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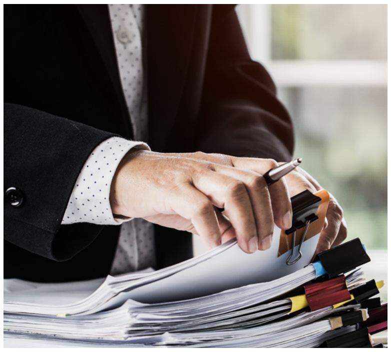
The unitranche loan market has grown as parties have used the unitranche structure for more deals and larger deals. ***This issue of Bank On It*** *explores the unitranche loan structure and key issues affecting unitranche deals.*

Unitranche Loans: A Developed Market

By Kim Wynn, Brian Sirower, and Nathan Fronk



The unitranche loan market has grown as parties have used the unitranche structure for more deals and larger deals, with volume reaching a record $10.7 billion in the third quarter of 2019 and average loan size reaching $235,000,000 in the same quarter[1]. Unitranche loans have been particularly attractive to mid-market corporate borrowers with annual sales less than $100,000,000 and EBITDA less than $50,000,000[2]. The unitranche loan market was originally dominated by a smaller group of non-bank direct lenders. More lenders have gotten into the mix and borrowers have more often taken advantage of the benefits of these loans. The full effects of the COVID-19 pandemic on this trend have yet to play out. The credit markets have cooled, and the indications are that deals in the direct lending market are trending toward increased pricing and more lender-friendly documentation[3].

A unitranche loan is a hybrid structure that combines aspects of senior and subordinated debt into one loan facility. The resulting instrument has a single interest rate and term, typically five to seven years. Under the classic unitranche loan structure, a non-bank direct lender enters into a loan transaction with a borrower under a single loan agreement, perhaps to fund an acquisition, and perhaps it is the type of acquisition that would otherwise be funded under a first lien/second lien structure. With one lender, one lender's

[1] Kelsey Butler & Allison McNeely, *A Booming Corner of Private Credit Has Some Investors on Edge,* BLOOMBERG.COM, November 25, 2019, https://www.bloomberg.com/news/articles/2019-11-25/a-booming-corner-of-private-credit-has-some-investors-on-edge

[2] *Structure Series: Unitranche Versus Syndicated Loans (Unitranche Borrowers Eye Simple Execution Despite Variety of Risks,* FITCH.COM, October 1, 2019, https://www.fitchratings.com/site/re/10090036

[3] *Middle market sponsors face increased pricing, covenants as COVID-19 deepens,* Reuters.com, April 30, 2020, https://www.reuters.com/article/coronavirus-loans/middle-market-sponsors-face-increased-pricing-covenants-as-covid-19-crisis-deepens-idUSL8N2CIAMX

law firm, one set of loan documents and one lien, the transaction can close more quickly and efficiently than under a traditional first lien/second lien structure.

After the closing, the lender brings in additional lender parties under the original loan documents. Separately, the lenders enter into an agreement among lenders that has characteristics of a last-out participation agreement and characteristics of an intercreditor agreement. This agreement, known as an Agreement Among Lenders ("AAL"), creates "first-out" and "last-out" tranches, each with separate rights. The borrower continues to be party to a single set of loan documents, and the AAL synthetically creates rights and remedies for the lenders that are akin to the rights and remedies that would exist under a first lien/second lien loan structure, including reallocation of interest payments to give a higher effective rate to the Last Out Lenders who accept greater risk, and including allocation of voting rights and creation of a payment waterfall. The borrower is not necessarily a party to the AAL and may not know the terms of the AAL.

The variations on the unitranche theme are endless. An AAL can create more than two tiers of debt, can create multiple administrative agents for the multiple tiers and can allocate risks and rewards in ways that are tailored to specific transactions. Banks are getting involved in unitranche transactions, generally as First Out Lenders, and by providing asset-based loans or other revolving loans, either as part of the unitranche facility or as separate financing transactions. Banks have also directly or indirectly invested in unitranche funds.

A unitranche structure can also be used by banks and other lenders in a work-out scenario when the deal was not originally intended as a unitranche loan. A party may buy into an existing distressed deal, using an AAL to allocate interest payments and other rights in a way that provides incentive for the party to invest in the distressed deal.

