Intercreditors under the spotlight

Navigating the similarities and differences between US and European intercreditors

US second lien and European mezzanine intercreditors operate differently, and have been constructed to achieve different objectives. European mezzanine intercreditors typically combine payment seniority, security interest priority (across a range of creditor classes), lien subordination, claim subordination, broad enforcement standstill provisions (extending from acceleration of the junior facility to enforcement of collateral) and release mechanics upon enforcement by senior creditors. US second lien intercreditors, on the other hand, establish lien subordination, which regulates the rights of the US second lien with respect to collateral only, and include an enforcement standstill with respect to collateral.

What is the reason for these distinctions? Generally speaking, US second lien intercreditors are predicated on two key assumptions: first, that the business will be reorganised pursuant to Chapter 11; and second, that the first lien lenders have a comprehensive collateral package (including shares, cash, receivables and tangible assets). US second lien intercreditors routinely contain waivers from the second lien of rights to object to a debtor-in-possession (DIP) financing, a section 363 sale, a plan of reorganisation supported by first lien lenders, and provide relief from automatic stay. European mezzanine intercreditors in contrast, make no assumption as to where the business will be reorganised. Instead they assume the financing structure will be amenable to a swift enforcement sale or pre-pack, resulting in a financial restructuring where so-called out-of-the-money creditors' claims are removed from the structure.

The following table highlights differences between these two types of intercreditors. We have focused on these two types of intercreditor arrangements as the first-second lien relationship in the US more closely resembles the senior-mezzanine relationship in Europe rather than, say, the senior (unsecured) mezzanine relationship in the US or the first-second lien relationship in Europe. Note that European mezzanine is second lien secured.

By Milbank partners Suhrud Mehta in London and Lauren Hanrahan in New York

Leveraged finance quarterly

In this quarterly feature, Milbank's leveraged finance group distil, compare and contrast key features of the US and European leveraged finance markets.

It will shine a light on the legal blindspots that have arisen as markets and products converge, and as companies increasingly look to structure transatlantic deals.

Contributions from partners on both sides of the Atlantic have looked at loans and bonds, with large-cap or big sponsor-backed LBO documentation in mind.

Past instalments have focused on voting rights and revolving credit facilities. The next contribution will appear in the March edition of IFLR magazine.

Feature	US: first-second lien	Europe: senior mezzanine
1. Overview	US second lien intercreditors establish lien subordination only (no claim subordination) and limit rights of the second lien with respect to the collateral, typically by imposing an enforcement standstill with respect to collateral only. They also contain various bankruptcy (Chapter 11) waivers from the second lien of rights to object to a DIP financing, section 363 sale, or a plan of reorganisation supported by first lien lenders, and to relief from an automatic stay.	European senior mezzanine intercreditors provide for both types of subordination, contain broad enforcement standstills which extend from acceleration to enforcement of collateral and, importantly, contain mechanics for junior creditors' claims and security to be released upon enforcement by senior creditors.
2. Payment blocks	No payment block of second lien by first lien on first lien default.	Payment block during senior payment default. Typically also for 120 days per year during any other senior default.

3. Standstill	• No standstill on exercise of remedies as unsecured creditors, all rights as unsecured creditors preserved (although newer inter-creditors are seeking to limit rights as unsecured creditors as well);
	• Only prevents enforcement of collateral by the second lien, typically between 90-180 days.
		• Standstill on acceleration and enforcement for, typically:
		  • 90 days following notice of payment default;
		  • 120 days following notice of financial covenant default;
		  • 150 days following notice of other default;
		  • Plus (in some cases) 120 days if senior taking enforcement action.

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4. Enforcement	• Voting: Simple majority of >50% of first lien outstanding loans and commitments (not hedging) to enforce; • First lien creditors control enforcement so long as taking action.	• Voting: >66 ⅔% majority vote of senior (whether drawn or undrawn) debt plus hedging to enforce; • Mezzanine entitlement to enforce only after lapse of standstill; • Senior control enforcement – can override junior mezzanine instructions to security agent; • Mezzanine relatively passive – can only influence timing of enforcement action after standstill.
5. Purchase option	Second lien debt can purchase first lien in full (excluding hedging) following acceleration and/or other triggers (as negotiated) at par plus accrued interest.	Mezzanine lenders can purchase senior (in full and including hedging) following acceleration, at par plus accrued interest.

