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LENDING AND RESTRUCTURING ALERT

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Second Lien Lending: The Big Picture

The middle market has seen a trend developing in which senior lenders permit their borrowers to obtain additional financing from new breeds of "second lien" lenders, where the collateral of each lender consists of substantially all assets of the borrower. Secondarily collateralized loan volume in 2004 has already surpassed that of 2003, which was a record year. Usually, under these arrangements, the first lien lender is a traditional lending institution. The identity of the second lien lender--who would rather not be called a "subordinated debtholder"--may vary. It could be a rather aggressive investment or "hedge" fund of the type that sometimes takes equity stakes in distressed companies. Alternatively, a Wall Street institution may arrange the loan with the intent of selling it in the capital markets. Under either scenario, intercreditor issues arise when structuring and documenting the financing.

One set of loan documents or two?

The first lien lender will usually prefer that the borrower enter into separate loan documents with its lenders. It wants to minimize any requirements that it consult with the subordinated lienholder before it may exercise its rights and remedies in case of a default. In addition, the first lienholder will seek to ensure that its secured claim is distinct from the secured claim of the junior lienholder. Otherwise, if the borrower files for bankruptcy, the court may find that the liens of both lenders actually constitute a single claim, that the first lienholder is not oversecured, and that it is therefore not entitled to post-petition interest. One set of loan documents could also expose the first lienholder to a greater risk of equitable subordination in a bankruptcy. The subordinated lienholder may hold an equity stake in the borrower, and it may therefore be deemed to be an "insider." It is easier to equitably subordinate the claims of insiders than the claims of non-insider lenders. Thus, if only one set of loan documents is used, the first lienholder could unhappily face an equitable subordination lawsuit based upon the conduct of the second lienholder.

Of course, the subordinated lienholder may likely prefer the use of one set of loan documents. It will seek to have input should the first lienholder consider declaring a default or waiving loan covenants, and does not want to waive any rights regarding voting on a bankruptcy plan. One set of loan documents is more likely to create a situation in which the first lienholder may owe duties to, or at a minimum have to afford greater deference to, the subordinated lienholder. The tension is manifest.

Rights to Payments

The first lienholder will try to limit payments to the subordinated lienholder to the greatest extent possible. For example, it will want to block payments to the subordinated lender if the borrower is in default, or until its debt is paid down to a certain level. The subordinated lender will typically admit that it should be paid from the proceeds of sale of collateral only after the first lender is repaid, but it will otherwise look for the right to be paid without further restriction. It will want the right to receive voluntary pre-

payments. One compromise could be for the lenders to agree in advance to a schedule of amortization payments.

Loan Modifications

The first lien lender desires the flexibility to increase the amount of its debt--e.g., to make protective advances--without the consent of the subordinated lienholder. Indeed, it may be difficult and time consuming to obtain the consent of the subordinated lienholder if the junior liens are held by a large number of lenders or bondholders. The first lienholder will also want amendments to its loan documents to apply automatically to the loan documents of the subordinated lienholder.

But the second lienholder will seek to avoid the risk that the borrower becomes over-leveraged and to limit the size of the senior lien. It can be expected to negotiate for a veto over significant loan modifications, such as the first lienholder extending the maturity of its debt or increasing its interest rate, altering its schedule of principal payments, or increasing the borrower's availability. Moreover, the second lienholder will try to limit the amount of time it must forbear from exercising its rights and remedies should the borrower's condition deteriorate. It will not want to wait long while the first lienholder decides whether to proceed against the collateral or to enter into a workout agreement with the borrower.

Release of Collateral

Once it has begun to exercise its remedies in accordance with its loan documents, the second lien lender will want the right to proceed with liquidation of the collateral subject only to the rights of the first lienholder to priority in repayment from the net proceeds. The first lienholder, of course, will ask the second lienholder to agree to release its lien on assets to facilitate a disposition on terms acceptable to the first lienholder, and to waive its right to exercise remedies against collateral until the first lienholder has been fully repaid. One compromise would be for the second lienholder's waiver to expire after three to six months. Expect this point to be a source of friction.

Closing Thoughts

Second lien financing presents an attractive alternative to traditional debt solutions or expensive mezzanine capital. Lenders should expect to see continued growth in this market area. In negotiating the loan documentation, hedge funds are more aggressively seeking rights to intervene and act proactively than are the Wall Street firms who intend to sell these loans in the capital markets. Sometimes, the negotiations can become fierce. At this juncture, no documentation has been recognized as standardized for second lien lending. This is not simply because of the recent growth in second lien lending in the middle market. It is largely due to the varying identity, character and approach of the second lien lenders.

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