

INTERCREDITOR AGREEMENTS

Spot the difference

The structure and detail of US and English law intercreditor agreements can vary greatly. It is vital to understand the differences

US and English law intercreditor agreements appear very different at first glance. Many English law intercreditor agreements, whether used for transactions involving English companies or continental European companies, are based on the LMA precedent intercreditor agreement produced by the Loan Markets Association. This agreement is prepared for a leveraged transaction involving senior and mezzanine debt, and so requires substantial modification for use in a high-yield bond deal. In the US, banks and law firms tend to use their own intercreditor agreement precedents, which vary in style and substance.

The American Bar Association has published a model form of intercreditor agreement for first and second lien transactions, but this is significantly different from the forms of agreement that have become widely accepted and understood by the main stakeholders in the US finance and acquisition markets. It is rarely used as the starting precedent in large financings.

Intercreditor agreements for European deals typically combine payment seniority, contractual subordination and security interest priority across a range of creditor classes. US intercreditor agreements typically regulate security interest priority. Regulation of payment seniority and subordination is treated as a separate matter and is commonly achieved in the US through structural subordination or separate subordination agreement.

US intercreditor agreements also provide for more flexibility for refinancings and for the inclusion of additional secured debt.

The two types of intercreditor agreements also deal differently with the parties involved. In European deals, hedge counterparties are party to the intercreditor agreement and share the security granted to the senior lenders with a right to enforcement recoveries usually ranking *pari passu* with the most senior class of debt. Hedge counterparties also have voting rights on enforcement and other issues based on the close out amount or the marked to market value of the hedge.

In US deals, hedge counterparties are generally not themselves party to the intercreditor agreement. They can share security rights if their interests in the security are represented by the applicable administrative or security agent under the senior credit agreement and the associated security documents in the same manner as such agent represents the interests of the lenders under the relevant credit agreement. To share in such rights they must also accept the rights and limitations provided under the applicable credit documents. In US deals hedge counterparties typically have no voting rights or other direct control mechanisms.

In European bank/bond deals the bond trustee is a party to the intercreditor agreement. In US bank/bond deals, the bond

trustee is not usually a party unless the bonds are secured. If the bonds are subordinated, the senior creditors rely on subordination provisions in the subordinated indenture, guarantees and proceeds loan which the senior creditors are given rights to enforce (third-party rights).

Secured bonds are rare in contemporary US transactions but were not uncommon in 2009 as the US bond market recovered from the 2008 financial crisis.

US intercreditor agreements contain provisions reflecting US bankruptcy laws which facilitate restructurings. The restructuring process under Chapter 11 of the US Bankruptcy Code has no real equivalent counterpart in Europe.

Secured creditors with second priority rights to security (second secured creditors) may agree in an intercreditor agreement that they will have no right to object to debtor-in-possession financing in a bankruptcy where such financing and the security securing it are *pari passu* with, or superior in priority to, the rights of the existing creditors with first priority rights to the security (first secured creditors), and as such are ahead of the rights

Typical structures in US and European leveraged financings

Europe

- Senior secured bonds with a smaller secured revolving credit facility (RCF) which ranks ahead of the senior secured bonds as regards the proceeds of security enforcement but equally in right of payment (the super senior RCF structure)
- Senior secured term debt and an RCF and senior secured bonds ranking equally as regards the proceeds of security enforcement and payment (the *pari passu* bank/bond structure)
- Senior secured term debt and an RCF with a smaller amount of structurally subordinated high-yield notes benefiting from subordinated security and guarantees subject to payment blockage and enforcement standstills
- Senior secured term debt and an RCF and secured mezzanine debt borrowed by the borrower of the senior term debt, the mezzanine debt ranking behind the senior term debt and RCF as regards the proceeds of security enforcement and being subject to payment subordination



of the existing second secured creditors in the security. This is on the condition that the debtor-in-possession financing does not exceed an agreed cap and satisfies certain other (often highly negotiated) criteria. New money provided in a restructuring of an English company would only gain priority over debt secured by existing fixed security if the secured creditors agreed.

