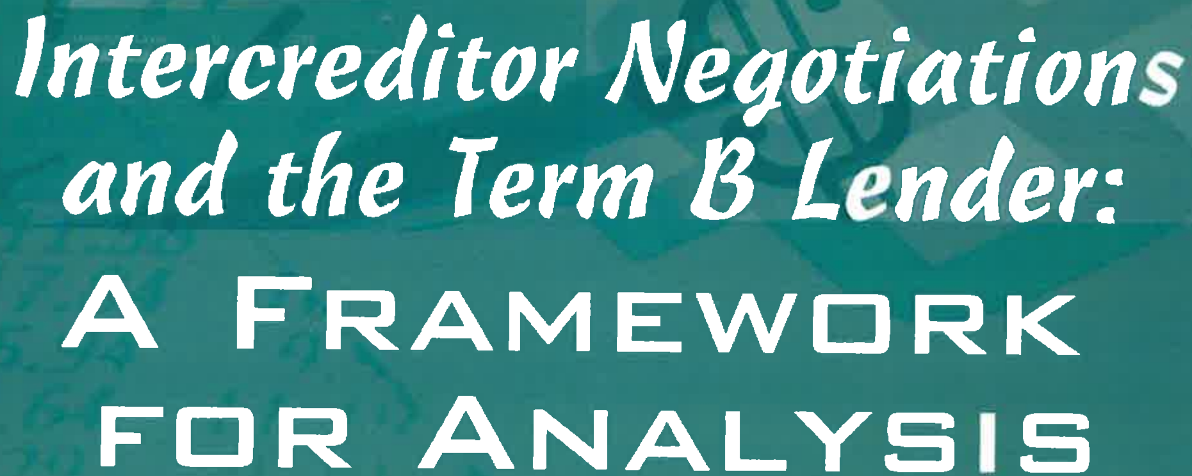

# Intercreditor Negotiations and the Term B Lender: A Framework for Analysis

by John J. Brignola and Joel F. Brown

The junior secured lender, occupying a position in a debtor's capital structure somewhere along the spectrum between senior secured and mezzanine debt, has emerged over the past several years as an increasingly vital source of transactional financing. A number of market and economic trends have fueled and continue to support the growth of this so-called "Term B" lending: consolidation among senior lenders leading to decreased market liquidity; tightening of senior lender underwriting standards; declining performance of borrowers; perceived efficiency over separate mezzanine negotiation and documentation; and an increased interest among certain investors in the heightened yield and overall risk/return profile of Term B loans. These and other factors have prompted the launch of many specialized lenders concentrating, sometimes exclusively, on junior secured debt products.

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The growth of the junior secured market has added a new and challenging dynamic to the process of deal structure and administration. Legal intercreditor issues stand as perhaps the most challenging aspect of successfully consummating a financing that includes a junior secured tranche. This article explores several of the most fundamental intercreditor issues that senior secured lenders need to consider when structuring deals with a Term B loan component.

In approaching these issues, this article uses as an analytical framework the set of intercreditor agreements that, in the main, have become customary between senior secured and mezzanine lenders. Term B lenders may bristle at the suggestion that their products should be compared to mezzanine debt, especially from a subordination and intercreditor perspective; indeed, many Term B lenders reject the proposition that their debt is "subordinated debt" at all. Still, the long track record of mezzanine lending has provided a relatively predictable and stable set of intercreditor relationships between senior secured and mezzanine lenders, thus providing a helpful and, for many senior lenders, a natural point of departure when addressing and negotiating the rights of Term B lenders.

