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Unitranche Financing Facilities: Simpler or More Confused?

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The unitranche financing facility, versus a more traditional two-loan structure, is widely thought to generate efficiencies, ease the process of closing, streamline administrative functions, and, ultimately, to pass along cost savings to lenders and borrowers. The authors of this article examine unitranche financing facilities, and conclude that while unitranche deals offer clear benefits, there are significant elements of uncertainty associated with such deal structures that the careful practitioner must be aware of in drafting loan documents and advising clients.

Unitranche facilities are a relatively recent innovation in the middle market lending sector designed as an alternative to the typical first and second lien loan structure. The unitranche facility, versus a more traditional two-loan structure, is widely thought to generate efficiencies, ease the process of closing, streamline administrative functions, and, ultimately, to pass along cost savings to lenders and borrowers.

A middle market loan is often structured as two separate loans — a first lien facility and a second lien facility. The first lien facility generally consists of the larger portion of the overall borrowing, including, potentially, both a term and revolving loan. The first and second lien lenders commonly will take security interests in the same collateral — substantially all of the borrow-

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ers' assets — with the relationship between the first and second lien lenders governed by an "intercreditor agreement" that delineates the priorities of the lenders in the collateral and sets forth the rights and obligations among the lenders. More specifically, the intercreditor agreement typically will subordinate the liens and rights of the second lien lenders (including rights to payment) to those of the first lien lenders and may require the second lien lenders to "standstill" on any enforcement actions in respect of the collateral until such time as the obligations owing under the first lien facility are paid in full.

The intercreditor agreement also contains a myriad of other provisions that govern the rights of the first and second lien lenders in the context of a bankruptcy proceeding, including the rights of the lenders to object to asset sales or the borrower's proposed plan of reorganization, credit bid in asset sales, receive adequate protection or postpetition interest, consent to the use of cash collateral, or provide debtor in possession financing, among other things. The borrower is typically a party to the intercreditor agreement.

Importantly, the first and second lien facilities are entirely separate credit arrangements, although particular lenders may hold both first or second lien debt. Each loan in this two-loan structure is governed by its own fully negotiated set of lending documents (although the documentation likely will be similar between the facilities), including, among others, a credit agreement, security agreement, guaranties, collateral trust agreements, and other supporting documentation negotiated and prepared by separate counsel and other advisors. Each loan also will typically be administered independently by separate collateral and administrative agents. Fees and costs associated with negotiating, documenting, and administering each of the first and second lien facilities — including agent fees and professional expenses — are borne by the borrower independently.

The unitranche facility offers an interesting alternative in middle market deals, where cost sensitivities have driven lenders to offer more streamlined products. The unitranche structure has found a popular audience as a potentially simpler, more cost-effective method of funding a middle market company than traditional structures. While trends in the unitranche space are beginning to emerge, it is important to remember that these deal structures are still somewhat nascent, and, thus, terms may vary widely between deals and will turn on the relative negotiating positions of the parties.

In contrast to the first lien/second lien deal structure described above, a unitranche facility is structured as a single loan, secured by a single first lien in collateral, but with two tranches of debt — a "first out" tranche and a "last out" tranche. The first out tranche also may contain a revolver. As the names imply, the first out tranche of the facility has priority in payment over the last out tranche. Fees and interest, and any amortization, are allocated disproportionately among first out and last out lenders based on the relative risk of the lenders, and, typically, the last out tranche accrues at a higher rate of interest than the first out tranche. The borrower pays one blended interest rate on the entire amount of the facility, and the entire loan balance is amortized over a single amortization schedule. In some instances, the loan may be weighted more heavily in the last out tranche.

The relationship between the first out and last out lenders is governed by an "agreement among lenders" ("AAL"). The AAL operates much like an intercreditor agreement and sets forth many of the operative provisions of the unitranche structure, including those provisions that subordinate the interests of the last out lenders to those of the first out lenders. Interestingly, unlike an intercreditor agreement, the borrower is typically not a party to the AAL, and, as a general matter, the borrower may have very little visibility into the two-tiered nature of the credit facility. This may ultimately prove a disadvantage to the borrower, as there is a general lack of transparency with respect to the lender group and the varying economic interests among them, which could complicate any effort to restructure a unitranche loan.

A CLOSER LOOK AT THE UNITRANCHE SUBORDINATION STRUCTURE

Among the lenders, the AAL contains important features that distinguish between first out and last out lenders, the most important of which are discussed below. From a practice perspective, it is critical to note that issues not adequately addressed in the AAL are resolved by reference to the underlying credit agreement. Thus, in order to maximize predictability, it is critical to ensure that the key elements of the parties' agreement are adequately resolved by the express terms of the AAL or credit agreement.

Payment Waterfall

The chief function of the AAL is to establish the payment waterfall among the first out and last out lenders. The common structure of a unitranche facility provides that interest payments, and, in some instances, principal payments, made by the borrower in the ordinary course of the loan will be apportioned among the first out and last out lenders by the administrative agent in accordance with their *pro rata* shares of the debt, with the blended rate of interest and method of apportionment, unique for each deal.

Proceeds of collateral, however, following an enforcement of remedies by the collateral agent, or, in some cases, any payments received from the borrower following a material event of default (such as a bankruptcy filing, violation of a leverage ratio covenant or a payment default) will typically be paid: first, to the administrative and/or collateral agent on account of fees and expenses; second, to the first out lenders on account of fees and expenses; third, to the agents for interest and principal owing on any advances, and fourth, to the first out lenders on account of first out debt obligations, including principal and interest. Only once these amounts have been paid in full (including postpetition interest in the case of a bankruptcy filing) are the last out lenders entitled to receive any payment on account of their fees and expenses, or the principal and interest owing in respect of the last out debt.

Additionally, it is common for optional and mandatory prepayments, and in some deals, amortization payments, to be applied first toward the principal of first out loans until paid in full, and only then to the principal of the last out loans. However, in some instances, mandatory prepayments from excess cash flow or equity proceeds may be made ratably among first out and last out lenders.