Alternatively, in the case of an English administration, if new money is borrowed by an administrator, the debt will rank ahead of the claims of the holders of floating charges but not fixed security. As a result it can be very difficult to fund trading in administration.

A US intercreditor agreement may contain agreements by the second secured creditors restricting their ability to object to matters supported by the first secured creditors in a US bankruptcy (such as asset sales and plans). The agreement may also require the second secured creditors to vote on plans of reorganisation in a manner specified by the first secured creditors. First secured creditors may also seek to silence second secured creditors in respect of adequate protection motions. Such motions may, for example, have the effect of requiring the debtor to grant additional or replacement security and/or cash payments if priming security is granted to DIP lenders.

A US intercreditor agreement may also provide for the position on an exit from

bankruptcy so that the second secured creditors can receive equity and/or debt instruments under a plan of reorganisation and the intercreditor arrangements will continue to apply to the debt instruments after the exit from Chapter 11. One of the difficulties with the current LMA intercreditor agreement is that the security agent is not permitted to distribute equity and debt instruments to secured creditors in satisfaction of their claims until converted to cash and a restructuring involving a debt for equity swap is often difficult.

Comparison of structures

Structures used for European leveraged financings have commonly followed one of four models (see first box).

In a super senior RCF structure the RCF usually benefits from incurrence covenants mirroring those applicable to the senior secured bonds, plus one or two financial covenants and covenants to protect the super senior status. Such covenants may include restrictions on securing structurally senior debt and the purchase of senior secured bonds without reducing the RCF *pro rata*. No payment blockages or enforcement standstills apply to guarantees and security. The secured bondholders have the right under the intercreditor agreement to control security enforcement for the first four to six months. There is no restriction on the RCF lenders accelerating their debt and following an RCF event of default triggering an insolvency proceeding and forcing the hand of the secured bondholders.

In a pari bank/bond structure the term debt and RCF benefit from maintenance covenants. No payment blockages or enforcement standstills apply to guarantees and security. In some existing structures the majority lenders of the bank facilities control security enforcement until the bank commitments fall below an agreed percentage (usually 25–30%) of the total secured debt so the secured bondholders do not have a day one vote. In other structures the secured bondholders have a day one vote on security enforcement. However, the bondholders' share of the vote is often lower than their share of the secured debt, being capped at typically 25–30% until the secured bond debt represents two-thirds of the total secured debt.

Bond investors have been arguing for greater voting rights under European pari bank/bond structures. In a recent tap issue the secured bondholders successfully argued for the cap on their voting rights to be increased to 40%. This issue is a hot topic in other current deals. Although the security for secured bonds cannot be released on an enforcement unless certain value protection

conditions are satisfied the secured bondholders with restricted voting power may find themselves in a weak position in a restructuring (as on the Seat deal). Non-bank investors holding either loans or bonds may find it more difficult than banks to participate in steering groups if they need to receive non-public information. They may also have a conflict of interest if they hold bank and bond debt.

There are concerns that, if secured bondholders have increased voting power, this may slow down a restructuring unless there is greater transparency of information. Often, though, secured bondholders also hold senior secured term loans and transparency has increased recently. In the US bondholders tend to be better organised in a restructuring and information is more readily available.

Structures used for US leveraged financings differ from those used in European acquisition financings, and the intercreditor agreements differ as a result. In the US it would be very unusual for publicly-listed senior secured bonds to be structurally subordinated. When structurally subordinated bonds are issued at holdco or superholdco level they are usually unsecured. The structurally subordinated bond debt is typically not regulated by an intercreditor agreement and is not included in any financial or indebtedness tests or calculations imposed under bank financing documents entered into by the issuer. Such bond debt is often regarded as more akin to equity in an analysis of the capital structure of the issuer and its consolidated subsidiaries. This is a logical approach where the source of repayment of the structurally subordinated debt is the upstream payment of dividends by the issuer, although ratings agencies continue to view these instruments with caution.

