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New ABA Model Intercreditor Agreement Offers Guidance

By **Barbara M. Goodstein and Alan M. Christenfeld**

An intercreditor agreement is, as the name suggests, an agreement among different creditors of a common borrower that specifies the relationship among the creditors, often addressing such issues as priority of payments, subordination of liens, and actions in a bankruptcy of the borrower. This column has tackled intercreditor and subordination issues on several occasions over the past dozen years.¹ During that period, the institutional second lien debt market, and the corresponding importance of intercreditor agreements, have grown enormously. Today we discuss the model intercreditor agreement recently promulgated by an American Bar Association task force for use in negotiating intercreditor arrangements between a lender or lending syndicate making commercial loans secured by a first priority lien on specified collateral (first lien loans) and a lender or lending syndicate making commercial loans secured by a second priority lien on the same collateral (second lien loans).²

Background

When this column addressed key issues for secured creditors in subordinated debt arrangements in 1999, the structures that involved intercreditor agreements were much simpler than those employed in recent years. The subordinating creditor then usually was an insider or investor in the borrower, rather than a financial institution seeking a return on a financing arrangement. Where the subordinating creditor was a financial institution, normally it was an investment company, rather than a bank or other commercial lender, that provided mezzanine financing. Mezzanine financing — a hybrid of debt and equity that sits midway between the two in a borrower's capital structure — is debt capital that gives the lender the right to convert the debt into an ownership or equity interest in the borrower upon foreclosure or default of the loan, and mezzanine lenders often receive equity or warrants for equity in the borrower as a compensation “kicker.”

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Both the right to payment of, and any liens securing, both insider debt and mezzanine debt are typically subordinated to the claims and liens of the borrower's senior lenders. In second lien loan transactions, however, the second lien loans are pari passu with the first lien loans and only the liens securing the second lien loans are subordinated. This significant feature of second lien lending has attracted many money-center banks and other large commercial lenders that have sought to enhance the yield on their loan portfolio while managing credit risk. It has also drawn borrowers looking to finance themselves at an all-in cost lower than that charged in traditional mezzanine arrangements. As a result, the second lien loan market, barely an infant in 1999, grew to a volume exceeding \$29 billion by 2006 and reached \$15.21 billion in the second quarter of 2007 alone.³ Moreover, it spread from large leveraged loans to the middle-market and asset-based loans.⁴

As larger amounts of institutional capital have flowed into the second lien loan market, the dynamics of negotiating senior-junior loan transactions have evolved. The junior lenders have increasingly become sophisticated financial institutions having bargaining power similar to that of the senior lenders, and they are represented by high-powered law firms experienced in large commercial lending transactions. Yet, there has been no market "standard" form of intercreditor agreement and little published guidance on the issues that counsel should consider in drafting or reviewing an intercreditor agreement. Periodically a titanic "battle of the forms" has erupted, each side proffering a draft intercreditor agreement that is favorable to it and often invoking its interpretation of the nebulous and ever-shifting "market practice" to justify its position on contested issues. Inevitably, therefore, intercreditor agreements have become among the most complex and heavily-negotiated documents in commercial lending transactions. As a result, the creditors have become obliged to invest significant time and effort negotiating intercreditor arrangements and the intercreditor agreements found in the market vary greatly in terms. Many market participants have voiced the need to articulate a standard to reduce the time and resources used in structuring intercreditor arrangements and to create a semblance of uniformity from deal to deal.

Recognizing the need for standardization of intercreditor agreements, the Committee on Commercial Finance of the American Bar Association's Business Law Section established the Model First Lien/Second Lien Intercreditor Agreement Task Force ("task force") in 1999. The task force's mandate was to develop a "middle of the road" model intercreditor agreement that is acceptable to both first lien holders and second lien holders. The task force developed a model through a series of discussions and reviews by lawyers who regularly have represented the three principal affected constituencies—first lien lenders, second lien lenders and borrowers. The task force's final Model First Lien/Second Lien Intercreditor Agreement ("model agreement"), together with a covering report, annotations and commentary, was published in the May 2010 edition of *The Business Lawyer*.⁵

The New Model Agreement

The model agreement, with annotations and commentary, occupies nearly 75 densely printed pages, and it covers dozens of issues that could be the subject of loan origination and post-default negotiations. Space limitations compel us to confine our discussion here to the broad intent and purposes of the model agreement. Readers interested in the new model's details should, of course, review the model agreement, annotations and commentary in their entirety.

When first evaluating the model agreement, one needs to bear in mind what the new model is not. Created in large part to address the issues concerning the relationship between first lien holders and second lien holders with a borrower and collateral in common, the model agreement does not address the issues arising from mezzanine or other lending arrangements, such as payment subordination. Even with respect to second lien debt financings, the model is not intended to cover all factual permutations or varying business arrangements in such transactions. As the task force clearly states, the model agreement should not be used as “a universal solution to the problem of identifying the ‘correct form’ to use for a transaction. The form will necessarily be determined by the details of the transaction.” Nevertheless, although the details of different first lien/second lien financing transactions vary in many ways, the task force notes that nearly all intercreditor agreements dealing with priority of liens in common collateral must necessarily address similar lien subordination issues as well as the effect of the intercreditor terms both in and out of bankruptcy proceedings involving the borrower. “While there will be structural differences in the transaction itself, the same issues will be present.”⁶

