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Unitranche Credit Facilities: An Untested Trend Gains Traction

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The recent frothiness of the credit markets has been accompanied by re-emergence of the so-called unitranche credit facility. This is not surprising given the continuing quest of borrowers in the middle-market space, particularly those with private equity sponsors, for flexibility and simplicity in loan structures.

Unitranche credit facilities arrived on the scene approximately a decade ago. The defining characteristic of a unitranche credit facility is a single credit agreement among the borrower and its senior and mezzanine/junior lenders, with intercreditor arrangements addressed in a separate agreement to which the borrower is not a party. These loan structures are favored by borrowers because, with one credit agreement, they are, at least in theory if not in practice, more easily assembled and closed than a typical first/second debt or lien financing arrangement, thereby reducing the time and cost burdens on a borrower.

But there are also a number of concerns, as yet unanswered by courts, regarding the treatment of unitranche structures in a bankruptcy proceeding.

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Today we explore the characteristics of unitranche credit facilities, the advantages of those structures, and the issues and uncertainty that surround them.

Background

The reason for the attraction of unitranche facilities is obvious. These facilities provide a single credit agreement, single set of security documents and single administrative agent for the lenders. That is music to the ears of borrowers who have struggled to bring junior and senior credit facilities with differing terms and agents into an intercreditor arrangement.

Thus far, unitranche facilities are a feature of the middle market. Middle market borrowers[1] will often finance themselves with both senior and junior lenders, each through separate credit facilities. The junior lenders (i.e., second lien lenders) may hold pari passu secured debt that they subordinate to other lenders solely in respect of their rights to collateral, or they may hold debt obligations (i.e., mezzanine lenders), typically, though not always, unsecured, that are subordinated in right of repayment to other lenders. Traditionally, these loan facilities have been provided under two different sets of credit documents. The borrower and lenders then enter into an intercreditor agreement that sets forth the various lien or debt positions and rights and obligations of each creditor. Large financial institutions tend to occupy the first lien role, whereas the second lien role may often be filled with an alternative debt provider, such as a hedge or private equity fund, or business development company.

In a unitranche facility, the borrower enters into a single secured credit facility with all of the lenders. The credit agreement does not differentiate among lenders in regard to senior versus junior positions, contains one set of covenants, and provides for a single rate of interest payable by the borrower to all lenders, calculated using the weighted average rates that would apply under separate senior/junior loan facilities. In a separate document called the Agreement Among Lenders (AAL), to which the borrower is not a party, the lenders agree amongst themselves to create so-called first-out and last-out tranches. The AAL then governs the respective rights, obligations and priorities of the different tranches, which includes reallocation of a portion of the interest payments from the first-out to the last-out lenders, so that the first-out lenders may receive a lower interest rate and the last-out lenders a higher rate than they would have otherwise under separate facilities.

Features of the AAL

The AAL contains many features recognizable to practitioners familiar with intercreditor arrangements.

Payments are allocated between the tranches based on the concept of a waterfall priority of payments. In general, the first-out and last-out lenders receive interest payments and certain principal payments (such as mandatory prepayments from excess cash flow) pro rata until the occurrence of certain waterfall trigger events, which often include a payment default, a financial covenant default, or a bankruptcy default. After the occurrence of one of these events, the waterfall will apply all payments, including proceeds of collateral, to first-out lender obligations, although prepayment premiums, certain fees and other contingent obligations may be payable after the last-out lenders are paid their principal and interest.

Not unlike many traditional intercreditor agreements, the AAL will often contain provisions granting a buy-out option in favor of the last-out lenders and a right of first refusal in favor of both first-out and last-out lenders. It will also typically contain voting arrangements in regard to amendments, provisions addressing certain rights and restrictions in regard to exercise of remedies in enforcement, and agreements governing conduct in a borrower bankruptcy proceeding. First-out lenders (and occasionally last-out lenders) will sometimes be given the right to make protective advances, subject to a cap; amounts in excess of the cap would be repayable after payment in full to the last-out lenders.

