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Second-Lien Lending Rides a Gusher

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How Second-Liens Complicate a Workout

Editor's note: Workouts of second-lien loans have become a significant issue for lenders — and for borrowers, if the lenders aren't experienced with resolving problem loans.

By Eric Goodison

To successfully complete a workout, a borrower has to negotiate with its lenders on the terms and parameters of that workout. With second-lien loans in play, a borrower that needs to work out its capital structure should focus on two main issues before approaching its lenders. The first is with whom the borrower negotiates, and second is what the workout looks like.

Complicating matters is the fact that second-lien lenders are not traditional financial institutions with workout or restructuring groups. Additionally, many second-lien lenders are new to leveraged lending and have not been through a down credit cycle. The second-lien lenders' lack of infrastructure and workout experience may make them unwilling to devote the substantial time and effort that a successful workout requires.

For borrowers with public bonds or equities, there is an additional complication. Many investors in second-lien loans also invest in the borrower's public debt and equity securities and will not want to be restricted from trading those securities.

Moreover, participating in a workout means receiving detailed data that may be material non-public information. Receipt of that information could prevent the second-lien lender from trading. As a result, the borrower will need to understand the composition of its bank group and who will represent the second-lien lenders in the negotiations, as well as what and how much authority the representatives have.

A natural starting point is to ask the lenders' administrative agent to represent the second-lien lenders. However, in most second-lien loan transactions, the administrative agent acts for both the first-lien and second-lien lenders. This dual representation presents potential conflicts between the two lending groups, and the administrative agent may be unwilling to act for both.

Conversely, even if the administrative agent is willing to continue with the dual representation, the second-lien lenders may not accept it. If the administrative agent won't act for both the first and second-lien lenders, in all likelihood, the agent will continue to act for the first-lien group, given the first-lien lenders' greater control over the collateral and any proceedings and the enhanced ability to provide a debtor-in-possession (DIP) financing in any bankruptcy.

If the administrative agent either will not or cannot act for the second-lien lenders, the borrower has to identify who will represent them. Given their lack of infrastructure and experience, the second-lien lenders themselves may not be willing to participate in the workout negotiations, meaning that the second-lien lenders will want professional help in the form of their own counsel and financial advisors.

Of course, the second-lien lenders will not bear the costs of this professional help, so it will fall to the borrower. For borrowers, this means they need to understand that if the administrative agent cannot represent the second-lien lenders, the borrower should help the lenders organize themselves to find a representative in the negotiations. It also means distressed borrowers may have to be prepared to pick up additional costs.

The second issue for borrowers is what will be included in the negotiations. The borrower needs to understand its current circumstances and needs, the goals of the bank group (which may be different than the borrower's) and what a successful workout will include. Again, the existence of second-lien loans will require greater planning and preparation.

For borrowers, a successful workout may involve a range of options, including:

- (a) financial covenant relief to allow the borrower time to execute an operational turnaround;
- (b) maturity extension;
- (c) infusion of new capital;
- (d) the incurrence of additional debt to fund certain needs;
- (e) strategic acquisitions to realize synergies or efficiencies;
- (f) sales of material assets;
- (g) debt-to-equity conversions; or
- (h) bankruptcy to implement any of the forgoing options or to keep creditors at bay.

The presence of any second-lien loans in the borrower's capital structure adds issues and complexity to any of these strategies.

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