

Corporates/U.S. and Canada
Special Report

Overview of the U.S. Second-Lien Loan Market

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■ Introduction

Over the past three years the once-nascent U.S. second-lien loan market has established itself as a critical and enduring financing alternative for highly leveraged companies in search of additional sources of available funding. Despite the fact that second-lien obligations add further complexity to already complicated capital structures and create even greater uncertainty regarding the relative recoveries among creditors in the event of bankruptcy, their newfound popularity appears to be more than a passing phenomenon.

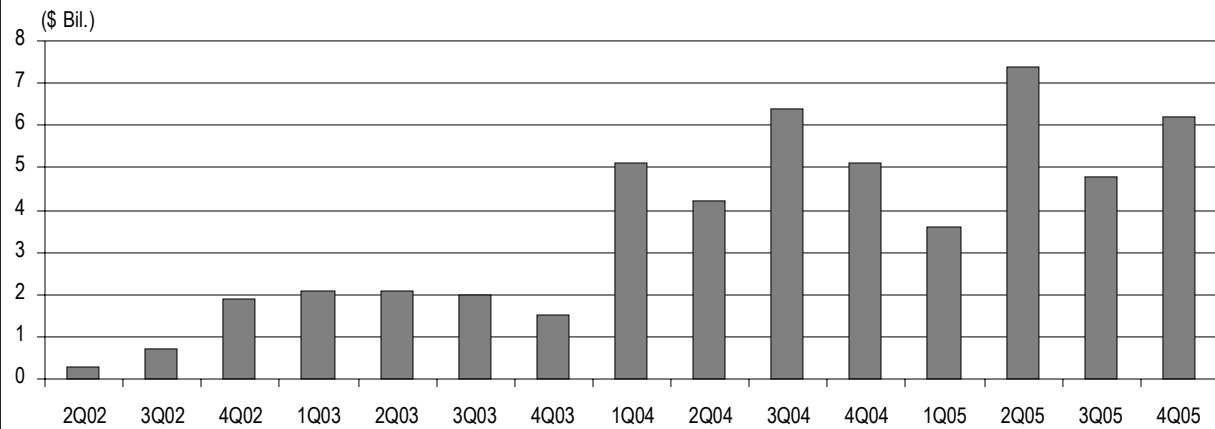
The rate of loan growth within the second-lien loan market has been significant since 2003. Second-lien loan volume (based upon Reuters Loan Pricing Corporation data) grew from \$7.7 billion during 2003, to \$20.8 billion during 2004, and then to \$22.0 billion during 2005. It is furthermore important to note that the large syndicated second-lien loan deals are the transactions most efficiently tracked by the industry. There may, therefore, be additional volume associated with smaller deals that did not get captured in these figures due to the fact that many U.S. second-lien loan deals are highly negotiated private transactions executed by a sophisticated “club” of direct lenders.

Future U.S. second-lien market loan volumes and demand volatility are actually quite difficult to predict. The U.S. second-lien loan product remains in the very early stages of its evolution, and there is limited actual case history available to fully clarify the interplay of these loans versus the more traditional components of company capital structures. Since the large-scale introduction of second-lien loans over the past several years was distinguished by a benign credit cycle with below-average defaults, there has been very limited real world testing of these transactions. A much broader array of loan workouts and company reorganizations is required to establish with greater certainty how bankruptcy courts can be expected to interpret the intent and enforceability of the critical intercreditor agreements governing these transactions. Further complicating this issue is the wide variability that exists among these transactions. Documentation supporting the largest syndicated U.S. second-lien loans typically incorporates truly “silent” second liens and closely resembles more established documentation for U.S. second-lien high yield bonds. Documentation supporting most other U.S. second-lien loan deals is characterized by a notable lack of standardization of terms, since these transactions tend to be negotiated extensively on a deal-by-deal basis.

It remains to be seen whether actual results will support the presumption by investors that second-lien lenders stand to recover more in bankruptcy than unsecured creditors. Another key issue of interest is whether second-lien loan transactions will prove to have

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U.S. Second-Lien Loan Issuance



Source: Reuters Loan Pricing Corporation/DealScan.

greater-than-expected potential to undermine the recovery rights of first-lien lenders, particularly where the transactions entailed cash flow-based structures. In most instances Fitch's current approach when completing the debt waterfall analysis used to determine recovery ratings is, in fact, to slot second-lien senior secured debt between first-lien senior secured debt and senior unsecured debt with regard to priority of repayment.

■ **The Evolution of the Second-Lien Loan Market**

Initial U.S. Second-Lien Deals During the Late 1990s Incorporated Primarily Asset-Based Loan Structures

The origin of the U.S. second-lien loan market dates back to the late 1990s. Prior to that point, first-lien lenders almost universally insisted upon receiving exclusive liens. The initial second-lien deals were completed by a select group of specialized lenders that focused on underperforming companies with traditional asset-based loan structures. These early second-lien loan transactions were evidenced by clear over-collateralization of the first-lien loan obligations and a specific need for additional available funding. The initial entrants to the second-lien loan market therefore had confidence that their investments possessed relatively low risk, with proportionately high rates of return.

