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The International Comparative Legal Guide to:

Lending & Secured Finance 2019

7th Edition

A practical cross-border insight into lending and secured finance

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EDITORIAL

Welcome to the seventh edition of *The International Comparative Legal Guide to: Lending & Secured Finance*.

This guide provides corporate counsel and international practitioners with a comprehensive worldwide legal analysis of the laws and regulations of lending and secured finance.

It is divided into three main sections:

Three editorial chapters. These are overview chapters and have been contributed by the LSTA, the LMA and the APLMA.

Twenty-five general chapters. These chapters are designed to provide readers with an overview of key issues affecting lending and secured finance, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in lending and secured finance laws and regulations in 51 jurisdictions.

All chapters are written by leading lending and secured finance lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor Thomas Mellor of Morgan, Lewis & Bockius LLP for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.com.

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Analysis and Update on the Continuing Evolution of Terms in Private Credit Transactions

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Proskauer Rose LLP

Michelle Lee Iodice

For the past eight years, The Private Credit Group at Proskauer Rose LLP has tracked deal data for private credit transactions (our "data"). The data referred to in this article reflects trends and evolving terms in over 188 private credit transactions closed by The Private Credit Group at Proskauer Rose LLP in 2018 and may not be indicative of overall market trends. In prior years, our data reflected that, as the market became more competitive, the middle market experienced an influx of financing terms that were once only found in large cap financings. While middle market transactions had not fully incorporated the complete slate of large cap financing terms, the increasing competition for deal origination resulted in the selective inclusion of certain large cap financing terms, albeit with a middle market orientation. In 2018, large cap financing terms remained strongly planted in the middle market but were generally less prevalent as compared to what the data demonstrated in prior years. Although the middle market experienced a slowdown in the migration of such terms, middle market lenders have a limited ability to unwind provisions that have been adopted. As such, we expect the influx of large cap financing terms to continue. Given that large cap terms assume a profitable and durable business model, middle market lenders react to the introduction of large cap terms with additional conditionality and risk mitigants as deal sizes get smaller and the borrower's business model is less able to withstand adverse economic results. Middle market lenders' appetite for certain of these large cap financing terms differ not only based on institutional biases, but also based on the size of the borrower's consolidated EBITDA. As a result, the evolution of these large cap financing terms can be traced, in certain respects, to the size of the borrower's consolidated EBITDA. This results in a further division of the middle market into the "lower middle market", "traditional middle market" and the "upper middle market". This article will analyse the continuing evolution of certain key financing terms in the private credit middle market as well as discuss the related market drivers and trends influencing such terms. The analysis will provide a description of the terms, proprietary data pertaining to the usage of such terms within the traditional middle market across various industries, and future changes to such terms in light of the continuing evolution of the private credit identity and market variables.

Overview of Proskauer Rose LLP Private Credit Transactions in 2018

The top five industries represented in middle market transactions, as shown in our data, include (a) business services, (b) consumer, (c) healthcare, (d) manufacturing, and (e) software and technology. These primary industries comprise 74% of our deals in 2018. Notably, manufacturing deals have increased to represent 17% of all our deals in 2018 while health care deals showed the biggest decline from 27% in 2017 to 15% in 2018. First lien and second lien transactions increased for the year; whereas mezzanine loan transactions continue to decline in popularity falling to 5% of all deals in 2018 compared to 8% in 2017. Interest rate margins (the percentage points added to a benchmark rate for purposes of calculating a floating or variable rate) across all deal types in our data have trended lower since 2015. In 2015, only 16.7% of deals had margins less than 7.0%. The percentage of deals having margins less than 7.0% increased to 31.8% in 2016, 38.2% in 2017, and 51.4% in 2018. However, the impact to lenders of decreasing interest rate margins is partially offset by a steady increase in the LIBOR benchmark in recent times. With respect to commitment fees and OID, in 2018, 54% of commitment fees and OID were between 2.0%–2.49% of the principal amount of the loans and commitments at closing, which is generally consistent with the levels for 2017.

