# Memorandum

**From** Orrick, Herrington & Sutcliffe LLP

**Date** April 22, 2015

**Re** Agreements Among Lenders in Unitranche Transactions

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Introduction

In recent years, "unitranche" has become synonymous in the United States with what was formerly known as "bifurcated unitranche" – *i.e.* a single credit facility with a separate agreement among lenders designating one set of lenders as "first out lenders" and the other as "last out lenders" for purposes of allocating collateral proceeds and certain other payments. Many papers and presentations have discussed unitranche generally, but few have focused on the contents of that separate agreement specifically, namely the "***Agreement Among Lenders***", or "***AAL***". This memorandum intends to do just that.

Although the U.S. unitranche market is still highly fragmented, in this paper we attempt to describe common elements in most AALs. In addition, we discuss terms in AALs that are custom-tailored, and terms that we consider to be subject to material risk of unenforceability in a bankruptcy proceeding.

For explanatory convenience, we will use a simple first lien secured term loan facility with no other secured debt in the capital structure as our example in this paper. We will also assume that there are only two groups of creditors, "first out" and "last out", and that the two share in a single pool of collateral (with those priorities applied uniformly). In actual practice, unitranche facilities can be far more complicated, incorporating any of the following additional features:

- revolving and/or asset based lending facilities;
- other classes of secured creditors outside of the unitranche structure;
- additional groups of creditors within the unitranche structure (*e.g.* "third out" lenders); and
- shifting priority over collateral proceeds based on the nature of the collateral.

The last two complications listed above can be particularly difficult to address in an AAL, because they undermine the fundamental dynamic of the agreement, to which we now turn.

## The Fundamental Dynamic of the AAL

In a simple unitranche facility, the lenders separately agree among themselves that one group of lenders (the "***first out lenders***") will be repaid with the proceeds of any collateral securing the credit facility before the other group of lenders (the "***last out lenders***"). Concomitant with their safer collateral position, the first out lenders are also given primary control over bankruptcy and enforcement proceedings. In return,

the last out lenders receive a higher allocation of the overall economics under the credit facility, together with certain other protective rights set forth below.

In a situation in which one group of lenders not only receives collateral proceeds first, but also exercises primary control over bankruptcy and enforcement proceedings, one of the following three distinct scenarios will exist at any time in the future that the borrower may become distressed:

(a) Both groups of lenders expect to be made whole in an enforcement scenario;

(b) Both groups expect to sustain material losses in an enforcement scenario; or

(c) The first out lenders expect to be made whole (or largely whole) in an enforcement scenario, but the last out lenders expect to sustain material losses.

In theory, the interests of the two groups of lenders should be aligned in scenarios (a) and (b) above (with exceptions discussed below). However, in scenario (c), where the first out lenders are over-collateralized and the last out lenders are under-collateralized, the interests of the two groups of lenders are likely to diverge, and it may become disadvantageous to the last out lenders that enforcement proceedings are being controlled by a group of lenders who, unlike them, expect to walk away whole in a quick liquidation.

This fundamental dynamic is not unique to unitranche structures, and appears in first lien / second lien and mezzanine structures as well. However, it becomes more trenchant in a unitranche facility, because last out lenders do not have their own separate debt document. Therefore, their interests can erode further in advance than in a more conventional structure, and, perhaps, more decisively.

The Buy-Out Right

In response to this dynamic, the basic protection available to the last out lenders is the right to purchase the interests of the first out lenders at par (the "***Buy-Out Right***"). This protection is available at the option of each last out lender and no last out lender must participate unless it so wishes (with a period of about five business days to make up its mind). Conversely, if more than one last out lender participates, the interests of the first out lenders are purchased ratably among them up to the amount each participating lender is willing to purchase. While Agreements Among Lenders seldom specify a minimum percentage of the first out interests that must be purchased, as a practical matter last out lenders in recent AALs will seldom purchase less than 50-75% of the relevant interests, for the reasons discussed below in the section entitled "Voting".

