

PROSKAUER

Do unitranches work?

The ‘agreement among lenders’ used in unitranche financing is relatively untested. However, there is one example of a court case that provides comfort for those concerned about enforceability. **Peter J. Antoszyk** and **Stephen A. Boyko** of Proskauer explain

In the last five years, lenders in the mid-market have experienced stiff competition from a relatively new form of financing commonly referred to as “unitranche”. A typical unitranche (although they can come in many different forms) is evidenced by a single loan agreement, with one loan, one rate and one security interest.

The unitranche lenders enter into an agreement among lenders (or AAL) which is designed to pull the structure apart to replicate a two-document structure, such as a first-lien, second-lien transaction, where some of the lenders take first-lien risk and others take second-lien risk. In that case, many of the provisions of the AAL mirror provisions found in a typical first-lien, second-lien intercreditor agreement.

Over the years, a reasonable body of case law and practical experience has developed to help guide lenders through a workout and restructuring of a capital structure with first-lien and second-lien loans. Many key intercreditor provisions have been tested and interpreted by practitioners in workouts and insolvency proceedings.

With unitranches, it’s a different story (or so it seems). There is only one reported decision that interprets an AAL; there are a number of unique (and untested) issues; and there are very few practitioners with practical experience in dealing with unitranches in a work-out. This leads us to the \$64,000 question: Do unitranches work?

WHAT IS A UNITRANCHE AND HOW DID WE GET HERE?

Before addressing this question, some background is in order. Unitranches have been around for approximately 15 years



Peter J. Antoszyk

but did not really gain traction in the market until 2006 to 2007. At that time, they were designed to replicate a first-lien, second-lien, two-document structure and were used exclusively in mid-market transactions.

The unitranche has since evolved into a platform of products that can replicate any two-document structure. Today we see unitranches replicating not only first-lien, second-lien structures but also senior-mezzanine, split collateral, upside down or silent-first lien structures as well as many unique and innovative hybrid debt structures. The product, which started in the mid-market, has also been adopted by the upper mid-market with transaction sizes exceeding \$500 million.

The structure has proven attractive to sponsors and borrowers who like the simplicity of the single document structure. It has the advantage of being preceded by one commitment letter, one term sheet, one diligence process and ultimately one suite of

loans documents. This expedites and simplifies execution and may result in significant cost savings, particularly in transactions with heavy real estate, intellectual property, motor vehicles or other unique forms of collateral. As a result, billions of dollars of financings have been successfully closed with unitranche structures, and there is no reason to believe that unitranches will not continue to be popular.

AGREEMENT AMONG LENDERS

The unique aspect of unitranches is the agreement among lenders, or AAL. With the stroke of a pen, the AAL attempts to pull the one-document structure apart and transform it into a two-document structure. While AALs started as simple five-page documents with pricing terms and payment waterfalls, today they are often 50 pages or more with many of the familiar features of an intercreditor agreement. These include an acknowledgement of lien and payment priorities, remedy standstills, lien releases, buyout rights and bankruptcy waivers that address debtor-in-possession financings, asset sales, adequate protection, relief from stay, and voting on a plan of reorganisation.

The AAL also contains provisions unique to a unitranche and not found in an intercreditor agreement. For instance, unitranches often include provisions that re-allocate the economics under the credit agreement, such as principal, interest, fees and prepayment premiums. In these cases, the last-out lenders are entitled to receive a portion of the economics that would have otherwise been payable to the first-out lenders. This is commonly referred to as a “skim.”

In a typical AAL, there is also a payment waterfall that re-allocates many (if not all) payments to the lenders following the occurrence of a significant credit event (such as a payment default or an exercise of remedies); class voting rights in favor of the first-out and last-out lenders in respect of some or all amendments and waivers; provisions that address how lenders may vote in an insolvency proceeding; terms that re-allocate debt and equity securities received by the lenders in respect of their claims in an insolvency proceeding; rights of first offer or refusal on the assignment of debt by a lender in another tranche; and a number of other provisions that can only be found in unitranche.

BUT DO THEY WORK?

All of these provisions, when taken in the context of the single-document, single-lien unitranche structure, serve to bind lenders more closely together than in a comparable two-document structure. They create a partnership that is important in light of the interconnected nature of unitranche.

We have found that the lenders that enter into these arrangements often take time to identify like-minded partners, approach underwriting, credit and work-outs in a similar fashion, and forge relationships between their institutions at the highest levels. This creates a different dynamic between the lenders than is customary in a two-document structure. In a two-document structure, lenders of different tranches are in separate lender groups; have their own agent with separate counsel; have separate lender meetings and retain separate professional advisors, including turnaround advisors and investment bankers; and are under no obligation to share information with other tranches. This creates an adversarial environment with little to no cooperation between the lender groups.

By contrast, in a unitranche, the lenders are a part of the same lender group, share a common agent, listen to the advice of



Stephen A. Boyko

the same counsel and advisors, receive the same information and reports, and participate in lender meetings together. In dealing with a work-out, unitranche lenders also have to consider the overall relationship between their institutions, the overall portfolio that they co-manage and the collective work-out experience they have developed together throughout the programme. All of this, we find, encourages unitranche lenders to work together as partners to seek a mutually beneficial resolution. In essence, the structure of a unitranche encourages lenders to work together.

Unfortunately, work-outs are not always settled in a conference room. To date, there has been only one bankruptcy case in which an AAL was put before the court for consideration. Radio Shack involved a first-out, last-out unitranche in which the last-out lenders agreed not to object to a debtor-in-possession (DIP) financing that met certain pre-agreed criteria. Radio Shack filed bankruptcy and the last-out lenders objected to the DIP financing. The first-out lenders filed a motion with the court asking it to determine that the objection by the last-out lenders was a breach of the AAL.

In Radio Shack, the court found that the filing of the objection did not breach the AAL as the last-out lender retained the right to object to DIP financing on any grounds available to an unsecured creditor.

The result in that case is somewhat unremarkable. The AAL was not ambiguous on this point and the court had little trouble coming to its conclusion. The larger point of the case was that the court took the issue under advisement and ruled on the agreement between the lenders. In doing so, the court telegraphed to the lending world that the AAL, like the hundreds of intercreditor agreements that preceded it, was enforceable (at least with respect to the issue presented).

We would expect provisions that are similar to those found in intercreditor agreements to be adjudicated in a similar fashion. Meanwhile, other provisions that are unique to an AAL are merely contractual provisions that are susceptible to interpretation and enforcement by a court on the same basis as other contracts, including intercreditor agreements. The rules of contract interpretation are well understood by practitioners, and we would expect that they would apply to agreements among lenders in the same way as other contracts, absent a fundamental violation of public policy.

The market, and at least one court, has spoken. We believe that unitranche are here to stay, and lenders and borrowers alike are growing more and more comfortable with unitranche as an alternative to traditional lending structures. ■

1. A number of lenders have also formed unitranche joint ventures but those relationships, which are governed at the fund level and not by an AAL, are beyond the scope of this article. For reference, the first of these vehicles—Unitranche Fund LLC—was formed by GE Commercial Finance and Allied Capital in 2007.

2. *In re RadioShack Corp.*, Case No. 15-10197 (Bankr. D. Del.).

Peter J. Antoszyk is a partner in the Corporate Department and a member of the Multi-Tranche Finance and Business Solutions, Governance, Restructuring & Bankruptcy Groups at Proskauer; **Stephen A. Boyko** is a partner in the Corporate Department and co-head of the firm's Finance Group and Multi-Tranche Finance Group.