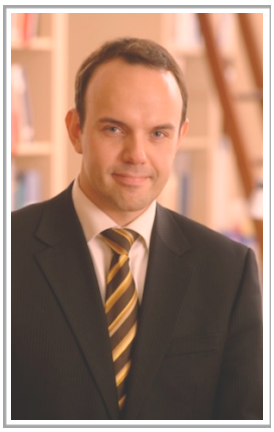
Attorneys-at-law TRUST.

Negotiating Finnish Intercreditor Agreements

by Mika J. Lehtimäki



Mika J. Lehtimäki
LLM Helsinki, M.Jur Oxford, M.St. Oxford
tel. +358 40 534 2273
Attorneys-at-Law TRUST.
Mika.Lehtimaki@theTrust.fi

Introduction

I have discussed in this update certain negotiating issues arising in connection with intercreditor agreements often concluded in connection with leveraged corporate acquisitions in Finland. This update is directed mainly for debt investors investing in transactions governed by Finnish law.

The update is constructed in a checklist format. The checklists are in summary form and non-comprehensive descriptions of the main negotiating points.

I have assumed that the reader is aware of the most common transaction structures used in leveraged M&A transactions.

Under Finnish law, most of the questions concerning intercreditor agreements are linked to the general law. Therefore, the same solutions may at least in part be applied also to other financing forms such as project finance.

The LMA model agreement and the domestic arrangements

Finnish market participants have used already for years intercreditor agreements governed by Finnish law. However, it appears fair to say that there is no well-established market standard. The domestic agreements have either been based on the model agreements used by international clients of the law firms or on the Loan Market Association (later "LMA") model intercreditor agreement.

The LMA Intercreditor Agreement is intended to be used in leveraged acquisition finance transactions. Use of the agreement is usually feasible only if there are different priority creditors involved in the same transaction. The model agreement involves several different lenders and investors i.e. senior creditors, mezzanine creditors, intra-group lenders, parent, investors and e.g. hedging counterparties. If the arrangement does not include a particular lender category, the relevant clauses may be deleted from the model agreement rather easily.

The LMA model intercreditor agreement is constructed to operate together with the LMA Senior Multicurrency Term and Revolving Facilities Agreement, which is the senior loan agreement. Therefore, the terminology of these documents (including the mezzanine loan agreement) is usually the same. Finnish law firms have during the last years adopted localized versions of the senior loan agreement and these agreements correspond to a good extent to the structure and the content of the LMA model agreement.

Why is it a good idea to enter into an intercreditor agreement?

Intercreditor agreements have three basic purposes

1. ensuring the effectiveness of contractual subordination and

priorities of certain creditors in relation to other creditors (later "debt subordination");
2. regulation of granting of waivers and administration of the arrangement within the maturities of the loans; and
3. establishment of a coordinated procedure for restructuring of the indebtedness and structure of the debtor group.

In addition, intercreditor agreements regulate:

4. allowed payments to creditors and limits and conditions for making such payments;
5. the creditors' acceleration and enforcement measures of the credits and security;
6. nomination of creditor and debtor agents (in England "trustee");
7. so-called standstill period that applies when the debtor is in financial difficulties (room to breathe during the restructuring negotiations);
8. actions, set-off and payments concerning"non-allowed" fund transfers.

The main situation when intercreditor agreements are relevant is the debtor group's insolvency or situation where the debtor group is close to insolvency.

Intercreditor agreements also ensure that none of the creditors of a particular arrangement are being unjustly preferred, that so-called "hold-out creditors" can be managed with sufficient certainty and that the debtor group can, if needed, be sold on a "going concern"-basis by the secured creditors.

The main risk involved in intercreditor agreements is that debt subordination or the enforcement restrictions of the subordinated creditors would be considered null and void or voidable in a bankruptcy or a statutory corporate restructuring of the debtor or the junior creditors.

Basic things to Remember in Negotiations

Before it is worthwhile to start negotiations on the contents of the intercreditor agreement, a creditor should (in addition to its own investment principles and the particular facts of the arrangement) bear in mind the following basic features of Finnish law. These are relevant in the most important situation where intercreditor agreements are applied, i.e. in restructuring.

1. Absolute right to payment

A creditor's right to payment cannot, under Finnish law, be amended against the will of the creditor other thank in bankruptcy or in statutory corporate restructuring plan approved by a requisite majority of the relevant creditors.

2. Creditors have only contractual rights

Creditors have no right, without appropriate contractual clauses, to convert their receivables into equity or demand the shareholders give up their ownership in the debtor company. The creditors' control is based on loan covenants and negotiation power in a situation where the debtor defaults in its loan payments.