The Buy-Out Right is a dramatic remedy, and the list of circumstances under which the last out lenders may exercise it is short. Typically included on that list are:

(a) The last out lenders have not been paid in full when the amounts owed to them are due (after any grace period);

(b) The administrative agent has accelerated the loans;

(c) A bankruptcy event;

(d) The administrative agent has begun enforcing remedies, or has been directed to do so by the first out lenders;

(e) The first out lenders have instructed the administrative agent to begin applying collateral proceeds in accordance with the AAL's payment waterfall; and

(f) For a pre-agreed period of time (often 90 to 120 days), the first out lenders fail to vote in favor of an amendment, waiver or other voting matter that a majority of the last out lenders wish to pass. [1]

Few first out lenders are troubled by the idea that in a true distress situation of the types set forth in (a) through (d) above, or even (e), their interests may be purchased by the last out lenders at par. However, clause (f) is different, because it permits first out lenders to be yanked out of their assets, which may be healthy and performing, simply for failing to vote in favor of an amendment desired by the last out lenders. Since first out lenders are often more focused on collateral quality and last out lenders tend to be more focused on cash flow, the Buy-Out Right can be potent leverage for last out lenders to squeeze aggressive amendments past the first out lenders (*e.g.* permitting receivables factoring, the creation of joint ventures, etc.).

Upon an exercise of the Buy-Out Right, the last out lenders must pay: (1) all amounts owed to the administrative agent, (2) all principal, interest, fees, costs, expenses and indemnities owed to the first out lenders and (3) to the extent first out lenders provide letters of credit, cash collateral constituting 105% of the face amount of the outstanding letters of credit. In addition, if the underlying credit documentation provides *pari passu* security for amounts owed by the borrower to hedge and cash management providers, first out lenders will attempt to negotiate for those obligations to be cash collateralized (also at 105%) in connection with any exercise of the Buy-Out Right. Last, because the AAL on its face survives a borrower's entry into bankruptcy, payments in connection with the Buy-Out Right should include obligations owed to first out lenders under DIP loans and even exit financings, though this is often overlooked in AALs currently in the market.

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[1] Additional circumstances that are often but not always included comprise: (i) the failure of first out revolving credit lenders to provide the borrower with liquidity for more than a pre-agreed number of days, and (ii) the exercise by the first out lenders of any Reverse Buy-Out Right (as defined below.)

As an exception to the otherwise comprehensive nature of the preceding list, it is not customary for last out lenders to be required to pay first out lenders any make-whole or prepayment premium in effect at the time the Buy-Out Right is exercised, though first out lenders will sometimes negotiate for the right to be reimbursed for that premium if the last out lenders receive it from the borrower on account of the purchased loans within 90 to 180 days after the Buy-Out Right is exercised.

Although less common, first out lenders sometimes negotiate for their own version of the Buy-Out Right (a "***Reverse Buy-Out Right***"), enabling them to purchase the interests of the last out lenders at par under certain circumstances. These circumstances tend to be more limited than those available to the last out lenders, do not include activation of the payment waterfall, and seldom include failure of the last out lenders to vote as requested. The Reverse Buy-Out Right is subordinate to the Buy-Out Right (in case both rights are exercised simultaneously) and, in light of the fundamental dynamic of the AAL, is less likely to be of practical use to the first out lenders than its counterpart.

Preemptive Rights on Transferability

In addition to the Buy-Out Right (and occasional Reverse Buy-Out Right), the other method by which each group of lenders exercises control over who holds the other group's interests is by way of a preemptive right over the sale (via assignment or participation) of interests in the other group's loans. While there is no "market standard" for almost any AAL terms, the preemptive rights are the terms that are the most custom tailored for each new deal or inter-lender relationship in our experience.

The most common forms of preemptive rights are the right of first offer (a "***ROFO***") and the right of first refusal (a "***ROFR***"). Both the ROFO (*i.e.* the right to make the first offer on the seller's loans) and the ROFR (*i.e.* the right to match the final bid on the seller's loans) can take many different forms, and it would not be possible to enumerate them all in this memorandum. However, among the points typically negotiated are how many days each side has to evaluate sale terms, the required finality of the sale terms presented to the non-selling party, and under what circumstances preemptive rights reassert themselves if they are initially declined.

