A united front

Unitranche facilities have changed dynamics between first and last out lenders. Their relationship is set out in a separate agreement, usually not involving the borrower

Loan documents governing a US-style unitranche financing generally provide for a single tranche of debt, with a single interest rate, secured by a single grant of a security interest contained in a single set of security documents. At risk of over-simplification, a separate agreement among lenders (AAL) to which the borrower is not usually a party, splits the single tranche of debt into a first out (FO) tranche and a last out (LO) tranche.

While there are, of course, provisions that are frequently included in AALs with a FO/LO structure, there are areas where FO and LO lenders tend to disagree. Further, some important bankruptcy and other issues are often overlooked in AALs. Failing to address these can unintentionally change the economics and outcomes the parties had bargained for.

Which issues are addressed in an AAL?

Generally, an AAL contains eight substantive provisions:

- tranching
- payment waterfall
- reallocation of economics
- voting
- buyout rights
- right of first refusal or right of first offer
- exercise of remedies and remedy standstills
- bankruptcy-related matters

As these provisions are often heavily negotiated or structured to reflect deal-specific considerations, each merits a closer look.

Tranching

The tranches are created under the AAL by contractually tranching the debt provided for under the loan agreement into FO debt and LO debt. If the credit agreement provides for a revolver, that generally falls into the FO bucket. FO debt also often includes protective advances or overadvances, cash management and hedging obligations owed to FO lenders and their affiliates, a specified portion of the term loan drawn at closing, and any delayed draw or incremental loan commitments held by FO lenders.

LO debt is essentially the debt provided for under the credit agreement other than FO debt; although the defined term in the AAL will typically identify the LO debt. LO debt usually includes the balance of the closing date term loan not included in FO debt (which tends to be the bulk of that loan) and any delayed draw or incremental term loan commitments held by LO lenders.

Payment waterfall

Unless a waterfall trigger event exists, the payment waterfall in the loan agreement governs. Under the loan agreement, the FO and LO obligations are usually paid *pari passu* at all times.

When a waterfall trigger event exists, all collateral proceeds and payments from the borrower (other than permitted reorganisation securities or adequate protection payments issued or paid to LO lenders to the extent not in breach of the AAL) are applied according to the AAL payment waterfall.

During a trigger event, FO obligations are usually paid in full first, and then LO obligations. However, the amount of FO obligations is often capped for purposes of the payment waterfall. In most cases, any amounts in excess of that cap are deemed excess FO obligations, and are payable after the LO obligations. If addressed in the AAL, FO obligations held by a private equity sponsor or affiliates (or in some cases by a defaulting FO lender) are usually paid after the LO obligations. LO lenders often push to:

- exclude from the FO obligations payable under the waterfall disallowed post-petition default interest, interest on interest, and loan fees;
- require that any payments applied to FO revolving loans be accompanied by a corresponding reduction in the revolving commitments (to ensure that those amounts can't be reborrowed and flow through the waterfall more than once); and
- cap the amount or limit the type of certain FO obligations (such as hedging and bank product obligations and protective advances) payable ahead of LO obligations. This is typically in accordance with what is bargained for when setting the first lien debt cap in a first/second lien intercreditor agreement.

Typical triggers for the AAL waterfall include: an ongoing payment event of default (sometimes in excess of a specified amount and often limited to a payment event of default on the FO obligations); a bankruptcy or insolvency event of default; an ongoing financial maintenance covenant event of default, often subject to a negotiated percentage cushion from the applicable covenant level in the loan agreement; and, delivery of notice by the FO lenders directing the agent to exercise secured creditor remedies, which often includes acceleration of the obligations.

Another trigger sought by some FO lenders is an injunction that prevents the loan parties from conducting a material portion of their business. If there is a corresponding event of default in the loan agreement, this may be harder for LO lenders to successfully push back on. However many LO lenders believe that the loan agreement language is not dispositive or even relevant.

LO lenders usually have a separate right to buyout the FO obligations. For some LO lenders it is important to be able to exercise that buyout right whenever a payment waterfall trigger is in effect. This should not be an issue for most FO lenders. In a number of AALs, though, the buyout triggers are narrower than the waterfall triggers. In some cases, this reflects the business deal; in others it may be an oversight.

Reallocation of economics

In a unitranche deal, the loan agreement contains a single interest rate. Since the AAL bifurcates the debt into pieces with different risk profiles, the AAL adjusts the yield payable to the FO and LO lenders. It does this through so-called skim provisions that reallocate interest payments, and sometimes other amounts payable by the borrower, from the FO lenders (or their agent) to the LO lenders. In some deals with call protection, the call premium is allocated to the LO lenders, while in others it is shared ratably between the FO and LO lenders.

