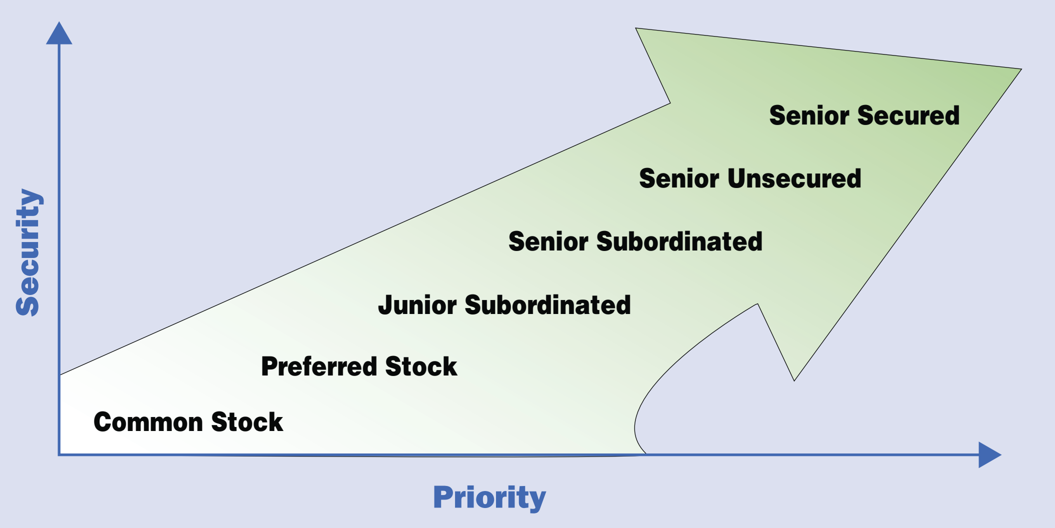
NOTE ON INTERCREDITOR PRIORITY

How subordination and security affect credit structure

THE BASICS OF PRIORITY

A company in financial distress may not have enough cash or other assets to satisfy all of its creditors. Creditors are not necessarily treated equally in this situation; some may be repaid fully in cash, others may receive new debt or equity securities in satisfaction of their claims, and others may receive nothing at all. Intercreditor priority is the order in which creditors' claims are satisfied using a company's cash and other assets in times of distress, such as a corporate liquidation or reorganization.

Chart 1: Intercreditor priority



Note: Senior debt can be structured as loans or bonds, senior subordinated debt is typically high yield bonds, and junior subordinated debt is often referred to as ***mezzanine finance***.

The methods for establishing intercreditor priority are generally determined by the laws of the states and countries in which a company operates or has assets. Bankruptcy laws and laws surrounding the pledging of collateral vary from country to country or even within countries. Given this variation, it is important to obtain legal advice when executing or evaluating transactions involving different classes of creditors.

Though the intricacies of the law may differ by jurisdiction, generally there are five methods used to establish or determine priority.

Contractual Subordination
This requires a subordination agreement between a company and one or more of its creditors.

Structural Subordination
This is done through the company's legal organization; it typically involves a holding company and operating subsidiaries, and the appropriate placement of debt within that structure.

Security
A company pledges collateral through an agreement with one or more of its creditors. This pledge becomes binding, or ***perfected***, by filing various documents with appropriate government offices.

Statutory Subordination
The laws of jurisdictions in which the company operates or has assets govern statutory subordination; these laws favor certain types of creditors.

Effective Subordination
This is done by pledging assets to some creditor and leaving others unsecured, or by scheduling the repayment of some debt earlier than other debt.

ISSUER AND INVESTOR PERSPECTIVES

It is often expensive and cumbersome for an issuer[1] to establish priority among its creditors. Contractual subordination requires the negotiation of complex documents and subordinated creditors demand a higher return. By providing creditors with security, the company's use of the secured assets is subject to certain limitations, thus also limiting the company's operating and financial flexibility.