Asset-based RCFs are also common in the US. Although growing in popularity in Europe, such facilities are less common in cross-border European financings due to the cost and complication of putting the relevant cross-border collateral package in place. In US transactions, the RCF and term facilities are generally borrowed at the same level although subsidiaries of the borrower may be co-borrowers under the RCF. In European transactions the borrowers of the RCF are usually specified subsidiaries with bank consent being required for new borrowers.

The common structures used in US acquisition financings are rather different (see first box). Structures involving senior secured term debt and an asset based RCF or borrowing base RCF are common. The RCF lenders have a first priority interest in specific collateral (usually receivables and/or inventory, and the proceeds thereof) and a second priority interest in all other assets

US

- Senior secured term debt and an RCF, and unsecured senior bonds borrowed/issued by the same group company (usually the parent), such bonds not being regulated by an intercreditor agreement
- Senior secured term debt and an RCF, and unsecured senior bonds issued by a holding company of the borrower of the senior bank facilities, such bonds not being regulated by an intercreditor agreement
- Senior secured term debt and an RCF, and unsecured mezzanine debt issued by a holding company of the borrower, such mezzanine debt being subject to payment subordination and regulated by an intercreditor agreement if there are overlapping obligors
- Senior secured term debt and an RCF, and second lien debt, borrowed at the same level and having the same payment seniority but the second lien lenders having a second priority security to the collateral

Peculiarities of US second lien and mezzanine intercreditor agreements

- A standstill period may often only commence running on a mezzanine payment event of default or financial covenant event of default and not just an event of default under the senior facilities.
- Refinancing of the senior facilities may be permitted without mezzanine or second lien lender consent, subject to certain criteria being satisfied.
- Whereas European mezzanine facilities usually have maintenance covenants similar to those in the senior facilities with limited additional headroom, US second lien and mezzanine facilities often have fewer and/or looser covenants than those applicable to the senior facilities.
- The amount by which the first secured facilities can be increased and retain priority may be 10-15% of the original principal amount (including any applicable incremental facilities and any capitalised interest), as reduced by mandatory prepayments and commitment reductions, whereas headroom under some European intercreditor agreements may be reduced by nearly all prepayments.

(principally plant, property and equipment and the proceeds thereof). The term lenders have a second priority interest in the RCF collateral and a first priority interest in all other assets. The arrangements would be documented in an intercreditor agreement.

The intercreditor terms for European mezzanine transactions have similarities to those for US second lien transactions but differ somewhat to those for US mezzanine transactions. US mezzanine loans are often made to a holding company above the borrower of the senior facilities and are generally unsecured and, if there are overlapping obligors between the senior and mezzanine debt, then also subject to payment subordination (see second box for other ways in which US second lien and mezzanine intercreditor agreements may differ from those in Europe).

Cross default

The impact on the intercreditor position of a default under a class of secured debt also differs between US and European deals.

In European senior/mezzanine deals, a standstill period usually starts to run from the date a mezzanine payment or financial covenant event of default occurs and the senior facility agent receives notice. In a US deal, however, the standstill period may often only start to run on a mezzanine payment or

financial covenant event of default.

In European super senior RCF deals the RCF usually benefits from incurrence covenants based on those in the secured bonds and a financial covenant, which may be soft. Therefore, an RCF event of default is not likely to occur before an event of default occurs under the secured bonds. If the debtor becomes financially distressed, restructuring is likely to occur at a later stage when options may be limited and within a compressed time frame. In European pari bank/bond deals the bank facilities benefit from maintenance covenants so an event of default can be triggered and, therefore, a restructuring at an earlier stage.

The secured bonds will only benefit from incurrence covenants and will have a cross-acceleration event of default rather than a cross-default event of default. The occurrence of an event of default under the bank facilities will not entitle the secured bondholders to enforce, unless the facility lenders actually accelerate. This means that in a pari bank/bond structure the secured bondholders cannot benefit from the lenders' maintenance covenants by the back door. This, combined with the day one voting rights or capped voting rights, means the bondholders are in a weaker position than the facility lenders in a restructuring.

US senior facilities may be covenant-lite so the senior lenders may not obtain the right to enforce before the bondholders if the financial position of the debtor deteriorates. Alternatively, the RCF alone may benefit directly from a leverage-based financial covenant. However, in a typical covenant-lite deal this covenant would only trigger a default if any portion of the RCF is drawn in the preceding quarter, including where there are outstanding letters of credit that are not then cash collateralised.

