Workouts for Borrowers With Second-Lien Loans: More Time, More Trouble

by Eric Goodison

Second-lien lenders and borrowers are generally familiar with the economic advantages and disadvantages of second-lien loans. It is not clear that they also fully appreciate the array of complexities and issues surrounding the intercreditor agreements which bind second-lien lenders and first-lien lenders. These complexities will most likely hinder workouts with second-lien loans and cost vital time. Intercreditor agreements lack uniformity and standardization, making comparisons and analysis that much more difficult.

(Continued on page 22)

Because of the low interest rate and default rate environments of the past several years — which contributed to the development and burgeoning growth of the syndicated second-lien loan market — few companies have had to deal with these issues. From a small start in 2003 with approximately $5 billion in issuance, this market grew to in excess of $20 billion in 2005, according to the Loan, Syndications and Trading Association. In return for agreeing that their right to proceeds from the collateral is second in priority to first-lien bank loans, second-lien lenders receive a substantially higher spread than first-lien lenders. The participants in this market have been largely nontraditional lenders such as hedge funds and CLOs, which have enjoyed the higher yield that a second-lien loan offers.

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The Fed, however, has raised short-term interest rates by four percent since June 2004. Because the syndicated second-lien loan market has not been through a downturn in the credit cycle, there is little guidance or experience on how workouts for borrowers with second-lien lenders might play out. Notwithstanding the existence of an intercreditor agreement, if there is an increase in the number of workouts with second-lien borrowers, there are a combination of market and legal factors that are likely to make workouts with second-lien loans more difficult, time-consuming and costly.

To avoid or mitigate these consequences, borrowers will need to do more work and planning at the beginning of a workout. They will also need to have a clear vision of what they expect to achieve in a workout and how to accomplish those goals. Borrowers will also have to be realistic about what they can achieve from the various constituencies who may have different views and desired outcomes. This will be especially true if the second-lien loans become concentrated in the hands of distressed investors.

The second-lien lenders' agreement with respect to the collateral is embodied in the intercreditor agreement. At a minimum, a second-lien intercreditor agreement should provide for: (a) the application of the proceeds of the collateral to the repayment in full of the first-lien loans before any proceeds are applied to the second-lien loans; (b) a standstill period following default of typically 90-180 days where the first-lien lenders have the exclusive right to exercise remedies with respect to collateral and (c) the right of the first-lien lenders to control any proceedings with respect to the collateral. Additionally, intercreditor agreements may provide for: (a) limits on the ability of the first-lien lenders or the second-lien lenders to increase or amend the indebtedness secured by the shared collateral; (b) the ability of the first-lien lenders to compel the second-lien lenders to release their lien in the collateral if the first-lien lenders are releasing their lien in such collateral and (c) certain rights of the parties in any bankruptcy proceeding of the borrower (including the ability of the first-lien lenders to provide a DIP or consent to an asset sale or to vote the claims of the second-lien lenders in certain circumstances). A key purpose of these additional provisions is to give the first-lien lenders more certainty and control in a workout without interference from the second-lien lenders.

Even with all this, it is not certain that intercreditor agreements are sufficient to make workouts with second-lien lenders easier.

In order for a borrower to successfully work out its debt, all parties with a stake in the workout need to come to a consensus. To reach this consensus requires participation in time-consuming negotiations. How and to what extent second-lien lenders will participate in these negotiations is uncertain. Second-lien lenders are not traditional lenders. Many of them do not have workout experience or the infrastructure to devote to a complex series of workout negotiations.

Another issue for a second-lien lender is the size of its investment. Many second-lien lenders have investments in a particular second-lien loan of $1,000,000 or less. Even if a particular hedge fund or CLO manager has multiple accounts invested in a particular second-lien loan, the

(Continued on page 24)

aggregate amount still may not be material to the manager and all of its funds. This lack of experience, infrastructure and material exposure means that a particular lender may not be interested in participating in the workout negotiations.

