Themes of Change: Key themes underlying the September 2012 changes to the LMA Intercreditor Agreement and implications for Mezzanine Creditors

As the mezzanine market continues to mature, mezzanine creditors have been seeking enhanced protections in their contractual relationship with senior creditors. The themes behind last month's revisions to the Loan Market Association (LMA) recommended form of intercreditor agreement for leveraged acquisition finance reflect an attempt to take into account recent changes in market practice and feedback from market practitioners.

According to the LMA, the September revisions to the intercreditor agreement are grouped into four broad themes and are the product of the LMA's first wide ranging review process since the initial publication of the agreement in 2009. From a mezzanine perspective, these revisions address some key requests from mezzanine creditors who have been unsatisfied with what they perceive to be senior creditor friendly provisions in the 2009 agreement and its 2010 update.

Facilitation of Enforcement

Not surprisingly, one of the main themes underlying the September revisions concerns the facilitation of enforcement by way of sale of the business and the release of claims. For example, the new intercreditor agreement includes revised enforcement provisions, which have been supplemented for enforcements by way of appropriation or enforcement sale of shares.

While the general theme relates to the facilitation of a senior-led enforcement by the senior creditors, the LMA has recognised that the interests of all parties need to be addressed to avoid uncertainty, recurrent litigation and associated destruction of value for all stakeholders.

Proof of value consideration on enforcement

To this end, the revisions take into account the clear push by mezzanine creditors for more involvement in enforcement processes and objective valuation procedures, particularly following the high-profile cases on valuation in the last few years.

Senior creditors tend to push back requests by the mezzanine creditors to participate in the enforcement process. In the interests of controlling the enforcement strategy, senior creditors are reluctant to involve the mezzanine creditors in any decisions regarding the appointment of a valuer or the marketing of the business sale on the basis that this could have a material, negative impact on the timing and price of the sale. On the other hand, if the security agent has to rely on uncertain language to determine its responsibilities in an enforcement scenario, that would clearly be disruptive to all creditor classes and certainly impede a smooth enforcement process.

In response to these issues, rather than merely providing that the security agent has a duty to use reasonable care to obtain a fair market price, the new intercreditor agreement includes an option to *oblige* the security agent to obtain a fair market value on an enforcement disposal. Also included is a new optional provision which details processes that are deemed to satisfy the fair market value requirement. Such processes include the delivery to the security agent of a fair value opinion from an independent financial adviser, and a disposal made pursuant to an auction or other competitive sales process.

Whereas mezzanine creditors welcome these revisions, which in part satisfy their key requests, it is not hard to imagine where the next areas of tension with respect to mezzanine creditor concerns might be focused. Having achieved the upgrade of certain desired market practices to the status of "LMA recommended practice", the mezzanine creditors will now watch to see how these revisions pave the way to the next phase of scrutiny, direction and/or litigation. It is already clear, for example, that the term "competitive sales process" is open to interpretation - mezzanine creditors will be seeking to clarify the meaning of this term. In recent senior/mezzanine transactions, senior creditors have demonstrated a move towards accepting the addition of parameters around the definition of "competitive sales process", for example, they have been willing to qualify the definition with language restricting them from participating in the first round of the auction. The requirement of a fair market value opinion also immediately prompts certain questions, such as who will bear the cost of the opinion and who will provide the opinion. It is also not clear if the mezzanine creditors will have access to, or reliance upon, this opinion. Moreover, the new intercreditor agreement does not provide any guidelines as to timing for obtaining the opinion and the caps on the liabilities of any advisers providing the opinion.

Interestingly, the new intercreditor agreement does not provide any optionality with respect to the ability of the mezzanine to be consulted prior to enforcement even though we have seen mezzanine creditors successfully negotiating for the ability to be consulted over a reasonable period.

Non-cash consideration

The theme of facilitating enforcement prevails in the LMA's treatment of non-cash consideration in the new intercreditor agreement. Payment of non-cash consideration and its treatment under the terms of the intercreditor agreement were not addressed in the 2009 LMA intercreditor agreement. Until these revisions, the security agent, faced with a request to accept non-cash consideration for disposals of assets in an enforcement scenario, was unlikely to agree without a satisfactory indemnity or near unanimous consent from senior lenders. Instead, the new intercreditor agreement now includes a provision that expressly enables the security agent to receive non-cash consideration.

The mezzanine creditors are afforded some level of protection by the proviso that the value of any non-cash consideration (and the discharge of liabilities resulting from a distribution of non-cash consideration to creditors) must now be determined by an independent financial adviser, but choice of this adviser is within the control of the senior creditors. The senior creditors also control the instruction of the security agent to accept non-cash consideration and the decision as to whether to realise it for cash prior to distribution to creditors. The mezzanine creditors are in effect excluded from key decisions relating to matters involving non-cash consideration.

