP financings and the right to challenge the first liens. We think these limitations are appropriate. We have seen first lien creditors go even further, however, and request advance agreements by the second lien lenders on how they will vote on a plan of reorganization. These voting agreements are more controversial and may not be enforceable.

The right to vote on a plan of reorganization provides significant protections for a secured creditor. First and second lien creditors have very different interests, and they frequently (and often strongly) disagree on the merits of a proposed plan. Second lien lenders that agree to voting restrictions may lose significant traction in the plan discussions. Furthermore, unsecured creditors almost never agree to limit their voting rights in a plan, and including such a provision in an intercreditor agreement could cause the silent second lien creditor to have significantly less bargaining power than an unsecured creditor in plan negotiations. These factors may explain why restrictions on the right to vote for or against particular plans of reorganization are strongly resisted by second lien term loan lenders.

Who Controls Releases of Collateral?

Pre-Bankruptcy. Generally, the second lien loan documents provide for an automatic release of the second liens on any collateral upon a sale of that collateral in compliance with the asset sale covenant in the second lien loan agreement. Other collateral releases typically require the consent of the second lien lenders.

During Bankruptcy. During a bankruptcy, the second lien lenders typically agree not to object to any court-ordered asset sale approved by the first lien creditors as long as the second liens attach to the proceeds of the sale in accordance with the lien priorities agreed to in the intercreditor agreement. In light of the bankruptcy code restrictions on the sale of assets in bankruptcy, second lien term lenders tend to be comfortable with this approach.

Do Second Lien Holders Get the Same Collateral As First Lien Holders?

In general, the second lien collateral will not include any assets excluded from the first lien collateral. There will tend to be very few (if any) differences between the collateral securing the first lien debt and the collateral securing second lien term loans. If the first lien debt is an asset-based lending facility, sometimes the first lien lenders will take a first lien on the current assets of the borrower, such as receivables and inventory, and a second lien on the borrower's long-lived assets, such as equipment. The second lien term loans in turn may be secured by a first priority lien on the borrower's long-lived assets and a second priority lien on its current assets. These types of crisscross lien arrangements can simplify negotiation of the intercreditor terms since the first lien lenders will often have to live with the subordination terms they bargain for on their first lien collateral when it comes to their second lien collateral.

Are There Any Limits on the Amount of Future First and Second Lien Debt?

The typical covenant package in a second lien deal will fix the maximum principal amount of first lien debt that may be incurred (usually based on the amount of first lien commitments at the closing, plus a "cushion"). The typical second lien covenant package will also cap the borrower's ability to incur additional second lien debt. The cap on future second lien debt is usually based on a maximum leverage ratio or other financial test although it could be expressed as a dollar cap.

Are There Other "Permitted Prior Liens"?

The term "second lien debt" is not intended as an absolute statement of the priority of the liens securing second lien debt. In fact, the liens securing second lien debt are junior both to the liens securing the first lien debt and to certain other liens, usually called "permitted prior liens," which are permitted to rank ahead of the second liens (and often the first liens) under the terms of the security documents. The payment of creditors secured by permitted prior liens generally will be incorporated into the priority waterfall provisions for distributions of collateral sale proceeds contained in the intercreditor agreement.

As a general rule, permitted prior liens fall into four categories:

- Liens securing the first lien debt and all related first lien obligations
- Liens that predate the second liens (which, in some deals, may include liens that the borrower "inherits" if, for example, it acquires assets in the future that are subject to liens)
- Liens securing a maximum amount of purchase money debt
- Liens that are not voluntarily granted by the borrower but arise by operation of law and are entitled by law to priority over the second liens (for example, certain tax and ERISA [Employee Retirement Income Security Act of 1974] liens)

In some deals, the parties may agree to include other liens in the definition of permitted prior liens. If the obligations secured by permitted prior liens are material, however, the agent bank may find it much harder to market and/or syndicate the transaction successfully.

Can the Second Lien Lenders Purchase the First Lien Obligations?

In some second lien financings, the first lien creditors have given second lien lenders an option to purchase the first lien obligations. The exercise price is generally the par value of the outstanding first lien debt plus accrued interest (excluding any amounts payable as prepayment or acceleration penalties or premiums). Usually, the option can be exercised during an agreed time period starting on the date on which the borrower files for bankruptcy and/or the first lien creditors take any action to foreclose on their collateral. Some second lien lenders view the purchase option as a "must-have" provision. First lien creditors generally view the purchase option as acceptable since, if exercised, it allows them to exit a troubled credit at par.

There is some value to a purchase option for the second lien lenders because, once it is exercised, the second lien lenders will no longer be subject to any of the lien subordination arrangements discussed above and will be free to exercise all of the rights of a secured creditor. As a result, the second lien lenders will have increased leverage in the plan or out-of-court restructuring negotiations that may translate into a higher net recovery for the second lien lenders. Many second lien lenders place less emphasis on this purchase option, however, since, in their view, in most bankruptcies, first lien lenders generally will agree at the time to sell their debt to the second lien lenders at par.

Are Two Sets of Security Documents Needed?

The 1991 case of *In re Ionosphere Clubs, Inc.*[1] has stirred some debate as to whether the first and second liens can be granted in a single set of security documents (containing separate grants of security interests for the first and second liens) rather than in separate sets of security documents. Some first lien lenders are concerned that they may prejudice their right to post-petition interest unless the first and second liens have completely separate security documents.

We believe that, if properly documented, a single set of security documents should work to ensure that the first and second lien creditors hold separate secured claims. The prevailing sentiment in the second lien term loan market, however, has generally been to take the more conservative approach and to document the second liens in a separate set of security documents that substantively mirror the first lien security documents. This tends not to be controversial among borrowers since the incremental cost of creating a second set of conforming security documents tends to be fairly small. We expect this practice to continue in the second lien term loan market at least until the *Ionosphere* decision has been revisited and its holding clarified by the courts.

Conclusion

Second lien term loan financings are here to stay, at least for the foreseeable future. They provide an attractive, and typically attractively priced, investment for second lien lenders, and they allow borrowers to tap capital that might not otherwise be available to them. In many cases, the availability of second lien capital may make the difference for a borrower between being able to do a deal and being denied access to needed capital. The intercreditor terms that govern second lien financings have yet to be defined by market conventions and vary from deal to deal. Over time, though, we predict that market terms for the intercreditor provisions in these deals will emerge in much the same way that customary subordination terms have developed over time in subordinated debt deals. For now, though, it remains important for investors to read the small print in the intercreditor agreement to understand the terms of the debt they are purchasing.

Endnote

[1] *In re Ionosphere Clubs, Inc.*, 134 BR 528 (Bankr, S.D. N.V. 1991).

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