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# Unitranche "Agreements Among Lenders"

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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 fourth of a series on intercreditor arrangements – we examine the "agreement among lenders" ("AAL") that underlies unitranche financing deals.

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

## Background – Unitranche Financing

The term "unitranche" refers to a class of financial products for which, from the perspective of the lenders, the economic risk and reward is distributed differently between two or more lenders by means of an AAL, and for which, from the perspective of the borrower, there is only one tranche of debt under a single credit agreement. This species of credit first began appearing shortly after the 2008 financial crisis and continued to grow in use and acceptance thereafter. Simplicity from the perspective of the borrower and flexibility in delivering to lenders risk and reward according to differing risk appetites drove the popularity of the unitranche product. Allowing direct lenders and other investors to invest in debt that traditional lenders may not have preferred led to the development of an important market.

One advantage of the unitranche structure is a simplified negotiation process. With a single credit agreement governing the relationship, a borrower can focus on one package of covenants, conditions and events of default, as well as a single set of collateral documents. This lowers legal costs, reduces time in negotiation, and makes for an easier administration of the loan over the life of the transaction. In addition, because unitranche loan transactions typically have no "market flex" provisions (provisions which allow for a change in terms if needed to sell the loans to market), the borrower has greater certainty over the "all in" interest cost of the transaction. Finally, repayments of the loan, from the borrower's perspective, pay down the entire loan uniformly rather than the lower cost capital first, which might be typical in, for example, a payment subordinated or first and second lien loan transaction.

One disadvantage for borrowers is that unitranche facilities typically do not include revolving credit, and borrowers using a unitranche product, therefore, often need a separate cash flow or asset based revolver to provide working capital. The need for a second credit product for revolving credit may complicate matters, requiring additional documents negotiated separately from the unitranche facility, but which may have entangling ties to the unitranche facility. For example, a revolving credit provider might also provide part of the first-out capital (that part of the loan which gets paid first) in the unitranche, and require that paydowns of the unitranche capital be tied to a reduction in the revolver.

For lenders, disadvantages of the unitranche facility include the bespoke character of the AAL and the occasional question regarding the enforceability of the AAL in a bankruptcy, particularly given that the only parties normally aware of its terms are the lenders who are party thereto. Section 510(a) of the United States Bankruptcy Code does, however, provide that subordination agreements are enforceable in bankruptcy to the same extent enforceable under applicable non-bankruptcy law, and recent decisions, such as *In re RadioShack Corp.*, Case No. 15-10197 (Bankr. D. Del), while not directly ruling on the issue, suggest that AALs are to be regarded as within the ambit of section 510(a).

## Focus – Agreement Among Lenders

An AAL is essentially an intercreditor agreement, although, as mentioned above, its terms are usually kept confidential from the borrower, and, of course, strangers to the transaction. The provisions of the AAL divide the lenders into two or more classes of lenders, allocate the economics among them according to a waterfall or waterfalls, and allocate certain key rights as well. On the matter of economics, the waterfall allocates greater interest to the last-out lender (the lender that is paid last) as a proportion of its loan amount, but may include a skim of fees to the first-out lender that originated the loan.

The AAL also governs voting, and determines what amendments may be made to the loan agreement with the consent of only one lender (usually the first-out lender) and what amendments may be made only with the consent of the lower ranked lenders. There may be voting provisions that limit cross-over votes between classes to prevent one class from purchasing a majority of another class and controlling votes at the expense of one class to favor another.

The AAL also provides rules governing the exercise of remedies against collateral and unsecured creditor remedies. These are based on negotiated arrangements, permitting either the first-out lender or the last-out lender to control the process. In cases where the last-out lender controls the exercise of remedies, the capital structure is typically such that the last-out lender is likely to recover some amount in all plausible scenarios. This aligns the last-out lender's interest with that of the more senior classes of lender. In a two class AAL where the first-out lender is a very small part of the structure, this arrangement can be known as a "silent" first-out lender.

Typically the direction of the exercise of remedies is done through an allocation of rights to direct the agent to exercise remedies, rather than any right to take any action directly. Again, from the perspective of the borrower, even in the event of an exercise of remedies after an event of default or other credit event, the unitranche loan behaves as though the borrower were dealing with a single tranche of lenders, even though behind the scenes the competing interests of different lenders having different economics may drive the action.