Borrowers incur the trouble and expense of creating subordinated or secured debt to obtain these benefits:

Additional Funds
Issuers with high levels of business or financial risk often have difficulty obtaining all of the funds necessary to support their operating and financial strategies. In order to induce lenders to provide funds, borrowers can lower the credit risk of some of their debt by providing collateral and by subordinating other debt issues.

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[1] The terms "borrower" and "lender" are generally associated with the loan market, while the terms "issuer" and "investor" are generally associated with the bond market. Because the principles of structuring are the same in either market, we will use the terms interchangeably in this Note. "Creditors" include lenders, bond investors, and others - employees, tax authorities, and suppliers - which may have a financial claim against a company.

Lower Borrowing Costs

Borrowers can often obtain a lower interest rate on secured debt than on unsecured debt. This cost differential increases with a decline in an issuer's overall credit quality and with the increase of the value of the collateral relative to the debt it supports.

On the other hand, investors use security and subordination to adjust their risk-return profiles. They choose debt instruments with different priorities in order to:

Lower Risk

While priority does not influence a company's likelihood of default, properly structured senior or secured debt can provide lenders with greater protection against loss after a default. In exchange for this lower risk of loss, lenders accept a lower return.

Increase Return

Subordinated debt carries a higher interest rate than senior debt. Subordinated debt investors believe this increased return compensates them for the likely increased loss in the event of default.

PRIORITY AND CREDIT RISK

To calculate the expected loss from owning a particular debt issue, you must know the following:

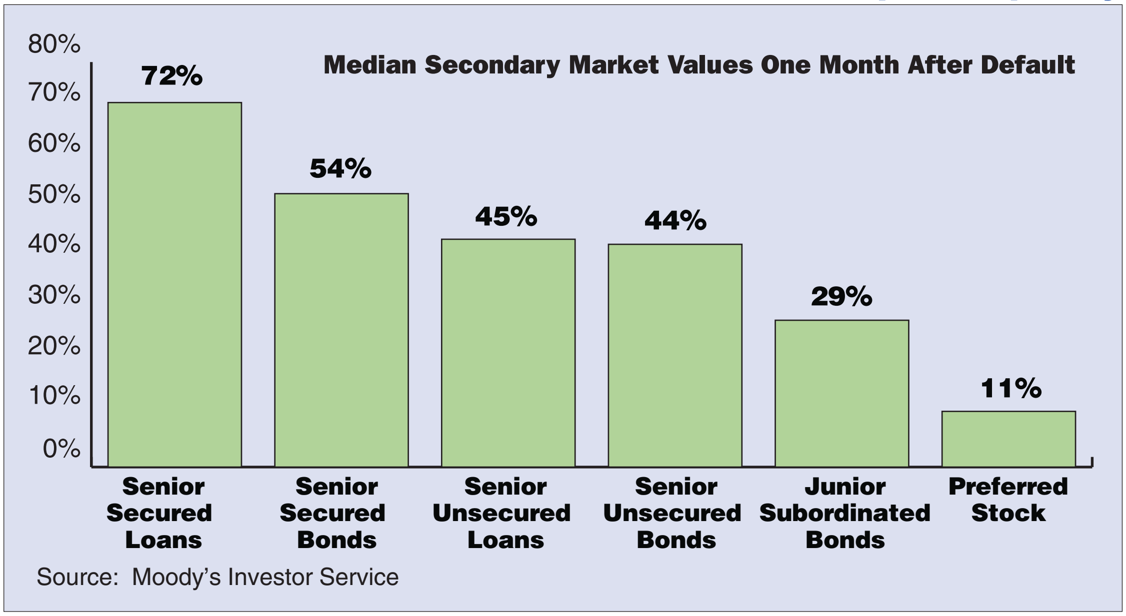
- The likelihood that the issuer will default, often called the ***expected default frequency (EDF)***.
- The expected ***loss in the event of default (LIED)***, often called ***loss given default (LGD)***.

You can assess the likelihood of default by analyzing a company's business risk and financial risk. The overall assessment of a company's credit quality can be expressed as a credit score or credit rating, often called an ***issuer rating, company rating,*** or ***counterparty rating***. This rating applies to the whole company, not to a particular debt issue. EDF is typically the same for all of a company's debt issues, since a default on one debt instrument generally causes or precedes defaults on all of the company's debt.