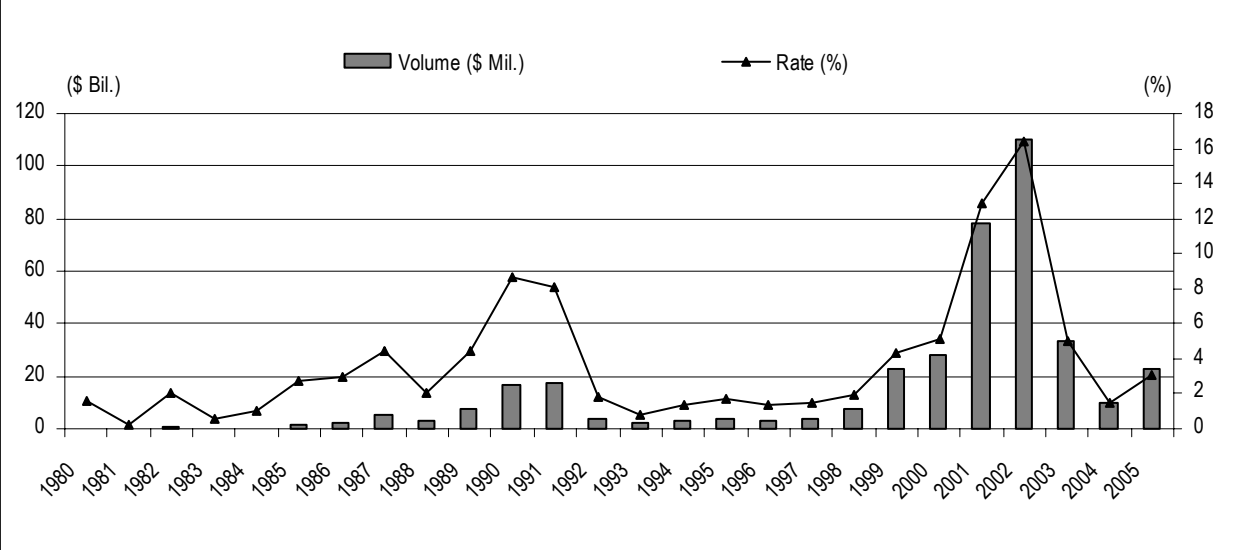
Second-Lien Deal Structures Became Less Conservative as Investors' Search for Yield Accelerated

A variety of market-driven factors then triggered changes that drove the explosive growth in 2003 of the new and decidedly less conservative breed of second-lien transactions, which have come to represent the latest iteration in the evolution of highly leveraged capital structures within the United States. The economic downturn had dragged on longer than anticipated, but the credit cycle was finally showing hints of improvement during 2003. The domestic commercial banking industry continued to consolidate, deal sizes got larger, the transactions under consideration became more complex, company cash flows and collateral values had not fully recovered from the economic stresses of 2001 and 2002, access to the public capital markets became increasingly restricted to larger companies, and interest and default rates dropped to record lows. These events drove a steady transformation in the U.S. capital markets. Second-lien loans suddenly became very attractive by virtue of their higher relative returns versus first-lien debt, their floating interest rate feature unavailable for most high yield bonds (which positioned investors to capture the future rate increases that were believed to be inevitable), and their secured status.

Hedge Fund Growth Introduced Tremendous Amounts of New Capital for Nonconventional Investment

Over the same period the formation of new hedge funds exploded and introduced tremendous amounts of new capital for investment in the financial

Fitch U.S. High Yield Par Default Index: 1980–2005



markets. Together with other nonconventional investors such as mezzanine funds, distressed debt and vulture funds, the hedge funds sought out high returns through creative investment in highly leveraged companies. They also recognized the benefits of expanding the applications of second-lien loan transactions, given the potential for greater recoveries to be realized in the event of bankruptcy through possession of collateral interests and other protections typically afforded to secured lenders. Hedge funds therefore quickly became the most active force behind the development of the second-lien loan market on a broad scale. The success of hedge funds in this market was further fueled by the fact that to this point they are neither regulated nor subject to public reporting requirements, and have therefore been able to act much more quickly and flexibly than commercial banks or other conventional investors. As U.S. second-lien loan transactions became more commonplace, they rapidly gained broader appeal for many more traditional institutional lenders (such as collateralized loan obligations and prime rate funds) whose charters otherwise precluded participations in offerings of subordinated debt obligations.

First-Lien Lenders More Broadly Began to Relax Their Lien Exclusivity Requirements

Senior secured first-lien lenders, which as a group had always closely guarded their collateral rights, began to recognize the value of permitting second-lien transactions as a means of refinancing portions of their first-lien exposures to many severely challenged borrowers. The senior secured first-lien

lenders also recognized that the continuation of prohibitions against all second-lien transactions would hurt their competitive positioning with regard to future new business opportunities. The result was that senior secured first-lien lenders gradually began to relax their requirements for lien exclusivity. Many first lien transactions, which would previously have included aggressive enterprise value-based term loan B facilities, were instead repackaged to include higher-return and longer-dated second-lien term loans.

