

Second Lien Loans Workouts – What Can Be Expected if the Credit Cycle Turns?

Eric Goodison, Partner, Paul Weiss Rifkind, Wharton & Garrison LLP, New York*

Overview

The US credit markets are now five years into a relatively benign credit cycle. Borrower defaults have been and remain modest. This low incidence of defaults has led to attractive risk-adjusted returns for investors in leveraged loans. One result of these circumstances has been to draw new investors into the leveraged loan market, including hedge funds, CLOs and other non-traditional lenders. This increased supply of funds available for leveraged lending has been a significant factor in the narrowing of loan spreads. As a result, beginning in 2003, when US interest rates were at historical lows some of these investors sought out ways to earn a higher spread. The search for higher spread has led to the development of a robust market in syndicated second lien loans. In 2003, the syndicated second lien loan market was almost non-existent. Today it is a significant portion of the leveraged finance market.

In its most basic form, a second lien loan is a senior secured loan with contractual terms which provide that the second lien loan's claim to recoveries from its collateral is second in priority to any first lien debt. The agreement with respect to the priority of the second lien loans is evidenced in an intercreditor agreement with the first lien lenders. The intercreditor agreement will often address additional issues such as:

- (a) standstill periods when the second lien lenders may not exercise remedies with respect to the collateral;
- (b) who will control any foreclosure proceedings as between the first and second lien lenders;
- (c) the ability to have additional first or second lien debt secured by the collateral;
- (d) the ability of the first lien lenders to compel releases of the collateral in certain circumstances; and
- (e) certain rights of the parties in any bankruptcy proceeding of the borrower.

It is worth noting, however, what a second lien loan is not. It is not a subordinated loan. In any bankruptcy or liquidation of the borrower, the second lien lenders will share ratably in any unsecured assets of the borrower with all other unsecured, unsubordinated creditors of the debtor.

There is concern in the marketplace that with the increase in US interest rates by 3.75% since June of 2004, the credit cycle could turn down and the number of workouts (including for borrowers with second lien loans) could rise significantly. As the second lien loan market is a recent phenomenon, it has not been through a down cycle. There is uncertainty as to whether workouts with second lien lenders will be more difficult than workouts prior to the development of the second lien loan market. Participants in the marketplace should expect workouts to be longer and more expensive, and ultimately that there will be more failed workouts. Issues which will drive this result include identifying willing and experienced parties to participate in the workout and greater and more involved negotiations among and with the creditors.

Who will participate in the workout?

Successful workouts are the result of negotiations among borrowers and creditors. The issue of who participates in the workout process is significant because a workout takes time, focused effort and commitment from all the parties in order to be able to reach an agreement. If one constituency does not bring these attributes to the negotiation it will be harder to agree on a course of action.

Prior to the development of the second lien loan market, the typical capital structure of a distressed leveraged borrower might include a secured first lien facility made up of a revolving credit facility and one or more term loans all secured equally and ratably and one or more issues of unsecured bonds. In the work-

Notes

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

out, it would not be unusual for the first lien lenders to be represented by their administrative agent, perhaps with the assistance of a steering committee of lenders and a financial advisor. The bond holders might have an unofficial committee of note holders pre any bankruptcy and be part of an official committee of unsecured creditors subsequent to the commencement of a bankruptcy case. Each constituency would also be represented by counsel. Administrative agents are generally large financial institutions with workout departments prepared to devote the necessary time and resources to a workout. Members of a bondholders committee are prepared to do the same. The players would also generally have experience and familiarity with workouts and their complexity.

The advent of syndicated second lien loans will add significant uncertainty and complexity for the participants and their roles. An initial issue will be determining who will act for the second lien lenders in any negotiations with the borrower and the first lien lenders. Most broadly syndicated second lien loans have the same administrative agent as the first lien loans. It might be natural for the administrative agent to try and act for all of the senior secured lenders – both first lien and second lien. However, there are conflicts between the interests of the first lien lenders and the second lien lenders which may lead either the second lien lenders to want separate representation or the administrative agent to decide it could not act for both classes of debt.

