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Structuring Commercial Loan Documents to Protect Non-Affiliated Lenders

Negotiating and Drafting Provisions Involving Loan Buybacks, Additional Pari Passu Debt, Non-Pro Rata Prepayments, and Intercreditor Agreements

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Affiliated Lenders: Risks and Related Provisions Addressing Shifting Control Over Lender's Rights

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Overview

Purchases of Loans by Borrowers and Their Affiliates

Generally, references to "buyback" and "affiliated lenders" credit agreement provisions refer to provisions in bank loan documents governing the purchases (or assignment) of loans made thereunder ("***Loans***") by the borrowers thereof ("***Borrowers***") or by the Borrowers' equity holders affiliates, including the Borrowers' financial sponsors (including their investment affiliates, "***Sponsor***").

Such purchases are usually made when Borrowers and their Sponsors desire to take advantage of a discount to par at which Loans may be traded, and are effected either by (i) direct purchases of Loans by the Borrower (referred to as "***buybacks***", "***discounted repurchases***" or "***discounted prepayments***") or (ii) purchases of Loans by the Sponsor.

Overview *(continued)*

Buyback as Voluntary Prepayment

As typically repurchases of Loans by Borrowers (and/or guarantors of Borrower's obligations) are viewed and treated in credit agreements as voluntary prepayments of the Loans, which, in many cases, are subject to ***pro-rata*** application requirement to all Loans held by the lenders ***at par***, Borrowers have negotiated, and many credit agreements provide, provisions permitting the Borrower, subject to certain limitations (discussed below), to repurchase term Loans at a discount to par on a non-pro rata basis.

Limitation on Loan Assignments

Assignment provisions in credit agreements provide that the consent of the agent to the lenders ("***Agent***") is required to be obtained to effect assignments of Loans (which consent is not to be unreasonably withheld). Accordingly, in light of the inherent conflicting interests of lenders and equity holders, Sponsors have negotiated, and many credit agreements provide, for specific provisions designed to specifically allow Sponsors and other affiliates of the Borrower, other than guarantors ("***Affiliated Lenders***") to purchase term Loans, so long as certain conditions are satisfied.

Note: Generally, Borrowers and Sponsors are restricted from acquiring loans and commitments under revolving facilities. However, recently, some credit agreements provided Sponsors with the right to purchase revolving Loans and commitment of "defaulting lenders" and, subject to certain limitations, provide a portion of the revolving commitments.

Non-Affiliated Lenders Protection

As the interests of equity affiliates of the Borrower, such as the Sponsor, and those of the non-Affiliated Lenders are in many cases diverse, specifically in distress situations, non-Affiliated Lenders require that credit agreements include provisions intended to assure that control over Lenders' rights and remedies will be maintained within the non-Affiliated Lenders group.

Typical Credit Agreement Provisions

To protect the non-Affiliated Lenders group, credit agreements typically provide that:

- Affiliated Lenders to not have the right to:
  - attend any meeting or discussions among Agent and any Lender to which representatives of the Borrower or the guarantors are not invited; or
  - receive any information or material prepared by Agent or any Lender or any communication by or among Agent and/or one or more Lenders, unless made available to the Borrower.

Non-Affiliated Lenders Protection *(continued)*

- For purposes of determining whether the "Required Lenders", all affected Lenders or all Lenders have (A) consented (or not consented) to any amendment, modification, waiver, consent or other action with respect to any of the terms of any loan document, (B) otherwise acted on any matter related to any loan document or (C) directed or required Agent or any Lender to undertake any action (or refrain from taking any action) with respect to or under any loan document, except for the matters described below for matters requiring the consent of Affiliated Lenders, an Affiliated Lender shall be deemed to have voted its Loans as a Lender, without discretion, in the same proportion as the allocation of voting with respect to such matter by the non-Affiliated Lenders.

- The consent of each Affiliated Lender ***is required*** for any amendment, modification, waiver consent or other action that (a) increases any Commitment of such Affiliated Lender, (b) extends the due date for any scheduled installment of principal of any term Loan held by such Affiliated Lender, (c) extends the due date for interest owed to such Affiliated Lender, or (4) reduces any amount owing to such Affiliated Lender under any loan document (other than in connection with a plan of organization).

