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RadioShack – Bankruptcy Court Implicitly Recognizes Enforceability of Agreement Among Lenders But Limits Coverage of First Out Contingent Indemnification Claims

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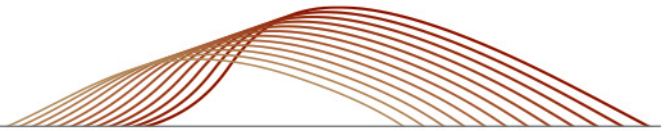
The unitranche financing market has expanded significantly in recent years. Generally, a unitranche deal involves two lenders (or groups of lenders) that provide financing on a "first out" and "last out" basis. In conjunction with the financing, the borrower grants one lien and enters into a single credit agreement and the lenders enter into an "Agreement Among Lenders" ("AAL"). An AAL is similar to an intercreditor agreement and provides for certain rights and remedies of the lenders. AALs typically include the first out and last out payment waterfall and govern certain of the lenders' voting powers, exercise of remedies, and bankruptcy rights.

To date, there are no reported decisions that provide clear guidance on whether, or the extent to which, a bankruptcy court would enforce an AAL in a borrower's chapter 11 case.[1] On the one hand, an AAL is arguably a subordination agreement, and the Bankruptcy Code recognizes such agreements to the same extent they are enforceable under nonbankruptcy law.[2] On the other hand, the borrower/debtor is usually not a party to the AAL. This gives rise to potential arguments that the AAL is not property of the debtor's estate and that the bankruptcy court cannot (or should not) enforce the AAL in the debtor's chapter 11 case. This argument may gain further support from the single lien structure of a unitranche financing.

In *In re RadioShack Corporation, et al.* (the "Bankruptcy Case"), the United States Bankruptcy Court for the District of Delaware considered the relative rights of first out and last out lenders under an AAL in the context of a sale of the debtors' assets. Specifically, the Bankruptcy Court addressed whether the right of the first out lenders to receive payment in full under the AAL prior to the last out lenders receiving any recovery through a credit bid of their last out debt includes payment of the first out lenders' contingent indemnification claims. The Bankruptcy Court stated that the first out lenders have rights "that must be respected under the documents and rights that must be respected under the [Bankruptcy] Code"[3] and that "the indemnification rights [are] part of the collateral package and part of the rights that the First Out [] lenders have and that I am obliged to treat and respect."[4] However, the Bankruptcy Court also made clear that the debtor's obligation to establish a cash reserve to pay the contingent indemnification claims would be limited to an amount significantly less than the

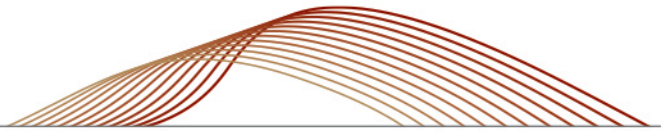


potential maximum amount of the claims. Otherwise, as determined by the Bankruptcy Court, the sale of RadioShack as a going concern, and 7,500 jobs, would be at risk. The Bankruptcy Court also took into account that the principal and interest of the first out lenders would be paid in full. Equitable and practical concerns, therefore, tempered the Bankruptcy Court's treatment of the first out lenders' contingent indemnification claims despite the Bankruptcy Court's implicit recognition of the validity of the AAL.

