REPRINTED FROM
THE JOURNAL OF CORPORATE RENEWAL

SECOND-LIEN FINANCING

'Silent Firsts' Offer Alternative to Typical Intercreditor Terms

BY DAVID ISENBERG, OF COUNSEL, MILBANK, TWEED, HADLEY & MCCLOY LLP

The rapid growth of second-lien financings in recent years has produced general acceptance for a structure that assigns to first-lien lenders a safe harbor period, often called the standstill period. During that time first-lien lenders may enforce against a distressed borrower rights and remedies in collateral, free from competing and perhaps conflicting collection efforts of second-lien creditors. This is one aspect of a typical intercreditor relationship under a second-lien structure.

The growing acceptance of second-lien financing has led to a number of transactions in which substantially all of the financing is provided by second-lien lenders as a term loan. Only a small liquidity facility, principally available to even out cash flows due to seasonality and to provide letter-of-credit availability, is provided as a first-lien revolving line of credit.

Here is a hypothetical but representative example. Acme Widget Company obtains a $10 million revolving loan from a large bank by issuing a first lien on its plant and equipment. In conjunction with this financing, the company also obtains a construction and term loan of $100 million for physical plant expansion. That loan receives a second lien on Acme Widget's plant and equipment.

Each financing is governed by a separate contractual agreement, and the two are tied together — and kept apart — by an intercreditor agreement between the first- and second-lien lenders. In a conventional second-lien arrangement, the lender holding the $10 million revolving line of credit, as first-lien lender, could exercise its rights, including forcing a sale of all collateral, without coordinating with or receiving the consent of the second-lien lender, who in this example has provided 90 percent of the financing. Among its many provisions, the intercreditor agreement between the two says that the second-lien holder will not receive interest or principal payments until the first-lien holder is current on both.

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Demand for widgets is brisk. Acme has drawn down the entire $10 million revolver, using it to buy inventory, and the $100 million credit line, which it used to expand capacity. Because Acme is making payments on both financings, both the first- and second-lien holders are happy. That changes, however, when problems arise. Demand for its products falls, and Acme Widget goes into the red and falls behind on its loan payments.

Although neither lender is happy with the state of affairs, the second-tier lender is especially anxious for two reasons. It knows that with each passing month, Acme is burning through capital that could be used to repay the second lien. The first-tier lender knows this, too, but it isn't nearly as worried because its debt, although smaller in comparison, is senior and therefore is protected by the cushion of the much larger second-lien financing. It is willing to wait while Acme Widget attempts to work out its problems. Besides, intercreditor agreements almost always include a standstill clause that specifies a period during which a second-tier lender cannot foreclose. This period is typically 90 to 180 days but can run for as long as 270 days.

Its attempts to right itself have failed, and things have gone from bad to worse at Acme Widget. The first-lien holder forecloses. The intercreditor agreement contains a clause that allows the first-tier lender to release the second-tier lender's lien. It then proceeds with a sale of assets, which in this illustration produces only $70 million to satisfy a debt that, counting missed interest payments, is now more than $110 million. The first-lien holder recovers its entire principal and accrued interest, while the second-lien holder takes a haircut of more than $40 million.

Getting Creative

In several recent transactions, creative lenders recognized the issues posed by the conventional intercreditor structure described in the example of Acme Widget. These lenders have agreed that the significantly smaller first lien will stand still for a time in favor of reorganization or enforcement by the second-lien lenders. The second-lien lenders then have a period of time after a borrower defaults to attempt to resolve the issues with the distressed borrower before the first-lien creditors commence their enforcement actions.

Under such a structure, the *quid pro quo* for the first-lien lender's patience is twofold: the second-lien lender assures the first-lien lender contractually that it will receive all amounts due in full before the second-lien lender receives any payments (except current interest), regardless of the source of such payments. And the first-lien lender receives uninterrupted current cash interest during the period in which it is prevented from enforcing its liens.

So long as these and any other agreed-upon conditions are met, a junior lender is free to negotiate with the issuer and, if necessary, foreclose and sell the assets. In effect, the first-lien holder says, "Because my loan is so small in comparison to yours and because I get first dollars from any deal you make, I will let you try to get the borrower back on track."

Under such agreements — which are not yet common — a second-lien holder has incentive to obtain the maximum amount in a foreclosure and also to avoid foreclosing altogether if it determines that the issuing company is worth more alive than dead. The first-lien holder is motivated to cede control of the process to the second because it will receive interest, even if the borrower cannot make those payments, and it retains first call on whatever funds the second-lien lenders receive from the borrower.

If the issuer stops paying interest to the first-lien lender, the second-lien lender can permit the first-lien holder to foreclose immediately. If the second-lien lender believes it will recover more money than will the first, the second-lien lenders have the option to pay the interest due to the first, thereby retaining control of the process.

As second-lien financing continues to grow in popularity, it is possible that "silent firsts" will become more common, especially when a junior lender's exposure is substantially larger than that of the senior lender. ■

David Isenberg is of counsel to Milbank, Tweed, Hadley & McCloy LLP, and is resident in the firm's Los Angeles office. He has extensive experience in representing both first- and second-lien note purchasers.

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THE JOURNAL OF CORPORATE RENEWAL

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