Closing leverage for middle market transactions in our data remains stable with only a slight increase from 5.00× in 2017 to 5.20× in 2018, with 78% of deals having a closing leverage between 4.00× and 6.99× (consistent with 80% of deals in 2017). In comparison to 2017, covenant lite deals in our data remained consistent in 2018 at 14% of our deals with EBITDA greater than $50MM; however, we have seen an increase in our data of transactions where the financial covenant cushions are equal to or greater than 40%. Although financial covenants generally include total leverage ratio tests, 33% of our deals also included a fixed charge coverage ratio test which is down 8% from 2017. Of the transactions with financial covenants, 67% of them had five or more covenant step-downs and of these transactions, 84% of them had EBITDA of less than $50MM. In transactions with EBITDA greater than $50MM, only 28% of them had a cap on general non-recurring expenses as an add-back to EBITDA; whereas in transactions with EBITDA that is less than $50MM, 70% of them had a cap on general non-recurring expenses. It is worth noting that the loosening of parameters relating to the calculation of consolidated EBITDA in the traditional and upper middle market, including the increased prevalence of addbacks for run-rate cost savings and synergies, and larger caps (or the absence of caps) on addbacks generally, may be directly affecting closing leverage multiples and resulting in more forgiving financial covenants. Additionally, in connection with the general trend towards borrowers' counsel controlling the drafting process at both the commitment stage and the definitive deal documentation stage, an increasing percentage of our traditional middle market deals in 2018 were initially drafted by borrowers' counsel. In certain circumstances, the borrower also selects the precedent credit agreement to be used in a particular transaction (which may not have been a transaction in which the lender participated, or which may reflect a more upper market orientation than the current deal). Due to time sensitivity in certain

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transactions during the commitment stage, the lenders may find themselves agreeing to precedent credit agreements which could result in the lender accommodating terms that are more typically found in larger transactions.

Debt Incurrence

The flexibility given to borrowers to incur additional debt either within or outside the applicable loan facility continues to be one of the most transformative structural changes to make its appearance in the middle market.

Incremental Facilities and Incremental Equivalent Facilities

Leading the way in providing greater flexibility to borrowers is the evolution of incremental and incremental equivalent loan facilities. An incremental facility (also commonly referred to as an "accordion") allows the borrower to incur additional term loans or revolving loan commitments under the existing credit agreement within certain limitations and subject to certain conditions, without the consent of the existing lenders. Incremental equivalent debt has the same features of an incremental facility except that the debt is incurred outside the existing credit documentation, either pursuant to a separate credit facility or through the issuance of notes outside of the credit agreement (either issued in a public offering, Rule 144A or other private placement).

The migration of these additional debt facilities into the middle market can be summarised as follows: (a) the upper middle market will generally accommodate both incremental facilities and incremental equivalent facilities; (b) the traditional middle market is increasingly accommodating both incremental facilities and incremental equivalent facilities (subject, however, to stricter conditions, as discussed below) but remains stratified with respect to incremental equivalent facilities in approach depending on the consolidated EBITDA of the borrower and the leverage of the borrower and its subsidiaries; and (c) lower middle market deals generally do not provide for incremental or incremental equivalent facilities. Our data shows that 71% of traditional middle market deals include incremental facilities with 39% including both incremental facilities and incremental equivalent facilities, compared to 86% and 53%, respectively, from 2017.

Incremental Amount

- In large cap transactions, and increasingly in the upper middle market, the existing credit facility may limit the incremental facility to both a fixed amount (known as a "starter basket" or "free and clear basket") and an unlimited amount subject to compliance with one or more leverage ratios. The fixed amount will generally be no greater than 1.0× of consolidated EBITDA and will often have a "grower" component (see discussion on grower baskets below). Our data shows that 15.8% of traditional middle markets deals with incremental facilities contain a starter basket for the incremental facility equal to or greater than 1.0× of consolidated EBITDA, compared to 37.5% from 2017. The unlimited amount will generally be subject to compliance with a leverage ratio. Depending on whether the original transaction is structured as a first lien/second lien credit facility or senior/mezzanine credit facility and what type of incremental debt is being put in place (i.e. debt *pari passu* to the first lien or senior facility, debt that is subordinate to the first lien or senior facility but *pari passu* with the second lien/mezzanine facility, or unsecured debt), the type of leverage test will be different (i.e. first lien leverage test *vs.* secured leverage test *vs.* total leverage test). In larger deals, the level of the ratios will often be set at the closing date leverage multiple or, in the case of unsecured debt, sometimes 0.25× to 0.50× outside the closing date leverage multiple. There may be an alternative test in larger deals for the incurrence of incrementals to the extent the proceeds of such incrementals are utilised to fund permitted acquisitions. In such instances, the incurrence leverage ratio will be the leverage ratio of the borrower immediately prior to giving effect to such permitted acquisition. The upper middle market generally follows the larger deals in terms of how the incremental amount is capped.
- We have seen a continuing trend in the data in the traditional middle market to allow for both a starter basket and an unlimited amount, with 79% of traditional middle market deals in 2018 permitting both components of incremental facilities, compared to 62% in 2017. In the traditional middle market, it was common for the unlimited incremental amount to be subject to an incurrence leverage test as well as *pro forma* compliance with the maintenance financial covenants. However, our data has shown that including a requirement that the borrower be in *pro forma* financial covenant compliance in connection with the unlimited incremental amount has become rare. In some instances in the traditional middle market where the incremental amount is subject to a fixed cap amount, our data also shows that the incurrence of incremental debt under the fixed cap will be subject to an incurrence leverage test (and even less frequently, a *pro forma* compliance with the maintenance financial covenants in addition to such leverage test).

