Developments in Unitranche Financing (2016)

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The increasing use of unitranche financing, both domestically and abroad, has created new opportunities for middle market loan participants. However, lenders must understand the legal issues and potential bankruptcy risks unique to unitranche structures.

The volume of middle market unitranche financings continues to rise in the US and European loan markets. Unitranche loans combine separate senior and subordinated debt financings into a single debt instrument. While unitranche financing is not new, the increased use of this type of financing, both domestically and abroad, creates new opportunities for middle market loan participants. However, unitranche financing also poses risks, and lenders who participate in unitranche financings must understand the related legal issues in order to adequately mitigate these risks.

This article provides an overview of traditional unitranche financing in the US and looks at recent developments in this area. Specifically, it:

- Explores the growth of unitranche loans in the middle market.
- Describes the basic unitranche financing structure.
- Reviews the typical terms in an Agreement Among Lenders.
- Examines key bankruptcy-related risks that are unique to unitranche financing.
- Reviews recent cases involving unitranche financing.
- Briefly describes the growing unitranche market in Europe.

UNITRANCHE LOANS IN THE US MIDDLE MARKET

CURRENT DATA

In 2015, there were $142 billion of loans extended to middle market companies in the US (often defined as companies with annual revenues of less than $500 million and annual EBITDA of less than $100 million) (Thomson Reuters LPC, Leveraged Loan Monthly – Year-End 2015 Report). While there is not a lot of publicly available data on the volume of US unitranche financings, anecdotal evidence and tracking by regular market participants indicates a growing volume of activity in the middle market.

The principal amount of unitranche financings can vary depending on the needs of the borrower. However, $50 million to $100 million is a fairly common size. As unitranche financings have gained acceptance, deals far exceeding $100 million are now not unusual.

MIDDLE MARKET LENDING: KEY ADVANTAGES

The middle market differs from the large corporate (or large cap) loan market in many ways. Certain characteristics associated with middle market lending have attracted a wide array of participants to the market, resulting in greater demand for middle market loans.

These characteristics include:

- Higher yield for lenders.
- Smaller lender groups, often involving club deals (two to three lenders) or smaller syndicates, giving lenders more control over documentation and decision-making.
- Greater variety of investment structures available.
- Less adherence to market terms and precedent.
- Growing market share of business development companies (BDCs), mezzanine investment funds, hedge funds, and other non-bank lenders.
- Growing private equity sponsor investment in middle market companies.

COMMON MIDDLE MARKET FINANCING STRUCTURES

There are two common middle market financing structures which involve both senior debt and a type of subordinated debt. They are:

- **1st/2nd lien financing**. In a 1st/2nd lien financing, there are two separate groups of lenders who are separately granted liens on the same collateral. Pursuant to an intercreditor agreement, the two lender groups agree that the first lien lenders have a senior priority lien and therefore recover first on the value of the collateral following the exercise of remedies by the lenders against the borrower.
- **Subordinated debt financing**. In a subordinated debt financing, there are similarly two separate groups of lenders. In addition to

the collateral arrangement of a 1st/2nd lien financing, the junior lenders contractually subordinate their loans and agree not to receive payment on their loans until the senior debt is repaid.

There are other traditional middle market financing structures which are beyond the scope of this article, including structurally subordinated financings and hybrid debt/equity structures.

Both of these common financing structures involve two sets of loan documents, which often contain different covenants. Each lender group is often represented by separate law firms, who also negotiate an intercreditor or subordination agreement to define the relative priority of the debt and shared liens. These agreements contain provisions restricting the lenders' rights to, among other things:

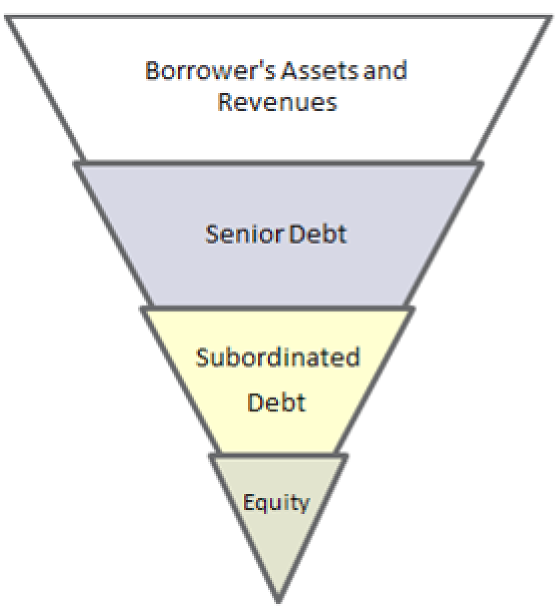
- Amend their respective loan documents.
- Bring remedies against the borrower or the collateral.
- Raise certain technical defenses or claims as part of the borrower's bankruptcy.

