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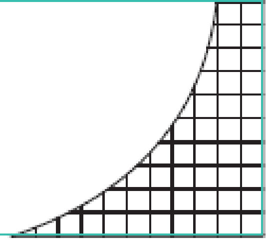

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"Crossover" or "Split Collateral" Lien Subordination

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Overview

Whenever a borrower incurs debt under more than one facility, the parties to the credit transactions face the question of ranking the different facilities – which one will be repaid first, in the event the borrower cannot repay all of its debts? There are many circumstances under which it is appropriate or desirable to allocate different priority to different credit facilities. For example, an asset-based lender might be given priority over the pool of assets that it is primarily lending against – its borrowing base. Or higher- and lower-priority debt might be marketed to different segments of the financial markets, with different expectations and orientations along the risk/reward curve. Or a particular ranking within the borrower's capital structure might be available, under existing contractual obligations, for the issuance of new debt, whether to raise cash or to use as currency in an exchange offer.

Just as there are different business rationales for establishing credit facilities with different rankings, there are also different ways of documenting intercreditor arrangements. A thorough understanding of intercreditor agreements is vital to any practitioner dealing with finance transactions, especially leveraged finance, as well as bankruptcy and restructuring practitioners. In this overview – the second of a series on intercreditor arrangements – we examine the "crossover" or "split collateral" lien subordination arrangement, most commonly applied to asset-based lending facilities.

Access the Bloomberg Law Precedent Database of **Intercreditor Agreements** used in real transactions.

Background – Asset-Based Lending

The term “asset based lending” describes a specific class of financial products. For these products, the granting of credit is based upon a borrower’s assets rather than upon a borrower’s historical or projected financial performance. Asset based loans usually consist of a collateralized line of credit limited to a specified percentage of the value of the assets that secure the credit. The assets and percentages upon which these limits are based are called a borrowing base. Asset based lending works well for certain types of borrowers, particularly manufacturers and retailers, although it is by no means limited to these sectors. Borrowers in these sectors tend to have inventory and receivables that are liquid and have predictable values.

While an asset based lender, or ABL lender, looks to specific asset classes, it usually has a lien on all assets of the borrower. Because there is usually residual value on an asset based lending borrowing base, it is common for other lenders in the capital structure to have a second lien on the ABL priority collateral and for the asset lender to have a second lien on the other encumbered assets of the borrower.

Focus - “Crossover” or “Split Collateral” Lien Subordination

The distinguishing characteristic of “crossover” or “split collateral” intercreditor agreements is that, while the two sets of creditors (typically, the ABL lender and the term loan lender, or syndicates thereof) both have liens on the entire collateral pool, each has priority over a different side of the pool. The ABL lender will have priority liens over the borrowing base assets (most commonly current assets such as receivables and inventory) which is often referred to as the ABL priority collateral, and junior liens over the remaining asset base (chiefly fixed assets). The term loan lender, conversely, will have priority liens over the fixed assets and junior liens over the borrowing base assets.

A usual feature shared by most “split collateral” intercreditor agreements is symmetry – the priority rights of the ABL lender with respect to the ABL priority collateral will for the most part mirror the priority rights of the term lender with respect to the term loan priority collateral. On the one hand, this can streamline negotiations by “keeping the parties honest” – each side knows that seeking an aggressive position with respect to its own priority collateral will leave it in a weaker position with respect to the other party’s priority collateral. On the other hand, this means that there are two drivers steering the pursuit of secured creditor remedies against the debtors, and their respective needs and interests need to be addressed with delicacy and clarity.

A common complicating factor in the negotiating dynamic is that the two sets of creditors – the ABL lender and the term lender – often have very different orientations with respect to their investment theses. Whereas an “all assets” intercreditor arrangement between a first-lien term lender and a second-lien term lender typically involves two cashflow-based creditors with a similar view of the credit but different appetites for risk/yield, a “split collateral” intercreditor typically involves an ABL lender that is by definition focused on the most liquid collateral of the

borrower, and a term lender that may be either collateral-focused (if there are significant fixed assets) or looking almost entirely to cashflows to support the credit. The differences in investment theses will inform the two creditors' preferred approach to the exercise of remedies, as well as the structure of their respective covenant packages (and thus the timing of a default under their respective underlying credit documents), and this difference will need to be addressed in the intercreditor agreement.