Background

In October 2014, affiliates of Standard General L.P. (collectively, "Standard General") acquired a $585 million ABL facility (the "Pre-Petition Facility") from RadioShack's lenders. Through a series of agreements, Standard General converted the Pre-Petition Facility into a $275 million term out revolving loan, a $50 million term loan, a $120 million letter of credit facility, and a $140 million revolving loan facility. Standard General retained the $120 million letter of credit facility and the $140 million revolving loan and assigned the $275 million term out revolving loan and $50 million term loan to a group of non-bank lenders. Standard General and these lenders then entered into an AAL that designated the $275 million term out revolving loan and the $50 million term loan as First Out Debt, the $120 million letter of credit facility as Second Out Debt, and the $140 million revolving loan facility as Last Out Debt. The AAL provided, among other things, that upon the occurrence of certain events (i) the lenders holding the First Out Debt ("First Out Lenders") would be entitled to payment priority ahead of certain claims of lenders holding the Second Out Debt ("Second Out Lenders") and the Last Out Debt ("Last Out Lenders") and (ii) the Second Out Lenders would be entitled to payment priority ahead of certain claims of the Last Out Lenders. For the sake of simplicity, this article refers to both the Second Out Debt and the Last Out Debt as "last out claims". Under the AAL, the First Out Lenders' claims included indemnity obligations, other than contingent indemnification obligations "to the extent no claim giving rise thereto has been asserted." The First Out Lenders and Standard General were sued regarding $129 million in payments they received prior to the chapter 11 case (the "SCP Adversary Proceeding"). Additionally, during the Bankruptcy Case the Official Committee of Unsecured Creditors (the "Committee") articulated potential claims against the First Out Lenders and Standard General. As a result, the First Out Lenders argued that claims have been asserted against them that give rise to an indemnity obligation of RadioShack in favor of the First Out Lenders.

Standard General proposed to acquire RadioShack by "credit bidding" its last out claims (inclusive of certain subordinated participations Standard General had acquired from the First Out Lenders under a Subordinated Participation Agreement) and repaying the principal and interest of the First Out Lenders in cash (the "Sale"). The First Out Lenders objected to the Sale contending that, pursuant to the AAL and Subordinated Participation Agreement, they were entitled to have their first out claims discharged in full in cash prior to Standard General receiving any recovery by credit bidding its last out debt. The issue before the Bankruptcy Court was the extent of those first out "claims." The First Out Lenders contended that the Sale must account for their indemnification claims against the debtors. Specifically, the First Out Lenders pointed to the pending and threatened litigation (*i.e.*, the SCP Adversary Proceeding and the Committee's alleged causes of action) against them as giving rise to first out, secured indemnification obligations that RadioShack had to pay from the proceeds of any sale before Standard General could obtain any satisfaction of its last out debt. Moreover, the First Out Lenders objected on the grounds that the Sale would provide for a full release of any claims against Standard General while the First Out Lenders' first out claims still would be exposed to attack, effectively violating the AAL by placing Standard General's claims ahead of those of the First Out Lenders.



The crux of the dispute revolved around the interpretation of the AAL. Section 3(a) of the AAL (the waterfall provision) provided that "payment of . . . any indemnification obligations owing to, the First Out Lenders" will come before any payments to the Second Out Lenders and Last Out Lenders. Moreover, Section 6(b)(vii) of the AAL stated that "the Lenders in any Junior Class do not waive any rights to credit bid in any sale or disposition in accordance with Section 363(k) of the Bankruptcy Code, *so long as any such credit bid provides for the immediate discharge in cash of Senior Claims*." (emphasis added). Under the AAL, Senior Claims is defined, in part, as "all Secured Claims [which, by definition, include indemnification obligations] due and owing to the First Out Lenders." The question before the Bankruptcy Court was whether the definition of Senior Claims encompassed indemnification claims for causes of action that have been asserted where no real costs or fees have yet been fixed or accrued and where such indemnification claims would continue to accrue as long as any litigation against the First Out Lenders endured.

At one point during oral argument the AAL was described as "an agreement that does not impact the debtors and [has] nothing to do with the debtors' estates."[5] At another point, the AAL was described as "a classic subordination agreement, enforceable in these bankruptcy proceedings under section 510(a) of the Bankruptcy Code."[6] In order to fully preserve their indemnification claims and allow the Sale to proceed, the First Out Lenders initially proposed that Standard General be obligated to pay the first $120 million of damages awarded to any plaintiffs, including the Committee, who are successful in their causes of action against the First Out Lenders with respect to the $585 million Pre-Petition Facility against the lenders.[7] Later in the hearing the First Out Lenders acknowledged that their indemnification claims could be adequately protected by a cash reserve, but that the amount of that reserve should be $120 million.

