C A D W A L A D E R

Intercreditor Issues for Fund Finance Lawyers in Europe

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Introduction

Simple subscription lines in Europe do not typically come with an intercreditor agreement (an ICA). Keeping the fund at the top of the structure “clean” with very restricted permitted financial indebtedness undertakings and a robust negative pledge preventing the creation of any security, should prevent competing creditors and security. That said, due to both: (i) the increasing value and complexity of transactions in the fund finance space; and (ii) the simple fact that, in Europe at least, documentation remains driven by the LMA form, for any loan drafted in a syndicated style, aspects of the LMA ICA need to be brought into a facility agreement, where there is no separate ICA. The necessary drafting for the majority of the points is not controversial and, baring a few pinch points, does not tend to be heavily negotiated, but should often be included in a well drafted suite of documents for a fund finance deal.

Getting the parties right

Before simply transposing any provision from an ICA into a facility agreement, thought must be given to the parties to the facility agreement. Facility agreements are typically between the finance parties, the obligors (being the borrowers and guarantors) and, in the fund finance world, the entities controlling the relevant fund.

The scope of the ICA is wider, and involves any entities within the structure who are lending to each other and any entities out-with the structure who are providing funding into it, where such funding must be subordinated to the relevant loan provided by the finance parties. Proper subordination requires (amongst other things) both the borrower to undertake that it will not pay the subordinated loan (unless expressly permitted) and the subordinated creditor to agree that it will not seek repayment (again unless expressly permitted). In a case where the loan in question is made by a parent to its subsidiary (where such subsidiary is a borrower under the relevant facility), including the subordination language in the facility will only be properly effective where the parent is also a party to it. If it is not, then this should be dealt with in a separate short form subordination agreement.

Getting this analysis correct at the start of the transaction (which can often be done quickly with a well annotated structure chart) will prevent any problematic issues further down the track.

Ticking the box – the security trust and the investors

One of the quirks of the LMA suite of syndicated loan documents is that the “Facility Agent” is appointed in the facility agreement but the trust under which the “Security Agent” holds the security is created under the ICA (as is any parallel debt structures required in jurisdiction which may not recognise a security trust).

Where a facility agreement includes the role of a security agent or trustee to hold security, then the LMA provisions creating this trust must be included in the facility agreement. Such provisions are seldom negotiated and are not controversial, but their presence must always be checked in a typical fund finance facility agreement in Europe.

The other check which must be carried out is on the subordination of any loans made by investors in a fund to the facility provided under a loan to that fund. Often, investors will invest in a fund by way of a loan (rather than an investment in the capital of the fund). As such, investors will be unsecured creditors of a fund, and where such fund is also a borrower under a subscription line, they are competing creditors with the lenders under that subscription line (would be especially relevant if there is a shortfall after a lender has realised the secured assets).

A facility agreement will normally include a prohibition on paying amounts to such investors in prescribed circumstances (the first half of the subordination described above) but given the investors themselves will never be a party to the facility agreement, including the restrictions on subordinated lenders will not be possible. This is very rarely an issue in any fund finance transaction because of a combination of: (i) there often being statutory or common law provisions dealing with the subordination of loans payable to equity holders (and similar) in many jurisdictions, which apply as a matter of law; and (ii) the constitutional documents will make it clear that such an investor cannot raise a claim for such repayment in a way which would potentially hamper the lenders enforcement of their loan. This is a point which should be dealt with in a diligence report for any subscription line deal where the investors provide funds by way of a loan.

Tranching

As the quantum and complexity of fund finance transactions has increased, we are starting to see different products appear in this space. Simple revolving facilities have been replaced with more complex multi tranche term loan facilities or the issue of series of loan notes, where such tranches can have different maturities, pricing and ranking (with the cheaper debt being paid first and the more expensive debt being last in the queue of the secured lenders).

This type of tranching of debt has been prevalent in many parts of the market for a while, so much of the relevant ICA drafting required between the creditors can be originated from the CLO space, but such structures are becoming more common in the fund finance space.

Hedging

Most fund finance facility agreements will seek to restrict the treasury transactions which the relevant obligors can enter into, this normally seeks to mirror the relevant provisions in the constitutional documents of the fund, as most borrowers will not accept a tighter restriction in the facility agreement, from that which they have agreed with their investors. Where such a restriction is included any such permitted hedging which is undertaken will constitute financial indebtedness of the relevant entity for the purposes of the facility agreement, in the event that such hedge is out of the money.

There is then a separate question as to whether or not such hedging liabilities could share in the transaction security. It can be the case that lenders require hedging to be entered into in respect of interest or currency risks and, as a result, are willing to allow such hedging to share in their transaction security. If such secured hedging is included in a deal there are several changes to the facility agreement (to allow hedge counterparties to be secured parties and for liabilities under hedging agreement to be secured liabilities) but there is also a fairly extensive piece of ICA drafting required in order to regulate (amongst other things): (i) the form of hedging agreement (will be ISDA) and any amendments to it; (ii) when hedging liabilities can be paid; (iii) when hedging agreements can be closed out; and (iv) how (and when) hedge counterparties are included as the instructing group on how security should be enforced.

There are certain pinch points in the drafting which can be subject to negotiation (when hedge counterparties may close out hedging agreements can involve some negotiation), but these provisions are typically taken fairly closely from the LMA ICA position.

Intercreditor issues specific to share security

We do see share security being taken in fund finance transactions (often in the NAV space, the relevant borrower will be a drop down subsidiary of a fund, over which such security can be taken, and share security is sometimes taken over asset holding vehicles). As above, it is often the case that a shareholder (or equivalent) will not only have provided its funding to a subsidiary solely by way of share capital, but also through shareholder loans. In addition to taking security over that receivable (alongside the share security), it is necessary to regulate how such a loan can be dealt with on enforcement of the share security. It stands to reason that no buyer is particularly likely to buy shares where the relevant company still has a large receivable owing to its previous shareholder. Ideally security is taken over the shareholder loan as well as the shares, to provide a single point of enforcement. However, the LMA ICA deals with this by giving the security agent express powers to release this liability owed to the shareholder upon a “distressed disposal” of the relevant shares. Such wording should be included in a document which the parent is party to, to facilitate the intended enforcement of the transaction security, so the lenders can sell the shares to realise value.

One other ICA issue which arises in respect of such “distressed disposals” of shares is the “fair value” protection around the process by which such shares are sold. Subordinated creditors will only receive the excess enforcement proceeds that are not applied in respect of the prior ranking claims. Such subordinated creditors may insist that the security agent is under an obligation to obtain a fair (market) price for the shares at the relevant time. In order to meet this obligation the security agent may make such a sale by: (i) a court sanctioned process; (ii) instructing an insolvency officer; (iii) make the sake by way of an auction/competitive sales process; or (iv) which are covered by an opinion of a financial adviser. There is no requirement to delay any process to get a higher price, by following the relevant agreed processes, the security agent will have discharged its duty to obtain its fair value. Again such drafting is not particularly controversial but may be required in a situation where there is both share security and competing creditors.