LAW360

Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

An Overview Of 1st-Out Revolvers

By Marc P. Hanrahan and Jerome McCluskey, Milbank Tweed Hadley & McCloy LLP

Law360, New York (June 13, 2012, 6:01 PM ET) -- "Let's structure it as a first-out tranche." This refrain is being voiced with increasing frequency as arrangers and underwriters of credit facilities attempt to design capital structures with the broadest appeal to market participants. As the name suggests, a “first-out” credit facility (also referred to as a “superpriority” or “super-senior” credit facility) at its most basic level is characterized by one lender group being paid ahead of other equally and ratably secured lenders in certain circumstances and thus becoming the “first out” among otherwise equally ranked creditors.

In recent years, the debt markets have included a wide variety of credit facilities employing some element of a first-out structure. A search by the authors of recent examples of first-out facilities has uncovered first-out revolving credit facilities alongside term loan facilities, asset-based revolvers structured with a first-out tranche and a last-out tranche, term loan facilities split into first-out and last-out tranches and cash flow revolver facilities split into first-out and last-out tranches. First-out facilities also have appeared in recent years in foreign debt markets including several notable European acquisition financings that have relied on “super-senior” revolving facilities paired alongside secured bonds.[1]

While the reader should keep in mind the broader use of the first-out structure in today's debt markets, our focus in this article is first-out revolving credit facilities attached to term loan facilities or secured bonds.[2] In this article, we address three principal areas of interest in respect of first-out structures: first, the market rationale for first-out revolvers; second, the common provisions in credit documentation that establish the first-out mechanics and, last, the pros and cons of these facilities for borrowers and lenders.

Why Use The First-Out Revolver?

Revolving facilities, as compared to funded term loan facilities, can be challenging to syndicate in today’s loan market. One primary reason for the difficulty lies in the fact that revolving facilities can be relatively unattractive from an economic return perspective. If a borrower is performing well and generating sufficient cash from operations to fund its business, it is less likely to borrow under its revolving credit facility. For the revolving lender, this means that instead of earning interest on funded loans, its economic return will primarily consist of the smaller fees on its unfunded commitment.

The result is that the revolving lender earns less than the stated yield. The revolver will only be drawn when the borrower experiences a liquidity crunch and requires revolving credit loans to fund its cash needs. Only then in the borrower's more distressed state will the revolver be drawn to a fuller extent. If the distress continues and eventually results in a bankruptcy, the revolving lenders will have a credit exposure like the term lenders but will have earned a substantially lower return because of the shorter period of time that the revolving credit loans have been outstanding.

For these reasons, many loan investors have a limited appetite for undrawn revolver exposure. Adding to the difficulty in syndicating revolving loan facilities is the fact that many lenders are restricted by charter from investing in revolvers and instead invest solely in fully funded loans.

As explained below, the first-out feature has been one solution to improving the attractiveness of undrawn revolvers as it gives the first-out investor greater assurance that it will be repaid in full even if other investors are not.

What Makes a Facility "First-Out"?

Priority of Payments

While, as discussed below, variations can be found among the terms and conditions of first-out structures, the one feature common to all is the prior application of collateral proceeds to the first-out lenders ahead of other pari passu lenders. Absent such an arrangement, the typical payment waterfall application would otherwise provide that revolving lenders and other pari passu creditors (e.g., the term lenders) receive a proportionate payout. Instead, first-out arrangements provide that proceeds of collateral are applied to repay the first-out tranche ahead of other tranches secured by the same collateral.

Thus, in a workout or bankruptcy proceeding, a collateral agent in a first-out structure who receives proceeds from a foreclosure or other distribution on account of collateral will be obligated to use the first dollars received for the benefit of the first-out revolving lenders. Thanks to the first-out provisions, the first-out lenders can take comfort in the fact that, if collateral is sufficient to repay their claims, they will be repaid in full even if other secured lenders are not.

