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Intercreditor Arrangements in Fund Finance Transactions

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It is an exciting time to be in the fund finance space. Sponsors continue to seek liquidity to fund investments, and banks and alternative lenders are thinking creatively about how to offer this additional leverage. There isn't just increased deal-making volume and transactions getting done, but the deals have interesting and novel features which borrow concepts that we see in other types of financing transactions.

Among what we are seeing is parties taking a second look at the value of the collateral package and getting comfortable with the idea of putting a second lien on that collateral. It isn't so long ago that second-lien loans were a form of distressed debt. Then they went mainstream and became a typical form of financing for companies seeking extra leverage while offering the lenders – which range from money center banks to hedge funds and private equity funds and other direct lenders – a nice return on their capital. It only makes sense that, given this concept is prevalent in other types of financings, it would make its way over to the fund finance space.

Interestingly, we are *not* seeing traditional first-lien/second-lien structures that you typically see in the lev fin space. Fund finance lenders are eschewing plain vanilla in favor of creative and bespoke structures that balance the liquidity needs of borrowers with credit risk and a collateral package that works for the lenders. In many cases, the collateral that is subject to the first-lien/second-lien structure is the traditional collateral package in the subline consisting of the uncalled capital of the investors, the right to call capital from investors, and the bank accounts into which capital calls are deposited. In many of these deals, there is a separate financing that sits alongside the subline, and that's where it gets really interesting. We have seen a number of iterations of these concepts. In one deal, for example, a term loan sat alongside a subline revolver. In another, a revolving credit facility that looks to the NAV of the borrower for the borrowing base as well as the collateral sat alongside a subline, and the agent and lender on the NAV facility had a second lien on the subline collateral.

When concocting these cool structures, some bankers are surprised to learn that some additional documents will be needed in the suite of deal documents beyond just the credit

agreements and collateral documents. Any time multiple lenders or multiple classes of lenders have a claim against the same entities and the same collateral package, the parties enter into an intercreditor agreement, which is an agreement among these lenders or classes of lenders, which describes the rights and obligations that each party has with respect to the obligors and their assets. These agreements typically include provisions which specify, among other things, who can declare defaults, who can exercise rights in the shared collateral, who may amend their loan documents and even grant waivers. An intercreditor agreement will also outline how payments from the obligors and the proceeds of collateral will be distributed among the lenders. The most common intercreditor arrangement is a first-lien/second-lien structure where two lenders or groups of lenders agree to share common collateral, but the party that holds the first lien has priority over the second lien holder when it comes to proceeds of the collateral. Another iteration is a subordination agreement whereby a senior lender and a subordinated lender enter into an arrangement where the senior lender has priority against the subordinated lender in respect of the rights to payment from the borrower. There are many permutations of these arrangements, but it can mean that the junior lender is not entitled to any payment until the senior lender is paid in full.

If you are working on structuring a deal where your institution may hold the second lien on collateral or you are contemplating consenting to a second lien on an existing collateral package, here are some 6 bullets on the typical provisions that an intercreditor agreement will contain:

- **Lien Subordination**: One lender has priority over the other when it comes to the shared collateral.
- **Payment Subordination**: This can take a number of forms. It is distinguishable from lien subordination, which relates to the collateral, while payment subordination relates to the right to payment from the borrower. We generally do not see payment subordination in the fund finance space.
- **Right to Amend Deal Documents**: Each lender will want to make sure that the other lender cannot change the terms of its financing arrangement with the borrower in a way that materially disadvantages it. Generally, certain amendments will require the consent of the other lender. An example of this is that a senior lender will not be permitted to increase the size of its loan past a certain percentage without the consent of the junior lender. Likewise, each lender will want to keep tabs on the interest rate in the other facility.
- **Rights to Enforcement and Exercise of Remedies**: An intercreditor agreement will govern which lender may take enforcement action against the debtor and its collateral. This works two ways. First, the senior lender will want to be able to control the process, at least initially, without the second-lien lender interfering. This being the case, the second-lien lender will often be subject to a “standstill period” where it needs to sit on its hands while the first-lien lender determines the order of play and has the exclusive right to take enforcement action. This period is generally about 180 days, but it can be less and is often subject to negotiation.
- **Purchase Right**: Most intercreditor agreements give the second-lien lender the right to buy out the first-lien lender. This also gives that lender the right to run enforcement and exercise of remedies.

- **Bankruptcy Provisions**: We don’t say the “B word” much in fund finance, but an intercreditor agreement will be critical in a bankruptcy and will dictate everything from who can provide a debtor-in-possession financing to the borrower in a bankruptcy to who may file a proof of claim in the bankruptcy court.

Conclusion

We hope our readers find this high-level primer on intercreditor concepts helpful. As you consider new, creative deal structures in the fund finance space, we can provide helpful counsel in understanding the dynamics and implications of these various deal structures.