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## 2017 Southeast Bankruptcy Workshop

### **Unitranche Credit Facilities, Agreements Among Lenders, and Related Bankruptcy Considerations**

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# Unitranche Credit Facilities, Agreements Among Lenders and Related Bankruptcy Considerations

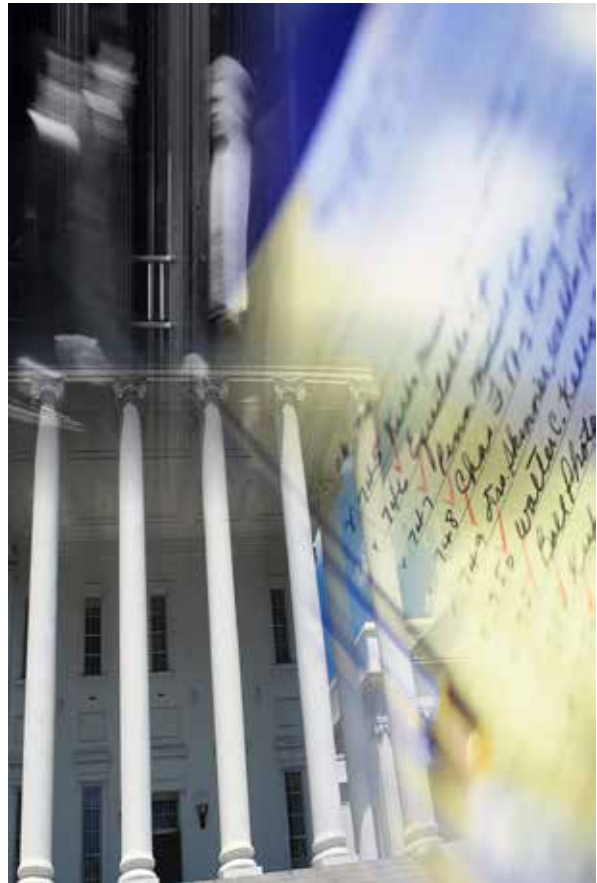
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## Agenda

- Introductions
- Overview and Comparison to Other Structures
- Brief History
- Recent Trends
- Players
- Advantages and Disadvantages
- Agreement Among Lenders
- Key Terms
- Workout and Bankruptcy Issues
- Recent Intercreditor Litigation

## Overview: Traditional Structures

- **1<sup>st</sup> Lien / 2<sup>nd</sup> Lien Debt**
  - Two or more facilities, each with separate liens
  - One common collateral pool for the facilities
  - Lien (but not payment) subordination
- **Subordinated Debt**
  - Two or more facilities
  - Collateral pool would favor only senior lender
  - Payment subordination
- **“Mezzanine with a Lien”**

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## Overview: Unitranche Structure

- **Structure**
  - One debt agreement with borrower(s)
  - One set of collateral documents
  - One collateral pool
  - One agent
- **Nomenclature and Types**
  - Focus of presentation: “First Out / Last Out”
- **Economics**

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## Brief History of the Unitranche Product

- **1990s**
  - Makes appearance in smaller “club” deals
  - One lender seeks yield enhancement
- **Late 1990s / Early 2000s**
  - Unitranche “funds” established
- **Post-2009**
  - Increased liquidity
  - Growth in direct lending funds
  - Declining yields

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## Trends

- Size of Market
  - Private debt - \$700B market
    - Direct Lending - \$160B
  - Growing – Approx. 300 in market; \$120B
- Players
  - Private debt funds, hedge funds, BDC's, banks selectively
- Other Trends
  - Increase in global institutional investors
  - More aggressive market given abundance of capital (i.e., \$200B of dry powder)

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## Why use a Unitranche Facility?

### ➤ Perspective of Issuers (Advantages)

- ✓ Provides for simpler documentation
- ✓ Provides for simpler administration
- ✓ Efficiency by reducing syndication risk
- ✓ Lower debt service burden
- ✓ Higher leverage

### ✓ Perspective of Issuers (Questionable Advantages)

- ✓ Mitigates class voting issues created by two facilities
- ✓ Allows issuer to avoid intercreditor documentation fights

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## Why use a Unitranche Facility?