Equal Lien Ranking

It is important to understand that although the first-out lenders have payment priority in respect of collateral proceeds, a first-out structure should not be confused with a first/second lien structure. The first-out lenders are pari passu with other secured lenders with respect to shared collateral. Consistent with their pari passu status, first-out lenders do not have an independent or senior lien relative to other secured creditors but rather are secured by the same liens in favor of a single collateral agent acting on behalf of all pari passu creditors.

In contrast, under a typical first lien/second lien structure, the first lien and second lien creditors are granted separate liens under separate documentation and their relationship is governed by an intercreditor agreement that usually gives the first lien lenders far more control rights with respect to collateral matters than the rights afforded to first-out lenders. Control rights of first-out lenders are further discussed below.

How are First-Outs Documented?

Next we turn to how common provisions for a first-out revolver facility are typically reflected in credit documentation. As discussed in more detail below, customary first-out provisions include (i) the priority of payments waterfall favoring the first-out lenders and its related turnover provision, (ii) class voting rights on modifications affecting the first-out structure and (iii) provisions governing enforcement of collateral rights and control of remedial action. Additional provisions may include covenants not to challenge enforcement actions of the pari passu lenders, a remedies standstill and other intercreditor-related provisions.

A gating issue is determining the agreements in which the relevant first-out provisions ought to be incorporated. Where there is a first-out revolver facility alongside a term loan facility, typically both credit facilities and certain first-out specific provisions, such as special voting rights, will be set forth in a single credit agreement and the first-out waterfall is set forth in the related security agreement. If, however, the first-out revolver and term loan are truly separate facilities with separate lender groups, the first-out revolver facility and the term facility might be set forth in two separate credit agreements.

Similarly, in the case of a "bank/bond" financing with, for example, a first-out revolver alongside a high-yield bond, the first-out revolver will be reflected in a standalone credit agreement containing only the revolving credit facility. In transactions involving two separate credit agreements and in bank/bond transactions, the waterfall is typically set forth in an intercreditor agreement or common security agreement that also contains enforcement provisions and certain other intercreditor provisions with the first-out related voting provisions set out in the respective debt agreements.

1. Priority of Payments

A standard first-out waterfall provision provides that first-out obligations have top priority in payment save for payment of certain enforcement-related and other amounts owing to agents of the pari passu creditors in their capacities as such. Following payment in full of the first-out obligations (and the agent obligations), next allocations under the waterfall provision provide for the payment in full of other pari passu obligations. The following is an example of a typical first-out payment waterfall involving a first-out revolving lender class:

> "Except as otherwise provided herein, all proceeds received by the Collateral Agent in respect of any sale of, collection from, or other realization upon all or any part of the Collateral, and any payments received by the Collateral Agent pursuant to the [Guarantee and Collateral Agreement], in each case after the occurrence and during the continuance of an Event of Default, may, in the discretion of the Collateral Agent, be held by the Collateral Agent as Collateral for, and/or (then or at any time thereafter) applied in full or in part by the Collateral Agent against, the Secured Obligations in the following order or priority: first, to the payment of all costs and

> expenses of such sale, collection or other realization, including reasonable compensation to the Collateral Agent and its agents and counsel, and all other expenses, liabilities and advances made or incurred by the Collateral Agent in connection therewith, and all amounts for which the Collateral Agent is entitled to indemnification under such Security Documents and hereunder and all advances made by the Collateral Agent thereunder for the account of the applicable Loan Party, and to the payment of all costs and expenses paid or incurred by Collateral Agent in connection with the exercise of any right or remedy under such Security Document or hereunder, all in accordance with the terms hereof; second, to the extent of any excess such proceeds, to the payment of all other Secured Obligations in respect of the Revolving Loans and Letters of Credit (unless such Letter of Credit has been cash collateralized) for the ratable benefit of the holders or issuers thereof; third, to the extent of any excess such proceeds, to the payment of all other such Secured Obligations for the ratable benefit of the holders thereof; and fourth, to the extent of any excess such proceeds, to the payment to or upon the order of such Loan Party or Guarantor, as applicable, or to whosoever may be lawfully entitled to receive the same or as a court of competent jurisdiction may direct."