The buy-out right is usually triggered by the same events, such as payment default or bankruptcy, which result in amounts being re-allocated to first-out lenders under the waterfall priority of payments. It may also be triggered if the first-out lenders fail to agree to an amendment to the credit agreement approved by the last-out lenders. The buy-out purchase price is par plus accrued and unpaid interest and sometimes prepayment premium for a limited pre-negotiated period. The buy-out right is often only available to last-out lenders when they hold a minimum percentage of the principal balance of the unitranche loan obligations.

There are a number of concerns, as yet unanswered by courts, regarding the treatment of unitranche structures in a bankruptcy proceeding.

A right of first refusal (ROFR) in favor of both first- and last-out lenders is also a feature of many AAL's. Any lender that wishes to transfer its loan obligations may therefore be required first to offer them to the other lenders (or sometimes just to the last-out lenders). As with the buy-out right, the purchase price for the debt, whether first- or last-out, is equal to the amounts owed to that lender as of the transfer date. Assignments to affiliates, sales of entire portfolios of a lender, assignments to a collection or similar agency or pledges for financing purposes would typically be exceptions to this right. Again, this is often only available to last-out lenders if they hold a minimum percentage of loan obligations in the facility.

The AAL generally requires a majority of both first-out and last-out lenders to agree to amendments or other modifications to the credit documents. However, following an event of default, the majority of first-out lenders will usually have the right to direct the administrative agent with regard to amendments or exercise of remedies (subject to the usual "sacred rights" provisions (i.e., rate, amortization, term and security)). Accordingly, last-out lenders often negotiate a standstill period before the first-out lenders can exercise remedies, usually to enable them to exercise buy-out rights or otherwise negotiate a modification acceptable to the first-out lenders, similar to what one might find in a debt subordination agreement.

AAL's may contain provisions governing actions by the lenders in a bankruptcy proceeding of the borrower, including the procedures for consent to the use of cash collateral, DIP financing and §363 sales of assets.[2] In regard to 363 sales, these procedures oftentimes prohibit the first-out lenders from objecting to a sale of collateral provided the sale is approved by the last-out lenders and the lien of the first-out lenders attaches to the proceeds of the sold collateral. As further examined below, the effect and enforceability of a number of these provisions may be open to question.

Bankruptcy Considerations

Perhaps the most-discussed concern with respect to unitranche facilities is how the AAL would be construed and enforced in the borrower's bankruptcy.

As noted above, the unitranche facility is comprised of a single credit facility and a single legal obligation. As a result, in a bankruptcy proceeding involving the unitranche borrower there is a risk that the entire unitranche loan will be viewed as a single secured claim. If the collateral is insufficient to secure the entire unitranche loan, it may be deemed as an unsecured claim in its entirety. By contrast, in a first lien/second lien or debt facility, because each facility provides separate legal obligations for the borrower, the first priority lender does not face the risk of being unsecured because of an under-collateralized position in the second lien debt facility.

A finding by a bankruptcy court that a unitranche claim is undersecured could prevent a first-out lender from receiving post-petition interest, expenses and adequate protection payments.[3] In addition, under §1122(a) of the Bankruptcy Code,[4] a plan may place claims or interests into a particular class only if that claim or interest is substantially similar to the other claims or interest of such class. Section 1126(d) of the Bankruptcy Code[5] requires at least two-thirds in amount and a majority in number of allowed claims to approve a plan of reorganization of a debtor. If last-out lenders and first-out lenders are not considered one class of creditors under a proposed plan of reorganization, there is a risk last-out lenders may reject a plan of reorganization accepted by first-out lenders. Moreover, if the lenders are considered one class of creditors, but if, for example, last-out lenders constitute at least two-thirds in amount and a majority in number of creditors under the facility, the last-out lenders may consent to a plan of reorganization rejected by the first-out lenders. While AAL's can be drafted to prevent these results by including "silent seconds" provisions that prohibit last-out lenders from objecting to actions supported by the first-out lenders, AAL's remain untested in bankruptcy court.

Parties seeking to enforce an AAL may find themselves unable to do so in the debtor's bankruptcy proceeding, given that, unlike a traditional intercreditor agreement, the borrower is not a party to the AAL. It is possible that a bankruptcy court will hold that it does not have jurisdiction over an AAL.[6] That result may require creditors to commence an entirely new proceeding in a different forum outside the bankruptcy case in order to enforce the AAL.

