UNDERSTANDING SUBORDINATED DEBT AND THE RISKS

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A. Definition of Subordinated Debt

1. General speaking, “Subordinated Debt” is indebtedness of a creditor with respect to which such creditor’s rights are subject to another creditor’s rights.

a) Debt subordination is typically accomplished with a subordination agreement. Such subordination applies to the right to payment from any source.

b) Lien Subordination is typically accomplished with an intercreditor agreement. Such subordination applies only to the right to payment from collateral proceeds.

c) Intercreditor agreements and subordination agreements may address both debt and lien subordination within the same document. The titles of such agreements are often used somewhat interchangeably.

d) Please note that the terms (i) subordinated creditor and subordinated lender and (ii) senior creditor and senior lender, in each case, are used interchangeably herein but in the case of clause (i) shall mean such creditor in which its rights are subject to another creditor’s rights and in the case of clause (ii) shall mean such creditor in which its rights are superior to another creditor’s rights.

2. In practice, there are many financial scenarios encompassed within the term “Subordinated Debt”.

B. Due Diligence on the Borrower

1. Important for the creditor (whether senior or subordinated) to know the capital structure of the borrower and the other loan parties in order to assess the risk of whether any other creditor or third party has any right that would prime the rights of the proposed creditor.

2. Reviewing Borrower Structure

a) Determining where the debt exists, given that the location of the debt in the organization structure can lead to subordination (see below for a discussion on structural subordination).

b) Are there any restrictions in the organizational documents of the loan parties concerning the incurrence of debt or the granting of liens? Restrictions on the transfer of equity interests are also relevant if an equity pledge is anticipated to be part of the collateral pool. Provisions restricting the disposition or other transfer of assets should also be closely reviewed, as a foreseeable result of the granting of a lien is foreclosure on the collateral.

c) Is shareholder/director/member consent required for the loan parties to incur the proposed debt and/or to grant the proposed liens or guaranties?

d) What other entities will be obligated on the debt? This is important because such other entities may have other indebtedness that must be diligenced and addressed as well.

3. Existing Debt and Liens

a) Existing liens could prime any proposed lien of the new senior or subordinated lender.

b) How do you find existing debt and liens?

(1) Lien Searches at the secretary of state level are standard. Lenders also generally search for state tax liens, federal tax liens, bankruptcy and judgement liens.

(2) Title searches and commitments should be obtained if real estate collateral will be taken.

(3) County-level fixture filing searches should be obtained if the lender is relying on fixtures as collateral.

(4) Lenders may require the loan parties to complete and return a Diligence Questionnaire early in the documentation process, but that is only as reliable as the borrower is truthful.

4. Contractual Prohibitions/Third Party Consent Rights

a) After the disclosure of each loan party's indebtedness, lenders should review all existing debt documents to confirm whether any existing creditor's consent is required for the loan parties to incur the proposed debt or otherwise enter into the proposed transaction.

b) The lender or its counsel should review material contracts to determine whether any assignment/pledge of such contract as collateral requires consent of a third party. If a pledge of equity interests will be taken, the change of control provisions should also be reviewed. Depending on the materiality of third-party contracts, the lender might rely on the certifications, representations, and warranties of the loan parties concerning the provisions of third-party contracts.

c) In an acquisition financing, careful attention should be given to the assignment provisions of the purchase agreement if the purchase agreement is to be collateral for the proposed debt (i.e., if the lender would like the ability to exercise rights and remedies under the purchase agreement). If collateral assignment to the purchaser's lender is not expressly permitted without necessity of any further action, then the lender may require that the seller deliver a separate consent to such collateral assignment (or an amendment to the purchase agreement).

C. Senior Lender's Interests

1. The senior lender's ideal scenario – depending of course on the business deal – would be a fulsome intercreditor agreement providing that:

a) there is no limitation on the amount of senior debt;

b) any amount owed to the subordinated lender constitutes subordinated debt;

c) no payment may be made on the subordinated debt until such time as the senior debt is paid in full in cash;

d) the liens of the subordinated lender are fully subordinated to the liens of the senior lender;

e) the subordinated lender will not exercise any of its rights or remedies until such time as the senior lender permits it to do so; and

f) the subordinated loan documents will not be modified in any way without the prior written consent of the senior lender (but the senior loan documents may be freely modified).

2. The senior lender would also want the loan documents to be calibrated so that an event of default would occur under the senior loan documents prior to occurring under the subordinated loan documents, and would in no event occur under the subordinated loan documents prior to occurring under the senior loan documents. Subordinated debt may be cross-accelerated with senior debt, but should not be cross-defaulted with the senior debt.

3. The senior lender should review the financial covenants in the subordinated loan agreement in detail in order to ensure that they do not restrict the amount of senior debt more severely than any negotiated limitation in the intercreditor agreement.

