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Client Alert

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Bankruptcy Implications of Affiliated Lender Provisions and Debt Buybacks

Affiliated Lender Provisions and Debt Buybacks - Unenforceability of Bankruptcy Voting Proxies Expose Flaws in "Market Standard" Provisions

Over the last few years, provisions in credit agreements permitting the Borrower's equity sponsor and other affiliates (typically referred to as "*Affiliated Lenders*"), to purchase term loans made thereunder[1] and allowing the Borrower to "repurchase"[2] such term loans on a non-pro rata basis, have become common. However, many of the provisions governing such purchases that have become "market standard" do not adequately protect the non-Affiliated Lenders' interests in a bankruptcy of the Borrower. This note explores such provisions, how they fail to protect non-Affiliated Lenders and how they could be properly drafted in order to address non-Affiliated Lenders' concerns.

I. Affiliated Lenders

The standard provision that permits Affiliated Lenders[3] to purchase term loans permit such purchases so long as (i) the number of Affiliated Lenders is limited (usually to two or three Affiliated Lenders), (ii) at the time of the purchase, the Affiliated Lenders, in the aggregate, will not own more than 20 - 25% of the term loans, (iii) each Affiliated Lender agrees to vote under the credit agreement (or is deemed to vote under the credit agreement) in the same manner as the non-Affiliated Lenders on a pro rata basis (except for certain sacred rights, which vary among credit agreements), (iv) each Affiliated Lender provides to the Administrative Agent a proxy allowing the Administrative Agent to vote its claim in a bankruptcy and (v) the Affiliated Lenders agree that they can be excluded from "lender only" information and meetings. In some agreements, an Affiliated Lender must also represent that it has no material non-public information regarding the Borrower at the time of purchase.

The provisions are designed to allow Affiliated Lenders to support the Borrower by purchasing debt and to be in a position to purchase debt at a discount if that is available. The provisions are also designed to prevent Affiliated Lenders from controlling any work-out or bankruptcy process, and make the Affiliated Lenders, in effect, passive investors in the term loan.

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II. Borrower Buybacks

The standard provisions that permit Borrower buybacks typically permit the Borrower to purchase term loans through a "Dutch Auction" process so long as (i) the purchased term loans are cancelled upon purchase (so that at no time does the Borrower actually hold a term loan) and (ii) the offer to purchase the term loans is made on a pro rata basis to all lenders under mechanical bidding and acceptance procedures that are either laid out in the credit agreement or acceptable to the Administrative Agent. In any case, by purchasing term loans from non-Affiliated Lenders (and not from Affiliated Lenders) and concurrently cancelling the purchased term loans, the Borrower can increase the percentage of the aggregate outstanding term loans owned by Affiliated Lenders. Recall that "market standard" provisions only impose the 20 - 25% limit *at the time of purchase* by the Affiliated Lender. Thus, Borrower buybacks can push Affiliated Lenders' ownership of term loans above the percentage ownership limit without creating a default under the credit agreement.

III. Implications of a Bankruptcy

Under the Bankruptcy Code, a plan of reorganization (other than a "cram-down" plan)[4] 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 *and* the holders of at least two-thirds in amount of the claims in that class must accept the plan. Thus, assuming that claims under the 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 more than one-third of the amount of claims thereunder.

There are three provisions in the "market standard" provisions that are designed to prevent this result. First, the number of claimants is limited to two or three, under the assumption that two or three lenders will be less than 50% of the number of lenders. Second, the amount of term loans that can be purchased by Affiliated Lenders is limited to 20 - 25% of the aggregate principal amount of the term loans, so that Affiliated Lenders will not obtain a blocking position of more than one-third. Third, the provisions provide a proxy to the Administrative Agent to vote, in a bankruptcy, the claims of the Affiliated Lenders under the credit agreement in the same manner (on a pro rata basis) as voted by the non-Affiliated Lenders. As discussed, none of these "market standard" provisions adequately protects the non-Affiliated Lenders from the Affiliated Lenders obtaining a blocking position on a plan or reorganization.

The limit to two or three Affiliated Lenders will in most instances work to ensure that the Affiliated Lenders do not represent 50% or more of the number of holders of claims under the credit agreement. However, since the target of 50% is a known quantity, it would certainly be safer and more direct to provide that Affiliated Lenders can never (at the time or purchase or thereafter) be more than the lesser of (x) two or three lenders and (y) 50% of the number of lenders under the credit agreement. Since the number of lenders can vary (and two or three Affiliated Lenders can be at one point in time less than 50% and then become more than 50% through no action on the part of the Affiliated Lenders), a mechanism can be introduced into the credit agreement to solve for this problem. One such mechanism would require that Affiliated Lenders dispose of their term loans in order to stay within the 50% requirement (by assigning them in full to other Affiliated Lenders in order to reduce the number of total holders of Affiliated Lenders, by assigning them in full to non-Affiliated Lenders or by contributing them to the capital of the Borrower). While these are unpopular requirements with Sponsors, because it is conceivable that Affiliated Lenders may be forced to dispose of their term loans at a loss, it is rare that a Sponsor will use more than one affiliate to purchase term loans in the first place. Further, intra-Affiliated Lender group transfers should not result in a loss to the Sponsor group as a whole (recalling that affiliates of the Sponsor that are bona fide debt funds are not included as Affiliated Lenders in any event).