RISKS AND RETURNS IN MIDDLE MARKET LENDING

To understand any financing structure involving subordinated debt, market participants need to understand both the financial returns and the risks should the borrower fail to repay its loans. Figure A is a simple illustration of basic risk and return characteristics of the two traditional middle market financing structures in the event of a liquidation of the borrower's assets.

FIGURE A: ILLUSTRATION OF RISKS AND RETURNS

The liquidation value of the borrower's assets flow through the inverted pyramid, and gets paid to the borrower's creditors, with any residual liquidation proceeds being paid last to the borrower's equity holders.



SENIOR DEBT (1ST LIEN/SENIOR DEBT):

- First lien lenders get priority on the borrower's assets.
- Lower risk of economic loss compared to subordinated debt and equity.
- Lower interest rate than subordinated debt.

SUBORDINATED DEBT (2ND LIEN/SUBORDINATED DEBT):

- Intermediate economic level of a company's capital structure.
- Higher risk of economic loss than senior debt.
- Lower risk of economic loss than equity.
- Higher interest rate than senior debt.

BASIC UNITRANCHE FINANCING STRUCTURE

Unitranche financing is a unique debt structure that involves a single layer of senior secured debt, without a separate subordinated debt financing. Because unitranche financing combines multiple debt tranches into a single financing, a borrower with a simple capital structure would appear to have only one class of creditors.

Unlike the traditional senior/subordinated debt structures, a unitranche financing has a single credit agreement and security agreement, signed by all of the lenders and the borrower. In a classic unitranche structure, the single credit agreement provides for a single tranche of term loans with the borrower paying a single interest rate to all lenders.

The interest rate is a "blended" rate which is often higher than, or about the same as, the interest rate of traditional senior debt, but lower than the interest rate for traditional 2nd lien or subordinated debt. All lenders benefit from the same covenants and defaults and, as described further below, the voting provisions are similar to a non-unitranche credit agreement (that is, governed by the majority vote of the lenders with some amendments being subject to the vote of all lenders or all affected lenders).

Separate from the credit agreement, unitranche lenders agree among themselves to create "first out" and "last out" tranches (also known as "first out" and "second out" tranches) through an agreement typically known as an Agreement Among Lenders (AAL). Common terms of AALs are described below (see Typical Terms in an AAL). The sizing of the first out and last out tranches changes by deal and is dependent on the attractiveness of the blended pricing that can be achieved and the lenders interested in any given deal at the proposed pricing and terms

Unitranche structures are growing more complicated and some provide for multiple tranches of term loans and a revolving loan facility, and even multiple, separate unitranche facilities. For example, the revolving loan facility may be the first out tranche and the term loan may be the last out tranche or there may be a revolver with more than one term loan tranche, with layers of priorities among the term loan tranches. In some unitranche deals with multiple tranches of term loans, the tranches represent the first out and last out tranches and include separate pricing for the tranches on the face of the credit agreement. Some of these multi-tranche deals also provide for voting rules by tranche on the face of the credit agreement. As described below, in a classic unitranche structure, pricing and voting arrangements among the lenders are dealt with in the AAL.

BENEFITS OF UNITRANCHE FINANCING

The volume of unitranche financings have increased as more borrowers have discovered the benefits of unitranche financing as compared to other middle market lending structures. The benefits include:

- **Reduced closing and administrative costs**. With only one credit agreement, the amount of required loan documentation is cut in half. In addition, there is only one administrative agent and one law firm representing all of the lenders.