From an agent's perspective, there is a lack of clarity as to how the Senior Agent is authorised to apply non-cash recoveries in discharge of the underlying debt obligations if faced with lenders unwilling or unable to accept non-cash proceeds and how the provisions relating to non-cash consideration dovetail with certain other provisions, including those on loss-sharing.

Refinancing

One important issue for mezzanine lenders has been the ability of the borrower, in some cases, to incur a large amount of debt ranking in priority to the mezzanine debt as a result of the concept of senior headroom. Mezzanine creditors have been pushing to reduce senior headroom by the amount of senior payments and deferrals of amortisation. The majority of these deductions are now settled market practice.

With respect to generating more debt, a framework designed to facilitate a refinancing of the senior facilities in full without the need to amend the intercreditor agreement or gain mezzanine consent

has been introduced into the new intercreditor agreement, with the new facilities having to meet certain criteria relating to size, tenor and other terms. The new further assurance clause with respect to the release of transaction security by the security agent will need to be considered on a transaction specific basis. Certainly the release and provision of security must not have a material effect on any of the secured parties.

The senior headroom now operates slightly differently. It includes an option that is to be used in circumstances where the commercial agreement is that the senior facilities, where there are amortisations, may only be increased from their reduced level just before the refinancing in an amount equal to the senior headroom. It also allows a cap to the yield, although it is worth remembering that the senior creditors, in the context of primary syndication of the senior facilities, still retain the ability to increase the margin, fees or commission pursuant to senior flex rights. In this respect, mezzanine creditors are advised to seek disclosure of any flex terms prior to signing.

Creditor Controls

The second theme running through the latest revisions to the intercreditor agreement relates to creditor controls.

Permitted Payments

In the revised intercreditor agreement, payments by obligors to a hedge counterparty arising as a result of termination following a bankruptcy event or force majeure event are permitted if there is no senior default/event of default. In addition, automatic early termination in hedging agreements is permitted in certain circumstances as are payments arising as a result of automatic early termination if there is no senior default/event of default.

Mezzanine Lenders' adviser costs

The issue of payment of mezzanine creditors' legal fees in the context of receiving advice when a restructuring is imminent has been the subject of much debate. A new provision has been added to allow for mezzanine creditors to be paid certain restructuring expenses (subject to a cap) provided no senior payment default has occurred. These restructuring expenses relate to the fees, costs and expenses of the mezzanine agent and of any advisers in respect of restructuring advice or valuations relating to the group. However, there is an option to carve out those incurred in connection with the dispute of any aspect of certain disposals of assets or sales of liabilities in distressed circumstances and in connection with any provision of the debt documents (the intercreditor agreement, the security documents and the senior and mezzanine finance agreements, among others). The revisions reflect the move towards permitting the mezzanine creditors to recoup reasonable expenses absent litigation.

In addition, the definition of "Mezzanine Creditor" now includes the mezzanine agent. This means that the mezzanine agent's fees are considered as part of the mezzanine liabilities and are ranked pursuant to the provisions on ranking and priority.

Security Agency

Another group of changes relate to the security agent and the general theme is accommodating the security agent's evolving role, with some security agents having to exercise an increasing degree of commercial judgement and discretion. The LMA has revised the intercreditor agreement so that the security agent is afforded additional protections in light of this. New protections include: the right to charge for management time; an enhanced right to rely on certificates; the express right to engage independent legal counsel and to engage counsel/experts/professional advisers; and enhanced and more explicit liability exclusions. The revisions take into account the fact that the exercise of the security agent's powers and judgement often have a commercial impact on the secured creditors and are not merely contractual and administrative. This is particularly the case with respect to valuations, for example. As a result,

the trend has been for the security agent to become increasingly involved in intercreditor agreement disputes, as seen in a number of recent high-profile debt restructurings. The security agent has often found itself in a position where it has to exercise its commercial judgement in order to carry out its contractual duties. Whereas in the past the existence of a conflict with the interests of the mezzanine creditors would not necessarily prevent it from carrying out seemingly valid instructions which were nevertheless open to some interpretation, it could be that we begin to see a new dynamic, with the security agent engaging independent counsel merely if it reasonably "deems this to be desirable". Furthermore, it will not be liable for relying on this advice.

Smaller Drafting Changes

Lastly, there are a group of revisions that are simply smaller drafting changes that accommodate the other changes and make the intercreditor agreement easier to follow.

Conclusion

The revisions are to be welcomed by the mezzanine creditors on the whole, but some of their key requests have been incorporated into the new intercreditor agreement only in part or as an option rather than a recommended position. The latest revisions by no means provide a settled intercreditor agreement position, with key issues still very much amenable to further negotiation. While legal advisers for the mezzanine creditors continue to seek further protections and concessions, the underlying themes to the latest changes to the intercreditor agreement will no doubt continue to run through each stage of its future evolution.

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