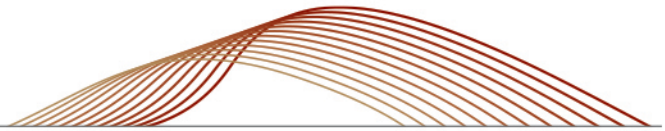
Standard General, in its response to the First Out Lenders' objection, contended that the language in the definition of Senior Claims limits the First Out Lenders' claims that had to be discharged in cash to those that are "due and owing." Standard General argued that any indemnification claims against RadioShack arising from the SCP Adversary Proceeding and the potential Committee litigation were not yet due and owing and were not required to be accounted for in the Sale. The First Out Lenders countered that where a claim has been asserted against them, such as the SCP Adversary Proceeding, the debtors' indemnification obligations already existed.

The Hearing

The hearing on the Sale spanned four days. With respect to the AAL issues, the Bankruptcy Court provided insight into the potential ruling if the parties did not come to an agreement. Specifically, the Bankruptcy Court stated that:

> As to the first out [] lenders and the agent -- but I see that as a tag-along issue -- to me, it boils down to a question of the treatment of a secured creditor. That secured creditor has rights that must be respected under the documents and rights that must be respected under the [Bankruptcy] Code. The economic treatment of that creditor, the first out [] lenders, as I understand it, is being treated by payment in full of all principal, interest and fees, the economic costs. But there is at least an argument, and I've seen the Standard General response regarding the -- what we've called the indemnification issue. At a minimum, I would regard the indemnification rights as part of the collateral package and part of the rights that the first out [] lenders have and that I am obliged to treat and respect them . . . .[8]

The above statement from the Bankruptcy Court appears to recognize the enforceability of the AAL in the bankruptcy, at least implicitly. But while the Bankruptcy Court appears to recognize the



enforceability of the AAL (which is the agreement that requires that indemnification obligations be paid to the First Out Lenders prior to the payment of obligations owing to the Second Out Lenders and Last Out Lenders), it was not going to let the indemnification claims impede the sale:

> I would [respect the contingent indemnity claims] by way of reserve. That reserve is not $120 million. It's not even anything close to it. To me, that reserve is responsive to what I, as an experienced legal professional, not necessarily as the judge but as a lawyer, would look to for a reasonable reserve.[9]

The parties settled on a reserve for expenses of $5 million and a reserve for indemnification claims of $7 million. The parties also retained any rights against each other under the AAL and other financing documents.

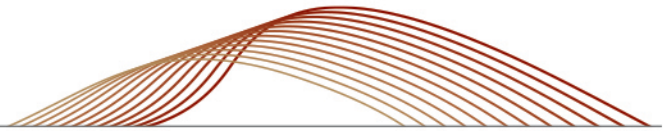
Conclusion

The Bankruptcy Court recognized the AAL and the First Out Lenders' rights to indemnification therein. While not binding precedent because the Bankruptcy Court did not rule on the issues, it is a positive signal for lenders who support the position that AALs should be enforceable in a chapter 11 case.

Notably, there were practical concerns in this case that influenced the Bankruptcy Court which may not be present in other instances. These included the need for the Sale to close in order to preserve RadioShack as a going concern and the jobs of its employees, and that Standard General's bid was the highest and best offer. The Bankruptcy Court also noted at the beginning of the Sale hearing that any creditors getting paid their outstanding principal and interest, including the First Out Lenders, were often not the most aggrieved parties in a chapter 11 case. It is not clear if a court would be influenced by such concerns, as opposed to the documents, if claims for principal and interest were at issue instead of only claims for indemnification, the amount of which were unknown and potentially limited. Moreover, because RadioShack was not a party to the AAL, the debtors did not take a position as to whether the AAL was enforceable. This leaves the question open as to how much of an impact a debtor's position with respect to an AAL would have on a bankruptcy court if such debtor was a party to the AAL in dispute.