  Borrowers prefer to craft incremental provisions so that different leverage tests are used as a governor to incur different types of debt (i.e. first lien debt, second lien debt or unsecured debt). This approach creates significant flexibility for a borrower, in that it allows a borrower to incur multiple layers of debt in excess of the overall total leverage test originally used as the leverage multiple. For example, in computing a total leverage ratio, the indebtedness included in such a calculation would typically include all funded indebtedness of the applicable credit parties and those subsidiaries included in the financial metrics of the credit parties. The indebtedness included in calculating a first lien leverage ratio would be limited to funded indebtedness subject to a first lien on the assets of the credit parties. As a result, a borrower could (I) first incur unsecured indebtedness up to the total leverage ratio cap, and (II) second incur additional first lien indebtedness up to the first lien leverage ratio cap. In this example, the second incurrence of debt would bust the total leverage ratio cap but this would not prevent the incurrence of first lien debt because the first lien leverage ratio does not include the unsecured indebtedness previously incurred by the borrower. This flexibility, although provided in the upper middle market, is often rejected in the traditional middle market transactions. Traditional middle market deals will usually only apply a total leverage ratio test for all types of incremental loans (or will apply a total leverage ratio test in addition to any other leverage based test that may be applicable to the incurrence of a certain profile of incremental debt).
- In large cap and upper middle market transactions, borrowers will also seek the ability to (a) elect to use the ratio based unlimited incremental amount prior to the fixed amount, (b) reclassify (at their discretion or automatically) incremental debt which was originally incurred under the fixed amount as incurred under the ratio based unlimited amount (thereby reloading the fixed amount), and (c) in instances where an incremental loan is incurred based on both the fixed amount and the unlimited amount, not take the fixed amount into account when testing leverage. In the instances where a traditional middle market financing allows for both a fixed starter basket and a ratio based unlimited incremental amount, historically the middle market lender has required that the fixed amount be used first and reclassification would generally not be permitted but that protection is beginning to erode as the reclassification concept moves down market.

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- In large cap and upper middle market transactions, the incremental amount may also be increased, over and above the fixed starter basket and ratio based unlimited incremental amount, by an amount equal to: (a) in the case of an incremental facility that effectively replaces any existing revolving commitment terminated under the "yank-a-bank" provisions, an amount equal to the portion of such terminated revolving commitments; (b) in the case of an incremental facility that serves to effectively extend the maturity of the existing facility, an amount equal to the amount of loans and/or commitments, as applicable, under the existing facility to be replaced with such incremental facility; and (c) all voluntary prepayments of the existing term loans, previously incurred incremental term loans and refinancings of the existing term loans and voluntary commitment reductions of the revolving facilities (except to the extent funded with the proceeds from an incurrence of long-term indebtedness (other than revolving indebtedness)). The incremental amount limitations will be the same for incremental equivalent facilities provided that the establishment of an incremental facility or the incurrence of incremental equivalent debt will result in a dollar-for-dollar reduction of the amount of indebtedness that may be incurred in the other facility. In this regard, the upper middle market is generally consistent with the larger deals. However, the traditional middle market will again differ in that if any additional amounts increase the incremental amount, it will be limited to the voluntary prepayments of indebtedness or commitment reductions of the revolving facilities.

