



RECENT TRENDS IN MULTI-TRANCHE INTERCREDITOR RELATIONSHIPS:

**Practical Differences Reflected in
Subordination, Lien Priority, and
Unitranche Structures**

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I. INTRODUCTION

- Subordination and intercreditor arrangements typically refer to either lien subordination, debt subordination, or both (in addition to lien or debt priorities determined by operation of law or equitable principles).
- Historically, the intercreditor relationship often took the form of a senior secured lender and junior unsecured creditor.
- Over the past number of years, commercial finance transactions are increasingly incorporating multi-tranche finance structures.

I. INTRODUCTION

- The traditional multi-tiered capital structure involving a senior secured lender and a subordinated unsecured term loan has morphed in many instances into one of the following structures:
 - 1) senior secured/subordinated unsecured (or deeply subordinated second lien);
 - 2) first lien/second lien;
 - 3) split lien collateral; and
 - 4) unitranche.

II. BASIC CONCEPTS

A. Why is a Subordination Agreement needed?

B. Types of Subordination

1. Structural vs. Contractual
2. Debt Subordination
3. Lien Subordination
4. When to Record

C. Definitions

1. “Obligations” or “Liabilities”
2. “Subordinated Debt”
3. Permitted Payments

II. BASIC CONCEPTS

D. Description of Collateral

1. All assets
2. Specific equipment/items of collateral/leased property
3. Consigned inventory

E. Standstill Periods

F. Payment Blockage

G. Other Provisions

III. RECENT TRENDS

- Commercial finance transactions are increasingly incorporating multiple tranches of debt.
- In order to meet market demand, there is growing interest among banks and other lenders to explore intercreditor structures in order to provide collateral protection for the junior lender as well as protect the expectations and interests of the senior lender.

STRUCTURE DOCUMENTATION

Senior/Mezzanine	First Lien/ Second Lien	Split Lien	Unitranche
<ul style="list-style-type: none"> • 2 sets of documents. • 2 liens (if a deal provides for a subordinated lien). • Subordination agreement governs the relationship between the Senior Secured and the Mezzanine. 	<ul style="list-style-type: none"> • 2 sets of documents. • 2 liens. • Intercreditor Agreement (“ICA”) generally governs the relationship between the First Lien and Second Lien. 	<ul style="list-style-type: none"> • 2 sets of documents. • 2 liens. • Highly negotiated ICA governs the relationship among the lenders and defines their respective pools of collateral and priorities therein. 	<ul style="list-style-type: none"> • 1 set of documents. • 1 lien. • Highly negotiated Agreement Among Lenders (“AAL”) governs relationship between the First Out and Last Out tranches. • Payment priority is addressed in the waterfall described below.

PRICING

Senior/Mezzanine	First Lien/ Second Lien	Split Lien	Unitranche
<ul style="list-style-type: none"> • Mezzanine is generally more expensive than other financing arrangements. 	<ul style="list-style-type: none"> • Generally less expensive than Mezzanine, with fewer covenants and no equity dilution. 	<ul style="list-style-type: none"> • Similar to First Lien/Second Lien. 	<ul style="list-style-type: none"> • Debtor pays one blended rate, which typically may be cheaper than Mezzanine and similar to, or slightly more expensive than, a two-lien arrangement. The interest rate “skim,” if any, will be set forth in the AAL.

DEBT SUBORDINATION / PAYMENT BLOCKAGE

Senior/Mezzanine	First Lien/ Second Lien	Split Lien	Unitranche
<ul style="list-style-type: none"> • Mezzanine is subordinated, with a limited ability to receive principal payments and a payment blockage (with corresponding turnover provisions) to the extent borrower defaults. • Certain scheduled payments (interest, fees, etc.) may be permitted absent an event of default. 	<ul style="list-style-type: none"> • Generally, no. • Payments on second lien debt may be subject to liquidity test or financial performance thresholds. • Limitation on second lien holders to receive mandatory repayments. 	<ul style="list-style-type: none"> • Generally, no. • The ICA may include debt caps and therefore limit the debt subject to the priority lien. 	<ul style="list-style-type: none"> • First Out, Last Out waterfall for payments, and collateral proceeds, upon certain triggering events to include at a minimum, payment default, acceleration, bankruptcy, and the exercise of certain secured creditor remedies following an event of default.

LIEN SUBORDINATION

Senior/Mezzanine	First Lien/ Second Lien	Split Lien	Unitranche
<ul style="list-style-type: none"> • Mezzanine is typically unsecured or has a deeply subordinated silent second lien, or secured by equity. 	<ul style="list-style-type: none"> • Second Lien is subordinated. 	<ul style="list-style-type: none"> • ABL lender has a first priority on working capital assets, second priority on fixed asset. • Term lender has a first priority on fixed assets, second priority on working capital assets. 	<ul style="list-style-type: none"> • The timing of the exercise of remedies may be subject to certain standstill periods, but in any event the proceeds of collateral shall be applied in accordance with the waterfall. Recent trend includes split lien priorities into the AAL structure.