U.S. Second-Lien Loan Market Quickly Became a Critical Financing Vehicle for Speculative Grade Issuers

Borrowers, lenders and equity investors alike progressively recognized that access by highly leveraged companies to the second-lien loan market presented one of the limited financing vehicles available to get a variety of transactions done. They also enthusiastically embraced the introduction of second-lien loans as a critical new alternative funding source. This was particularly true with regard to smaller and more complicated speculative grade issuers, which have always faced restricted access to the traditional capital markets. Today's second-lien loans are frequently extended as a component of cash flow transaction structures. In many instances full collateral coverage of the second-lien obligations now relies upon more subjective total enterprise values, as opposed to straight tangible asset values assuming orderly liquidation. This has enabled increases in average deal sizes and much greater transaction complexity. Borrowers have furthermore

been attracted to the fact that second-lien loans typically carry floating rates and less costly pricing, along with greater flexibility concerning a variety of other terms when compared to traditional high yield and mezzanine structures.

U.S. Second-lien Loan Structures Do Not Currently Trigger Violations to Standard “Anti-Layering” Provisions

Greater interest in second-lien loan transactions by various constituents within the market also appears to have been tied to restrictive “anti-layering” provisions in effect within most existing high yield indentures, as well as within some credit agreements. Anti-layering provisions are imposed for the purpose of restraining the ability of companies to incur material amounts of incremental debt possessing more senior priority status than existing debt. However, the standard definition of most existing anti-layering provisions has not historically been worded to capture U.S. second-lien loan structures by virtue of the fact that they are characterized by lien subordination without any corresponding debt subordination. This presented a critical documentation “loophole” during the past several years for issuers desirous of issuing meaningful levels of incremental debt. Additional discussion of this important issue follows below.

U.S. Second-Lien Market Is Still Evolving— Limited Standardization of Terms or Documentation Exists

While the initial second-lien loan deals completed incorporated truly “silent” second liens, investors in the U.S. second-lien loan market more recently appear to be garnering greater rights to actively negotiate many such transactions on a provision-by-provision basis. The additional degree of control over the documentation process that is now being obtained by the second-lien lenders in many cases could notably shift the balance of power among investors upon any future events of default. This latest trend is most likely due to the market’s continued high level of demand for the large supply of available funding that these investors in second-lien loans are able to offer. For this reason, and also given this relatively early stage in the lifecycle of the U.S. second-lien loan product, there is limited standardization of transaction terms and documentation practices within this market. This is most particularly the case with regard to the more complex non-syndicated private transactions.

Typical Characteristics of Today’s Second-Lien Loan Issuers

Large syndicated second-lien loan transactions that closely mimic high yield bond structures are readily available in the United States to many large speculative grade issuers. On the other hand, the ideal candidates for the smaller, more highly negotiated U.S. second-lien loan transactions, which generally do not entail truly “silent” second liens, are companies possessing the following characteristics. They are typically issuers with annual consolidated revenues ranging between \$500 million–\$1 billion and also possess defensible market positions. In addition, most of these companies already have complex capital structures in place along with an inability to refinance or raise additional available funding through traditional sources at a reasonable cost. An existing liquidity event, concerns about future liquidity prospects, a pending transaction, or encouragement from assertive investment bankers are the most likely triggers for initiatives to seek second-lien loan financings.

■ Lien Subordination—The Defining Feature of U.S. Second-Lien Loan Structures

The defining feature of second-lien senior secured loan structures within the U.S. debt market is that they are typically composed of senior secured obligations that are pari passu with all other senior secured debt of a company in every respect, except with regard to lien subordination. In basic language, the term “lien subordination” means that the liens pledged in support of second-lien senior secured loans are subordinated to any liens pledged in favor of first-lien senior secured loans. The first-lien lenders, therefore, retain first priority to get paid from the proceeds of any shared collateral, but do not otherwise have superior claims relative to the second-lien secured lenders due to the absence of formal debt subordination. Payment blockage provisions are notably also atypical within U.S. second-lien deals. Intercreditor or equivalent agreements, which are the documents that outline the relative priorities of multiple secured parties’ claims to a borrower’s collateral, remain the most heavily negotiated element of second-lien transactions.

In the event of bankruptcy, second-lien senior secured loans therefore have claims priority ahead of all subordinated debt. Second-lien senior secured loans also have priority ahead of all general unsecured claims to the extent that valuation analyses

conducted during the reorganization process validate that there is sufficient residual collateral value after satisfying all first-lien obligations. General unsecured claims incorporate senior unsecured notes, trade debt lacking administrative priority, contingencies, and a variety of other obligations. To the extent that the second-lien senior secured claims ultimately prove to be greater than the value of the collateral pledged, these claims would be expected to be divided into secured claims up to the value of collateral, and general unsecured claims for the balance.

While U.S. second-lien transactions almost universally share lien subordination along with the absence of debt subordination, it is of critical importance to understand that not all second-liens are created equal. Each second-lien transaction structure therefore deserves careful review. The specific terms negotiated for each intercreditor agreement establish to what degree the second-lien creditors have agreed to give up their rights as secured creditors and under what circumstances they have retained the ability to exercise their rights. A truly silent second-lien defers to the first-lien creditors regarding how and when to exercise the special rights of secured creditors, while still preserving the rights that would otherwise be available to unsecured creditors. As the second-lien market gains more traction and becomes increasingly critical to getting transactions done, the second-liens being negotiated are proving to be only muted (as opposed to completely silent) for an increasing number of transactions, particularly within deals that are not widely syndicated. Examples of the rights that second-lien holders obtain by virtue of being secured, but which they may agree not to exercise through “silent second” intercreditor provisions, include the ability to challenge the validity of first liens, the ability to challenge enforcement of foreclosure actions taken by holders of first liens, the ability to seek adequate protection, and the ability to exercise enforcement actions with respect to their own second liens.