Occasionally, a last out lender will suggest that only last out lenders should enjoy preemptive rights. Few savvy first out lenders agree to this proposal, because unlike the Reverse Buy-Out Right, preemptive rights may be very useful to first out lenders. This is particularly true in circumstances where the last out lenders' loans trade at a significant discount to par and might otherwise be purchased by investors to whom the first out lenders would prefer not to cede significant leverage.

In all cases, preemptive rights do not apply to transfers to affiliates, controlled investment funds, financing sources and certain other exempted transferees (loosely corresponding to the exceptions to consent also found in syndicated credit facilities).

Voting

One of the reasons the foregoing preemptive rights are considered essential in unitranche transactions is that prior to an enforcement or bankruptcy scenario, each group of lenders has an outsized influence over amendments, waivers or other departures from the loan documentation that would typically require the vote of the holders of only a majority of the loans and commitments under the credit facility (a "***Required Lender***" vote).

The mechanism for this influence is a provision in the Agreement Among Lenders that states that (a) if the first out lenders constitute the "Required Lenders" under the credit facility, they will not vote in favor of any voting matter unless the holders of a majority of the last out obligations vote in favor of such matter, and (b) if the last out lenders constitute the "Required Lenders", they will not vote in favor of any such voting matter unless the holders of a majority of the first out obligations vote in favor of such matter.

Commentators often lament that this provision of the AAL requires "unanimous" consent, or at least "a majority of both classes", unbeknownst to the borrower. Neither is precisely accurate.

For illustrative purposes, let us revisit our simple unitranche example above and further assume that the term loan facility is held by four lenders, who hold their loans in the following proportions:

| **Lender** | **Percentage of Loans Held** |
|---|---|
| Lender A – (First Out): | 45% |
| Lender B – (First Out): | 25% |
| Lender C – (Last Out): | 20% |
| Lender D – (Last Out): | 10% |

In this example, the first out lenders, who hold 70% of the obligations in the aggregate, comprise the Required Lenders and therefore cannot pass an amendment alone. Nor can they pass an amendment solely with the addition of Lender D, who holds only a third of the last out obligations, because the amendment would still lack the vote of a majority of the last out obligations.

In fact, no amendment may pass without the vote of Lender C. This is worth pausing to consider, because it means that Lender C controls all voting matters, even while holding only 20% of the facility. This is significantly more power than is held by Lender A, who owns close to half the facility, but can still be outvoted.

Thus, Agreements Among Lenders do not require unanimity or even a majority of both classes to pass a Required Lender vote. Instead, a simple majority is all that is ever needed, so long as it has the support of the lender or lenders holding a majority of the minority group of loans. [2]

Recently, certain incremental changes to the voting provisions have become more prevalent. For example, last out lenders have begun occasionally requesting the unilateral right to grant minor financial covenant relief, collateral deadline relief and the expansion of incurrence baskets. Conversely, first out lenders have begun insisting that last out lenders be "dragged along" in key bankruptcy and enforcement proceedings (*e.g.* voting for a first out DIP facility). Finally, more recent AALs contemplate that a lender of one group may not vote loans of the other group it has acquired until it has acquired at least 50-75% of the loans of such group. This requirement can act as a disincentive to both the Buy-Out Right and the use of preemptive rights, and is therefore sometimes seen as an important impediment to the abuse of those two provisions.

Exercise of Remedies

As briefly discussed above, the first out lenders in an Agreement Among Lenders are given the primary right to control most of the proceedings available to secured creditors in the case of an uncured event of default. Such rights (each, an "***Exercise of Remedies***") include:

(a) Accelerating all outstanding loans and other amounts due;

(b) Seizing dominion over deposit accounts and securities accounts;

(c) Notifying A/R debtors to make payment to the administrative agent;

(d) Foreclosing on liens;

(e) Liquidating collateral;

(f) Hiring third parties to assist with the sale of collateral;

(g) Filing an involuntary bankruptcy proceeding; and

(h) Any other enforcement rights generally available to secured creditors following an event of default.