Priority does not impact a company's overall credit quality, issuer credit rating, or EDF. Instead, priority is used to assess how value will be divided among creditors in a financial restructuring or liquidation after a default. Priority is the main determinant of LGD.

The bankruptcy codes in most countries are based on the ***absolute priority rule***: senior claimants must be paid in full before junior creditors get anything. While this rule is not always fully enforced, recoveries after a default are generally higher for senior debt and secured debt, and lower for subordinated debt, unsecured debt, and preferred stock.

Chart 2: Recoveries after a default depend on priority



Other factors that influence recovery rates are:

Collateral

Debt secured by liquid assets whose value is independent of the condition of the borrower has higher recovery rates.

Type of Debt

Loans, which normally have strong covenant packages and more active investors, typically have higher recovery rates than bonds; bonds generally have higher recovery rates than preferred stock.

Facility or ***issue credit ratings*** are based on the issuer's likelihood of default plus the expected recovery after a default. For a particular debt issue, a borrower's company rating may be adjusted up or down based on the debt issue's priority. This process is known as ***notching***. Thus, senior secured debt would typically be rated one or more sub-grades higher than the same borrower's senior unsecured debt, while the subordinated debt would be rated one or more sub-grades lower.

CONTRACTUAL SUBORDINATION

One way to establish priority among creditors is for one group of investors to agree, under certain circumstances, not to be paid until another group is paid in full. This arrangement is called ***contractual subordination***, since it is documented by way of either a ***subordination agreement*** or an ***intercreditor agreement***. A subordination agreement is a contract between the issuer and investors, while the intercreditor agreement is a contract between the investors. ***Senior debt*** is the debt to be paid first, while ***subordinated debt*** takes a lower position in the event of default.

Subordination agreements share common features, but there are many variations. The following are some of the common issues addressed by subordination agreements:

Bankruptcy
The benefits of the subordination may be limited to a bankruptcy or liquidation situation. Companies in distress or even in default may continue to pay interest and principal to subordinated debt as long as they are not in bankruptcy.

Principal
The subordination may be limited to repayment of principal, not interest.

Payment Block
Some agreements give senior debt holders the right, in certain circumstances such as a default, to block payment of interest on the subordinated debt temporarily, even if the issuer is not in bankruptcy.

Senior Debt
The benefits of subordination may be limited to specific debt issues or to senior debt generally. Thus, suppliers and other trade creditors may not get the benefit of the subordination.

Layering
There can be several layers of subordinated debt. ***Senior subordinated debt***, for example, would get paid after senior debt but before ***junior subordinated debt***, which is sometimes referred to as ***mezzanine financing***.

ISSUER AND INVESTOR PERSPECTIVES

While any debt instrument can be either senior or subordinated, in practice, investor appetite for risk varies. The three general levels of debt instruments, from least risky to riskiest, are:

Senior Debt is typically structured as a loan or public bond. Banks and institutional investors, such as pension funds, mutual funds, and insurance companies are the main buyers of senior debt.

Subordinated Debt is typically structured as a bond. This may be registered or privately placed, often as a ***144A issue***.

Institutional investors are the main buyers of subordinated debt. Subordinated loans are rare, as banks are typically more risk-averse than institutional investors.

Junior Subordinated Debt is typically structured as a bond, often with added equity features, such as warrants or convertibility. This debt is often privately placed with institutional investors that specialize in this high-risk paper.

Issuers incur the additional cost of issuing subordinated debt in order to increase their overall debt capacity. Senior debt investors often try to limit a borrower's ability to increase leverage. For example, a loan agreement may include a covenant limiting senior debt leverage to 3.0x EBITDA. That same agreement, however, may allow the borrower to increase total leverage to 4.0x EBITDA, with the additional borrowing in the form of subordinated debt.