The “anti-layering” covenants prevalent within the US high yield market typically prohibit issuers from incurring new debt that is “subordinated in right of payment” to senior debt, unless that new debt is also subordinated to (or *pari passu* with) the debt containing the anti-layering provision. Since second-lien debt facilities do not usually incorporate actual debt subordination, they are not “subordinated in right of payment” and therefore are not precluded by the existing standard for the definition of these anti-layering provisions. This fact has clearly amplified

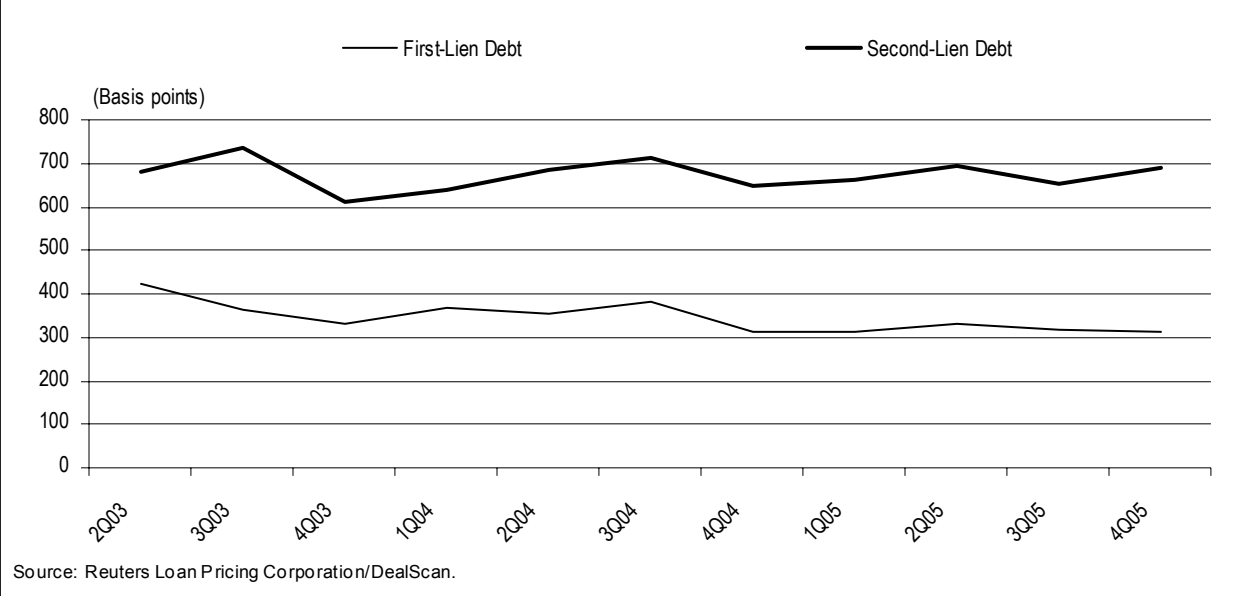
demand for second-lien structures over the past few years. It remains to be seen whether the definition for anti-layering provisions to be incorporated within future high yield notes offerings will be revised by strengthening the restriction to a prohibition of new debt that is “subordinated in any respect,” and thereby capture any new debt to be structured with simply lien subordination. Since anti-layering provisions are fairly standard covenant limitations present within most bond indentures, investors are undoubtedly carefully weighing the pros and cons of permitting issuers to originate what effectively constitutes a new layer of senior debt.

■ **Additional Features Characteristic of U.S. Second-Lien Loan Structures**

U.S. second-lien loans are typically floating-rate obligations. While these loans usually carry materially higher interest rate spreads than first-lien loans, they are generally substantially less costly than mezzanine debt. In addition, U.S. second-lien loans rarely entail warrants or other equity give-ups by issuers. The competitive pricing of U.S. second-lien loans is ascribed to the fact that second-lien loans retain the rights of secured loans, subject to restrictive intercreditor provisions. Prepayment terms for U.S. second-lien loans are also considerably less onerous than those for mezzanine debt and high yield bonds, which enhances flexibility for companies that are only seeking transitional capital. Most U.S. second-lien loans can be prepaid at par, or with a modest premium that unwinds over time. In contrast, traditional U.S. high yield securities are generally non-call for three or more years, and traditional U.S. mezzanine debt is generally non-call for two or more years. Furthermore, pricing changes associated with the U.S. second-lien loan market are not highly volatile in response to short-term capital markets swings. This is presumably attributable to the fact that investors in second-lien loans typically have funds dedicated to these types of transactions, regardless of the state of the economy.

U.S. second-lien loans seem to have broad appeal to investors because they promise good returns while also preserving priority over senior unsecured creditors (capped to the extent of available collateral coverage). While there is negligible case history at this point to prove the hypothesis, it is widely believed that second-lien lenders will realize better recoveries than unsecured lenders under distress scenarios, even when the second liens are truly silent.

