July 2014

Banking briefing

European second lien – it's back

European second lien issuance peaked in 2007 at 12 per cent (€13.6bn) of leveraged loan volume before vaporising to zero by the end of 2008. Six years on – it's back. It's new and it's different. This briefing examines how this second generation product (2G 2nd lien) is evolving relative to its previous incarnation[1] and its US cousin.

Identity crisis

2G 2nd lien is being relaunched with something of an identity crisis. Is it a non-subordinated second secured stretched senior instrument? Or is it a fully subordinated second secured mezzesque instrument? Does it cohabit alongside 1st lien loans in a common senior facilities agreement or does it stand apart in its own loan agreement? How do its payment, acceleration and security enforcement rights pan out relative to those of the 1st lien? And how do its rights compare to those of other junior instruments in a given capital structure?

To answer these questions, we compare and contrast certain fundamental features across 2nd lien, modern mezzanine[2] and senior (subordinated) high yield bonds.

Debt instruments

2G 2nd lien facilities may be documented either: (i) as part of a single senior facilities agreement recording both 1st and 2nd lien facilities (option 1); or (ii) in a self-standing separate loan agreement (option 2). Option 1 requires that 1st and 2nd lien vote together on most decisions as a combined class. Unless the 2nd lien commitments represent more than one-third of the combined 1st and 2nd lien commitments (which would be unusual), 2nd lien lenders can be outvoted by the 1st lien lenders. Option 2 provides 2nd lien lenders with a bigger voice and greater influence. Any consent or decision will require approval from the relevant majority of both 1st and 2nd lien lenders voting as independent classes. Early indications suggest the majority of 2G 2nd lien (in contrast to 1G 2nd lien) will be documented in a separate loan agreement and thereby wield more voting power.

2nd lien financial covenants

2G 2nd lien typically benefits from the same financial covenants as 1st lien. If 1st lien lenders benefit from a full suite of maintenance covenants, so will 2nd lien lenders. If 1st lien only has incurrence-based covenants, 2nd lien follows that lead. But 2G 2nd lien financial covenants are likely to be set with an extra (say) 5 per cent headroom to the 1st lien covenant levels. Contrast this with 1G 2nd lien which seldom conferred additional covenant headroom[3].

2nd lien subordination

2G 2nd lien facilities rank second behind the 1st lien in respect of secured recoveries. But what of unsecured recoveries? The majority of European 1G 2nd lien was subordinated to 1st lien recoveries. As a result, it ranked second for both secured and unsecured recoveries. This contrasts with its US cousin, which typically is not subordinated to 1st lien and so ranks *pari passu* with the 1st lien for any unsecured recoveries. This difference may be explained in part[4] by the fact that US subsidiary guarantors typically provide full secured guarantee support (rendering the likelihood of unsecured recoveries low) whereas subsidiary guarantors in continental Europe are very often legally constrained from providing full secured guarantee support (rendering the potential for unsecured recoveries somewhat higher). So we should expect European 2G 2nd lien on most financings to follow the path of 1G 2nd lien and be both second secured and subordinated to 1st lien. However, there have been recent examples where this is not the case. Lenders therefore need to take care with the distinction between secured and unsecured recoveries (something not always clearly addressed in the intercreditor agreement).

2nd lien security

2G 2nd lien facilities enjoy the same security package as the 1st lien facilities, albeit on a second-ranking basis. This reflects both the pre-2008 position and the US position, and therefore typically includes full upstream security and guarantees from operating subsidiaries (to the extent legally and commercially practicable). This places 2nd lien lenders in a much better position that senior (subordinated) bondholders

who typically benefit from a limited security package from holding companies at the top of the group.

2nd lien payment block protocols

Payment blocks against 2nd lien lenders are in a state of some flux. Those structured as stretched senior may not be subject to any blockage provisions at all. Others (and we anticipate this will become the market norm) will be subject to mezzanine style payment blocks if the 1st lien facilities default. So expect all payments on 2nd lien to be frozen for so long as a 1st lien payment default subsists. Also, expect payment blocks of up to 120, 150 or even 179 days if there is any other form of 1st lien default[5].

2nd lien enforcement rights

As with the payment block protocols, regulating the rights of 2nd lien enforcement following a 2nd lien default is also in some flux. There are two basic rights to regulate. First, we have **unsecured** enforcement action. Action such as accelerating the 2nd lien debt claims, demanding payment and forcing the liquidation of 2nd lien obligors. Second, we have **secured** enforcement action. This is the right to instruct the security trustee to enforce the security jointly held for the benefit of 1st and 2nd lien lenders.

2nd lien secured enforcement action

The position regarding secured enforcement is the more straightforward. 2G 2nd lien lenders should expect a majority of the 1st lien lenders to control the timing and manner of enforcement of security. 2nd lien lenders may have a right to be consulted but will only take over the security enforcement decisions if an agreed period has elapsed following a 2nd lien default without the 1st lien lenders instigating security enforcement. That period will vary from deal to deal but will likely be in the 75–90 day range (so somewhat shorter than the historic 90/120/150-day mezzanine standstill convention). This position is what you would expect and is consistent with both US and 1G 2nd lien. 2G 2nd lien has, however, borrowed some new features taken from developments in modern mezzanine. These include: (i) a requirement for the 1st lien lenders to enforce over a minimum threshold of assets to retain their control rights; (ii) consultation and information sharing; and (iii) public auction and/or third party valuation requirements as a condition of 1st lien lenders enforcing if the 2nd lien will not be paid off in full.

