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By Sarah R. Borders, Jeffrey R. Dutson and Jeffrey Misher

Unitranche Credit Facilities and the LSTA New Form AAL

Sarah R. Borders
King & Spalding LLP
Atlanta

Jeffrey R. Dutson
King & Spalding LLP
Atlanta

Jeffrey Misher
King & Spalding LLP
New York

Unitranche credit facilities are unfamiliar to most restructuring professionals. Apart from the *RadioShack* bankruptcy, there have been few significant bankruptcy cases involving unitranche financing. This will undoubtedly change with the next downturn.

Since the "Great Recession," annual deal volume for unitranche facilities has grown from only $1.1 billion in 2011 to an astounding $16.7 billion in 2017. For that reason, restructuring professionals should take note of the form agreement among lenders (AAL) issued on March 1, 2019, by the Loan Syndications & Trading Association (LSTA). An AAL is the intercreditor agreement that governs lenders' respective rights under a unitranche facility, and is a key document for purposes of understanding a unitranche lender's rights in a bankruptcy scenario. This article provides a brief overview of the history, development and structure of unitranche credit facilities, then highlights the provisions of the LSTA AAL that are particularly relevant for restructuring professionals.

Unitranche Overview, History and Development

Unitranche financing combines aspects of a traditional first-lien/second-lien structure into a single credit facility with one set of loan documents, one shared lien, shared (or "blended") interest payments, and one covenant package. From the borrower's perspective, it is party to only one credit facility with one set of lenders; it signs one set of loan documents, grants one lien and makes one monthly interest payment.

However, to create a structure that is intended to resemble separate first- and second-lien credit facilities, the lenders in a unitranche facility — separated into "first-out" lenders and "last-out" lenders — enter into an AAL, pursuant to which the payments, voting rights, enforcement rights and other rights under the unitranche facility are allocated among each tranche of lenders. The AAL is a complex document that can be more than 30 pages long. Similar to a traditional intercreditor agreement, the AAL sets forth, among other things, the respective rights of each tranche of holders in the event of bankruptcy.

Unitranche financing, in its current form, was introduced as a distinct financial product in the early 2000s as an alternative to traditional second-lien and mezzanine financing. For borrowers, the new structure provided the higher leverage that they could obtain in a first-lien/second-lien or senior/mezzanine structure, but provided greater efficiency, reduced closing costs and eased ongoing administration when compared with those other structures. The unitranche structure also provided benefits to lenders, as it allowed them to tailor their intercreditor rights depending on the size of the respective first-out and last-out facilities and other deal-specific factors.

Notwithstanding these advantages, some first-lien lenders were reluctant to enter the unitranche market based on a concern that by sharing a single lien with the last-out lenders, they risked losing the right to post-petition interest and attorneys' fees that are available under § 506(b) of the Bankruptcy Code for fully secured claims. Where there is a single lien and the value of collateral exceeds the first-out claim but not the aggregate of the first-out claim and the last-out claim, the entire claim is undersecured and not entitled to recover post-petition interest and attorneys' fees from the debtor's estate.[1] Over time, first-out lenders became more comfortable with the

1 *See Ionosphere Clubs Inc. v. Midlantic Nat'l Bank (In re Ionosphere Clubs Inc.)*, 134 B.R. 528, 532-36 (Bankr. S.D.N.Y. 1991).

enforceability of provisions allowing them to collect post-petition interest from a junior creditor's recovery when such amounts are not available from a debtor's estate.

Owing to this and other factors, the unitranche market has exploded, growing in annual deal volume by more than 1,000 percent in the last eight years. With a variety of lenders in the market and significant diversity in deal structure, the terms of the AAL can vary significantly from deal to deal. In the early stages of the product, AALs would often be favorable to the first-out lender (similar to a first-lien/second-lien intercreditor agreement). However, as unitranche financing has evolved, last-out lenders have led transactions and made a push to hold a larger portion of the underlying loans in exchange for greater control in intra-lender matters, including enhanced rights in connection with an insolvency proceeding.

In the midst of this growing market, the LSTA took on the ambitious task of publishing a form AAL for general use among unitranche lenders. The LSTA regularly publishes and updates form financing documents for a variety of deal structures, and their forms often set the "market" for standard agreement provisions. However, with the LSTA AAL, it set out to provide standardized terms for an agreement that is anything but standard. The final published LSTA AAL was the result of over a year and a half of work by the LSTA Primary Market Committee and reflected comments on multiple drafts by many industry professionals, including bankers and restructuring and finance lawyers.

Sarah Borders and Jeffrey Dutson are restructuring partners in the Corporate, Finance and Investments Team of King & Spalding LLP in Atlanta. Jeffrey Misher is a finance partner in the firm's New York office.