### ➤ Perspective of First Out Lenders

- ✓ Allows for more competitive pricing with similar risk profile
- ✓ Allows for control over cash flows to last out lenders
- ✓ Greater degree of subordination when ultimately triggered

### ➤ Perspective of Last Out Lenders

- ✓ Structure can be put in place post-closing
- ✓ Flexibility for non-traditional lenders
- ✓ Potentially lower cost of capital on own credit facilities

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## Key Structuring Aspects of a Unitranche Facility

- **Credit Agreement and Collateral Documents**
  - ✓ Negotiated and executed by lenders, agent and borrowers
- **Agreement Among Lenders (“AAL”)**
  - ✓ Re-creates relative rights among lenders
  - ✓ Heavily negotiated intercreditor agreement – typically excludes borrower
  - ✓ Interest reallocation (or “skim”) in favor of the last out lenders
  - ✓ Reallocation of fees and voluntary and mandatory prepayments
  - ✓ Voting provisions among lender group
  - ✓ Contractual waterfall for application of payments post-trigger
  - ✓ Remedial standstill
  - ✓ Restrictions on assignability
  - ✓ Purchase options
  - ✓ Attempts to address bankruptcy issues

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## Material Issues Addressed in AAL

- **Interest Skim Mechanics**
  - ✓ Borrower pays one interest rate under credit agreement
  - ✓ Agent pays over interest in excess of an agreed upon amount to last out lenders
  - ✓ First out lenders keep any default interest
  - ✓ Yield on last out debt is variable
  - ✓ Skim on “ancillary” products and revolving loans
- **Reallocation of Fees and Prepayments**
  - ✓ Commitment fees, facility fees and other regularly accruing fees
  - ✓ Voluntary and mandatory prepayments
    - ✓ Balance competing priorities of lenders
    - ✓ Typically pro rata application, but several variations thereto

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## Material Issues Addressed in AAL

### ➤ Voting Agreement

- ✓ Even holds of first out / last out: typically class votes
- ✓ Majority first out: typically class vote with “drag” rights
- ✓ Majority last out: typically “required lender” with protective votes
- ✓ Cross-over voting: how to treat lenders in both classes

### ➤ Waterfall Triggers and Application of Payments

- ✓ Triggers
  - ✓ Standard: bankruptcy, material (uncured) payment defaults, exercise of remedies
  - ✓ Non-Standard: covenant-based triggers
- ✓ Waterfall
  - ✓ Once triggered, all funds go to first out lenders
  - ✓ Result is indefinite payment blockage
- ✓ Entails greater economic risk for last out lenders in under-secured transactions

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## Material Issues Addressed in AAL

### ➤ Exercise of Remedies and Related Standstill Periods

- ✓ First Out: some standstill period of 15-45 days
- ✓ Last Out: no clear market standard, although most commonly 90-120 days
- ✓ Possible terms:
  - ✓ First out lenders may cause after any EOD and the passage of time (30 days)
  - ✓ First out lenders may cause after the occurrence of an EOD that qualifies as a “waterfall trigger event”
  - ✓ Last out lenders may direct exercise of remedies after a period of time
- ✓ Direction to exercise remedies will trigger purchase options

### ➤ Assignability / Purchase Options

- ✓ Assignability
  - ✓ Customary restrictions seen in non-unitranche credit agreement
  - ✓ Additional consents or restrictions
  - ✓ Right of first offer
- ✓ Purchase Options
  - ✓ Par purchase and prepayment premiums
  - ✓ Limited representations and warranties
  - ✓ Treatment of “ancillary” facilities

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## Material Issues Addressed in AAL

### ➤ Bankruptcy Provisions

- ✓ Attempt to track second lien intercreditor provisions
- ✓ Interplay between 11 U.S.C. § 510(a), applicable non-bankruptcy law and fundamental bankruptcy rights
- ✓ Bankruptcy court jurisdiction
- ✓ Post-petition interest
- ✓ Classification under 11 U.S.C. § 1122(a)
- ✓ 363 Sales
- ✓ Plan considerations
- ✓ Reorganization securities

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## Comparison to Traditional Subordinated Debt

	Traditional Subordinated Debt	Unitranche Facility
Credit Documentation	Two credit agreements with different pricing	One credit agreement reflecting a single blended rate
Collateral Grant	Two separate collateral grants	Single shared collateral grant
Cap on Senior Debt	Set forth in intercreditor (10 to 20%)	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	90 – 120 days for exercise of remedies by last out lender  10 - 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	Required lenders under each facility	100% of lenders

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## Issues with Unitranche Structure

- **Workouts and restructurings are not contemplated**
  - ✓ Assumption that upon “Waterfall Trigger Event”, borrower is liquidated or in bankruptcy
  - ✓ Once triggered, all funds go to first out lenders
  - ✓ In an amendment and waiver of defaults, yield enhancement to the last out facility reduced
  - ✓ Restructuring may require re-tranching of the debt obligations
  - ✓ Restructuring may convert “required lender” issues into 100% voting issues

