THE ROAD AHEAD FOR LENDERS IN 2015: Legal Developments and Documentation Trends Affecting Middle-Market Lending Transactions

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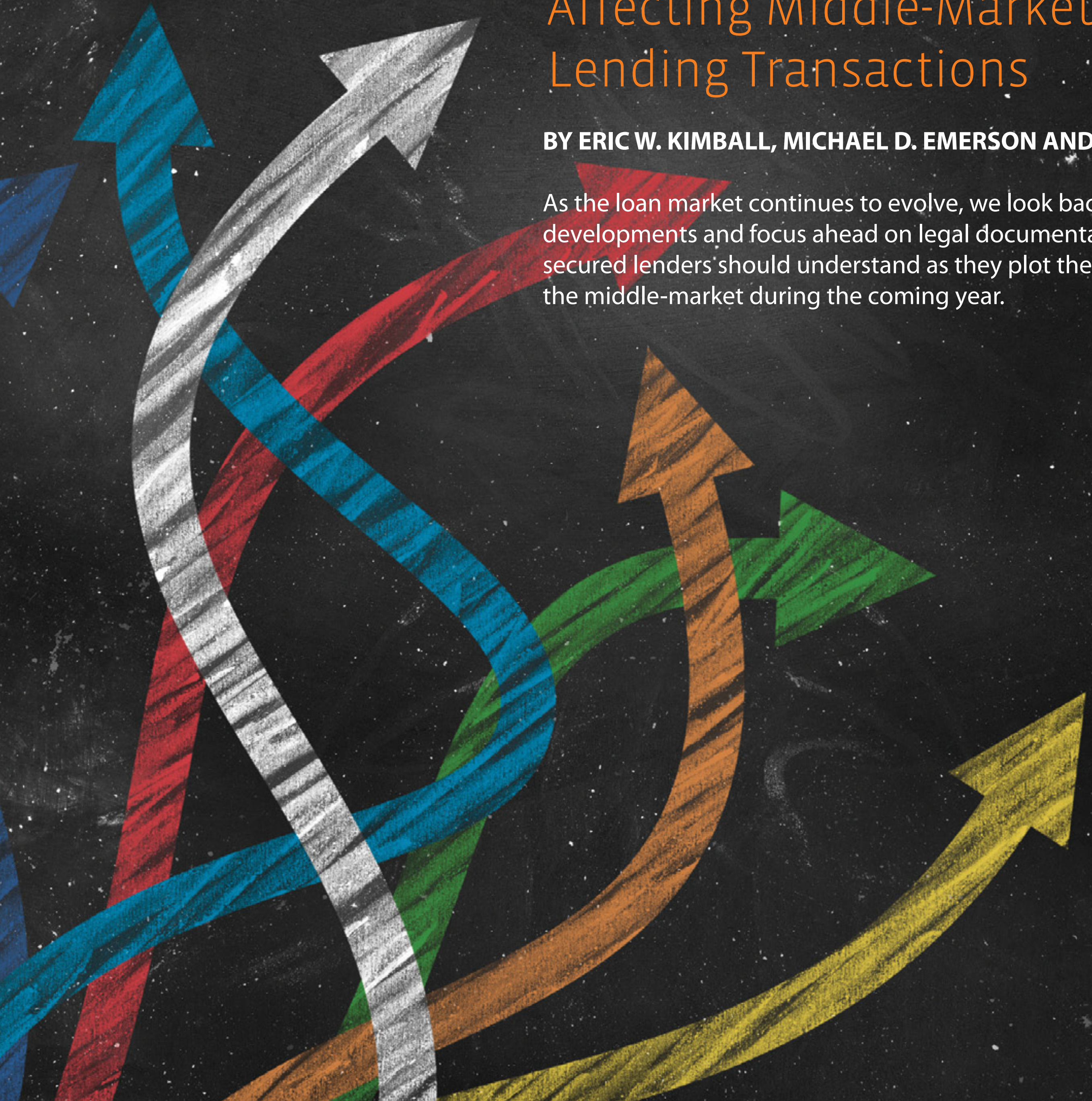
As the loan market continues to evolve, we look back at recent legal developments and focus ahead on legal documentation trends that secured lenders should understand as they plot their course through the middle-market during the coming year.



