Intercreditor / Subordination Agreements

Prepared by:
My Ngo and Stephanie A. Zabela
McGuireWoods LLP

LORMAN®

Published on www.lorman.com - April 2018

Intercreditor / Subordination Agreements

A. What is an intercreditor/subordination agreement and when is it necessary?

1. Generally speaking, an intercreditor or subordination agreement is an agreement among creditors establishing their respective rights in their dealings with a common debtor or debtors.

a) As previously noted, debt subordinations are typically accomplished with a subordination agreement and they apply to the right of payment from any source.

b) As previously noted, lien subordinations are typically accomplished with an intercreditor agreement and they apply only to the right of payment from collateral proceeds.

2. At its core, a written agreement is necessary when contractually determining who gets payments and when, who has rights to recover against assets and to exercise remedies and in what order.

B. What does it address?

1. Lien Subordination: Priority of liens (if subordinated creditor has them) and rights with respect to collateral.

2. Payment Subordination: Priority and timing of payments.

3. Exercise of remedies (including remedies on collateral).

4. Miscellaneous other items that directly or indirectly affect the relationship between the creditors, including:

a) Ability to amend terms;

b) Ability to refinance, increase and extend debt;

c) Ability to transfer debt / bind successors; and

d) Bankruptcy rights and remedies.

C. Who is involved and what are their goals?

1. Parties involved – Borrower, Senior Creditor and Subordinated Creditor.

2. Common Interests of Senior Creditor and Subordinated Creditor:

a) Sharing of recoveries;

b) Guaranty/collateral structure;

c) Coordinated remedies/avoid negative incentives of one creditor to act to the detriment of the other creditor in order to be first to recover; and

d) Cooperation in liquidation/sale of collateral.

3. Borrower Perspective

a) Get the deal done as painlessly as possible. Maybe the senior creditor could not extend enough credit to the borrower based on borrower's leverage. In the context of an acquisition, maybe borrower could not provide enough upfront consideration and therefore agreed to pay a portion of the acquisition consideration over time via a seller promissory note.

b) From an administration perspective, borrower wants to make sure it can live with (and comply with) both sets of debt documents.

c) Can the senior creditor and subordinated creditor agree to the terms of the intercreditor/subordination arrangement?

(1) Negotiate the material intercreditor/subordination arrangement upfront at the term sheet stage vs at the documentation stage.

(2) If the senior creditor and the subordinated creditor cannot agree to the intercreditor/subordination arrangement, is the deal dead for the borrower?

d) Borrower will want to be very cognizant of basic structural issues (liens, guarantors, collateral) and whether the borrower will provide similar credit support for the subordinated creditor's debt.

4. Senior Creditor Perspective:

a) Wants to keep the subordinated creditor in a "silent" position;

b) Prevent prepayment absent specified conditions;

c) Get paid first in bankruptcy or liquidation and does not want to be forced into foreclosure or bankruptcy by the subordinated creditor;

d) Make sure subordinated debt covenants are less restrictive than senior debt covenants to ensure that if there is a default under the senior debt then borrower only deals with senior lender at that time;

e) Establish proper lien priority and control the collateral and lien remedies;

f) Wants the ability to provide DIP financing without having to deal with the subordinated creditor; and

g) Flexibility to deal with the borrower, any guarantor and collateral and agree to any amendment without subordinated creditor consent.

5. Subordinated Creditor Perspective:

a) Preserve their business deal and ability to recover in the event of a distressed borrower or borrower bankruptcy;

b) Wants to be at the table if the borrower defaults;

c) Avoid payment blockage on their debt;

d) Not have the senior creditor hold off subordinated debt enforcement actions indefinitely;

e) Does not want to give senior creditor complete control of collateral remedies;

f) Seeks to preserve as many rights as a secured and unsecured creditor of the borrower in a bankruptcy scenario as is possible (if second lien debt, in a bankruptcy scenario the second lien creditor will most likely have a secured claim and an unsecured claim because collateral is first used to pay off first lien creditor);

g) Ability of subordinated creditor to purchase senior creditor indebtedness to protect subordinated creditor interests; and

h) The subordinated creditor will want to use documentation with which it is familiar, but for consistency and ease of execution the subordinated creditor will typically prepare its documentation based on the senior debt documentation with appropriate changes (and cushions to covenants).

