Law360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

An Overview Of Silent 2nd-Lien Loans In The US And Europe

By **Frederick Fisher, Thomas Kiriakos, Andrew Crotty and Alex Dell**

Law360, New York (May 23, 2017, 3:38 PM EDT) -- Many capital structures include one or more debt facilities that are junior to senior debt secured by the same assets or property. One such type of junior debt that doesn't fit neatly in traditional structures, but is commonly discussed, is debt with a "silent second lien." This article briefly describes the silent second-lien debt product (including how this terminology is often vaguely used or overused in the market), highlights some differences between the U.S. and European markets, and discusses considerations in connection with the use of the product in each market and in cross-border transactions.

Frederick Fisher

Thomas Kiriakos

Andrew Crotty

Alex Dell

Overview

Lenders choose to extend credit on a secured or unsecured basis based on market conditions, the borrower's historical and projected performance and perceived ability to repay the debt, and an evaluation of other relevant factors. One type of secured debt is silent second-lien debt, which is usually provided in the form of loans (as opposed to notes).

There can be a debate in the lending markets as to all of the elements of a "silent second lien," and the term "silent second," although used often in deal negotiations, has different meanings to different institutions and different meanings in the United States and Europe. Conceptually, at least in the United States, the structure generally is used where junior debt would otherwise be unsecured but is accorded a junior lien on the first-lien lender's collateral for the purpose of capturing on a priority basis (including ahead of trade debt) any residual value of the collateral remaining after satisfaction of the first-lien debt.

In these situations, the junior-lien lender's rights in and to the collateral are to be passive or "silent," and the first-lien lender's rights in and to the collateral generally are to be unimpaired and unimpeded. In the underlying intercreditor documents, this generally is reflected by the junior lender subordinating its lien and severely limiting its enforcement and other rights in favor of the senior lender in exchange for receiving a co-extensive lien on all of the collateral held by the senior lender. Such an arrangement would likely take on many characteristics of mezzanine

financing, including an expectation of an extended or complete standstill in the event of a borrower default.

In the U.S. debt markets, the components of the silent second-lien position can include agreement by the silent second-lien lender to:

- subordinate its lien priority in all respects to the lien securing the obligations of the first-lien lender, irrespective of the manner or order of grant or perfection or of validity, perfection or priority, including in bankruptcy, of such lien;
- cooperate so that the lien of the first-lien lender extends to the same collateral as securing its second lien;
- not object to the validity or enforceability of the first-lien lender's security interest;
- not take certain enforcement actions with respect to the shared collateral (but instead be subject to a standstill), in the event of a payment and/or other default by the borrower, in favor of the first-lien lender taking such actions and not challenge such actions by the first-lien lender;
- generally cooperate in connection with the first-lien lender's exercise of remedies, including being required to release its liens in certain circumstances;
- not receive or retain (but instead be affirmatively obligated to turn over to the first-lien lender) any proceeds of dispositions of the collateral until payment in full of the first-lien lender's claims, even if the first lien is avoided in bankruptcy or otherwise nullified or if the first-lien lender's claims are disallowed (e.g., post-bankruptcy interest owing to an undersecured creditor);
- waive certain rights usually associated with status as a lender with secured and/or unsecured claims;
- limit its rights to vote on the borrower's plan of reorganization in bankruptcy (e.g., that the second-lien lender will vote in alignment with the first-lien lender or at least not vote for a plan that is inconsistent with the other provisions of the operative subordination agreement);
- not oppose the first-lien lender's other decisions in bankruptcy, e.g., to permit the use of cash collateral and to provide (or permit) post-petition financing on a "superpriority" basis regarding adequate protection or regarding dispositions in respect of shared collateral; and
- permit the refinancing of the first-lien lender's debt, with the replacement facility to succeed to the benefits of such "silent second" arrangement.

In European-only transactions, the term "silent" is rarely used although the main principles of "silent" second liens are present and accepted when structuring European transactions.