If the determination is made that the second lien lenders are to have separate representation, the issue arises as to who that will be. As mentioned above, the providers of second lien loans are not financial institutions with a workout infrastructure. This lack of infrastructure may also result in second lien lenders not being willing to devote scarce human resources to a time-consuming workout. Other factors which may cause second lien lenders to decline to participate include:

- (a) free rider concerns that if a particular second lien lender commits the time and resources to a workout when others do not, those other lenders will benefit to the same extent as the participating lender;
- (b) lack of relevant workout experience; and
- (c) receiving material non-public information which would restrict the second lien lender from such trading the borrower's other classes of debt and equity.

In all likelihood these factors will make it difficult to find members of the second lien group to participate fully in the workout. A probable solution to this problem is the outsourcing of the workout by second lien lenders. The second lien lenders would hire their own financial advisors and legal counsel independent of the first lien lenders. This is not a complete solution,

however, especially if second lien lenders are not willing to receive the non-public information that would be required for them to work with and give appropriate guidance to their advisors. It makes it much more difficult for the advisors to engage with the other participants without such guidance from their clients and means that negotiations will be longer and more difficult. Additionally, because the debtor has to pay for the expense of these advisors, it will certainly increase the costs of the workout.

An alternative possibility is that some second lien lenders would exit the facility by selling to willing buyers. In fact, some structured types of investors, CLOs in particular, are either required to sell defaulted loans within a given time period or are economically compelled to sell because of the harsh treatment of defaulted loans for their own covenant compliance. Willing buyers would likely be experienced distress investors. Distressed investors have been raising capital and looking for investments during the past few years. Having a significant distressed investor base could mitigate but not eliminate some of the issues concerning who participates in the workout.

How will intercreditor negotiations change in second lien workouts

Pre-bankruptcy – Prior to the advent of the second lien market the first lien lenders generally had a lot of room to negotiate with the borrower without having to worry about interference or participation by the unsecured creditors. The first lien creditors would generally have financial covenants and tight negative covenants that would be triggered prior to those of any other creditor. Unsecured creditors would usually have no financial covenants and much looser negative covenants. Problems that would trigger first lien lenders covenants might not even give rise to a default under the unsecured debt. If there were a problem with the unsecured debt, unsecured creditors generally were limited to accelerating their debt on default and suing for non-payment. Additionally, if the unsecured debt were subordinated, which would not be uncommon, the first lien creditors could prevent the unsecured creditors from exercising these remedies for a substantial period of time or, in certain circumstances, indefinitely. All of these factors meant that at the beginning of a workout, the first lien creditors were usually the only ones at the table with the borrower.

Being the only creditor with a security interest in the borrower's assets and having the tightest covenant package often meant that much could be agreed to by the first lien lenders and the borrower without the need for consent of additional creditors. Actions a first lien creditor group might be able to consent to alone could include:

- (a) incurrence of additional indebtedness (especially if the unsecured debt had unused baskets or room in an incurrence test);
- (b) asset sales;
- (c) waivers of cash sweeps from issuance of new equity;
- (d) financial covenant relief; and
- (e) acquisition transactions.

Also, it would not have been unusual for there to be a gap of several years between the maturity of the first lien debt and the unsecured debt, which means the first lien lenders could have room to stretch their maturity. This is less likely to be the case with a second lien loan where the maturity is typically only six to at most twelve months beyond the first lien debt.

Unlike unsecured creditors who were generally on the outside looking in, second lien lenders should be expected to be at the table from the very beginning of a workout. Also, by virtue of the second lien's more restrictive covenant package and secured position, the first lien lenders will have less flexibility to agree on a course of action solely with the borrower. What and how much flexibility the first lien lenders have will depend on both (i) the second lien covenant package and how much cushion there is between those covenants and the first lien covenants, and (ii) the terms of the intercreditor agreement, where the second lien lenders may have given back some approval rights.