These provisions aim to make the effective interest rate payable to the LO lenders the same as the rate that the LO lenders would charge in a first/second lien deal in which the LO lenders hold second lien debt.

Amounts subject to the skim are required to be turned over to the LO lenders by the FO agent, to the extent actually received by the FO agent in cash. The so-called in-cash requirement may be problematic for LO lenders in deals where the FO debt includes paid-in-kind (PIK) interest. Unless the AAL language is modified to address non-cash interest, the turnover will not include PIK interest – which is to the detriment of the LO lenders. The intended treatment of PIK interest therefore needs to be carefully considered by the LO lenders. The payment waterfall may also need to be changed to address PIK interest.

Voting

An AAL generally includes provisions setting out the requisite lender consents to amend, modify or waive terms of the loan documents. These are in addition to the voting requirements in the loan agreement. The AAL provisions are intended to give FO and LO lenders a say in certain changes that are adverse to their interests, by providing class voting rights. Despite the simple premise, the voting provisions and the degree of protection afforded to lenders vary significantly from deal to deal. In some cases, the consent of required FO lenders and required LO lenders is needed at all times. In others, required LO lenders control voting, subject to negotiated exceptions where required FO lender consent is also needed. The scope of the exceptions differs from deal to deal. Sometimes the AAL voting provisions apply only during a voting trigger event. These triggers are often heavily negotiated. In some deals, the voting triggers are similar to the AAL waterfall trigger events.

'Required FO lenders' and 'required LO lenders' are typically defined as the holders of a majority in interest of their respective tranches of debt, including commitments.

Buyout rights

LO lenders with a significant stake in the LO tranche (either a minimum percentage or dollar amount) typically have the right to purchase FO obligations when a trigger event is ongoing. In some deals the buyout trigger is any event of default, but it is usually narrower. Common trigger events include: acceleration under the loan agreement; an ongoing payment event of default (sometimes in excess of a specified amount, and sometimes limited to a payment event of default on the LO obligations); a bankruptcy or insolvency event of default; and breach of a maximum FO leverage ratio.

LO lenders often push to include other trigger events. By way of example, these can include delivery of notice by FO lenders to the agent directing the agent to exercise secured creditor remedies, and a payment event of default on the FO obligations. They may also push for any other waterfall trigger events not otherwise included in the buyout trigger events.

In addition, some AALs include a yank-a-bank type trigger. This allows LO lenders holding buyout rights to buy the debt of FO lenders that don't vote in favour of an amendment to the loan documents approved by required LO lenders, but not required FO lenders. The yank-a-bank trigger often does not apply to amendments to so-called sacred rights provisions; these can only be amended under the credit agreement by all lenders or all affected lenders.

Generally, the LO lenders must purchase all FO obligations (limited in the case of a yank-a-bank trigger to the FO obligations of the non-approving FO lenders). The purchase price is typically par, and often includes any prepayment premiums received by the LO lenders within a certain period (often 90 days) following the purchase of the FO obligations. It's common for LO lenders to further limit the turnover of prepayment premiums to those amounts that the FO lenders would otherwise have been entitled to under the loan documents.

A more controversial point is whether the LO lenders can release the liens securing bank product and hedging obligations which are provided by FO lenders (or their affiliates) and included in the purchased obligations. FO lenders usually feel strongly that LO lenders should not be able to do this. However, in some deals, FO lenders have agreed that these obligations must remain secured only as long as, and to the extent that, the LO obligations are secured.

Right of first offer or refusal

These provisions are for the benefit of LO lenders with a significant stake in the LO tranche (typically based on the same test that governs eligibility to exercise buyout rights). They provide a right of first offer (ROFO) or right of first refusal (ROFR) to purchase any loans or commitments proposed to be sold by a FO lender to a third party. In some deals, the loans or commitments must be offered first to the other FO lenders before offering them to LO lenders.

Under a ROFO, an eligible LO lender can specify an offer price that the selling lender can accept or reject. With a ROFR, the purchase price is the price specified by the selling lender. If the parties don't agree on a purchase price under the ROFO, or if the ROFR is not exercised, the selling lender usually has around 90 days to close a sale to a third party. This is conditional on the net cash consideration received by the selling lender being at least equal to the highest price, if any, offered to the seller in the ROFO, or the price set by the seller in the ROFR.

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In some deals, there is a reciprocal ROFO or ROFR running in favour of eligible FO lenders.

Exercise of remedies and remedy standstills

During a remedies trigger event, some AALs give FO lenders the initial right to exercise secured creditor remedies, subject to the right of required LO lenders to exercise secured creditor remedies if required FO lenders fail to exercise those remedies within a specified period. An alternative formulation, which in the real world generally gets to the same result, is to allow either required FO lenders or required LO lenders to initiate the exercise of remedies, after the standstill period expires. LO lenders are generally always subject to a standstill period, often between 60 to 90 days. FO lenders are often, but not always, subject to a standstill period; if so, it is shorter than the LO lender standstill. As a result, if LO lenders decide to exercise remedies, FO lenders can take control over remedies if they act before the LO lender standstill expires. In practice, it is unlikely that FO lenders will allow LO lenders to control the exercise of remedies.

