Proskauer

Private Credit Deep Dives – MFN (United States)

July 24, 2023

In recent months – as credit spreads have continued to widen – sponsors, borrowers and lenders alike have frequently found themselves combing through their loan documents to check the scope of the pricing "MFN" provisions applicable to their debt facilities. "MFN" stands for "most favored nation," and the term originates from the world of international trade agreements, referring to the principle that trade terms that are offered to certain nations are then required to be offered to others. In the context of lending, the MFN is a form of pricing protection for debt. This deep dive with Bharat Moudgil (Partner) and Kathryn Potter (Associate), lawyers in Proskauer's Private Credit Group, will explain what the MFN is, what it seeks to achieve, how sponsors have sought to limit its application and how it is viewed and negotiated in the current US market.

Click here to read how the MFN is viewed and negotiated in the current European Market, as explained by Daniel Hendon (Partner) and Phil Anscombe (Associate).

When a lender advances a loan as part of a financing, it will seek for the credit agreement to contain a provision stating that if the borrower incurs more indebtedness in the future (subject to certain limited exceptions) and that indebtedness is priced at a higher level than the original loan (other than an agreed-upon cushion), then the pricing of the original loan must be increased to match (or at least increased so that the cushion is not exceeded). So, if, for example (and all other things being equal), the original loan had a margin of 7.00% and the agreed cushion was 0.50%, but a subsequent loan was advanced for 9.00% margin, the original loan would be repriced to an 8.50% margin to ensure the buffer would not be exceeded. By these means, a lender can protect against pricing risk in the broader market, and if its borrower elects to incur further debt, the lender could increase the pricing across all the facilities it offers that borrower to reflect the new market dynamics. It additionally offers some "anti-embarrassment" protection for a lender, in the event that incremental debt is incurred which prices above the original loan. Given the prevalence of private equity "buy-and-build" strategies (which necessitate regular increases in committed debt to fund a busy M&A pipeline), these provisions are material business points for borrowers and lenders alike.

As you might expect, given the increasing power of sponsors in the leveraged finance market over the last decade, such sponsors have sought to limit the application of the MFN. The extent of the exceptions or carve-outs in the US will vary depending on the size of the deal, the status of the sponsor and the relative strength or weakness of the credit. However, such exceptions generally fall into one of the following categories:

1. **Pricing Cushion** – The US market allows incremental debt to price up to 0.50% higher than existing term loans, and in certain sponsor-favorable deals, this differential can be as high as 0.75% (versus in Europe, where the market is relatively settled in allowing incremental debt to price up to 1.00% over the existing debt before any MFN protection kicks in). This is one of the few areas where the US market is less generous to borrowers than in Europe, with US pricing offering less bandwidth to borrowers and sponsors.
2. **Sunset Provisions** – Not typically agreed to in true "middle market" deals, a "sunset" provision allows the MFN protection to fall away after a certain period of time after the original closing (so that the borrower/sponsor is not at risk for market shifts in the pricing of debt for the full life of the loan). Proskauer data shows that only 3% of US direct lending deals in 2022 had a sunset provision (all in deals with EBITDA of greater than $50M), which is in sharp contrast to the European market, where 60% of direct lending deals in 2022 contained a sunset.

The sunset provisions in Europe typically range from 6 months for the most sponsor-friendly deals to 24 months for the more lender-friendly deals.

3. **Pricing Calculation** – When calculating whether the MFN is triggered (and what its effect should be), it is necessary to determine what "pricing" means. In both the US and European markets, sponsors will look to measure this simply by reference to the margin on the loans, which would not factor in other forms of economic return that lenders can lock in (e.g., reference rate floors (for SOFR, SONIA, EURIBOR, etc.), OID or other up-front fees). However, lenders generally push for a calculation methodology which looks at "all-in yield," for which purposes OID/up-front fees are generally amortized on a 3-year basis in European markets, and a 4-year basis in the US. Care should be taken by private credit funds to ensure all up-front fees they charge are covered (given sometimes these will be expressed as "arrangement" or "underwriting" fees or similar, rather than as OID, which would be the relevant metric for a syndicated facility). In such instances, upfront fees are often included in the yield calculation solely to the extent they are "generally payable" to all lenders (as opposed to a fee for arranging capital ultimately provided by other institutions).

