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C H A N C E

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LEAN, MEAN AND MEZZANINE

As the leveraged finance market returns, mezzanine investors are taking a tougher stance - possibly as a consequence of lessons learned on restructurings over the last 18 months. A number of specialist mezzanine investors have produced lists of issues setting out the further protections that they require. The central themes running through these lists are a desire by the mezzanine investors both to limit the amounts which may rank ahead of them in a restructuring and to exert greater influence over any future restructuring negotiations or enforcement action. However, agreeing to such changes will come at a cost to other debt and equity investors.

The protections requested by the mezzanine investors range from positions already widely accepted in the market, such as no structural subordination, to the more controversial: for example control and limitations on enforcement by way of disposals. In this note, we look at a selection of some of the safeguards sought by mezzanine investors and consider their implications.

Protections relating to prior-ranking debt

No new/super priority class of creditor without mezzanine consent
In a stressed or restructuring situation, additional finance may be required to support the borrowing group. This will often be provided by all or some of the senior lenders, and frequently only on a super senior basis. Agreeing to this mezzanine request may make it more difficult to provide additional debt to the borrowing group in the future. Mezzanine investors are already typically protected against being pushed down the debt structure by the intercreditor arrangements. For example under the LMA recommended form of intercreditor agreement, consent from a majority of the mezzanine investors would be required to the extent that a new or super priority debt would result in an increase in the size of the senior facilities in excess of the senior headroom (that is, the amount by which senior debt can be increased and rank as senior debt without the mezzanine investors consent). Also, senior lenders would not normally have any objections to anti-layering provisions preventing the creation of more tiers of debt between the senior and mezzanine investors.

Focus on what falls within senior headroom
There is a greater focus on what comprises "senior headroom". It is recognised that credit can effectively be extended in ways other than straightforward lending. As a consequence, mezzanine investors are scrutinising the composition of senior headroom more closely and revisiting the extent to which this should include things like waivers of mandatory prepayments, deferral of amortising repayments and roll up of interest or fees.

Key Issues

Mezzanine investors are taking a tougher stance on finance terms and intercreditor arrangements.

Their terms if accepted, would enable them to exert greater control over future restructuring negotiations and enforcement action.

Their terms would also provide more protection against unexpected changes to the senior finance arrangements, such as increased compensation.

This will have consequences for other debt and equity providers and this note considers the implications.

If you would like to know more about the subjects covered in this publication or our services, please contact:

Charles Cochrane +44 (0)20 7006 2196

Nicholas Frome +44 (0)20 7006 2762

Philip Hertz +44 (0)20 7006 1666

Alan Inglis +44 (0)20 7006 2036

James Johnson +44 (0)20 7006 2764

Jim MacHale +44 (0)20 7006 2680

Malcolm Sweeting +44 (0)20 7006 2028

Lorraine Vaz +44 (0)20 7006 2731

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance LLP, 10 Upper Bank Street, London, E14 5JJ, UK
www.cliffordchance.com

No senior market flex without mezzanine consent
As some senior arrangers indicate a willingness to return to underwriting transactions, they are less likely to be comfortable with this request which could limit their ability to flex and sell down the senior financing. This is in addition to whether or not the right to exercise flex falls within the senior headroom. It also implies that the market flex provisions would need to be disclosed to the mezzanine investors (where there is no obligation to do so at present) and private equity sponsors may feel that such disclosure affects their negotiating position with the mezzanine investors.

No changes to senior interest without mezzanine consent
Understandably mezzanine investors do not want to see unexpected increases in senior margin which are not anticipated in the financing documents. Senior lenders have recognised this in the past and have, for example, been prepared to agree that increases in senior pricing should be subject to a cap and/or only made pursuant to market flex arrangements. Mezzanine investors are seeking to go beyond this and require mezzanine investors consent to any changes to the basis on which senior interest is calculated, or accrued, and the use of fees or other compensation to increase the return to senior lenders.

Protections relating to enforcement

No structural subordination
Mezzanine investors wish to lend at the same level as the senior debt (at the highest level in the group), rather than lending at an even higher level in the group and being structurally subordinated. Although some recent transactions have been completed on the basis of structural subordination, lending at the same level is not unusual and, assuming it does not restrict push down of senior debt into the operating subsidiaries of the group, this request is likely to be acceptable in a wide range of transactions.