**Definitions and documentation alternatives**

A few clarifications and observations are in order before proceeding further. First, the Term B loans discussed in this article are unrelated to institutional senior secured Term B loans ("Institutional Term B Loans"), which are typically marked by a *pari passu* collateral position with senior secured Term A loans and revolving loans, and long-term principal repayment with minimal scheduled amortization. Institutional Term B Loans were created to offer certain long-term investors — insurance companies, mutual funds and other institutional investors — a higher yielding slice of senior secured debt without compromising collateral priority. In marked contrast to this product, the Term B loans discussed in this article are typically last-out on collateral, often mature concurrently with working capital facilities, and bear interest in excess of senior secured debt. Such loans, which are also confusingly called "Term B" loans (as well as "junior secured," "senior-stretch" and "last-out" senior loans, among other labels), have been designed specifically to work with primary senior secured debt, including Institutional Term B Loans.

Junior secured loans may be documented in any of three basic ways. First, they may be documented as a separate tranche of debt fully integrated into the senior secured loan documentation. In such arrangements, intercreditor provisions will be similarly contained within the body of the senior secured documents.

Second, the junior loans may be independently documented, with the junior secured lender preparing its own separate credit and collateral security documents. In these cases, intercreditor provisions will usually be located

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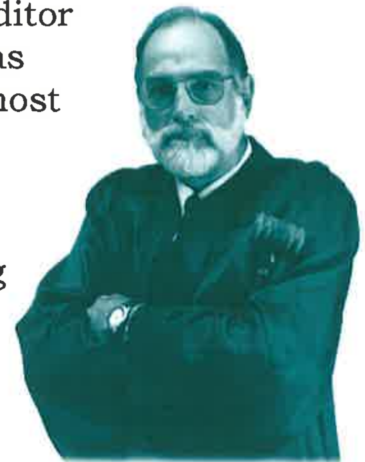

in a separate agreement that will link the senior secured facility with the junior secured facility.

Third, the junior lender may have its credit terms separately documented, but may agree with the senior lenders that one party will serve as collateral agent for both the senior and the junior lenders, thereby avoiding the need for duplicative collateral security documents. In these hybrid arrangements, a similar hybrid approach regarding the location of intercreditor provisions may govern (*i.e.,* a separate intercreditor agreement may address certain elements of the independent credit documents, while other intercreditor matters, particularly those pertaining to collateral matters, may be addressed in the common security documents).

The decision regarding the appropriate form of documentation for junior secured loans will be driven by the exigencies of each transaction, with weight given to such factors as deal timing, cost of dual perfection, marketing objectives and legal considerations. Many Term B lenders, for example, market their rapid closing processes, which may be highly desired by debtors, especially where capital shortfalls giving rise to the need for junior capital emerge late in a deal cycle. Transaction speed often militates in favor of documenting the junior debt within the confines of the senior facility, thereby avoiding the need for separate loan documents, which may otherwise take time to prepare and negotiate.

The decision regarding the form of documentation will affect baseline legal rights. For example, the junior lender that documents its own lien will have, as a starting point, independent rights and remedies as a secured creditor. By way of contrast, the junior lender that documents its loans through the senior secured facility will not have an independent lien, but instead will share in the benefits of collateral

*(Continued on page 12)*

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only by the action of a designated collateral agent. These baseline rights, however, generally — though not always, as may be the case with respect to certain bankruptcy related rights[1] — may be modified by contract, thereby making the chosen form of documentation irrelevant for many intercreditor purposes, including those discussed below.

**Debt subordination**

In a typical senior secured transaction involving mezzanine debt, the mezzanine lender will usually accept some level of debt subordination. This means that the subordinated lender's right to get paid on its debt may be suspended upon the occurrence of certain events or conditions. As a starting point, the mezzanine lender will usually agree not to accept principal or interest payments at any time a payment default has occurred and remains in existence under the senior debt. The mezzanine lender will usually also agree to accept limited payment suspension in the face of nonpayment defaults on the senior debt. Negotiation in this arena will often center on the number of payment blockage days that may be foisted on the subordinated lender in the case of non-payment defaults (with no such limitation in the case of payment defaults; if the senior debt is in payment default, mezzanine debt should be suspended until senior debt is current), and on the types of nonpayment defaults that may be used to trigger junior payment suspension. For example, a mezzanine lender may seek to negotiate (with no guaranty of success) that nonpayment defaults should be limited to financial covenant breaches and the breach of various designated "material" nonfinancial covenants. As an additional element of debt subordination, a mezzanine lender will usually agree not to accept voluntary or mandatory prepayments on its debt while the senior secured debt is outstanding. The guiding principle is that there should be no return on junior capital, except for permitted payments of scheduled debt service (usually interest only), while any senior debt remains outstanding.