Loan Pricing Trends — Spreads over LIBOR



■ **Controversial Negotiating Points Surrounding U.S. Second-Lien Loan Transactions**

The terms negotiated within intercreditor agreements or equivalent documents governing the key provisions of U.S. second-lien loan transactions are of critical importance. Any lenders covered by first liens, second liens, and even more junior liens must agree up front on all critical matters regarding how their respective collateral remedies may be exercised, as well as the order in which any proceeds of their shared collateral would be applied against the borrower’s various secured obligations outstanding. The balance of power dictated by the terms of intercreditor agreement negotiations stands to have a material impact upon what “seat at the table” second-lien lenders can expect to take in the event of future default and bankruptcy.

As explained previously, intercreditor agreements contain little standardization. To date, the larger syndicated second-lien loan transactions have most closely mimicked the more mature U.S. second-lien high yield bond market and thereby rendered the second-lien lenders to those facilities almost completely silent. Within many of the smaller club deals the trend appears to be that second-lien lenders are steadily gaining a greater degree of control over the documentation process. The balance of power between first- and second-lien lenders will undoubtedly shift repeatedly in the future, depending upon prevailing market conditions at any given point

in time. Once the U.S. default rate begins its inevitable rise and the competition for deal flow at targeted investment returns escalates, first-lien lenders are likely to once again become increasingly more vigilant and forceful during intercreditor negotiations.

The most critical and controversial intercreditor issues that must be negotiated center around exactly how “silent” the second lien will be. The primary objective of intercreditor agreements for these transactions is to delineate the circumstances under which the second-lien lenders agree in advance not to exercise some or all of the special rights that they otherwise obtained by virtue of being secured lenders. The key intercreditor provisions to be negotiated more specifically include, but are not limited to:

- The circumstances under which second-lien creditors will automatically waive their rights to exercise remedies against collateral, or to challenge the first liens;
- The degree to which second-lien lenders agree in advance to forfeit their otherwise mandated “adequate protection” rights as secured lenders which are intended to serve as protection against diminution of pre-petition collateral (see the more detailed discussion of adequate protection just below);
- The length and scope of standstills for lien enforcement by the second-lien lenders;

- The extent of tag-along rights enabling second-lien lenders to retain the same security interests as first-lien lenders in any new collateral offered up by the issuer;
- Whether second-lien lenders agree in advance to waive votes they would otherwise be entitled to in bankruptcy;
- The amount of any restrictive hard dollar caps on future first-lien debt and debtor-in-possession (DIP) loans;
- Whether DIP facilities will be automatically permitted to prime pre-petition second-lien facilities on an inconsistent basis versus pre-petition first-lien facilities;
- Whether second-lien lenders will have the right to buy out the first-lien debt at a pre-agreed price (with the possible goals of preventing fire sales with respect to collateral or “loaning to own”);
- Whether, and under what conditions, second-lien lenders will automatically permit releases of their liens during a bankruptcy upon a “Section 363 sale” of collateral approved only by first-lien holders (see explanation of Section 363 sales below);
- The degree to which second-lien lenders will have the ability to preserve enforcement rights as a separate class of creditor;
- whether or not there will be any payment blockage provisions applicable to the second-lien obligations (not typical), and
- Whether second-lien lenders will, at a minimum, possess the ability to assert rights as basic unsecured creditors.

Adequate protection provisions under the U.S. Bankruptcy Code were notably established for the specific purpose of minimizing diminution of the collateral base pledged to pre-petition senior secured lenders that would otherwise be expected to result during a company’s reorganization process. DIP facilities notably often feature super-priority claims and “priming liens” that provide the new lenders to a company during bankruptcy with repayment rights and security positions ahead of all pre-petition secured parties. In order for DIP lenders to be able to obtain such priming liens, it must be demonstrated that the pre-petition secured creditors are “adequately protected,” and additionally that the DIP financing could not be obtained from another source on materially better terms. Adequate protection is therefore designed to safeguard pre-petition secured lenders against further subordination of their pre-petition liens as a result of diminution in the value of

their collateral support upon a DIP’s actions to obtain new first-out senior secured financing or to utilize cash collateral that is otherwise subject to the pre-petition liens. Holders of pre-petition senior secured first-lien debt are usually prepared to offer similar replacement liens to holders of pre-petition senior secured second-lien debt (often referred to as “tag-along rights” to any replacement collateral), so long as such replacement liens are junior to theirs. Over-collateralization of existing assets by pre-petition lenders is often critical to the successful syndication of DIP facilities. The entitlement of second-lien debt holders to seek greater adequate protection—in the form of current interest or principal payments, other compensation, or the elimination of any obligation to turn over payments actually received to the holders of the first-lien debt—may be overridden by restrictions within the intercreditor arrangements negotiated between the holders of the first- and second-lien debt in advance of new transactions. Following the same logic, it is reasonable to believe that in situations where the second-lien debt holders are able to retain greater degrees of adequate protection, they will be much better positioned to exact greater concessions from first-lien debt holders who desire to avoid contested hearings.

Section 363 sales approved by the bankruptcy court represent sales of assets outside the ordinary course of business after the bankruptcy petition is filed, but before a plan of reorganization is confirmed. Such sales may occur either on a piecemeal basis for specific items of collateral, or may involve the sale of large blocks of collateral all at once.