Although this list may appear exhaustive, certain regularly used lender actions, including the levying of default interest, seeking specific performance from the borrower, and almost all consensual arrangements

[2] We pause to note how powerful the voting rules and Buy-Out Rights could be in the hands of an aggressive debt investor. Such an investor could obtain blocking rights over the entire facility by purchasing a mere fraction of its face amount. In addition, once the investor held this pivotal debt, it could use aggressive tactics to threaten or force a Buy-Out, thereby obtaining a majority of the principal amount (if it so desired) or any of a number of other desired outcomes.

arrived at with a borrower prior to an event of default do not constitute Exercises of Remedies and therefore would be subject to the ordinary voting mechanics listed above.[3] In addition, revolving lenders in a unitranche facility often expect to maintain the exclusive right to terminate the revolving commitments at any time following an event of default, separate from the Exercise of Remedies provisions.

Although the first out lenders have the initial right to commence an Exercise of Remedies, they do not have the right to do so immediately following an event of default.[4] Instead, the first out lenders must obey a standstill period, which is a negotiated period of 5 to 60 days (and lately, almost always 30 or 45), during which the first out lenders must wait to commence any Exercise of Remedies, other than the retention of valuation experts. The standstill period is thought to give the last out lenders an opportunity to negotiate an arrangement with the borrower satisfactory to all parties that allows the business to continue as a going concern. As a fallback, it also gives the last out lenders the opportunity to make a determination whether to exercise their Buy-Out Right.

A borrower sometimes views the standstill provisions of an AAL as "double grace", or a bonus period to cure defaults once the borrower's initial grace period under the loan documentation has expired.[5] To the extent that the interests of the first out lenders and last out lenders diverge, there is practical truth to this assertion. However, borrowers should remember that the standstill period is not their right to enforce, and it may therefore not be available to them when they need or expect it.

Upon the expiration of the first out lenders' standstill period, the first out lenders may begin the Exercise of Remedies, and once they have begun to do so the process is theirs to control. But what if the first out lenders are dilatory or fail to diligently enforce against the borrower? In those circumstances, the protection available to the last out lenders is the right to direct the Exercise of Remedies themselves after the expiration of a second standstill period, typically lasting 60 to 120 days after the commencement of the event of default. This second, longer period gives the first out lenders plenty of time between the expiration of their own standstill period and the expiration of the last out lenders' standstill period to begin exercising remedies. If they fail to do so, they risk ceding permanent control over enforcement proceedings to the last out lenders.

One exception to both standstill periods is the occurrence of so-called "exigent circumstances", which are understood to occur if (a) a secured creditor outside the lender group begins enforcing against the borrower or the loan parties, or (b) another event occurs (*e.g.* fraud, imminent destruction, etc.) that

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[3] An exception is the levying of default interest. Many AALs contemplate that either group of lenders by itself may instruct the administrative agent to levy default interest.

[4] An exception to this rule is for lenders of asset based lending facilities, for whom any standstill provisions could threaten their collateral pool.

[5] To be sure, this assumes the presence of a sophisticated borrower who has demanded to see the AAL or have its material terms summarized. Most borrowers still do not do so, and lenders generally resist the request when made.

constitutes an immediate threat to the lenders recovering the value of the collateral. In exigent circumstances, the administrative agent may act immediately and is not subject to any standstill period.

The Waterfall

The order of payment priority referred to as the "waterfall" is perhaps the most important provision of the AAL, because it is what gives effect to the "first out" / "last out" structure that drives substantially all the other provisions of the AAL. Despite this importance, the waterfall seldom becomes effective.

In order for the payment waterfall to become effective, the first out lenders must first deliver notice that a "waterfall triggering event" has occurred. Waterfall triggering events are negotiated provisions of AALs and therefore differ from deal to deal. However, the following occurrences are always triggering events:

- An acceleration of the borrower's obligations;
- A bankruptcy event; and
- An Exercise of Remedies by the administrative agent.