- **Speedier closings**. Many unitranche lenders are willing to underwrite the full financing without pre-closing syndication. Combined with the faster documentation of one credit agreement, unitranche financing is particularly attractive in deals with multiple lenders competing to provide the financing and short timeframes to closing (such as in acquisitions).
- **Less syndication risk**. In deals with full underwriting and no pre-closing syndication, there is no risk that the lead bank arranging the financing will be unable to syndicate the loans and, therefore, not close the financing. Similarly, many unitranche deals do not have flex provisions allowing the lead bank arranging a syndicate to change pricing and other loan terms to match the demands of the syndication market.
- **Greater amount of available senior debt**. In many cases, the amount of senior debt available to a borrower in a unitranche financing is much higher than in a more traditional senior/subordinated financing structure.
- **Lower debt service costs**. Unitranche loan pricing can be attractive compared to other middle market financing structures. Depending on the borrower and the sizing of the first out and last out tranches, the blended interest rate and fees can be lower.
- **Often no amortization or prepayment premiums**. Many unitranche financing deals do not have amortization or prepayment premiums. This gives the borrower flexibility to refinance or pay down more expensive debt, which they may not have in a 1st/2nd lien or subordinated financing with a call premium. However, as unitranche structures have grown more complex, some multi-tranche unitranche deals have amortization or prepayment premiums in favor of the last out tranche.
- **Easier compliance and administration**. With only one set of covenants and one reporting package to prepare, unitranche financing is easier for the borrower to administer and comply with.

While unitranche financing started as a structure used mostly by specialty finance companies, its acceptance has grown. Banks, BDCs, fund lenders, and other types of lenders now regularly provide unitranche financing options to their customers.

TYPICAL TERMS IN AN AAL

The AAL synthetically creates the benefits and risks to the lenders found in a senior and subordinated financing by defining which lenders are first out and which are last out. The AAL provides that the lenders holding the first out tranche (the first out lenders) receive a lower return for their lower risk of repayment and the lenders holding the last out tranches (the last out lenders) receive a higher return for their higher risk. The AAL includes other terms similar to an intercreditor agreement. For example, in an AAL, the lenders agree that as part of the remedies against the collateral (or possibly the borrower), the last out lenders will turn over any remedial recoveries to the first out lenders.

AAL terms vary from deal to deal. There is not a standard market form and there is not yet an agreed-upon set of "market" terms to be included in an AAL. With that caveat, typical terms seen in AALs deal with:

- Tranching.
- Payment waterfalls.
- Interest and fee skims.
- Voting.
- Buyouts.
- Remedial standstill.

The lack of standardization of AAL terms and forms has resulted in certain unitranche lenders working together more regularly based on a form of AAL that they have negotiated and generally use from deal to deal. As more lenders are entering the unitranche market, these pre-negotiated AAL forms are receiving more comments and changes.

Whether the borrower sees the AAL, or even acknowledges it (as it does with a typical 1st/2nd lien intercreditor agreement), varies by deal. In many deals, the borrower does not see the AAL and does not know how the tranches are split between the lenders. Recently, more unitranche borrowers are seeing AALs, especially with deals where some of the unitranche terms are included within the credit agreement. Private equity sponsors, who are now very active in the middle market, typically require a full understanding of the unitranche terms (including the terms in the AAL).

To win mandates from borrowers, many lenders who arrange unitranche deals are willing to underwrite and close the deal without pre-closing syndication. For an arranging lender who underwrites, having good partnerships with other unitranche lenders who regularly agree on AAL terms can help lessen the risk of not being able to assign the unitranche loans to other lenders post-closing. Some of these arranging lenders will also plan to hold all of the last out tranche under the belief that selling down the first out tranche may be easier, especially to banks who may be more interested in the first out tranche because many banks prefer the risk profile of the first out tranche.

TRANCHING

The AAL creates the separate first out and last out tranches and sets out how much of each tranche a lender holds. This core structural feature of the AAL synthetically creates a structure similar to 1st/2nd lien and debt subordinated structures where one lender group has more risk and gets paid more of the economics in return. The mechanics of this risk and return in unitranche financing is described further below.

PAYMENT WATERFALLS

Most AALs introduce the concept of a "waterfall triggering event," (also sometimes known as a "payment application event"), which addresses how the two tranches share payments by the borrower under the credit agreement. While no waterfall triggering event exists, unitranche lenders usually share payments under the credit agreement pro rata (but subject to the interest and fee skims described below), without one group of lenders being paid first. In more complex unitranche structures, however, sharing of prepayments may be subject to a waterfall even in the absence of a waterfall triggering event.

Following a waterfall triggering event, the last out lenders are required to pay over any amounts received under the credit agreement (including all payments and proceeds of collateral enforcement) to the first out lenders until the first out lenders are paid in full.

