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Evolution of Second Lien Loans

With the changes in the financial markets over the past 10 years, more creativity was brought to bear and financings were structured in ways that provided more benefits for the borrowers than ever before. The economic downturn early in this decade lasted longer than originally anticipated, causing cash flows and collateral values to fall drastically.[16] In response to escalating rates of default, lenders tightened credit polices and, for a time, leveraged cash-flow lending essentially disappeared from the lending landscape.[17] The result of the 2001-03 credit crunch was that

16 *See* "Loan Market 2000: Defaults Rise, Angels Fall; Lenders Seek Safety in Low Leverage, Stolid Sectors," *Gold Sheets,* Vol. XV, No. 1 (January 2001) at 1; *see also* "Cirque 2001: High-grade Takes Center Ring, As Balance Sheets Turn and Borrowers Tumble," *Gold Sheets*, Vol. XVI, No. 1 (January 2002) at 1; and "Gravity's Rainbow? As Markets Tumble, Lending Slips but Angel's Fall Is Leveraged's [*sic*] Redemption," *Gold Sheets*, Vol. XVII, No. 1 (January 2003) at 7.

17 *See* Loan Market 2000, *supra* note 16, at 18-21; *see also* Cirque 2001, *supra* note 16, at 1 (following Sept. 11, 2001, the "leveraged loan market collapsed").

by 2003, many public and private companies were in a quandary as to how to refinance their debt as it matured.[18]

At the same time, the syndicated loan market was further depressed by a lack of demand for new debt from borrowers not forced to refinance because of impending debt maturity.[19] As corporate profits suffered during the 2001-03 recession, non-investment-grade merger and acquisition activity (a significant source of lending demand in any market) initially waned as private-equity investors waited to see how far equity prices would fall.[20] Even after purchase prices plummeted to levels that encouraged buyers to re-enter the market, these buyers found lenders unwilling to finance acquisitions with high levels of total debt.[21] Instead, lenders insisted on seeing more equity dollars invested in the deal.[22] Faced with the prospect of putting more of their own skin in the game, private-equity groups became even more critical of new deals and sought creative solutions to finance quality deals.[23]

One solution that emerged was a traditional asset-based loan in conjunction with a second lien financing. This approach succeeded because the tight credit policies and asset-based approach of senior lenders prior to 2003 meant that collateral frequently had considerable value in excess of amounts needed to ensure that the senior lenders would, in a liquidation,

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18 *See* "Completing the Capital Structure with a Second Lien Loan," *CapitalEyes*, Bank of America Business Capital Newsletter (April 2003).

19 *See* Cirque 2001, *supra* note 16, at 1, 19. *See also* "Gravity's Rainbow?" *supra* note 16, at 1, 18 and "From Bear Baiting to Bull Run: 12 Months of Fundamentals, Technicals and Recovery" *Gold Sheets*, Vol. XVIII, No. 1 (January 2004) at 18.

20 *See* Cirque 2001, *supra* note 16, at 16, *citing* Thompson Financial: "U.S. merger activity fell by 57% from 2000 levels, and loans backing M&A tumbled by one-third to only $146 billion. Unsurprisingly, the leveraged sector was hard hit, with M&A lending falling more than 40%. Within the leveraged segment, LBO activity was even harder hit: Less than $13 billion come from that sector, leaving financial sponsors sitting on considerable war chests, but with few deals." *See also* "Gravity's Rainbow?," *supra* note 16, at 1, 19; and "From Bear Baiting to Bull Run," *supra* note 19, at 18.

21 *See* "More Attractive Assets, Easier Financing Facilitate Mid-Cap LBO's Reload," *Gold Sheets*, Vol. XVII, No. 21 (June 2003) at 1, 22 (noting that "[l]ender wariness has translated into conservative deal structures for sponsored credits, with the average maximum total debt to EBITDA covenant restricted to 4.28 times. This is just a hair's breadth higher than 2002's 4.4 times, but far more restrictive than 1999's 5.11 times average").

22 *See Id.* ("[L]enders' demands are similar to, if not more stringent than, their demands the past few quarters—high equity infusions, low leverage levels and high compensation in margin.")

23 *See* "LBOs Reload," *supra* note 21, at 24 ("Burned by a previous crop of deals, sponsor shops and lenders have become more cautious, placing more emphasis on due diligence than on return. So if there is an LBO surge, it is likely to be a muted one.").

be paid in full.[24] The expanded use of chapter 11 to facilitate a quick sale of a debtor's assets and greater sophistication by liquidators may have contributed to the nontraditional lenders' comfort with the theory that they could realize value beyond what traditional secured lenders were requiring as a basis to lend. What followed was that borrowers and a new crop of lenders were able to use second liens to unlock the value of this "excess" collateral and provide much-needed liquidity. Although second lien loans were offered at interest rates in excess of the then-current senior debt market (to reflect the increased risk to the second lien position), these rates and other costs to the borrower's equityholders were far below what had been demanded for unsecured subordinated mezzanine debt. By the fourth quarter of 2003, second lien debt was being used not only to solve liquidity problems, but also to replace subordinated mezzanine debt in typical leveraged buyout transactions.[25] In short, the pricing of second lien loans hit the sweet spot by appealing both to lenders and borrowers alike. Not surprisingly, thereafter, the rate of growth for the second lien market increased significantly and rapidly. According to Standard & Poor's Leveraged Commentary and Data (LCD) quarterly reviews, between 2003 and 2005 second lien volume spiked from $3.1 billion to $16.3 billion.[26] By 2006, LCD reported that the volume increased to $28.3 billion; in 2007, the volume grew to nearly $30 billion, with more than 90 percent of the loans funded during the first three quarters of the year.[27] Interestingly, the statistics show that during 2006 and the early part of 2007, the second lien transactions were significantly less collateralized than prior years.[28]