Over the past year, demand for middle-market loan facilities has continued to increase, though the rate of growth has slowed from 2013. Despite the slight deceleration, banks and other financial institutions are still seeing increased competition, requiring flexibility in both pricing and structure to win deals. This article reviews developments that impact the structuring, documentation and management of middle-market lending facilities in the coming year. We will first review some recent cases affecting lender remedies in workout scenarios that have broader applicability to deal documentation. Then, we will summarize certain updates to the LSTA's forms of primary market loan documents and discuss the potential impact of those changes.

THE REARVIEW MIRROR: RECENT LEGAL DEVELOPMENTS

Pick a Lane: Resolving Cramdown Issues

The aptly named *Momentive Performance Materials* [1] case weighed in on several issues affecting secured lenders, including the ability to incorporate a "make-whole" premium into a bankruptcy claim, the appropriate method for selecting a "cramdown" rate of interest for a non-consensual Chapter 11 plan and the treatment of reorganization securities under an intercreditor agreement's waterfall provision.

Many of these issues arose from a dispute concerning the senior secured lenders' ability to include a "make-whole" premium (totaling approximately $200 million) in their bankruptcy claims. The *Momentive* debtors argued that the senior secured lenders' loan documents did not require payment of a make-whole premium because the senior secured loan had been accelerated due to the bankruptcy filing and the premium only applied to prepayments of amounts not yet due.

The *Momentive* debtors sought to resolve the "make-whole" dispute through plan confirmation by forcing the senior secured lenders to choose between two alternatives in a plan "deathtrap" scenario. Under the first alternative, if a senior secured lender voted in favor of the plan, it would waive the make-whole premium and would be paid in full (other than the make-whole premium) on the plan's effective date with cash from the debtors' proposed exit financing. Under the second alternative, if the senior secured lender voted to reject the plan, the debtors would not pay the senior secured lender's claim in full in cash on the effective date. Instead, the debtors would satisfy the senior secured lender's claim with replacement notes paying a low interest rate and would continue to contest allowance of the make-whole premium, paying only the amount of make-whole premium (if any) awarded by the court.

In an effort to prevail on their make-whole premium claim, the senior secured lenders voted to reject the plan. A fight then ensued over the inclusion of the make-whole premium in the senior secured lenders' claims and the interest rate applicable to the replacement notes. Unfortunately for the senior secured lenders, neither issue was resolved in their favor.

First, the court denied the senior secured lenders' make-whole premium claim. Though the underlying loan documents did provide for a "make-whole" premium upon voluntary prepayment of the loans, the court held that under New York law a prepayment premium may only be chargeable following acceleration of the loan obligations (including acceleration by bankruptcy filing) if the loan documents explicitly provide that either (i) the premium is payable notwithstanding the acceleration of the loans, or (ii) the premium is applicable whenever the loan is repaid before its original maturity date. Because the *Momentive* loan documents lacked either clause, no "make-whole" premium was allowed.

Second, the *Momentive* court addressed the applicable rate of interest to be paid on the replacement notes. Specifically, it examined whether the cramdown interest rate for the replacement notes should be determined using a market approach, or a simplified "prime plus" approach, where a 1% to 3% margin is added to a base interest rate (usually the prime rate).

Unfortunately (again) for the senior secured lenders, the *Momentive* court selected the cramdown rate for the replacement notes using a simplified, "prime plus" cramdown rate formula, instead of selecting a rate based on comparable, nonbankruptcy loans. Notably, it used this formula, even though a "market" rate for the senior secured lender claims appeared readily available by reference to the debtors' negotiated exit financing facility (carrying a higher interest rate than the replacement notes). In reaching this holding, the *Momentive* court noted that a cramdown rate need not provide a lender with profit comparable to what it would otherwise earn on a non-plan loan. Instead, a cramdown rate need only provide the lender with some base rate of return, with a minor adjustment based on the debtor's unique risks.

Practical Roadmap: *The Momentive* court's holding provides debtors (at least in certain jurisdictions) with additional leverage in cramdown and plan negotiations. Secured lenders should be mindful of the possibility of being crammed down and stretched out at an undesirable rate and should take proactive steps early in restructuring and workout negotiations to mitigate such risks. Potential mitigation tools could include building sale, marketing or plan support covenants into DIP financing provided to the debtors at the start of a case, or strengthening guaranty agreements to cover any interest or claim deficiencies resulting from a low cramdown interest rate. Moreover, secured lenders, wishing to preserve their right to a "make-whole" premium following acceleration, should examine their loan documentation forms and should make any necessary adjustments to provide for such premiums following acceleration.