4. The senior loan documents should contain a restricted payment covenant that does not permit the company to make any payment of the subordinated debt that would not be permitted pursuant to the intercreditor agreement. The payment conditions may be expressly set forth in the senior loan agreement.

5. The senior lender might want to make all filings and recordings that are necessary for perfection of its liens and the liens of the subordinated lender. This allows the senior lender to control the order of filing and thus ensure that the lien priority negotiated in the intercreditor agreement is backed up by the timing of perfection.

D. Subordinated Lender’s Interests

1. The subordinated lender will want to preserve and provide for as many benefits, rights, and remedies as possible.

2. This can include negotiating the overall structure of the transaction so that certain payments of subordinated debt are permitted, the subordinated debt may be secured, and certain of its liens might have a higher priority (i.e., a wrapping-lien scenario).

3. The subordinated lender may negotiate the intercreditor agreement in order to decrease the length and frequency of payment blockage periods and to decrease the length of standstill periods. The subordinated lender may also negotiate for a cap on the amount of the senior debt and/or increases in the interest rate, and to preserve its ability to exercise rights and remedies in certain scenarios.

4. These aspects of intercreditor agreements will be covered in more detail under the “Intercreditor/Subordination Agreement” section.

II. Different Structures and Approaches to Subordinated Debt

A. Structural Subordination

1. The term "structural subordination" refers to subordination resulting from the borrower's place in the organizational structure of a company. There are other ways that lien and payment priority may be tiered by means of tactics other than a written subordination agreement. Although not technically "structural subordination", it is reasonable to touch upon those methods under this heading.

2. "Structural subordination" occurs because a lender to the parent entity in an organizational structure will not have direct access to the assets of the subsidiaries, but rather only those assets that reach the parent level by means of dividends and distributions. In a bankruptcy scenario, a lender to the subsidiaries would be paid prior to the distribution of assets to the parent company for application to the debts of the parent company. The interest of a lender to the parent company in the assets of the subsidiary is thus structurally subordinated to that of a lender that has advanced a loan directly to such subsidiary.

3. A lender may cause its loan to a company to be prioritized in terms of payment by setting a maturity date that is prior to the maturity date of other debt of the company.

    a) Such lender should carefully review the documents governing such other debt. Prepayment requirements and default triggers merit particular attention.

    b) Such lender should restrict the company's ability to modify the documents governing such other debt.

4. With respect to a company with both secured and unsecured debt, the unsecured debt is essentially "subordinated" to the secured debt to the extent of the value of the collateral.

5. Lien "subordination" may occur without the use of a written subordination agreement. One lien can have a higher priority than another lien in the same collateral due to the timing or the means of perfection.

    a) Time of Filing/Recording:

(1) When lien priority depends on time of filing, the lender that perfects first on a particular asset has a lien that is higher in priority than the lien of a lender that subsequently perfects its security interest on such asset.

(2) For instance, if Lender A files a UCC-1 financing statement in the appropriate filing office in the morning of the closing day, and Lender B so files in the afternoon of the closing day, Lender B's lien perfected in this manner is of a lower priority than Lender A's corresponding lien.

(3) When multiple financings close on the same day, it is common practice – even if a written subordination agreement is in place – for the lender that is to have the higher priority lien on a particular category of collateral to make the filings and recordings necessary for perfection with respect to such collateral on its own behalf and on behalf of the lenders that are to have lower-priority liens. This increases efficiency in an enforcement scenario and provides an additional level of assurance.

b) Superior Mode of Perfection:

(1) Liens on certain assets can be perfected in several ways, but certain modes of perfection will result in a higher-priority lien.

(2) A lien on a deposit account is one of the most common examples. Such a lien can be perfected either by filing a UCC-1 financing statement with the appropriate filing office or by obtaining control over the deposit account. The Uniform Commercial Code provides that:

(a) A security interest held by a secured party having control of the deposit account has priority over a conflicting security interest held by a secured party that does not have control.

(b) A secured party bank has control of deposit accounts that constitute collateral and are maintained with such bank by the debtor.

(c) Control can also be obtained by having the debtor, the secured party, and the bank enter into a “control agreement”, by which the bank agrees to comply with instructions concerning the disposition of funds originated by the secured party, without further consent by the debtor.

(d) Control is also obtained when the secured party becomes the bank’s customer with respect to the deposit account.

(e) In summary, in terms of lien priority, perfecting by control is more favorable than perfecting by filing, and a security interest held by the bank with which the deposit account is maintained has priority over a conflicting security interest held by another secured party (unless that other secured party has become the bank’s customer with respect to such deposit account).

(f) The moral is that a secured party that is relying on a particular deposit account maintained by the debtor with a third-party bank should not simply file a UCC-1 financing statement with respect to such deposit account, but should also enter into a control agreement concerning such deposit account (or be the “customer” with respect thereto).

