REPRINTED FROM
THE JOURNAL OF CORPORATE RENEWAL

SURVIVING AND THRIVING IN A TROUBLED ECONOMY

Exercising the Intercreditor Buyout Clause: Lessons from the Trenches

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

With further softening in the economy and continuing tight credit markets, the number of secured credit facilities that slide into default is sure to rise. Inevitably, a number of these defaulted credit facilities will have senior lien/junior lien structures, with the relationship between secured credit facilities defined by an intercreditor agreement.

While the rise of second lien lending among both investors and borrowers has been well documented in this publication and others, a few of the key concepts are repeated here. If the senior lien facility and junior lien facility are designed to accommodate multiple holders, as most are, a collateral agent or administrative agent will be appointed by the original holders at each priority level to hold the liens as agent.

The greater security of the senior lien position generally attracts more traditional lenders that are willing to accept traditional lending returns in exchange for traditional lending risk levels. Consequently, original holders of senior lien obligations are generally traditional lenders that are focused on return of principal when borrowers fall into distress.

Original junior lien holders, on the other hand, are often nontraditional lenders that are attracted to the investment by the prospect of receiving a greater return on a secured investment, albeit one that offers less assurance of a recovery from liquidation of collateral if the borrower goes into distress. Indeed, junior lien holders typically rely on the enterprise or going concern value of the borrower to provide a recovery or otherwise support the junior lien holder's exit.

To secure their position against junior lien holders, the first-lien holders typically require the junior lien holders to agree that, in the event that collateral is liquidated, whether through foreclosure or a sale of the business, the senior lien holders must be paid in full before any proceeds of such enforcement or sale are applied to repayment of the junior lien holders.

> In many intercreditor agreements, the buyout provisions were drafted with attention to timing, trigger events, and the purchase price but without significant thought to process.

As first-lien holders and second-lien holders of debt of a distressed borrower maneuver to protect their interests, disagreements as to how to proceed may arise between senior lien holders, who are more likely to be protected in a liquidation, and junior lien holders, who may feel that reorganization or a liquidation run by the junior lien holders is the best way to maximize value. These inevitable differences will cause junior lien holders to chafe under the burden of the limitations placed on junior lien action that are part of many intercreditor agreements.

This potential for fundamental disagreement was anticipated and led to the inclusion in many intercreditor agreements of a provision permitting the junior lien holders to purchase all of the interests of the senior lien holders for the full amount then owing to the senior lien holders under the applicable credit documents, commonly referred to as the "buyout provision." One can expect that, to a greater extent than in the past, second-lien holders will seek to buy out the debt and rights of the first-lien holders because the seconds will believe doing so may be the only way to, directly or indirectly, recover their junior lien investment.

In many intercreditor agreements, the buyout provisions were drafted with attention to timing, trigger events, and the purchase price but without significant thought to process. Therefore, many intercreditor agreements do not provide an adequate road map to either junior lien holders seeking to exercise a buyout or to the senior lien holders that are being bought out.

In the absence of attention to process, restructuring professionals advising both the junior lien holders and the senior lien holders may find themselves needing to invent a process and appropriate documentation as they proceed. Several of the potential problems that face both second-lien holders and senior lien holders in these situations are examined in the remainder of this article.

Competing Concerns

The reason for providing the junior lien holders with a buyout opportunity is illuminated by the following hypothetical situation. Wonder Widget Corporation pledges all its real and personal property as collateral for a $300 million loan, and first-lien holders put up $200 million and second-lien holders put up $100 million. If the loan goes into default and the first-lien holders foreclose, they must realize only 67 cents on the dollar from the collateral to be made whole.

If Wonder Widget is liquidated at 80 cents on the dollar, for a total of $240 million, the firsts will take their entire $200 million in principal, and the seconds will receive $40 million — less whatever interest in arrears is owed on the first-lien loan. So in this hypothetical instance, the firsts have recovered every penny of principal and interest, while the seconds have taken a haircut of more than 60 percent.

But what if the true value of Wonder Widget — the enterprise value — actually is $300 million or even more? To preserve the enterprise value and control the restructuring,

continued on page 2

continued from page 1

Also placed in play by execution of the buyout is the willingness of existing depository banks and the existing administrative agent to remain in their current roles, at least during an orderly transition period.

junior lien holders in this scenario will at least consider exercising their buyout right.

If a core group of junior lien holders does elect to exercise their buyout right, then issues arise almost immediately. Neither the typical credit agreement nor the intercreditor agreement contemplate, nor do they prohibit, a buyout of the senior lien by fewer than all of the junior lien holders or provide any structure for such a group. This leads to the possibility that not all junior lien holders will participate or, even more problematic, that competing groups of junior lien holders will seek to make buyout offers to the senior lien holders.

The first task for junior lien holders is to organize; their second is to formalize their plans into binding contractual obligations. Most intercreditor agreements provide that a buyout notice, once given, is irrevocable.[1] Junior lien holders wishing to exercise the buyout right therefore must organize themselves into a committed group. This requires time and should commence well before the window of opportunity to exercise the buyout right opens.