Viewing themselves fully as senior capital (albeit junior on collateral payout), Term B lenders will often reject any concept of debt subordination, at least when it comes to scheduled payments of interest. Most Term B lenders expect the unfettered right to collect their interest, like any other portion of the senior debt, irrespective of underlying defaults, including payment defaults, on other portions of the senior debt. Their argument is that, without the enhanced return associated with equity (such as through the receipt of warrants or other equity kickers, which are usually not issued to Term B lenders as part of their overall loan package) the lower return on junior secured debt relative to mezzanine does not adequately compensate the junior lender for the risk of suspended payments in a downside scenario.

This argument loses much of its power in the context of prepayments. Term B loans are usually structured as interest-only loans with bullet principal repayment on maturity. Senior secured lenders have a forceful argument that junior secured lenders have no right to expect, and should agree contractually not to accept, voluntary or mandatory prepayments of their debt in advance of full repayment of the senior secured debt. This may not engender much resistance, as most junior secured lenders will seek to maximize their real dollar return by keeping their principal fully deployed until maturity. The only point of contention here concerns prepayments remitted to the senior secured lender that do not permanently reduce senior secured debt, such as a repayment of revolving loans with no concurrent commitment reduction. Such prepayments do not meaningfully reduce credit exposure for the junior secured lenders, thereby representing, from the perspective of the Term B lender, a wasting of available cash flow for debt service purposes, the loss of residual asset coverage or diminution of enterprise value. The junior lender may therefore negotiate for a mandatory application of prepayment proceeds to senior secured term debt facilities (which may not be reborrowed), a commitment reduction or permanent availability block in connection with prepayments applied to revolving loans, or a permitted prepayment on the Term B debt.

**Lien subordination**

Mezzanine loans are typically unsecured, thereby depriving the junior lender of all lienholder rights and remedies. Infrequently, mezzanine lenders will bargain for collateral rights, and where such rights are consented to by the senior lender, they are almost always documented as "silent second" liens. In concept, the senior lender will agree to give the mezzanine lender any residual collateral value after the senior lender has been paid in full and its facility has

*(Continued on page 14)*

been terminated in accordance with its terms; prior to such repayment and termination, the mezzanine lender is expected to be prohibited from exercising any meaningful lienholder rights and remedies, including the right to accept proceeds of any collateral.

Junior secured lenders typically agree that their payout on collateral is junior to the payout to the senior secured lenders. This is a hallmark of the junior secured debt product, and a key justification for its higher interest return relative to senior secured debt. Negotiation may ensue over the relative priority of the junior lender's right to recover its expenses and the senior lender's right to certain fees. For example, a junior lender may seek *pari passu* recovery status for its deal expenses vis-à-vis senior lender deal expenses, on the grounds that such recovery is ordinary course and does not represent profit on the deal, and that subordination of such expense recoveries would unfairly punish the junior lender's active monitoring of, and participation in, loan administration, as well as other activities that generate ongoing expenses. The junior lender may also seek to subordinate any senior lender prepayment or early termination fee, so that such fees get paid only after the junior lender has received a full recovery. The only other regular material deviation from this expectation of lien proceed subordination arises in situations where the junior lender has predicated its loan in full or in part on specific assets of a debtor, which assets do not directly support the senior loans. In such arrangements, it is obviously fair for the junior lender to recover all proceeds of the liquidation of such assets before remitting any excess recovery to the senior lender. All of these agreements and arrangements will be set forth in a series of "waterfall" provisions, which are an integral element of all junior lien subordination agreements.