The second-lien loan agreement and intercreditor terms may either be built into a single credit agreement that is shared with the first-lien lenders, or may be split into separate documents. Bankruptcy considerations are clearly prominent with regard to the ongoing process of fine-tuning and standardizing intercreditor documentation. Unfortunately there remains limited case law at this stage of the evolution of the U.S. second-lien loan market to prove which strategy works best for each class of interested parties. The use of a single document increases overall consistency and enhances the timeliness with which transactions can close. This documentation strategy was very common among the earliest transactions completed. However, there appear to be an increasing number of circumstances when separate documents are becoming the strategy of choice in order to establish completely segregated liens, as well as independent representations and warranties,

covenants, events of default and remedy provisions. First-lien lenders have become more concerned that utilization of a single credit agreement and security documents actually increases the risk that a bankruptcy court could find the first- and second-lien holders party to a single claim which is then ultimately determined to be under-secured. Second-lien lenders seem to more frequently be favoring split documents as a vehicle to negotiate more rights and remedies. Borrowers also appear to have a preference for two documents because they believe this reduces the probability and complications of default.

■ **Comparison of the U.S. Second-Lien Loan Market versus the U.S. Second-Lien Bond Market**

The U.S. second-lien high yield bond market is at a considerably more mature stage of development than the nascent U.S. second-lien loan market, and is thereby characterized by much more standardization of terms at this point. The substantial majority of second-lien high yield deals in the United States are subject to truly “silent” second liens, whereas many second-lien loan deals are subject to liens which are what the industry calls “quieted” or “muted.” Second-lien high yield bondholders are therefore generally more accommodating by virtue of typically agreeing in advance to waive most of their rights as secured lenders until the first-lien debt is paid in full, including their abilities to exercise remedies against collateral and retain entitlements of adequate protection. In contrast, investors in second-lien loan transactions expect a much greater degree of access to restructuring negotiations than is generally unavailable to investors in second-lien bonds. The terms of the larger and more widely-syndicated U.S. second-lien loan transactions tend to most closely resemble the more standardized terms of the U.S. second-lien high yield bond market.

■ **U.S. Second-Lien Loan Product Is Not Evolving on a Parallel Course In European Markets**

The U.S. second-lien loan product has not evolved on a parallel path within European markets due to several significant differences in existing laws and practices.

The European market most notably has a much longer history of granting second-ranking security for junior obligations, which represents one of the main reasons why the European second-lien model will

continue to differ from its U.S. counterpart. The form of mezzanine debt that is widely prevalent in Europe already relies upon the bestowal of second security and contractual debt subordination, as well as a series of restrictive enforcement standstills and payment blockage provisions triggered upon the occurrence of first-lien defaults. The pre-existence of a deeply rooted European mezzanine loan model that already incorporates second-ranking security largely dictates that the European second-lien market must have a lot of commonality with that market. Under-collateralization concerns clearly escalate with the prospect of adding an intermediate second-lien debt layer between first-lien facilities and traditional European mezzanine tranches, given that this structure leaves the mezzanine tranches with third-ranking security. Despite this fact, many such deals entailing three tiers of secured debt are currently getting done in Europe given the continued aggressive demand for funding in that market. Alternatively, second-lien debt facilities can be used in Europe as less expensive replacements for European mezzanine debt or for high yield issuance. While this strategy became common at the height of the market during the second quarter of 2005, there were ultimately a number of such deals that struggled and caused the popularity of this structure to quickly wane. The market quickly realized that these second-lien deals were essentially no different from traditional mezzanine paper, but were priced at half the usual mezzanine margin.

Within many European jurisdictions it is difficult to have separate security documents covering the same set of assets, particularly in locations where floating charges over substantially all assets are not permitted. Creation of valid security interests in several European countries requires actual possession in some form, such as the shares of the company. Tax-related issues which vary by country may also limit the ability of second-lien lenders to take collateral in certain circumstances. However, these impediments do not in fact appear to be presenting major constraints to the growth of second-lien loan market in Europe. The ranking of claims to security (first, second, third, etc.) is typically governed in Europe by the intercreditor agreements, rather than through the execution of multiple sets of security documents.

Insolvency regimes are also notably different in Europe versus the United States and vary significantly among countries. Europe has no

equivalent to the Chapter 11 moratorium on payments to conserve cash in a workout situation. European bankruptcy regimes can vary widely across jurisdictions and may permit automatic releases of second liens without court approval as a means to enable asset sales for substantially all cash. Out-of-court restructurings are much more common overseas than in the United States for these and other reasons.

The European second-lien loan market is notably similar to that in the United States in that no standardized form of documentation and intercreditor rights has yet emerged. Second-lien facilities may be structured either as a tranche within the first priority loan documentation or as a separate facility, which is increasingly the preferred route. While the majority of European second-lien deals are still structured as loans due to their small size, there is a growing trend for some of the larger European second-lien loans to be packaged as high yield notes rather than loans (e.g., Wind Telecomunicazioni/Weather).

■ **Limited Examples of Early Second-Lien Defaults Have Provided Insufficient Feedback to Date**

There has been limited feedback to date through actual case history to theorize what the most likely pattern will be within the courts regarding interpretation of the definitive rights and recoveries of second-lien lenders upon default and bankruptcy. The U.S. second-lien market remains in its infancy, and the U.S. default rate has been at record lows over the past several years. Most of the companies which had put in place second-lien loans and then subsequently filed for Chapter 11 bankruptcy protection either ended up settling the key reorganization issues outside of the bankruptcy courts or still remain in bankruptcy limbo. The following are reviews of the more notable cases to date:

Westpoint Stevens Inc.

