Unitranche Financings in Bankruptcy and the RadioShack Case

By Damian S. Schaible [*]

Unitranche financings have become an increasingly popular alternative for borrowers looking for a simpler financing alternative and a more streamlined closing and compliance process. These financings first gained popularity with specialty finance companies in the middle market, but they have since gained acceptance by most other types of lenders and in larger deals. Because these financings are governed by relatively new, untested subordination agreements among lenders, it wasn't until the 2015 *RadioShack* case[1] that unitranche financings and their underlying documents were truly tested in bankruptcy courts.[2] These written materials discuss the basics of unitranche financing and the bankruptcy treatment of these facilities through the lens of *RadioShack*.

INTRODUCTION TO UNITRANCHE FINANCINGS

Unitranche financings emerged relatively recently as a structure designed as an alternative to the traditional first-lien/second-lien structure. While not uniform, most unitranche financings have several key characteristics in common:

- Typically structured as a single credit facility with two sets of lenders that would share the same lien, but one group, the "first out" group, has priority of payment over the "last out" group
- Rather than a traditional intercreditor agreement, the relationship between the first-out and last-out lenders is governed by an agreement among lenders ("AAL")
    - The administrative and collateral agent is appointed in the AAL to hold the lien and administer the loan

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

[2] Limited aspects of unitranche financings were touched on in *In re Am. Rds. LLC*, 496 B.R. 727 (Bankr. S.D.N.Y. 2013) (enforcing a no-action clause in a unitranche financing document).

    - The administrative and collateral agent acts on behalf of both the first-out and last-out lenders
    - Borrowers are typically not a party to AALs, and less sophisticated borrowers may even not be aware that a facility is a unitranche facility
    - Voting provisions in AALs will often require that exercising voting rights under the credit agreement be contingent on attaining the required majority of both the first-out and last-out lenders
- The Borrower pays one blended interest rate on the entire amount of the facility, with the distribution to lenders of the cash interest payment stream dictated by the AAL
- Principal payments are distributed ratably to the first-out and last-out lenders until the occurrence of certain "waterfall trigger" or "payment application" events
    - Waterfall trigger events cause any proceeds of collateral to go to the first-out lenders until they are paid in full
    - Events typically include payment or covenant defaults (within a percentage range), bankruptcy, loan acceleration or any other exercise of remedies
- AALs typically contain limitations on the last-out lenders' rights to object or take other actions in bankruptcy, similar to those seen in intercreditor agreements:
    - Last-out lenders are typically barred from making objections or taking other actions that are reserved for secured creditors
    - Rights to take actions available to an unsecured creditor are often preserved

THE RADIOSHACK CASE

RadioShack filed for bankruptcy in the District of Delaware on February 5, 2015. The chapter 11 reorganization involved two credit facilities, a term loan and an ABL facility, each with unitranche structures governed by AALs.

One AAL-related issue to come before the bankruptcy court involved the term loan, which was provided by Cerberus Capital Management as first-out lender ("Cerberus") and Salus Capital Partners as last-out lender. The relationship between Cerberus and Salus was governed by an AAL (the "TL AAL") that gave rise to an additional objection by Salus to the proposed sale of RadioShack assets. Cerberus supported the sale and, facing an objection by Salus on various grounds, pointed to a section of the TL AAL that provided that Salus could not object to any sale supported by Cerberus if the grounds of such objection could only be asserted by a secured creditor.

Certain of the grounds of the Salus objection were, among other things, that the sale process was fundamentally unfair and opaque, that Standard General's bid undervalued the intellectual property collateral securing the term loan and that the bid also violated both section 363(f) of the Bankruptcy Code and Salus' rights to adequate protection.

The bankruptcy court took up the Salus objection and ruled that certain of the grounds of the objection were precluded because they were claims that could only be made by a secured creditor. The grounds reserved for secured creditors included, for example, the objections based on section 363(f) of the Bankruptcy Code or a lack of adequate protection, which according to the court were classic secured creditor objections. These claims, the court reasoned, were plainly disallowed by the TL AAL. The court allowed Salus to pursue other grounds for objection, such as its argument that the sale process was unfair or that the collateral was undervalued, because any unsecured creditor could raise those objections. The court ultimately overruled Salus' remaining grounds for objection and approved the sale.