1. Benefits of Unitranche Loans

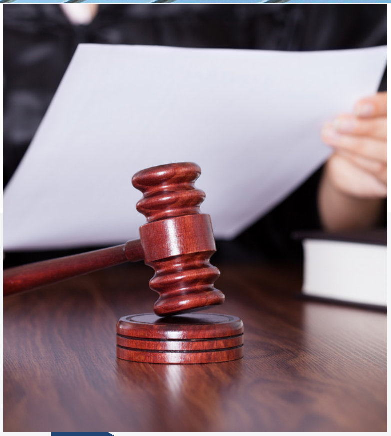
For borrowers, particularly private equity funds pursuing acquisitions, the unitranche structure has a number of advantages. The time to closing is shorter, with more streamlined approval processes and documentation than in a traditional first lien/second lien structure. Also, the closing and the deal terms are more certain without syndication risk and without flex terms that may vary depending on the syndicated loan market. There is also an expectation that direct lenders can provide more flexible terms, most notably, committed delayed-draw term loans for future acquisitions. With one credit agreement and one lender's counsel, closing costs are reduced, and after closing there is one credit agreement with one set of covenants and one set of reporting obligations, which lowers administrative costs.

Unitranche loans tend to be priced at about 0.5% above other financing, and investors are attracted to unitranche loans for the higher return. The investors believe they can manage risk well by developing close relationships with the private equity firms they partner with, investing more time into in-depth due diligence and being more selective in choosing deals.

2. Cautions Regarding Unitranche Deals

Unitranche borrowers generally pay higher interest rates and agree to prepayment premiums, making the facilities more expensive and less flexible. Also, the documents may be more conservative and more tailored to the contemplated transaction, giving the lenders consent rights over future events. There will likely be little or no revolver initially, and it may be difficult to negotiate changes due to the more complex voting structure in most AALs.

The primary caution for investors is that the unitranche structure has not been extensively tested in the courts, and as further discussed below there are some issues regarding how an AAL would be treated in a bankruptcy proceeding. Unitranche deals can be less liquid, with no established market for trading unitranche deals and with the potential for difficulty selling a complex and



unique AAL arrangement. Most lenders close unitranche financings with the intent to hold much of their position.

3. AALs in Bankruptcy Court

An AAL typically contains robust bankruptcy provisions, including rights and restrictions with respect to debtor-in-possession ("DIP") financing, use of cash collateral, credit-bidding, asset sales, and claim classification. Notwithstanding these AAL provisions, there is little case law regarding unitranche loans. One of the questions unitranche lenders face is how the AAL will be treated by a bankruptcy court. While most AALs will include provisions declaring the AAL to be a "subordination agreement" and therefore enforceable in a bankruptcy case, not all AAL provisions are traditional subordination terms and bankruptcy courts could elect to separately review the enforceability of other terms, such as voting waivers and objection rights that do not specifically relate to the subordination of claims or liens. Also, since the agreement is among the lenders and the borrower is not a party, a bankruptcy court could decide that the AAL should be litigated in a separate court proceeding outside of bankruptcy. There is a trend toward including the borrower as a signatory to the AAL, at least as a consenting party, to increase the likelihood that a bankruptcy court will have jurisdiction to enter binding orders in the bankruptcy proceeding adjudicating the rights of the First Out Lenders and Last Out Lenders, vis-à-vis each other.

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Other questions that have not been definitively answered by bankruptcy courts include whether the claims of the First Out Lenders and Last Out Lenders should be treated in the case and in a reorganization plan as one claim since there is one Credit Agreement and one lien, or should be treated as multiple claims as created by the AAL. Also, a question remains as to whether a court will honor the voting rights, objection rights, and waivers as allocated in the AAL. Another issue is whether the First Out Lenders will receive post-petition interest if the Credit Agreement debt as a whole is undersecured. Given that a court may be reluctant to enforce general restrictions on voting rights, objection rights, and waivers, it will be important for the AAL to expressly address bankruptcy issues with specificity to increase the likelihood that a court will enforce the AAL according to its terms.

4. Key Terms of an AAL

Generally, an AAL has characteristics of a last out participation and characteristics of an intercreditor agreement. The AAL will create a first-out tranche and a last-out tranche. The two tranches are serviced together, unless a trigger event (such as a missed payment, financial covenant default, bankruptcy, or acceleration) occurs, at which time the First Out Lenders would receive priority over the Last Out Lenders. The agreement allocates voting rights, standstills and buy-out options.