Rate and maturity

- Generally, incremental term loans: (a) cannot have a final maturity date earlier than the existing term loan maturity date; (b) cannot have a weighted average life to maturity shorter than the weighted average life to maturity of the existing term loans; (c) rank *pari passu* with the existing loans or junior in right of payment and/or security or are unsecured; (d) are not secured by any collateral other than collateral securing the existing term loans or guaranteed by any guarantors not guaranteeing the existing term loans; (e) participate *pro rata* or less than (but not greater than) *pro rata* with the existing term loans in mandatory prepayments; (f) have covenants and events of default substantially similar to, or no more favourable to the lenders providing such incremental term loans than those applicable to the existing term loans, except to the extent such terms apply only after the latest maturity date of the existing term loans or (sometimes) if the loan agreement is amended to add or conform to the more favourable terms for the benefit of the existing term lenders; and (g) if incremental equivalent debt is permitted, such incremental equivalent debt is subject to customary and satisfactory intercreditor arrangements. Some borrowers in larger deals have been successful in negotiating a carve-out from the maturity requirement which would allow the borrower to incur incremental term loans with earlier maturities, up to a maximum amount governed by a fixed dollar basket.

  These terms have generally been adopted in the upper middle market. The traditional middle market does not contain significant variations, except that the traditional middle market sometimes only allows the incurrence of incremental debt that is *pari passu* debt, contains additional restrictions on *pro rata* or less than (but not greater than) *pro rata* voluntary prepayments with the existing term loans and will not permit earlier maturities of incremental loans. Although it seems that allowing the borrower to incur either lien subordinated or unsecured subordinated debt instead of *pari passu* debt would be beneficial to the lenders, the traditional middle market's resistance to allowing different types of debt stems from a desire to maintain a simpler capital structure especially in credit transactions where there are no other financings.

- The interest rate provisions applicable to incremental facilities customarily provide some form of pricing protection that ensures that the all-in yield of the existing credit facility would be increased to match (less 50 basis points) any new incremental facility (to the extent *pari passu* in claim and lien priority to the existing credit facility) whose all-in yield was greater than 50 basis points above the existing credit facility. These provisions are generally referred to as the "MFN (most favoured nations) provisions". In large cap and upper middle market transactions, the MFN provision often contains a "sunset", meaning that the pricing protection is no longer applicable after a period of time. This period ranges from 12 months to 18 months (some with sunset periods as short as six months). The sunset provision, however, may be eliminated altogether or flexed out, depending on market conditions. As the ability to designate incrementals with different payment and lien priorities (or as incremental equivalent debt) has become commonplace in large cap and upper middle market transactions, borrowers generally request provisions that effectively erode MFN pricing protections, including (i) additional carve outs to the calculation of all-in yield for amounts that do not clearly constitute "one-time" fees (for example, OID and upfront fees), thereby making it easier to remain below the MFN trigger threshold, (ii) limiting the application of the MFN protection to the term loan facility originally issued under the credit facility, and (iii) excluding from the MFN provisions incrementals (or incremental equivalent debt) that (a) are incurred in reliance on the started basket amount, (b) are utilised for specific purposes (e.g., for permitted acquisitions), (c) are structured as an issuance of notes (whether issued in a public offering, Rule 144A or other private placement) as opposed to loans, (d) mature later than the latest maturity debt of any other term loans under the credit facility or which are bridge-financings, and (e) are within a certain capped amount. Without adding further protections, allowing the incurrence of an incremental loan based upon the starter basket amount to be free of the MFN protection has the potential of eliminating the MFN treatment altogether in deals where the borrower has the ability to redesignate starter amount incrementals as leveraged based incrementals because the borrowers are able to, in certain circumstances, reload the starter basket amount. Our 2018 data shows that only 9% of traditional middle market deals with MFN provisions include a sunset period, consistent with 9% in 2017, but increased from 3% in 2016.

  The traditional middle market takes a somewhat consistent approach to the upper middle market's treatment of the MFN provision. For the most part, *pari passu* debt issued in reliance upon the incremental provisions is subject to the MFN provisions. However, middle market lenders may also require that the impact of the MFN provisions apply to all debt outstanding under the credit facility, including incremental loans previously funded. Traditional middle market lenders in single-lender or club deals have had some success maintaining the MFN provisions without a sunset with exceptions generally limited to first lien transactions and senior stretch transactions where the credit is intended to be syndicated.