In addition, first out lenders often negotiate for some or all of the following occurrences to be waterfall triggering events as well:

- Payment defaults;
- Financial covenant defaults, or financial covenant defaults beyond a certain pre-agreed cushion; and
- Other deal or credit specific events (*e.g.* overdrawing the borrowing base in the case of an asset based lending facility).

Following a delivery by the first out lenders of notice of a waterfall triggering event, and while such event is continuing, the proceeds of collateral and all other payments received by the administrative agent are generally applied in the following order of priority:

(1) To the agents, in the following sequence: (a) reimbursing expenses and then (b) paying fees;

(2) To the first out lenders, in the following sequence: (a) reimbursing expenses, (b) paying fees (other than prepayment premiums), (c) paying accrued interest, and finally (d) repaying principal, and to the extent any exist, cash collateralizing letters of credit and hedging obligations and cash management exposure (sometimes subject to a cap);

(3) To the last out lenders, in the following sequence: (a) reimbursing expenses, (b) paying fees (other than prepayment premiums), (c) paying accrued interest, and finally (d) repaying principal, and to

the extent any exist, cash collateralizing letters of credit and hedging obligations and cash management exposure (sometimes also subject to a cap);

(4) Paying prepayment premiums, first to the first out lenders and then to the last out lenders; and

(5) Ratably repaying obligations owed to the lenders not otherwise covered above.

Prior to the activation of the waterfall, and except as discussed in the next section, payments from the borrower are applied ratably to the first out lenders and last out lenders. This includes voluntary and mandatory prepayments of the credit facility, unless a deal-specific reason mitigates in favor of one group of lenders being repaid quicker than the other.

The Skim

In return for the many concessions they make in the Agreement Among Lenders, the last out lenders are entitled to collect the so-called "skim" from the first out lenders -- *i.e.* a portion of the interest payments and fees under the credit facility that would otherwise be paid to the first out lenders.

This is effected by a provision in the AAL that states that when the administrative agent receives a cash payment of interest or fees from the borrower on account of loans held by the first out lenders, it will pay only a portion of the collected amounts to the first out lenders and remit the remainder to the last out lenders instead. This provision applies only to cash payments by the borrower, and the first out lenders are never required to pay the skim out of pocket.

Besides the interest rate allocation between the two groups of lenders, the parties will also negotiate which fees are subject to the skim. For example, commitment fees on a revolver are seldom subject to the skim, but up front and early prepayment fees are often allocated exclusively to the last out lenders.

Of particular interest to borrowers is the effect of the skim on the availability of incremental facilities. Even where an AAL otherwise contemplates the future inclusion of incremental lenders (which itself is rare), it is usually impossible in practice to effectively allocate collateral coverage and skim economics against an incremental tranche of debt. For this reason, successful incremental drawings by unitranche borrowers are exceedingly rare.

Bankruptcy Provisions

Historically, Agreements Among Lenders had few provisions relating to the lender groups' respective rights and obligations in bankruptcy proceedings, other than the application of the payment waterfall. To this day, most AAL precedents have fewer bankruptcy provisions than Orrick would consider prudent.

This is explained partially by the difficulty in pre-wiring an equitable outcome long in advance of any potential bankruptcy filing. For example, in a $100 unitranche term loan, assume that $50 is held by first out lenders and the remaining $50 is held by last out lenders. In a situation where the liquidation value of the collateral is $52 and declining, the first out lenders should be vouchsafed the ability to conduct a quick sale of the collateral before their position becomes impaired. On the other hand, in a situation where the liquidation value of the collateral is $95 and holding steady, the first out lenders might be content to conduct a fire sale of the collateral, but it is more equitable to permit the last out lenders to take the time necessary to explore less hasty solutions that might maximize their recovery.

That said, first out lenders generally are given the initial right to control most bankruptcy proceedings, including (i) seeking relief from the automatic stay, (ii) the use of cash collateral, and (iii) the sale of collateral. In addition, the first out lenders are given the right to provide DIP financing (subject to commercial reasonableness and other appropriate protections). In each of these cases, the last out lenders agree not to object to the position taken by the first out lenders, and, if the first out lenders decline to do so, they may take those positions themselves (subject to any superseding rights of the first out lenders).

