

MEZZANINE

## Intercreditor agreements for mezzanine lenders

BY CLAIRE SPENCER



Market participants had hoped that the decline of second lien lending, which overshadowed mezzanine during the private equity boom years, would allow mezzanine providers to re-establish themselves in the wake of the credit crunch. But they are still waiting for buyout activity to recover. In the meantime, mezzanine lenders are keeping a close eye on their existing portfolio, which may present challenges if a debtor fails to maintain its repayments in the current climate and senior lenders look to exercise their rights at the expense of subordinated creditors. To protect their interests, mezzanine lenders are advised to focus on maximising their position in the intercreditor agreement.

### The role of mezzanine in the current market

After the financial crisis broke, the use of mezzanine instruments, along with all types of lending, plummeted dramatically. However, it was widely held that mezzanine would experience something of a renaissance when the market recovered, due to its relatively low-risk profile and ability to fill various gaps in the capital structure. But this is yet to occur. The situation owes much to the fact

that traditional mezzanine lending depends heavily on the senior debt markets, which are still heavily constrained, explains Michael A. Jacobson, a partner at Katten Muchin Rosenman LLP. "The pricing parameters of mezzanine providers, often organised as partnership funds, are linked directly to their limited partners' return expectations or, more apropos, requirements. Given those expectations and requirements, mezzanine funds face inherent difficulties in providing lower-priced senior debt, senior stretch and second lien debt. Therefore, they, alone, cannot fill the senior debt vacancy," he explains. Furthermore, mezzanine debt is comparatively expensive, albeit cheaper than equity, and this impacts its appeal to potential borrowers. Another factor is that traditional providers of capital are increasingly using it on the secondary markets, where the yields tend to be more compelling than the pricing that borrowers are typically prepared to pay for mezzanine on new deals.

Lending activity in the middle market and lower middle market has increased slightly in recent months. In addition, fundraising has been relatively robust among new funds, led by professionals displaced during the collapse of the senior debt markets, and second-

ary funds led by experienced players. These funds can deploy their capital more flexibly as fund documents have become more tolerant during this uncertain investment period.

Flexibility of deployment methods is prudent, along with flexibility of the actual structure of mezzanine instruments – although it is fair to say that 'flexible' is not synonymous with 'loose' in this scenario. Indeed, in today's market, mezzanine providers will insist on elements such as penny warrants and equity kickers to compensate for the elevated lending risk. Considering the tough lending environment, many borrowers will agree, sometimes granting between 5 and 15 percent of the fully-diluted equity in the form of warrants. "Capital structures vary from deal to deal. Some sponsors reluctant to issue 'in the money' equity positions at closing try to implement variations of preferred equity structures that diminish the effects of such grants until real growth is realised. So-called 'no-call' provisions and higher prepayment premiums also are prevalent – mezzanine providers don't want to take credit risk today only to be taken out of a transaction upon the loosening of the senior debt markets," notes Mr Jacobson. In addition, with mezzanine interest rates sitting between 16 and 18 percent, cash-only interest structures have vanished to be replaced by a combination of cash pay and payment-in-kind interest.

This may seem attractive but, in reality, mezzanine lenders can easily find themselves in an untenable position if the borrower becomes distressed. "The main problem that may arise for mezzanine lenders is that, as warrant holders, they will want to be protected against a conversion of senior debt into equity," says Pascal Chadenet, a partner at Salans LLP. "But normally, the terms of their warrants protect them against dilution. In France, most mezzanine lenders have so far managed to assert that protection," he adds.

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**If a mezzanine provider wishes to convert some of its debt into a controlling equity position, as part of an informal restructuring, there are a number of factors to consider.**

tion, as part of an informal restructuring, there are a number of factors to consider. Firstly, can they sustain the day-to-day running of the business? This predominantly concerns a healthy level of working capital, but can also involve strategies and incentives to retain key members of management, while weeding out the management practices that may have led the company into trouble in the future. They may also need to appease the senior lender, as well as addressing unsecured trade creditors. Furthermore, issues that arise from the change in control, debt structures, and other regulatory factors must also be taken into account.