Non-Affiliated Lenders Protection *(continued)*

Note: A sub-set of Affiliated Lenders are bone fide investment affiliates of the Sponsor (usually referred to as "***Affiliated Debt Funds***"), i.e., such affiliates that are primarily engaged in investing in, acquiring or trading commercial loans, bonds and similar securities (but not equity investments) in the ordinary course, with respect to which the Sponsor does not possess the power to direct the investment policies of such affiliate.

Affiliated Debt Funds are typically not subject to the limitations applicable to other Affiliated Lenders and generally are treated in the same manner as non-Affiliated Lenders. However, some credit agreements provide that Affiliated Debt Funds may not, on their own, constitute "required lenders".

Implications of Affiliated Lenders in Bankruptcy

Numerosity and Claims Amount Tests

Under the Bankruptcy Code, a plan of reorganization (other than a "cramdown" plan) requires the acceptance of the plan by each class of claims that is impaired under the plan. For a plan to be accepted by a class, a simple ***majority of the number of claim holders*** in such impaired class (the "**Numerosity Test**") and the holders of ***at least two-thirds in amount of the claims*** in that class (the "**Claims Amount Test**") must accept the plan.

Assuming that claims under a credit agreement are a single class and Affiliated Lenders could vote their claims thereunder, Affiliated Lenders could effectively block approval of a plan of reorganization supported by the non-Affiliated Lenders if they represent 50% or more of the number of claimants under the credit agreement ***or*** hold an aggregate amount of more than one-third of the claims under the credit agreement and any other claims that is included in the same class as the obligations under the credit agreement.

Implications of Affiliated Lenders in Bankruptcy *(continued)*

<u>Cramdown Plan</u>

Under Section 1129(b)(1) of the Bankruptcy Code, a "cramdown" plan can be approved without the acceptance of all impaired classes if there is at least one class that is "impaired" under the plan and that class accepts the plan. In determining acceptance by that impaired class, the "acceptance" of the plan by "insiders" is excluded (Bankruptcy Code Section 1129(a)(10)).

Therefore, Affiliated Lenders' votes cannot force a cramdown on non-Affiliated Lenders (assuming that the Affiliated Lender meets the definition of "insider" under the Bankruptcy Code). That definition will draw in affiliates of the Borrower under a 20% voting securities threshold test (Bankruptcy Code Sections 101(2) and 101(31)(E)). Typically, "affiliates" in a credit agreement are defined, among other factors, by reference to a 10% voting securities threshold and could draw in "affiliated lenders" that are not "insiders" under the Bankruptcy Code.

Some credit agreements provide for an acknowledgment by each Affiliated Lenders that it is an "insider" under Section 101(31) of the Bankruptcy Code and, as such, the claims associated with the Loans and commitments owned by it shall not be included in determining whether the applicable class of creditors holding such claims has voted to accept a proposed cramdown plan (an "***Insider Acknowledgment***").

Implications of Affiliated Lenders in Bankruptcy *(continued)*

Credit Agreement Provisions Addressing Implications in Bankruptcy

To address such implications in bankruptcy and to assure that control over the "credit agreement class" in the Borrower's bankruptcy case is maintained by the non-Affiliated Lender, many credit agreements include all or some of the following standard limitations on Affiliated Lenders:

- All Loans purchased by (or assigned to) Borrower or any guarantor is to be immediately canceled or extinguished;
- The number of Affiliated Lenders that may hold Loans is limited (usually to two or three Affiliated Lenders);
- ***At the time of a Loan purchase*** by an Affiliated Lender, and after giving effect thereto, all Affiliated Lenders, in the aggregate, may not own more than 20–25 percent ***of the term Loans***;
- Each Affiliated Lender agrees to vote (or is deemed to vote) its claims with respect to any matter, without discretion, in the same proportion as the allocation of voting with respect to such matter by the non-Affiliated Lenders;

Implications of Affiliated Lenders in Bankruptcy *(continued)*

Credit Agreement Provisions Addressing Implications in Bankruptcy *(continued)*

- Each Affiliated Lender provides an Insider Acknowledgement; and
- Each Affiliated Lender provides to the Agent a proxy allowing the Agent to vote such Affiliated Lender's claim in the Borrower's or the guarantors' bankruptcy case as provided above.