4. **Applicable Rate** – While the amount of OID or up-front fees is generally straightforward to determine, it sometimes requires clarification as to exactly which margin level will be used to test whether the MFN applies (particularly where there are different margin levels that may apply depending on the group's leverage profile at any point in time). On aggressive deals, sponsors may suggest that when looking at the existing debt, the benchmark rate should be the highest margin that has applied since closing (or, on syndicated deals, the underwritten margin before the impact of any reverse flex). Lenders instead argue that you should compare "like with like" and that the comparison should be between opening margin for the incremental debt and the actual applicable margin for the existing debt (pro forma for the impact of the incremental debt on leverage and therefore on the applicable margin ratchet level, which would be measured at the time of incurrence and locked in). Absent express language to the contrary, the opening margin for the incremental debt is usually compared to the applicable margin for the existing debt at the time the incremental is incurred, rather than being re-measured as the existing debt's pricing fluctuates depending on the company's leverage profile. Top-tier sponsors also sometimes push for the MFN to work by ascribing a weighted average to the pricing levels for all incremental facilities, and test that average against the original facility (thereby smoothing out the impact if there is a sudden shift in the market, when previous incremental facilities have already been established that were priced closer to the original deal). For obvious reasons, lenders prefer a more sensitive and immediate trigger if the pricing of risk moves suddenly.

5. **Type of Indebtedness** – Sponsors that frequently operate in the large-cap space commonly use precedent documents that limit the application of the MFN to the incurrence of broadly syndicated, floating rate term loans – the idea being that it must be a similar debt product that is being incurred in order for the pricing comparison to be meaningful (versus, for example, fixed rate bonds). The extent to which this construct is relevant will depend on whether sidecar debt is permitted (i.e., whether the material debt permissions facilitate debt to be incurred under a different document than the existing loans, e.g., via a bond or separate loan document), as more conservative credit agreements will restrict material debt incurrence to incremental facilities under the same loan agreement and would often be limited to floating rate term loans anyway. Where there is more flexibility, any such exclusions would be subject to negotiation, but limiting the scope of the MFN to "broadly syndicated" debt is increasingly hard to justify on any deal, given the prevalence of private credit as a debt solution in the market. Care should also be taken around limiting this to term loans, given it is increasingly common for documents to permit incremental revolvers, which (absent any clean-down and/or any restrictions on usage) can, to all intents and purposes, function as term facilities notwithstanding being structured and designated as revolving. Another point of focus should be whether the MFN only applies to term loans as described above, or would also be triggered upon the purchase of notes, a point that lenders often push for in the middle market with varying levels of success.

6. **Ranking** – Traditional loan documents only allow the material debt baskets to be used to incur incremental pari passu senior secured debt, and, as such, this qualification would not be relevant on such deals. However, more aggressive sponsors frequently retain the ability to incur junior secured/unsecured incrementals or, in European deals and subject to a sub-cap, super senior incrementals. On such deals, they generally seek to limit the application of the MFN to senior secured debt. It would be difficult to argue that junior/unsecured incremental incurrence should trigger MFN protection for prior ranking debt (since such junior/unsecured debt would always have been more expensive). Equally, it is unlikely that super senior debt in a European transaction would be priced wider than senior debt, and, for that reason, some European lenders are relaxed about accepting this carve-out. Care should be taken here where the covenants around debt incurrence more broadly are relatively loose – if there is significant scope for the incurrence of debt secured against non-collateral assets (which would therefore not be "senior secured" under the definitions in the documents, despite effectively ranking ahead of the senior secured lenders with respect to those non-collateral assets), it should be noted that such debt would fall outside the scope of the MFN.

7. **Purpose** – Top-tier sponsors may take the position that MFN protection does not apply where the debt is incurred for the purposes of funding M&A. This is a material exception, given M&A is the most common reason that incremental debt is required in the first place. The rationale that sponsors would cite is that they should not be delayed/prevented from pursuing accretive M&A opportunities due to the potential fallout of repricing their existing facilities and raising their overall cost of capital. However, lenders in the middle market will largely push back on such a carve-out.

8. **Baskets** – Traditional loan documents only permit incremental facilities to be incurred to the extent a certain pro forma leverage level is complied with (i.e., it is incurred under the ratio-based prong of the incremental basket). It is generally accepted on all deals that the capped baskets relating to ordinary course permissions (e.g., general basket and sometimes local working capital lines) fall outside of the ambit of the MFN. In the US, it is commonplace for more sponsor-friendly deals to contain a "freebie" basket (i.e., a cash capped basket for incurrence within the credit agreement without needing to comply with the applicable leverage ratio test). On such deals, sponsors commonly propose that any incurrence under this freebie basket would also fall outside the MFN. The likelihood of lenders accepting this may hinge on the size of that freebie basket, and it also interplays with the point below on the de minimis quantum. On deals using large cap style precedent documentation, care should be taken to ensure that if there is a basket for acquisition/acquired debt that also operates by reference to a leverage ratio, that this is also caught by the MFN alongside the regular ratio basket.

9. **De Minimis Quantum** – Aggressive sponsors may seek to include a de minimis threshold amount (with sizing commonly ranging from 0.5x-1.0x of consolidated group EBITDA), such that any incremental debt incurrence below that level does not trigger the MFN. Care should be taken to note that, if a freebie basket is also included on the deal and an MFN exception is given for freebie debt incurrence (as per above), then, effectively, you may be offering a "double de minimis," with freebies themselves (where applicable and accepted) generally ranging from 0.5x-1.0x of consolidated group EBITDA.