As noted in the foregoing example, only agent fees and expenses (described in step first) will be paid ahead of the first-out facility (described in step second) and the first-out facility will in turn be paid in full ahead of the remaining tranches (described in step third). It should be noted that first-out obligations are typically defined to include principal, interest, any letter of credit reimbursement obligations and related fees. Also, favorably for first-out lenders, "first-out obligations" has been commonly defined to also include any interest, fees and other amounts accrued following the filing of a debtor bankruptcy petition, whether or not they are allowable claims in bankruptcy).

While in its most common form (as exemplified above), the first-out priority waterfall governs only proceeds realized from enforcement of collateral security, more aggressive structures may also require that all amounts received on account of the secured obligations (whether as a result of payment under guaranties, mandatory prepayments, an exercise of setoff rights, distribution in a bankruptcy proceeding or otherwise) be applied through the first-out waterfall. These more aggressive first-out structures may even go further and provide for a payment block of sorts that prohibits the borrower from making any voluntary prepayments whatsoever of the non-first-out debt during the continuance of a default. An example of this more aggressive waterfall is as follows:

> "Notwithstanding anything to the contrary set forth in this Agreement or any other Credit Document, unless the Majority Lenders holding Revolving Loan Commitments (and/or Revolving Obligations, as applicable) otherwise agree, (x) if any [revolving lender] has any [revolving loan exposure] or any other outstanding Revolving Obligations and any Default or Event of Default then exists, no voluntary prepayment of Term Loans shall be permitted and (y) if any Default or Event of Default exists at the time any mandatory repayment of Terms Loans is otherwise required to be made, then (i) Swingline Loans, and if no Swingline Loans are or remain outstanding, Revolving Loans, and if no Swingline Loans or Revolving Loans are or remain outstanding, Letter of Credit Outstandings, shall first be repaid or cash collateralized on terms reasonably satisfactory to the Administrative Agent, as applicable, in the amount otherwise required to be applied to the repayment of Term Loans in the absence of this subsection, (ii) if (and only if) a Specified Default has occurred and is continuing, the Total Revolving Loan Commitment shall be reduced by the amount of the mandatory repayment of Term Loans otherwise required to be applied to the repayment of Term Loans in the absence of this subsection and (iii) after application pursuant to preceding clause (i), any excess portion of such

> mandatory repayment of Term Loans not so applied shall be applied to the repayment of Term Loans as otherwise required in the absence of this subsection.”

If the rationale for a first-out structure is to protect the payment priority irrespective of the source of payment, then preventing prepayments to non-first-out debt during such periods of distress would seem a logical extension of that rationale. If, however, the rationale for first-out structures is instead to provide preferential payment rights only with respect to collateral proceeds derived from enforcement or from a bankruptcy, then widening the scope of the waterfall in such a manner (and prohibiting voluntary prepayments) could be viewed as a more controversial expansion of the first-out structure. While the typical "collateral proceeds-only" style of first-out waterfall is akin to lien subordination, the more aggressive "any proceeds" style waterfall approaches something closer to payment subordination.

In an effort to remove any doubt concerning the intended effect in any bankruptcy scenario, some first-out lenders have negotiated an express acknowledgement by the other creditors that the waterfall is deemed to constitute a “subordination agreement” enforceable under Section 510(a) of the Bankruptcy Code. In a similar vein, at least one recent transaction provided for a waiver of rights of any secured party to support a “nonconforming” plan of reorganization which was defined to include any plan of reorganization that did not provide payments in accordance with the first-out priority of payments and was not supported by a majority of first-out lenders.

In a final example of efforts of first-out lenders to strengthen their hand in the enforcement and bankruptcy contexts, several recent transactions have seen first-out lenders successfully add acknowledgements by the other pari passu secured creditors that the first-out and non-first-out tranches be treated as separate and distinct creditor classes for purposes of distributions and voting in bankruptcy. While consensual agreements among creditors on contractual priority of distributions are generally viewed as enforceable within, as well as outside of, the bankruptcy context, the enforceability of prepetition agreements to waive plan voting rights or acknowledge separate class treatment is another matter.