The remedies trigger event may be any event of default, although it is common to require both an event of default and a separate remedies trigger event. Those trigger events are often the same as, or very similar to, the waterfall trigger events.

Bankruptcy-related issues and provisions

Under the US Bankruptcy Code (Code), a subordination agreement is as enforceable in a bankruptcy as it is outside of it. Many AALs contain a self-serving statement that the AAL is a subordination agreement for the purposes of the Code. These statements are likely to have little effect, as the bankruptcy court will enforce based on the agreement's operative terms, and parties usually cannot contract around the Code.

An inherent risk in unitranche deals is that the claims of the FO and LO lenders will be classified as a single class under a chapter 11 reorganisation plan. A bankruptcy court may disregard the contractual tranching of the debt in the AAL (to which the debtor is not a party) and instead decide the issue with reference to the loan agreement (to which the debtor is a party) which provides for a single tranche of debt.

The intended treatment of PIK interest therefore needs to be carefully considered by the LO lenders

To FO and LO lenders, classification matters for at least two reasons.

First, a secured creditor is entitled to post-petition interest to the extent that the value of its collateral exceeds the amount of its claim. Take the example of a debtor owing $50 million to the FO lenders and $150 million to the LO lenders, the collateral being worth $75 million, and the FO and LO claims being classified separately. The FO lenders would have a $50 million secured claim, and the LO lenders a $25 million secured claim and a residual $125 million unsecured claim. Only the FO lenders are entitled to post-petition interest.

However, if the FO and LO claims are classified as a single $200 million claim, which is undersecured, none of the lenders will be entitled to post-petition interest. FO lenders generally protect against this risk by providing that the FO obligations entitled to payment priority include post-petition interest on the FO tranche (with possible exceptions for default interest and interest on interest). The effect is to reduce dollar-for-dollar the amount of the LO lenders' secured claim by the amount of that post-petition interest.

Second, creditors in each class have the right to vote on a reorganisation plan. However, in certain circumstances a court may confirm a plan over the objections of a creditor class. If the FO and LO secured claims are in separate classes, one class could possibly be crammed down by the other. As a result, some AALs see FO and LO lenders agree that, as holders of secured claims, they won't vote to accept a plan unless the holders of at least two-thirds in amount and half in number of lenders in the relevant tranche have voted to accept the plan. In other AALs, the mutual no-cram down language is limited to plans with certain features, such as the conversion of FO and LO (debt) obligations to equity reorganisation securities.

Some AALs state that the claims in respect of FO and LO obligations will be classified separately. In others, the FO and LO lenders agree not to object to separate classification under a plan. The latter provision should be enforceable in the bankruptcy case. However, the former is not likely enforceable except as between the FO and LO lenders, not only because parties usually may not contract around the Bankruptcy Code, but also because only the FO and LO lenders are parties to the AAL. A party filing a plan, whether the debtor or the creditor, specifies in the plan the classification of claims, which must comply with the Bankruptcy Code provision that prohibits classification together of claims that are not substantially similar.

Waivers of creditor rights during a bankruptcy

Secured and unsecured creditors have valuable rights in a US bankruptcy. Unsecured creditors may vote on a plan and object to actions taken or not taken in the case. Secured creditors have all of the rights of unsecured creditors and more, such as the right to credit bid and to object to a debtor-in-possession financing secured by liens that are senior to or *pari passu* with that creditor's liens, the use of cash collateral and asset sales.

In some deals, both the FO and LO lenders reserve virtually all of their secured and unsecured creditor rights. An increasingly common approach is to require LO lenders to waive specified secured creditor rights as long as certain conditions are met or protections provided to the LO lenders. The scope of the conditions and protections varies from deal to deal. However, open ended waivers of secured creditor rights are rarely agreed to. LO lenders almost never agree to waive their unsecured creditor rights, but they may agree to not exercise unsecured creditor rights to the extent it would breach the AAL or specified provisions such as the payment waterfall.

Permitted reorganisation securities

An increasing number of deals allow LO lenders to receive permitted reorganisation securities – debt or equity securities issued by a reorganised debtor which have been distributed under a plan on account of FO or LO obligations. This is often allowed if the FO lenders receive permitted reorganisation securities under the plan with a value equal to the allowed amount of the FO secured claims, and any debt or debt-like reorganisation securities issued to LO lenders are subject to an intercreditor agreement on substantially the same terms as the AAL.

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