The provision limiting the ownership of Affiliated Lenders to 20 - 25% 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. As discussed above, the Borrower is free to purchase and cancel term loans on a non-pro rata basis (so long as the offers are made on a pro rata basis). By purchasing from non-Affiliated Lenders, these purchases, combined with the requisite cancellation of the term loans, can result in the ownership by Affiliated Lenders of more than one-third of the aggregate principal amount of the term loans. In order to protect against this result, credit agreements should provide that the 20 - 25% test must be met “at all times” (not just when an Affiliated Lender purchases the term loans). In order to police this requirement, the credit agreement should require that Affiliated Lenders dispose of their term loans in order to maintain compliance within the limit (either by assigning term loans to non-Affiliated Lenders or contributing them to the capital of the Borrower). This problem can also be addressed by providing that, when an Affiliated Lender receives an offer in a “Dutch Auction” to purchase a term loan (which, as discussed above, must be made to all lenders on a pro rata basis), such Affiliated Lender must accept such offer (or at least accept it in an amount that will guarantee that Affiliated Lenders will stay within the 20 - 25% cap following completion of such offered purchase).

Credit agreements safeguard against any flaws in the number of Affiliated Lenders test and the percentage ownership test by requiring that Affiliated Lenders provide a proxy to the Administrative Agent to vote, in a bankruptcy, their claims under the Credit Agreement in the same manner that non-Affiliated Lenders vote (on a pro rata basis). If this safeguard were full-proof, the flaws outlined above in the number and percentage tests could be tolerated. However, recent case law has held that voting proxies between lenders may not be enforced. The leading case on this subject is *In Re SW Boston Hotel Venture, LLC*.[5] In that case, the court refused to enforce a pre-petition assignment of voting rights between first and second lien lenders, holding that such an agreement impermissibly alters substantive provisions of the Bankruptcy Code. A second case, later in 2011, reached the same conclusion, *In Re Croatan Surf Club, LLC*.[6] Other courts have looked at the issue and have reached the opposite conclusion, i.e., that pre-petition assignments of voting rights in bankruptcy are enforceable.[7] While those cases are helpful, they do not overcome the risk that outside the districts in which the cases were decided pre-petition assignments of voting rights are not enforceable. As yet, there are no circuit court cases on the issue and there is no Supreme Court case.

In order to adequately protect the interest of non-Affiliated Lenders the “number” test in Credit Agreements should be set at 50% (in addition to any definite number of Affiliated Lenders which is based on the expected total number of lenders), the percentage test should apply at all times (rather than at the time of purchase only) and Affiliated Lenders should be required to accept “Dutch Auction” offers on a pro rata basis (or at least in an amount that will guarantee that the Affiliated Lenders remain within the 20 - 25% cap). Credit agreements should also police the number and percentage limits with forced sales and/or capital contributions.

[1] Because most credit agreements generally prohibit purchases of revolving loans or acquiring revolving commitments by affiliates of the borrower, this discussion is limited to term loans.

[2] Some credit agreements provide for Borrower non-pro rata "prepayments", but for this discussion the impact is the same.

[3] Credit Agreements routinely exclude from "Affiliated Lenders" that are subject to the provisions being discussed here, bona fide debt funds that are affiliates of the Borrower (through the Sponsor) and that are separately managed from the equity portfolio of the Sponsor. For this discussion, Affiliated Lenders will mean affiliates of the Borrower that are not so excluded.

[4] Under Section 1129(b)(1) of the Bankruptcy Code, a "cram-down" 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. The acceptance by that impaired class excludes the "acceptance" of the plan by "insiders" (Bankruptcy Code Section 1129(a)(10)). Thus, Affiliated Lenders' votes cannot force a cram-down 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 (Bankruptcy Code Sections 101(2) and 101(31)(E)). Typically, "affiliates" in a Credit Agreement are defined by reference to a 10% voting securities threshold and could draw in "Affiliated Lenders" that are not insiders under the Bankruptcy Code.

[5] 460 B.R. 38 (Bankr. D. Mass 2011).

[6] No. 11-00194-8-SWH, 2011 WL 5909199, at *1 (Bankr. E.D. N.C. Oct. 25, 2011).

[7] In re Coastal Broadcasting Systems, Inc., Case No. 11-10596 (Bankr. D. N.J., July 6, 2012); Blue Ridge Investors II, L.P. v. Wachovia Bank (In re Aerosol Packaging, LLC), 362 B.R. 43 (N. D. Ga. 2006); Avondale Gateway Center Entitlement, LLC v. National Bank of Arizona, No. CV10-1772-PHX-DGC, 02-09-BK-12153-CGC, 2011 WL 1376997, at *2 (D. Ariz. Apr. 12, 2011).