Viewing themselves fully as senior capital (albeit junior on collateral payout), Term B lenders will often reject any concept of debt subordination, at least when it comes to scheduled payments of interest.

Aside from agreeing to these waterfall terms, and subject only to accepting limited remedy standstill rights (as discussed below), Term B lenders will generally resist any further encroachments on their lienholder rights. In marked contrast to the "silent second" lien available, if at all, in the mezzanine market, the Term B lender expects to have the full right to exercise its lienholder rights in a default situation either directly (*i.e.*, to effect a liquidation of the debtor), or indirectly (*i.e.*, to agree to forbear from exercising lienholder rights in exchange for material concessions, such as an orderly sale of the debtor in whole or in part).

These powerful rights are of central importance to the junior secured lender and, given the comparatively shorter deal horizon relative to mezzanine lenders, highlight the key distinguishing feature between junior secured and mezzanine lenders: the means to influence a deal's destiny. Senior lenders are generally familiar with the willingness of mezzanine lenders to remain quiet, even for long stretches, in the face of covenant defaults, and even sometimes in the face of payment default. The higher return enjoyed by mezzanine debt, which is sometimes combined with an equity stake, plus the high cost and time delay associated with enforcing unsecured (or deeply subordinated, silent secured) debt often prompts many mezzanine lenders to pursue more gradual, nonjudicial remedies over direct enforcement of debtholder rights. By contrast, junior secured lenders have shorter time horizons for the return of capital, view themselves as insufficiently compensated to accept inaction as a strategy and have the means of effecting fundamental deal change on a relatively low cost basis. Senior lenders that fail to sufficiently understand these differences, or that choose to enter deals with Term B lenders of unproven track record, may find themselves in a deal dynamic quite outside their expectation or control.

**Remedy standstill**

Even when unsecured, mezzanine lenders are not without meaningful rights and remedies. Chief among their remedies are the rights to accelerate their defaulted debt, to bring suit to enforce a judgment and to join with other creditors to initiate an involuntary bankruptcy of their borrower. The decision by a mezzanine lender to accelerate its debt could precipitate cross-defaults in other material contracts of the debtor, result in materially adverse trade-credit terms and otherwise lead to a financial situation where the debtor views a voluntary bankruptcy as its only viable option. Though, as noted above, the exercise of remedies by an unsecured mezzanine lender may be costly and time-consuming, left unchecked the mezzanine lender may ultimately have a great impact upon critical aspects of a debtor's financial position.

While, as between the secured and mezzanine claimants, the secured debt will have first claim in or out of

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bankruptcy against proceeds of collateral, senior lenders clearly have goals beyond recovering first proceeds of a liquidation. Senior lenders also desire to control the timing of debt enforcement actions, which may be essential to an overall successful exit strategy. To balance this goal with the mezzanine lender's ultimate right to safeguard its own rights and remedies, the market has generally accepted the notion of a "remedy standstill" in mezzanine transactions. Under a typical remedy standstill, following the occurrence of a default under mezzanine loan documents, the mezzanine lender would be required to give the secured lender prior written notice, typically 60 to 180 days (with the specific number being negotiated deal to deal) before exercising its enforcement rights, including the right to accelerate. During this period, the secured lenders may assess the likelihood of cure by the debtor, may caucus among themselves regarding their own enforcement options and strategies and may seek to engage the mezzanine lender in waiver or workout discussions, all without risk of precipitous mezzanine enforcement action.

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The concept of a remedy standstill also plays a role in junior secured financings, but here works in two related ways. The first way is the "upfront" standstill, which functions identically to the mezzanine standstill, though usually with a tighter standstill period. Thus, the Term B lender will typically agree to give the senior secured lender some advance notice, ranging from 30 to 180 days, but rarely as much as would be afforded by mezzanine debt, prior to having the right to exercise rights and remedies. The shorter timetable is justified by Term B lenders as a consequence of their lower yield relative to mezzanine debt.

