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Market Flex Provisions

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Market Flex

The market flex provisions of a fee letter permit the arranger to modify the financing contemplated by the commitment letter in various ways to have a successful syndication, including potentially permitting the arranger to re-structure the debt (for example, replacing a portion of a senior secured term loan with a second lien or mezzanine loan), increasing pricing, or resizing the commitments (without reducing the aggregate amount). The market flex provisions are often heavily negotiated and will be influenced by factors such as the borrower's industry, the nature of the underlying transaction and the strength of the syndicated loan market.

For example, arrangers may require flexibility to increase pricing of the facilities. While this is a common flex right, borrowers may want to limit the ability to increase pricing if certain ratings thresholds are achieved, such that if a borrower receives certain minimum credit ratings, the arrangers cannot increase pricing at all or only increase pricing by a portion of the amount by which the arrangers could have increased pricing if those credit ratings were not received. Another wrinkle in the pricing flex discussions may involve the right to utilize "unused" pricing flex, which may come up in first lien-second lien financings (or other financing structures that contain multiple tranches of debt). Arrangers may press for, and borrowers often resist, the ability to increase either the first lien or second lien tranche pricing by the amount of any "unused" pricing flex from the other tranche, so long as the weighted average interest rate for both tranches after giving effect to such increase does not exceed the weighted average interest rate that would have been in effect had the full amount of pricing flex been exercised for each tranche.

Arrangers are usually permitted to exercise their market flex rights if they determine it is necessary or advisable to facilitate a successful syndication or that a successful syndication cannot be achieved. If there are multiple commitment parties, such determination is usually made by commitment parties holding a majority of the aggregate commitments.

As a practice tip, often the parties will define what constitutes a "successful syndication" in the fee letter and will also set an outside date on when market flex rights can be exercised (usually no later than 60 to 90 days after the closing date). A common definition of "successful syndication" is when the commitment parties hold loans and commitments less than a designated amount (for example, not more than \$xx under the Revolving Credit Facility and not more than \$xx under the Term Facility).

Market flex provisions can be either "open" or "closed." "Open" flex permits the arrangers to make changes generally, subject to a few enumerated limitations. For example, the arrangers may be permitted to change the structure, pricing and terms, to the extent that the weighted average interest rate does not exceed a certain threshold amount. "Closed" flex permits the arrangers to only make specific changes that are outlined in the market flex provisions.

Common market flex items are:

Increased Pricing and OID: ability to increase the interest yield (usually subject to a cap), including the ability to increase original issue discount or fees paid to the market. Pricing flex may be tied to the receipt of certain credit ratings on the borrower or the credit facilities.

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Original issue discount arises when a loan is issued at less than par which increases the overall return to the lender making such loan. In certain circumstances, original issue discount may be preferred to simply increasing the underlying interest rate, however, original issue discount reduces the cash proceeds received by a borrower and may not be feasible for certain transactions. Parties will often negotiate a maximum cap of original issue discount that may be taken and borrowers will negotiate the ability to borrow under revolving credit facilities on the closing date to finance any cash shortfall arising from the implementation of original issue discount.

Prepayment Premiums: credit facilities, particularly second lien facilities, may have prepayment premiums for the first few years (for example, 2% on principal amounts prepaid in year one and 1% in year two). Arrangers may require a flex right to push these premiums out, such that the premium in year two is 2% and year three is 1%, with year one being increased to 3% or even a "no-call" period (i.e., where a borrower is only permitted to voluntarily prepay the loans by paying a make-whole premium for the remaining life of the loans, which can be prohibitively expensive).

Incremental Facilities: modifications to or removal of incremental debt facilities.

Structure Flex: changes to the structure of the credit facility; however, to the extent changes to structure are permitted, borrowers will often require that any structure flex will not reduce the aggregate principal amount of debt being provided by the commitment parties. It is common in first lien–second lien financings for arrangers to require the right to re-allocate a portion of the first lien term loans into the second lien, which is often subject to an aggregate cap or a weighted average interest rate cap. In certain transactions, arrangers may require the right to reduce the size of the revolving credit facility or to move secured debt into an unsecured tranche.

In other circumstances, arrangers may agree to more aggressive borrower-friendly terms in the commitment letter and term sheet, with the ability to scale back or remove such terms through the market flex provisions in the fee letter to the extent necessary to syndicate the credit facilities. In this case, especially in the case of "closed" market flex, arrangers and their counsel must carefully craft the market flex provisions to ensure any such provisions can be addressed in the case of a negative response from prospective Lenders during syndication. Of course, the exercise of market flex rights during a post-closing syndication period will require an amendment to the credit agreement, thus, the borrower typically agrees in the fee letter to cooperate in preparation of any amendment necessary to implement market flex changes. Accordingly, one reason why the fee letter survives the closing of the transaction is to ensure that the market flex and cooperation provisions remain applicable throughout any post-closing syndication period.

Market flex provisions are less common in financings that are not, or are not intended to be, broadly syndicated. Institutions providing "club" financings can point to the lack of market flex provisions as one of the benefits to such financings and that the terms agreed to in the term sheet will not be "flexed" to the detriment of the borrower.

Reverse Flex

When pre-closing marketing of a financing is successful such that the financing is "oversubscribed," arrangers may revise the terms of such financing in ways that are more favorable to the borrower. Such a "reverse flex" may be due to excellent market conditions, a borrower with a strong credit profile, or other reasons. Common reverse flex terms include a reduction in pricing, looser covenants (or elimination of certain restrictive or financial maintenance covenants), or additional flexibility for the borrower to incur debt. Borrowers are usually informed by the arranger about the syndication process, and will often push for more aggressive, borrower-friendly terms if the financing is oversubscribed. Reverse flex terms are not documented and are informally discussed between the borrower and arrangers over the course of the syndication process. Under these circumstances, arrangers are often more amenable to the borrower's requests so long as the modifications do not adversely impact the syndication of the financing.

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