Sharing the Road: Enforcement of Intercreditor Agreements

An intercreditor dispute between Momentive's second lien lenders and senior secured lenders may also have momentous consequences.[2] Momentive's senior secured lenders and its second lien lenders had entered into an intercreditor arrangement. Though the second lien lenders were significantly undersecured, Momentive's proposed plan of reorganization provided the second lien lenders with significant consideration, including equity securities of the reorganized debtors, reimbursement of professional fees and payment of up to $30,000,000 for backstopping a rights offering. Not surprisingly, the second lien lenders supported the plan.

Momentive's senior secured lenders sued the second lien lenders, claiming that the intercreditor agreement required the second lien lenders to turn over all plan consideration received because the *Momentive* plan did not fully repay the senior secured lender claims in cash. While admittedly, the intercreditor agreement between the parties addressed lien subordination, not debt subordination, the senior secured lenders essentially argued that, because they had a lien on all assets, any consideration paid to the second lien lenders before repayment in full of the senior secured lenders violated the intercreditor agreement. The senior secured lenders had little success with this argument, as the court found that the plan's treatment of the second lien lenders did not violate the intercreditor agreement.

The key to the court's analysis was the distinction between debt subordination and lien subordination. The *Momentive* intercreditor agreement addressed lien subordination – that is, it subordinated the second lien lenders' rights as secured creditors to collateral and related proceeds, but it did not subordinate all payment rights from the debtors. As a result, the treatment afforded the second lien lenders did not violate the intercreditor agreement's collateral proceeds waterfall, according to the court. Specifically, it held that equity in the reorganized debtors did not constitute proceeds of collateral subject to the intercreditor agreement.

Practical Roadmap: The *Momentive* holding serves as another cautionary tale to all secured lenders that intercreditor agreements will be strictly construed and enforced. A lien subordination agreement may not necessarily restrict a junior lienholder's ability to exercise rights and receive plan distributions in its capacity as an unsecured creditor. Senior secured lenders, wishing to ensure that a second lien lender remains truly "silent", will need to carefully examine their intercreditor agreements to ensure that such intent is clearly expressed.

Excessive Speed: Restrictions on Credit Bidding for "Cause"

Secured lenders should remember that even in the wake of the United States Supreme Court's *RadLax* holding (where the Supreme Court held that a debtor could not use a bankruptcy plan to strip away credit bidding rights without cause), a secured creditor's right to credit bid is not absolute. The bankruptcy code itself has always permitted credit bidding rights to be restricted for *cause*.

Last year's *Fisker Automotive*[3] case was one notable instance of a court finding cause to restrict credit bidding. There, a lender that had purchased its secured claim at a deep discount aimed to acquire substantially all of the debtor's assets securing the loan via a "loan to own" strategy. The secured lender intended to credit bid for substantially all of the debtor's assets in a private, expedited sale under section 363 of the bankruptcy code.

Fisker's unsecured creditors were concerned with the speed and timing of the secured lender's proposed sale. Among other things, the objecting creditors argued that the secured lender's expedited private sale would prohibit other bidders from testing the value of the assets in a competitive auction (even after another serious bidder expressed interest in bidding) and would result in the de-facto allowance of the secured lender's claim before an investigation of the nature and extent of such claim (or challenges thereto) could be completed.

Ultimately, the court found the unsecured creditors' concerns persuasive and approved a resolution that allowed a competitive auction process to proceed. Though the secured lender was permitted to participate at that auction and credit bid its debt up to the amount of the purchase price paid (in this case, approximately 15 cents on the dollar), the *Fisker* court found that the potential for bid chilling, the expedited sale timeline and other creditor concerns constituted "cause" to restrict the secured lender from credit bidding the full amount of its secured claim.

Practical Roadmap: Secured lenders, seeking to avoid similar credit bidding restrictions for "cause", need to be aware that there may be a potential tradeoff between insisting on a swift, final sale and the ability to submit an unrestricted credit bid. Permitting a competitive auction process and providing all stakeholders with additional time to ensure that the sale process has been fair and thorough could help to insulate against potential credit bidding restrictions.

Designated Drivers: Interpreting "Eligible Assignee" Provisions

Many lenders would argue that a distressed debt fund constitutes a "financial institution." The lenders made that argument in the *Meridian Sunrise Village*[4] case, but the court disagreed.

In *Meridian Sunrise Village*, the court interpreted the meaning of a credit agreement assignment restriction that allowed lenders to assign their loans only to "Eligible Assignees." The scope of "Eligible Assignees" was negotiated before the closing to include commercial banks, insurance companies and institutional lenders, as well as "financial institutions." According to the borrower, this language was selected to prevent loans from being transferred to distressed debt investors or hedge funds.

