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Lead Left Interview – Neil Cummings, G. Thomas Stromberg and Richard Levin

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This week we chat with Neil Cummings, G. Thomas Stromberg and Richard Levin, partners at Jenner Block, an international firm with offices in Chicago, London, Los Angeles, New York, and Washington D.C.

Lead Left: Gentlemen, you have written extensively about the legal issues surrounding the unitranche agreement among lenders. Could you give us a quick summary of what it is?

Neil Cummings: Absolutely. In a unitranche financing, lenders enter into a side agreement called an agreement among lenders, or AAL. An AAL splits a single tranche of debt into first out and last out tranches, with a goal of replicating economic and other terms of another type of financing. Typically the AAL mimics a first/second lien financing. But an AAL is a very flexible tool and it can be adapted to mirror other financing structures.

TLL: Isn't the documentation simpler than the normal first lien/second lien financing?

Tom Stromberg: Yes. In a first/second lien financing, there are two credit agreements, two sets of security documents and an intercreditor agreement. In a unitranche deal styled after a first/second lien deal, there is a single credit agreement and a single set of security documents, thanks to the AAL.

TLL: What is included in first out debt and last out debt?

NC: The first out and last out tranches are created under the AAL by dividing the debt into first out debt and last out debt. First out debt generally includes any revolver provided under the credit agreement and often includes a specified portion of the term loan drawn at closing as well as any delayed draw or incremental loan commitments held by first out lenders. Last out debt is the debt provided for under the credit agreement other than first out debt.

TLL: How is the interest payable by the borrower allocated between first out and last out lenders?

NC: In a unitranche deal, the credit agreement contains a single interest rate. Since the AAL spits the debt into pieces with different risk profiles, the AAL adjusts the yield payable to the first out and last out lenders through skim, or turnover, provisions. These provisions reallocate a portion of the interest and sometimes other amounts payable by the borrower, from the first out lenders to the last out lenders. The total amount payable by the borrower is unchanged; the AAL just changes how that amount is split between the first out and last out lenders. The reallocated interest rate on each tranche is intended to match the interest rate a first or second lien lender would receive if the deal was structured as a first/second lien financing. If the AAL is set up to mirror, say, a senior/mezz structure, the reallocated interest rates would reflect what lenders would expect to receive in a senior/mezz deal.

TLL: How are payments applied?

TS: If there is no waterfall trigger event, the first out and last out obligations are paid in accordance with the credit agreement payment waterfall, subject to the interest rate skims that Neil just described. Because the tranching of the obligations into first out and last out debt occurs in the AAL rather than the credit agreement, the credit agreement waterfall doesn't differentiate between first out and last out debt. Payments under the credit agreement waterfall are generally made ratably based on general types of credit agreement obligations, such as fees, interest and principal.

TLL: What happens when a waterfall trigger event exists?

TS: In that case all collateral proceeds and payments from the borrower are applied according to the AAL payment waterfall. During a waterfall trigger event, first out obligations are usually paid in full first, before any amounts are applied to last out obligations. The last out lenders will often bargain for a cap on the amount of first out obligations that can be paid ahead of them.

Any amounts in excess of that cap are deemed excess first out obligations, and are payable after the last out obligations. The interest rate skim Neil talked about earlier continues to apply for the benefit of the last out lenders. But payment of the last out debt is subject to payment in full of the first out obligations, again subject to any cap. If addressed in the AAL, first out obligations held by a private equity sponsor or affiliates (or in some cases by defaulting first out lenders) are usually paid after the last out obligations. AAL waterfall triggers vary from deal to deal, but they will typically include a payment, bankruptcy or financial covenant event of default, or notice of exercise of remedies by the first out lenders.

TLL: Are there restrictions on voting?

NC: That's a good question. The answer's yes. The AAL will specify the requisite lender consents to amend, modify or waive terms of the loan documents. The AAL provisions are in addition to the voting requirements in the credit agreement. They are intended to give first out and last out lenders a say in certain changes that can harm their interests by providing class voting rights. The voting provisions, and the degree of protection they give lenders, vary greatly from deal to deal. They tend to be heavily negotiated.

To be continued the week of Dec 21

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