Each situation will be unique not only because of the circumstances surrounding the borrower but because of the terms of the intercreditor agreement. These agreements are not standardised and will require careful analysis and review because differences in terms can lead to different outcomes. These outcomes can be more favourable to the first lien lenders or the second lien lenders depending on the provisions. For example, if the first lien lenders agree to release their lien on certain assets being sold, some intercreditor agreements require the second lien lenders to automatically release their lien on those same assets. In situations where this provision exists, it may be easier for the first lien lenders to agree with the borrower on a significant asset sale. Conversely, some intercreditor agreements cap the ability of the first lien lenders to increase interest rates, which is often an early action taken by the first lien lenders in return for a forbearance or financial covenant relief. If the intercreditor agreement blocks those actions, the second lien lenders will have to be part of the negotiations sooner. These are just two illustrations of the impact an intercreditor agreement might have. The permutations and combinations are probably as numerous as the number of different intercreditor agreements. No matter how these variations work, in general, participants should expect more negotiations with more parties sooner in the process.

More negotiations with more parties will inevitably take more time. Additionally, it is possible (and, in all likelihood, probable) that the first lien lenders and the second lien lenders will disagree over the meaning and interpretation of the intercreditor agreement. These disagreements could lead to further delays for borrowers, failure to reach an out of court settlement or litigation among the creditors.

Post-bankruptcy – In the pre-second lien world, a first lien lender could agree on debtor in possession financing and cash collateral orders without having to worry about an adequate protection fight from unsecured creditors. Additionally, the ability of second lien creditors to object to actions like assets sales may be greater than the ability of unsecured creditors to object. As with pre bankruptcy actions, the presence of second lien loans will clearly impact the ability of the first lien lenders to negotiate exclusively with the borrower. The extent to which the second lien lenders are at the table will be a function of what is being proposed and what rights the second lien lenders may have given up in the intercreditor agreement. Common waivers by second lien lenders that may potentially be found in intercreditor agreements include not objecting to:

- (a) debtor in possession financing and use of cash collateral supported by the first lien lenders (but usually subject to a cap in the case of the financing);
- (b) the granting of adequate protection to the first lien lenders in respect of their pre petition claims (often subject to the right of the second lien lenders to seek similar protection); and
- (c) asset sales supported by the first lien lenders (but potentially subject to a second lien in the proceeds of such sales or a requirement that the asset pay down debt or both).

As with the pre-petition activities, the provisions and interpretation of the intercreditor agreement will be crucial to the timing and level of the second lien lenders' participation in the workout. However once the borrower has become a debtor in bankruptcy there are potentially other issues. The intercreditor agreement is an agreement among the creditors of the borrower. It is not clear if the bankruptcy court has or does not have jurisdiction to enforce an agreement in a dispute among the creditors. Additionally, Section 510(a) of the US Bankruptcy Code provides for the enforcement of subordination agreements. There is potential concern that not all of the provisions of an intercreditor agreement will be treated as a subordination agreement. Such provisions may include adequate protection waivers and claim voting provisions. Unfortunately, there is not much case law on these points and what decisions exist are not consistent. Some decisions have enforced all of

the terms of intercreditor agreements and others have not. The uncertainty over this issue has the potential to complicate and delay any bankruptcy case.

Another area of concern is that the rights of the second lien lenders in any bankruptcy are dependant on the second lien lenders being in a secured position. Accordingly, if the value of the collateral is not more than the claim of the first lien lenders, the second lien lenders will be unsecured creditors with unsecured creditor rights and it will not matter if the second lien holders have waived their rights or if the intercreditor agreement is unenforceable. In a situation where the valuation question is a close call and the first and second lien lenders cannot reach agreement on an issue, it is possible that the first lien lender will initiate a valuation fight, which will be expensive and time-consuming.

Conclusions

There is no way to know if there will be a boom in workouts in the short term. If there is, participants should expect workouts involving second lien loans to take longer, consume more of the borrower's resources and possibly not result in any agreement or successful restructuring. It will be more difficult and expensive for the borrower to bring someone to the table who can speak for the second lien lenders. Once that participant is at the table, the negotiations will be more involved and cover more issues than workouts in the past. There will be more leverage in the hands of the second lien lenders by virtue of their secured party rights and possible intercreditor protections. That leverage will lead to more difficult negotiations and a greater potential for the negotiations to fail. The impact of these negotiations will be more free fall bankruptcies and liquidations and fewer successful restructurings.