On appeal, the court agreed, holding that a "financial institution" was an entity regularly in the business of originating loans, not an institution that merely acquires loans. It noted that, if any moneyed entity (regardless of its characteristics) was a "financial institution," the assignment restriction would be meaningless – a result at odds with the deliberate inclusion of that language.

Practical Roadmap: The Meridian Sunrise Village case could impact any secured lender that would like to assign loans to nonbank "financial institutions." Lenders wishing to preserve such rights should consider whether it would be appropriate to add loan agreement language creating an affirmative right to transfer loans to such distressed debt investors, or limit loan transfer restrictions to "neutral" factors, such as the size of the institution or assets under management.

The Road Ahead: Legal Documentation Trends

Last August, the Loan Syndications and Trading Association (LSTA) published an updated version of its Model Credit Agreement Provisions (MCAP) that incorporates several terms that have become more prevalent in the middle market. As anticipated, these provisions address borrower and sponsor buybacks and disqualified lender lists. Because the LSTA's model credit agreement provisions often drive (or otherwise, reflect) market-standard language, secured lenders should consider whether these new conceptual additions should be incorporated into their documentation forms.

Borrower and Sponsor Buybacks

Over the past few years, sponsors and borrowers have requested the ability to purchase portions of their debt facility. The MCAPs now include provisions permitting purchases of term loans by borrowers and their affiliates, subject to some protections for the non-affiliate lenders.

Under the MCAP provisions, borrower buybacks must be completed through a Dutch auction process made available to all non-affiliate lenders holding the same class of term loans. The borrower may not use the proceeds of any related revolving loan to purchase the term loans. And, immediately upon the effectiveness of the buyback, the term loans must be extinguished and the borrower may not obtain any residual rights with respect to the repurchased loans.

Affiliates of the borrower (including sponsors) may purchase term loans in the open market. The MCAP provisions distinguish between affiliates who are debt funds and affiliates who are not debt funds in determining an affiliate's rights under the loan agreement. Non-debt fund affiliates are generally subject to more restrictions than debt funds. For example, the non-debt fund affiliates will not have information rights and will be restricted from lender meetings and communications. And with respect to voting rights, non-debt fund affiliates will be deemed to vote for any action in the same proportion as the other lenders, unless the matter requires the consent of all lenders and adversely affects the affiliate more than the other lenders in a material respect. Voting rights of non-debt fund affiliates are further restricted in connection with an insolvency proceeding – non-debt fund affiliates are deemed to have no rights to vote on a plan of reorganization.

Disqualified Lender Lists

The new MCAPs also include provisions that allow the borrower to restrict assignment or participation of loans to certain disqualified institutions, including a borrower's competitors and other persons identified by the borrower in writing at or after the closing. The MCAP leaves the term "competitor" to be specifically defined within each individual loan facility.

Assignments or participations to a disqualified institution without the borrower's consent are not treated as void or invalid. Rather, the borrower may terminate any revolving loan commitment held by the disqualified institution, purchase or prepay any term loan held by such disqualified institution or require the disqualified institution to assign its interest to an eligible assignee. Disqualified institutions will also be subject to restrictions similar to those described above as affecting non-debt fund affiliates. For example, the disqualified institution will not have information rights and will not be permitted to attend lender meetings. Further, a disqualified institution will be deemed to have neither any voting rights with respect to the loan facility (its interest deemed to be voted in proportion with the other lenders) nor any voting rights on a plan of reorganization.

LOOKING DOWN THE ROAD

The road ahead for middle-market lending in 2015 looks friendly for borrowers and sponsors. Loan documentation will continue to reflect more advantageous borrower and sponsor terms, barring an unforeseen event. Remaining aware of loan documentation trends and current legal issues will help keep your institution in the driver's seat. TSL

1. *Meridian Sunrise Village, LLC v. NB Distressed Debt Inv. Fund Ltd.,* 2014 WL 909219 (W.D. Wash. Mar. 7, 2014).
2. *In re MPM Silicones, LLC,* 2014 WL 5168589 (Bankr. S.D.N.Y. Oct. 14, 2014).
3. *In re Fisker Automotive Holdings, Inc.,* 510 B.R. 55 (Bankr. D. Del. 2014).
4. *Meridian Sunrise Village, LLC v. NB Distressed Debt Inv. Fund Ltd.*, 2014 WL 909219 (W.D. Wash. Mar. 7, 2014).

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