3. Operation in the "shadow of the Insolvency Law"

A creditor whose position is worse off than in a statutory insolvency procedure always has an incentive to prohibit a voluntary restructuring procedure. A creditor that has a controlling share of a particular creditor group also controls approval of a statutory corporate restructuring plan.

4. Priorities between different classes of creditors is based on mandatory law

Creditor priorities applying in bankruptcy and in statutory corporate restructuring are a piece of mandatory legislation. Economically, also the shareholders are included in the priority structure with last priority. In addition, controlling other secured creditors required contractual restrictions to limit their actions.

Debt Subordination

The effectiveness of contractual subordination of debt is important especially if one of the parties of a transaction is either insolvent or close to insolvency. In other circumstances, debt subordination is largely a procedural issue. It should be noted that debt subordination is not effective in all situations even under English law according to which the LMA model agreement is interpreted.

There are two basic forms of debt subordination: contractual subordination (the receivable is subordination by a contractual clause to all other indebtedness of the debtor and turnover subordination (any dividends are distributed by either the junior creditor or creditor trustee to the senior creditor until all its claims have been settled in full). Intercreditor agreements are based on turnover subordination as is secures so-called "double dividend" to senior creditors in the insolvency of the debtor.

Subordination clauses used in intercreditor agreements are often short-form and it covers both the payments under the intercreditor agreements and any funds received from the enforcement of the security assets. The order of priority is as follows:

1. Senior creditors (and hedging counterparties);
2. Mezzanine creditors; and
3. other creditors pari passu, i.e. with the same order of priority (intra group, vendor receivables, investor receivables).

Debt subordination may take effect in three different forms:

1. originally when the loan is granted;
2. as a result of an event; or
3. it can be agreed on eg. in restructuring.

The risks of a debt subordination transaction depend on the form of the subordination and of the manner it becomes effective. The most important risks are the court deeming the transaction void in the insolvency of the junior creditor; as a preference or a transaction at an undervalue; the subordination clause being unclear as to its form and effect; and the set-off risk of the junior creditor.

Turnover subordination may not become effective in the insolvency of the junior creditor and the subordination should not prevent proving of the debt in the insolvency of the debtor. Otherwise, the senior creditor may lose any advantages of the subordination as well as the "double dividend".

CHECKLIST

The Subordination Clause

1. does the clause create subordination sought for (contractual, turnover, conditional debt);
2. are also the security interests subordinated;
3. the *payment waterfall* has to be clear;
4. is the security subordinated: contractually and/or through second lien;
5. will a possible new credit be subject to subordination;
6. when does the subordination take effect
    a. does it relate to insolvency of the junior creditor;
    b. are the dividends paid through a trust (secure) or can proper dividend payments be secured otherwise (e.g. agency) in insolvency situations.

The Parties

7. are hedging counterparties parties to ICA;
8. Is it necessary to apply subordination provisions between the intra group, vendors and investor claims;
9. how are other claims (than the ones covered by the ICA) handled:
    a. transfers of receivables to third parties;
    b. same creditors on different levels of priority (is there a conflict).

Special Questions

10. is the junior creditor able to circumvent subordination by means of set-off (the risk is prevalent e.g. under English law, unless there is a trust);
11. who determines the moment when subordination becomes effective;
12. what laws are applied to different receivables (affects validity and set-off).

Changes to the Loan Agreements

Changes to the loan agreements often affect the relative priorities of the creditors of a particular transaction. For this purpose, amendments to the underlying loan agreement have been restricted in ICAs. I have described below the most common clauses used in Finnish law governed ICAs a typical starting position.

Senior Creditors

- the senior creditors are generally entitled to amend the terms of their loan documents and grant waivers without restrictions;
- their rights are usually restricted in relation to increases of loan capital, interest margin, costs and postponement of payments (allowed within pre-agreed maximum amounts and periods);
- the restriction is often linked to a so-called Senior Headroom (note: this may affect feasibility of restructuring negotiations);
- Anti-layering clause usually prohibits debtor taking on additional debt prioritized to the mezzanine indebtedness.

Mezzanine Creditors

- right to amend the terms of the loan documentation and to grant waivers is restricted;
- capitalization of interest and postponement of payments is allowed;
- covenant changes and other changes allowed with senior creditor consent cannot worsen their position.

Other Creditors

- changes to terms of investor and parent company loans require senior creditor consent usually allowed if minor.

The central question relating to amendment clauses is: can the prioritized creditors require other creditors change their agreements accordingly or do the amendments require consents from such creditors. This question is relevant above all in financial restructuring and when granting waivers under the loan documentation.

A part of the problems relating to amending of loan terms can be avoided by ensuring before the transaction that the terms of the agreements correspond materially to each other. If the required changes cannot be implemented or pre-agreed, can e.g. triggering of a cross-default clause cause difficult problems for the participants.