Once a group of junior lien holders has committed among themselves to fully fund the exercise of a buyout right, they are best served by entering into a formal written agreement that addresses the following points:

- The allocation of the total amount of the senior lien obligations among the participating junior lien holders
- Each junior lien holder's irrevocable commitment to fund its specified portion of the buyout amount
- Nomination of a junior lien holder to give notices and instructions on behalf of the group
- Agreement on ratable participation in any issued senior lien notes to be assigned through the buyout (replacement notes in the correct amounts are unlikely to be re-issued to the purchasing junior lien holders by the borrower, which often will have commenced a bankruptcy case)
- Agreement on allocation of senior lien buyout commitments to any additional junior lien holder that joins the agreement after initial execution
- Acknowledgment that each junior lien holder will have, and their several reaffirmations of their agreement to perform, all obligations of a holder under the senior lien credit agreement, including the obligation to provide indemnity and reimbursement to the senior lien administrative (and if applicable, collateral) agent
- A commitment to provide any reasonably required additional indemnification to the second lien agent
- An instruction to the junior lien agent to disregard any instructions from a non-participating junior lien holder to give a competing notice of exercise of the buyout right if the organized junior lien holders constitute a sufficient plurality to give such instructions to the junior lien agent

Once organized, the junior lien holders must advise the junior lien agent of their plans to exercise the buyout right. Intercreditor agreements typically provide that the junior lien collateral agent, in its agency capacity, will give all notices to the senior lien holders and execute the actual purchase of the senior lien obligations. The junior lien holders exercising the buyout will need to negotiate with the junior lien agent regarding a number of issues, including:

- The scope of additional indemnification for the junior lien agent
- An invitation to non-participating junior lien holders to join the buyout group (which such agent may feel obligated to provide, whether or not this notice is mandated by the credit agreement or the intercreditor agreement)
- The form of notices and other documents that are to be provided by the junior lien agent to the senior lien holders.

The results of negotiations between the buyout group and the junior lien agent should also be memorialized in a formal agreement. These arrangements can be memorialized either in the same agreement as the buyout group's funding commitments, if appropriate, or in a separate agreement that sets out the agreed forms of documents, such as the necessary notices.

The offer to other junior lien holders is generally to participate in the purchase of the senior lien in a maximum ratable amount equal to the ratable percentage of the junior lien obligations they hold at the time of the offer. First, the junior lien agent generally will take the position, correctly, that it cannot be an active participant in a process from which any junior lien holders are excluded. By offering the opportunity to participate to all junior lien holders on the same terms and conditions, the buyout group can remove this concern.

The junior lien agent usually will not be concerned with a holder that elects not to take advantage of an opportunity that was properly offered. In addition, by offering the non-participating junior lien holders an opportunity to participate on a ratable basis, the buyout group will obtain some protection against possible later allegations that actions were taken in the junior lien position primarily to benefit the senior lien position.

Other Concerns

The typical buyout provision of the intercreditor agreement does not really provide sufficient time, after giving notice of intention to execute the buyout, to complete paperwork for an orderly purchase of all of the senior lien obligations. In addition to outstanding principal and interest, these obligations

continued on page 3

continued from page 2

include ancillary secured obligations, such as cash management obligations, swap obligations, and outstanding letters of credit.

Also placed in play by execution of the buyout is the willingness of existing depository banks and the existing administrative agent to remain in their current roles, at least during an orderly transition period. Therefore, as soon as the decision to exercise the buyout has been made and the projected full buyout price at least informally committed, pre-notification conversations should be commenced with the senior lien agent and its counsel on the form of buyout documentation.

Neither the typical assignment and assumption agreement attached to the senior lien credit agreement as an exhibit nor the Loan Syndication and Trading Association (LSTA) forms work well with the exercise of the buyout, as they are geared specifically for the sale of positions by a single senior lien holder. Customized documentation will be necessary to address the multiple-holder nature of the transaction and also to address the ancillary issues raised in this article.

This documentation will include representations and warranties from each selling senior lien holder confirming the extent of the loans and commitments held thereby, as well as the lien-free title and authority to do the transaction, and should therefore be executed by each senior lien holder concurrently with the buyout's becoming effective.

In addition, the assets and commitments being transferred by each existing senior lien holder, and the transferee's interests and obligations therein, will need to be scheduled. Participating junior lien holders that are also existing senior lien holders may wish to net out their interests to reduce the cash that they need to provide to close the transaction, and may even end up being net recipients of cash if their existing senior lien positions are larger than their post buyout senior lien positions.

Finally, the terms and conditions of the existing depository bank and senior lien agent's continuing service or transition therefrom need to be arranged, including, if necessary, immediate appointment of a replacement agent or the opening of new accounts for the underling obligor.

And what about the owners and pre-existing management of the troubled company? Essentially, they have no input in this entire process. CR

[1] Some agreements provide an opportunity to cancel a buyout notice without penalty one or more times, but this feature appears to be restricted to a distinct minority of intercreditor agreements.

David Isenberg, a specialist in distressed finance, is of counsel to Milbank, Tweed, Hadley & McCloy LLP at its Los Angeles office and can be reached at Disenberg@Milbank.com. He recently guided a group of junior lien holders and the junior lien administrative agent through the exercise of a buyout of a senior lien position in a high-profile bankruptcy case. None of the principals in either the senior or junior lien positions had previously been involved in the actual exercise of a buyout clause.

This article is reprinted with permission of *The Journal of Corporate Renewal.* All rights reserved.