Use of proceeds

- In large cap and upper middle market transactions, proceeds from the incurrence of incremental and incremental equivalent debt may generally be used for any purpose not otherwise prohibited by the original credit facility. In contrast, the traditional middle market sometimes restricts the use of proceeds to very specific purposes such as acquisitions or capital expenditures. Our data shows a clear migration of the large cap and upper middle market flexibility with respect to the use of incremental proceeds filtering down to the traditional middle market. Increasingly, middle market lenders are permitting incremental proceeds to be used for general purposes, including for restricted payments such as dividends and payment of junior debt but subject to stricter leverage tests. As a result, limitations placed on the use of proceeds for incremental loans are mostly seen in lower middle market deals in today's market.

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Ratio Debt

In addition to the incremental and incremental equivalent facilities described above, large cap and upper middle market transactions often include additional debt incurrence capacity through the inclusion of "ratio debt" provisions. These provisions can be traced back to the high-yield bond market. Ratio debt allows a borrower to incur additional indebtedness so long as the borrower meets the applicable leverage ratio or interest coverage ratio test. If this debt is leverage-based, the ratio is typically set at the same level required for incurrence of incremental and incremental equivalent debt. In upper middle market transactions that include ratio debt provisions, the conditions for incurrence (other than the applicable leverage or interest coverage test) may be looser than the conditions to incurrence of incremental and incremental equivalent debt, though lenders have had some success in standardising the conditions across the different types of permitted debt incurrence. To the extent ratio debt provisions appear in traditional middle market transactions, the incurrence of such debt is often conditioned on such debt being subordinated in right of payment to the credit facility (and is not otherwise permitted to be secured). Additionally, where the traditional middle market allows for ratio debt, it requires that any applicable MFN provisions be applied to any ratio debt that is *pari passu* to the credit facility obligations. Notably, this middle market term has migrated up market as upper middle market deals have increasingly adopted this protection in respect to ratio debt. Lower middle market transactions generally do not provide for ratio debt. Our data shows that 41% of traditional middle market deals permitted ratio debt, compared to 48% in 2017.

Acquisition Indebtedness

Generally, credit agreements will allow the borrower to incur certain indebtedness in connection with a permitted acquisition or investment. Not surprisingly, the larger deals will commonly allow the borrowers the most flexible formulation and permit the incurrence of any acquisition indebtedness, provided that it is only the obligation of the entity or its subsidiaries that are acquired. The upper middle market takes a similar (but more restrictive) approach to the large cap market and will sometimes provide that, after giving effect to the acquisition indebtedness, the borrower must be in *pro forma* compliance with the financial covenants and/or meet a leverage test (i.e. closing date leverage). Although it is not uncommon for this type of indebtedness to be permitted in the lower middle market, it will be subject to additional limitations, including required subordination terms and dollar caps. In lower middle market deals, there is still a preference for allowing acquisition indebtedness to the extent it is subject to a dollar cap.

Limited Condition Transactions

One of the best known outcomes of the loosened credit markets in 2005 was the "certain funds provision" technology proposed by sellers who gave preference to those potential buyers who had financing locked down. Certain funds provisions (also commonly known as the SunGard provisions) provide that, except as expressly set forth in a conditions annex to the commitment papers, there can be no other conditions precedent to the closing and funding of the credit facility in the definitive loan documentation, and it limits the representations and warranties required to be true and correct at closing to certain material representations set forth in the acquisition agreement that give the buyer or its affiliates a right to terminate the transaction (the "acquisition agreement representations") and a narrow set of additional "specified representations". It also limits the actions required to be taken by a borrower pre-closing to perfect security interests in the collateral to certain essential actions, with all other actions to be taken on a post-closing basis. The certain funds provisions were designed to assure buyers and sellers that, so long as the conditions to closing under the acquisition agreement were met, the lenders would not have an "out" beyond a narrow set of conditions in the conditions annex.

Acquisition financings in general, regardless of the market, have generally adopted the SunGard provisions which require that the only representations and warranties at closing that are conditions to closing and funding loans are "specified representations" and the acquisition agreement representations. All other representations and warranties in the credit agreement are made at closing, but their truth and correctness are not conditions to closing. Even if such representations and warranties are not true and correct, the lenders will be required to close the financing, but with a default immediately following the closing. In most competitive deals, the borrower will seek to limit the representations and warranties made only to the specified representations and the acquisition agreement representations so that even if the other representations are not true, the borrower will not have a default post-closing. The upper middle market has generally followed the larger deals in this respect but not without objection, especially in first lien and second lien financing transactions where the second lien lenders will not benefit from a regular bring down of the representations by way of the conditions precedent to borrowing under a revolver. The traditional middle market, for the most part, continues to resist the requirement that only specified representations and acquisition agreement representations should be made at close.