Since investment grade companies are typically able to fund all of their needs in the senior debt market, they do not need the increased debt capacity that subordinated debt may provide. Thus, highly leveraged, non-investment grade companies are the primary issuers of subordinated debt. In addition, banks and other financial institutions are large issuers of subordinated debt since certain types of subordinated debt satisfy regulatory capital requirements.

In reality…

The AES Corporation is an example of a company that issues contractually subordinated debt. AES is the third largest power producer in the world. From 1996 to 2000, revenue and assets grew at a compound annual growth rate of 60%. Much of this growth was funded with debt; at December 31, 2000, AES's consolidated debt to capital was over 70%. Much of AES's debt is at the project, subsidiary level. At the parent company, AES had the following debt facilities as of December 31, 2000.

Table 1: Debt seniority and rating

($ millions)	Amount	% Total	Rating
Senior bank facilities	$850	20%	Ba1/BB
Senior notes	$2,100	50%	Ba1/BB
Senior subordinated notes and debentures	$1,075	26%	Ba3/B+
Convertible junior subordinated notes	$150	4%	NA
Total	$4,175	100%	

Source: company reports

Note that AES's subordinated debt is rated two sub-grades (or "notches") lower than its senior debt. AES is typical of subordinated debt issuers; it has a non-investment grade credit rating, is growing quickly, and has a large financing need. Though AES uses a combination of bank facilities and bonds, the bulk of its debt financing is senior. High-risk borrowers often seek as broad an investor base as possible. They also issue only as much subordinated debt as is necessary to obtain the senior debt they need.

STRUCTURAL SUBORDINATION

Even without a subordination agreement, it is possible for one creditor to have priority over another creditor. This can occur when the borrower has a multi-layer legal structure. A ***holding company***, sometimes called a ***group company*** or a ***parent company***, is a company whose primary assets are the stock in other companies. The holding company and its subsidiaries, or ***operating companies***, are often managed as if they were one entity, and may be consolidated for accounting and tax purposes.

The consolidated entity's assets and ability to generate cash are generally at the subsidiary level. The holding company's primary source of cash to pay dividends and service debt is dividends from its subsidiaries. It may also receive cash from its subsidiaries via inter-company loans, and management and other fees. This structure effectively subordinates creditors of the holding company to creditors of the subsidiaries, because in times of distress, the subsidiary creditors will be paid first.

Outside of a Bankruptcy

There may be regulatory or contractual reasons why a subsidiary would not be able to make payments to its parent. For example, the subsidiary may have covenants in its debt agreements limiting its ability to pay dividends. If the subsidiary is a financial institution, it may have capital requirements that effectively limit its ability to pay dividends. A subsidiary may also be subject to currency controls if it is located in a different country than its parent.

In Bankruptcy or Liquidation

When a group of related companies is being shut down or reorganized in bankruptcy, holding company creditors are only entitled to the residual net worth of the operating companies after all operating company obligations, senior and subordinated, are satisfied in full.

Because of the structural subordination, the credit quality of a holding company is often lower than that of its subsidiaries. The credit rating agencies often rate holding companies one or more sub-grades lower than their principal operating subsidiaries. In parts of Europe where contractual subordination may not be enforceable, highly leveraged transactions are often structured with some holding company debt, substituting structurally subordinated debt for contractually subordinated bonds.

In order to minimize the impact of structural subordination, lenders to holding companies often include these provisions in their debt agreements:

Subsidiary Debt Limitation Covenant

This provision prohibits a holding company's subsidiaries from borrowing money above a fixed amount, thereby limiting the amount of debt to which holding company creditors can be structurally subordinated.

Upstream Guarantees

A subsidiary may guarantee the debt of its parent. Such a guarantee is often senior and may be secured by the subsidiary's assets. This provides the parent company lender rights as a creditor of the operating company as well.

In reality…

Six Flags, Inc. operates 38 theme and water parks in seven countries. Many of these assets were assembled by the company in a series of acquisitions in the late 1990s. As of December 31, 2000, the company's leverage was over 6.0x debt to EBITDA or 60% debt to total capitalization.