Note: Recent case law has held that voting proxies between lenders may not be enforced and although other courts have reached the opposite conclusion on the same issue, they do not overcome the risk of unenforceability outside the districts in which those cases were decided.

Are the Standard Provisions Sufficient to Maintain Control?

Numerosity Test

For broadly syndicated loans, provisions limiting the number of Affiliated Lenders to two or three will in most instances work to ensure that the non-Affiliated Lenders represent less than 50 percent of the number of holders of claims arising under the credit agreement. However, this may not be the case for “club deals”, or if a substantial portion of the credit agreement obligations are purchased by a small number of distress debt investors (either prior to or during the bankruptcy case).

Note: The case law provides that, absent special circumstances, a bankruptcy court will respect the separate identity of claims holders, including those held by affiliated entities.

Accordingly, and in view of the clear target of ensuring that ***at all times*** non-Affiliated Lenders constitute ***more*** than 50 percent of the credit agreement claimholders, it is safer and more direct to provide in the credit agreement that the number of Affiliated Lenders may not, ***at any time*** (including after giving effect to any proposed purchase) be greater than the lesser of (x) two or three lenders and (y) less than 50 percent (50%) of the total number of lenders.

Are the Standard Provisions Sufficient to Maintain Control? *(continued)*

Numerosity Test *(continued)*

Since the number of lenders can vary (and two or three Affiliated Lenders can constitute at one point in time less than 50 percent and then become 50 percent or more, including through no action on the part of the Affiliated Lenders), including as a result of assignments among non-Affiliated Lenders, non-pro rata prepayments or by holding other claims that are part of the same class as the claims arising under the credit agreement (discussed below), provisions should be introduced to the credit agreement requiring Affiliated Lenders to dispose of their Loans in amounts sufficient to maintain compliance with the limitations addressing the Numerosity Test.

Such provisions may require an assignment of the Loans held by the applicable number of Affiliated Lenders to other Affiliated Lenders, by assigning them in full to non-Affiliated Lenders, or by contributing Loans to the capital of the Borrower, in each case in order to reduce the ***number*** of Affiliated Lenders. While these are unpopular requirements with Sponsors (because it is conceivable that, if Affiliated Lenders are forced to dispose of their Loans to third parties, such disposition could result in a loss), it is rare that a Sponsor will use more than one affiliate to purchase Loans in the first place. Further, dispositions within the Affiliated Lenders' group should not result in a loss to the Sponsor group as a whole (recall that typically affiliates of the Sponsor that are bona fide debt funds are not included as Affiliated Lenders).

Are the Standard Provisions Sufficient to Maintain Control? *(continued)*

Claims Amount Test

The provision limiting the ownership of affiliated lenders to 20 - 25 percent ***at the time of purchase*** by an affiliated lender can also fail to protect the non-Affiliated Lenders from the Affiliated Lenders acquiring a blocking position. This is due to provisions in the credit agreement (discussed below) which permit (a) non-pro rata prepayment of Loans under the credit agreement and (b) the incurrence of additional pari passu secured debt that may be classified in the same class as the claims arising under the credit agreement.

Non-Pro Rata Prepayments

Loan Buybacks:

Provisions in credit agreements provide that the Borrower's Loan buybacks (a/k/a discounted purchases or discounted prepayments) are to be ***offered*** to all lenders through a Dutch auction or similar method. However, as the Borrower has no right to require any or all lenders to participate in such auction or accept any buyback offer, the prepayment or the purchase and immediate extinguishment of the Loans purchased by the Borrower results (unless accepted by all lenders, which is highly unlikely) in a non-pro rata reduction of the Loans and an increase in the percentage share of claims arising under the credit agreement of the non-participating lenders, including any non-participating Affiliated Lenders.

To address the increase in the percentage of Loans held by Affiliated Lenders as a result of non-pro rata prepayments or purchases, some credit agreements require Affiliated Lenders to accept the offer of prepayment or purchase made by the Borrower at least to the extent necessary to maintain compliance by the Affiliated Lenders with the 20-25 percent limit.

