**Subordination**

• We have now considered the key clauses in a loan agreement.

• The remaining slides focus on a problem that arises when there is a group of companies and there are loans at different levels of the group.

• This is known as **structural subordination.**

**Structural Subordination**

• It is very common for companies to operate under a group structure where a holding company has 100% shareholdings in subsidiaries. These subsidiaries may be operating companies, running businesses and owning assets or themselves intermediate holding companies of operating companies. Lenders may lend to the holding company which then filters the money down to the subsidiary(y/ies).

• This can cause problems for the lender which lends to the holding company if the subsidiaries have existing loans or later take out loans. This is because of the statutory order of repayment of creditors on the winding-up of a company.

**The repayment of creditors on a winding-up is made in the following order (note: this is a deliberately simplified list):**

• fixed chargeholders;

• preferential creditors;

• payments out of the ring-fenced fund;

• floating chargeholders;

• unsecured creditors; and finally

• shareholders.

**Subordination**

**Example:**

[Diagram: Bank X arrow under box “Lends” to Hold Co ; line from Hold Co to Company A and line from Hold Co Company B (under box “100% subsidiaries”) ; Arrow from Bank Y to Company B under box “Lends 18 months later”].

**Structural Subordination**

**Example:**

• Companies A and B are wholly-owned subsidiaries of HoldCo. Companies A and B are the operating companies owning the majority of the group’s assets and generating the income for the group. HoldCo’s only assets of value are the shares in its subsidiaries and it does not generate any of its own income.

• Bank X lends money to HoldCo. 18 months later, Bank Y lends money to Company B.

• On a winding up of the group, the assets of Company B will not be available to satisfy the debt owed by HoldCo to Bank X until Bank Y (and any other creditors of Company B) has been paid in full. This is because HoldCo only has a claim to the assets of Companies A and B as a shareholder – and, as can be seen from the above list, shareholders are the last to be paid on a winding up.

• Note that the issue is the existence of the **loan** to Bank Y. **It does not matter if this loan between Company B and Bank Y is secured or not** because Bank Y, whether as a fixed chargeholder (if the loan is secured) or an unsecured creditor (if the loan is unsecured), will still rank above Holdco as shareholder.

• Because of the group structure, and the order of claims imposed by the statutory order of payments on a winding up, **Bank X is said to be ‘structurally subordinated’ to Bank Y**.

**Structural Subordination- solutions**

**Unsurprisingly, this situation is unsatisfactory to Bank X. To reduce the effect of a situation like the one in the example, Bank X can:**

• Insist on HoldCo giving (1) no financial indebtedness, (2) negative pledge and (3) no disposals undertakings to Bank X in the loan agreement. These would restrict HoldCo and HoldCo’s subsidiaries from (1) creating more than a certain amount of debt; (2) granting security over their assets; and (3) selling any of their assets. The aim is to limit the amount owed to creditors that would rank ahead of Bank X on a winding up of the group and to retain as many assets as possible in the group which are unsecured and available to pay off creditors. These would also ensure that no further debt could be taken on at Company B level, meaning that Bank X is not further structurally subordinated in respect of additional lenders to Company B.

• Take a guarantee and/or take security from Company B so Bank X has a direct claim against Company B or its assets.

• Require a subordination agreement between the respective lenders (i.e., contractual subordination) (see slides below).

**Contractual Subordination**

• Where there are different lenders either in a group structure (as above) or within a transaction (e.g. there may be a loan from a syndicate as well as a separate loan being given by a shareholder or the directors) then these lenders can decide amongst themselves the order in which they will be paid by a defaulting borrower.

• The document which governs this arrangement is invariably either called a subordination agreement, an intercreditor deed or a deed of priorities.

• There are various ways that contractual subordination can be structured but the most common is when the junior lender agrees that it will not demand the junior debt from the borrower until such time as the senior lender has been paid in full.

• This might be drafted to include all monies owed to the junior lender or just the amount of principal owed (so the junior lender is able to receive any fees or interest owed to it).

• Only when the senior lender has been paid in full will all amounts outstanding to the junior lender be paid in the agreed contractual order of priority.

• If the junior lender receives money from the borrower before the senior lender has been paid in full the agreement usually provides that the junior lender will hold this money on trust for the senior lender.

• It is sometimes the case that all of the lenders who have entered into a contractual subordination agreement have taken security for their loans. In this instance, the senior lender will not want a junior lender being able to enforce its security (and thereby forcing the senior lender’s hand) so the agreement will also include a provision restricting when the junior lender can enforce its security.

• Enforcement of security is often only allowed with the consent of the senior lender.

• The agreement should also provide that all parties are restricted from amending the loan agreement in specified ways without the other lenders’ consent. This will primarily relate to changes such as increasing amounts due under the respective loan agreement (interest and principal) or making the terms of the loan agreement materially more onerous for the borrower.

• This will help to maintain the level of indebtedness due to any party and the terms with which the borrower has to comply.

• You might be wondering why a junior lender would agree to these terms which, in effect, means they are more exposed to potentially not having their debt repaid in full or even at all. However, to reflect this increased risk of non-payment a junior lender will be able to charge the borrower higher fees and/or margin.

• The order of priority under a subordination agreement will only be relevant if the borrower becomes insolvent or enters into financial difficulty. Most of the time, the borrower will be able to pay both the senior and junior lenders in accordance with the repayment schedule in their respective loan agreements.

• Another reason why a junior lender might agree to entering into a subordination agreement is if there is a need for a cash injection into the borrower/group. Agreeing to be subordinated to another lender might be the only way to attract a new lender. This is one of the reasons why a lender to a subsidiary might agree to give up their priority in a structural subordination situation (as in the example above).