D. What are the core issues you need to review? We note that we have listed commonly negotiated outcomes below but that each transaction is different and may differ from the views we describe.

1. Scope of Senior Debt and Subordinated Debt

a) Core Issues:

(1) How broad is the definition of debt that is subject to the intercreditor/subordination agreement?

(2) Is it limited to debt under specified loan documents? As a subordinated creditor you would want to limit the scope of the debt that is to be subordinated as much as possible. Does it include the following:

(a) Principal;

(b) Interest;

(c) Premium ("make whole") amounts;

(d) Fees, expenses, and legal costs;

(e) Indemnity payments;

(f) Post-petition interest;

(g) Treasury management;

(h) Protective Advances (ABL credit facilities); or

(i) Swaps (interest rate/FX/commodity).

(3) Does it include extensions, renewals, replacements and increases?

b) Common Negotiated Outcomes:

(1) Refinancings and renewals of the senior debt are covered, but subject to the original debt cap. From a borrower's perspective, this is desirable in order to reduce negotiation costs if there is a refinancing of the senior debt (such as an amendment and restatement of the senior loan agreement).

(2) Second Lien Debt – Possibly excludes disallowed amounts from a bankruptcy proceeding.

(3) Mezzanine Debt – Usually includes all amounts (subject to any debt cap), whether or not a claim is allowed in a bankruptcy proceeding.

(4) Seller Subordinated Debt – May have a broader scope than other commercial relationships.

2. Debt Amount Caps

a) Core Issues:

(1) Formulations

(a) Specified dollar cap (look out for the inclusion of any accordion feature);

(b) Reducing dollar cap by term loan prepayments; and

(c) Cap based on a specified leverage test.

(2) Are cash management obligations and hedging obligations subject to the debt cap?

(3) Separate DIP financing cap.

b) Common Negotiated Outcomes:

(1) Second Lien Debt

(a) Some type of debt cap is usually present on the senior debt.

(b) Often includes a "cushion" of at least 10-15% over the original principal amount.

(c) Typically applies to principal only, less term loan repayments and permanent reductions to revolver commitments.

(2) Mezzanine Debt – Often times very similar to second lien debt.

(a) Some type of debt cap is usually present on the senior debt.

(b) Often includes a "cushion" of at least 10-15% over the original principal amount.

(c) Typically applies to principal only, less term loan repayments and permanent reductions to revolver commitments.

(3) Seller Subordinated Debt – Often times no debt cap on senior debt.

3. Payment Block

a) Core Issues:

(1) What payments are permitted/prohibited generally?

(a) Regularly scheduled payments of interest and/or principal;

(b) Fees, expense and other indemnities;

(c) Earn-outs and other equity features (e.g. conversion rights and put rights); and

(d) Management fees/consulting fees.

(2) What triggers payment blockage?

(a) Triggered by any default or certain specified defaults.

(b) Does payment blockage require notice?

(c) If notice is the trigger, who must receive the notice?

(3) Is the blockage period limited to a set period of time?

(4) Once a default is cured, are blocked payments permitted, including default interest?

b) Common Negotiated Outcomes:

(1) Second Lien Debt – None in the intercreditor agreement except to the extent from collateral proceeds to be distributed in accordance with the intercreditor agreement.

(2) Mezzanine Debt:

(a) 180-day block for non-payment defaults under the senior debt. There may be a limit on the number of times such payment blockage can be exercised.

(b) Indefinite payment blockage if any payment default occurs with respect to the senior debt.

(3) Seller Subordinated Debt – Generally indefinitely blocked if any default exists under the senior debt or would result from such payment.

4. Remedies Block/Standstill

a) Core Issues:

(1) What triggers the standstill period?