Westpoint Stevens Inc. (Westpoint Stevens), a manufacturer of linens, blankets and towels, filed for Chapter 11 bankruptcy protection in June 2003. The inability of the first-lien and second-lien lenders to agree on key issues was apparently the major contributor to the decision to sell off the company. Westpoint Stevens' operating assets were subsequently sold to a group led by financier Carl Icahn. Prior to that ultimate decision, one major investor had sought to convert the debt into majority ownership via a debt-for-equity swap. This had raised multiple legal and financial issues, including

valuation, standing of the second-lien creditors to bid in the auction, and distribution of proceeds among first- and second-lien holders, among others.

New World Pasta Co.

New World Pasta Co. (New World Pasta), which filed for Chapter 11 protection during May 2004, received a final court order from the bankruptcy court during July 2004, and announced court approval of its Chapter 11 reorganization plan to end the year-and-a-half-long bankruptcy case on Nov. 30, 2005. The first- and second-lien senior lenders will all be repaid in full in cash for their aggregate outstanding principal (estimated at \$147 million) through use of proceeds from the reorganization funding. However, the situation was not always as amicable. Upon commencement of the Chapter 11 case, the second-lien lenders acknowledged that New World Pasta needed post-petition financing on a super-priority basis, but requested that the bankruptcy court waive the enforceability of "offending language" within the pre-petition agreements. Their claim was that this "offending language" caused the second-lien lenders to trade away fundamental bankruptcy rights and protections, most notably including the right to adequate protection as well as the right to vote on the DIP financing, the future plan of reorganization and other issues.

Earlier bankruptcy court rulings regarding New World Pasta argued that approval of the DIP financing and the company's use of the cash collateral could not be used to settle issues regarding the enforceability of intercreditor provisions without the initiation of an adversary proceeding. However, the final order of the bankruptcy court did ultimately dilute the "offending language" by providing for the ability of either the first- or second-lien lenders to express future reservations regarding the question of enforceability of second-lien waivers incorporated within the intercreditor agreement. It has been reported that the decision to allow these revisions and effectively reserve any fight for a later date was based upon consensual agreement among all the interested parties. Indications were that everyone involved ultimately agreed that New World Pasta had an urgent need for financing and desired to avoid a protracted dispute.

It is important to note that the July 2004 final order concerning New World Pasta's case did uphold the premise that repayment of the pre-petition second-lien debt would be subordinated to repayment of all

pre-petition first-lien debt to the extent of the collateral.

Tower Automotive, Inc.

Automotive supplier Tower Automotive, Inc. (Tower Automotive) filed for Chapter 11 bankruptcy during February 2005. At the time of the filing the company had a \$155 million second-lien obligation in effect that was governed under a single credit agreement with the first-lien bank deal. With bankruptcy court approval the second-lien agent SilverPoint Finance (which notably had just taken over as a replacement for the original agent) voluntarily offered to buy out all of the other second-lien lenders through a new second-lien facility having a higher interest spread. This action most likely forestalled pressure from hedge fund investors in the second-lien tranche to pursue a substantial share of the company's equity upon reorganization. The DIP facility that was obtained was sufficiently sized to repay all of the first-lien pre-petition debt.

Meridian Automotive Systems Inc.

Automotive supplier Meridian Automotive Systems Inc. (Meridian) filed for bankruptcy protection during April 2005. This presented one of the first cases in which the first-lien debt holders openly clashed with the second-lien debt holders. Hedge funds holding \$175 million in second-lien debt were largely attributed with causing Meridian's earlier problems in obtaining short-term debtor-in-possession financing. Meridian's bankruptcy case remains unresolved. The company most recently requested permission from the bankruptcy court to extend the deadline for submitting a reorganization plan to April 21, 2006, with a further two months allowed for gaining creditor approval.

Atkins Nutritionals Inc.

Diet company Atkins Nutritionals Inc. (Atkins Nutritionals) filed for Chapter 11 bankruptcy protection in July 2005 under a prepackaged plan. This was followed up by the filing of a reorganization plan during August 2005. The reorganization plan provided for its pre-petition first- and second-lien lenders (owed an aggregate of approximately \$300 million) to be treated on a pari passu basis under which they will receive two-thirds of the reorganized company's new common stock and \$110 million in new Tranche A notes. Atkins Nutritionals' general unsecured creditors (including trade creditors), which have claims totaling about \$24.6 million, received nothing under the turnaround plan. The private equity

investors Parthenon Capital Inc. and Goldman Sachs Capital Partners, which had acquired an 80.1% stake in the company during 2003, also received no compensation upon reorganization.

■ Unknown Variables Concerning the U.S. Second-Lien Loan Market Outlook

The high U.S. demand level for second-lien loans may prove to just be a quirk of the recent credit cycle that enabled companies facing liquidity problems to obtain additional availability in the face of unfavorable bond market conditions. Second-lien loans compete directly with the high yield bond market and other classes of debt for the attention of hedge funds and other non-traditional accounts. Relative spreads among the debt markets are key drivers for determining the components of transactions that get done at any given point in time.