In 1998, the company moved all of its assets to a subsidiary, now called Six Flags Operations. The new parent company, Six Flags, Inc., is a holding company with one asset: 100% ownership of the stock of Six Flags Operations. In turn, Six Flags Operations does not own any theme parks directly; it owns stock in a number of subsidiaries that own the operating assets. The largest subsidiary of Six Flags Operations is Six Flags Theme Parks.

Thus, the company has at least three levels in its corporate structure:

- Six Flags, Inc., is the holding company, or ultimate parent, which is publicly owned. It owns stock in subsidiaries.
- Six Flags Operations is an intermediate holding company, owned by Six Flags, Inc. It owns stock in subsidiaries.
- Six Flags Theme Parks and others are operating companies owned by Six Flags Operations. They own operating assets directly and through subsidiaries.

Of the consolidated entity's $2.3 billion in debt, the ultimate parent owes 45%, the intermediate holding company owes 13%, and the operating companies (primarily Six Flags Theme Parks) owe the remaining 42%.

The credit ratings of each entity's debt reflect their structural and contractual priority. Secured debt of Six Flags Theme Parks, the entity closest to the operating assets and cash flow, is rated Ba2. The intermediate holding company has a B1 senior implied rating, two notches below its subsidiary. The ultimate parent's senior debt is rated B3, two notches below its subsidiary. Finally, the ultimate parent's subordinated debt rating is Caa2, two notches below its senior debt rating.

SECURITY

A common way to establish priority among creditors is to use security. A properly perfected security interest gives a creditor priority over unsecured creditors to the extent of the collateral's value. As long as the company is not in default, it can continue to use the pledged assets and keep any cash generated by their use or sale.

If a borrower defaults on a secured debt, the lender has the right to foreclose on and sell the pledged assets, using the proceeds to satisfy the debt. If the sale proceeds exceed the amount of the secured obligation (including interest and foreclosure costs), the excess is returned to the borrower. If the sale proceeds are less that the secured obligation, the remaining balance, or ***deficiency***, becomes an unsecured obligation of the borrower.

In practice, lenders in the U.S. rarely foreclose on collateral pledged by large corporate borrowers. The threat of foreclosure will generally lead to the company filing for reorganization under Chapter 11 of the bankruptcy code. In a U.S. bankruptcy proceeding, secured creditors face the following restrictions and likely outcomes:

Automatic Stay
This provision in the bankruptcy code allows a company to use all of its assets to develop a plan of reorganization. Secured creditors cannot foreclose on the collateral or otherwise act to collect the debt without approval from the bankruptcy court. If the pledged assets are important for the company's operations, the court would be unlikely to grant such approval.

Cash Collateral
Secured creditors are entitled to the cash derived from the use of the pledged assets. The bankruptcy court, however, may allow the borrower to use this cash if the secured creditor is otherwise adequately protected.

Post-Petition Interest
Secured creditors are entitled to interest accrued after the bankruptcy filing to the extent of the value of the collateral. Generally, no other creditors are entitled to such post-petition interest.

Reorganization
Secured creditors will likely be repaid only as part of a plan of reorganization approved by the bankruptcy court, which generally takes 12 to 18 months to complete. The repayment may be in cash, but will more likely be with new secured debt or other securities.

The bankruptcy code in the U.S. is among the most debtor-friendly in the world. Management can often stay in control of a bankrupt company for years, continuing to use assets that have been pledged to support loans. The other extreme is the United Kingdom, considered creditor-friendly; after a default, secured creditors can immediately appoint a receiver to liquidate the collateral. The borrower and other creditors can do little to stop this process.

PERFECTING A LIEN

Perfection is a formal process by which liens become legally enforceable. The goals are to give notice of the lien to other current and potential creditors and to establish the lien holder's security interest in the collateral. The method of perfecting a lien depends on the type of asset, its location, and the location of the borrower.

In general, liens are perfected in a two-step process. In step one, the borrower executes a security agreement granting the lender a lien on the collateral. In step two, the secured party files a statement, signed by the borrower, with the appropriate government recording office.