Relevant Bankruptcy Provisions

As previously noted, the AAL sets out various rights and payment priorities of the respective first-out and last-out tranches; it is a critical agreement in a unitranche structure. Among other things, it addresses the payment waterfall for the loan tranches upon the occurrence of certain triggers, the voting and enforcement rights of each group of lenders, and terms and conditions on which one set of lenders can purchase all the debt of the other tranche. In addition, an AAL typically contains robust bankruptcy provisions, including rights and restrictions with respect to debtor-in-possession (DIP) financing, use of cash collateral, credit-bidding, asset sales and claim classification.

Unlike a first-lien/second-lien intercreditor agreement, in which the senior class generally controls the insolvency process, an AAL provides various rights for each tranche of debt (including the last-out lenders), depending on certain factors. In a standard transaction in which the first-out lenders hold 50 percent or more of the underlying debt, the first-out lenders typically control most aspects of an insolvency proceeding in the same manner that the first-lien lenders would be given control under an intercreditor agreement.

However, in certain cases (especially in a low-leverage first-out structure where the first-out lenders hold a relatively small portion of the unitranche loans), the last-out lenders may have the right to control key bankruptcy actions while the first-out lenders are forced to sit and watch, relying only on their priority in the payment waterfall. The following is a discussion of some of these insolvency-related terms and their treatment in the LSTA AAL.

Commencement of a Bankruptcy Proceeding

A typical AAL gives either the first-out or last-out lenders the right to control the exercise of remedies, and the tranche that controls the exercise of remedies typically has the right to direct the agent to commence an insolvency proceeding. The LSTA AAL gives the first-out lenders those rights, at least initially. The LSTA AAL provides that the first-out lenders have the right to control the exercise of remedies (subject, in some cases, to a short standstill), while the last-out lenders can only exercise remedies after a negotiated standstill period runs. These same rights would apply to commencement of an insolvency proceeding, as the LSTA AAL provides that each group of lenders could commence or join in the commencement of an insolvency proceeding only at a time that such group would otherwise be permitted to exercise remedies generally.

Plan Claim Classification

The LSTA AAL provides that each tranche of lenders agrees that its respective claims shall be separately classified (within the meaning of § 1126(c) of the Bankruptcy Code) in any bankruptcy proceeding and that it will not object to the separate classification of its respective claims. In addition, in the event that the claims are classified together in a single class under any plan, each class agrees that it will not vote to approve such plan unless at least two-thirds in amount and more than half in number of obligations of the other tranche vote to approve such plan. The enforceability of such voting agreements in AALs has not yet been tested by the courts. In other contexts, some courts have been unwilling to enforce the assignment of voting rights as void against public policy, while other courts have approved such assignments. It is unclear how court will view voting agreements as compared with voting assignments.[2]

DIP Financing/Cash Collateral

The LSTA AAL provides that the first-out lenders have the right to provide or approve any DIP financing and/or use of cash collateral. As long as such DIP financing and/or cash collateral use satisfies certain standard conditions (including adequate-protection liens for the last-out lenders and

2 *See Ion Media Networks Inc.*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009) (noting that some courts have refrained from enforcing waivers of right to vote on reorganization plan).

the absence of any requirement to liquidate collateral or seek confirmation of a particular plan), the last-out lenders are deemed to have approved such DIP financing and/or cash collateral use.

As last-out lenders gain more leverage in the unitranche market, AAL terms are more likely to permit last-out lenders to provide or support DIP financing and/or cash collateral use that is either used to pay out the first-out obligations in full at closing, or that is secured by liens that are junior to the liens securing the unitranche facility. First-out lenders often push back on these rights, as they view the ability to provide DIP financing as integral to "controlling" the bankruptcy case, and thus, a critical first-out right.

Reorganization Securities

In a typical AAL, each class of lenders is permitted to receive "reorganization securities" (*i.e.*, debt or equity issued by the borrower in connection with a reorganization plan), so long as the first-out lenders receive the fair market value of their secured claims. The LSTA AAL contains a detailed waterfall provision with respect to any reorganization securities received in a bankruptcy, and the payment waterfall is consistent with the notion that the first-out lenders must receive the fair market value of their secured claims before the last-out lenders receive value. The LSTA AAL also contains an alternative construct in which the value of the reorganization securities is based on the value determined under the plan, which may result in a scenario in which the first-out lenders do not receive full fair market value payment of their secured claims.

