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Unlocking Liquidity With a Tranche B Facility

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Liquidity solutions are a topic du jour in fund finance. With bank balance sheets somewhat restricted by macroeconomic concerns and risk-weighted asset regulations, fund finance borrowers and lenders have sought creative ways to put capital to work. One construct that may open up this optionality is the tranche B facility, a subordinated line of credit that sits within the same transaction as a senior revolver or term loan. This article explores the basic tenets and nuances that may be negotiated for constructing a tranche B facility in your deals.

Basic Framework

In this piece we describe how a tranche B facility is set up, explore the benefits for borrowers and lenders, and detail the main provisions that may be impacted in a credit agreement. Tranche B facilities have existed in fund finance for over a decade but have been much more prominent in other areas of finance until recently. The foundation of a tranche B facility is having a lender or group of lenders provide loans that are junior to the loans offered by another lender or set of lenders. There are generally two ways this can be accomplished: lien subordination or payment subordination.

In lien subordination, separate security is granted to the tranche A lenders and the tranche B lenders in the same collateral of the fund. If the borrower defaults, the tranche A lenders have the right to enforce remedies against the collateral before the tranche B lenders may do so. For payment subordination, the tranche A lenders and tranche B lenders have equal rights in the collateral. It’s just that in a default scenario, the tranche A lenders have the right to have their loans repaid before the tranche B lenders.

While either approach could work to accomplish a tranche B facility, we’ve seen fund finance parties generally opt for payment subordination due to its ease of execution. Both forms of subordination would be governed by an intercreditor agreement, as discussed in more detail below. Payment subordination can be drafted directly into the credit agreement with the other changes that are required to reference the tranche B facility. Lien subordination, on the other hand, requires a separate pledge of the collateral to each class of lenders, making for additional documentation and related costs.

Primary Purposes

Before delving into the intricacies of an intercreditor agreement, let’s explore why parties may desire a tranche B facility. Borrowers can benefit from a facility in two ways. It provides liquidity from a second set of lenders that may not participate in the tranche A facility. This access to extra funding could be critical for a borrower to manage working capital or make investments in a competitive bidding situation. A tranche B facility will also typically have a higher advance rate in the borrowing base. This can extend the value of the collateral for a borrower, particularly when the unfunded capital commitments of the investors have been significantly reduced later in the life of a fund or if the borrower has deployed capital quickly for investments.

There are several benefits for lenders, too. Lenders under the tranche B facility may be able to enjoy enhanced risk-weighted returns. Pricing for a tranche B facility is higher because of the increased advance rate and the tranche B lenders being junior to the tranche A lenders. With fund finance facilities historically being an incredibly safe product, this can be attractive for lenders willing to subordinate their interests. For the tranche A lenders, the benefit is providing the flexibility for the borrower to gain more access to capital. This accommodation can enhance the relationship of the tranche A lenders with the sponsor by showing a willingness to give greater flexibility and value in the trade.

Intercreditor Arrangements

After we describe the principal provisions in an intercreditor agreement, we discuss other items that should be updated in the credit agreement when implementing a tranche B facility. Here we focus solely on an intercreditor arrangement governing payment subordination, rather than lien subordination, due to its prevalence in the tranche B facilities we've seen in the fund finance market.

As a basic principle, borrowers are generally permitted to direct the application of payments to outstanding facility obligations as they choose when there is no default. The intercreditor section may stipulate this for payments by the borrowers in the ordinary course as between the tranche A and tranche B facilities. If there is an event of default, the intercreditor language will require that all obligations owed to the tranche A lenders will have to be paid before the tranche B lenders may be remunerated. The parties should consider what subordination applies during breaches by the borrowers, material potential defaults and mandatory prepayments. The parties may further negotiate other enhanced positions, such as (1) restricting the ability of the tranche B lenders to consent to take actions to varying degrees, (2) whether the payment subordination relates to funds from all sources or only the facility collateral, and (3) any standstill positions for when the tranche B lenders may initiate enforcement remedies through the administrative agent.

Care should be taken in drafting intercreditor provisions to ensure they function as intended in all situations. Case law has found they are enforceable in bankruptcy situations to the same degree that they are enforceable in non-bankruptcy situations. Courts will generally construe the arrangement based on the language agreed to by the parties. Preparing the intercreditor agreement can be highly technical, particularly when instituting subordination, subrogation and bankruptcy-related frameworks. When crafted properly, intercreditor provisions will put the tranche A lenders in essentially the same position they'd be in without the tranche B facility. At the same time, the tranche B lenders will be in a better position as it relates to the facility collateral against outside creditors.

Other Prominent Points

In addition to the intercreditor provisions and pricing points, there are several sections in the credit agreement that could use meticulous consideration when adding a tranche B facility. Take, for example, the borrowing base. With its higher advance rate, availability under the tranche B facility will be calculated separately from the tranche A facility. The tranche B facility borrowing base could be constructed using a tiered approach based on investor classifications for rated investors, non-rated investors and designated investors, but we've more commonly seen it have a flat advance rate. Importantly, the tranche B facility should take into account the availability under the tranche A facility to keep the aggregate limit under the combined facilities within the maximum amount allowed under the credit agreement and any leverage limitations in the fund constituent documents.

Because of the separate facility availability, the parties should pay keen attention to how mandatory prepayments may be triggered. Loans in excess of the available commitment under either tranche A or tranche B should lead to a mandatory prepayment under the relevant tranche. The parties can discuss related arrangements for whether one tranche must be repaid before the other, or if there are excess loans under one facility but not both, whether those excess loans could be reallocated to the second facility where there is additional capacity.

Lender voting is another critical feature to decide on. In general, the credit agreement may reflect that tranche A lenders will approve items that impact the tranche A facility while tranche B lenders consent to decisions that affect the tranche B facility. The parties should assess the provisions tied to majority lender votes and decide on any provisions for which it may be more appropriate to have either majority tranche A lenders or majority tranche B lenders vote. To ensure incentives are properly aligned, it may even be pertinent with some voting items to require the majority tranche A lenders and the majority tranche B lenders to collectively decide, rather than the lenders holding fifty percent of the combined commitments under the credit agreement. There may also be places where the tranche A lenders should have a say on changes to the tranche B facility that impact the overall facility, in order to keep the debt and credit risk profile of the total transaction in line with how it would be without the tranche B. Those could include the size of the tranche B facility and its advance rate.

Conclusion

While tranche B facilities have been in our market for a long time, the recent commercial environment has made borrowers and lenders pull them out of their bag of creative liquidity solutions more frequently. With careful decision-making and precise drafting, the parties can craft an agreement that gives each side the benefits of implementing a tranche B facility.