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Unitranche Debt Structures: Practical Insights for Borrowers and Lenders

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Unitranche financing structures, also known as first out/last out or "FOLO," are not new to the lending market but have become increasingly common in recent years, particularly in private equity sponsor-backed middle-market transactions. In recent years, unitranche deal volume in the U.S. has experienced significant growth, with industry estimates indicating that middle-market issuances reached a record $210 billion in 2024, up from $94 billion in 2023. The adaptability and efficiency of the unitranche structure make it a valuable tool for borrowers, traditional bank lenders, and private credit and direct lenders.

Basic Unitranche Financing Structure

Unitranche financings differ from a traditional first-lien/second-lien structure in that they combine the debt that would otherwise be provided by separate groups of senior and subordinated lenders – each group having its own loan documents and security interests – into a single credit facility secured by a single all-assets lien on the borrower and any guarantors. By merging both tiers of debt into one credit agreement, borrowers face only one set of loan restrictions and interact with one group of creditors.

This streamlined approach typically features a single borrower-facing interest rate – higher than a traditional senior loan but lower than what would be expected for a separate second-lien or subordinated facility – reflecting a blended yield required by both the lenders that would otherwise be senior lenders (usually, but not always, bank lenders) and those that would otherwise be subordinated lenders (usually, but not always, mezzanine or other private credit funds). Similarly, the borrower benefits from a single set of fees and consolidated amortization and interest payments.

The relationship between the lender groups is governed by an agreement among lenders (AAL), which divides the facility into "first out" and "last out" tranches of debt. The AAL sets forth economic terms, voting rights, and other inter-lender rights and responsibilities in a way that mirrors the protections and risk allocations found in a traditional senior/junior intercreditor agreement. Borrowers typically acknowledge the AAL but are not intended beneficiaries and have no enforcement rights. If there is sensitivity regarding disclosure to the borrowers of inter-lender economic arrangements or other matters, certain terms may be moved to a separate confidential agreement to which the borrower will not have visibility.

Strategic Advantages for Borrowers and Lenders

For borrowers, unitranche financing offers multiple benefits that go beyond simple debt consolidation. By reducing the number of loan facilities and counterparties in negotiation, unitranche facilities reduce closing and administrative costs, shorten closing timelines, and streamline procedures for ongoing fundings (for deals that include delayed-draw or similar facilities). Borrowers also benefit from a single set of covenants and reporting requirements, simplifying post-closing compliance and avoiding the potential for conflicting obligations under separate documents.

Lenders see similar benefits from the simplified legal documentation and faster deal execution and closings that unitranche structures offer. This is particularly true once a lead first out lender and lead last out lender have previously negotiated AALs together, allowing them to use established precedents for subsequent transactions. It is important to note that AALs are inherently complex and subject to extensive negotiation. In practice, the initial unitranche transaction between a new set of lenders is not appreciably less costly or more efficient than a traditional structure.

The negotiated points are often driven by institutional preferences. For example, certain lenders may require that they always serve as collateral agent when involved in a unitranche or may only enter into AALs that provide for voting rights to be equally allocated between the first out and last out groups. By contrast, other lenders may require their AALs to disproportionately assign voting power to the first out or last out group unless certain conditions are met.

A common variation provides for voting on most matters to be controlled by the last out group unless a leverage ratio of first out debt to EBITDA (earnings before interest, taxes, depreciation, and amortization) is exceeded – on the theory that the first out group is sufficiently collateralized and more assured of recovery, while the last out group holds higher risk and thus needs greater ability to manage the credit. In any event, many of these institutional preferences are not deal-specific and, once a precedent has been established, it can often be applied in large part to any future unitranche transaction involving those same lender parties with increasing efficiency. For this reason, it is common (even more than in the traditional market) for first out lenders, last out lenders, and private equity sponsors to seek repeat transactions with prior partners and agreed precedent.

Key Terms of the Agreement Among Lenders

The AAL is the foundational document in unitranche structures, governing the relationship between the "first out" and "last out" lender tranches, independent of the borrower. It outlines the allocation of payments, voting rights, enforcement actions, and other inter-lender dynamics. The provisions outlined below are commonly negotiated by lenders to achieve their desired return and manage exposure.

- *Economic Terms:* Allocates how the stated rate of interest will be shared among the first out and last out groups of lenders, with the first out group typically receiving a discount to the face rate and the last out group receiving a premium over it. The AAL may also specify how mandatory and optional prepayments are shared, with it not being unusual for first out lenders to receive most or all of these amounts.

- *Payment Waterfall*: Specifies how principal and interest payments are distributed between the lenders after the occurrence of certain triggering events, with first out lenders receiving priority on repayments before last out lenders.

- *Voting Rights and Control*: Defines voting control over amendments, waivers, and enforcement decisions, and serves as an override to the voting provisions in the underlying loan documents. In many deals, amendments to the loan documents will require a majority of the first out plus a majority of the last out lenders. In others, last out lenders may have control over day-to-day decisions unless a certain level of first out leverage is reached. This can be an area of significant negotiation, with a wide range of voting structures across deals in the market.

- *Loss Sharing and Remedies*: Addresses how losses are shared in distressed situations and sets rules for enforcement actions, including standstill periods and coordination requirements. This too can be highly negotiated, especially with respect to who can initiate an exercise of remedies and in what circumstances.

- *Buyout Rights*: Provides an option for the last out lenders to purchase the first out position on the occurrence of certain events (comparable to the purchase option commonly seen in intercreditor agreements). This allows the last out group to protect its position in a situation where it expects the first out group to take foreclosure action that might generate proceeds insufficient to cover the last out portion of the debt, or to break a stalemate on important amendments or waivers that are not supported by the first out group.

- *Bankruptcy and Insolvency Matters:* Establishes procedures for the direction and control of dispositions of collateral (including consent to a sale requiring release of liens), approvals of DIP financings, uses of cash collateral, seeking and acceptance of adequate protection or replacement liens, and approvals of any plans of reorganization.

Bankruptcy Risk Considerations

Even with a carefully negotiated and defined AAL, a critical concern for both lender groups (and a common question from clients) is whether the AAL will be enforceable in a bankruptcy proceeding. Traditionally, the borrower was not a party to the AAL, as the agreement is designed to govern the relationship among the lenders themselves. This raises the question of whether a bankruptcy court will recognize and enforce the terms of the AAL. Further, there is the question of whether the first out and last out tranches will be treated as truly separate claims for bankruptcy purposes, given that they share one lien.

A full exploration of these issues is beyond the scope of this article, but the general consensus among practitioners and market participants is that AALs are most likely enforceable as subordination agreements. To help mitigate these risks, though, borrowers are increasingly being required to acknowledge – or even become parties to – the AAL, at least with respect to certain provisions. Lenders may also seek to include language in the credit agreement itself that references and incorporates key terms of the AAL, further integrating the inter-lender arrangements into the financing structure.

Future of Unitranche Structures

The unitranche structure continues to be a strong financing product, with increasing use among banks and private credit funds, especially in the middle- and lower-middle market. We expect that these structures will continue to play a central role in the coming years, with documentation adapting to balance borrower desire for streamlined and efficient structures and the yield and risk tolerances of a widening range of lender types.

If you have questions or need additional information, contact the authors Peter E. Bosman, Tricia A. McNeill, and Zachary S. Ishee.