Clearly, conversions to equity are immense-ly complex, and do not always occur. Indeed, it is quite often the case that the mezzanine provider is contractually subordinated to the provider of senior debt. The contract can limit

the rights that may be exercised by mezzanine lenders, sometimes prohibiting specific actions until the senior debt is fully paid. But in this market, the proceeds arising from a liquidation may not be sufficient to cover the senior debt, let alone the mezzanine tranche behind it in the capital structure. Consequently, bankruptcies can wipe out the mezzanine element altogether if it is not the fulcrum claim, as well as in cases where the sponsor is prepared to inject more equity as part of a pre-pack administration. Furthermore, Mr Jacobson explains that if the mezzanine claim is found to be unsecured, their claims will most likely be classified as being *pari passu* with other unsecured creditors. To make matters worse, the mezzanine providers remain subject to turnover provisions in the subordination agreements, thereby reducing or eliminating any potential recovery relative to other unsecured claimants.

**Securing recoveries**

With regards to mezzanine lending in Europe, lenders must ensure that they are protected by a strong intercreditor agreement. This should even be the case when the borrowers have detailed direct restrictions and limitations in the deal documents, and in spite of the fact that intercreditor agreements tend to benefit the senior lender to the greatest extent. “There are some provisions which operate to protect the mezzanine, including a restriction on the freedom of the senior lenders to amend the senior agreements without the consent of the mezzanine lenders,” explains John D Markland, a partner at Kirkland & Ellis International LLP. “For example, the mezzanine lenders need to be able to prevent the senior lenders from agreeing to add more than a certain percentage of senior debt – usually 10 percent – to protect them from being buried under an ever-increasing amount of prior-ranking debt,” he says. Any senior debt exceeding that percentage must then rank behind the mezzanine tranche. Consequently, a breach of those provisions by the senior lender would provide the mezzanine lender with a direct claim against that lender, as opposed to the borrower, which is desirable. Other limitations can also be put

into place, including on fees and interest rates. Furthermore, prohibitions on contractual restrictions on mezzanine debt payments can also be arranged.

Mr Markland also identifies some other desirable elements of the agreement. For example, they can compel any enforcement by senior lenders to be commercially reasonable, so that the highest price possible is obtained. They can also ensure that they are not subject to a so-called ‘drag’ provision, which would force them to go along with any decisions made by the senior lenders. “Another key point to focus on is the rights afforded to the mezzanine provider in a bankruptcy proceeding. Can the mezzanine provider participate on a creditor’s committee, vote its claim without restriction, or provide a DIP facility? The breadth of issues expands if the mezzanine provider is to be granted a junior lien, as is usually the case in European deals. Ideally, due to the intricacies of these arrangements, the representatives of the mezzanine providers would draft the provisions and agreements to maintain consistency within the portfolio and in their approach,” adds Mr Jacobson. Furthermore, they should ensure that the senior lenders are unable to release their claims in the case of a security enforcement, as well as (ideally) ensuring that their costs and expenses are covered, even in the case of a payment default.

Of course, in some jurisdictions, intercreditor agreements are of a fairly set form. “Intercreditor agreements have become pretty standard in France, and there is not much room for negotiation,” notes Mr Chadenet. “Among the few issues that remain to be negotiated are the terms of the stand-still period and the rights of the senior lenders to amend their financing documentation without the mezzanine having a say in it,” he notes. Indeed, market consensus for the basic tenements of a subordination agreement is fairly widespread. In Europe, the Loan Market Association has recently issued a standard intercreditor agreement, which has been widely adopted. In the US however, things are generally more complicated for mezzanine deals, as terms, structure, and complexity tend to vary wildly from



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deal to deal. Other rogue factors include industry focus, leverage ratios, the identity and relationship between key participants, and the relative sizes of the various tranches.

Ultimately, the mezzanine market is not growing as quickly as many would like, but it is still growing and positioning itself for further growth. "For example, debt providers in France have become more sophisticated at negotiating that part of the intercreditor agreement that relates to the rights to sell the

secured assets in the event of foreclosure," says Mr Chadenet. "And just a few years ago, as an increasing number of deals were financed by staple financing arrangements, terms and covenants of the mezzanine component began to be aligned on, if not identical to, those of the senior loan. This trend has subsided," he adds.

Mezzanine structures have been through the wars in the last year, but there is now light at the end of the tunnel. Indeed, new funds are raising

capital in spite of the sluggish market, and developing new and innovative investment strategies that will allow them to be more responsive to any changes. The intercreditor arrangement is an important element of future strategies, as it limits the chances of a mezzanine lender being placed entirely at the mercy of senior lenders in a workout scenario. The confidence to lend with greater security will allow mezzanine to continue playing an important role in leveraged financing arrangements. ■



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