Non-Pro Rata Prepayments *(continued)*

Tranche Prepayments

Many credit agreements provide Borrowers with the right to determine which tranche or class of Loans are to be voluntary prepaid (provided that the lenders holding such tranche of Loans are being prepaid on a pro rata basis of their holdings of such tranche). Further, some credit agreements provide that mandatory prepayments shall first be applied to a certain tranche of Loans prior to application to other tranches. For example, in credit agreements that include a Term Loan A Facility and a Term Loan B Facility, the Borrower may elect to voluntarily prepay (or, in the case of mandatory prepayment, may be required to prepay), Loans under the Term Loan A Facility, but not (or prior to) Loans under the Term Loan B Facility. Assuming that the lenders do not hold Loans of each tranche on the same pro rata basis, voluntary and mandatory prepayments that are applied to certain, but not all, tranches of Loans, result in an increase of the percentage share of claims arising under the credit agreement of lenders, including Affiliated Lenders, who hold tranches of Loans not so prepaid.

Non-Pro Rata Prepayments *(continued)*

<u>Lenders Right to Refuse Prepayments</u>

In many recent transactions, credit agreements provide that each lender, including Affiliated Lenders, may refuse to accept certain types of mandatory prepayments due to such lender.

Accordingly, a refusal by less than all the lenders to accept a mandatory prepayment will result in an increase of the percentage share of claims arising under the credit agreement of lenders, including Affiliated Lenders, who refused to accept such mandatory prepayments.

To address this issue, the credit agreement provisions limiting the amount of Loans that may be held by Affiliated Lenders (e.g., to 20-25 percent) should provide that such limitations apply to Loans held by Affiliated Lenders at ***all times*** (not just at the time of purchase) and require Affiliated Lenders to either (i) dispose of such amount of Loans held by the Affiliated Lenders that, in the aggregate, exceeds the agreed limit, by a sale to non-Affiliated Lenders, or (ii) contribute Loans in an amount of such excess to the capital of the Borrower with the immediate extinguishment of the contributed Loans.

ADDITIONAL SECURED DEBT

Claim Classification

Section 1122(a) of the Bankruptcy Code states that “[e]xcept as provided in subsection (b) of this section, 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…”. Accordingly, classification of secured claims is to be determined on the basis of (i) priority, (ii) nature of the collateral and (iii) agreements among the creditors with respect to subordination. The typical rule of claim classification is that two creditors with liens of the same priority on the same collateral will be classified together.

Permitted Additional Pari Passu Debt

Many credit agreements permit Borrowers to incur additional debt that is secured on a pari passu basis by the same collateral securing the obligations under the credit agreement. As noted above, claims arising under such pari passu secured debt will in high likelihood be part of the same class as claims arising under the credit agreement and, therefore, Affiliate Lenders’ holdings of such pari passu debt raise the same implication in bankruptcy as those discussed above.

ADDITIONAL SECURED DEBT *(continued)*

Incremental Facilities

Provisions in credit agreements relating to incremental facilities, also referred to as "accordion feature", typically permit Borrowers, subject to certain conditions, to incur additional term loan tranches or increase the revolving commitments under the same credit agreement. Many credit agreements provide that, other than as specifically permitted in such provisions, incremental facilities are to have the same terms as the initial loans incurred under the credit agreement and, therefore, limitations on holding by Affiliated Lenders are typically also applicable to holdings of Loan under incremental facilities.

However, many credit agreements only provide for provisions limiting the ***purchases or assignments*** of Loans by Affiliated Lenders (and accordingly reside in the provision of the credit agreement relating to assignment) and do not generally (or at least not specifically) limit Affiliated Lender's from ***making*** initial Loans under the credit agreement (including by way of providing incremental facilities).

ADDITIONAL SECURED DEBT *(continued)*

Incremental Facilities *(continued)*

Some credit agreements provide that only "Eligible Assignees" may provide incremental facilities and in the relevant definition provide that Affiliated Lenders constitute Eligible Assignees subject to the same limitation applicable to Loan purchases by Affiliated Lenders.