Voting Rights – Remedies Enforcement and Amendments

It is typical in larger credit facilities, which contain more than one level of secured debt and one or more syndicate of lenders, for the applicable loan documents to delineate clearly the voting rights among lenders within a facility, and to award some composition of "required lenders" the power to direct the administrative and collateral agents to act in certain instances, including in the face of an event of default. As credit facilities have grown larger and more widely syndicated, disputes regarding the power of the majority lenders to direct the agent to act, and an agent's ability to bind dissenting lenders on important issues have arisen, with fairly consistent results in the courts, as discussed in greater detail below.

In the unitranche context, these issues are perhaps of greater complexity given the unique relationship between the first out and last out lenders. As with many of the more important aspects of unitranche deals, there are no set market terms for how voting rights should be apportioned among the first out and last out lenders, or governing which lenders should have the power to direct the agent.

A common variation, however, allows "required last out lenders" (i.e., holders of at least 50 percent of last out debt) to participate in decision-making with respect to the enforcement of remedies or the amendment of key credit documents until there is a material event of default — typically, the violation of a leverage ratio covenant, a payment default, or the commencement of a bankruptcy or insolvency proceeding. Following an event of default of this nature, only the "required" first out lenders (i.e., holders of 50 percent or more of the first out debt) can direct the agent to exercise remedies or amend the lending documents. Moreover, irrespective of whether there is a continuing event of default, first out lenders typically have the exclusive right to agree to any amendments to the credit documents that impact material financial terms of the first out debt or any financial covenants.

Buy-Out Option

The typical AAL contains a "buy-out" option under which the last out lenders have the right, under certain defined circumstances, to buy out the 100 percent interests of all, or a certain sub-set of the first out lenders. Triggering events for the buy-out option typically include (but are not limited to) the following situations:

- a maturity of the loan obligations has been accelerated based on an event of default under the terms of the applicable loan documents;
- another event of default under the applicable loan documents;

- the collateral agent is required to commence remedies, including enforcement actions, or has exercised any secured creditor remedies with respect to any loan party;
- violation by the borrower of certain leverage ratio covenants; or
- the occurrence and continuance of an insolvency proceeding.

All, or some sub-set, of the last out lenders may elect to initiate the buy-out option by giving notice to the administrative agent of their intention to buy out the first out interests following the occurrence of one of the aforementioned trigger events. Within a period of time that notice has been received by the agent — typically five to 10 business days — the electing last out lenders are committed to buy 100 percent of the first out interests in a *pro rata* amount based on their holdings of last out interests. The purchase price is, generally speaking, equal to the outstanding obligations (principal and interest) owing in respect of the first out loan obligations, including term and revolving loans, committed letters of credit, and the fees and expenses owing to the first out lenders.

Certain AALs additionally give last out lenders a buy-out option in the event that the required last out lenders have agreed to certain modifications or amendments to the loan documents, and the required first out lenders have not given such consent. In these, or similar instances, the last out lenders may be permitted to buy out the amount of the "hold out" first out loan interests as necessary to permit the amendment or modification.

In either instance, the buy-out option is designed to give the last out lenders some element of control in instances where the loan has become a troubled credit and the payment of the last out debt may be in jeopardy. While these provisions may impact the liquidity of the loans, the careful practitioner will consider these provisions closely before including them in an AAL.

Right of First Refusal

Another common feature of an AAL is a right of first refusal, whereby the lenders — both first out and last out — agree that before selling or otherwise transferring their interests in any of the debt to a third party, the selling lender must offer its right in the debt position to the administrative agent (who may also be a lender) prior to consummating a sale to a third party. In some instances, it is only the last out lenders who may have this right of first refusal. As with the buy-out right, the right of first refusal is designed to give the existing parties to the loan some element of control within the lending syndicate.

Agreements on Conduct in Bankruptcy

An AAL may also address certain issues relating to the parties' conduct in a bankruptcy proceeding, which may or may not resemble those set forth in a typical intercreditor agreement depending on the relative negotiating power of the parties. For instance, AALs will typically place restrictions on the ability of first out and last out lenders to commence involuntary insolvency proceedings against the borrower. AALs will also commonly preserve the ability of lenders to object to proceedings in their capacity as unsecured creditors. Moreover, and importantly, AALs will set forth procedures for requiring and obtaining any necessary consent with respect to the use of cash collateral or debtor-in-possession financing, as well as for conducting or objecting to sales of assets under Section 363 of the Bankruptcy Code.

Nevertheless, last out lenders will not typically agree in advance to any kind of asset sale, debtor in possession financing, use of cash collateral or other important bankruptcy proceeding matter. Moreover, it is not uncommon for the first out lenders to agree not to object to a sale of any collateral free and clear of their liens, provided that the collateral agent and the last out lenders have consented to the sale. In such situations, however, the first out lenders' liens will typically attach to the proceeds of the sale, and the waterfall scheme set forth in the AAL would apply to the distribution of the proceeds.

First out lenders also may agree not to object to debtor-in-possession financing provided by the last out lenders so long as the first out lenders are not primed as part of the bankruptcy financing, the first out lenders are afforded adequate protection liens on postpetition assets to the same extent as the postpetiton lenders, and the amount of postpetition financing does not exceed a certain express cap. In each instance, the first out lenders will commonly retain their rights to object in their capacities as unsecured creditors, or to the extent the proposed transaction is not in accordance with the AAL.

COMMON BENEFITS OF THE UNITRANCHE FACILITY

There are a number of reasons why the unitranche structure is attractive in smaller sized deals. As a general matter, transaction costs are lower in unitranche deals than the typical first lien/second lien structure because there are fewer financing agreements and fewer parties to the negotiations. For the same reasons, unitranche deals can close more quickly than a more traditionally structured deal. Additionally, unitranche loans are not typically syndicated widely, if at all, and thus, there is greater certainty of closing on schedule and in accordance with the originally agreed upon terms. Moreover, with fewer lenders in a unitranche deal, a borrower may benefit from streamlined due diligence.