Right to convert mezzanine claims into equity
The mezzanine investors want restrictions lifted on their ability to receive new equity from a holding company of the group upon a release of mezzanine debt or guarantee claims. Typically, under an intercreditor agreement, consent would be required from the majority senior lenders to implement this. Mezzanine investors would like to be able to swap debt for equity with the agreement of the borrowing group but without senior lender consent. A conversion of mezzanine claims into equity might at first glance seem acceptable to the senior lenders, but if the leverage financial covenant ratios in the senior facilities agreement are calculated on a total net debt basis (i.e. including the mezzanine debt) then such a conversion could materially weaken the senior lenders' protection. A solution might be to return to the position where there is a senior leverage financial covenant at the outset in the senior facilities agreement or a "springing" senior leverage financial covenant which becomes operable upon a conversion of mezzanine debt into equity.

Top level share security to be granted to mezzanine investors
Mezzanine investors are also seeking the ability to take a share pledge/charge over an entity above the borrowing group, the effect of which would be to cut the sponsor off from any economic interest in the borrowing group. The result of this would be that the senior lenders would have to negotiate with the mezzanine investors in their capacity as owners, rather than with the sponsor they originally backed and with whom they have a relationship.

Mezzanine equity cure
Mezzanine investors want the right to inject further mezzanine debt as an "equity cure" if the private equity sponsor has failed to do so. This is unlikely to be acceptable to private equity sponsors (since such debt would rank ahead of any shareholder debt provided by them) and, from a senior lender perspective, will not help to remedy a breach of any total leverage covenant.

Control over enforcement by way of disposal
In a recessionary environment, lenders look to protect their position both in a liquidation of the borrowing group and in a forced sale of the business. A number of recent restructurings have enforced security by way of a share sale. Mezzanine investors are seeking greater control over the disposal process and the related release of their debt and guarantee claims in a manner not dissimilar to that which is more commonly seen in the high yield market. For example:

- **No disposals without a fair value opinion or by public auction**

  Senior/mezzanine intercreditor arrangements focus on achieving a fair price on disposal, in light of the circumstances at the time, rather than being prescriptive about the means of disposal. Moreover, a public auction may not achieve the best price and alternative disposal routes may be preferred. That said, local law requirements also need to be considered. Although this is not the case in England, local jurisdictions may require shares to be sold at public auction or within other prescribed parameters.

  The concept of a "fair market value" opinion would also need careful consideration For example: who should provide the opinion; what is the basis on which the valuation should be made; when should the opinion be obtained; how will the cost of the opinion be funded and by whom? A simple obligation to seek a "fair market value opinion", without further formulation, leaves scope for uncertainty and delay at a time when it may be important to act promptly so as to retain value in the companies to be disposed of.

As a matter or English law there is in any event an obligation to achieve the best price reasonably obtainable in the circumstances. A formulation along these lines would appear to be an approach capable of giving the different classes of lenders comfort.

- **Automatic release of guarantee and security only to apply to disposal of the whole or substantially the whole of the group**

  This would restrict the ability to sell particular divisions of the borrowing group as part of the enforcement strategy. This could be problematic and cause delays at a time when it may be more efficient to sell off certain divisions of the borrowing group on a piecemeal basis.

- **Participation of mezzanine investors in relation to the appointment of the valuer and the marketing exercise**

  This could impact adversely on the enforcement timetable and strategy as it would necessitate getting both the senior and mezzanine syndicates involved before any action could be taken. Moreover, senior lenders are unlikely to agree to be compelled to undertake a marketing exercise (which may in itself, depending on the circumstances, be potentially damaging to the value of the business). It may be possible to get both sides comfortable with an alternative formulation where the senior lenders agree to consult (if practicable) with the mezzanine investors in relation to the appointment of a valuer.

Conclusion

We have considered a selection of the protections asked for by mezzanine investors and there are others. As activity continues in the leveraged finance market, the mezzanine investors will undoubtedly seek to improve their position and there will be greater scrutiny of intercreditor terms by all sides. The LMA recommended form of intercreditor agreement published in November 2009 includes various optional clauses which address some of the mezzanine requests outlined above. It will of course be a matter for negotiation between the parties as to where the appropriate middle ground lies but clearly the mezzanine investors feel that there is more that they would wish to see. Careful thought will need to be given regarding how these changes will impact on flexibility at the time financing is entered into (for example market flex controls) and subsequently – including agreeing a corporate rescue and restructuring plan.