

# Leveraged Lending Guidelines, New Debt Structures and Pitfalls in Bankruptcy

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## Introduction

In today's regulatory regime, traditional banks have become limited in their ability to provide certain leveraged loans under lending guidelines jointly enforced by the Federal Reserve System (the "*Federal Reserve*"), the Office of the Comptroller of the Currency ("*OCC*") and the Federal Deposit Insurance Corporation ("*FDIC*", and together with the Federal Reserve and OCC, the "*Agencies*"). Although certain exceptions to these guidelines exist, the guidelines have resulted in limiting the ability of traditional banks to make loans deemed "risky" by federal regulators.

As a result of these new lending guidelines and the limitations placed on traditional banks, highly levered companies are being forced to turn to non-traditional financing sources. Such sources include non-bank lenders, such as hedge funds and business development companies or "*BDCs*". In addition, the debt facilities provided by these alternative lenders to highly levered companies may be non-traditional, such as unitranche loan facilities. These alternative sources of financing, however, come with increased or different risks, especially when an over-levered company opts to restructure or sell itself as a part of a bankruptcy proceeding.

This article will discuss the leveraged lending guidelines, unitranche facilities and the risks associated with unitranche facilities, including with respect to "agreements among lenders" as illustrated by the recent case of *In re Radio Shack Corporation* ("*RadioShack*").[1]

## Leveraged Lending Guidelines

### Origin and Goals

On March 22, 2013, the Agencies together issued new guidance for agency-supervised institutions or "traditional lenders" to address concerns relating to an increase in the leveraged lending volumes since 2009 (the "*Leveraged Lending Guidelines*" or the "*Guidelines*").[2] As summarized by the Agencies in the Leveraged Lending Guidelines, the guidance "outlines for agency-supervised institutions high-level principles related to safe-and-sound leveraged lending

1 No. 15-10197 (Bankr. D. Del.). Another case, *In re American Roads LLC,* 496 B.R. 727 (Bankr. S.D.N.Y. 2013), considered an "insured unitranche" facility, which presented issues that are different than those presented with a unitranche facility associated with a financing and involving an agreement among lenders.

2 *See* Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766-01 (March 22, 2013), available at https://www.gpo.gov/fdsys/pkg/FR-2013-03-22/pdf/2013-06567.pdf.

activities, including underwriting considerations, assessing and documenting enterprise value, risk management expectations for credit awaiting distribution, stress-testing expectations, pipeline portfolio management, and risk management expectations for exposures held by the institution."[3] These Guidelines superseded previous guidelines issued by the Agencies in April 2001. As a part of the Guidelines, the Agencies highlighted the deterioration of prudent underwriting practices, including the fact that a number of debt facilities no longer contained early warning features such as maintenance covenants. Although the Leveraged Lending Guidelines are not formal rulemaking, traditional lenders who do not comply with the Guidelines could subject themselves to a broad range of potential informal and formal enforcement measures.

**Main Restrictions and Exceptions**

The Leveraged Lending Guidelines require that each financial institution's credit policies and procedures for leveraged lending address several areas including (i) pipeline limits and hold levels, (ii) appropriate oversight by senior management, along with adequate and timely reporting to the institution's board of directors and (iii) effective underwriting practices for primary loan origination and secondary loan acquisition.

Additionally, with respect to the underwriting standards, the Guidelines provide that financial institutions should analyze whether the borrower has capacity to repay a loan facility and de-lever a sustainable level of the debt over a reasonable period. As a general guide, the Guidelines include provisions suggesting that each financial institution consider whether base case cash flow projections demonstrate the ability of a borrower to fully amortize senior secured debt or repay a significant portion of total debt over the medium term. The Guidelines also assert that in most industries, debt serviced from operating cash flow in excess of 6x total debt/EBITDA raises such concerns. In addition, when identifying possible definitions for the term "levered lending" to be included in the policies of financial institutions, the Guidelines comprise a potential combination of several elements including an even lower leveraged threshold — total debt to EBITDA or senior debt to EBITDA exceeding 4.0x or 3.0x, respectively, and clarify that cash should not be netted against debt (commonly referred to as "Net Leverage Ratios") for purposes of the calculations.