EXERCISE OF REMEDIES/ STANDSTILL PERIOD

Senior/Mezzanine	First Lien/ Second Lien	Split Lien	Unitranche
<ul style="list-style-type: none"> • Mezzanine generally is subject to a negotiated standstill period. • A permanent standstill for payment defaults, and often times 180 days for nonpayment defaults, with a limitation on the number of standstill periods over the life of the Senior loan and the number of days that any standstill may be in effect in any 365 day period. 	<ul style="list-style-type: none"> • Second Lien standstill (generally 90 days to 180 days). 	<ul style="list-style-type: none"> • Second Lien standstill (generally 90 days to 180 days, but the standstill periods have recently been subject to more negotiation). • Collateral access rights are generally provided to the ABL Lender. 	<ul style="list-style-type: none"> • First Out standstill (e.g., 0 days to 30 days). • Last Out standstill (e.g., 30 days to 90 days). • These standstill periods will vary depending on which lender has more leverage with respect to decision-making in the exercise of rights and remedies. • Revolver need not fund during an event of default.

WATERFALL

Senior/Mezzanine	First Lien/ Second Lien	Split Lien	Unitranche
<ul style="list-style-type: none"> • Senior paid in full first. 	<ul style="list-style-type: none"> • First Lien paid in full first from the proceeds of the collateral. 	<ul style="list-style-type: none"> • Each first priority lien creditor is paid first out of its own priority collateral, and the respective priority debt may be subject to a cap. 	<ul style="list-style-type: none"> • First Out, Last Out waterfall upon a triggering event (but certain fees and costs of last out lender in connection with the exercise of remedies, may, in certain circumstances, have a pari passu priority with the first out lender's fees and costs).

BUYOUT RIGHT/RIGHT OF FIRST OFFER

Senior/Mezzanine	First Lien/ Second Lien	Split Lien	Unitranche
<ul style="list-style-type: none"> • Generally, no. 	<ul style="list-style-type: none"> • Second Lien generally has buyout right. 	<ul style="list-style-type: none"> • Term lender generally has buyout right, although it may be reciprocal. 	<ul style="list-style-type: none"> • Last Out generally has buyout right and may also have a right of first offer.

AMENDMENTS / WAIVERS

Senior/Mezzanine	First Lien/ Second Lien	Split Lien	Unitranche
<ul style="list-style-type: none"> Operate independently, except for short list (e.g., increasing interest rate by more than 2% above contract rate, extending or shortening maturity, increasing principal loan balance, adding or modifying events of default, increasing advance rates). 	<ul style="list-style-type: none"> Operate independently, except for short list (e.g., increasing interest rate by more than 2% above contract rate, extending or shortening maturity, increasing principal loan balance, adding or modifying events of default, increasing advance rates, limitations on payment of second of lien debt). 	<ul style="list-style-type: none"> Operate independently, except for short list. (e.g., increasing interest rate by more than 2% above contract rate, extending or shortening maturity, increasing principal loan balance, adding or modifying events of default, increasing advance rates, limitations on payment of second of lien debt). 	<p>AAL may include:</p> <ul style="list-style-type: none"> “Drag alongs” – matters that Last Out agrees to with deemed consent of First Out (this would be more likely contained in an agreement where the Last Out held a much greater percentage of the overall debt or otherwise held significant leverage over the First Out). “Sacred rights” – matters that cannot be agreed without the unanimous consent of all lenders.” Default interest – “required lenders” in a tranche can require agent to impose default rate on their respective tranche.

BANKRUPTCY PROVISIONS

Senior/Mezzanine	First Lien/ Second Lien	Split Lien	Unitranche
<ul style="list-style-type: none"> Generally few bankruptcy provisions (DIP financing, 363 sales, and plan classification not addressed). 	<p>Numerous detailed provisions, including:</p> <ul style="list-style-type: none"> ICA enforceable as a subordination agreement (Section 510(a) of the Bankruptcy Code). DIP financing provided by, or consented to by, First Lien up to cap. Second Lien consent to 363 sale approved by First Lien. First and Second Liens separately classified in the plan. 	<p>Numerous detailed provisions, including:</p> <ul style="list-style-type: none"> ICA enforceable as a subordination agreement (Section 510(a) of the Bankruptcy Code). DIP financing with priming lien provided by either ABL or term lender, subject to certain conditions. Term lender consent to sale approved by ABL lender, and adequate protection requested by ABL lender, subject to certain conditions. ABL and term lender claims separately classified in the plan. 	<p>Select bankruptcy provisions are included in documentation:</p> <ul style="list-style-type: none"> May include that the AAL enforceable as a subordination agreement (Section 510(a) of the Bankruptcy Code). May include DIP financing provisions similar to First Lien/Second Lien. May include 363 sale provision similar to First Lien/Second Lien, subject to triggering events. May include plan provision similar to First Lien/Second Lien with limitation on plan voting. Plan voting may often limit the agent's ability to vote in favor of a plan to only when both the required First Out lenders and required Last Out lenders affirmatively direct such vote.

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