The document should also address the status of future loans, including increases to revolving loans, delayed draw term loans and incremental facilities. Other obligations that should be addressed may include hedge obligations, cash management obligations, letter of credit obligations and DIP financing. The parties will negotiate regarding caps on future indebtedness and regarding the manner in which future indebtedness will treated under the AAL.

a. Allocation of Interest and Fees

An AAL will usually provide a specific return for the First Out Lenders at a rate lower than the Credit Agreement rate, and the remaining interest will payable to the Last Out Lenders. The AAL will also allocate other amounts, such as default interest, prepayment fees and facility fees.

b. Payment Waterfall

Initially, payments will be applied to outstanding loans pro rata. One important negotiation point in an AAL is the trigger for the payment waterfall that directs all payments to the First Out Lenders. Generally, bankruptcy, acceleration and exercise of remedies will trigger the payment waterfall. The AAL will also address the types of payment defaults and covenant defaults that will invoke the waterfall. As part of that determination, the document may measure a "First Out Leverage Ratio" specifically focused on the First Out Lenders' exposure.

c. Voting

The Credit Agreement with the borrower will provide for Required Lenders, usually lenders holding greater than 50% of the exposure, to approve amendments, with certain sacred rights requiring approval of all lenders or all lenders affected thereby. The "sacred rights" concept would typically provide that a lender would have to consent to any of the following affecting the lender: a forgiveness of principal, a decrease in the interest rate, an increase in the commitment, an extension of the scheduled payments or the maturity date, a change to the voting rights, and certain releases of collateral or obligors.

An AAL can be expected to retain similar protections for sacred rights and also provide that the lenders will not vote for an amendment (will not achieve a Required Lenders vote) under the Credit Agreement unless both the First Out Lenders and Last Out Lenders, voting separately, approve. As with the shift from pro rata payment to the waterfall, the voting rights will shift upon the occurrence of certain defaults, giving the First Out Lenders control of waivers and amendments (subject to sacred rights) and exercise of remedies.

The AAL will likely contain special provisions with respect to exercise of remedies. If the First Out Lenders have voting control and want to direct the administrative agent to exercise remedies, there will likely be a short standstill period, long enough to allow the Last Out Lenders to exercise buyout rights. For their part, the Last Out Lenders will be able to direct the administrative agent to exercise remedies after a longer standstill period, and then only if the First Out Lenders fail to act.

If the First Out Lenders' portion of the total Credit Agreement obligations is very small, making it all but certain that the First Out Lenders will be paid in full, the Last Out Lenders may retain greater voting power. Also, a Last Out Lender that provides additional liquidity in a distress scenario may negotiate for greater control rights.

If the documents permit a deal sponsor to become a First Out Lender or Last Out Lender, the AAL will likely provide that the sponsor will not be permitted to vote. The sponsor may be permitted to vote with respect to sacred rights, particularly if under the proposal that is subject to the vote the sponsor will be treated differently than other similarly situated lenders.

The AAL will likely also prohibit cross-over voting. This prohibition would prevent a Last Out Lender from buying into a First Out Lender position and then influencing the First Out Lenders' vote.

d. Buyout Rights

The First Out Lenders and Last Out Lenders will have buyout rights and rights of first offer. The buyout rights will likely be triggered in a payment waterfall or exercise of remedies scenario and may be triggered if one group of

lenders will not consent to an amendment or waiver. The purchase right is generally at par and will need to address hedges, letters of credit and cash management risk, particularly if the lender who is the purchaser in the buyout does not have the capacity to provide these services to the borrower.

e. Bankruptcy

An AAL will also address key aspects of a borrower bankruptcy. The AAL will specifically address a wide range of bankruptcy issues, including, among other things, DIP financing, cash collateral, voting rights, waivers, collateral sales, credit bids, rights to distributions (including securities), plan classification, provisions for payment of First Out Lender interest, and avoidance issues (i.e., preference and fraudulent transfer matters).

For example, if the First Out Lenders have consented to a sale, or adequate protection for collateral, the Last Out Lenders may be contractually prohibited from objecting to bankruptcy sales or adequate protection arrangements. Likewise, the AAL will clearly delineate credit bid rights and describe the types of actions that can be pursued or which are restricted by lenders. Also, the First Out Lenders likely will be granted exclusive rights to condition the use of cash collateral and to provide debtor-in-possession financing, subject to conditions that would include a negotiated cap. The Last Out Lenders may be permitted to provide such financing if the First Out Lenders do not.

5. Conclusion

The unitranche structure can be an attractive option for borrowers and investors, and the unitranche loan market has grown. AALs are complex documents that to some extent are untested, but many of the characteristics of AALs are familiar in that they are analogous to participation agreements, subordination agreements and co-lender provisions of Credit Agreements. Despite the complexity of an Agreement Among Lenders, the agreement facilitates streamlined loan documentation and, if structured properly, can be a useful tool available to borrowers and lenders alike under the right circumstances.

For any questions regarding the unitranche loan market contact your Quarles & Brady attorney or:

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