The transcript and pleadings in this case are instructive regarding drafting measures that lenders and practitioners should consider carefully in the unitranche market. The AALs in the market today evolved from the AALs used in "club" deals, which were more akin to side letters that established the first out, last out nature of the claims and contained certain voting and exercise of remedies provisions. Bankruptcy provisions have made their way into AALs only over the past several years, and many bankruptcy terms in AALs are specifically negotiated and tailored rather than derived from "model" provisions in the market. As a result, many AALs are silent regarding issues such as indemnification claims.

Practitioners and lenders should carefully review AALs to determine how indemnification claims are addressed and should consider whether a particular AAL should be more (or perhaps less) explicit regarding the treatment of indemnification claims. For example, practitioners and lenders could include "payment in full" type definitions in AALs that are similar to those contained in two lien intercreditor agreements (many AALs do not include payment in full definitions that look like those in two lien intercreditor agreements). The "payment in full" definitions could provide that payment in full does not occur until cash collateral is provided to the relevant lenders in an amount that such lenders determine is reasonably necessary to secure such lenders in respect of asserted or threatened claims.



Alternatively, practitioners and first out lenders could be more explicit in the credit bidding provisions of the AAL to condition the ability of the last out lenders to credit bid their last out claims upon the first out claims being satisfied in full in conjunction with a sale (specifically including cash collateralization of contingent indemnification claims in an amount that the first out lenders determine is reasonably necessary to secure them in respect of asserted or threatened claims).

Of course, the explicit provisions described above would invariably be more beneficial to the first out lenders. Last out lenders should analyze the indemnification claim provisions in AALs with an eye towards determining whether the potential upside from the deal is worth the risk that the claims ahead of them may include uncapped contingent indemnification obligation exposure.

In addition to the treatment of indemnities and other "first out" claims, unitranche financings may create other disputes in bankruptcy, both among lenders and between lenders and other chapter 11 constituencies. The bankruptcy court in the RadioShack hearings did not address, for example, whether the claims of the lenders in a unitranche financing will be classified in a single class (because they share a single lien) or in separate classes (because they have different payment and other rights under the AAL) under a chapter 11 plan. Plan classification would impact many significant chapter 11 matters, including the lenders' recoveries, whether the first out or last-out lenders hold a "blocking position" within a single voting class (such that the class cannot accept the plan without their vote), and whether the first out and last out lenders could be classified separately and one group (or both groups) being at risk of a plan being confirmed over their objection via "cram down." Bankruptcy courts also will likely grapple with controversies over adequate protection, whether (or how much of) a claim collateralized by a single lien will be allowed as a secured claim, the lenders' entitlement to post-petition interest, and other issues raised by unitranche financings.

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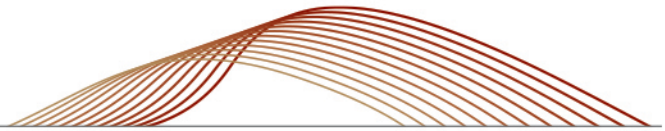

[1] The only reported case involving unitranche financing involved the enforceability of a "no-action" clause against a group of bondholders whose claims were fully covered by a monoline insurer. *In re American Roads*, *LLC*, 496 B.R. 727 (Bankr. S.D.N.Y. 2013).

[2] 11 U.S.C. § 510(a).

[3] Hr'g Tr. 19:15-17 (March 30, 2015, PM Session).

[4] Hr'g Tr. 19:23-20:1 (March 30, 2015, PM Session).

[5] Hr'g Tr. 64:8-9 (March 26, 2015, AM Session).

[6] Objection of First Out Lenders at Pg 4, Para 6. (ECF. Dckt. # 1549).

[7] Hr'g Tr. 68:23-25 (March 26, 2015, AM Session).

[8] Hr'g Tr. 19:12-20:1 (March 30, 2015, PM Session).

[9] Hr'g Tr. 20:1-6 (March 30, 2015, PM Session).