As borrowers continued to push for greater flexibility in credit documents, the certain funds provisions continued to evolve, widening its applicability to include future acquisitions financed from the proceeds of incremental loan facilities or ratio debt. As this becomes applied more broadly, limited conditionality with respect to conditions to borrowing incremental debt primarily to finance a limited condition acquisition has become customary. These features provide a borrower comfort that financing for follow-on acquisitions will be available. In larger deals, borrowers have been successful in extending this "limited condition acquisition" protection to all acquisitions using an incremental facility, regardless of whether there is a financing condition in the underlying acquisition documentation. Currently, the applicability of the certain funds provisions has been further broadened to include not only future acquisitions but also other investments, paydown of indebtedness, and restricted payments. Within the middle market, only the lower middle market still shows resistance to the broader applicability of the certain funds provisions.

Customarily, as noted above, conditions to incremental debt and "ratio debt" incurrence have included material accuracy of representations and warranties, absence of default or event of default, and in certain areas of the market, either a *pro forma* compliance with the existing financial covenant (if any) or meeting a specific leverage test, each tested at the time of incurrence of the incremental debt. Limited condition acquisition provisions enable a borrower to elect the signing date (also known as the "effective date") of the acquisition agreement ("acquisition agreement test date") as the relevant date for meeting the required conditions. As a result, if the borrower made such an election then the combined conditions to accessing the incremental loans and making a permitted acquisition (which may have included accuracy of representations and warranties, no events of default, and leverage tests) would be tested at the time the acquisition agreement is executed, with a subsequent no payment or bankruptcy event of default test upon the consummation of the transaction, and the borrower would have the ability to include the

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financial metrics of the target entity (i.e. EBITDA) at the time of such testing. Although the middle market has largely incorporated the limited condition acquisition protections, some lenders in lower middle market deals continue to push for a requirement that the relevant acquisition close within a specified time frame from execution of the purchase agreement (usually not longer than 180 days), otherwise the limited condition acquisition protections fall away. As a result, in the event the acquisition does not close within the agreed-upon time frame, the limited conditionality is eliminated and the borrower would have to comply with all the conditions at the time of the incurrence of the incremental loan.

The limited conditionality provision permits a borrower to elect the effective date of the acquisition agreement (or the date of the agreement documenting an investment, paydown of indebtedness or restricted payment) (instead of the closing date) as the date of determination for purposes of calculating leverage ratios in order to test ratio-based incremental debt capacity (as well as other incurrence tests described below). Testing the leverage ratio at signing eliminates the risk of a decline in consolidated EBITDA of the borrower and the target between signing and closing (the period between execution of the acquisition agreement and closing date referred to as the "Intervening Period"), when the ratio would otherwise be tested. This risk is of special concern in deals involving a lengthy delay between signing and closing due to regulatory approvals.

As the leverage test is intended to include the financials of the acquisition target on a *pro forma* basis, borrowers have further requested that any other incurrence based leverage test (required in connection with any other investment, incurrence of debt, restricted payment etc.) that is tested during the Intervening Period include the financials of the acquisition target on a *pro forma* basis. Generally, the markets have responded to this request in three different ways:

- *Most Borrower Favourable*: In large deals, any leverage test required during the Intervening Period will be tested after giving *pro forma* effect to the acquisition. In the event the acquisition does not close, any leverage test applied during the Intervening Period will be deemed to be valid regardless of whether the borrower would have failed to meet the leverage test without giving effect to the acquisition target's EBITDA. The upper middle market has not yet fully embraced this calculation of the leverage test, although we are seeing this construct more frequently.
- *Most Lender Favourable*: Any leverage test required during the Intervening Period will be tested on a stand-alone basis. The traditional middle market and the upper middle market (but less frequently) will generally take this approach.
- *Compromise*: The maintenance financial covenant and any incurrence leverage test pertaining to the payment of restricted payments (including junior debt payments) are tested on a stand-alone basis but the remaining incurrence leverage tests are tested giving *pro forma* effect to the acquisition. Another compromise is to test all maintenance financial covenants and incurrence leverage tests on both a *pro forma* and stand-alone basis. This application of the leverage test is often seen in the upper middle market.