On the administration side, a unitranche deal features a single administrative agent and collateral agent, which reduces costs, and fewer lenders can mean more streamlined decision-making. With respect to pricing, there is some perception that a unitranche deal may offer some interest savings in that a single rate for the borrower may be less than the blended rate of first and second lien debt under a more traditional structure. Nevertheless, as discussed at greater length below, the uncertain nature of certain key issues with respect to the treatment of a unitranche facility in bankruptcy may offset, at least in part, some of the perceived benefits of the more streamlined loan structure.

ENFORCEMENT AND BANKRUPTCY RELATED ISSUES

The relatively recent advent of the unitranche structure raises some interesting questions in the context of a bankruptcy proceeding, where the enforcement of an AAL, and the various issues that commonly arise between lenders in a bankruptcy proceeding are, to date, untested. Many of these issues are addressed below.

Enforcement of an AAL as a Subordination Agreement

To our knowledge, a bankruptcy court has never passed on the issue of whether an AAL is enforceable in a bankruptcy proceeding, and thus, binding in that context. Pursuant to Section 510(a) of the Bankruptcy Code, a "subordination agreement is enforceable under [the Bankruptcy Code] to the same extent that such agreement is enforceable under applicable nonbankruptcy law."[1] Thus, to the extent an AAL is considered a "subordination agreement" and is otherwise enforceable under applicable state law, the AAL should fall within Section 510(a) of the Bankruptcy Code and would be enforced by its terms.

A key threshold issue, however, is whether the bankruptcy court would have jurisdiction over a dispute arising out of the AAL given that the borrower is not a party to the agreement. Bankruptcy courts are generally loathe to preside over purely third party disputes, and in particular, intra-creditor fights that do not implicate the debtor. Given that any dispute between a first out and a last out lender would necessarily require the bankruptcy court to delve into the minutiae of an agreement between lenders to which the debtor is not even a party, a bankruptcy court could very well determine that any dispute between the lenders is not properly before it. In such case, the parties would presumably end up in the appropriate state court to settle the contract dispute.

Nevertheless, Section 510(a) of the Bankruptcy Code does not state that the debtor must be a party to the contract for the subordination agreement to be enforceable in bankruptcy. Moreover, to the extent a dispute relates to a lender's treatment under a Chapter 11 plan (such as classification, payment of postpetition interest, etc.), a court may very well decide the issue.[2] Some agreements we have seen go so far as to expressly state that the AAL shall constitute a subordination agreement for purposes of Section 510(a) of the Bankruptcy Code, and, therefore, are enforceable by their terms in a bankruptcy proceeding. It is unclear, however, that such language would be dispositive of the issue.

To the extent a bankruptcy court did entertain a dispute among lenders with respect to an AAL, the court could look to existing law in the subordination agreement context for guidance. In that regard, bankruptcy courts have consistently enforced subordination agreements to subordinate a junior lienholder's right to payment under a plan of reorganization.[3] And, as discussed in greater detail below, courts have specifically enforced subordination agreements in the context of a senior lender's ability to collect postpetition interest prior to any recovery by a junior creditor.[4]

In some instances, however, courts have not enforced a subordination agreement when such agreements infringed on what the courts considered to be fundamental bankruptcy rights, such as preventing a party from voting on a plan of reorganization or objecting to key issues within a bankruptcy proceeding.[5] But even then, courts are hardly uniform on the issue.[6] Some courts have also refused to enforce a subordination agreement where its subordination provisions were not sufficiently specific to give the junior creditor notice of the subordination.[7]

Thus, to the extent a bankruptcy court were to treat an AAL as a subordination agreement, and further entertain a dispute between first out and last out lenders regarding its subordination provisions, a court would, based on existing precedent, likely enforce the agreement except to the extent, potentially, that the last out lenders had been forced to forego what courts have considered to be fundamental bankruptcy rights. Many of the AALs we have seen expressly preserve the right of respective lenders to participate in proceedings in their capacity as unsecured creditors, to vote on a plan of reorganization, to provide and object to debtor in possession financing and use of cash collateral, and to partake in, or object to, the sale of assets in a proceeding. Consequently, these agreements would appear to comport with existing case law on the enforcement of a subordination agreement. Nevertheless, enforcement of an AAL is not certain in bankruptcy no matter how tight the drafting, which could result in the first out and last out lenders dueling in an applicable non-bankruptcy court.

Collection of Postpetition Interest

Assuming an AAL is enforced as a subordination agreement in bankruptcy, another interesting issue that may arise in the bankruptcy context is the ability of a first out lender to collect postpetition interest on its claim prior to a last out lender collecting on its claim. As has been well established, the general rule in bankruptcy is that creditors — secured and unsecured — are not entitled to collect interest that accrues on their prepetition claims following the filing of a bankruptcy petition.[8] An exception to that general rule is set forth in Section 506(b) of the Bankruptcy Code, which allows a secured creditor to recover reasonable fees, costs and interest that accrue postpetition and which arise under the express terms of a credit agreement, to the extent that such secured creditor is "oversecured" by its collateral.[9]

In the typical first lien/second lien scenario, the determination of whether a first lien creditor is oversecured, and thus entitled to postpetition interest, is a relatively simple matter after the amount of the claim is settled and the collateral securing the claim has been valued. Provided the collateral is worth more than the claim, the first lien lender is entitled to postpetition interest; and pursuant to the typical intercreditor agreement between the first and second lien lenders, the first lien lender may be entitled to collect such interest prior to any distribution to the second lien lender.