## Negotiating an Agreement Among Lenders

One difference between some intercreditor agreements and a unitranche AAL is that a unitranche credit agreement typically does not contain references to the intercreditor agreement, such as an override provision. Override provisions usually state that in the event of a conflict between the credit agreement and the intercreditor agreement, the intercreditor agreement prevails. Since the borrower in a unitranche transaction is not a party to, and does not know the terms contained in, the AAL, the credit agreement cannot contain an override (as a matter of law, an override of an unknown document may not be enforceable against a borrower for lack of satisfying the requirements of contract formation). Thus, if an AAL contains provisions that are irreconcilably at odds with the credit agreement, the lenders party to the AAL will be required to abide by the terms in the credit agreement.

That said, an AAL will typically refer to, and govern the lenders' use of, the voting provisions to the credit agreement. The sacred rights (those rights that require all lenders to amend) in the credit agreement may be restated in the AAL and additional sacred rights, which prohibit one lender from voting in favor of changes to which other lenders have not also agreed, may be included.

It is important to emphasize that while market conventions have developed, there remains no standard form for an AAL. Confidentiality surrounding these documents limits the growth of precedent. As a result, these documents tend to be highly bespoke with various provisions that are structured around the particular needs of the lenders to the particular credit agreement.

Below are some of the key negotiating points that arise in unitranche financing AALs.

### The Waterfall

The core of an AAL is the waterfall. The waterfall typically has two basic operating modes. The first mode deals with the allocation of regular payments of interest and principal (if any) in the ordinary course. This first mode of the waterfall allocates interest payments (and principal repayments, if any) made by the borrower among the different tranches of lenders such that the last-out lender receives a higher yield and the first-out lender receives a lower yield, commensurate with such lender's lower risk.

The second mode of waterfall allocates payments received after an event of default or a similar credit event. This mode of waterfall, rather than representing the distribution of yield, represents the distribution of risk in the downside case. The first-out lender is typically paid first with respect to its yield and principal from payments after an event of default or from the exercise of remedies. The last-out lender receives what remains after the first-out lender is paid in full.

**First-out Lender perspective**: From the first-out lender's perspective, the key elements of the pre-credit event waterfall are that the yield is divided in accordance with the bargained-for economics, including with respect to any skim on fees for the origination. The first-out lender has a singular concern in a post-credit event waterfall: first recovery ahead of any last-out lender. All payments after a credit event are paid first to the first-out lender's yield and then to the first-out lender's return of capital, regardless of whether the payment is made in respect of principal or interest.

**Last-out Lender perspective:** The last-out lender's perspective on the waterfall is the inverse image of the first-out lender's perspective. The last-out lender receives a greater yield in the pre-credit event waterfall from payments of interest. In the post-credit event waterfall, the last-out lender receives distributions only after the payment in full of the first-out lender. To the extent that the last-out lender receives any distribution of payments or value from adequate protection awarded in a bankruptcy, the last-out lender must turn the same over to be applied in accordance with the waterfall.

**Turnover Provisions:** In order to enforce waterfall provisions, as is typical in other intercreditor arrangements, an AAL usually provides that payments received in respect of the credit, whether before or after an event of default or other credit event, must be held in trust and turned over for application in accordance with the waterfall. This ensures that there is no circumvention of the allocation of yield or the allocation of risk by a lender that receives a payment or other compensation apart from the agent or other intermediary that is to run the waterfall as payments or collections are received.

### Remedies

The remedies provisions of an AAL can be structured in several ways. One typical structure designates a controlling lender that has the right to direct the agent after an event of default or

other credit event. The controlling lender has the right to determine most – if not all – decisions with respect the exercise of remedies, such as acceleration or actions taken against collateral. These decisions and the timing of these decisions can critically affect recovery values, so the allocation of these rights is often a high impact item.