Accordingly, the model agreement and accompanying comments, other footnotes and text “are intended, first and foremost, to be a reference tool for practitioners.” The model agreement “introduces the major components of lien intercreditor agreements generally, addresses why such provisions are necessary, and explores the effect of drafting a provision in a manner more favorable to a first or second lien lender.” The comments, in turn, explain the general purpose of each section, highlight the principal issues encountered in practice and purport to convey prevailing market expectations. “Armed with an understanding of these basic concepts and their implementation in the Model Agreement, the practitioner may construct an intercreditor agreement that fits his or her transaction.”⁷

Potential Benefits

Although the task force has not attempted to promulgate a “standard form,” the model agreement promises to be quite useful to practitioners and their clients. Since the model provides ample footnotes and comments that highlight the most commonly-negotiated issues, both legal and commercial, it will function as a helpful checklist of issues to review and consider when structuring and negotiating a first lien/second lien intercreditor arrangement.

The model agreement can also serve as a starting point for negotiations between the parties, providing guidance as to the range of industry-acceptable results of the issues that are commonly debated. In many of its provisions, the model agreement explains the different options that the market

has observed for such provisions in past transactions and offers alternative business options — either first lien friendly, second lien friendly or neutral — and language implementing the different choices. Being a model, of course, it supplies well-vetted and accepted language to memorialize in the intercreditor agreement the results of the parties' business negotiations. It remains to be seen whether the model agreement will enable senior and junior lenders to reduce the time and effort they spend negotiating, but it should facilitate drafting the agreed provisions and thereby save time and expense.

Moreover, the model agreement ought to facilitate the management of client expectations. The players in first lien/second lien financing transactions sometimes have unrealistic expectations, especially if the deal is relatively small or if one of the lenders is new to this type of transaction. A first lien lender might consider the second lien lender philosophically to be an equity holder with a lien (rather than as a *pari passu* lender that is merely subordinating its lien), while the second lien lender might view itself to be a senior lender with a higher coupon. Either such party might then make requests that are inconsistent with the nature of the actual intercreditor relationship. The development of a model document that is the product of discussions among various participants in the first lien/second lien market should help practitioners to anchor the intercreditor expectations of their clients in reality.

Conclusion

As with other forms of financing, the volume of second lien lending fell sharply during the financial crisis in 2008.⁸ Recent first lien/second lien financings have been much smaller than those in vogue before the onset of the "Great Recession," as illustrated by the \$20 million second lien financing of Hoffmaster Inc. by Prospect Capital Corporation announced last month.⁹ However, when the economy and commercial loan markets improve, the demand for a tranche of institutional debt that is subordinated in some manner to the senior loan but yields a higher coupon is likely to increase. Some industry experts have predicted that the next wave of institutional subordinated tranche will take the form of mezzanine loans rather than second lien liens.¹⁰ Nevertheless, whether second lien loans regain their prefinancial crisis prominence or are replaced in whole or in part by mezzanine loans, the lien subordination issues that the senior and junior lenders will confront will remain largely the same. Moreover, many first lien/second lien credits remain outstanding. Accordingly, the model agreement should remain relevant irrespective of how the institutional subordinated debt markets evolve in the future.

The model agreement is the product of years of give and take by lawyers who regularly represent the principal players in the first lien/second lien market. Although the new model does not supply a solution for every issue that first lien and second lien lenders could encounter in a financing transaction, it highlights the key issues to consider when dealing with intercreditor agreements, provides guidance for market practice regarding intercreditor relations and furnishes drafting language for various alternative business arrangements. One hopes that it will gain wide acceptance among financing lawyers and clients. In any event, the model agreement is required reading for everyone who engages regularly in first lien/second lien transactions.

This article is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations.

For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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Notes

1. See Alan M. Christenfeld & Shephard W. Melzer, "Navigating the Second Lien Financing Market," *NYLJ*, Oct. 6, 2005 at 5; "An Introduction To Intercreditor Agreements," *NYLJ*, April 4, 2002 at 5; and "Subordinated Debt: Key Issues for Senior Creditors," *NYLJ*, Oct. 7, 1999, at 5.
2. Committee on Commercial Finance, ABA Section of Business Law, Report of the Model First Lien/Second Lien Intercreditor Agreement task force, 65 Bus. Law. 810 (May 2010) ("ABA Report").
3. *Id.* at 810 (citing *LoanConnector*, www.loanconnector.com (downloaded April 1, 2010)).
4. A typical structure in a middle-market or asset-based loan is for a revolving lender to hold a first lien on all accounts, inventory and other current assets while a term lender holds a first lien on equipment, real estate, and other fixed assets, with each lender also taking a second lien in the other's primary collateral. "Variations of such 'wrap' structures have become increasingly creative." *Id.*
5. See ABA Report, *supra* n.2.
6. *Id.* at 810-811.
7. *Id.* at 811.
8. *Id.* at 810.
9. See "Prospect Capital Makes \$20 Million Secured Debt Investment in Hoffmaster," *Marketwire* (June 3, 2010), <http://www.marketwire.com/press-release/Prospect-Capital-Makes-20-Million-Secured-Debt-Investment-in-Hoffmaster-NAS-DAQSEC-1270445.htm> (last visited July 28, 2010).
10. See, e.g., Richard Kellerhals, "Mezzanine Debt Draws Investor Interest," *Investment Dealers Digest*, June 18, 2010 at 6.