CHECKLIST

Senior Creditor Amendmends

1. are they entitled to amend the terms freely;
2. what is the amount of senior headroom;
3. can the liquidity requirements in a financial restructuring be carried out within the limits of senior headroom / debtor cash flow;
4. can they require other creditors make the same amendments;
5. what percentage of senior creditors controls the decision-making;
6. what happens to the security and guarantees if there are changes to loan documentation (are they released);
7. *what are "market flex"* limits and the maximum limit for payment postponements.

Mezzanine Creditor Rights

8. should the right to amend be unrestricted;
9. is the approval of senior creditor amendments acceptable to the investors of the mezzanine funds;
10. should the right to grant waivers be broad since it does not really worsen senior creditor protection;
11. should payment postponements be unrestricted on the same grounds;
12. inside which limits should increases of the PIK-margin be allowed.

Other Creditors

13. should amendments be freely allowed (other than for deeply subordinated debt) if the assets remain within the debtor group;
14. do the transfer pricing (tax) rules restrict amending loan margins;
15. should the consent of the facility agent be sufficient for amendments.

Permitted Payments and Enforcement Measures

The permitted repayment, acceleration and enforcement of loans granted under a same financing transaction is usually restricted for the purposes of preserving the agreed-upon financing structure. Unless the senior creditors are able to control these situations, the priority structure created by the ICA and other loan documentation may not work as intended. I have listed below the usual starting position under Finnish law ICAs:

Senior Creditors

- no restrictions on payments or enforcement measures;
- deviations from other creditors' acceleration, enforcement and rights to payment with senior majority consent;
- make the decision on acceleration and security enforcement;
- acceleration clauses of the senior creditors (also the hedging creditors) should be harmonized due to their equal treatment.

Mezzanine Creditors

- repayment only after full repayment of the senior indebtedness (except in insolvency, contractual interest, expenses, etc.);
- deviations from restrictions with the consent of the senior creditors;
- no payments allowed if senior indebtedness in default or if a Mezzanine Payment Stop Notice is outstanding;
- Mezzanine Payment Stop Notice issued if the senior indebtedness can be accelerated (Event of Default);
- there is often a possibility to purchase senior indebtedness for during the restricted period or the standstill period;
- enforcement measures restricted significantly but may accelerate and make claims e.g. if the senior creditors have accelerated, after the Mezzanine Standstill Period and in insolvency.

Intra Group Creditors

- payments often allowed unless senior or mezzanine indebtedness accelerated;
- even then payments allowed if the senior creditors consent or payment enables payments to senior/mezzanine creditors;
- security only with consent of senior and mezzanine creditors;
- enforcement only after senior & mezzanine repayment or in insolvency.

Investor Creditors

- repayment only after senior and mezzanine indebtedness have been paid in full, with their consent or in insolvency;
- enforcement only after senior and mezzanine indebtedness have been repaid in full or in insolvency.

CHECKLIST

Senior Creditors

1. is priority payment of advisor costs allowed in full or to a "reasonable extent".

Mezzanine Creditors

2. how long is the *Mezzanine Stop Period*;
3. how many times senior creditors can assert a particular ground for issuing a *Mezzanine Stop Notice*;
4. is repayment or interest payment allowed before repayment of senior indebtedness and to what extent;
5. how does the mezzanine loan operate in an exit situation if the creditor has warrants or shares in the debtor company;
6. should reasonable advisor expenses or mandatory prepayments be allowed during the Mezzanine Stop Period cost ceiling;
7. is the Mezzanine Stop Notice linked to a "material" Event of Default do senior creditors determine that;
8. time periods after which enforcement measures may be taken independently.

Other Creditors

9. are intra group debt repayments allowed before an Event of Default/acceleration;
10. situations where payments to the parent company are allowed;
11. are any payments to subordinated creditors allowed;
12. how are management fees dealt with.

Enforcement of Security and Divestments

As a general rule, any decisions concerning commencement and manner or enforcement of security is decided by:

- the Majority Senior Creditors;
- the Majority Mezzanine Creditors (after repayment of senior indebtedness or if, no directions given to the security agent).

Creditors holding second or lower priority to the security assets can in effect restrict effective enforcement by claiming that the enforcement is carried out with too low a consideration (unless there is an ICA) or if the ICA clauses are unclear in relation to the enforcement.

If the creditors enforce a share security (shares in one of the debtors), the security agent must usually be able to release:

- all security interests granted by the debtor group are released; and
- all indebtedness under the loan agreements or alternatively transfer the claims and obligations under the loan agreements to the purchaser of the debtor group.

The creditors may debtor group may also be taken over by the creditors who do not receive full repayment of their loans in the enforcement process (other than out-of the money creditors) also through a debt-equity swap.

