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Structuring Agreements Among Lenders in Unitranche Loan Facilities: New LSTA Form

Tranching, Payment Waterfalls, Interest and Fees, Voting, Buyouts, Standstill and Assignment Provisions, Enforcement in Bankruptcy

THURSDAY, AUGUST 22, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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King & Spalding

UNITRANCHE FINANCING

August 22, 2019

Evolution of the Unitranche Product

- History
  - 1^{st} Lien/2^{nd} Lien Debt
  - Subordinated Debt
  - Mezzanine with a Lien
- Size of Market
- Players
- Trends

1st Lien/2nd Lien vs Unitranche Financing

1st Lien/2nd Lien Financing	Unitranche
Two separate groups of lenders	One set of Lenders; tranched in the AAL
Two separate agents	Single agent
Two sets of loan documents	Single debt agreement with borrower; Single set of collateral documents; Single set of covenants
Two liens with lien subordination; one common collateral pool	Single Lien; One common collateral pool

Advantages of Unitranche

- Speed of Transaction
- Certainty of Closing
- Reduced Closing Costs
- Post-Closing Administration Simplicity

Disadvantages of Unitranche

- Less established market and great variety of structures seen in the market
- Less precedent for assessing enforceability
- Syndication complications
- More “Last Out” friendly
- Bankruptcy complications
- Market movement to mitigate disadvantages
  - Market practice for Credit Parties to sign AAL

Agreement Among Lenders (AAL)

- Separate agreement that creates separate “first out” and “last out” tranches of the unitranche
- Reallocation of interest between lenders
- Payment waterfall
- Voting rights of lenders
- Purchase option
- Remedy standstill
- Bankruptcy Provisions

Agreement Among Lenders (AAL)

- LSTA Model Form Agreement Among Lenders
  - "this form is best used for a synthetic first lien/second lien unitranche financing where the first out holders and last out holders intend to split the rights and risks in a manner consistent with a balanced, typical first lien/second lien financing"
  - The "intention is for this form to serve as a helpful drafting resource and we have included different drafting options along with explanatory footnotes"
- LSTA distributed an initial exposure draft in October 2017; Final form was distributed in March 2019
  - Included multiple rounds of comments from members of the Primary Market Committee
- Represents LSTA's first published document intended for middle market lending

Tranching

- “First Out”
  - Revolver/ Protective Advances/ Letters of Credit
  - Portion of Closing Date Term Loan/Term Loan A
  - Hedge and Cash Management Products
- “Last Out”
  - Portion of Closing Date Term Loan/Term Loan B
  - Protective Advances?
- Tranche Sizing/Leverage Position Often Determines Controlling Tranche

Tranching

- Negotiation Points:
  - Sizing
  - Caps
    - "Maximum First Out/Last Out Amount"
    - "Permitted Swap/Bank Products Obligations Amount"
    - DIP Financing
  - Incremental Facility (ratable)
  - Movement to Credit Agreement

Waterfall

- Prior to trigger event, payments are allocated per the debt agreement (subject to interest/fee skim if not already set forth in debt agreement).
  - Ratable payment
- After trigger event, AAL reallocates all collateral proceeds and all payments received post trigger to affect first out/last out priority.
  - Agent fees and expenses paid first, followed by all first out amounts, and finally all last out amounts.

Waterfall

- Trigger events (from LSTA AAL):
  - Payment default
  - Financial covenant default
  - Bankruptcy
  - Acceleration/Commencement of exercise of remedies
  - Others:
    - Terminate Revolver
    - Failure to deliver financial statements
    - Failure to timely deliver a borrowing base certificate (ABL deals)

Waterfall

- Negotiation Points:
  - Trigger Grace Periods/Financial Covenant Cushions
    - Highly leveraged Last Out facility
  - Proceeds of Collateral
  - Automatic or Required Notice
  - Last Out Representative
  - Priority of Prepayment Premiums
  - Last Out Protective Advances
  - Different Waterfalls Based on Trigger Event