Where the term loans and the RCF are documented by separate credit agreements with their separate claims regulated pursuant to an intercreditor agreement (as in the case of an asset-backed or borrowing base RCF) the term loan lenders may have a cross-default right though subject to a standstill period. Therefore the term loan lenders benefit indirectly from the RCF financial covenant. RCF lenders may however waive the breach to prevent triggering the cross-default until they are ready to start a restructuring.

In US deals, the right of the company to cure financial covenant breaches by putting in more cash is more generous than the European equity cure rights and so it may be easier to cure a financial covenant breach. Usually in US bank facilities Ebitda can be increased by new cash which does not need to be applied in repayment. But given the

financial markets, a more rigorous Ebitda definition is likely to apply to European acquisition financings.

Cramdowns and releases

Both European and US intercreditor agreements require second secured creditors to release their security over shares in a company on an enforcement sale of the company on the instructions of the first secured lenders.

A substitute lien will attach to the sale proceeds in the case of US intercreditor agreements. European intercreditor agreements also contain extensive release provisions requiring a release of claims of second secured creditors and group companies against not only the company sold but also its subsidiaries provided certain negotiated conditions are satisfied.

Under the LMA form of intercreditor agreement, in the case of an enforcement sale by or at the request of the security agent, the security agent must take reasonable care to obtain a fair market price in the prevailing market conditions. This reflects the position under English law but is rather vague and so is often negotiated. It leaves the bondholders in a weak position particularly if the senior lenders are the only buyers and, therefore, set the price.

This level of detail in the release provisions is not seen in US intercreditor agreements as the US bankruptcy law provides a mechanism for release of claims on a bankruptcy sale and also covers the valuations required. These provisions are, however, critical in a European transaction as an enforcement sale coupled with releases pursuant to the intercreditor agreement may be the only way to achieve an effective cramdown of second secured creditors in a restructuring. English courts do not have a consistent method for dealing with valuations whereas US courts are familiar with valuation methodology and the limitations of using liquidation valuations.

Under an intercreditor agreement for a European deal, a release of claims against a company and its subsidiaries on an enforcement sale of shares in a holding company is subject to negotiated conditions designed to ensure a sale for a fair market value.

Firstly, a release of a bank/bond deal and, increasingly, a mezzanine deal, is usually conditioned on the senior ranking and *pari passu* claims being released and not assumed by the purchaser or an affiliate (although such claims may be purchased if this gives a better realisation for creditors).

Secondly, the proceeds must be in cash or in the form of marketable securities and must be applied in accordance with the intercreditor waterfall.

This condition and the condition above are intended to prevent a debt for equity swap

leaving the second secured creditors with no cash proceeds or the first secured creditors conducting a sale of the shares through a pre-pack administration for nominal consideration and rolling the senior debt to a newco vehicle.

Finally, the sale must be made by a public auction or competitive bid process (or court supervised sale involving a fair value determination) or with the benefit of a fair market value opinion. This condition is to ensure third party involvement in the valuation and sale process.

In a Chapter 11 it is possible for senior lenders to force through their vote for a plan of reorganisation, including a cramdown of junior debt classes which are impaired (so they will not receive a full recovery). The release provisions in an intercreditor agreement may be of less importance. Also, enforcement of security is not common in a US bankruptcy. Chapter 11 will trigger an automatic stay preventing such enforcement. Secured creditors may seek a court order lifting the stay in appropriate circumstances. The intercreditor agreement will usually restrict the second secured creditors from seeking relief from the stay so that the first secured creditors control any effort to enforce (at least until a standstill period has run).

English insolvency law and most other European insolvency laws do not allow for a similar cramdown of a class of secured creditors.

In an English scheme of arrangement a majority of creditors representing 75% in value of those present or represented at a creditors' meeting can cram down the minority of creditors in a class. Each class whose rights are compromised has a separate vote, however. Unlike in the US, one class cannot cram-down another. Creditors with a second ranking right to security would usually form a separate class to creditors with a first ranking right. RCF lenders may also form a different class to term lenders.