Furthermore, with respect to separate class acknowledgements, a dearth of relevant case law makes the enforceability of such provisions unclear and likely to invite challenge. While the enforceability of these and similar prepetition agreements is beyond the scope of this article, we merely point out that the language on these points is evolving and presents additional issues to be considered by first-out lenders and non-first out lenders alike.

Most first-out structures also contain what is commonly called a “turnover” provision. A turnover provision requires that any proceeds received by a lender in contravention of the payment waterfall priorities be held in trust and immediately turned over for the benefit of the first-out lenders, thereby protecting the integrity of the waterfall while providing additional claims against non-complying recoveries by the other pari passu lenders. The following is an example of a common turnover provision:

> “If any Lender collects or receives any amounts received on account of the Obligations to which it is not entitled as a result of the application of this [prepayments waterfall provision], such Lender shall hold the same in trust for the Secured Parties and shall forthwith deliver the same to the Administrative Agent, for the account of the applicable Secured Parties, to be applied in

accordance with this [prepayments waterfall provision] or, if then applicable, [default application of proceeds provision]."

Until the first-out debt is paid in full, the first-out lender expects that collateral proceeds be paid to them ahead of the other secured lenders whether such proceeds come from the collateral agent or are turned over by the other pari passu lenders. As drafted, and as evidenced in the above example, the turnover provision applies only to amounts that should have been applied through the waterfall (i.e., collateral proceeds or certain prepayments) but for whatever reason were not so applied. It is generally understood that the non-first out lenders may retain other amounts that are not subject to the waterfall such as regularly scheduled interest and principal and other payments not made during distressed periods.

2. Class Voting Rights

First-out facilities often contain special voting rights that run in favor of first-out lenders as well as, in some cases, the other pari passu lenders. Voting rights favorable to first-out lenders typically include class-specific veto rights over any modifications to the waterfall provision as well as to any protective intercreditor provisions. In some recent transactions, the veto rights have been drafted more broadly to require unanimous first-out lender consent with respect to any modifications that "adversely affect" their first-out priority status.

The veto rights held by term lenders and bond holders most frequently relate to permitted increases in the aggregate amount of the first-out tranche. Some recent deals have included an express cap on the amount of permitted first-out debt. However, in most cases, given the small relative size of the first-out tranche as compared with the overall debt amount, the term lenders or bondholders would, in any event, control increases in the size of any first-out tranche under typical "majority rules" voting mechanics.

3. Control of Enforcement Actions

The issue of controlling enforcement actions brings the opposing interests of the first-out tranche and the other pari passu secured lenders into its starkest relief. Typically, the relative sizes of the first-out revolver versus the usually larger term loan or secured bond can lead to directly opposing views in the enforcement process.

Term loan lenders or secured noteholders will have a greater interest in maximizing the overall recovery, which may argue for a more patient and time-consuming process. Investors in a smaller first-out tranche may be more concerned with quickly recovering amounts sufficient to pay out the first-out tranche and therefore may have a greater interest in the speed, rather than the total amount of, the recovery. The balancing of these competing goals can cause the management and control of enforcement rights to be a hotly negotiated issue.

First-out facilities have generally provided that enforcement actions, whether pre-bankruptcy or during an insolvency or bankruptcy proceeding, are controlled by lenders holding a majority of the senior secured obligations. Under such an arrangement, the term debt holders, which as a group will often have made a larger investment than the first-out revolving facility, will dictate if and when enforcement rights are exercised against the shared collateral.

However, as evidenced by certain recent transactions, this default position in favor of the larger term lenders or noteholders has been increasingly circumscribed. A few first-out transactions in recent years have even flipped the traditional priority of creditors by providing the first-out revolving tranche with exclusive control of enforcement actions while the holders of term loans or bonds were left in the more typically junior position of having to accept a more passive role and a standstill period. Such a reversal of roles may be encountered relatively infrequently and be wholly dependent on relative negotiating leverage and other transaction-specific considerations. An important takeaway from these developments, however, is that first-out lenders are increasingly focused on limiting dilatory enforcement.