The list of events that constitute a waterfall triggering event varies. It can include the occurrence of any event of default, although the market is moving away from this approach. Many AALs have a negotiated and limited list of waterfall triggers. This list is becoming more complex and bespoke by deal or sponsor. The negotiated list, at a minimum, typically includes:

- Payment default.
- Bankruptcy/insolvency default.
- Financial covenant default.
- Exercise of remedies.
- Acceleration of the loans.

There are four noteworthy complications relating to payments:

- Paid in kind (PIK) interest is now common in many middle market deals, and is being included in unitranche deals. Payment waterfalls in unitranche deals with PIK interest need to address how and when PIK interest is paid.
- In deals with a revolver, the revolving lenders want to be the first out tranche. Some revolving lenders negotiate additional rights more akin to the "super senior" status that is typical in UK unitranche deals (see European Perspective).
- With banks being seen more in unitranche deals, particularly as first out lenders providing revolving loans, they typically seek to have any hedges or other bank products included as first out obligations. AALs need to address whether these obligations should be given priority, and if so any applicable caps.
- In unitranche facilities where sponsors or their affiliates participate, AALs include complex provisions addressing rights of these inside lenders.

INTEREST AND FEE SKIMS

While the borrower pays one interest rate to all lenders under the credit agreement, the first out lenders assume less risk than the last out lenders. To compensate the last out lenders for their increased risk, the AAL requires the first out lenders to pay over to the last out lenders a specified portion of the interest received from the borrower. The administrative agent under the credit agreement manages these payments after receipt of debt service payments from the borrower.

In addition, some AALs provide that the first out lenders similarly pay over to the last out lenders a portion of the commitment fees, facility fees, and other regularly accruing credit agreement fees.

VOTING

Like a non-unitranche credit agreement, voting under a unitranche credit agreement on amendments, waivers, or remedies requires the consent of a majority of the lenders, with a few specified matters requiring the vote of all lenders or all affected lenders. Unitranche lenders in many AALs agree not to exercise these voting rights under the credit agreement unless the majority of both first out and last out lenders consent. This approach has resulted in practical difficulties for getting amendments passed, frustrating borrowers and sponsors. More complex voting arrangements are being seen in some AALs, sometimes becoming effective only after the occurrence of certain events of default, which are similar to the waterfall triggering events, or only if the tranche without a blocking position would be adversely impacted.

Other AALs specify just certain credit agreement provisions that require a voting arrangement different from the customary majority lender vote in the credit agreement, including pro rata sharing and payment application provisions. A further complication arises when a lender holds both first out and last out loans, which some AALs prohibit or limit.

As borrowers and sponsors run into practicalities of getting amendments and waivers passed in unitranche deals, different mechanisms are being used to limit the ability of lenders to block amendments and waivers and, instead, encourage lender support.

BUYOUTS

Some AALs grant both first out and last out lenders the right to buy out each other's loans at par in certain circumstances, including:

- If the other debt tranche does not consent to an amendment or waiver.
- Upon a payment default or the occurrence of any of the other waterfall triggering events.
- For deals with complex voting provisions, some deals permit the buyout of the position of any lender blocking a desired vote.

REMEDIAL STANDSTILL

AALs often have standstill provisions similar to 1st/2nd intercreditor agreements that, in a classic AAL, restrict the right of the last out lenders to bring remedies following an event of default and give the first out lenders the exclusive right to bring remedies. Restrictions relating to decisions during bankruptcy are also often included. In many deals, however, the first out tranche is significantly smaller, by dollar amount, than the last out tranches. Last out lenders with more leverage try to negotiate broader remedial rights as a way to ensure remedies are carried out in a way that generates maximum proceeds, sufficient to reach the last out tranche.

AALs, accordingly, have become more complex with respect to remedial arrangements. The AAL may provide that the last out lenders can control remedies following certain, or even all, events of default. Other AALs provide for:

- Remedies to be subject to the vote of the majority of both tranches.
- Exclusive remedies in favor of the first out tranche only for certain enumerated defaults.

ASSIGNMENTS

Unitranche credit agreements usually have customary restrictions on assignments similar to a non-unitranche credit agreement. Those restrictions can include borrower or agent consent rights, with some exceptions for certain types of assignments, including assignments to affiliates or other lenders. Many AALs have additional assignment restrictions. This could include requiring consent of certain of the lenders, or requiring a selling lender to give the other lenders a right of first refusal or right of first offer before selling to a third party.