In the unitranche structure, determining whether a first out lender is entitled to postpetition interest is a more complicated endeavor given that the first out and the last out lenders hold different tranches of the same first lien claim. Unlike the first lien/second lien scenario, there are not separate claims against the debtor that can be easily delineated in a unitranche deal. Moreover, the debtor is not even a party to the AAL, the operative document that arguably bifurcates the first out and last out claims. Thus, a court could decide that first out and last out claims are simply one claim against the debtor. Thus, if the entire claim is worth less than the collateral, the first out lenders (even if otherwise "oversecured") are undersecured for purposes of 506(b), and therefore, not entitled to postpetition interest.

The court in *Ionosphere* faced a similar factual scenario and reached that very conclusion. In that case, the debtor had issued three series of notes under the same indenture, each in differing amounts, at differing interest rates, and each with separate trustees.[10] Each issuance was secured by a first lien on the same collateral — a pool of aircraft and engines.[11] As of the petition date, the aggregate outstanding amounts owing under the notes was $453,765,000, with $187,934,000 owing on the first series, $168,665,000 owing on the second series, and $97,166,000 owing on the third series.[12] The debtor ultimately sold the collateral in the bankruptcy proceedings for approximately $232,000,000.[13]

The debtor and the collateral trustee agreed by stipulation to a turnover of nearly all of the proceeds (save for a small holdback for certain expenses and claims), and thereafter, the first series noteholders instructed the collateral trustee to turn over all of the proceeds on account of first series noteholder claims, which represented both the principal and interest owing on the petition date, as well as postpetition interest.[14] The first series noteholders argued their claim was oversecured because the proceeds exceeded the amount of their claim on the petition date, and, pursuant to an intercreditor agreement among the various series of noteholders, the first series noteholders were entitled to the full payment of postpetition interest prior to any recovery by the second or third series noteholders.[15] Conversely, the second series holders argued that only $187,934,000 of the proceeds should be turned over to the first series holders — the principal and interest owing on account of their claims as of the petition date — with the remainder turned over to the second series holders on account of their claims.[16]

The first issue addressed by the court was whether the three series of notes should be considered three separate claims, as argued by the first series holders, such that the first series could be considered "oversecured." The court held the claims should be considered one claim — and thus, undersecured — writing that:

> It is clear that if the three Series held separate liens against the Collateral, then the First Series would be oversecured and would be entitled to postpetition interest, but that is not the structure of this transaction. The Debtor granted only one lien, only one secured claim, in favor of all the Certificateholders. How the rights to proceeds of the lien collateral were to be distributed under the Indenture was an intramural matter for the Collateral Trustee and the various series, not the Debtor.[17]

Because there was only one secured claim against the debtor, the court found the claim to be undersecured as a whole, and thus, the first series were not entitled to postpetition interest from the debtor.[18]

That conclusion did not end the court's analysis, however. The court went on to discuss the relative rights of the secured lenders under their subordination agreement, which the court found to be enforceable in bankruptcy under Section 510(a) of the Bankruptcy Code.[19] The first series argued that if postpetition interest could not be recovered under Section 506(b) of the Bankruptcy Code from the debtor, the first series noteholders were still entitled to recover postpetition interest on their claims out of the recovery to junior creditors to the extent provided by the terms of the intercreditor agreement between the parties.[20] The court ultimately held that applicable state law (New York) requires that any right of the first lien lenders to recover postpetition interest out of the recovery to the second lien lenders to be clear and explicit, and that the intercreditor agreement was not sufficiently clear on this point to notify the junior noteholders that their claims might be subordinated in this fashion.[21] Nevertheless, the court held out the possibility that if clear and explicit, an agreement of this nature could be enforced.[22]

Since the ruling in *Ionosphere*, the jurisprudence on the ability of an undersecured creditor to collect postpetition interest on its claim from a junior creditor under the terms of an intercreditor agreement is fairly well developed. In that regard, courts have held that a senior creditor under a subordination agreement can assert that its claim is entitled to postpetition interest, with the payment of interest coming not from the debtor's estate, but from the dividend that would otherwise be paid in respect of the subordinated claim.[23] Courts have followed this logic, provided that the agreement in question is consistent with applicable state law, which generally requires the subordination to be clear and explicit.[24] Prior to the enactment of Section 510(a), this was known in jurisprudence as the "rule of explicitness," which was replaced with the enactment of Section 510(a) and reference to applicable state law.[25]

Based on the foregoing, it seems likely that, pursuant to the reasoning in *Ionosphere*, a unitranche facility would be considered a single secured claim based on the single facility and the single lien granted in respect of the claim. Thus, to the extent that the total aggregate unitranche claim was undersecured, an "in the money" first out lender is unlikely to be able to recover postpetition interest from the borrower's estate under 506(b) of the Bankruptcy Code.

Nevertheless, under the reasoning of *Ionosphere* and related cases, a first out lender may still be able to collect postpetition interest at the expense of a last out lender under the terms of the AAL, provided that the right to recovery is clear and explicit, particularly when the agreement in question is governed by New York law (which still follows the rule of explicitness). As such, simply providing that all first out obligations are to be "paid in full" prior to the receipt of funds by the last out lenders is insufficient in this regard. Instead, the AAL should make clear that no recovery in a bankruptcy proceeding is to be had by the last out lenders unless and until all the claims of the first out lenders are paid in their entirety, including, without limitation, all claims for postpetition interest and other fees and expenses associated with the bankruptcy.

Classification of Claims, Claim Treatment and Confirmation-Related Issues

Probably the most critical, and complicated issues that arise in the bankruptcy context — which potentially weigh on how much flexibility a borrower has to restructure a unitranche facility — relate to the classification and treatment of the first out and last out claims. These issues are of particular importance if a unitranche deal is more heavily weighted in the last out tranche. In such instances, if first out and last out claims are classified together, the last out lenders could hold a blocking position within the class of lenders on any Chapter 11 plan despite having been subordinated under the AAL, thus potentially making the last out lenders a relevant negotiating party.