One tactic for first-out lenders in the more typical "junior" position, at least as far as enforcement rights go, has been to negotiate for a remedy standstill period as short as possible (i.e., 90-120 days). Following the expiration of the standstill period, if the term debt holders are not exercising remedies, the first-out revolving lenders are able to step in to direct remedial action.

Additional protections include (i) a requirement that, prior to the commencement of any enforcement of rights or any exercise of remedies with respect to the shared collateral, the controlling lenders provide written notice thereof to the non-controlling agent as far in advance of such commencement as is reasonably practicable, (ii) requirements for enforcing creditor groups to consult in good faith with the non-enforcing creditor groups prior to and during such enforcement and (iii) a requirement that enforcing lenders act and otherwise cooperate in a commercially reasonable manner in any enforcement of rights or any exercise of remedies with respect to the shared collateral.

Furthermore, first-out structures are incorporating increasingly fulsome intercreditor provisions such as prohibitions on additional liens in favor of one or the other creditor group and a buyout right usually in favor of the term debt holders.

Pros and Cons for Borrowers and Lenders

From the borrower's perspective, the principal advantage of a first-out revolving facility may be additional liquidity. To the extent certain revolving lenders would not participate in the revolver facility but for the first-out feature, the size of the revolver is higher than would otherwise be available.

In addition, the borrower's operations will benefit from the enhanced liquidity and creditworthiness in general and credit ratings, in particular, may be positively impacted by the access to additional liquidity. Lastly, the inclusion of a first-out feature improves the credit profile of the revolving facility which has resulted in a single notch increase in the ratings of some recent first-out facilities. Ultimately, the stronger credit profile and higher ratings of any first-out revolver will lead to less expensive debt than would otherwise be available.

However on the "con" side of the ledger, a first-out facility may increase the number of constituencies with veto rights over modifications and other actions under the applicable credit documentation. Certain amendments and waivers, such as increases in the size of the first-out tranche, will usually require the consent of the non-first-out lenders rather than, for example, only those lenders affected by and holding the upsized debt facility (e.g., the first-out lenders). The blocking positions accruing to the holders of these special voting rights are certainly not insurmountable but can complicate the amendment or waiver process.

From the perspective of the first-out lenders, the benefits of such structures are self-evident. For non-first-out term debt holders, who are expecting to be at the most senior position in the capital structure, there are also self-evident reasons to dislike first-out facilities. For every first-out tranche that is included in a credit facility a “next-out” tranche is also included and, for that reason, resistance to the first-out feature can be expected from those lenders not holding any of the first-out facility.

Conclusion

In today’s loan market, first-out revolving credit facilities, like the first-out feature more generally, are not a widespread phenomenon. Rather, first-out revolving facilities serve as more of a niche product serving to accomplish certain objectives of prospective investors.

To date, certain contractual first-out provisions, such as those governing priority of payments, class voting rights and, to a lesser extent, enforcement rights, have exhibited a reasonable amount of consistency in debt agreements. However, such provisions continue to undergo scrutiny of market participants and it seems reasonable to expect these and other elements of first-out structures to continue to evolve.

The balancing of the rights and protections expected by the borrower and various creditor constituencies will continue to shape the contours of these provisions going forward. Potential challenges of first-out provisions in future bankruptcy proceedings, especially in respect of the more unsettled elements of first-out provisions, will also help further refine these provisions. It remains to be seen whether the first-out structure continues to appear at a similar rate as in recent years and in what form such first-out structures take in future financings.

Marc Hanrahan is a partner with Milbank in the firm's New York office and practice group leader of the firm’s leveraged finance group. Jerome McCluskey is an associate in the firm's New York office.

The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] Recent examples from the Euro market include the 2009 acquisition of Unitymedia by affiliates of Liberty Media, CVC Capital Partners’ 2010 acquisition of Sunrise Communications S.A. and 2009 refinancing in connection with Umbrellastream’s acquisition of Expro.

[2] Recent examples include first-out revolvers issued in 2010 by Borgata (Marina District Finance), Integra Telecom, Reader’s Digest and Reddy Ice and in 2011 by Bankrate, IASIS Healthcare and Radio One.

All Content © 2003-2012, Portfolio Media, Inc.