For inventory, receivables, equipment, and other assets governed in the U.S. by the Uniform Commercial Code (***UCC)***, the recording office is the Secretary of State in the state where the company is incorporated. For real estate, the recording office is generally the county clerk or recorder of deeds for the county in which the property is located. For assets governed by federal statutes, such as airplanes and ships, the recording office may be a federal agency. For certain assets, such as cash, securities, and documents of title, the creditor must take possession or control of the asset in order to perfect the lien.

The methods for perfecting a lien are usually quite complex and vary widely from country to country. Even within the U.S., these methods can vary from state to state, depending on the type of asset pledged. Lawyers specializing in secured lending typically perform this process.

ISSUER AND INVESTOR PERSPECTIVES

Issuers do not like to pledge collateral, because it restricts operating flexibility by limiting a company's ability to sell assets quickly and easily. It also limits financial flexibility and debt capacity, because assets pledged today have limited value to support new debt in the future. Pledging collateral can also carry a negative connotation in the marketplace, marking the borrower as high risk. Thus, borrowers generally pledge assets only when required to do so by lenders.

The most common types of secured borrowers are large companies with non-investment grade ratings, middle market companies, and individuals. In addition, companies in certain asset-intensive industries, such as commodities, real estate, and transportation, often use secured financing. Investment grade companies are generally able to borrow unsecured and prefer to do so.

Pledging collateral generally does not impact a company's likelihood of default. Collateral, however, can improve a lender's loss given default. For this reason, lenders are often willing to make a secured loan when they are unwilling to make an unsecured one. In addition, secured debt generally carries a lower interest rate than unsecured debt to the same borrower. Finally, the credit rating agencies will often rate secured debt one to three sub-grades higher than a borrower's unsecured or issuer credit rating.

STATUTORY AND EFFECTIVE SUBORDINATION

Without making the loan to a holding company or using a subordination agreement to get contractual subordination, it is still possible for one group of creditors to gain effective priority over others.

STATUTORY SUBORDINATION

When a company is in bankruptcy, the laws of most jurisdictions give seniority, or ***super priority***, to certain creditors, often ahead of senior debt holders and even ahead of secured creditors. While the types of super priority claims vary from country to country, they often include:

- Professional fees and other reorganization costs incurred after the bankruptcy filing, together called ***administrative expenses***.
- Loans to the company after the bankruptcy filing, called ***debtor in possession*** or ***DIP*** financing.
- Employee wages.
- Real estate and sales taxes.

These amounts are often not material relative to a bankrupt company's overall liabilities, but they can seriously reduce recoveries to other creditors under these circumstances:

- When the bankruptcy process is long and contentious. In this case, administrative expenses and DIP loans can be very large. For this reason, issuers and investors often try to restructure debts outside of bankruptcy.
- When the borrower stopped paying operating expenses, such as taxes and wages, long before starting a formal bankruptcy process. For this reason, loan agreements often contain covenants requiring the borrower to make timely payment of taxes and other expenses that have super priority status.

EFFECTIVE SUBORDINATION

When a company pledges collateral, secured creditors have a first claim on the cash flows and eventual sale proceeds generated by those pledged assets. Thus, unsecured creditors are effectively subordinated to secured creditors, at least as to a portion of the borrower's asset value.

When an issuer has a substantial amount of secured debt (e.g., over 20% of total debt), treat senior unsecured creditors as effectively subordinated. Depending on the amount of secured debt, the credit rating agencies will notch down senior unsecured debt one or two sub-grades from the company's issuer rating, because of the effective subordination.

Finally, creditors often assess their priority with regard to debt maturities. Outside of a bankruptcy proceeding, issuers generally have the right to use their cash to pay whichever creditors they choose, regardless of seniority and security. They will often choose to pay the debt that matures earliest. This, in effect, subordinates the debt with the longest maturity to that with the shortest maturity.

This Note is part of the Financial Training Partners *"Fundamentals of Debt Structuring"* series. If you have comments on or would like information on this series, e-mail us at: **notes@fintrain.com**