AALs also often have restrictions on lenders holding both first out and last out loans. While middle market and subordinated loans often have less liquidity than large cap loans, the bespoke nature of unitranche financing, including additional restrictions on assignments in some deals, can further limit the liquidity of unitranche loans.

KEY BANKRUPTCY-RELATED RISKS

As seen in bankruptcy disputes among creditors in 1st/2nd lien financings, disputes among unitranche creditors could have a significant economic impact on creditor recoveries and the efficient resolution of a borrower's bankruptcy case. Resolution of potential disputes among unitranche lenders, however, has not been fully tested by courts.

It is critical for unitranche lenders to accept this uncertainty and understand the potential bankruptcy risks unique to unitranche structures. Unitranche lenders can obtain some guidance from the intercreditor disputes in the 1st/2nd financing lien context, but in some cases, unitranche financings are fundamentally different and raise unique issues.

Potential issues that could arise in a bankruptcy proceeding of a borrower with a unitranche financing include:

- Enforceability of the subordination provisions.
- Jurisdiction over the AAL terms.
- Whether voting provisions of the AAL will be enforced regarding sales of collateral or confirmation of a plan of reorganization.
- Whether the first out lender will accrue post-petition interest.
- How the claims will be classified.

SUBORDINATION

Subordination provisions, a feature of 1st/2nd lien intercreditor agreements and AALs, allow creditors to agree among themselves to repayment in a particular priority. These agreements are enforceable in bankruptcy under section 510(a) of the Bankruptcy Code, and are regularly given effect in bankruptcy plans of reorganization.

Although express reference to subordination in the Bankruptcy Code appears straightforward, it has given rise to disputes. When a bankruptcy court is asked to interpret a subordination provision (assuming it has the power to do so), the court applies applicable nonbankruptcy law. If a clause is enforceable under nonbankruptcy law, an issue that bankruptcy courts have addressed in a few cases is whether enforcement of an intercreditor agreement in the bankruptcy context negatively impacts fundamental rights afforded by the Bankruptcy Code to creditors and/or the debtor. In these circumstances, courts have ultimately refused to enforce the subordination provisions (or portions thereof) despite being allowable under nonbankruptcy law.

While the 1st/2nd lien bankruptcy cases on the meaning and limits of subordination, including the importance of fundamental bankruptcy policy, will be instructive for a unitranche dispute, there are unique aspects to unitranche financings that have not been previously addressed by bankruptcy courts. One open question is whether the unitranche lenders party to one debt instrument with a borrower presents a material difference compared to a 1st/2nd lien financing. The answer is likely to inform how a court interprets the AAL restrictions within the larger scope of promoting fundamental bankruptcy rights.

JURISDICTION

Generally, for a bankruptcy court to have jurisdiction over a dispute, the dispute needs to "arise in," "arise under," or be related to a case under the Bankruptcy Code. Bankruptcy courts often hold that a dispute between lenders brought before the court is not subject to the jurisdiction of the bankruptcy court on the grounds that the dispute is not inextricably related to the bankruptcy case. This is particularly true with these kinds of disputes arising early in a bankruptcy case, versus later in the case when the lender dispute could derail a chapter 11 plan that otherwise appears to have the necessary support.

This principle should also carry over to the unitranche financing context. Unlike 1st/2nd lien intercreditor agreements, however, many AALs are entered into only between lenders and, in some cases, without the knowledge of the borrower. It is unknown whether this distinguishing structure of unitranche financings could be a determinative factor in a jurisdiction dispute over AAL terms.

SALES OF COLLATERAL AND PLAN VOTING

Bankruptcy courts are often asked to resolve intercreditor disputes prior to approving a sale of collateral that secures more than one group of creditors or as part of a plan of reorganization. Often, 1st/2nd lien intercreditor agreements and AALs prohibit a second lien or last out lender from objecting to a sale in bankruptcy of collateral supported by the first lien or first out lenders or otherwise voting on a plan which has payment waterfalls that are inconsistent with those in the intercreditor agreement or AAL. Some intercreditor agreements and AALs also have the second lien or last out lenders assign bankruptcy voting rights to the first lien or first out lenders.