Economics

- Interest in excess of an agreed upon amount is paid over to Last Out Lenders
  - Match economics from a first/second lien financing
- Skim does not typically apply to “other” first out obligations such as hedging obligations, bank products etc., but <u>may</u> apply to revolving loans
- Voluntary and mandatory prepayments typically applied pro rata to first out and last out term loans, but this application is often deal specific

Economics

- Negotiation Points:
  - Default Interest
  - Mandatory/Voluntary Prepayments
    - Applicability of First Out Leverage Ratio
  - Amortization
  - Prepayment Premium
  - Last Out Protective Advances

Voting Rights

- Amendments generally are Required Lenders vote (subject to sacred rights)
  - Could result in Last Out Lender control
- AAL may override required lender votes to require a majority of first out lenders and a majority of last out lenders
  - Could result in deadlock
  - Economics ultimately will govern
- AAL may also include a list of items requiring approval of all lenders.
- Upon a trigger event, majority of first out lenders may control amendments on certain aspects of the debt documents.

Voting Rights

- Negotiation Points
  - Trigger events may include payment default, bankruptcy default, or exercise of remedies, with delivery of notice to the relevant tranche.
  - Following Event of Default, period during which neither tranche can act alone
  - Revolver rights/protections
  - Drag along requirements
  - Last Out Control and Control Triggers
    - First Out Leverage Ratio

Purchase Option

- Principal way to resolve disagreement on how to proceed in a restructuring/workout
- Provides last out lenders with right to purchase the first out obligations upon the occurrence of certain trigger events
- Extends standstill
- First out lenders may have a limited right to purchase the last out obligations

Purchase Option

- Trigger Events (from LSTA AAL):
  - Acceleration
  - Termination of Revolver
  - Bankruptcy
  - FO Lenders have directed commencement of exercise of remedies
  - Waterfall Trigger/Activation
  - Payment Default (over minimum amount)

Purchase Option

- Negotiation Points
  - Trigger events
  - Holdout Lenders
  - Prepayment claw-back
  - Letters of Credit/Bank Products
  - Indemnity Rights
  - Minimum hold to exercise?

Exercise of Remedies/Standstill

- Debt agreement may provide that a majority of lenders control remedies (which would mean the larger tranche controls) or that a majority of either class or both classes is required to institute remedies.
- Control over remedies may change based on trigger events.
- Standstill Periods
  - First Out Lenders
  - Last Out Lenders
  - Reversed in highly leveraged Last Out facility

Exercise of Remedies/Standstill

- Negotiation Points
  - Definition of “Exercise of Remedies” (from LSTA AAL)
    - Acceleration
    - Solicitation of bids/Retention of sales brokers/bankers, etc. (with specific exclusions)
    - Action to foreclose on lien/take other remedy/sell or dispose (all/any portion/any material portion of collateral)
    - Bankruptcy

Exercise of Remedies/Standstill

- Negotiation Points
  - Definition of “Exercise of Remedies” (from LSTA AAL)
    - Exclusions:
      - Actions to perfect
      - Charging default interest (governed by other Sections of the AAL)
      - Delivery of notice of default
      - Filing proof of claim (governed by other Sections of the AAL)
      - Refusal to extend credit due to continuing default

Exercise of Remedies/Standstill

- Negotiation Points
  - Initial Control
  - Standstill
  - Exigent Circumstances
  - Permitted Actions (specific performance, actions to toll statute of limitations)
  - Unsecured creditor rights
  - Revolver protections
    - Terminate commitments
    - Sweep of cash/notices to DACA banks

Assignability

- Consent rights
  - Agent
  - Borrower
- Right of first offer/Right of first refusal
  - Requirement to offer within Class first