(a) Any event of default?

(b) An event of default plus acceleration?

(c) Is there a notice requirement?

(2) How long is the standstill period? Can it be extended?

(3) What actions are still permitted during standstill?

(a) Acceleration/unsecured creditor rights/insolvency?

(b) Action to preserve lien?

(c) Action to obtain judgment?

(d) Action to prevent running of the statute of limitations?

b) Common Negotiated Outcomes:

(1) Second Lien Debt

(a) First lien creditors typically have exclusive right to foreclose on collateral following an event of default and acceleration under the first or second lien facility.

(b) Second lien creditors typically may foreclose on collateral only after (i) an event of default and acceleration of the second-lien facility, (ii) notice to first lien creditor and (iii) expiration of the standstill period (45-180 days).

(2) Mezzanine Debt

(a) General remedies block with standstill period typically lasting 180 days.

(3) Seller Subordinated Debt

(a) Lengthy general remedies block (270 days or more; sometimes no enforcement action until senior debt is paid in full).

5. Covenant Cushions/Amendments

a) Core Issues:

(1) Financial/negative covenant cushion between the senior debt and subordinated debt?

(2) Is the subordinated debt cross accelerated or cross defaulted to the senior debt?

(3) Restrictions on amendments to senior debt and subordinated debt?

b) Common Negotiated Outcomes:

(1) Second Lien Debt

(a) 10-20% financial covenant and other negative covenant cushions.

(b) Common amendments to senior debt documents that require subordinated creditor consent:

(i) Obligations in excess of debt cap;

(ii) Interest rate increases above a certain threshold;

(iii) Change in maturity date; and

(iv) Making any covenant governing payment of the subordinated debt more restrictive.

(c) Common amendments to subordinated debt documents that require senior creditor consent:

(i) Expansion of collateral;

(ii) Shortening its term;

(iii) Amending its mandatory prepayment provisions;

(iv) Obligations in excess of debt cap;

(v) Interest rate increases above a certain threshold;

(vi) Make its asset sale covenant more restrictive; and

(vii) Make its events of default more restrictive.

(d) Cross defaulted or cross-accelerated.

(2) Mezzanine Debt

(a) 10-25% financial covenant and other negative covenant cushions.

(b) Cross accelerated.

(c) Very few limitations on amendments to senior debt, often limited to the following:

(i) Obligations in excess of debt cap;

(ii) Interest rate increases above a certain threshold;

(iii) Change in maturity date; and

(iv) Making any covenant governing payment of the subordinated debt more restrictive.

(3) Seller Subordinated Debt

(a) Often blanket restriction on amendments to seller subordinated debt.

(b) Often no restrictions on amendments to senior debt.

6. Turn Over/Sharing of Payments

a) Core Issues:

(1) Turnover of amounts received by subordinated creditor in violation of the intercreditor/subordination agreement.

(2) If payment subordinated, turnover to allow senior creditor to be paid in full first whether or not the order of a bankruptcy court awards the senior creditor less than full recovery.

(3) If lien subordinated only, proceeds of collateral to be paid to senior creditor first until paid in full.

b) Common Negotiated Outcomes:

(1) Second lien debt – No payment subordination; only turnover of proceeds of collateral.

(2) Mezzanine – All payments turned over to senior creditor (other than "Reorganization Securities").

(3) Seller Subordinated Debt – All payments turned over to senior creditor (other than "Reorganization Securities").

7. Collateral Issues

a) Core Issues:

(1) What collateral is covered by the intercreditor agreement?

(2) What happens if a lien is invalid, unperfected or otherwise avoidable?

(3) Who has the ability to exercise remedies against the collateral?

(4) What happens when collateral is sold (and liens released) outside a borrower bankruptcy?

b) Common Negotiated Outcomes:

(1) Typically each of the senior creditor and the subordinated creditor should have liens on the same assets.

(2) Each lender should be prohibited from taking a lien on any borrower assets unless: (A) the other lender also has a lien on such assets and (B) any additional collateral is also subject to the intercreditor agreement.