Courts are split on the enforceability of these clauses in the context of 1st/2nd lien intercreditor agreements. Some courts view certain rights of junior creditors as fundamental bankruptcy rights that cannot be altered by contract. Courts have not enforced assignments or waivers of voting rights in a few cases. In other cases, however, courts have enforced the contractual provisions of a 1st/2nd lien intercreditor agreement that waive or assign the junior lender's right to vote on a sale. Courts uniformly, however, are less likely to enforce an intercreditor agreement (and likely an AAL) that does not clearly and expressly evidence the intent of the lenders.

In the unitranche financing context, the added wrinkle is that only one lien secures all lenders, and therefore there is only one class of secured lenders whose vote is needed (subject to the discussion below on classification). With a 1st/2nd lien financing, the second lien lenders are clearly in a separate class from the first lien lenders, with their own voting rights. With a unitranche financing, the single lien and often intended single class of creditors raises an issue regarding whether a court would permit one tranche to vote separately for these purposes or would be more likely to enforce a provision in the AAL that permits one tranche of lenders to control voting for all lenders in a bankruptcy.

POST-PETITION INTEREST

Section 506(b) of the Bankruptcy Code states that "to the extent that an allowed secured claim is secured by property the value of which, after any recovery . . . is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim."

Generally, loan principal does not accrue interest in a bankruptcy case unless the principal is secured and the value of the collateral is greater than the principal amount of the loan (that is, the lender is oversecured).

Some bankruptcy cases addressing post-petition interest issues outside the unitranche context have held that a single collateral granting clause covering multiple tranches of debt is considered to be one lien covering all tranches. In these cases, all tranches covered by the single granting clause were calculated together for purposes of post-petition interest. If the reasoning of these cases were applied in the unitranche context, it may be harder for a court to find that the outstanding debt to first out and last out lenders (taken as one class) exceeds the value of the collateral. A first out lender who might otherwise accrue post-petition interest if the financing were a 1st/2nd lien financing may not be able to accrue the same post-petition interest in a unitranche financing.

CLASSIFICATION

Under section 1122(a) of the Bankruptcy Code, "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class." Claims may not get classified together if they are not substantially similar. Generally, courts have approved separate classification of first lien and senior claims, on the one hand, and second lien and subordinated claims, on the other, based on their unique legal rights (similar to separately classifying subordinated claims from general unsecured claims).

Classification can have a significant impact on creditors' rights in a bankruptcy case, including recoveries and voting. If a disproportionately large block of senior debt is classified together with a small block of subordinated debt, the subordinated lenders may find themselves disenfranchised (that is, unable to reject a plan of restructuring that benefits the majority of the senior lenders but is not in the junior lenders' best interests). Alternatively, if a large block of subordinated debt is classified with a small block of senior debt, the senior debt holders may find themselves disenfranchised. In either scenario, a voting assignment provision in the AAL could be agreed with the understanding that some bankruptcy courts have found these voting arrangements unenforceable.

ADDRESSING BANKRUPTCY RISKS

Clear documentation, strategic timing, and a keen understanding of the potentially significant economic impacts of a bankruptcy are the hallmarks for maximizing recoveries under the unitranche financing structure. Lenders and their counsel need to understand intercreditor disputes and be attuned to the possibility of exerting leverage at any point in the reorganization process to achieve a desired goal, including by seeking the bankruptcy court's assistance. Because unitranche AALs involve private deals, lenders' counsel needs to be experienced in addressing the issues specific to unitranche lending, as well as the associated bankruptcy implications.

US UNITRANCHE CASES

It remains an open question as to whether a bankruptcy court will accept jurisdiction, and to what extent, to enforce a unitranche AAL. This is particularly so with an AAL where the borrower is not a party and may not even know about the agreement. There are two instructive bankruptcy cases involving unitranche financings, but neither provides clear guidance on how a bankruptcy court will deal with unitranche financings.

AMERICAN ROADS

The first case, *In re American Roads LLC*, is a 2013 case heard in the US Bankruptcy Court for the Southern District of New York (*In re American Roads, LLC,* 496 B.R. 727 (Bankr. S.D.N.Y. 2013)). American Roads issued two series of bonds, together with a swap for each series. Syncora Guarantee, Inc., a monoline insurer, insured both series and the swaps. The rights to payment of the bondholders, swap counterparties, and Syncora were secured by a single lien on the assets of American Roads. The loan documentation included a payment waterfall giving Syncora priority payment rights and a "no-action" clause, which, broadly speaking, gave Syncora the sole right to bring remedies against American Roads.