10. **Currency** – Again, mainly a feature of large cap/top-tier sponsor documentation, some sponsors seek to ensure that the MFN only applies on a "per currency" basis, i.e., the incurrence of higher-priced USD debt would only trigger MFN protection for existing USD-denominated facilities. The rationale for this would be that in the syndicated markets, different currencies price at different levels (in part due to technical features of those markets, including the depth of the underlying investor base and liquidity in the relevant secondary markets), and

therefore, the only fair comparison would be between facilities in the same currency. Lenders would argue that although the different markets are not fully aligned in terms of pricing movements, there is at least a strong correlation, and a broad market repricing would affect all currencies substantially equally, meaning all existing currencies should be similarly protected. Private credit funds may also take the view that they lend out of one pot of capital (irrespective of the currency that is ultimately funded) and that, for any particular credit, the return should be broadly symmetrical across any currencies in which they have funded.

11. **Sidecar** – As mentioned above, it is increasingly common for loan documents to allow for debt to be incurred under the material debt baskets (e.g., ratio basket and/or freebie amounts) outside of the original credit agreement, i.e., under a different agreement or instrument. The primary reason for a more conservative approach barring such sidecars is to ensure that incremental debt is provided on the basis of the same package of covenants and restrictions and to ensure that all lenders will vote together on any waivers, amendments or consents going forward. In larger deals, where documentation has increasingly converged with that more typically seen in the world of high-yield bonds, it is typical to allow any permitted debt to be incurred on a "sidecar" basis, i.e., under any document or instrument. Where this is the case, sponsors commonly push for the MFN to apply only to "Additional Facilities" (being incremental loan facilities under the same credit agreement), but not to sidecar facilities or instruments. This seems difficult to justify, if the same debt incurrence capacity is available by either method (and particularly given some of the other exceptions and carve-outs that are simultaneously being pushed, as set out above). However, it is something that is often missed at grid or term sheet stage, on the basis that participants may mistakenly take "Additional Facilities" to generically refer to all incremental debt, and sometimes makes its way into long-form documentation accordingly. While less common in the European market, sidecar facilities are increasingly typical in US deals, though lenders often push to subject such material debt to the same restrictions as the traditional incremental facility in their loan document in an effort to prevent one form of material debt from being more attractive than the other. This includes the MFN, which would apply to pari passu senior secured debt incurred under these additional material baskets, e.g., ratio debt, acquisition debt, etc.

12. **Tenor** – Large sponsors may seek to limit the MFN application to the incurrence of incremental debt of a certain tenor (e.g., indebtedness that matures after the termination date for the existing debt, but no more than 12 months thereafter). The logic behind this is that (all else being equal) longer-dated debt usually attracts higher pricing. In practice, on the majority of sponsor-backed deals, if incremental debt is incurred on a senior secured basis, it is unlikely to have a

maturity date outside the existing debt (as the incremental providers would not be willing to accept potentially being temporally subordinated at maturity), and therefore, the concept is probably irrelevant. However, it may become relevant if it is a very large business with a variety of different debt instruments in its capital structure maturing at different times. Care should be taken with regards to accepting that any debt that matures inside the existing debt is outside the ambit of the MFN – on aggressive deals, there may be specific "inside maturity" baskets that permit an amount of debt to mature early, which effectively would add another de minimis that falls outside the MFN in addition to those set out above.

In summary, lenders continue to consider MFN protection to be a sacred right that should always be included in US loan agreements, and will usually negotiate against sunsets or material carve-outs. However, the increasing effort on the part of sponsors and borrowers to limit the application of MFN in recent years has eroded the scope of protection provided by MFN terms. Private credit funds, in particular, have had to navigate the development of the direct lending product, to the extent that it now competes on larger deals with the syndicated market and has therefore been forced to confront and appraise the top-tier sponsor terms commonly put forward in that space. With the arrival of a white-hot credit market in the aftermath of COVID-19, this trend accelerated, and it is only now (with a slight dislocation in credit markets) that lenders are refocusing on this traditional term and re-evaluating its importance on new primary financings. For any related questions on this topic, please reach out to your contact within Proskauer's Private Credit Group.

About Proskauer

The Firm's Private Credit Group is made up of cross-disciplinary finance and restructuring experts exclusively dedicated to private credit investors. It includes over 90 finance and restructuring lawyers focused on representing credit funds, business development companies and other direct lending funds in connection with "clubbed" and syndicated credits, preferred equity, special situations and alternative investments. Over the past five years, Proskauer has been involved in more than 1,000 deals for over 75 private credit clients across the U.S. and Europe with an aggregate transaction value exceeding $260 billion.

Related Professionals

- **Bharat K. Moudgil**
  Partner
- **Kathryn Potter**
  Associate