Section 1122(a) of the Bankruptcy Code sets forth the rules for classifying claims in a plan, providing that "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."[26] While the Bankruptcy Code provides that substantially similar claims *may* be classified together, the Bankruptcy Code does not *require* that they be classified together.[27]

Nevertheless, courts have constructed some limitations on a debtor's ability to classify similar claims separately. For example, in *John Hancock*, the Third Circuit noted that:

> [I]t seems clear that the Code was not meant to allow a debtor complete freedom to place substantially similar claims in separate classes. The critical confirmation requirements set out in section 1129(a)(8) and section 1129(a)(10) would be seriously undermined if a debtor could gerrymander classes.[28]

Thus, the Third Circuit explained that, while the Bankruptcy Code does not necessarily prohibit the placement of similar claims in different classes,

> There must be some limit on a debtor's power to classify creditors in such a manner [to assure that at least one class of impaired creditors will vote for the plan and make it eligible for cram down consideration by the court]. The potential for abuse would be significant otherwise. Unless there is some requirement of keeping similar claims together, nothing would stand in the way of a debtor seeking out a few impaired creditors (or even one such creditor) who will vote for the plan and placing them in their own class.[29]

Consequently, a classification scheme must be reasonable in light of the purposes that classification serves under the Bankruptcy Code — voting to determine whether a plan can be confirmed, and the treatment of claims under the plan. For purposes of cramming down a plan on a class of dissenting creditors, this means that each class must represent a voting interest that is sufficiently distinct and weighty to merit a separate voice in the decision-making process on a plan.

In the context of secured claims, creditors with liens of different priority in the same property will usually be classified separately in a Chapter 11 plan.[30] This is particularly the case where treatment among secured creditors will vary.[31] Thus, secured claims are very commonly classified together when such claims arise from the same agreement and are secured by, and have the same priority in, the debtor's property.[32]

Based on the foregoing well-established law, in the typical first lien/second lien structure first lien lenders and second lien lenders are almost uniformly classified separately, as the claims held by each group arise out of different credit agreements and have different priorities in the debtor's collateral. Moreover, given the different priorities in the debtor's assets, first and second lien lenders also typically receive quite different treatment under a plan. Due to their subordinated nature, the second lien lenders may have little control over the plan process, or the treatment of the first lien lenders in a restructuring. Sometimes, the debtor may negotiate almost exclusively with the first lien lenders regarding the terms of a restructuring, with the second lien lenders playing a more minor role in any negotiations.

In a unitranche scenario, however, it may not be clear how a debtor should classify and then treat the first out and last out claims under a plan of reorganization. Assuming a unitranche facility where the last out lenders hold a blocking position if classified with the first out lenders, and further assuming that there is no consensus among the debtor and the last out lenders with respect to a restructuring, the debtor will need to seek confirmation of its plan over the objection of the dissenting last out lenders through cramdown. Section 1129(b) of the Bankruptcy Code sets forth the requirements for approving a plan of reorganization over the objections of a secured creditor, providing that in order to cram down a plan on a dissenting class of secured creditors, the plan must avoid unfairly discriminating against such class, and the plan must be fair and equitable in the treatment of the claims of such class, requirements discussed at greater length below.[33] Section 1129(a)(10) (applicable in a cramdown) also requires that at least one class of impaired, non-insider creditors votes to accept the plan.

From the debtor's perspective, the simplest plan structure would be to classify the first out and last out claims together, and provide all lenders the same treatment under the plan, with any distributional true-up under the AAL administered by the lender's administrative agent. From a legal perspective, this classification and treatment of the unitranche lender claims would be the least controversial, and would not appear to run afoul of any bankruptcy jurisprudence. Moreover, the debtor would not be burdened with the complicated task of determining the varying economic interests among the lenders in proposing the treatment of lender claims.

Nevertheless, by classifying all of the lenders together, the plan could be voted down by the unitranche lender class because, under the assumed facts, the dissenting last out lenders would hold a blocking position on the plan vote. Thus, the debtor could have to cram down the plan on the entire class of unitranche lenders, thus triggering the "fair and equitable" requirements of Section 1129(b) of the Bankruptcy Code.[34] In order for the plan to be fair and equitable, the lender class would need to retain its liens on the debtor's assets, and the plan must provide for a stream of payments to the lenders over a reasonable period of time and accruing at an interest rate that reflects the "present value" of the lenders' claims as of the effective date of the plan. Presumably, under this plan structure, the debtor would propose replacing the prepetition debt with a secured note that reflects the full facility amount, accruing interest at a rate that protects the present value of the entire facility, and would not otherwise give effect to the economic variables set forth in the AAL.

As noted, the debtor needs to secure the affirmative vote in favor of the plan by at least one class of impaired, non-insider creditors. Thus, if the debtor does not have sufficient support of the lenders to carry the plan through to confirmation, attention will need to be given to gaining the support of some other voting constituency to obtain the necessary affirmative vote of an impaired class. Although beyond the scope of this article, there are well-established restrictions on a debtor's ability to create what courts consider to be "artificially" impaired classes of creditors for the purpose of securing the vote of an impaired class.[35] Thus, the careful practitioner will ensure that there is at least one truly impaired class of creditors that supports the plan — the most likely being general unsecured creditors, to the extent they can be convinced that the plan offers them enhanced recovery over the alternatives. Absent the affirmative vote of an impaired class, this classification and treatment strategy will not succeed.

In an effort to avoid the classification issue altogether, we have seen AALs where the first out and last out lenders simply agree among themselves that their respective claims shall be classified separately in a bankruptcy. Given that the debtor is not a party to the AAL, as noted, it is unclear that such an agreement would be enforceable against the debtor. Thus, if the debtor chose to classify the first out and last out lenders together, it is unclear that the lenders could force a different result by virtue of the AAL. Nevertheless, the debtor may choose to give effect to this classification agreement and separately classify the lender claims. The question at that point is, what treatment to provide each class of lenders.

