Acquisition Finance: The "Inside Second Lien" Covenant Structure

ARI B. BLAUT AND JOYCE Y. KWOK, SULLIVAN & CROMWELL LLP

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An article by Ari B. Blaut and Joyce Y. Kwok of Sullivan & Cromwell LLP on a recent and growing trend regarding the covenant structure of second lien loans in first and second lien acquisition financings.

Second lien lending in the U.S. leveraged loan market has recently become dominated by direct lenders. According to Standard & Poor's Leveraged Commentary & Data, 74% of the $5.25 billion of second lien loans issued in the second quarter of 2019 ($3.87 billion) were in the form of privately placed loans. By contrast, 86% of the $11.84 billion of second lien loans issued in the second quarter of 2018 ($10.13 billion) were in the form of syndicated loans. This seismic shift in the second lien loan market from syndicated loans to pre-placed loans with direct lenders has important implications for borrowers, first lien lenders, second lien lenders and sponsors, particularly with respect to covenant flexibility for borrowers in acquisition financings.

COVENANT STRUCTURES IN FIRST LIEN AND SECOND LIEN LOANS

Negative covenants in second lien loans have traditionally been substantially identical to those in first lien loans, with the exception of permissive baskets and thresholds. Basket and threshold levels for second lien loans have historically been outside the corresponding first lien baskets and thresholds by an additional "cushion" that typically ranges from 15% to 25% of first lien covenant levels. The size of the cushion and whether it only applies to fixed dollar baskets and thresholds, or includes ratio-based baskets and thresholds, are common points of negotiation.

Otherwise, there are only limited instances in which second lien loans have typically included tighter covenants than their first lien counterparts, such as anti-layering provisions which prevent the borrower from incurring debt that is junior in right of payment to the first lien loans but senior in right of payment to the second lien loans.

The overarching principle governing the relationship between first lien and second lien loans is that the first lien lenders should have the first opportunity to work through covenant breaches with the borrower, without interference from the second lien lenders.

As the market has shifted over the past year towards syndicated first lien loans with privately placed second lien loans, it has become increasingly common for the privately placed second lien loans to have a significant number of covenant baskets and thresholds set inside the corresponding first lien covenant baskets and thresholds. This trend has been driven by:

- The need for private credit to provide junior capital.
- First lien arrangers being increasingly willing to go to market in the first instance with aggressive sponsor-favorable terms, while relying on broad market flex provisions to cut back on these more permissive terms if necessary to ensure a successful syndication.

Second lien lenders generally benefit from flex on the first lien loans because changes to the first lien loan terms require corresponding changes to the second lien loans. However, there is no assurance that aggressive borrower-favorable terms marketed by the first lien arrangers will ultimately be flexed, because the syndication may be successful on the terms initially proposed. Given the loose terms marketed by arrangers of first lien loans, some private credit providers have pushed for significantly tighter covenant terms in the second lien loans than those of the corresponding first lien paper. Sponsors and borrowers have been willing to accommodate those tighter second lien terms due to:

- The economic certainty provided by privately underwritten loans.
- The relationship between the borrower or its sponsor and the private credit provider.
- Recognition that private credit providers are "buy-and-hold" investors, rather than arrangers that often do not retain large positions in the deals they arrange.

CHANGES IN SECOND LIEN LOAN COVENANTS

Terms that become tighter in many second lien loans include restrictions on:

- Debt and liens.
- Investments and restricted payments.

DEBT AND LIENS

Second lien lenders have been focused on limiting debt incurrence by the borrower and its guarantor subsidiaries, as well as by the borrower's non-guarantor subsidiaries.

Regarding the borrower and its guarantor subsidiaries, second lien lenders are particularly concerned about the amount of permitted first lien debt, which must be paid in full before any proceeds from collateral can be applied to repay the second lien loans. Without specific limitations, borrowers can potentially use multiple debt and lien baskets to incur additional first lien debt, including the increasingly generous general debt and lien baskets. In some recent deals, second lien lenders successfully argued to impose specific limits on first lien debt so that, with respect to lien priority, the second lien lenders only rank behind:

- First lien term loans and revolving commitments existing at the closing of the second lien loans.
- First lien incremental debt up to the first lien leverage ratio at closing.
- Permitted refinancings of first lien debt.