American Roads and Syncora negotiated a pre-packaged bankruptcy plan that:

- Discharged Syncora's claims in exchange for 100% of the equity of American Roads.
- Separately classified the bondholders' claims and discharged the claims without any distribution. (The swap counterparties' claims had been previously discharged through their receipt of payments under the insurance policies.)

The bondholders raised objections. The court, however, held that the bondholders did not have legal standing to raise their objections because of the no-action clause.

Traditional unitranche lenders may be alarmed by this decision, including because the junior claimholders with a shared lien did not have standing to participate in a bankruptcy case. The junior claimholders therefore did not have the opportunity for their objections to the plan to be heard. The structure of the American Roads financing, however, is significantly different from a traditional unitranche financing because:

- The "insured unitranche" structure involved two classes of claims. A traditional unitranche financing, by contrast, is structured as a single claim, which would likely frustrate a borrower's attempt to divide the single claim into multiple claims in order to confirm a plan.
- American Roads' bondholders were not without a pathway to recovery. They had rights to seek payment from Syncora under the insurance policies.

Even if last out lenders in a traditional unitranche financing would not separately be classified and would have standing, unlike the junior creditors in *American Roads*, the court's holding on the enforceability of the no-action clause is still noteworthy. The court, in a well-reasoned opinion, concluded that sophisticated parties would be bound by their prepetition agreements with respect to properly drafted no-action clauses. As discussed above, this conclusion is largely consistent with section 510(a) of the Bankruptcy Code, which provides that subordination agreements are enforceable in bankruptcy to the same extent they are otherwise enforceable under other applicable law.

RADIOSHACK

In re RadioShack Corp., heard in the US Bankruptcy Court for the District of Delaware, is more relevant for unitranche lenders, as the case involved more traditional unitranche structures (*In re RadioShack Corp.,* No. 15-10197 (*Bankr. D. Del.*)). RadioShack had two unitranche financings with a split-collateral structure that included a:

- Traditional unitranche term loan, where all term loan lenders shared a single first lien on RadioShack's fixed assets and a single second lien on liquid assets.
- Separate traditional unitranche asset-based loan with a single separate lien on the same collateral as the other loan facility, but with reversed priorities.

The relevant dispute in the *RadioShack* case arose in connection with a section 363 sale, where RadioShack sought to sell its assets. Standard General, the last out lender, offered to purchase a substantial portion of RadioShack's stores by credit bidding its last out asset-based loans. As part of the credit bid, the first out lenders would be paid in cash. The first out lenders objected to the credit bid, contending that certain of their potential indemnification claims were not being discharged as required by the AAL. The primary question was whether the AAL required creation of a reserve for these potential claims before the last out lender could proceed with a credit bid.

Following four days of hearings, the unitranche lenders agreed to a settlement. The hearing transcripts show that many of the concerns with respect to AALs were raised by the lenders or the court. The judge explicitly stated that he was not ruling on whether the court had jurisdiction to hear the case, as the parties consented to jurisdiction. Further, arguments were made that the AAL does not impact the debtors' estates, while others argued that the AAL was a subordination agreement enforceable under the Bankruptcy Code.

Unitranche lenders can take comfort that the *RadioShack* court permitted hearings and offered guidance in interpretation of an AAL. It is positive for unitranche lenders that the court was willing to recognize the importance of the AAL to a successful section 363 sale and to hear disputes regarding the agreement. The extent of comfort unitranche lenders should take, however, is unclear for a number of reasons, including that:

- The court did not rule on whether it had jurisdiction to hear disputes regarding RadioShack's AALs. The relevant parties in interest consented to the court hearing the dispute. As a result, *RadioShack* is not clear precedent that a bankruptcy court will accept jurisdiction to adjudicate the enforceability of an AAL, at least absent consent of the lenders.
- All parties agreed, including the court, that the section 363 sale was critical to the survival of *RadioShack* as a going concern. It is unclear how much this swayed the court's willingness to hold hearings on the AAL and whether the court would have permitted hearings had the unitranche dispute been less important to the case.
- The unitranche lenders ultimately agreed on a settlement of their disputes and the court did not issue a ruling on the unitranche issues. Accordingly, we have no clear guidance on how the *RadioShack* court would have handled the ongoing dispute, which had the potential to derail a critical section 363 sale. The transcript of the court hearing is useful, but does not have the same precedential import as a reasoned opinion.