Having said that, the basic architecture of a "split collateral" intercreditor agreement is patterned after a typical "all assets" intercreditor agreement. The documentation will include provisions establishing the respective lien priorities, enforcement standstill periods, turnover and application-of-proceeds clauses, a set of bankruptcy right waivers, limits on amending one side's credit documents without the other side's consent, and a buyout right (which is sometimes drafted bilaterally in accordance with the general principle of symmetry in "split collateral" arrangements, but is also often drafted solely in favor of the term loan lender, especially when the ABL facility is relatively small and there is little prospect of the ABL lender desiring to pay out the term loan lender in order to step into its shoes). All of these are familiar constructs in the "all assets" intercreditor agreement context.

Negotiating a "Split Collateral" Intercreditor Agreement

A typical "split collateral" arrangement will have "anchoring" provisions in the documentation of the underlying credit facilities (e.g., the ABL credit agreement and the term loan agreement or note purchase agreement), to the effect that the credit facilities are subject to the provisions of the intercreditor agreement. It is the intercreditor agreement itself, however – a standalone, separately negotiated document – that will contain the provisions governing the intercreditor arrangement. The intercreditor agreement, while developed and entered into as part of the credit documentation for the underlying credit facilities, is mostly the product of negotiations among the creditors, albeit with some borrower input.

Though there is no "standard" intercreditor agreement, it is possible to identify topics that draw most professionals' attention during the negotiation of such "split collateral" intercreditor agreements. Many of these topics are the same as for an "all assets" intercreditor agreement, and are presented in the first overview in this series – with each creditor taking the "first-lien" position with respect to its priority collateral, and the "second-lien" position with respect to the other side's priority collateral, and raising the applicable arguments accordingly. Presented below are some of the distinguishing high value topics that arise in a "split collateral" intercreditor arrangement but not in (or in a different way from) "all assets" intercreditor arrangements.

Delineation of Priority Collateral

Typically, ABL priority collateral is defined by reference to asset classes, while term priority collateral (or the equivalent) is defined as all shared collateral that is not ABL priority collateral (usually inventory, receivables and cash). The lines drawn in the intercreditor agreement have an impact on the underlying credit agreements as well – for example, in articulating the term loan agreement's mandatory prepayment requirements in respect of dispositions of collateral. The intercreditor agreement also specifies how to allocate the proceeds of mixed priority collateral – i.e. how much of the proceeds to attribute to the ABL priority collateral and how much to the

term priority collateral (for example, allocating book value to the ABL priority collateral and the remainder of the proceeds to the term priority collateral).

> **ABL Creditor perspective**: in addition to the core borrowing base assets, such as inventory and accounts receivable, the ABL priority collateral must include references to UCC asset classes such as chattel paper, deposit accounts, documents, instruments, supporting obligations and general intangibles, to the extent related to any of the other covered asset categories; products and proceeds of the foregoing should be covered as well.

> **Term Creditor perspective**: seeks to carve back from the ABL priority collateral any assets that constitute proceeds of the term priority collateral – such as any receivables and payment intangibles owed on account of a disposition of fixed assets, or deposit accounts containing proceeds of fixed assets or other term priority collateral; equity interests in subsidiaries may be expressly carved out as well.

ABL Lender's Access to Fixed Assets

The fixed assets that the asset based lender will typically be most concerned with include the locations of ABL priority collateral (such as a warehouse storing inventory, or an office storing books and records constituting ABL priority collateral), to which the ABL Creditor needs *access*; and fixed assets, predominantly intellectual property, which the ABL Creditor needs to *use* in order to realize value from the ABL priority collateral.

> **ABL Creditor perspective**: ensure ability to enter relevant facilities and locations to retrieve ABL priority collateral, and ideally retain the right to conduct a sale of the ABL priority collateral on site (in many cases, the right to use fixed assets to continue to process current assets, such as assembling parts into finished inventory, can also be valuable and should be expressly included); ensure both access to, and non-exclusive royalty-free license to use, intellectual property for the purpose of realizing value from ABL priority collateral (this includes both logos and other intellectual property that may be affixed to inventory, as well as customer lists and record-keeping or tracking systems that may be used to facilitate sales of inventory and collection of receivables); ensure that any restrictions imposed by the term creditor account for relevant contingencies (for example, if access to locations and fixed assets is limited in duration, the duration should be tolled by the length of any stay on enforcement).