Credit Bid

The LSTA AAL provides that no last-out lender may credit bid any last-out obligations unless the cash proceeds of the bid are sufficient to pay out the first-out obligations in full.[3] The first-out lenders may credit bid the first-out obligations at their discretion. In some low-leverage first-out transactions, first-out lenders are blocked from credit bidding the first-out obligations unless their first-out leverage ratio is greater than certain negotiated thresholds and/or unless the last-out lenders fail to credit bid. This is another example of an area where last-out lenders have been attempting to exert more control.

Collateral Sales

As in first-lien/second-lien intercreditor agreements, an AAL typically permits the first-out lenders to control the sale of any collateral and prohibits the last-out lenders from raising a secured creditor objection. The LSTA AAL provides that no last-out lender may object to a collateral sale under §§ 363, 365 or 1129 of the Bankruptcy Code that has been consented to by the first-out lenders, so long as the net proceeds are included as collateral and applied under the payment waterfall set forth in the AAL.

Whether the last-out lenders can raise objections that are generally available to unsecured creditors (as opposed to sale objections of a type that may only be raised by unsecured creditors) is typically a negotiated issue, and the LSTA AAL includes this concept in brackets. As is the case with credit bidding, in some low-leverage first-out transactions, the last-out lenders could have the right to control the sale process unless the first-out leverage ratio is greater than certain negotiated thresholds. In such a scenario, the first-out lenders would need to make sure they are comfortable relying solely on their waterfall priority rights.

In the unitranche market, which already contains countless permutations of structure and AAL terms and is continuing to evolve, there is no consensus on what constitutes a typical structure or a typical AAL.

Reinstatement

The LSTA AAL provides that in the event of an avoidance action that results in any first-out lender repaying any amounts it had previously been paid, the first-out obligations subject to such avoidance will be automatically reinstated, and at all times after such reinstatement will retain their priority payment status. However, the LSTA AAL does not address the treatment of any payments received by the last-out lenders in the period prior to such reinstatement. First-out lenders may try to include a provision requiring the last-out lenders to turn any such amounts over to the first-out lenders, while last-out lenders will argue that once they have received and applied loan proceeds (which often include distributions to third-party participants and investors), they have no way of retrieving these amounts and turning them over to the first-out lenders.

Enforceability in Bankruptcy

An important question in unitranche financing is whether a bankruptcy court will exercise its jurisdiction to enforce and construe an AAL in a borrower's bankruptcy case. Like most intercreditor agreements, the LSTA AAL provides that the AAL should be considered a "subordination agreement" under § 510(a) of the Bankruptcy Code. Section 510(a) provides that a subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.

However, a bankruptcy court will not necessarily enforce an agreement simply because it purports to be a subordination agreement. Most observers expect that courts will treat AALs like other intercreditor agreements, enforcing subordination provisions and expressly and clearly stated waivers. Provisions of an intercreditor agreement that clearly relate

3 In the *RadioShack* bankruptcy case, one of the last-out lenders sought to credit bid its portion of the loan and pay (in cash) the first-out lender in full. Although the last-out lender agreed to pay all of the first-out lender's principal and interest in full, the first-out lender argued that the AAL required the last-out lender to establish a reserve to satisfy contingent-indemnification claims that would likely arise in the future as a result of litigation brought by the official committee of unsecured creditors. The first-out lender objected to the credit bid, but the parties ultimately reached a settlement whereby a portion of the sale proceeds were reserved to satisfy the indemnification claims. *See In re RadioShack Corp.*, Case No. 15-10197 (Bankr. D. Del.).

4 *See In re 203 N. LaSalle St. P'ship*, 246 B.R. 325, 331 (Bankr. N.D. Ill. 2000) (concluding that § 510(a) requires courts to enforce provisions regarding subordination of claims and liens, but does not require courts to enforce voting waivers and other provisions in an intercreditor agreement that are contrary to applicable law and do not relate to subordination of claims and liens); *In re Boston Generating LLC*, 440 B.R. 302, 320 (Bankr. S.D.N.Y. 2010) (upholding right of subordinated creditor to object to bidding procedures because purported waiver of that right in intercreditor agreement was ambiguous).

to one claimant subordinating its claims or liens to those of another claimant should be enforced under § 510(a). On the other hand, provisions of an intercreditor agreement that deal with waiver of rights beyond the priority of claims and liens (*e.g.*, waive of the right to credit bid, waiver of the right to object to a sale and voting assignments) are typically only enforced if the waiver is clearly drafted without any ambiguity.[4]

Conclusion

The LSTA AAL is the first industry-wide form AAL to be published in an attempt to provide guidance on many of the important issues that arise in a unitranche facility. In the unitranche market, which already contains countless permutations of structure and AAL terms and is continuing to evolve, there is no consensus on what constitutes a typical structure or a typical AAL. However, the LSTA AAL will, at a minimum, serve as a guide in working through the general terms that come up in AAL negotiations. abi

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