For simplicity of administration, the debtor could provide each class with the same treatment (i.e., a secured note, for instance) with any distributional true-up under the AAL to be administered by the lenders' administrative agent. Under ordinary circumstances, a treatment such as this would be very controversial, as separately classifying, and yet providing the same treatment to, creditors of the same priority would draw scrutiny as potential vote gerrymandering.

Along those lines, the last out lenders could resist this approach arguing that separate classification is impermissible in this instance because, although the AAL sets forth differing priorities among the lenders, the debtor is not a party to the AAL, and, thus, cannot be enforced by the debtor. Moreover, vis à vis the debtor, the first out lenders and the last out lenders each hold a single first lien claim against the same collateral, which arises out of the same credit agreement. Thus, under existing case law, the last out lenders might argue there is no basis for separately classifying the first out and last out lenders, particularly if separate classification is proposed to simply influence the outcome of plan voting, which appears obvious given the similar treatment among classes.

The debtor could nevertheless cogently assert that an agreement regarding the classification of first out and last out claims, while not enforceable *against* the debtor (because it is not a party to the agreement), could very well be enforced *among* the lenders as parties to the AAL, consistent with the *Ionosphere* opinion.[36] Moreover, the debtor could assert that by agreeing to separate classification in the AAL, the last out lenders implicitly waived any right to object to separate classification and are thus estopped from opposing the plan on that ground.

There are also arguably substantive bases for separately classifying the first out and last out claims. For instance, the debtor could argue that by virtue of the AAL, the first out and last out claims are substantially different, and have different rights to recovery, thus creating very different legal rights against the estate, thus justifying separate classification. Moreover, providing what appears to be the same treatment in this context simply is designed to give effect to the distributional agreement among the lenders, which results in different recoveries among such lenders and is best enforced by the lenders' administrative agent, not the debtor. It could be further asserted that the fact that the debtor is not a party to the AAL should be of no moment because, as noted above, Section 510(a) of the Bankruptcy Code simply provides that subordination agreements are enforceable in bankruptcy and contains no requirement that the debtor be a party to such agreement.

Nevertheless, it is unclear how a court would decide this issue. From a drafting perspective, it may be best practice to include language in an AAL expressly providing that not only do the lenders agree to separate classification, but that the last outs expressly agree to give the AAL economic effect under any Chapter 11 plan and waive any objections they may have to a plan based on classification.

The debtor's other option would be to classify the lender claims separately and to provide different treatment to the first out and last out lenders, consistent with the economic terms of the AAL. This may be the most complicated plan structure of the various potential options, raising a myriad of issues that are not easily answered. Aside from the classification issues that have been analyzed above with respect to separately classifying the first out and last out claims, if the debtor has little visibility into the economics of the agreement among the lenders, how would the debtor propose a plan that gives express legal effect to the AAL? How would the rights among the lenders be governed post-confirmation with respect to distributions if the parties are issued new debt documents pursuant to the plan — would the AAL still control, or would the plan control?

Moreover, if the plan provided the last out lenders with significantly different, and worse treatment than the first out lenders, the last out lenders would have an argument that the plan is presumed to discriminate unfairly against the last out lenders because it provides secured creditors with the same priority in the debtor's assets with markedly different treatment.[37] The debtor could rebut such presumption by arguing that there is a valid distinction between the lenders based on the prepetition AAL.[38] Nevertheless, the outcome of this legal issue is uncertain and further complicates any effort to achieve confirmation in this context.

Unlike the traditional first lien/second lien scenario, where the classification and treatment of lender claims is relatively straightforward, the unitranche structure creates an interesting power dynamic among first out and last out lenders that is not easily resolved.

Fiduciary Duty Issues

Another issue worth exploring in this context is the fiduciary obligations of the agent where there is a single agent acting on behalf of all the lenders – the first out, and last out lenders, when they have such disparate economic interests, and yet, the same agent is tasked with administering the loan on their behalf. As noted above, most AALs provide that following a material event of default, the agent is to follow the direction of the required first out lenders in enforcing remedies and liquidating collateral. This may be, in certain instances, to the detriment of the last out lenders (particularly when the collateral value is below the par value of the debt), raising the issue of what, if any, duty the agent owes to the last out lenders in this regard.

As a general matter, so long as an agent follows the express terms of the governing loan documents, courts have held that an agent has the power to bind a class of lenders, even when an agent's actions may be objectionable to a sub-set of lenders.[39] Similarly, in the unitranche scenario, the agent's obligations to the lenders should be delineated and set forth in the governing loan documents. Moreover, unless the loan documents provide otherwise, no fiduciary or other duty should arise between the agent and the lenders.[40] From a drafting perspective, it is important that any fiduciary duty be clearly disavowed by the agent. There is almost assuredly going to be discord among lenders in any meaningful decisions being made under a credit facility, especially in situations of distress. Thus, it is key that the loan documents are clear that an agent's obligations are to follow the terms of the loan documents, and there is no liability to any party for doing so.

CONCLUSION

Unitranche facilities offer a simpler, potentially much more cost effective method of funding a middle market company than a traditional first lien/second lien deal structure. In particular, unitranche deals offer, among other things, a simplified structure, an ease of closing, and streamlined administration, all of which reduce costs and otherwise generate mutual benefits to both borrowers and lenders. Nevertheless, interesting and unique issues arise in respect of a unitranche deal when the credit becomes troubled, and enters the Chapter 11 realm. Given the relatively recent rise of the unitranche structure, these issues are, to date, untested in bankruptcy courts. Consequently, while unitranche deals offer clear benefits, there are significant elements of uncertainty associated with such deal structures that the careful practitioner must be aware of in drafting loan documents and advising clients.

NOTES

1 11 U.S.C. §510(a).

2 *See, e.g.*, *In re Ionosphere Clubs, Inc.*, 134 B.R. 528, 535 (Bankr. S.D.N.Y. 1991) (deciding dispute between lenders under terms of subordination agreement).