A table summarizing and comparing certain aspects of the silent second-lien product in the U.S. and European practices is provided below. One of the more interesting takeaways from this analysis is that even if the underlying result is similar, the rationale and approach is different. For instance: (1) in

Europe, junior secured debt may often appear "silent" in the U.S. sense in order to account for legal or corporate benefit restrictions in certain jurisdictions that restrict financial assistance or prohibit subsidiary guarantors of the borrower's debt from providing full cross-collateralized and cross-guaranteed support (rather than for the financial and business motives in the United States); (2) in U.S. practice, it is assumed that in the event of the borrower's bankruptcy, the borrower will be reorganized or its assets liquidated under the U.S. Bankruptcy Code, whereas in European practice, no such assumption is made as no consistent equivalent court-approved process readily exists across European insolvency regimes, and therefore, the focus on intercreditor arrangements is to facilitate a swift enforcement sale outside of court and bankruptcy proceedings and the effective distribution, among creditors, of sale proceeds or recoveries.

Feature	U.S. Practice	European Practice
Documentation	First-lien and second-lien debt often documented in separate and independent debt instruments, including security documents, and subject to an intercreditor agreement.	First-lien and second-lien debt generally documented in separate and independent debt instruments. There will generally be only one set of security documents, which are held by a common security agent on behalf of the first- and second-lien creditors with the first-lien/second-lien structure being contractually agreed to in an intercreditor agreement signed by all creditors.
Subordination	Generally, complete lien subordination, but level of debt subordination varies, from no debt (only lien) subordination up to and including complete payment subordination until the first-lien debt is paid in full.	Usually contractually subordinated to first-lien debt in relation to both secured and unsecured recoveries.
Scope of Security	Same as first-lien/senior debt.	Same as United States.
Ranking of Security	Ranking second to first-lien/senior debt.	Same as United States. Because there is generally a shared security package documented in one set of security documents, the second-lien lenders will contractually agree in the intercreditor agreement that the first-lien debt ranks ahead of the second-lien debt in relation to such security.

Feature	U.S. Practice	European Practice
Payment Block in the Event of a Payment Default on First-Lien Debt by Borrower	Usually (a) permanent until first-lien debt is paid in full, (b) for a time period such as 90-180 days or (c) none, with (b) being the most common for institutional nonaffiliated parties. This has the potential to be highly negotiated.	Same as United States but more likely to have a set period of time.
Payment Block for Other Defaults by Borrower	Usually (a) for a time period such as 90-180 days or (b) none, with (a) being the most common for institutional nonaffiliated parties. This has the potential to be highly negotiated.	Same as United States, but more likely to have a set period of time.
Unsecured Creditor Rights of Second-Lien Lender	Usually extremely limited, subject to material failure by the first-lien lender to take enforcement action and/or standstill time period (e.g., 90-180 days).	Same as United States, but standstill periods are often shorter (e.g., 75-90 days).
Secured Creditor Enforcement Rights of Second-Lien Lender	Same as above. In short, the first-lien lender is expected to be able to "drive the bus" when it comes to the enforcement of remedies.	Same as above, but the first-lien lenders retain control of the enforcement process unless they instruct the security agent not to enforce or do not provide instructions to the security agent within a certain period of time. Enforcement includes making payment claims under any guarantees.
Bankruptcy	Fundamental elements of arrangement, e.g., subordination and accompanying turnover obligations expressly continue into and apply in bankruptcy. Also, there will be bankruptcy-specific provisions — including as to plan voting, use of cash collateral, post-petition financing on a "super-priority" basis, and bankruptcy sales — expressly setting forth the dominant rights of the first-lien lender. The range with respect to the negotiation of	For the reasons discussed in the text above, usually not as detailed or specific as in the United States.

Feature	U.S. Practice	European Practice
	these bankruptcy-specific provisions varies depending on the provision at issue and the other particular circumstances of the transaction. For example, it is not uncommon to see the ability of the first-lien lender to provide (or consent to) post-petition financing on a "superpriority" basis limited to a negotiated maximum amount or "basket" of "superpriority" debt.	
First-Lien Purchase Option upon Acceleration/Enforcement of First Lien	Depends on relative sizes of the first-lien and second-lien facilities, but overall generally available in full (at par) on a "nonrecourse" basis and with a release of liability by the second-lien purchaser in favor of the first-lien lender. Also, there often is negotiation over related terms, such as notice rights, length of exercise period, and standstill (or no standstill) by the first-lien lender during the exercise period.	Same as United States.