Available Amount Basket

Once the leveraged financing markets revived following the down turn of the financial markets in 2008–2009, the concept of builder baskets or the "available amount basket" seen in high-yield bond deals migrated into, and became prevalent in, the middle market. It is worth noting, however, that the lower middle market has not fully embraced the inclusion of available amount baskets. An available amount basket is also commonly referred to as a "cumulative amount" or a "builder basket". The purpose of an available amount basket is to give the borrower the ability to increase certain baskets in the negative covenants (i.e. investments, dividends and payment of junior indebtedness) without asking for a consent from the lender. The rationale behind lenders conceding to an increase in certain baskets in the negative covenants was an attempt to recognise and reward an increase in the borrower's profitability by permitting the borrower to deleverage its debt and permit the borrower the ability to increase baskets in the negative covenants that generally restrict cash outflow. Our data shows that 76% of traditional middle market deals include the available amount basket concept, compared to 81% in 2017.

The available amount basket will be generally constructed to be the sum of the following:

- *Starter Basket Amount*: A starting amount (commonly referred to as a "starter basket amount") which initially, unlike the incremental starter amount, was not necessarily based on a percentage of the borrower's EBITDA but was, instead, generally determined on a case-by-case basis (which amount may be further increased by a grower basket in the larger deals). Currently, the starter basket amount will often be 25%–50% of the borrower's EBITDA. Middle market deals (but less frequently in the lower middle market transactions) will often include a starter basket amount. Our data shows that 85% of traditional middle market deals with the available amount basket include a starter basket amount, compared to 94% in 2017.
- *Retained Excess Cash Flow or a Percentage of Consolidated Net Income*: Typically in larger deals, the available amount basket will include a percentage of consolidated net income in addition to the retained excess cash flow because the borrower will have quicker access to the consolidated net income. This is especially relevant in those transactions that close in the first half of a fiscal year since the borrower will not be able to build retained excess cash flow until the end of the following fiscal year. Upper middle market transactions will often use either retained excess cash flow or a percentage of consolidated net income. In contrast, the traditional middle market deals will more often include retained excess cash flow which, in addition to having limited accessibility, will most likely be defined in a manner that results in as little actual excess cash flow as possible since the borrower will be required to make a mandatory prepayment in an amount equal to a percentage of such excess cash flow. As a result, the borrower is incentivised to minimise the amount of excess cash flow generated.
- *Contributed Equity*: If the available amount basket is included in the financing, then having it increased by the amount of equity contributions that are not otherwise applied under the credit agreement will be common regardless of the size of the deal. It is also commonly accepted that equity contributions made in connection with equity cures will be excluded from the available amount basket.
- *ROI on Investments Made With the Available Amount Basket*: Larger deals and upper middle market deals will commonly permit an increase in the available amount basket by the amount of returns in cash, cash equivalents (including dividends, interest, distributions, returns of principal, profits on sale, repayments, income and similar amounts) or investments. However, not all traditional middle market deals will include returns in cash, cash equivalents or investments in the available amount basket. If included, they will only be permitted to the extent such investments were initially made using the available amount basket and in an amount not to exceed the original investment.
- *Declined Proceeds*: Declined proceeds from mandatory prepayments required to be made by the borrower will commonly be included in the calculation of the available amount basket regardless of the size of the deal.

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- *Debt Exchanged for Equity*: In larger deals, to the extent that any debt owed by the borrower is converted into equity, such amount will be included in the available amount basket. The upper middle market will often adopt this formulation while the traditional middle market has not fully accepted the addition of debt exchanged for equity in the calculation of the available amount basket.
- *Redesignation or Sale of Unrestricted Subsidiaries*: In larger deals and often in the upper middle market transactions, in the event an unrestricted subsidiary is (i) redesignated as a restricted subsidiary, or (ii) the subject of a disposition, the fair market value (generally determined in good faith by the borrower) of the investments in such unrestricted subsidiary at the time of such redesignation (in the case of clause (i)) or the net proceeds of such sale actually received by a restricted subsidiary or the borrower in excess of the original investment in such unrestricted subsidiary (in the case of clause (ii)), will increase the available amount basket so long as such investments were originally made using the available amount basket. The traditional middle market has not fully accepted this component of the available amount basket.