2nd lien unsecured enforcement

The position in relation to unsecured enforcement action is more dynamic. Some financings do not regulate the position at all – leaving 2nd lien lenders able to threaten liquidation and force the 1st lien lenders' hand at any time following a 2nd lien default – even during a period when 2nd lien lenders are constrained from taking secured enforcement action. On other transactions, 2nd lien lenders may only accelerate their claims in very defined circumstances, commonly including: (i) a 2nd lien payment default which remains outstanding for (say) 75 or 90 days; (ii) acceleration by the 1st lien lenders; and/or (iii) an insolvency default occurring (sometimes limited to just the 2nd lien borrower). If, as seems likely, 2G 2nd lien is set to become a stand-alone instrument which votes independently of the 1st lien, the logical development would be for 2nd lien unsecured enforcement action to be constrained and regulated in similar fashion to secured enforcement action. For obvious reasons and with a few notable exceptions, the restructuring of European borrowers seldom takes place under the auspices of Chapter 11 (and its worldwide stay on virtually all forms of enforcement action – including unsecured action). So, it would be odd for European deals (which mostly have to rely on contractual provisions in intercreditor agreements to restrain creditor action) to leave 2nd lien unsecured action free of standstill restraints in circumstances where other junior lenders (including mezzanine lenders and high yield bondholders) would be so constrained.

Market comparisons

Analysis of recent deals (completed and in progress) suggests the following trends noted in the table overleaf.

Direction of travel

It will be interesting to see how 2G 2nd lien evolves from here, and how the interests of 2nd lien lenders are counter-balanced against the interests of other debt providers in increasingly diverse and flexible capital structures. Getting that balance right is legally challenging, requires careful thought and a knowledge of local jurisdictional constraints. It is also easily overlooked in newly buoyant European loan markets, where the rush for higher yielding paper is in danger of being the number one priority that trumps all others.

Notes

1. Click here for a copy of our paper "Historic Study - First Generation European 2nd Lien – 2003 to 2007
2. By "modern mezzanine" we mean mezzanine intercreditor rights as they have evolved through a series of financings starting with WorldPay and continuing through CPA Global, Wood Mackenzie and the other deals which follow broadly the same approach.
3. Albeit that it typically voted as part of a combined class with the 1st lien – potentially diminishing the practical value of such protection.
4. We understand US 2nd lien was first introduced as a way of injecting additional debt into existing funding structures which included high yield bonds with anti-layering restrictions that prevented the introduction of an intermediate subordinated debt but did not prevent the injection of additional senior debt on a non-subordinated but second secured basis.
5. On some transactions confined to major 1st lien defaults (e.g. financial covenant breach, insolvency events).

Feature	2G 2nd lien	Modern Mezzanine	Senior Sub HYB
Debt instrument *Independent or shared with 1st lien*	Either but more likely independent	Independent	Independent
Subordinated to 1st lien?	Not always – but mostly	Yes	Yes (in respect of upstream guarantees)
Security scope & ranking	Same as 1st lien – but second-ranking	Same as 1st lien – but second-ranking	Holdco shared security
Payment block – *(1st lien payment default)*	Either (a) permanent (sometimes up to 120/180 days) or (b) less likely, none	Permanent (sometimes 120 days)	Permanent
Payment block – *(other 1st lien defaults)*	Either (a) payment blocked for up to 180 days or (b) less likely, none	120 days (sometimes permanent)	179 days
Unsecured acceleration rights (and other unsecured enforcement action)	(i) Limited to major defaults and subject to 75–90 day standstill period or (ii) unrestricted or (iii) subject to mezzanine style (but shorter) standstill periods	90/120/150 days for mezzanine payment / financial covenant / other defaults respectively	179 days standstill (excluding against issuer)
Secured enforcement rights	75–90 day standstill – but 1st lien retains control of enforcement	90/120/150 days for mezzanine payment / financial covenant / other default respectively	179 days standstill (excluding against issuer)

Key contacts

For more information, please contact one of the following Partners, or your usual Ashurst contact.

Mark Vickers
Partner
T: +44 (0)20 7859 1955
E: mark.vickers@ashurst.com

Nigel Ward
Partner
T: +44 (0)20 7859 1236
E: nigel.ward@ashurst.com

Helen Burton
Partner
T: +44 (0)20 7859 2979
E: helen.burton@ashurst.com

Ross Ollerhead
Partner
T: +44 (0)20 7859 3352
E: ross.ollerhead@ashurst.com

Paul Stewart
Partner
T: +44 (0)20 7859 1459
E: paul.stewart@ashurst.com

Luke McDougall
Partner
T: +44 (0)20 7859 1170
E: luke.mcdougall@ashurst.com

This publication is not intended to be a comprehensive review of all developments in the law and practice, or to cover all aspects of those referred to. Readers should take legal advice before applying the information contained in this publication to specific issues or transactions. For more information please contact us at Broadwalk House, 5 Appold Street, London EC2A 2HA T: +44 (0)20 7638 1111 F: +44 (0)20 7638 1112 www.ashurst.com.

Ashurst LLP is a limited liability partnership registered in England and Wales under number OC330252 and is part of the Ashurst Group. It is a law firm authorised and regulated by the Solicitors Regulation Authority of England and Wales under number 468653. The term "partner" is used to refer to a member of Ashurst LLP or to an employee or consultant with equivalent standing and qualifications or to an individual with equivalent status in one of Ashurst LLP's affiliates. Further details about Ashurst can be found at www.ashurst.com.
© Ashurst LLP 2014 Ref: 36394307 30 July 2014