(3) Subordinated creditor will not contest the validity, enforceability, perfection or priority of the senior creditor's liens or secured debt.

(4) Senior creditor will not contest the validity, enforceability, perfection or priority of the subordinated creditor's liens or secured debt.

(5) Senior creditor retains exclusive control of collateral remedies if it is exercising the same as this avoids confusion of two secured parties exercising same remedies concurrently.

(a) Remedies may include the engagement of brokers, investment bankers or others to sell collateral; notification of account debtors to pay receivables to lenders or other actions to realize on the collateral. See any applicable security agreement.

(b) Exclusivity of collateral remedies, however, may shift to the subordinated creditor at the end of the standstill period (but all subject to the turnover provisions in the intercreditor agreement).

(6) Sale of collateral outside of borrower bankruptcy.

(a) If borrower is the seller of its own collateral in a distressed scenario, it is likely to get highest price at lowest costs. Creditors will not be required to release liens unless such disposition is permitted under the credit documents or consent is obtained.

(b) Subordinated creditor is typically required in the intercreditor agreement to release its liens on any collateral sold by the borrower during a senior default and with senior creditor's consent, with the proceeds of such sale being used to permanently reduce the senior debt.

(c) Generally speaking, the foreclosure of the senior lien results in the release of a subordinated lien by operation of law (but the subordinated lien attaches to any surplus proceeds).

(d) Subordinated creditor should agree to release its lien on collateral that is sold by senior creditor, but proceeds should permanently reduce the senior debt and any additional proceeds should go to the subordinated creditor.

(e) Subordinated creditor should require prior notice of senior creditor's sale in order to facilitate subordinated creditor bidding at sale. Also, subordinated creditor may request that the senior creditor sell in a "commercially reasonable" manner.

8. Subordinated Creditor Purchase Option

a) To protect against a "fire sale" of collateral or other senior creditor misbehavior, subordinated creditor may seek option to purchase senior debt and liens.

b) Core Issues:

(1) What would the purchase price be?

(2) When can the purchase option be exercised?

(3) What type of notices are required?

(4) Can senior creditor take enforcement actions while the purchase is pending?

c) Common Negotiated Outcomes:

(1) If purchase option permitted, the purchase price would be a par (principal, interest and fees) for cash.

(2) Exercisable within a certain time (up to 10 business days) after any of the following events: (A) an acceleration of the senior debt, (B) a payment default under the senior debt that is not waived/cured within a certain time period or (C) the commencement of a borrower bankruptcy (each, a "Purchase Event").

(3) Subordinated creditor provides irrevocable notice to exercise purchase option after the occurrence of a Purchase Event. Thereafter, within a short time period (up to 10 business days), subordinated creditor consummates the purchase option.

(4) While the purchase option is pending, the senior creditor is generally prohibited from taking any enforcement action, subject to the following exceptions: (A) the exercise of control over any of borrower's deposit or securities accounts, (B) the collection of proceeds of accounts and payment intangibles, and (C) enforcement actions taken under "exigent circumstances". "Exigent circumstances" generally means circumstances that the senior creditor reasonably believes render necessary or appropriate an enforcement action to prevent or mitigate the destruction of, physical harm to, impairment of or decrease in value of the collateral or the rights and interests of senior creditor.

9. Bankruptcy Rights

a) Per Section 510(a) of the Bankruptcy Code, lien and debt subordinations are enforceable in a bankruptcy. In the intercreditor/subordination agreement, however, parties will still stipulate that such agreement survive a borrower bankruptcy in order to avoid any doubt. This means that for purposes of the intercreditor/subordination agreement:

(1) "Borrower" includes the post-petition debtor in possession;

(2) Senior debt and subordinated debt each includes pre-petition and post-petition debt (including any DIP financing provided by the senior creditor);

(3) Collateral includes pre-petition and post-petition assets of borrower; and

(4) Liens covered by the intercreditor agreement include pre-petition liens and any post-petition adequate protection replacement lien.

b) Core Issues:

(1) Typically, these are the most heavily negotiated provisions of an intercreditor/subordination agreement.