Therefore, it is prudent to provide in provisions relating to incremental facilities that Affiliated Lenders may not provide revolving commitments or fund Loans under incremental facilities, or, at the least, provide that it is a condition to any Affiliated Lender providing any term Loans under an incremental facility that, after giving effect to such Loans, the limitations applicable to holding of Loans by Affiliated Lenders are met.

ADDITIONAL SECURED DEBT *(continued)*

Refinancing Facilities

Provisions in credit agreements relating to "refinancing facilities" permit Borrowers, subject to certain condition, to refinance a portion of Loans and commitments outstanding under the credit agreement with pari passu secured, junior secured, unsecured or subordinated debt, so long as the proceeds of such credit facilities, which may be in the form on bonds, are used to partially refinance Loans and commitments outstanding under the credit agreement.

Because such refinancing facilities are to be secured by liens of the same priority and on the same collateral securing the Loans under the credit agreement, credit agreements provide that it is a condition to incurring such facilities that an intercreditor agreement among the pari passu lenders will be entered into and that such intercreditor agreement shall be in a form that is reasonably acceptable to the Agent. However, such provisions typically do not specifically address or provide for limitations on Affiliated Lenders holdings of loans or notes issued under such refinancing facilities.

ADDITIONAL SECURED DEBT *(continued)*

Refinancing Facilities *(continued)*

Because the refinancing facilities reduce the amount of Loans outstanding, and can typically be owned without restriction by Affiliated Lenders, the use of such refinancing facilities to prepay Loans under the credit agreement can quickly result in 50% of more of the total amount of pari passu secured debt being owned by Affiliated Lenders.

As it is highly likely that claims arising under pari passu secured refinancing facilities will be classified in bankruptcy as one class together with claims arising under the credit agreement, it is important to specifically provide in credit agreements that the limitations on Affiliated Lenders holdings provided in the credit agreement are to be tested on an aggregate basis with obligations owned by Affiliated Lenders under any "refinancing facilities".

ADDITIONAL SECURED DEBT *(continued)*

Ratio Debt and Equivalent Debt Facilities

Some credit agreement, typically at the "high-end" of the leveraged finance market, permit Borrowers, subject to certain conditions, to incur additional debt, which may be secured by liens of the same priority on the same collateral as the obligations under the credit agreement, so long as the pro forma maximum senior secured (or first lien) leverage shall not exceed a pre agreed level or to the extent that such pari passu debt would have been permitted to be incurred as an incremental facility (i.e., that, but for the fact that such debt is not documented as an additional tranche of Loans or commitments under the credit agreement, all the conditions to incurring an incremental facility, including with respect to the maximum amount thereof, are satisfied).

Such additional permitted indebtedness may be incurred in the form of bonds or other bank loans and will be documented under separate documentation, e.g., another credit agreement or indenture, and the trustee or agent for the creditors thereunder most likely will not be the same as the Agent under the credit agreement.

Further, unlike credit agreement provisions with respect to incremental facilities, provisions governing permitted "ratio debt" and "equivalent debt facilities", do not require the lenders (or bondholders) providing such additional pari passu secured debt to be "Eligible Assignees" (discussed above) or otherwise to be acceptable to the Agent and do not provide for limitations on holdings by Affiliated Lenders.

ADDITIONAL SECURED DEBT *(continued)*

Ratio Debt and Equivalent Debt Facilities *(continued)*

Note: Similar issues arise in transactions where additional pari passu secured debt exists at the time of entry into the credit agreement and initial extension of the Loans, for example, in a combined bank/bond acquisition financing transactions if the bonds are secured on a pari passu basis by the same collateral as the obligations under the bank financing.

To address the issue of the separate, but equal, rights with respect to the collateral, many credit agreements require as a condition to incurring such pari passu debt, that the creditors thereunder (or the trustee or agent therefor) and the Agent under the credit agreement enter into an intercreditor agreement reasonably acceptable to the credit agreement Agent.

Similarly to other pari passu secured debt and refinancing facilities, it is highly likely that claims arising under equally secured "ratio debt" and "equivalent debt facilities" will be classified in bankruptcy under one class together with claims arising under the credit agreement, therefore, it would be prudent to provide that the limitations on Affiliated Lenders holdings provided in the credit agreement are to be tested on an aggregate basis with obligations owned by Affiliated Lenders under any such "ratio debt", "equivalent debt facilities" and "refinancing facilities".