Although the Leveraged Lending Guidelines are seemingly broad in their application, some exceptions do apply. For instance, the Guidelines do not cover bonds (including high-yield bonds). Additionally, traditional asset-based loans ("*ABL*") are generally excluded from the Leveraged Lending Guidelines, although any ABL that is part of a leveraged borrower's overall debt structure may be subject to the Guidelines. Another important exception to the Leveraged Lending Guidelines is the "fallen angel exception." Pursuant to this exception, a financial institution is only required to classify a loan as a "leveraged loan" in four events – when it is (i) originated, (ii) modified, (iii) extended or (iv) refinanced. As a result, if a loan becomes over-leveraged – a "fallen angel" – after these events, it will not be covered by the definition of "leveraged loan." It is important to note, however, that if a levered loan is modified or otherwise amended (such as to address the deterioration in a borrower's credit quality), the Leveraged Lending Guidelines would then apply.

In November 2014, the Agencies issued answers to frequently asked questions with respect to the Guidelines (the "*Additional Guidance*").[4] Pursuant to the Additional Guidance, the Agencies clarified that investments by financial institutions related to collateralized loan obligations ("*CLO*") should be treated as follows: (a) the Guidelines apply when a financial institution markets its loans through a BDC or funds a CLO through a warehouse line and the CLO markets the institution's own loans; (b) the Guidelines do not apply when a financial institution has indirect exposures arising from investments (*i.e.*, in CLOs) and (c) the Guidelines apply if the financial institution funds a BDC or a CLO that holds leveraged loans.

**Effect**

As will be discussed next, due to the broad restrictions of the Leveraged Lending Guidelines, these Guidelines have acted as a catalyst to foster the development of non-traditional lenders due to concerns of traditional lenders regulated by one of the Agencies that they may run afoul of the Guidelines.

## Non-Traditional Financing Sources and Structures — Unitranche Facilities

The restrictions imposed on traditional banks have resulted in non-traditional lenders such as hedge funds and BDCs stepping in to provide companies with over-levered facilities. In doing so, a new market has emerged willing to test new financing structures, such as unitranche loans, the interpretation of which are untested in a bankruptcy proceeding.

A unitranche facility combines what would otherwise be separate first and second lien facilities into a single secured loan facility provided by the same group of lenders and documented through a single credit agreement with one set of collateral documents. The facility may include both a term loan and a revolving loan component. A unitranche facility differs from any other loan facility because rather than a traditional intercreditor agreement to which the borrower is a party, all of the lenders typically enter into an agreement among lenders (the *"Agreement Among Lenders"* or the *"AAL"*) instead.

The primary advantage of the unitranche facility for a borrower is to close the loan facility quickly under a single set of loan documents while maintaining intercreditor arrangements between the first-out lenders and the last-out lenders. These arrangements are made through an Agreement Among Lenders. The AAL divides a single loan into two tranches usually defined as "first-out" and "last-out". The AAL also addresses certain issues

3 *Id.* at p. 17766.

4 *See* Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency, *Frequently Asked Questions (FAQ) for Implementing March 2013 Interagency Guidance on Leveraged Lending* (Nov. 7, 2014), available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20141107a3.pdf

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among the lenders such as priority of payments, voting arrangements, buy-out rights, remedy standstill provision, assignments and bankruptcy treatment. Simply put, the loan documents governing the unitranche facility provide for a single lien on the borrower's assets, which is granted to one agent, with the priority of payments addressed in the AAL.

Unitranche facilities are almost always used by lenders in connection with financing provided to middle-market companies. Middle-market companies are generally known in the market to cover companies with $5 million of revenue on the low end, and up to $500 million on the high end. These facilities are most often provided by a smaller "club" of lenders and are typically not available for use in largely syndicated loan facilities. Since each lender in the unitranche facility is required to become party to the AAL, the use of the unitranche facility is better suited for a middle-market club deal as it would be too burdensome to have all of the lenders in a broadly traded syndicated loan facility to enter into an AAL.

## Bankruptcy and the Unitranche Facility

Bankruptcy cases with respect to alternative sources of financing such as unitranche facilities are still incipient; therefore such alternatives do not come without risk. While every bankruptcy proceeding is different, the points discussed below provide a snapshot of issues that have recently arisen for secured creditors in bankruptcy proceedings.

