

Intercreditor Agreements – Getting Your Priorities Right

by Paul Durban

The contractual framework which regulates the rights of different classes of lenders and the ranking of different types of debt in respect of payments and security is principally set out in the intercreditor agreement.

While a company is solvent and able to meet its payment obligations to its lenders, the terms of the intercreditor agreement are unlikely to be tested. But once a company begins to experience financial difficulties and lenders are forced to assess their rights, many lenders realise too late that they paid insufficient attention to the terms of the intercreditor agreement at the time at which they lent. The effect of this can be fatal to efforts to protect value. We are increasingly seeing lender clients across the capital structure focusing (often forensically) on the finer detail of the intercreditor agreement both at the lending stage and when things take a turn for the worse to safeguard their interests. Responding to this trend, in this article, we look at 5 important intercreditor issues that lenders should be aware of.

1. Permitted Payments

The types of payments permitted to be made to junior lenders in the ordinary course of business can be contentious from the outset. It is generally accepted that payments of principal and PIK interest are not permitted, but that fees, cash interest, and increased cost payments should be.

The triggers allowing senior lenders to send a notice of default to other creditors to suspend these payments are typically not contested and include insolvency of the company, breach of a financial covenant, and non-payment to the senior lenders.

However, once a notice of default has been issued by the senior lenders, opinion is divided as to which payments should be suspended. The UK Loan Market Association (LMA) form of intercreditor agreement provides that most payments to junior lenders should be halted.

Related People

- Paul Durban

Related Capabilities

- Bankruptcy & Financial Restructuring
- Banking & Financial Institutions
- Lending Transactions

From a junior lender perspective, it is vital that payments to cover reasonable legal fees are permitted. This is so that these lenders can obtain independent legal advice and protect their position in a default scenario. Conversely, senior lenders tend to be naturally concerned about value leakage to other lenders who, in effect, will be spending the cash to prepare and mount a legal defence to senior lenders' actions. A capped payment amount is typically agreed, but the size of that cap will vary according to the transaction and the makeup of the lender group.

2. Enforcement of Security

The definition of Enforcement Action is an important defined term in the intercreditor agreement from a lender perspective. Typically, the definition of Enforcement Action will include: the acceleration of debt; the recovery (by legal proceedings or otherwise) of debt; the making of a demand against any member of the debtor's group in relation to the debt; and the exercise of any right to enforce any security under security documents.

The general principle is that the most senior class of lender controls the enforcement of security, but there is debate in the market about whether senior lenders have too much power when it comes to controlling the enforcement process, should the credit become distressed. To safeguard their position, thought needs to be given at the outset as to which procedural rights junior lenders will require. Lack of information for junior lenders and a lack of prescribed valuation requirements are commonly cited by junior lenders as problems which need addressing when the intercreditor agreement is being negotiated.

The Intercreditor Agreement should therefore be checked to see whether it contains any obligations for the senior lenders to consider the interests of the junior lenders when taking any Enforcement Action. Introducing provisions at the outset which give junior lenders access to valuation reports commissioned by the senior lenders or the ability for them to jointly instruct the report provider can help solve for these issues.

3. Cure Rights

The LMA form of intercreditor agreement gives junior lenders (as well as sponsors) a cure right by injecting new money as equity to cure a breach, such as breach of a financial covenant in the senior debt.

It is in the interests of the lenders to be given an equity cure right, so that in cases where the sponsor does not wish to inject further capital into the company, they can step in to remedy a default. Although, in principle, most senior lenders are not usually opposed to this, the longer the junior lender can prevent the senior lender from exercising its enforcement rights due to the junior lender exercising its cure rights, the better it will be for the junior lender. This may not be commercially acceptable to the senior lenders so the length of the cure period or the aggregate number of cure events will often be hotly debated. Depending on the length of the loan, it is common to see monetary cure rights limited to as few as 3-4 over the lifetime of the loan, with no more than 2 per year and no consecutive quarterly cures.

4. Release Provisions

Release provisions are contractual agreements that allow the security agent under the loan arrangements to release security and, in certain cases, to release borrowing and guarantee claims of lenders against the debtor.

Particular attention should be given to the release provisions in the intercreditor agreement in case of an asset disposal both pre and post enforcement. Mechanically, the release provisions relating to security that encumbers the asset being disposed of, must work correctly to allow for a “clean sale” free of junior lender claims. It is important to pay attention to the precise drafting of the clause, as the trigger event for the release right can be quite narrowly prescribed. On the other hand, loopholes or ambiguities in the drafting of these release provisions could provide leverage to junior lenders in relation to negotiations around asset sales.

Moreover, in certain transactions, the conditions for release aim to ensure that a more senior creditor class cannot release junior claims without some evidence that the value for which the assets are being disposed of is fair. These conditions often require a fairness opinion or transaction-based valuation provided by an appropriate expert, which can provide junior lenders with greater information and, depending on the situation, bargaining power in their negotiations. This is particularly relevant in the context of the senior lenders trying to effectuate a pre-packaged sale of the secured assets free from the claims of lower ranking creditors.

5. Pre-packaged Sales

Few intercreditor agreements will place restrictions on the senior lenders selling the secured assets to a special purpose vehicle owned by the senior lenders.

Historically it was also unusual to specify criteria with which the senior lenders had to comply during an asset enforcement process. But more recently, junior lenders have been advocating for restrictions to be placed on senior lenders trying to implement a pre-packaged sale of the secured assets.

In order to avoid circumstances where the sale price is such that the junior debt is entirely written off, requirements are increasingly being built into the terms of intercreditor agreements, so that disposal proceeds must be received in cash (given it is not uncommon to see intercreditor agreements which enable a security agent to accept non-cash consideration) and a fair market value is established (through a requirement for an independent valuation, fairness opinion, and a thorough marketing process).