While second lien loans were initially used primarily to pay off existing debt, to provide a short-term bridge as an exit loan for a bankruptcy case or to provide incremental liquidity, as corporations and lenders grew more comfortable with second lien financings, they were employed in a broader range of circumstances.[29] The second lien market grew as non-

24 Seife, *supra* note 1. *See also Cirque 2001, supra* note 16, at 18 (noting that "the best of deals are done at the worst of times").

25 Standard & Poor's Leveraged Commentary & Data (December 2003).

26 *Id. See also* Armagno, Dana S., Godush, Marie H., Stevens, Kathryn L., and Eidelman, Michael M., *VedderPrice Special Report,* Winter 2008-2009 at p. 2-6.

27 *Id.*

28 *Id.*

29 Standard & Poor's Leveraged Commentary & Data. (December 2003) (observing that lender willingness to use second lien financing in "mainstream" deal had replaced more limited use of

bank lenders, such as hedge funds, specialized finance companies and even subordinated mezzanine debt funds, were drawn to the structure by the relatively high margins offered on second lien debt.[30] Because these types of private investors were not regulated and were not constrained by internal credit risk ratings, they were free to look for true risk/return oriented structures and reviewed each potential deal on its own merits.[31] The familiarity lenders and borrowers gained with second lien structures early in this decade, coupled with the relaxation of credit standards in response to a strengthening economy, drove a dramatic expansion of the second lien market from 2004-07. In fact, second lien financings became so popular that full collateral coverage for both the first lien and second lien debt no longer appeared to be an absolute pre-condition of such financings. The creativity of lenders and borrowers alike in the context of an improving economy helped nurture this loan structure.[32]

Accordingly, borrowers and equity sponsors turned to second lien loans for various reasons. First, even though pricing varies widely based on the risk of the loan, the average price for second lien loans in the second quarter of 2004 was only LIBOR +697 basis points. While incrementally more expensive than a first lien loan when compared to 16-20 percent returns plus an equity kicker for traditional mezzanine debt, second lien financing was relatively cheap as a means to provide funding not available from a senior secured loan. Moreover, second lien loans were often viewed as transitional capital, allowing the borrower time to improve its performance in order to gain access in the future to traditional senior creditor facilities. As a result of this feature, most second lien facilities allow prepayment at par or with a nominal premium. Mezzanine loans, on the other hand, generally are non-callable for two to three years, and sometimes even continue to carry premiums. After years of losing out to second lien lenders, only recently did mezzanine lenders manage to win back some of their market share. The trend was explained by an increase in lenders' interest rates that made the price of second lien debt "only slightly more favorable than unsecured mezzanine...." Reports indicate

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second lien financing as rescue financing for borrowers "facing liquidity problems"). *See* "Why Today's Borrowers and Investors Are Leaning Toward Second Liens," *CapitalEyes,* Bank of America Business Capital Newsletter (February, 2004).

30 Standard & Poor's Leveraged Commentary & Data (December 2003).

31 *CapitalEyes* (February 2004), *supra* note 28.

32 *See generally* Batty, Brighton, *supra* note 3.

that "some senior lenders have grown leery of participating in deals with second lien lenders, fearing that junior lenders may be able to stop senior lenders from collecting all of their collateral if the borrower defaults."

One can argue that because interest rates have rebounded and because of the volume and acceptance of second lien loans in the marketplace, the second lien market may have reached its maturity point. The current credit crunch has caused lenders to focus on what happens in a challenged economy when the borrower seeks to reorganize or collateral is liquidated. Pricing has increased, making the second lien loan less attractive to borrowers. According to Reuters Loan Pricing Corporation (LPC), second lien issuance has been on a steady decline since the third quarter of 2007, with the decline continuing into 2008 with only $1.5 billion in issuance in the first quarter.[33] It is important to note, however, that middle-market second lien loans are generally not syndicated and do not show up in these numbers.[34] Colin Cross, managing director of Crystal Capital, said in August 2008 that "[t]here are more buyouts and refinance activity requiring junior debt, but there are fewer buyouts than one year ago."[35] Cross predicted, however, that there would be activity in the restructuring market that will produce transactions where second liens are still a good option for companies as they restructure their credit facilities.[36]

Flash forward to fall 2008 and the incredible global economic crisis. Not only did large, what many thought were invincible, institutions implode seemingly overnight, but the credit market all but dried up. Many loans deteriorated into default, while many others are "bubbling" in the background, saved thus far from being declared but cannot yet be declared as being in default because they were made either with no covenants, or with very few covenants (widely referred to as "covenant light" loans).

33 *See* Papavassilou, Stuart P., *ABF Journal,* July/August 2008 at 12.

34 *Id.*

35 *Id.*

36 *Id.*