(a) Goal of senior creditor is to limit situations in which subordinated creditor can impede senior creditor's actions in a borrower bankruptcy.

(b) Goal of subordinated creditor is to preserve its rights as a secured creditor in a borrower bankruptcy and to limit the ability of senior creditor to dispose of collateral at less than fair market value.

(2) Limit on voting rights.

(3) Consent by subordinated creditor to DIP financing by senior creditor to borrower.

(4) Consent by subordinated creditor to 363 sales.

(5) Waiver of right to seek/object to adequate protection.

(6) Agreement not to lift/contest request to lift automatic stay.

c) Common Negotiated Outcomes:

(1) Second Lien Debt

(a) Agree not to vote for reorganization plan unless it provides for payment of first lien debt in full.

(b) A subordinated creditor typically waives the right to object to a senior creditor's request for adequate protection for its senior liens, and a senior creditor typically insists that a subordinated creditor waive its rights to seek adequate protection for its subordinated liens.

(c) Relief from Automatic Stay

(i) A subordinated creditor typically is prohibited from seeking relief from the automatic stay to exercise its collateral remedies, which is a corollary of collateral standstill provisions.

(ii) A subordinated creditor also typically waives any right to object to a senior creditor seeking relief from the automatic stay to exercise its senior lien remedies, but, if relief is granted to the senior creditor, any proceeds of its exercise of collateral remedies must be applied in accordance with the intercreditor agreement.

(d) A subordinated creditor usually consents to borrower obtaining any DIP financing that is provided by the senior creditor, provided that the total amount of DIP financing does not exceed an agreed upon cap on the senior debt and any priming liens granted to secure the DIP financing have priority over the pre-petition liens of both the senior creditor and the subordinated creditor.

(e) A senior creditor must be paid in full in cash prior to a subordinated creditor obtaining the excess proceeds of a 363 sale. A senior creditor typically insists that a subordinated creditor waives its right to seek adequate protection and consents to such sales free and clear of its liens, but a subordinated creditor may be permitted to (i) exercise credit bid rights unless bankruptcy court orders otherwise and (ii) object to a 363 sale on any grounds that are afforded to a completely unsecured creditor of the borrower.

(f) A senior creditor may attempt to require a subordinated creditor to agree to limit its plan voting rights as follows:

(i) Subordinated creditor shall oppose any plan that is opposed by senior creditor;

(ii) Subordinated creditor shall supports any plan that is supported by senior creditor, or provide an alternative that is no less favorable to senior creditor;

(iii) Subordinated creditor transfers its plan voting rights to senior creditor outright; and

(iv) Subordinated creditor shall vote against any plan that fails to include certain criteria favorable to senior creditor.

(2) Mezzanine – More willing to give up some rights than second lien debt.

(3) Seller Subordinated Debt – Often will give up the right to vote its own claim.

10. Restrictions on Assignment/Pledge

a) Core Issues:

(1) Does any restriction on the assignment/pledge of the subordinated debt exist?

(2) Must an assignee or pledgee sign an acknowledgement or joinder agreement to the intercreditor/subordination agreement?

(3) Is there a requirement to put a legend on subordinated debt documentation to put parties on notice?

(4) Are assignments to the borrower/affiliates restricted?

b) Common Negotiated Outcomes:

(1) Second Lien Debt – Generally no restrictions, except assignee takes subject to the intercreditor agreement (via joinder or other acknowledgement).

(2) Mezzanine Debt – Same as second lien debt. Generally no restrictions, except assignee takes subject to the subordination agreement (via joinder or other acknowledgement).

(3) Seller Subordinated Debt – Usually flat prohibition on assignment/pledge.

(4) In all cases, there is typically a prohibition on assignments to borrower and borrower's affiliates and the legending of the subordinated debt documentation (particularly payment instruments and collateral documents) is typically required.