At the same time, second lien lenders have pushed to limit debt incurred by non-guarantor subsidiaries, because in a foreclosure the creditors of non-guarantor subsidiaries would be paid ahead of the lenders to the parent borrower with proceeds from the assets of the non-guarantor subsidiaries. To limit such structurally senior debt, second lien lenders have pushed successfully in some deals for aggregate caps on non-guarantor debt that apply to all debt baskets that may be used by non-guarantor subsidiaries, not just the ratio debt basket for which a cap on non-guarantor debt is more common.

Second lien lenders have also been concerned about the ability of the borrower to incur incremental debt that matures earlier than the initial second lien loans. Historically, incremental debt secured on a pari passu basis with the second lien loans cannot mature earlier than the maturity date of the initial second lien loans, while incremental debt secured on a junior basis must mature some while after the maturity date of the initial second lien loans (for example, at least 91 days after the maturity of the second lien loans).

In the last couple of years, many sponsors have pushed for an "inside maturity basket" that permits the incurrence of *pari passu* or junior incremental debt that has an earlier maturity date than the initial second lien loans. First lien arranging banks have been increasingly willing to bring these terms to market. This inside maturity basket raises similar concerns as senior priority debt and structurally senior debt in that it effectively allows other debt to be paid ahead of the initial second lien loans. Recently, second lien lenders have had some success in removing or reducing the size of the inside maturity basket.

INVESTMENTS AND RESTRICTED PAYMENTS

Second lien lenders have also been focused on limiting potential collateral leakage that may result from investments and restricted payments. It is important for second lien lenders to close any loopholes in those covenants that allow borrowers to remove collateral during times of financial difficulties in a way that may cause the second lien loans to become partially or even completely unsecured.

In recent years, credit agreements have increasingly adopted the approach taken in high-yield bonds, in which all investments in restricted subsidiaries are permitted. This can be problematic for secured lenders because non-guarantor restricted subsidiaries are not required to pledge any collateral and any transfers of collateral to non-guarantor restricted subsidiaries results in the release of the secured lender's liens on those assets. Therefore, in recent deals private second lien lenders have pushed more strongly for caps on investments in non-guarantor restricted subsidiaries.

Investments in unrestricted subsidiaries are an even greater concern for second lien lenders because unrestricted subsidiaries are not subject to the covenants in the credit agreement. Although these types of investments are generally subject to strict limitations, these limits have loosened in the borrower-favorable loan market of recent years. Certain distressed borrowers have exploited their increased flexibility by contributing significant assets, such as material intellectual property, to an unrestricted subsidiary and using those assets to secure additional debt incurred by the unrestricted subsidiary. In response to this development, private second lien lenders have negotiated for smaller baskets for permitted investments in unrestricted subsidiaries, intended only to permit occasional investments by the borrower in joint ventures. For borrowers whose intellectual property is material to their businesses, second lien lenders have also pushed for specific limitations on the transfer of intellectual property by the borrower or its guarantor subsidiaries to the borrower's non-guarantor subsidiaries, to ensure that any material intellectual property remains part of the lenders' collateral.

Sponsors have been able to achieve increasingly favorable permissions to make restricted payments in the syndicated first lien loan market, thanks to the arrangers' willingness to market those aggressive terms subject to market flex if the syndication is not initially successful. For example, the leverage-based restricted payments basket often only requires a minimal amount of deleveraging before the borrower can make unlimited restricted payments. Second lien lenders have resisted this and have negotiated leverage-based restricted payments baskets that require pro forma leverage to be at least one turn of EBITDA inside the closing date leverage. They have also imposed more limitations on the accessibility of builder baskets for restricted payments, such as requiring compliance with a leverage ratio.