6. Releases of collateral and claims	• Second lien generally agree not to object to asset sales approved by first lien and permitted by second lien documents (and potentially other negotiated exceptions);
	• Second lien will automatically release (on first lien enforcement) and attach to proceeds of sale;
	• Meaningful protection afforded by Uniform Commercial Code (UCC) requirement for sale to be made in a commercially reasonable manner (or in transparent 363 sale process in case of a court approved sale in Chapter 11).
		• Ordinary course: security released if asset sale conditions met;
		• Enforcement: junior security and debt and guarantee claims released (or may be disposed of) subject to negotiated pre-conditions;
		• Market practice evolving but fair sale provisions are increasingly common (eg public auction/sale process or independent fair value opinion);
		• The Loan Market Association (LMA) inter-creditor agreement requires the security agent to take reasonable care to obtain a fair market price/value, and permits sale of group entities and release of debt and guarantee claims, plus sale of mezzanine debt claims;
		• Recent changes to the LMA intercreditor provide that the security agent's duties will be discharged when:
		  • the sale is made under the direction/control of an insolvency officer;
		  • made pursuant to an auction/competitive sales process (which does not exclude mezzanine creditors from participating unless adverse to sales process);
		  • made as part of a court supervised/approved process; or
		  • a fairness opinion has been obtained.

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7. Credit bid	• Section 363(k) of the US Bankruptcy Code preserves right of secured creditor to bid the amount of its secured claim (ie credit bid) in a sale of its collateral; • First lien credit bid: second lien typically agree not to object to sale of their collateral free of their liens in sale approved by the first lien, provided junior liens attach to proceeds of sale. This waiver may qualify as consent by the second lien to a credit bid by the first lien; • Second lien credit bid: intercreditor agreements are not consistent in their approach – some waive second lien right, some preserve it, and a waiver may not be enforceable; • Credit bid by the second lien will (unless document provides otherwise) require them to pay off the first lien in cash. • If credit bid by the second lien provides more value to bankruptcy estate than one supported by the first lien, court may not enforce the second lien waiver, since the debtor has fiduciary duty to obtain highest and best price for assets.	• Possible to implement under European financial collateral arrangements, but subject to documentation terms; • Junior lenders often seek protection from senior credit bidding senior claims and releasing junior claims and security (leaving junior without residual unsecured claims and without recourse); • Junior protection typically sought via fair sale provisions (see above); • Recent changes to the LMA intercreditor include explicit provisions dealing with application of non-cash consideration.
8. Anti-layering	Not included in first-second lien deals.	Anti-layering not LMA standard, but contemplated and often included.
9. Senior headroom	First lien obligations often set at 110%-120% of the amount of the first lien term loans and revolving facility on the closing date, plus the maximum amount of any incremental facility on the closing date.	Typically included and often set at 110% of senior term debt (plus revolving credit facility (RCF)/Capex).

10. Amendment restrictions	• Modifications of first lien documents requiring requisite second lien consent subject to negotiation but may be subject to:
	  • Cap on yield or margin increase and of first lien principal, above the senior headroom amount (see above);
	  • Restriction on extending scheduled first lien maturity beyond the scheduled second lien maturity;
	  • With respect to the second lien, less frequently with regard to the first lien, and negotiated out of some deals – restriction on addition of more onerous or new events of default or covenants.
	• Modifications of second lien documents requiring requisite first lien consent also subject to negotiation but typically parallel to (and often more restrictive than) the amendment restrictions limiting the first lien documents.
		Modifications to senior without requiring majority mezzanine consent typically subject to:
		• senior headroom concept (see above);
		• negotiated caps on senior margin and fee increases above fixed percentage or weighted average cost;
		• mandatory prepayment waivers, and deferrals of scheduled amortisation beyond, for example, nine months or senior headroom concept;
		• Standard restriction on amendments resulting in more onerous obligations than senior.

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11. Senior/first lien, mezzanine/second lien right to vote claims (in insolvency proceedings)	Not seen/second liens retain right to vote on plan of reorganisation (eg not in a manner inconsistent with the intercreditor agreement).	Rarely seen – typically strongly resisted by junior, except the right of the senior to vote junior usually included for subordinated/ intra-group creditors only.
12. Hedging	Hedging typically secured if provided by lenders and their affiliates but not regulated by intercreditor.	Hedging typically secured and regulated by intercreditor.
13. Refinancing of senior facilities	US intercreditor agreements provide flexibility for refinancing and often for the inclusion of additional secured debt subject to various conditions being satisfied.	Refinancing of senior without mezzanine or second lien consent is not typically expressly dealt with in senior- mezzanine intercreditors, and so structuring solutions would need to be considered on a case-by-case basis.