In a European transaction, it may be possible to effectively cram-down out-of-the-money secured bondholders or mezzanine lenders if there is an enforcement sale at the direction of the first secured creditors. For example, an administrator appointed to an English borrower can sell the shares in the borrower's subsidiary to a bid vehicle owned by the first secured creditors if the claims of the other secured creditors and shareholders against the subsidiaries can be released.

The enforcement sale must be structured to satisfy the release conditions in the applicable intercreditor agreement, which many be difficult.

Such a route may not be feasible if the second secured debt is also borrowed by subsidiary companies. It is unclear whether

“US intercreditor agreements contain provisions reflecting US bankruptcy laws which facilitate restructurings”

the release provisions are effective to release principal debt claims so multiple enforcement sales would be needed which may just not be feasible.

An administration sale of a company's business will involve a sale of contracts and other business assets and may be extremely value destructive, particularly in the case of an operating company. A clause providing that a contract is terminable on insolvency can be invoked against an English company in administration or liquidation. Such *ipso-facto* clauses cannot be invoked against a US company in Chapter 11. Many UK restructuring professionals would like to see the stay on enforcement extended to the enforcement of *ipso-facto* clauses by suppliers and others to restrain duress creditors such as key suppliers.

In a US Chapter 11, there is some disagreement among US courts as to the extent to which secured creditors can credit-bid their debt and purchase a debtor. In the event of such a credit bid, the first secured creditors can credit-bid their debt and the other secured creditors can be left with no cash proceeds unless the other secured creditors make a higher bid. The other secured creditors are, therefore, usually given a right to purchase the first secured debt. The purchase mechanisms are sophisticated in US intercreditor agreements and include provisions to deal with undrawn letters of credit, prepayment premiums and the unwinding of secured hedging obligations.

In a European transaction second secured creditors are often given a right to purchase the whole (but not part) of the first secured debt at par following an event of default, acceleration or an insolvency event. The first secured creditors often require broad indemnities.

Emerging trends

The exercise of structural flex in bond bridges to include alternative financing to high-yield bonds within agreed cost limits is creating some variation in structure in European deals. As referred to above, in UK super senior RCF transactions, the bondholders typically have collateral enforcement control for between the

first four and six months and then the RCF lenders take over. If a mezzanine or second lien debt is added into the capital structure the RCF lenders will want to obtain enforcement control before any payment blockage or standstill periods applicable to such new debt expire.

Intercreditor agreements may become more flexible in allowing refinancings or additional debt and require amendments to the transaction documents. Snooze and lose provisions may become more important to ensure this can be done where the security agent cannot otherwise get instructions from an instructing group. Also less debt may be committed at the outset due to the lack of liquidity and cost so flexibility to add additional debt may be important.

It appears that the companies will increasingly rely on the high-yield bond market as the loan market contracts. It is likely that bondholders will succeed in getting greater voting rights and transparency in European pari bank/bond transactions to bring them somewhat closer to the US position. If bondholders have greater voting rights, they will need to have more involvement in restructurings and possibly be prepared to receive private-side information and accept a lock-up. Again, snooze and lose clauses may be helpful where bondholders do not want to vote.

European mezzanine lenders are likely to keep pressing for greater rights particularly while mezzanine is filling the funding gap. These are likely to include equivalent protections on enforcement given to bondholders, a wider class of permitted payments, flexibility to convert mezzanine debt to equity or even exercise cure rights, rights to receive financial reports and more restrictions on changes or restructuring of the senior facilities.

European companies may increasingly seek financing from the US markets while the European financial crisis continues and this may lead to some convergence of the European and US markets although the differing insolvency regimes will always necessitate some differences in approach.

In the US there appears to be a trend, in cases that have tested the enforceability of certain provisions of intercreditor agreements in US bankruptcies, for courts to be increasingly willing to allow creditors to agree rules before the Chapter 11 petition that will govern their relative rights in a US bankruptcy. US courts are also more willing to enforce intercreditor provisions such as those discussed above.

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