The second way is the "backend" standstill. In contrast to the holders of unsecured mezzanine or any other unsecured debt, the holders of junior secured debt have powerful rights under the Uniform Commercial Code, the exercise of which (absent agreement to the contrary) could determine a deal's destiny in short order. For example, at the end of a typical standstill period, junior secured creditors could, among other things, commence a private or public UCC sale of the debtor's collateral, rights unavailable to unsecured creditors. The exercise of these rights concurrently with a decision by the senior secured creditors to exercise their own enforcement rights could easily result in an uncoordinated effort to seek recovery, resulting in high transaction costs and lower recovery as compared to a coordinated recovery effort by the senior and junior lenders.

The "backend" standstill addresses this situation by providing for a continuing remedy standstill on the part of the junior secured creditor in the face of meaningful enforcement action by the senior secured creditor. This approach recognizes that only one set of secured creditors can meaningfully control a liquidation or protracted workout. In such a standstill, the junior creditor may not exercise certain rights and remedies, though it does expect to receive proceeds of any recovery engineered by the senior creditors, with such proceeds being distributed between the two sets of secured creditors through the "waterfall" provisions discussed above.

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The issue often negotiated in crafting this second-stage standstill is what constitutes a "meaningful" enforcement of remedies by the senior secured creditor. First, the value of certain remedies is driven by underwriting fundamentals, and there may not be agreement among different creditors at the outset of the deal as to the preferred exit scenario. For example, the liquidation of collateral may be fully appropriate in a tightly monitored asset-based transaction. However, liquidation may be a terrible exit scenario in a transaction that relies on a continuing cash flow, where asset valuation may be of secondary or even negligible consideration. In enterprise value deals, the favored exit scenario may be a sale of the debtor as a going concern, and the continuation of working capital financing and cooperation of the debtor may be essential elements of a successful sale process. Creditors at different positions in the capital structure may have very different views on the best approach for a successful credit exit.

Second, even when creditors agree in concept on the best exit approach, they may disagree on the level of activity that should suffice to trigger the standstill. For instance, in an enterprise value transaction, the junior secured lender, as a condition to a "backend" standstill, may seek to require a sale of a debtor on a division-by-division basis, and may request that, in order to maximize sale proceeds, there be some interval between sales so as to avoid sending "fire sale" signals to the marketplace. A senior secured creditor may not have such patience, and may require a tighter timetable, or more aggressive efforts to sell the entire business as a going concern.

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## Amendment and consent rights

Senior secured and mezzanine lenders each have a strong interest in obtaining consent rights over proposed amendments or other modifications to material provisions of the other creditors' debt facilities. This interest can be satisfied in one of two ways. First, the two sets of lenders will usually contractually agree not to approve certain basic credit modifications without the consent of the other. Marketplace convention here generally supports a near or total ban on mezzanine debt modification without senior lender approval, at least where the modifications could reasonably be viewed as detrimental to the debtor or the senior lenders. In contrast, senior lenders will generally agree not to modify their credit facilities without the consent of mezzanine lenders only in specific areas fundamental to the credit, such as: increasing the principal amount of senior secured debt (generally above a preapproved "cushion" for future growth or workout purposes); increasing interest rates above a certain preapproved cap; increasing amortization to the detriment of the debtor; and stretching out final amortization beyond certain negotiated limits. This short list of credit modifications gives the senior secured lenders more operational flexibility, because any modification outside the list may be, as a matter of law, amended or otherwise modified without mezzanine lender approval.

> In marked contrast to the "silent second" lien available, if at all, in the mezzanine market, the Term B lender expects to have the full right to exercise its lienholder rights in a default situation.