> **Term Creditor perspective**: ensure that any use of facilities and locations is limited in duration (such as a given term of days or months) and manner (reasonability, advance notice, business hours) and, if applicable, compensated, and that the asset based lender is subject to reimbursement and indemnity provisions for any damage or loss caused by its actions.

Cap on ABL Priority Obligations

The negotiation of a cap on the amount of obligations entitled to lien priority in a "split collateral" intercreditor agreement has many lines of resemblance to an "all assets" intercreditor agreement – for example, the handling of hedging and cash management obligations as priority obligations that do not count against the cap, or the arguments for including a cushion permitting the incurrence of additional priority debt in order to enable a creditor (here, most likely the asset based lender) to make protective advances without exceeding the cap. However, the centrality of

an ABL facility's borrowing base to the amount of debt that can be incurred under the facility introduces a new parameter to these intercreditor negotiations.

> **ABL Creditor perspective**: seeks either no cap on ABL priority obligations, or a cap on principal amount of loans and letters of credit set at a fixed amount (determined by reference to the maximum commitment amount under the ABL facility at closing, plus incremental ABL facilities if applicable, plus whatever cushion is agreed); to the extent a cap tied to borrowing base is agreed, seeks to ensure that inadvertent overadvances (resulting from fluctuations in borrowing base) are never excluded from ABL priority obligations, and ideally also that some amount of intentional overadvances is permitted to be made without exceeding the cap.

> **Term Creditor perspective**: seeks to impose a cap on ABL priority obligations set at the *lesser of* some fixed amount and the maximum amount of advances permitted by the borrowing base formula in place at closing; sometimes seeks to limit intentional overadvances that exceed a certain amount and/or remain outstanding for more than a set duration; sometimes seeks to require that hedging and cash management obligations, in order to qualify as ABL Priority Obligations, be reserved against the borrowing base.

Restrictions on Amendment of Debt Documents

While the negotiation of consent rights of the asset based lender and term creditor over amendments to one another's debt documents follows a similar template as in "all-assets" intercreditor agreements, again, the centrality of the borrowing base concept in an ABL facility introduces new concerns. The Term Creditor will seek to limit any amendments to the borrowing base criteria and formula, especially modifications with the effect of increasing the advance rate or pool of eligible borrowing base assets, whereas the ABL Creditor will seek to retain a free hand in adjusting these parameters, pointing out (where the ABL Priority Obligations are capped by reference to the borrowing base calculation in effect at closing) that subsequent changes in the borrowing base formula will not increase the maximum amount of ABL claims entitled to priority over the ABL priority collateral.

DIP Financing

The first need of an insolvent borrower is for more cash, and "split collateral" intercreditor agreements prominently address the use of cash collateral and post-petition financing, also known as debtor-in-possession financing, or DIP financing. Uses of cash collateral and DIP financing must be approved by a bankruptcy court, and as a result the provisions of a "split collateral" intercreditor agreement address who may object to the use of cash collateral and to a priming DIP financing.

The general rule of most "split collateral" intercreditor agreements is that use of cash collateral constituting ABL priority collateral and DIP financing that primes ABL priority collateral (but not term priority collateral) may not be objected to by the term lender if such use of cash collateral or DIP financing has been consented to by the asset based lender.

The reverse rule applies to term priority collateral. Use of cash collateral constituting term priority collateral and DIP financing that primes term priority collateral (but not ABL priority collateral) may not be objected to by the asset based lender if such use of cash collateral or DIP financing has been consented to by the term lender.

Adequate Protection

A lender that suffers a diminution in value of its interest in collateral as a result of a use of its collateral or the priming of its liens pursuant to DIP financing is generally entitled to adequate protection. Because an objection based on a lack of adequate protection can be a show-stopper in a bankruptcy case, adequate protection is carefully addressed in “split collateral” intercreditor agreements. Usually the method is very similar to that in standard first lien / second lien intercreditor agreements, with the distinction that the party entitled to seek limited adequate protection depends whether it is the term priority collateral and ABL priority collateral that is being used or primed. Essentially, where the ABL priority collateral is being used or primed, the term lenders are entitled to adequate protection in the form of a replacement lien if and only if the asset based lender is receiving a replacement lien. Conversely, where the term priority collateral is being used or primed the asset based lender is entitled to adequate protection in the form of a replacement lien if and only if the term priority lender is receiving a replacement lien. In each case, the replacement lien of the junior lender with respect to the class of collateral is subordinate to the lien of the senior lender with respect to the class of collateral.

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