Further, because many second-lien lenders are similarly situated, not all lenders can participate in the negotiations and a successful workout benefits all lenders equally, a lender may be reticent to participate because of the free rider benefits it would confer on nonparticipating second-lien lenders.

There is another concern for second-lien lenders and their participation in workout negotiations. In addition to investing in second-lien loans, many second-lien lenders trade securities of the borrower, including any public bonds or equity. Participants in workout negotiations may receive material nonpublic information. Receipt of this information could prevent a second-lien lender from trading the securities of a borrower.

All these factors mean that both second-lien lenders and their borrowers will have to figure out how the second-lien lenders' interests will be represented in a workout. Second-lien lenders will initially have to make one of two choices. Either retain the second-lien loan for the duration of the workout or sell the loan to a buyer who is willing to participate in the workout. Many of the investors in second-lien loans either mark their assets to market or, in the case of CLOs, are penalized for holding defaulted loans that are in workout. This means selling a second-lien loan at a market price substantially below par may not result in significant additional negative consequences for the lender as they will have already realized the economic effect of the default or loss in market value. If a second-lien lender is inclined to sell its distressed second-lien loan, it is likely to find a willing buyer in the numerous distressed investors who have been waiting through the current benign credit environment to find distressed assets to acquire.

The concentration of second-lien loans in the hands of distressed investors is potentially a complicating event for the borrower. While the distressed investors are more likely to be prepared to participate in negotiations and have the resources and experience to do so, the distressed investors' agenda may be significantly different than that of the borrower. The borrower may be trying to effect a consensual arrangement that allows the borrower to solve its debt problems. The distressed investors may not be interested in any such arrangement and instead view the second-lien loans as a path to ownership and control of the borrower.

Conversely, the decision of second-lien lenders to retain their loans is also potentially a complicating factor. As discussed above, there are significant issues to the second-lien lender's active participation in the workout negotiations. Accordingly, the concern for the second-lien lenders and a borrower that desires to have a successful negotiation is to identify who will represent the interests of the second-lien lenders. Assuming that the second-lien lenders will not participate directly, one option is to attempt to have the lenders' administrative agent represent the second-lien lenders. However, in most second-lien loan transactions the administrative agent acts for both the first-lien lenders and the second-lien lenders.

This dual representation presents potential conflicts between the two lending groups. Accordingly, the administrative agent may be unwilling to act for both groups. Alternatively, even if the administrative agent is willing to continue with the dual representation, the second-lien lenders may be unwilling to accept such representation. If the administrative agent is not going to act for both the first- and second-lien lenders, in all likelihood they will continue to act for the first-lien lenders and not the second-lien lenders. The reasons for this include the first-lien lenders' greater control over the collateral and any proceedings and the enhanced ability to provide a DIP in any bankruptcy, all as contemplated by the intercreditor agreement.

If the administrative agent is unable or unwilling to act for the second-lien lenders, another option is the outsourcing of the workout. This can be accomplished by the second-lien lenders hiring their own legal counsel and financial advisors. Of course, these professional advisors will need to be paid, which is an expense the borrower must cover. Compared to a traditional leveraged borrower with only one class of secured debt and where only the borrower and that single class of secured lenders initially participate in the negotiations, second-lien representation increases both the number of advisors to be paid and sitting at the negotiation table by 50 percent. This will undoubtedly make any negotiations more difficult and time-consuming.

There is a wild card to this analysis that may make the borrower's task even harder. It is possible that a particular second-lien lender could have hedged its exposure through the use of credit default swaps. Such a hedged lender may have no incentive to either participate in the workout or to sell to a willing participant. This issue is only likely to become more significant as participants in the credit default swap market work on new developments such as single-name loan swaps and cash (as opposed to physical delivery) settlement options. Both of these changes will increase the ability of a second-lien lender to hedge its exposure.