It is important to note that there is apparently no reported case law as to how a unitranche structure would be treated in bankruptcy.[7] Case law discussing intercreditor agreements may be instructive, but, as discussed above, there are distinct differences between the AAL and a first lien/second lien or debt intercreditor agreement, and there is no guarantee that the same principles will apply. As a result, there is a significant element of uncertainty associated with this structure.

Other Considerations

Unitranche loan facilities have been touted for their speed and efficiency in both closing and administration. Unitranche borrowers certainly have the benefit of negotiating one set of covenants and one set of lien documents, with one lead lender or a small group of lenders, as opposed to two separate credit facilities. In the context of acquisition financings, this clearly can present a significant benefit to a bidding sponsor looking to provide speed of execution. Moreover, it is said, the borrower does not need to mediate the sometimes contentious intercreditor agreement negotiations between the senior and junior lenders, further reducing delay.

While AAL's can be drafted to prevent these results by including "silent seconds" provisions that prohibit last-out lenders from objecting to actions supported by the first-out lenders, AAL's remain untested in bankruptcy court.

However, as unitranche facilities have grown in popularity, so has the typical size of these facilities and, accordingly, the number of lenders and likelihood for the need to syndicate these facilities, either before or after closing. Hence, while the borrower may be negotiating only one credit agreement with a lead or small number of lenders, a lead lender may itself be negotiating with other groups of lenders who will need to agree to the AAL either before or after closing.

In that respect, the behind-the-scenes nature of the AAL may not contribute all that much to the speed and efficiency of closing the credit facility. In addition, given that under the AAL amendments and modifications often need to be approved by a majority of both groups of lenders (as compared in many credit facilities to a majority of all lenders), there is a question whether unitranche facilities with multiple lenders will be able to continue to provide the expediency for which they are noted.

Unitranche loans, because they are still so bespoke, are relatively illiquid. Any assignee would have to become a party to the AAL, an agreement that lacks the kind of standardization that facilitates smooth loan trading. Furthermore, the right of first refusal contained in many AAL's often discourages free assignability of these interests.

Conclusion

The unitranche credit facility may provide obvious advantages for a borrower. The advantages to lenders, particularly first-out lenders, are less obvious. The prospect of being found undersecured in the event of a bankruptcy may not be appealing to large institutional lenders who traditionally occupy the first lien lender space, particularly given the pressure from regulators to institute more conservative lending standards. However, specialty finance companies, hedge funds and other creditors that tend to occupy the subordinate position in traditional intercreditor financings, and who often have minimal regulatory oversight and a demonstrated appetite for risk, have been providing a steady stream of lenders for both the first and subordinate tranches of these facilities. Until a court has reason to weigh in the provisions of an AAL, it will be difficult to fully gauge the extent of that risk.

1. The middle market is generally thought to be comprised of companies with pre-tax earnings of between $50 million and $1 billion. See Tom McGee, "Why the Middle Market Needs to Drive America's Jobs Rebound," Forbes (June 3, 2013), http://www.forbes.com/sites/steveschaefer/2013/06/03/why-the-middle-market-needs-to-drive-americas-jobs-rebound/ (noting that there is not a universally accepted definition for middle market, but characterizing the space as $50 million to $1 billion in revenue).
2. 11 U.S.C. §363.
3. See 11 U.S.C. §§361, 364 and 506(b). See also *In re Ionosphere Clubs*, 134 B.R. 528, 535 (Bankr. S.D.N.Y. 1991) (holding that three series of equipment trust certificates issued under an indenture constituted one undersecured claim, and therefore the senior claimant was not entitled to post-petition interest).
4. 11 U.S.C. §1122(a).
5. 11 U.S.C. §1126(d).
6. Note, however, that §510(a) of the Bankruptcy Code 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." See 11 U.S.C. §510(a).
7. See Brad B. Erens and David A. Hall, "Unitranche Financing Facilities: Simpler or More Confused?," 9 Pratt J. Bankr. L. 487, 488 (2013).