### Intercreditor Issues

The U.S. Bankruptcy Code and the bankruptcy courts have long recognized the jurisdiction of the bankruptcy courts to entertain intercreditor disputes surrounding subordination agreements. Specifically, section 510 of the Bankruptcy Code provides that a subordination agreement is enforceable in a bankruptcy proceeding to the same extent as under state law.[5] Indeed, the bankruptcy courts have long recognized their jurisdiction to hear disputes regarding subordination agreements where "the equitable reordering of the debtor-creditor and creditor-creditor relations cannot be accomplished in [the] case without resolution of the intercreditor dispute."[6] It is commonplace for bankruptcy courts to hear disputes involving issues of subordination arising under intercreditor agreements executed as part of a traditional financing facility.[7]

The Bankruptcy Code, however, has not caught up with modern alternative sources of financing and this has created uncertainty within the courts. Such lack of clarity is most evident with unitranche facilities. As discussed, unitranche facilities often include a separate Agreement Among Lenders to which the borrower is not a party that governs the relative agreed-to priorities among the lenders. In such facilities, because the borrower typically is not a party, it has remained unclear whether a bankruptcy court would entertain an intercreditor dispute between the first-out and last-out lenders under an AAL.

A recent bankruptcy case that considered issues arising from an Agreement Among Lenders related to a unitranche facility is *RadioShack*.[8] Although the *RadioShack* proceeding sheds light on how bankruptcy courts may interpret an AAL, unfortunately, it still remains unclear as to whether U.S. bankruptcy courts will assert jurisdiction to consider arguments arising under an AAL. In *RadioShack*, all of the relevant parties in the case had consented to the bankruptcy court's jurisdiction to consider the AAL in the underlying dispute, thus allowing the court to disregard the baseline issue of whether or not the court's jurisdiction over the AAL existed.

#### *In re Radio Shack Corporation*

In *Radio Shack*, in December 2013, RadioShack as part of a turnaround plan had entered into a $585 million asset-backed credit facility (the *"ABL Facility"*).[9] This ABL Facility was acquired by affiliates of Standard General, L.P. (*"Standard General"*) in October 2014 and the existing debt was reallocated to a $275 million term-out revolving loan facility, a $50 million term loan facility, a $120 million letter of credit facility, and a $140 million revolving facility. Standard General then assigned the $275 million term-out revolving loan facility and the $50 million term loan facility to a group of lenders (the *"First-Out Lenders"*). As part of the transaction, the First-Out Lenders and Standard General, as last-out lender, entered into an AAL. The AAL set forth the respective intercreditor rights of Standard General and the First-Out Lenders, including certain rights of the parties in the event of a bankruptcy proceeding. RadioShack was not a party to the AAL.

Pursuant to the AAL, the obligations owed to the First-Out Lenders were senior to the obligations owed to Standard General, as the last-out lender. The obligations owed to the First-Out Lenders included the loans held by the First-Out Lenders and all fees, costs, expenses, other charges and indemnification obligations incurred by the First-Out Lenders. Importantly, the underlying ABL Facility, and the DIP Credit Agreement to which the First-Out Lenders were a party, contained extensive indemnification provisions. Additionally, pursuant to the AAL, Standard General explicitly did not waive its right to credit bid under the U.S. Bankruptcy Code, so long as the credit bid was in an amount sufficient to pay out the First-Out Lenders "in full" in cash.

As a part of the sale process, Standard General submitted a credit bid for the Debtors' assets (the *"Standard General Bid"*) based on its last-out claims and proposed to fully repay the principal and interest owed the First-Out Lenders in cash. The First-Out Lenders recognized that the Standard General Bid was the only realistic option to preserve the debtors as a going concern. The First-Out

5 11 U.S.C. § 510(a) ("A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.").

6 *In re Best Products Co., Inc.*, 168 B.R. 35, 68 (Bankr. S.D.N.Y. 1994).

7 *See, e.g., In re Ion Media Networks*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009) (interpreting intercreditor agreement as part of plan confirmation process); *In re MPM Silicones, LLC,* 518 B.R. 740 (Bankr. S.D.N.Y. 2014) (interpreting intercreditor agreement).