Assignability

- Negotiation Points
  - Eligible Transferee
  - Cross-over Lenders/Threshold

Comparison to Traditional Subordinated Debt

	Traditional Subordinated Debt	Unitranche Facility
Cap on Senior Debt	Set forth in intercreditor (10 to 20%)	Set forth in AAL (10 to 20%)
Cap on Junior Debt	If any, set forth in intercreditor (10 to 20%)	If any, set forth in AAL (10 to 20%)
Principal reductions	No prepayment of subordinated debt; All amortization to senior lender	Principal reductions applied pro rata to first out and last out tranche; may specifically negotiate allocations of mandatory prepayments
Payment Blockage	180 days for Covenant Default Indefinite for Payment Default	Indefinite after any occurrence of a "trigger event"; usually higher threshold than simple covenant default
Remedy Standstill	150 – 180 days for exercise of remedies by subordinated lender None for senior lender	90 – 120 days for exercise of remedies by last out lender 0 - 30 days for exercise of remedies by first out lender
Voting	Inherent class voting due to separate credit agreements, although covenant levels in subordinated agreement typically reflect a cushion	Either: Class voting with certain "drag along" rights in favor of first out lenders or Majority lender with certain protective class votes in favor of smaller holder (whether first out or last out)
Buy – Out Rights	Subordinated lender has purchase option on senior debt after certain triggering events.	Last out lenders have purchase option on first out debt. First out lenders may have ROFO on sale of last out debt
Amendment of intercreditor agreement/AAL	Required Lenders under each facility	100% of lenders

Bankruptcy Concerns

- Section 510(a) of the Bankruptcy Code:

  "A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law."

Bankruptcy Concerns (cont.)

- Does an AAL constitute a Subordination Agreement?
  - Payment provisions
  - Post-petition interest, fees & expenses
  - Classification of claims and voting on a bankruptcy plan
  - Credit bidding
  - Sale of assets
  - DIP financing/use of cash collateral

Bankruptcy Concerns (cont.)

- A 2015 ruling in the *RadioShack* bankruptcy construed and enforced the terms of the applicable AAL.
  - The Last Out Lender opposed an asset sale that was supported by the First Out Lender.
  - The Bankruptcy Court concluded that certain objections raised by the Last Out Lender were prohibited under the AAL.

Bankruptcy Issues: Plan Classification

- AALs typically provide that each tranche will be separately classified
- In the event that the claims are classified together, each class agrees that it will not vote to approve a plan unless at least two-thirds in amount and more than one-half in number of the other tranche votes to approve.
- AAL may also limit Last Out lenders' ability to support certain types of plans without payment in full of First Out Obligations (see Section 3(f)(ii) of Form AAL, bracketed)
- Enforceability of voting agreements may be questioned.

Bankruptcy Issues: DIP Financing

- Oftentimes, First Out lender has the right to provide or approve DIP financing/cash collateral usage and all Last Out lenders will be deemed to consent.
- The LSTA Form AAL acknowledges that, in some AALs, the LO Lenders will have the right to provide DIP Financing.
- Don’t forget consent to carve out.

Bankruptcy Issues: Reorg. Securities

- AALs typically contemplate the receipt by the Agent of Reorganization Securities (debt and/or equity) in connection with a Plan.
- If the AAL requires debt Reorganization Securities to be distributed initially to the First Out lenders, valuation is critical.
    - Fair market v. plan valuation

Bankruptcy Issues: Credit Bidding

- LSTA AAL provides that no Last Out lender may credit bid unless the cash proceeds of the bid are sufficient to pay First Out obligations in full. First Out lenders have discretion to credit bid.
- In some low-leverage first-out transactions, First Out lenders will be blocked from credit bidding unless leverage ratios exceed certain thresholds.
- This is another provision where Last Out lenders have been seeking to assert more control.

Bankruptcy Issues: Collateral Sales

- Like 1st/2nd lien transactions, AALs typically provide that the Last Out lenders consent to a sale of collateral supported by the First Out lenders, so long as proceeds are applied pursuant to the waterfall. The LSTA form takes this approach
- Last Out lenders will seek to preserve rights/objections of an unsecured creditor.
- As with credit-bidding, Last Out lenders will seek more ability to direct the sale of collateral in low-leverage first-out deals.

Bankruptcy Issues: Reinstatement

- LSTA AAL provides that First Out obligations will be reinstated if prior payments are clawed back.
- However, the form does not address treatment of payments received prior to claw back.
- First Out lenders will push to have all such payments turned over.

Thank You

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