On one hand, it is important for the senior creditors that they can arrange for the sale in the manner they see most appropriate. On the other hand, it is important for the junior creditors to have a say in the restructuring or exit process as well as in the pricing of the sold assets. If the junior creditors have contractual rights to affect the selling process, they gain more negotiating power in the enforcement and restructuring process.

About the Sale Process

In connection with the security enforcement the parties must take in to consideration the general duty of care and loyalty to the grantor of security as well as the second lien creditors.

Due to this legal requirement it may be feasible to require in the ICA that any transfers take place at a market price or to agree on more specific valuation methods. The following is a senior creditor-friendly example of a duty of care clause:

> "...the Security Agent shall take reasonable care to obtain a fair market price in the prevailing market conditions (though the Security Agent shall have no obligation to postpone any such disposal in order to achieve a higher price)...., the Security Agent shall … exercise its discretion having [primary regard] / [regard only] to the interests of all the Senior Creditors."

Sale of the shares to the Senior Creditors (or possibly to the Mezzanine Creditors) is a very challenging arrangement legally. Notable issues are among other things that:

- the enforcement process must be allowed in the clauses of the security agreement;
- loss of security assets is not allowed as such;
- appropriate valuation to fair market value should be preferably ensured by two independent sources
- the parties must notify the debtor and grant a possibility to redeem the security assets.

CHECKLIST

Enforcement measures

1. have the parties agreed on the manner for enforcement, determination of the enforcement price and the specific sales process;
2. have the parties taken into consideration that enforcement of a real estate security and business mortgage require a court and a bailiff procedure;
3. how do the parties distribute the assets received in the enforcement process after the acceleration is the *waterfall* clause clear;
4. is the priority concerning the security assets contractual (in the ICA) or through second lien security (property law subordination).

Release of Security

5. does the ICA regulate release of security clearly enough;
6. can the purchaser rely on the fact that the assets are fully released from the security;
7. is the Security Agent appropriately authorized to release the security.

"Non-Distressed" Sale

8. how are non-distressed asset sales carried out if there is no Event of Default and there is a commercial justification for the sale;
9. is Senior Agent and Mezzanine Agent consent sufficient for the sale.

Restructuring of other Indebtedness

10. does the ICA enable restructuring of intra group indebtedness in connection with the wider restructuring measures;
11. if the creditors' receivables are transferred

Special Questions

Effectiveness of a Standstill Clause

The effectiveness of a so-called standstill clause under Finnish law is not settled if the debtor is technically insolvent.

Basics of cancellation of a debt write-off in a subsequent insolvency procedure:

1. if a company is declared bankrupt after a statutory corporate restructuring, the debt write-offs effected by the restructuring plan are automatically cancelled;
2. This does not apply to all measures embedded in the plan, e.g. changing ordinary loan into a capital loan or debt-equity swaps (the creditor accepts the risk);
3. cancellation of a voluntary arrangement in a subsequent insolvency may be used but causes major legal risks if relied upon.

The Risk of Avoidance of Transactions

The avoidance risk inherent in restructuring affected through an ICA is significant, especially:

4. avoidance of premature and considerable payments,
5. avoidance of set-off;
6. acts preferring certain creditors.

An important question is, can a voluntary restructuring be avoided under law if the majority creditors have been deemed have inappropriately pressured the minority creditors to accept and implement a particular restructuring plan?

7. See Redwood Master Fund v TD Bank Europe under English law;
8. The risk does exist but is manageable though prudent adherence to the statutory priority rules and minority protection rules.

Actions of the Owners or Sponsors

The minority shareholders of the debtor holding company may hinder issuance of shares (for the purposes of debt-equity swap) by resorting to company law minority protection rules:

9. The risk may be avoided by enforcing share security instead;
10. Owners cannot be forced to a debt-equity swap otherwise than by a threat of insolvency.

What to Do in Practice?

CHECKLIST

Recognition of a Problem Scenario

1. The debtor contacts its main creditor.
2. The debtor presents an "Independent Business Review".

Review of the Cross-Default Clauses

3. Which covenants are triggered; who will be in the negotiation table; the hedging creditors?
4. Who are the group's creditors; are they known?
5. Has the group issued bonds; are bond creditors parties to the ICA?
6. How large portion of the indebtedness is held by creditors parties to the ICA?

Standstill Period

7. A separate agreement on a standstill period; or
8. Senior Agent notifies of the standstill to other creditors based on the terms of the ICA.

Negotiations between the creditors, owners and other parties concerning

9. acceleration of the indebtedness;
10. enforcement of security; and
11. the restructuring procedure.

The views expressed in this memorandum are of general nature and should not be considered legal advice or relied upon in a specific situation.

Any actual situations should be evaluated legally on a case-by-case basis.

M.J.L.