There may additionally prove to be several potentially undesirable side effects from the growth of the second-lien loan market. While second-lien loans for many U.S. issuers may have been obtained as last-ditch efforts to head off bankruptcy filings, they could also prove to be a major stumbling block for future reorganizations. Debt caps incorporated within second-lien deals may end up perversely limiting the future ability of issuers to tap additional available funding through either new unsecured notes or increased commitments for first-lien debt. Furthermore, due to the reduced levels of untapped collateral value available in bankruptcy as a result of the growth of the second-lien loan market, the ability of issuers to obtain DIP financings may in fact be impaired. Moreover, originators of unsecured high yield transactions may look to strengthen their anti-layering provisions in order to eliminate a key loophole that was very instrumental in allowing the U.S. second-lien loan market to flourish.

It is additionally unknown at this point how the October 2005 revisions to the U.S. bankruptcy laws will affect demand and recovery rates within the second-lien market. One of the most pivotal changes affecting the future reorganization efforts of issuers is the fact that the exclusivity period for debtors to develop their own reorganization plans has now been capped at 18 months, with no flexibility for extensions. While the intention of limiting the exclusivity period appears to be to prevent companies from holding creditors hostage, the backlash may be

that creditors become less cooperative and increasingly attempt to wait out the exclusivity period with the goal of presenting their own plans. The need for the bankruptcy court to evaluate competing plans could affect the amount and allocation of future loan recoveries across an issuer's capital structure.

Another important unknown surrounds future prospects for the regulation of hedge funds and the likely impact on their future appetite for second-lien loans. It should also be emphasized that hedge funds invest in multiple layers of capital structure and do not necessarily have the company's best interests at heart. Second-lien loans have notably become creative vehicles for hedge funds to acquire control of companies in default in "loan-to-own" strategies, which may prove to be a serious future concern for issuers. Many funds currently investing in second-lien debt are actually the same ones that previously bought and sold the debt of bankrupt companies for profit, when the supply was larger. Evaluation of the objectives of the investor pool for the second-lien loan product will likely become a critical determinant of the attractiveness of the funding source for issuers.

An additional open question remains regarding whether the act of quickly obtaining consensual approval of the DIP financing, the use of cash collateral, and the application of adequate protection at the outset of a bankruptcy case with the unified goal of ensuring continued viability of a company's operations effectively constitute a waiver of the rights of the borrower or any of the lenders to challenge the intercreditor language at a later date.

Furthermore, there have not yet been any definitive rulings regarding whether post-petition interest applicable to second-lien obligations is subordinated to that of first-lien obligations. This issue has the potential to become a critical determinant of relative loan recovery rates among first-lien, second-lien and unsecured lenders going forward, particularly with regard to prolonged bankruptcy cases.

■ **Concluding Remarks**

The popularity of the U.S. second-lien loan product has grown extraordinarily quickly, and will undoubtedly have a permanent place as a mainstream source of funding for highly leveraged domestic companies. However, the ability to predict future second-lien market loan volumes and demand volatility remains difficult due to the need for further evolution of the product and a greater understanding

of the potential impact on other traditional elements of company capital structures. Supply and demand volatility within the public debt and equity markets also remains an important determinant of future second-lien demand. It is furthermore feasible that a backlash will result from the impact of reduced levels of untapped collateral value available in bankruptcy as a result of the growth of the second-lien loan market which could ultimately serve to reduce future demand for the U.S. second-lien product.

The U.S. second-lien loan market developed during a period of unusually low default rates and therefore has not yet been subject to real world testing of intercreditor agreements through loan workouts and bankruptcy proceedings. Wide variability remains among transactions, and limited case history exists to prove how bankruptcy courts can be expected to interpret the intent and enforceability of the key features of these earliest U.S. second-lien loan transactions. While ample history exists proving that payment subordination is fully enforceable by the bankruptcy courts, little clarity has been garnered at this point to definitively determine whether the bankruptcy courts will, or even can, enforce subordination of rights and remedies established through intercreditor agreements. Second-lien loan transactions may prove to have greater-than-expected potential to undermine the recovery rights of first-lien lenders. The number of second-lien loan transactions governed by separate credit agreements appears to be growing, but this trend could easily reverse as market conditions change.

There appears to be some evidence that the growth of the U.S. second-lien loan market has resulted in material leverage creep among speculative grade issuers. As the default rate begins its inevitable rise over the next year, it will undoubtedly trigger the beginning of a series of bankruptcy cases involving companies which entered into second-lien loan transactions over the past few years. The market will be looking for these cases to produce some landmark decisions. Clarification is needed through actual examples regarding the pros and cons from each relevant perspective regarding the effectiveness of utilizing single credit agreements, versus splitting the first-lien and second-lien loan documents into separate credit agreements. The information to be derived from actual bankruptcy court resolutions will be advantageous with respect to the formulation of more standardized provisions and documentation practices for future transactions by providing greater certainty regarding assumed risk levels and the

enforceability of intercreditor provisions. Such cases should also help determine whether second-lien lenders do in fact recover more in bankruptcy than do unsecured creditors, and additionally whether this second-lien recovery is obtained at the expense of full recovery by first-lien lenders. Disputes between first and second-lien investors over the proper interpretation of intercreditor agreements will inevitably take center stage.

In summary, while the U.S. second-lien loan market will invariably continue its evolution process, it promises to remain a critical ongoing source of funding for speculative grade issuers.

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