While these two cases are noteworthy and offer some guidance on how a bankruptcy court may adjudicate certain disputes related to a unitranche financing, the market is far from having the legal certainty that exists with disputes related to 1st/2nd lien intercreditor agreements. Unitranche lenders should continue to keep this in mind as they consider the legal risks of the unitranche structure.

EUROPEAN PERSPECTIVE

A strong market for unitranche financings exists in Europe. Non-banks in Europe (called direct-lenders) are the primary providers of unitranche loans in Europe, with the UK market particularly active. Deloitte Alternative Deal Tracker reports a 9% increase in direct-lender European deals closed in the last quarter of 2015, with the majority being unitranche.

Unitranche financing on both sides of the Atlantic has a common meaning, which is a combination of senior and junior debt tranches into one loan agreement with a blended interest rate falling between the rate for senior and junior debt. While unitranche financing in the US refers to a specific loan structure, the term is used more broadly in Europe and includes multiple loan structures. In the UK, the most basic unitranche structure is a single tranche term loan with a blended interest rate. All term lenders have the same rights in this structure.

The unitranche structure can become more complicated if the borrower also wants to include a revolving loan tranche in the loan agreement. When there is a term tranche and revolving tranche, the revolving tranche is usually smaller than the term tranche (giving the term tranche lenders voting control under typical voting rules, whether a 66-2/3% or majority lender vote standard). The revolving tranche is nonetheless typically given a "super senior" status under the loan agreement. This status affords the revolving tranche certain priority rights, including:

- Exclusive enforcement rights following default (or, often, only certain material defaults) and a standstill period.
- Priority payment rights from collateral.
- Often a separate financial covenant that benefits only the revolving tranche lenders.
- Veto rights over certain material collateral sales.
- Veto rights over amendments that adversely impact the super senior status.

Certain unitranche loan agreements add more complexity by granting term or swap debt (up to a cap) super senior status. These priority rights, however, are in the loan agreements and agreed to up front among the lenders and the borrower.

The US unitranche structure, with its AAL retranching loans behind the scenes, has been used in the UK and other European jurisdictions, but has not taken hold of the market yet. As European unitranche deals have grown in dollar amount and in the number of lenders, some deals use the US structure to attract more lenders by having the increased return that can result from retranching and interest/fee skims. Also, as more US private equity sponsors invest in Europe, their comfort with the US structure is resulting in its increased use in Europe. As in the US, European insolvency law has not tested this structure.

FUTURE OF UNITRANCHE FINANCING

Unitranche financing has gained a strong foothold in middle market lending as a preferred structure for borrowers and lenders. Below are a few thoughts on the future of unitranche financing:

- **Greater deal volume**. Unitranche deal volume should continue to grow as more borrowers, sponsors, and lenders (bank and non-bank) become comfortable with the structure and risks.
- **Increasingly complex deals**. Unitranche deals will continue to grow in complexity and be tailored to the express needs (pricing or structure) of the borrower or to satisfy the unique investment and return requirements of unitranche lenders.
- **More standardization of unitranche terms**. While the terms and forms used in many unitranche deals are viewed as proprietary and confidential by many lenders and counsel, more standardization of unitranche terms is expected. As deals get more complex, and more sponsors get comfortable with unitranche financing, there should be a push to have more standardized terms to speed up deal negotiation and closing. This should happen naturally as more lenders participate in unitranche deals, and a sense of "market terms" develops. Whether industry groups like the Loan Syndications and Trading Association (LSTA) or the American Bar Association choose to support standardization efforts will be a function of whether it is encouraged by their membership.
- **More cross-border deals**. The volume of unitranche structures will continue to grow outside of the US, including in Canada and Europe. The bankruptcy and insolvency analysis described above would need to be carefully considered by each jurisdiction so that lenders and attorneys understand the risks.
- **More multi-jurisdiction deals**. Unitranche structures are being seen in deals with borrower groups in multiple jurisdictions, and this is expected to continue. These multi-jurisdiction deals require an understanding of each jurisdiction's bankruptcy and insolvency risks. In addition, the documentation required for these deals will be more complex, reflecting the risks of all the jurisdictions.
- **Some migration of the unitranche structure to the large cap market**. Unitranche structures, with all lenders signing the AAL, makes for a more cumbersome loan transfer process. This could make migration of unitranche financing to the large cap market more difficult, where ease of trading and execution are valued. Further, the lack of standardization in unitranche terms and documents could slow migration. However, it is expected that lenders and borrowers will seek to find ways to allow for this structure.

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