(Continued on page 26)

Borrowers should determine what relief they are seeking from their lenders. Possibilities for requested relief include (but are not limited to): (a) a runway with covenant relief to effect an operational turnaround; (b) significant asset sales and deleveraging; (c) the incurrence of additional debt to finance an acquisition with significant synergies; (d) debt for equity swap or equity infusion to remove debt from the balance sheet; (e) sale or auction of the entire business; or (f) a bankruptcy to facilitate any of the foregoing or to just stay creditors from taking unilateral action.

Once the borrower has determined what it desires its workout to accomplish, it needs to analyze the intercreditor and other underlying documents to understand who has to agree to various actions. To obtain covenant relief requires the consent of the lenders who have the particular covenants. It is probable that a borrower will need covenant relief from both its first- and second-lien lenders. However, even if the borrower determines that it only needs relief from its first-lien covenants, it is likely that the second-lien lenders will need to be included in the process, because the first-lien lenders will not be willing to provide any relief without maintaining the same cushion between them and the second-lien lenders that exists prior to any amendments.

To effect a material asset sale, the borrower will need relief from any asset sale restrictions contained in both its first- and second-lien debt. However, if the intercreditor agreement compels the second-lien lenders to release their lien in collateral if the first-lien lenders are releasing their lien in such collateral, the borrower may be able to negotiate exclusively with the first-lien lenders. This assumes that the borrower does not need any additional relief from the second-lien lenders, such as to change in any respect how the proceeds of the asset sale are required to be applied.

The analysis for incurrence of additional debt is similar to the analysis for covenant relief. It depends on which class of debt needs to allow the debt to be incurred and the first-lien lenders' desire to maintain an unused basket for emergency liquidity if the new debt is first-lien debt.

A debt-for-equity exchange has the potential to trigger a change-of-control provision in the borrower's debt, in which case, relief from the class of debt having the provision would be needed. Such an exchange could also implicate any applicable provisions restricting voluntary redemptions of debt by the borrower. An equity infusion may be subject to an equity sweep (as well as change-of-control issues, if it is provided by a new investor), that will require relief. Distressed investors that have acquired the second-lien debt from the original investors may be particularly hostile to any new equity, especially if they are looking to obtain or control the borrower' equity.

If the borrower ultimately concludes that it needs to seek bankruptcy protection to affect its workout, it will need to have a source of liquidity. This liquidity will most likely come through a DIP financing and cash collateral orders. The most likely source of the DIP financing will be the first-lien lenders who will want to avoid any other lender priming their lien. The ability of the first-lien lenders to provide a DIP and obtain satisfactory cash collateral orders without consent or objection from the second-lien lenders will in all probability have been addressed subject to certain limits and parameters in the intercreditor agreement. However, this negotiation will have occurred at the beginning of the deal long before the borrower ran into trouble. Accordingly, the provisions of the intercreditor agreement may not allow the first-lien lenders and the borrower room to accomplish their desired goals either with respect to the amount of the DIP financing or the scope of the cash collateral orders. In such circumstances, the second-lien lenders will have to be included in the prefiling negotiation ,which could impair or delay the borrower's ability to get the financing it needs.

Once a borrower has determined what its desired workout looks like and has analyzed its underlying agreements to conclude whom it needs to negotiate with and what relief it needs to request, the borrower needs to engage with its lenders. To enhance the possibility of success, the borrower needs to understand its lending groups and who will represent them. While it may seem counterintuitive, the borrower should consider trying to facilitate the second-lien lenders' efforts to organize themselves, especially if they will not be represented by an administrative agent.

In conclusion, the existence of second-lien loans is going to change the nature of workouts. In addition to the representational problems presented by second-lien loans, there is the issue of more parties at the table, which will lead to longer and more costly workouts. These factors increase the risk of failure to achieve a consensual workout. There may be more free-fall bankruptcies and liquidations than reorganizations. To reduce these risks, borrowers need to do more planning and analysis at the beginning and take greater control of the process. ▲

The views expressed in this article are those of the author and not necessarily those of Paul, Weiss, Rifkind, Wharton & Garrison, LLP

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