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4.4.18 Defining Intercreditor and Subordination Terms in Deal Negotiations

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The overheated debt markets from 2003 to 2007 resulted in a record volume of buyout transactions by financial sponsors. The proliferation of second lien debt provided by hedge funds, private equity funds and other nontraditional investment vehicles like collateralized loan obligations satisfied the demand for leveraged debt created by these acquisitions. In contrast to traditional mezzanine indebtedness, second lien debt was less expensive and did not dilute the sponsor's equity ownership. In the current post-credit freeze era, second lien financing is disappearing, and mezzanine and other subordinated debt options are reemerging to fill the gap between senior loans and equity with a wide range of intercreditor and subordination terms. This article will discuss the importance of clearly defining these terms early in the process.

As the credit freeze begins to show signs of thawing, private equity groups and strategic acquirers looking to close buyout loans should expect banks and other lenders to approach these transactions with a "back to basics" mentality. An article in the October 9, 2009, edition of *The Wall Street Journal* entitled, "In Today's LBO Arena, Much Sweat, More Equity," provided recent examples of the more conservative capital structure mandated by senior lenders. Another area in which senior lenders' renewed preoccupation with fundamentals has manifested itself is intercreditor agreements. By entering into an intercreditor agreement with appropriate standstill, payment blockage, turnover and other key provisions, senior lenders and private equity groups may be able to avoid an unwelcome surprise in the form of a junior lender with the ability to disrupt workout negotiations at a later date.

Types of Subordination

Debt Subordination

Debt subordination refers to the agreement by a subordinated lender to defer payment of some or all of its claims until the senior loans are paid in full. A partial debt subordination would usually permit a subordinated lender to receive some or all of its scheduled payments in the absence of an event of default under the senior credit facility. A complete debt subordination means that the subordinated lender would not receive any payment on its loans until the senior lender received payment in full on its senior loans. A senior lender might require this type of subordination in a buyout transaction in which a portion of the purchase price is in the form of a note payable to the sellers in order to reduce the amount of cash necessary at closing to complete the acquisition. Second lien loans generally contained limited debt subordination provisions that were only triggered by collection actions. In contrast, current transactions involving mezzanine and other institutional subordinated debt typically provide the senior lender with the ability to implement a payment blockage against the subordinated lender for a specified period of time (generally set in the range of 90 to 180 days) for an event of default that does not involve the failure

to make a payment on senior debt, and a permanent payment blockage for a default due to failure to pay all or any portion of the senior debt.

Lien Subordination

Lien subordination means that one lender agrees that the priority of its liens on property that serves as common collateral will be subordinate to the liens of another lender. Subordinated secured lenders possess certain rights because of their status as lienholders that, in the absence of an agreement to the contrary, would interfere with the rights of senior lenders in workouts or bankruptcies. A typical lien subordination enables the senior lender to collect on the proceeds of its collateral before the subordinated lender, and the subordinated lender will agree to some short period of time before taking any foreclosure action against shared collateral. This is called a "remedy standstill" provision. The senior lender expects to be in the driver's seat for a period of time (*i.e.,* a range of 90 to 180 days) when it comes to dealing with, and exercising remedies against, the shared collateral. The generally accepted principle is that the subordinated lender should be permitted to exercise remedies in the event that the senior lender fails to commence an exercise of its remedies after this standstill period. Acquirers may want to move forward with documentation based on their lenders' mutual agreement that the second lien will be a "silent second" or that it will be "deeply" subordinated, but they do so at their peril. The meaning of both of those terms will vary from one deal to the next based upon numerous factors, including the composition of the senior and subordinated lender groups, the difficulty of syndicating those loans, the nature and value of the collateral for those loans, and the relative size of those loans. A deal can be delayed or sidetracked because of the lenders' failure to agree on what each side meant by the use of those terms.

Remedies standstill provisions will normally be accompanied by terms that require the subordinated lender to turn over any amounts that it may recover in a liquidation or bankruptcy to the senior lender. This type of "turnover clause" is intended to prevent a subordinated lender from receiving more than it would have been entitled to receive under the intercreditor agreement. Turnover provisions involve drafting nuances that may fundamentally modify their effect. For example, if the intercreditor agreement were to permit the subordinated lender to foreclose at the end of the remedies standstill period, then the drafting of the turnover provision might permit a subordinated lender to argue that it should not be obligated to turn over to the senior lender any funds that it received following the end of the standstill period.

Structural Subordination

Structural subordination is a device frequently encountered in transactions involving mezzanine and other types of subordinated debt. Structural subordination means that the priority of payment of an obligation as a practical matter is determined by the structure of the financing transaction and the recipient of the loan rather than by any express contractual agreement by a lender to subordinate its priority. In the standard structurally subordinated financing, the senior lender would make a loan to the operating company that owns the assets that serve as collateral for its loan, while the obligor of the mezzanine lender's loan would be a holding company that owns no assets other than the stock that it holds in the operating company.

Conclusion

In the current environment, one should expect that senior lenders will insist on structures that maintain the sanctity and protection of a deep subordination. At the same time, mezzanine and other subordinated lenders will be looking for better pricing, an opportunity for supplemental equity returns and greater rights than second lien lenders accepted during the frenzied credit environment that permeated from 2003 to 2007. Because of the conflicting goals of these two classes of lenders, a private equity group or other acquirer should convince its lenders to address intercreditor issues at an early stage in the deal negotiations in order to avoid potentially lengthy and costly delays when that deal is otherwise on the verge of consummation.

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