Another dispute involved a group of lenders (the "First-Out ABL Lenders") that had bought into the restructured ABL facility with affiliates of Standard General, L.P. ("Standard General") in the last-out portion of the facility. The First-Out ABL Lenders and Standard General had entered into an agreement among lenders (the "ABL AAL") to govern their relationship. The ABL AAL stipulated that, in addition to the principal amount of the loans provided by the First-Out ABL Lenders, the obligations owed to the First-Out ABL Lenders in respect of fees, expenses and other indemnification claims would be senior to the obligations owed to Standard General as last-out lender. Additionally, under the terms of the ABL AAL and a separate participation agreement, Standard General retained its right to credit bid in a bankruptcy auction to the extent that the amount of the credit bid would be sufficient to pay the First-Out ABL Lenders in full.

Standard General made a credit bid for RadioShack assets during the sale process under section 363 of the Bankruptcy Code. The bid promised First-Out ABL Lenders full payment of principal and interest, but did not include any consideration for potential future indemnification claims. The First-Out ABL Lenders claimed they could not be

paid in full without consideration in respect of these claims and asked the bankruptcy court to enforce the ABL AAL and deny approval for Standard General's bid. The court did not make any findings in respect of the First-Out Lenders' objection, but it ultimately led them to reach an agreement with Standard General by suggesting that they could protect their interests in the indemnification claims through a cash reserve held back from proceeds of the sale.

IS AN AAL ENFORCEABLE IN BANKRUPTCY COURT?

Whether an AAL would be considered an enforceable subordination agreement in bankruptcy is a key issue surrounding unitranche financings. The enforceability of an AAL in bankruptcy court first requires the jurisdiction of bankruptcy court. Section 510(a) of the Bankruptcy Code specifically provides for the enforcement of subordination agreements to the extent such agreements are enforceable under state law. Though various provisions of traditional intercreditor agreements have been the subject of litigation, the jurisdiction of the bankruptcy court to interpret and enforce a 510(a) subordination agreement has not been in doubt. Because the borrower is not party to an AAL, lenders have been less certain that a bankruptcy court would have the requisite jurisdiction to adjudicate disputes among lenders.

The *RadioShack* case did not provide a definitive answer to the issue of jurisdiction. At the outset of the bench ruling on Salus' objection, the court noted that the parties had "acknowledged and consented" to the jurisdiction of the bankruptcy court to construe and enforce the terms of the TL AAL.[3] Though the use of the word "acknowledged" could indicate a presumption of the court that an AAL would be subject to the bankruptcy court's jurisdiction, in neither dispute did the court cover the issue in a precedential ruling. Despite the continued uncertainty surrounding the legal question, some will take comfort in the court's willingness to interpret the TL AAL in light of the consent to jurisdiction by the parties.

[3] Transcript of Hearing, March 30, 2015, 9:00 A.M. at 63, *In re RadioShack Corp.*, Case No. 15-10197 (Bankr. D. Del.) (Docket No. 1746).

Even if a court would not treat an AAL as a subordination agreement entitled to enforcement under 510(a), a dispute among creditors party to an AAL could still be considered a "core proceeding" pursuant to section 157(b)(1) of the Bankruptcy Code, which affords the bankruptcy court the ability to adjudicate such proceedings.

The final question of enforceability lies in the enforceability of the actual terms of the AAL. Certain waivers in intercreditor agreements have had mixed results in bankruptcy courts, especially if they are perceived to circumvent the fundamental rights of the Bankruptcy Code.[4] The court's willingness to construe the waivers in the Salus objection should add confidence that such waivers, if drafted correctly in an AAL, can be enforced in the bankruptcy court.

OTHER BANKRUPTCY ISSUES

Additional issues raised by unitranche financings in the bankruptcy context, but not addressed by *RadioShack* include:

- Collection of post-petition interest under section 506(b) of the Bankruptcy Code, which may not be allowed to first-out lenders in a unitranche facility that would otherwise be oversecured and entitled to post-petition interest had they participated in a traditional first-lien facility[5]
- Separate classification of first-out and last-out claims, especially if the last-out lenders are the larger piece and could potentially hold a blocking position over the first-out lenders
- Adequate protection for first-out and last-out lenders and whether the unitranche facility should be treated as one secured claim or separate secured claims and how the court would construe the AAL in this context

[4] *See, e.g.*, *In re 203 N. LaSalle Street Partnership*, 246 B.R. 325 (Bankr. N.D. Ill. 2000).

[5] Consider the ruling in *In re Ionosphere Clubs, Inc.*, 134 B.R. 528, 535 (Bankr. S.D.N.Y. 1991) (holding that lenders would not be entitled to 506(b) post-petition interest by the terms of a subordination agreement).