8 Case No. 15-10197 (Bankr. D. Del.).

9 The following background is based upon the pleadings filed by the parties in the RadioShack proceeding.

Lenders asserted, however, that the Standard General Bid constituted a breach of the AAL, because the bid did not account for potential indemnification claims made by the First-Out Lenders for actions that could potentially be brought by the unsecured creditors committee and for an adversary action that had been brought by Salus Capital Partners LLP. The First-Out Lenders argued that the failure to cover the potential indemnification claims was not a payment to the First-Out Lenders "in full."

Over the course of a marathon four-day hearing, the Delaware bankruptcy court heard arguments with respect to the fairness of the Standard General Bid and the relative treatment of the First-Out Lenders. Although the bankruptcy court entertained arguments arising under the AAL, it never had the opportunity to determine whether it had jurisdiction to hear those arguments because the parties consented to the court's jurisdiction.[10]

Because it was not required to determine the jurisdictional issues, the court considered the issue in dispute between the First-Out Lenders and Standard General — "whether or not [the AAL could] directly provide for the transfer of assets free and clear of all of [the First-Out Lenders'] liens, claims, encumbrances [including indemnification claims]," given the language of the AAL.[11] The court noted: "to me, it boils down to a question of treatment of a secured creditor. That secured creditor has rights that must be respected under the documents and rights that must be respected under the Code."[12] The court made these statements in an effort to push the First-Out Lenders and Standard General to settle their issues, which eventually occurred, permitting the bankruptcy court to approve the Standard General Bid.[13]

While the bankruptcy court *did* consider the arguments of the First-Out Lenders and Standard General with respect to the AAL and the enforceability of that agreement, it only provided guidance to the parties. The court *did not* issue an opinion with respect to either its jurisdiction to hear arguments with respect to the AAL or the enforceability of that document. Thus, whether or not a bankruptcy court has jurisdiction to hear issues arising under an AAL and to enforce such agreements remains an unresolved issue.

Despite the *RadioShack* proceeding, it remains unclear what a bankruptcy court would do when issues arising under an AAL in a borrower's bankruptcy proceeding are actually litigated. It is unclear whether a bankruptcy court would view issues arising under an agreement among non-debtor entities as "core" to a debtor's bankruptcy proceeding, thus permitting the bankruptcy court to hear the action.[14] While the *RadioShack* case may be a helpful indication of how a bankruptcy court would interpret the provisions of an AAL, whether or not a bankruptcy court actually possesses jurisdiction to hear such claims has been reserved for another day.

## Conclusion

The Leveraged Lending Guidelines put pressure on the ability of traditional banks to make loans to over-levered companies. Hedge funds and BDCs have become alternative sources of financing while traditional banks have seen their participation in the levered lending market decrease. With new sources of financing have come new structures, such as unitranche facilities. Although these financing innovations are welcome, their bankruptcy treatment is still incipient and, therefore, such structures are not without risks.

*This article is intended to inform readers about legal matters of current interest. It is not intended as legal advice. Readers should not act upon the information contained in it without professional counsel.*


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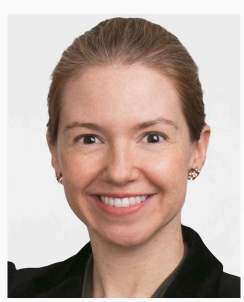

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10 Transcript of Record at 62:23-25, 63:1-3, *In re RadioShack Corp.*, No. 15-10197 (Bankr. D. Del.) (ECF No. 1746). The court provided: "I note, at the outset, that the parties have acknowledged and consented to my jurisdiction to construe and enforce the AAL and other loan documents in these cases."

11 *Id.* at 86:23-25; 87:1.

12 Transcript of Record at 19:12-17, *In re RadioShack Corp.*, No. 15-10197 (Bankr. D. Del.) (ECF No. 1746).

13 The parties ultimately settled on an expense reserve for $5 million and an indemnification reserve of $7 million, while retaining any rights that they may have against each other under the AAL and related documents. On March 31, 2015, as a result of this settlement and the resolution of other objections to the sale process, the bankruptcy court approved Standard General's credit bid.

14 *See, e.g., Stern v. Marshall*, 131 S.Ct. 2594 (2011) (discussing the relatively narrow jurisdiction of the bankruptcy courts in so-called non-core matters).