With respect to credit bidding the debt, the first out lenders have carte blanche to credit bid without objection by the last out lenders, but the last out lenders may not credit bid unless the first out lenders will be repaid in full in cash in connection with the bid.

Finally, several recent AALs have provided that the approval of any plan of reorganization requires a vote of the lenders holding two thirds of each group of obligations (unless the plan could have been approved by only one group if the groups were treated as separate classes).

Much like preemptive rights, the bankruptcy provisions in AALs differ dramatically between precedents, often less as a result of negotiations between the parties and more as a result of the law firms working on the agreement. The foregoing overview is therefore not intended to be definitive or comprehensive, but merely a framework for consideration.

## Enforcement Considerations

No U.S. bankruptcy court has ever opined on the enforceability of the provisions of an Agreement Among Lenders. As a result, there is substantial doubt about the treatment of an AAL in such a proceeding.

Perhaps the most serious issue is that the two groups of lenders may be treated as a single class of secured creditors by the bankruptcy court. For illustrative purposes, let us return to our example in the section above of a $100 term loan held in equal parts by first out and last out lenders. If, at the time of the filing, the collateral has a fair market value of $75, and if the loans are treated as a single class, then

for the court's purposes, the entire class of indebtedness is under-collateralized – not just the last out lenders.

As a result, the court will likely disallow cash interest to be paid on the indebtedness during the pendency of the case (and the question arises whether the post-petition interest owed to the first out lenders should reduce the principal amount ultimately recovered by the last out lenders pursuant to the waterfall). In addition, the claims could be bifurcated into two different classes -- not on the basis of the waterfall, but rather on the basis of the over-collateralized portion of the claims versus the under-collateralized portion. In such a situation, it is not clear that the payment waterfall would be sufficient to ensure that the claims of the first out lenders were allocated first to the secured class, rather than simply ratably. Finally, the under-collateralized exposure of the class as a whole is likely to provide the debtor, trustee and other constituencies in the bankruptcy significant negotiating leverage that they would lack vis-à-vis the first out lenders if the first out lenders were their own class.

Complicating the analysis is the fact that in some circumstances, the first out lenders may prefer not to be a separate class from the last out lenders after all. This is because an impaired class of last out lenders would have the ability to vote for a "cram down" plan that the first out lenders oppose.

Nor is it clear that an AAL can resolve these issues, even if it were possible to predict and pre-wire the desired outcome in advance. Several U.S. bankruptcy courts have ruled that creditors may not validly assign their post-petition ability to vote their claims in bankruptcy proceedings. Although the courts are split on the question, if a court invalidated the AAL voting provisions during the pendency of the bankruptcy proceeding, it could affect more than just the ability to approve a plan of reorganization, and extend to AAL provisions regarding the first out lenders' ability to control all of the other post-petition decisions discussed above, including the sale of collateral, relief from the automatic stay, provision of the DIP financing, etc.

Fortunately, most observers, including Orrick, believe that the waterfall provisions of the AAL would likely be upheld by a U.S. bankruptcy court. Consequently, while savvy first out lenders appreciate that their future control over a bankruptcy proceeding is less certain under a unitranche facility than in a classic first lien / second lien structure (and may request additional economics to reflect that fact), they should ultimately feel satisfied that they are in fact "first out" lenders with respect to collateral proceeds when all is said and done.

Concluding Remarks

As noted above, the U.S. unitranche market has not yet developed market standard provisions, and therefore the overview of Agreements Among Lenders provided by this memorandum does not purport to be definitive or comprehensive. Over time, Orrick expects the unitranche market to gradually coalesce around market standards, and we will endeavor to provide a supplement to this memorandum as

warranted. In the meantime, please feel free to contact B. J. Rosen in the Orrick Banking & Finance Group at (212) 506-5246, or bjrosen@orrick.com, with any questions about unitranche generally or the provisions of Agreements Among Lenders specifically.