3 *See Chemical Bank v. First Trust of New York (In re Southeast Banking Corp.)*, 156 F. 3d 1114, 1121 (11th Cir. 1998) (finding that Section 510(a) directs courts to enforce subordination agreements to the extent the agreements are enforceable under applicable nonbankruptcy law); *In re 203 North LaSalle Street Partnership*, 246 B.R. 325, 330 (Bankr. N.D. Ill. 2000) ("Pursuant to §510(a), it is certain that a subordination provision that violates no principle of bankruptcy law – such as the present one – must be enforced as it would be under nonbankruptcy law."); *see also In re Erickson Retirement Communities, LLC*, 425 B.R. 309, 313 (Bankr. N.D. Tex. 2010) (holding that junior creditor does not have standing to bring a motion for appointment of examiner pursuant to the terms of a subordination agreement); *In re Ion Media Networks, Inc.*, 419 B.R. 585, 597 (Bankr. S.D.N.Y. 2009) (finding that indenture prevented junior from objecting to plan).

4 *See Ionosphere Clubs, Inc.*, 134 B.R. at 535; *accord In re Bank of New England Corp.*, 364 F.3d 355, 368 (1st Cir. 2004) (finding that subordination agreement may allow first lien lender to collect postpetition interest at the expense of junior lender if enforceable under applicable state law); *In re Plymouth House Health Care Center*, 2005 WL 2589201 (Bankr. E.D. Pa. Mar. 15, 2005) (enforcing subordination agreement to allow senior lender to collect postpetition interest under Section 506 of Bankruptcy Code); *Wolohan Lumber Co. v. Robbins (In re Robbins)*, 21 B.R. 747, 751 (Bankr. S.D. Ohio 1982) (holding that subordination agreement was enforceable to allow first lien lender to collect postpetition interest prior to any recovery by junior lender).

5 *See 203 North LaSalle Street P'ship*, 246 B.R. at 330, 331-32 (holding that subordination agreement allowing senior lender to vote junior lender's claim could not be enforced); *see also Beatrice Foods Co. v. Hart Ski Mfg. Co. (In re Hart Ski Mfg. Co.)*, 5 B.R. 734, 736 (Bankr. D. Minn. 1980) ("The intent of section 510(a)…is to allow the consensual and contractual priority of payment to be maintained between creditors among themselves in a bankruptcy proceeding. There is no indication that Congress intended to allow creditors to alter, by a subordination agreement, the bankruptcy laws unrelated to distribution to assets.").

6 *See e.g. In re Aerosol Packaging, LLC*, 362 B.R. 43, 47 (Bankr. N.D. Ga. 2006)

(enforcing subordination agreement to allow senior lender to vote junior lender's claim in respect of plan of reorganization).

[7] *See In re Boston Generating, LLC*, 440 B.R. 302, 320 (Bankr. S.D.N.Y. 2010) (refusing to enforce subordination agreement to prevent second lien lenders from objecting to sale transaction where agreement was insufficiently drafted to put second lien lenders on notice of subordination).

[8] *See In re Tribune Company*, 472 B.R. 223, 250 (Bankr. D. Del. 2012); *203 North LaSalle Street P'ship*, 246 B.R. at 330; *Ionosphere Clubs, Inc.*, 134 B.R. at 531.

[9] 11 U.S.C. §506(b); *see also Tribune*, 472 B.R. at 250; *203 North LaSalle Street P'ship*, 246 B.R. at 330.

[10] *Ionosphere Clubs, Inc.*, 134 B.R. at 529.

[11] *Id.*

[12] *Id.* at 529-30.

[13] *Id.* at 530.

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.* at 532.

[18] *Id.*

[19] *Id.* at 532-33.

[20] *Id.* at 533.

[21] *Id.* at 535.

[22] *Id.*

[23] *See Tribune*, 472 B.R. at 250; *203 North LaSalle Street P'ship*, 246 B.R. at 330.

[24] *See Tribune*, 472 B.R. at 250; *In re Washington Mutual, Inc.*, 461 B.R. 200, 249 (Bankr. D. Del. 2011) (following Rule of Explicitness under New York law to interpret whether postpetition interest was due under subordination agreement); *203 North LaSalle Street P'ship*, 246 B.R. at 330 (holding that applicable state law controls the inquiry under Section 510(a)).

[25] *See Tribune*, 472 B.R. at 250; *accord In re Southeast Banking Corp.*, 179 F.3d 1307, 1310 (11th Cir. 1999) (looking to applicable state law to determine whether junior lender was subordinated to senior lender with respect to postpetition interest); *HSBC Bank USA v. Branch (In re Bank of New England Corp.)*, 364 F.3d 355, 367-68 (1st Cir. 2004) (applying New York law to question of whether subordination agreement allowed senior lender to collect postpetition interest at the expense of junior lender); *see also Wolohan Lumber Co. v. Robbins (In re*

Robbins), 21 B.R. 747, 751 (Bankr. S.D. Ohio 1982) (allowing recovery of senior creditor of postpetition interest over claim of junior creditor in same collateral); *In re Plymouth House Health Care Center*, 2005 WL 2589201 (Bankr. E.D. Pa. 2005) (same).

[26] 11 U.S.C. §1122(a).

[27] *John Hancock Mutual Life Ins. Co. v. Route 37 Business Park Assocs.*, 987 F.2d 154,158 (3d Cir. 1993) ("Section 1122(a) expressly provides only that claims that are not "substantially similar" may not be placed in the same class; Section 1122(a) does not expressly provide that "substantially similar" claims may not be placed in separate classes.").

[28] *See John Hancock Mutual Life Ins. Co*., 987 F.2d at 158; *see also Heartland Federal Savings & Loan Assoc. v. Briscoe Enterprises, LTD., II (In re Briscoe Enterprises, LTD., II)*, 994 F.2d 1160, 1167 (5th Cir. 1993) (holding that a classification scheme must be supported by sound business reasons); *In re Greystone*, 948 F.2d 134, 139 (5th Cir. 1991) (espousing the oft-quoted rule, "thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan.").