INTERCREDITOR AGREEMENT IMPLICATIONS

The cross-acceleration provisions in second lien credit agreements and the standstill provisions applicable to second lien lenders in intercreditor agreements are usually consistent with the overarching principle governing the relationship between the first lien lenders and their second lien counterpart. Instead of a cross-default, where an event of default under the first lien credit agreement automatically triggers an event of default under the second lien credit agreement, second lien credit agreements typically provide for a cross-acceleration to the first lien credit agreement.

This means that first lien lenders must accelerate their loans before an event of default occurs under the second lien credit agreement (unless there is an independent event of default under the second lien credit agreement). Even after an event of default occurs under the second lien credit agreement, the standstill provisions in intercreditor agreements generally prevent the second lien lenders from exercising remedies against shared collateral until a specified standstill period, which typically ranges from 90 to 180 days, has elapsed.

In some deals, the standstill period is triggered by an event of default under the second lien credit agreement, such as an uncured covenant breach, but in other cases the second lien lenders must accelerate their loans in order to trigger the standstill period. In any event, first lien lenders have the exclusive right to control the exercise of remedies for a considerable period of time post-default and second lien lenders only retain limited creditors' rights during that period.

In spite of a market shift towards tightening covenants in second lien credit agreements, the cross-default provisions in first lien credit agreements and the standstill provisions in intercreditor agreements have largely preserved the intercreditor dynamics described in the previous paragraph. Unlike the cross-acceleration provisions in second lien credit agreements, first lien credit agreements typically provide for cross-defaults to the second lien credit agreement. This means that a covenant breach under the second lien loan agreement automatically triggers an event of default under the first lien credit agreement, regardless of whether the second lien lenders have accelerated their loans. As noted above, the standstill provisions in intercreditor agreements ensure that the first lien lenders have a seat at the table in any discussions with the borrower regarding its non-compliance. This holds true even when the borrower has only breached a covenant in the second lien loan agreement but not the first lien loan agreement.

Private second lien lenders have not generally negotiated for any changes to the standstill provision in connection with obtaining tighter covenant terms from the borrower, but they have been focused on the definition of "first lien cap" in intercreditor agreements.

In intercreditor agreements where there is a first lien cap, the waterfall provision provides that any first lien debt incurred by the borrower in excess of the first lien cap is paid after the payment in full of the second lien obligations. Without a properly defined first lien cap, the tighter limitations on the incurrence of first lien debt in the second lien credit agreement are less meaningful, as any first lien debt incurred in violation of the second lien credit agreement is still paid ahead of the second lien obligations under the waterfall provision in the intercreditor agreement. It is therefore important for second lien lenders to ensure that the first lien cap is defined in a way that is consistent with the debt covenant in the second lien credit agreement.

FIRST LIEN LENDER'S PERSPECTIVE

First lien lenders should consider whether and how the second lien debt may be tighter than the first lien debt and what that may mean if the borrower becomes distressed. The second lien lenders may have a seat at the table or have control over whether to waive certain defaults or events of default, which may change the creditor dynamic. While many credit agreements permit documentation with tighter provisions in many respects after the closing date, first lien lenders may not be fully aware of the scope of the tighter provisions on day one and should aim to educate themselves on the changing dynamic.

LEAD ARRANGER'S PERSPECTIVE

Lead arrangers must consider the potential disclosure implications related to having inside second lien debt, particularly in transactions where the second lien debt covenants are significantly inside the corresponding first lien debt covenants, and the potential syndicate is not fully aware of the depth of the tighter terms. There may be some concerns regarding the disclosure of tighter second lien loan terms to the first lien lenders. The extent to which more prominent disclosure highlighting the differences between the first and second lien covenants is warranted should be considered on a case-by-case basis.

THE FUTURE

The recent trend with respect to tighter second lien covenant terms is expected to continue, as private credit providers continue to dominate the second lien loan market amid market uncertainty. Credit market participants should not assume that second lien lenders will accept looser terns, with their covenant baskets and threshold amounts set with a cushion above the loose terms negotiated by first lien arranging banks in reliance on significant flex terms. The focus of second lien lenders will continue to be on terms that disproportionately affect them more than first lien lenders, including senior debt permission and collateral leakage, but second lien lenders may also look to tighten up covenants more generally when the current credit cycle turns.

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