(3) Similar frameworks concerning perfection by filing and control exist with respect to liens on investment property, electronic chattel paper, letter-of-credit rights, electronic documents, and beneficial interests in certain land trusts.

(4) There are several nuances concerning the perfection of a lien on fixtures. A lender relying on such collateral should become familiar with these nuances and conduct thorough diligence on the real property to which the fixtures are attached.

(5) This is not intended to be an exhaustive discussion of types of collateral with respect to which a lien can gain priority over another lien by a means other than a written subordination agreement or the order the respective UCC filings of the secured parties. Such a discussion would be a webinar unto itself.

(6) Subordination and intercreditor agreements typically contain a “bailee for perfection” concept to address scenarios in which it is possible for only one secured party to perfect by the method that provides a lien of the highest possible priority. The secured party relying most on that particular collateral will perfect by the most desirable method, and the second-lien secured party will name it as its bailee for perfection. This is designed so that the second-lien secured party can have the benefit of the superior perfection method against third parties. A common example of this scenario arises with respect to certificated equity interests.

B. Mezzanine Debt

1. Mezzanine debt is so named because it occupies a place in the company’s capital structure between debt and equity. It can be comprised of unsecured debt, second-lien debt, or preferred equity.

2. The senior lender will usually insist that the mezzanine debt have a maturity date that is later than the maturity date of the senior debt.

3. It is fairly typical for the mezzanine loan documents generally to mirror the senior loan documents, but for the details of the financing, the maturity date, and cushions on baskets and financial covenants. A senior lender will not want it to be possible for an event of default to occur with respect to the mezzanine debt prior to the occurrence of an event of default with respect to the senior debt.

4. Mezzanine debt is typically subordinated, in terms of both payment and liens (if secured), to senior debt by means of a written subordination agreement. Mezzanine debt may also be structurally subordinated as an additional assurance, by causing the parent entity in an organizational structure to be the sole obligor with respect to the mezzanine debt, while all entities in the organizational chart (with typical negotiated exceptions) are obligors of the senior debt.

5. If secured, the liens will be deeply subordinated or the scope of the collateral could be limited.

6. The mezzanine intercreditor agreement will typically address payment blockages (automatic and/or resulting from blockage notices), standstill provisions (essential if the mezzanine debt is secured), and turnover provisions. The mezzanine lender may negotiate for limitations on the frequency and total number of blockage notices and to shorten the length of a blockage or standstill period.

7. The parties may also agree that the mezzanine lender may receive certain types of payments even during a payment blockage scenario, such as interest that is “paid in kind”, i.e., added to the principal of the mezzanine debt or paid by the issuance of additional securities.

C. Seller Subordinated Debt

1. The deferred portion of the purchase price of an acquisition constitutes seller debt. Seller debt can be in either a known amount, such as debt evidenced by a promissory note given as part of the purchase consideration, or an earn-out obligation that arises only if certain performance targets are attained.

2. In either scenario, a lender to the purchaser will want to have control over when funds leave the company. This is best accomplished by both building restrictions into the negative covenants of the credit agreement and by the lender entering into a subordination agreement with the seller.

3. Incorporating an appropriate restricted payment covenant into the credit agreement is not enough, as such covenant is not binding on the seller and the company could be put into the position of deciding between violating the credit agreement or its agreement with the seller. This also raises tortious interference with contract concerns.

4. Seller debt is generally unsecured, but this can be somewhat complicated if the payment obligations are supported by escrowed funds. The lender to the purchaser will want to make sure that each party’s respective rights to such funds are clear and acceptable.

5. A standstill period with respect to seller debt can be of a very long or indefinite duration.

D. Second Lien Debt

1. One secured party may have a lien on all assets of a debtor that is subordinated to the lien of another secured party, or the secured parties may have “wrapping liens”.

2. Wrapping liens are common when one secured party provides a term loan and the other secured party provides an asset-based loan. Each would have a first lien on the collateral that directly supports its loan and a second lien on all other collateral. In a wrapping-lien scenario, the two lenders are on relatively equal footing in general, but their rights with respect to particular classes of collateral are carefully delineated.

3. Second-lien debt is not necessarily subordinated in terms of payment, but the extent of the subordination varies among second lien transactions. A second lien lender might agree that certain types of payments are not to be made on the second-lien debt until the first-lien debt has been paid in full. In a wrapping-lien scenario, rights to mandatory prepayments resulting from asset dispositions, excess cash flow, or receipt of insurance or condemnation proceeds would be addressed in detail.

4. In a full second-lien scenario, the intercreditor agreement would generally include standstill and turnover provisions, as well as a cap on the amount of debt that may constitute first-lien debt. It generally would not provide for payment blockage periods. The main idea is to allow the second-lien lender to preserve the rights that it would have as an unsecured creditor, but defer to the first-lien lender concerning the exercise of special rights of secured creditors.