**First-out Lender perspective**: From the first-out lender's perspective, having the right to control the exercise of remedies is critical in all but a few cases. Recall that the first-out lender has accepted a lower yield. That lower yield is tied to greater certainty with respect to recovery. That certainty requires that the first-out lender "calls the shots" with respect to the actions to recover. There is one circumstance where the first-out lender may be indifferent as to who "calls the shots," namely, where the first-out lender's exposure is small enough that in all plausible scenarios the collateral value will exceed the amount of the first-out lender's claims. In such circumstances, the last-out lender having the larger exposure has the incentive in all plausible scenarios to maximize recovery of collateral.

**Last-out Lender perspective:** From the last-out lender's perspective, it accepts the backseat in directing the exercise of remedies so long as the first-out lender's exposure is significant enough to incentivize the first-out lender to seek recoveries that maximize the value of the enterprise, or assets, thus maximizing recovery of the last-out lender as well. Last-out lenders must beware, however, of remedies provisions that would permit a sale of the assets outside of the context of bankruptcy court supervision without adequate assurance of an auction or sale process properly designed to maximize the sale price, as well as provisions with respect to credit bidding by the first-out lender. Poorly constructed provisions with respect to these key issues can result in incentives that are unfair to the last-out lender. The temptation in a downside case to structure a sale below the full value of the assets to pay the first-out lender in full can be real, and the right of the first-out lender to control remedies ought not permit waste of the recoverable assets.

**Insolvency**

An AAL almost always has provisions governing bankruptcy. These can be similar to those found in a first-lien / second-lien intercreditor agreement. For example, these provisions can provide the first-out lender with the right to silence the last-out lender with respect to approval of a debtor-in-possession financing (financing provided after the commencement of a bankruptcy case). In such circumstances, the last-out lender may be obliged to abjure objection to a debtor-in-possession financing or use of cash collateral so long as the basic conditions are met, such as the receipt of replacement liens and superpriority claims for any diminution in value resulting from the priming of the liens or the use of cash collateral.

The issue of adequate protection highlights an issue that is to some extent unique to unitranche loans. Because from the perspective of the borrower a unitranche loan represents a uniform claim of the lenders thereunder against it, a diminution in value claim in a bankruptcy will accrue to both lenders in proportion to their respective interests in collateral. To address this, all recoveries, including from adequate protection, flow through the waterfall in the AAL.

Another distinction of which unitranche lenders should be aware, in a bankruptcy proceeding only over-secured lenders are entitled to accrue interest. In a first lien / second lien arrangement it is possible that a first lien lender might accrue interest in a case in bankruptcy up to the value of the collateral. In a unitranche transaction, no interest accrues to the claims if any part of the

credit facility is underwater. However, the first-out lender normally takes its interest (at the default rate as provided in the AAL waterfall) first from any recovery.

**First-out Lender perspective**: From the first-out lender's perspective, the limitations on bankruptcy rights in an AAL ought to be similar to that for a first lien / second lien lender arrangement. The first-out lender will often want to have the right to consent to debtor in possession financing without the consent of the last-out lender, and to have the seat at the table to provide the same or to have a hand in negotiating its terms. In addition, the first-out lender may want control over bankruptcy approved sales, such as 363 sales and 1129 plan sales, without further consent of the last-out lender.

**Last-out Lender perspective:** From the last-out lender's perspective the limitations on bankruptcy rights in an AAL are a critical negotiating point in the agreement. A last-out lender wants debtor in possession financing to be reasonably sized and priced so as to not unduly impair the last-out recovery with the funding of excessive administrative expenses. A last-out lender also wants to be able to object to any debtor-in-possession financing that does not provide at least a replacement lien on unencumbered assets as adequate protection. While adequate protection recoveries flow through the waterfall, adequate protection claims are the only way that a last-out lender can be made whole from the decline in value of the collateral resulting from a priming lien (a lien that has first priority over existing liens by order of the bankruptcy court under section 364 of the Bankruptcy Code) or use of cash collateral. Finally, with respect to sales in any insolvency, the last-out lender wants to be protected at least to the extent of retaining in all cases a lien on the proceeds of any sale of collateral so that the proceeds flow through the waterfall, avoiding loss due to a sale that results in proceeds of the unitranche collateral flowing to unsecured creditors.

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