Considerations

Silent second-lien loans are important in the marketplace because they allow for a borrower to access additional capital when it might not otherwise be available. Silent second-lien loans may also provide advantageous pricing or other terms compared to traditional mezzanine or unsecured debt or incentivize a lender to continue in a credit or expand their loan at a time when they would otherwise not be able to do so on an unsecured basis.

There are also benefits to lenders in deploying silent second-lien debt in a borrower's capital structure. First-lien lenders benefit because silent second-lien debt decreases the amount of financing that the first-lien lender is asked to provide to the borrower and may enable refinancings and other transactions that might not otherwise be possible. Silent second-lien lenders benefit from placing themselves ahead of the unsecured creditors in a liquidation or reorganization.

Potential drawbacks to a silent second-lien position chiefly include disagreement in the documentation stage over the scope of the meaning of "silent," even after agreement in concept at the term sheet or negotiation stage. "Silent" often means different things to different parties, and disagreement on meaning can lead to a significant roadblock during negotiations. Specific areas of contention may

include triggering events and the time periods for payment blockages, ability to provide post-bankruptcy financing on a "superpriority" basis, ability to sell assets without the consent of the second-lien holder, and circumstances for enforcement of rights and remedies.

One example: a silent second-lien lender interprets its retained unsecured creditor rights to include the ability to take certain actions to frustrate the first-lien lender's efforts to exercise rights against shared collateral, while the first-lien lender interprets "silent" to mean that the silent second-lien lender must waive all of its rights to object to the first-lien lender's actions.

In cross-border deals, further confusion can result from a failure to recognize that the various market standards on how to document second-lien positions, including silent second liens, may not translate as expected to U.S. market practice.

Recent Trends

In our practices in 2016 and during the first part of 2017, we recognized a divergence in the use of silent second-lien debt between the U.S. and European finance markets. In the United States, we saw the use of silent second-lien debt increase, primarily due to (1) leveraged lending regulations constraining the availability of first-lien secured debt from "traditional" regulated lenders, (2) increased participation of nontraditional lenders and investors and (3) advantageous pricing as compared with mezzanine or unsecured debt. In Europe, we saw the use of silent second-lien debt decrease for a variety of reasons, including increased liquidity, which meant that desired leverage levels could be achieved with senior or unitranche debt.

Additionally, the circumstances under which silent second-lien debt is employed in a transaction have differed between the U.S. and European markets in recent years. In the United States, we have noted an increased use of silent second-lien loans by borrowers that are in the middle market and/or lower-performing or distressed situations. By contrast, in Europe, we have noted an increased use of second-lien loans (including silent second-lien loans) due to increasing competition between banks and alternative lenders, which has involved an increased offering of financing products and the need to invest in higher-yielding structures to compensate declining margins.

Conclusion

Silent second-lien debt can provide an attractive financing option to borrowers and lenders alike, allowing certain borrowers to bridge a capital gap and consummate a transaction or take advantage of opportunities that might not otherwise be available. So long as leveraged lending guidelines and other regulations restrict the availability of capital from traditional, regulated banking entities and there is a demand for the silent second-lien product offered at an attractive rate to borrowers and lenders, the product will continue to be available and evolve to meet those demands. Capital structures including silent second-lien debt can be complicated, particularly in cross-border transactions involving, for example, different insolvency or contract laws. Fortunately, potential drawbacks and risks associated with lending on a silent second-lien basis can be mitigated with some advance planning and detailed discussion on deal terms and coordination among various jurisdictions, particularly in each instance at the term sheet stage, to avoid any misunderstanding on what "silent" means in a given transaction.

Frederick C. Fisher and Thomas S. Kiriakos are partners in the Chicago office of Mayer Brown LLP. Andrew Crotty and Alex Dell are partners in the firm's London office.

Mayer Brown attorneys Martin Philipp Heuber, François-Régis Gonon and Anastasia N. Kaup also contributed to this article.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2017, Portfolio Media, Inc.