[29] *John Hancock Mutual Life Ins. Co.,* 987 F.2d at 158.

[30] *See In re Dilts*, 126 B.R. 470, 471 (Bankr. W.D. Pa. 1991) ("Classification of secured claims under 11 U.S.C. §1122 is ordinarily determined on the basis of priority, nature of collateral and agreements among creditors with respect to subordination."); *see also In re Buick*, 126 B.R. 840, 854 (Bankr. E.D. Pa. 1991) (classification of secured claims in same class in plan, despite differing collateral and disparate treatment among secured creditors, was impermissible); *In re Holthoff*, 58 B.R. 216, 219 (Bankr. E.D. Ark. 1985) (finding that "[s]ecured creditors with liens in different property, or liens in the same property may not be classified together since their legal rights are not substantially similar.").

[31] *See Buick*, 126 B.R. at 854.

[32] *See Keck, Mahin & Cate*, 241 B.R. 583, 590 (Bankr. N.D. Ill. 1999) (holding that holders of sub-debt that have the same priority in the same collateral of the debtor were properly classified in the same class).

[33] Section 1129(b) specifically provides:

> (1) Notwithstanding section 510 (a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to

each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides—

(i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363 (k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claim.

11 U.S.C. §1129(b). *See also In re TCI2 Holdings, LLC*, 428 B.R. 117, 158 (Bankr. D.N.J. 2010).

[34] In this scenario, there would be no "unfair discrimination" issue, because each of the first out and last out lenders would receive the same treatment, and are classified together.

[35] *In re Combustion Eng'ring, Inc.*, 391 F.3d 190, 243 (3d Cir. 2005) (noting that although the Bankruptcy Code does not expressly prohibit "artificial impairment," courts have found the practice troubling); *John Hancock Mut. Life Ins. Co.*, 987 F.2d at 158 (noting the problematic nature of class manipulation in Chapter 11 confirmation process); *In re Windsor on the River Assocs., Ltd*, 7 F.3d 127, 132-33 (8th Cir. 1993) (paying trade claims 60 post-effective date not legitimate impairment); *In re Global Ocean Carriers Ltd.*, 251 B.R. 31, 41-42 (Bankr. D. Del. 2000) (holding that artificial impairment violates multiple confirmation requirements); *But see Western Real Estate Equities, LLC v. Village at Camp Bowie I, LP (In re Village at Camp Bowie I, LP)*, 710 F.3d 239 (5th Cir. 2013) (Fifth Circuit joined the Ninth Circuit in holding that Section 1129(a)(10) of the Bankruptcy Code, which contains the impaired-class acceptance requirement, "does not distinguish between discretionary and economically driven impairment," but that artificial impairment may be relevant in assessing

whether a Chapter 11 plan has been proposed in bad faith).

[36] *Ionosphere Clubs, Inc.*, 134 B.R. at 533 (holding that subordination is enforceable among the parties, even if not enforceable against the debtor).

[37] *Tribune Company*, 472 B.R. at 241 (unfair discrimination is presumed when there is (1) a dissenting class, (2) another class of the same priority, and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution).

[38] *Id*. Interestingly, to the extent that the plan offered the last out lenders with *better* treatment than is contemplated in an AAL – for instance, by allowing for immediate amortization under a plan-issued note – the debtor could potentially confirm the plan over the objection of the first out lenders provided that all of the requirements of Section 1129(b)(2) were satisfied. *See Id*. 472 B.R. at 241 (The only logical reading of the term 'notwithstanding' in section 1129(b)(1) seems to be: Even though section 510(a) requires enforceability of [a] subordination agreement in a bankruptcy case to the same extent that the agreement is enforceable under nonbankruptcy law, if a nonconsensual plan meets all of the §1129(a) and (b) requirements, the court shall confirm the plan. The phrase "'[n]otwithstanding section 510(a) of this title' removes section 510(a) from the scope of 1129(b)(1) ….."); *see also TCI2 Holdings, LLC*, 428 B.R. at 158 (same).

[39] *See In re Chrysler LLC*, 405 B.R. 84, 102-03 (Bankr. S.D.N.Y. 2009) (holding that administrative agent had the exclusive authority, at direction of "required lenders," to direct the collateral trustee's exercise of the first lien lenders' remedies with respect to the first lien collateral); *In re Metaldyne Corp.*, 409 B.R. 671, 678 (Bankr. S.D.N.Y. 2009) (affirming an agent's right to affect a credit bid of entire facility at direction of majority of lenders, finding that the agent was authorized under the applicable credit documents to take such action); *In re GWLS Holdings, Inc.*, 2009 WL 453110 (Bankr. D. Del. Feb. 23, 2009) (upholding agent's authority to credit bid senior lenders' claims at behest of majority lenders over objection of dissenting first lien lender); *Beal Savings Bank v. Sommer*, 8 N.Y.3d 318, 328-29 (Ct. Appeal NY 2007) (holding that dissenting lender had no standing to sue agent to enforce "keep well" provision of agreement after "requisite lenders" directed agent to forbear from exercising remedies).

[40] *See Banque Arabe et Internationale D'investissement v. Maryland National Bank*, 57 F.3d 146, 158 (2d Cir. 1995) ("Generally, banking relationships are

not viewed as special relationships giving rise to a heightened duty of care."); *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51, 56 (2d Cir. 1992) (holding that "an arms length transaction between sophisticated financial institutions" creates no independent duty to disclose information that could have been discovered by the other party); *First Citizens Federal Savings and Loan Association v. Worthen Bank and Trust Co., N.A.*, 919 F.2d 510, 514 (9th Cir. 1990) ("Banks and savings institutions engaged in commercial transactions normally deal with one another at arm's length and not as fiduciaries.").