The reference in the preceding sentence to modifications "as a matter of law" is important, for while senior lenders may not be contractually bound to solicit mezzanine approval outside the enumerated list, such approval nonetheless will be important, if not necessary, in many scenarios. This approval is driven by overlapping structural elements of senior and mezzanine debt, which is the second of the two ways in which the two sets of lenders assure a level of control over modifications to the other creditors' facilities. Take, as an example, financial covenants. It is common in transactions with both senior secured and mezzanine debt that both sets of creditors will measure the same financial covenants, with the senior debt generally setting its covenant levels slightly tighter than mezzanine debt, thereby establishing at deal inception an earlier trigger for senior financial covenant defaults as compared to mezzanine financial covenant defaults. If, in the future, the debtor desires to modify its financial covenants, the senior lenders in a typical transaction would be able to modify such covenants without obtaining approval by the mezzanine lenders. However, while such approval may not be legally required, the senior lenders will quite often require comparable modification of the mezzanine debt so as to preserve the default cushion established at deal inception. Importantly, senior lenders rarely have the legal right to compel the mezzanine lenders to conform their documentation to changes agreed to by the senior lenders. As a result, while intercreditor agreements typically confer greater modification rights upon senior lenders, those rights are practically curtailed in important respects by the common design of the respective credit facilities.

The two main methods of assuring approval rights over modifications to the other creditors' facilities in the senior/mezzanine landscape — contractual agreement and by way of structural design — are also present in the senior secured/junior secured marketplace, though with some important differences. First, when it comes to contractual agreements not to modify, junior secured lenders will often negotiate for more upfront control over senior debt modification than is typical in the mezzanine context. This desire for heightened control on the part of junior secured creditors stems in large part from the particular position of junior secured creditors in a debtor's capital structure. Junior secured creditors will often argue that, because of the inherent risk associated with their last-out position on collateral, and because they are not compensated to the same extent as mezzanine debt, junior secured lenders require more control, as compared to mezzanine lenders, when it comes to senior secured credit modifications. For instance, junior secured lenders will typically be especially guarded on the topic of senior secured overadvance rights, a topic rarely addressed in intercreditor agreements between senior and mezzanine lenders. Junior secured lenders view senior secured overadvance rights as directly encroaching on their equity in collateral or enterprise value, and will typically negotiate at deal inception to limit the right to make overadvances without the junior lenders' approval. Junior lenders may also view other prospective changes to the senior secured facility as indirectly, but still materially, affecting their recovery rights, thereby causing junior lenders to request

upfront approval rights. Junior secured lenders may, for example, negotiate for the right to consent to the debtor's incurrence of additional debt (not just senior secured debt), the granting of additional liens and the consummation of a variety of fundamental changes, such as acquisitions and divestitures, as well as other areas of debtor activity typically not subject to mezzanine veto rights.

The relevance of structural design in the context of senior secured/junior secured approval rights turns on the manner by which the junior secured debt is documented. Mezzanine debt is typically documented separate from senior secured debt, though in preparing and negotiating their separate documents, both sets of lenders have an interest in assuring overlapping provisions (especially when it comes to financial and operating covenants). This interest drives the practical need for both sets of lenders to approve many requests for credit modification irrespective of any legal obligations to obtain such consents. By contrast, and as discussed earlier, there is no dominant market approach to drafting junior secured credit facilities. Such facilities may be a distinct tranche of a common senior/junior secured credit facility or may be documented separately, like mezzanine debt. Where the junior secured tranche is separately documented, senior lenders may be inclined to view approval rights in a manner consistent with the norms in the mezzanine market, where the junior debt is also documented separately from senior secured debt. Viewed from this perspective, the junior secured lender could not be forced into accepting a modification to its facility approved by the senior secured lenders on their facility. The absence of this "drag-along" right in favor of the senior lenders would practically require the consent of the junior secured lenders to many types of credit modification.

The relevance of structural design essentially disappears where junior secured debt is documented within the senior credit facility as a distinct tranche of debt. In such arrangements, one single set of covenants, representations and warranties and other agreements protect both the senior secured lenders and the junior secured lenders vis-à-vis the debtor. In such arrangements, senior secured lenders may argue that, except for the customary category of select modifications discussed earlier, junior secured lenders should have no enhanced voting rights when it comes to credit modification. By contrast, junior secured lenders in these arrangements may argue for greater approval rights, by arguing that such rights are necessary to put the junior secured lenders in the same practical control position they would have enjoyed had their debt been documented separately. As one may sense from the nature of the discussion, there is a range of arguments asserted and positions taken when it comes to amendment and consent rights, and no simple "market" solution has emerged.