ADDITIONAL SECURED DEBT *(continued)*

Provisions Designed to Prevent Shifting Control

To effectively provide protection to non-Affiliated Lenders from shifting control over a bankruptcy case of the Borrower due to the incurrence of pari passu secured debt (whether in the form of separate incremental facility tranches, refinancing facilities, ratio debtor equivalent debt facilities), credit agreements should include provisions that:

- Limit the ***number*** of Affiliated Lenders that may hold obligations under the credit agreement and any other obligations that are secured on an equal priority by the same collateral securing the credit agreement obligations, ***in the aggregate***, to such number of entities that ***at any time*** constitute less than 50% of the total number of holders of such debt.
- Limit the ***amount*** of such debt that may be owned by Affiliated Lenders to an amount that, ***in the aggregate and at any time***, does not exceed 30.0% of the aggregate amount of such debt (but, it is reasonable to include a cushion limiting such amount to 20-25%).

ADDITIONAL SECURED DEBT *(continued)*

Provisions Designed to Prevent Shifting Control *(continued)*

- Provide as a condition to the incurrence of any such pari passu debt that the documents governing such debt include limitations on the holdings thereof by Affiliated Lenders similar to those provided by the credit agreement and making the Agent and lenders under the credit agreement third party beneficiaries of such limitations.
- Provide technical provisions requiring Affiliated Lenders to dispose of credit agreement and other pari passu secured obligations upon the occurrence of an event resulting in violation of the limitations on their holdings.
- Include a provision in related intercreditor agreement (discussed below) providing that any revisions to the agreements governing the subject debt (and any permitted refinancing thereof) with respect to the limitations on holdings by Affiliated Lenders thereunder may only be made with the prior consent of the other credit (or agent therefor).

Intercreditor Agreements

Provisions in credit agreements relating to partial refinancing facilities and other permitted additional pari passu secured debt require that the lenders providing such debt enter into an intercreditor agreement that is reasonably acceptable to the Agent and do not provide a pre-agreed form of such agreement.

Accordingly, lenders are not assured that such intercreditor agreement will provide for sufficient protections with respect to Affiliated Lenders' holdings of the subject other pari passu secured debt, including that no amendments thereto will permit Affiliated Lenders to increase their holdings, or hold such debt, by more than the amount and number of holders that is permitted under such agreements at the time it is entered into.

Therefore, it would be prudent to include in the credit agreement provisions that permit the incurrence of pari passu secured debt a requirement that the documents governing such debt provide for limitations on the holdings thereof by Affiliated Lenders similar to those provided by the credit agreement and require that any related intercreditor agreement will prohibit any amendment to such provisions.

Intercreditor Agreements *(continued)*

Security Trust Agreements

Because creditors under the other pari passu secured debt, including such debt that is incurred at the time of closing under the credit agreement, may be (and in most cases will be) represented by a different agent (in the case of commercial bank loan) or a trustee (in the case of bonds), in many cases the intercreditor agreement will be in the form of a security trust agreement or similar agreement, which, in addition to documenting the equal priority of the creditors' liens on the collateral, also governs the rights of each creditor group to direct actions with respect to the collateral (typically by reference to a minimum share of the aggregate amount of all pari passu secured claims that are subject to such agreement, including such debt held by Affiliated Lenders and affiliated bondholders).

Intercreditor Agreements *(continued)*

<u>Security Trust Agreements *(continued)*</u>

To properly protect the non-Affiliated Lenders, it is important to include in such security trust agreements provisions that will:

- Specifically limit Affiliated Lenders' voting rights in directing actions with respect to the collateral (e.g., by providing that either Affiliated Lenders' claims are to be excluded in determining whether the minimum claims amount required to direct actions with respect to the collateral has been achieved, or require Affiliated Lenders' claims to be voted (or to be deemed voted) in the same proportion as the allocation of voting with respect to such actions by the non-Affiliated Lenders (or non-affiliated bondholders); and
- Similarly limit the voting rights of Affiliated Lenders with respect to amendments and other matters under such security trust agreement.