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## Workout Issues with Unitranche Structure: *Example*

- **Consider the following unitranche example:**
  - \$10MM Revolver/Term A at LIBOR (1% floor) plus 700
  - \$20MM Term A at LIBOR (1% floor) plus 700
- *An event of default occurs as a result of the fixed charge coverage ratio falling below 1:1. This event of default constitutes a “Trigger Event” for application of the AAL waterfall. Borrower continues to make interest payments for 1 year (\$2.4 MM on \$30 MM in principal).*
- *Portion of interest allocable to last out loan is \$1.6MM, but this amount is now paid over to first out lenders. In effect, the ledger balance of the first out lenders has been reduced by \$1.6MM as a result of the turnover.*
  - Scenario 1:** *Requisite first out and last out lenders are willing to waive the event of default and reset covenants due to improving financial performance.*
  - Scenario 2:** *Company continues to struggle and first out lenders are willing to sell obligations (or assets) to an aggressive “vulture fund”.*

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## Workout Issues with Unitranche Structure: *Scenario 1: Lenders Willing to Waive Default*

### **New restructuring issues:**

1. Treatment of first out lenders' claim going forward as either subrogation claim or participation interest given that from borrower's perspective it has only paid interest
2. Responsibility for tracking subrogation/participation rights going forward
3. Amendment of AAL to reflect new payment terms may effectively increase the voting requirement for the type of waiver at issue
4. Borrower's ability to assert a claim against the lenders where AAL voting requirements result in a failed workout process
5. Addressing issues at inception of documentation, if possible

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## Workout Issues with Unitranche Structure: *Scenario 2: Sale of Debt to "Vulture Fund"*

### **New restructuring issues:**

1. Senior lenders' debt may be less attractive to third party purchasers in a unitranche structure as compared to traditional subordinated debt.
2. Senior lenders' ability to sell assets free and clear of liens in a "default disposition" context over the objection of the last out lenders is typically not available.
3. Last out lenders in better position to demand a consent premium for any restructuring outside of bankruptcy (other than a true foreclosure).

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## Bankruptcy Issues with Unitranche Structure

### ➤ Treatment in bankruptcy is uncertain

- ✓ While intercreditor agreements are generally enforceable in bankruptcy, unitranche structures present a novel set of issues
- ✓ Facility is likely to be viewed as a single claim sharing a single lien regardless of drafting which may result in:
  - ✓ Over-secured first out lenders being treated as under-secured
  - ✓ Potential use or priming of collateral over the objection of the required lenders
  - ✓ Many rights as a secured creditor tie back to lien (e.g. adequate protection, 1111(b) election) rather than the first out claim
  - ✓ AAL attempts to contract around this discontinuity

### ➤ Plan Voting Issues

- ✓ Section 1129 permits confirmation of a plan of reorganization “Notwithstanding section 510(a)” - the provision that says a subordination agreement is enforceable in bankruptcy
- ✓ Could first out or last out lenders holding the requisite principal amounts under the Bankruptcy Code approve a plan of reorganization inconsistent with the AAL? Parties may be forced into another forum to enforce the agreement.

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## Bankruptcy Risks

### ➤ Limited precedent on enforceability and impact of *In re RadioShack Corp.*

- ✓ Oral ruling with limited precedential value
- ✓ Dispute related to 363 sale where last out lender sought to purchase assets through a credit bid that would pay the first out lenders in cash
- ✓ One last out lender objected to the fairness of the process
  - ✓ Court overruled last out lender's objection
- ✓ First out lenders objected to the credit bid and argued that their contingent indemnification claims were not being properly cash collateralized
  - ✓ Court did not issue a ruling because parties settled dispute and withheld cash
  - ✓ Before settlement, court made comments suggesting that indemnification claims were part of the first out lenders' claims, but that it would be unreasonable to withhold full amount of sale proceeds

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## Bankruptcy Risks (cont.)

- 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

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## So What Do We Make of the Unitranche Structure?

- Structure is attractive to issuers due to blended rate
- Structure is attractive to last out lenders given the ability to obtain higher leverage and control on the loans
- Structure entails risks in bankruptcy and restructurings that are not fully appreciated, making the product best suited for credits where first out lenders can look to collateral as a source of payment (ABL type facilities)

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## Panelist Contact Information

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