**Packaging the agreement; final thoughts**

A successful negotiation of Term B intercreditor provisions requires a keen sensitivity to the relationships among these provisions. For example, a Term B lender's willingness to accept a longer standstill period may turn on the level of control given to the Term B lender in the arena of senior credit modification. Conversely, a Term B lender may be willing to afford the senior secured lenders more flexibility on credit modification in exchange for more power to direct enforcement of remedies. Some lenders have introduced other elements into these negotiations, such as a buy-out right in favor of the junior secured lender. This device gives the junior lender the right under certain circumstances (but not the obligation) to purchase the senior secured debt at par, thereby giving the junior secured lender the unfettered right after the purchase to control the senior debt. This buy-out right is typically given in exchange for accepting remedy standstills, the notion being that if the Term B lender does not approve of enforcement actions (or inactions) taken by the senior secured lenders, the Term B lender has the power to control enforcement by "simply" buying out the senior secured lenders' position.[2]

Successful negotiation of Term B intercreditor agreements also requires a solid understanding of the underwriting principles supporting the Term B lender's loan approval. Decisions to extend secured credit may be predicated tightly on asset coverage — the hallmark of asset-based lending — or, at the other end of the spectrum, may be predicated on the debtor's enterprise value, with secondary or even minimal concern on asset coverage, and may also fall somewhere within this spectrum. The specific supporting principles of the transaction dictate the expected sources of debt service and ultimate loan repayment, which in turn establish the key sensitivities in structuring and negotiating credit terms, including intercreditor terms. Some

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## Intercreditor Negotiations...

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of the most difficult negotiations between senior secured lenders and Term B lenders occur where the two groups of lenders have different views of the credit or the potential outcome of the transaction. For example, a senior secured lender underwriting a transaction on a cash-flow basis will view a sale of the debtor's business as a more likely source of debt repayment than liquidation. Pairing up with a Term B lender that views asset coverage as its guiding principle may be quite difficult, as the Term B lender will expect to have robust and easily triggered liquidation rights, and may have little patience for the longer term sales process supported by the senior secured lender. There is no simple solution to underwriting incompatibility, though it is also the case that lenders often do not align themselves solely at one extreme or the other along the asset-based/cash flow spectrum, but instead will have a more nuanced view of the supporting hallmarks of each specific transaction. Identifying these underwriting principles as soon as possible should help establish the framework for a more principled and productive intercreditor negotiation.

The goal of this article has been to explore the major intercreditor topics likely to be most relevant to senior secured lenders and Term B lenders, but without endeavoring to peg any specific "market" resolution of such issues. The marketplace for Term B lending is young, fluid and ever-shifting, and any attempts to establish form intercreditor agreements or terms will likely be simplistic, and will almost certainly fail to accommodate the range of products offered by the Term B lender, and the highly dynamic relationships that can emerge between senior secured lenders and Term B lenders.

At this stage in the history of Term B lending, the best that can be served up is a principled framework of analysis so that future negotiations may be as productive as possible.

*This article represents the individual views of John Brignola, and should not be construed as representing the views of his employer, Citadel Investment Group, L.L.C.*

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**Endnotes**

[1] For example, because undersecured creditors cannot collect post-petition interest from borrowers in bankruptcy, where a Term B loan is documented separately, the junior loan may be deemed to be unsecured or under secured and the Term B lender may not be entitled to its full interest payment or even any interest payment in bankruptcy.

[2] Although attractive at first blush, practical exercise of the buy-out right entails a number of challenges. First and foremost is the high economic cost, and associated credit risk to the Term B lender, of purchasing the senior debt. A second consideration is that Term B lenders may not have the institutional structure or experience to manage a revolving line of credit, which is a typical feature of senior secured loans.