The conditions around the usage of the available amount basket vary greatly and the traditional middle market takes a very different approach than the upper middle market. As noted, the purpose of the available amount basket was to increase the baskets pertaining to cash leakage such as investments, dividends and junior debt payments. The upper middle market deals often place few conditions around the usage of the available amount basket. Such conditions may be further distinguished as follows. In most upper middle market transactions, conditions for accessing the available amount basket will usually apply in respect to a dividend or junior debt payment and such conditions may include no payment or bankruptcy events of default as well as a specific leverage test set at or within the closing date leverage level. In some cases, the specific leverage test will apply only to the extent the component of the available amount basket being accessed pertains to retained excess cash flow or a percentage of consolidated net income. In the more conservative upper middle market transactions and the traditional middle market deals, the approach will be to place conditions for the usage of the available amount basket for all investments, dividends and junior debt payments irrespective of which component of the available amount basket is being accessed. For the most part, these conditions may include a *pro forma* leverage ratio test as well as a no event of default condition. Additionally, in respect to the payment of dividends or junior debt, there will be an additional leverage ratio test that will be well within the closing date leverage (by as much as 1.0× to 2.0×).

Grower Baskets

Akin to the available amount basket, the "grower basket" is intended to provide the borrower with the flexibility of automatically increasing certain basket amounts based on the growth of the borrower's consolidated EBITDA or consolidated total assets. The middle market and, to a much lesser extent, the lower middle market, has generally adopted grower basket provisions (in certain circumstances, excluding baskets related to restricted payments and junior debt payments). Our data shows that 54% of traditional middle market deals include grower baskets in some form, compared to 63% in 2017.

Grower baskets are intended to be utilised at any time a hard capped amount is implemented. They are formulated as the greater of (i) a capped amount, and (ii) a percentage of either the consolidated total assets or consolidated EBITDA of the borrower. As such, grower baskets will be used in connection with the free and clear amount in incremental debt provisions, the starter basket amount in the computation of an available amount basket and other amounts set out as exceptions to negative covenants. In the upper middle market and traditional middle markets, certain transactions have incorporated exclusions with respect to baskets relating to restricted payments and junior debt payments from the grower basket concept, while still providing flexibility on baskets that are deemed to be accretive to the underlying business (such as investments).

Unlike the available amount basket, which represents an additional level of flexibility within the investments and restricted payment covenants by providing for an additional performance-based covenant exception, a grower basket is the addition of a growth component based on a percentage of EBITDA or consolidated total assets that corresponds to the growth of company. Utilisation of the grower basket will not be subject to any conditions such as there being no events of default or a leverage ratio test unless the exception for which the hard capped amount relates originally included any such condition.

Choosing between consolidated EBITDA or consolidated total assets is not exclusively beneficial to either the lender or the borrower. While EBITDA is better to measure the performance of companies that are not asset rich but are instead cash flow-centric, the downsides are that it can be volatile and, depending on the industry, very cyclical. Consolidated total assets, on the other hand, are better suited for companies that are asset-rich. However, the downside is that there may be certain assets that are difficult to value such as intellectual property and goodwill.

Unlike the available amount basket, which will uniformly build with a percentage of consolidated net income or retained excess cash flow, there is no established rate by which particular grower baskets are set. Instead, the parties will negotiate the hard-capped amount and set the percentage of either the closing date consolidated EBITDA or consolidated total assets to the equivalent hard-capped amount.

Unlike the calculation of the available amount basket which once increased would only decrease to the extent utilised, because grower baskets are formulated based on a "greater of" concept, if the growth component fluctuates in size, the quantum of the basket will also fluctuate (but limited down to the hard capped amount). Note, however, that since grower baskets are generally included in incurrence-based exceptions utilisation, if a grower reduces in size, any prior usage of the basket at the higher level will not trigger an event of default.

Looking Ahead

The Private Credit Group data reveals that, with each passing year, terms relating to debt incurrence, limited condition transactions, available amount baskets and grower baskets become more prevalent in the middle market as lenders adapt to the inclusion of what were once considered large cap terms. In 2018, our data demonstrated a slight slowdown in the adoption into the middle market of these large cap terms. Momentum was historically supported by evolving markets, the entrance of new capital and institutions into the middle market, a strong economy and fierce competition among lenders to place capital. We begin 2019 in the midst of a global economic slowdown and declining stock markets. Although the state of the economy remains uncertain and a potential economic downturn in US markets has been predicted by many economists, we expect many of these other historical factors to continue to impact the sustained migration of large cap terms into middle market transactions, to varying degrees based on the dividing lines of the lower middle market, traditional middle market or upper middle market. Recently lenders have achieved some success in flexing out more aggressive formulations of these terms during primary syndications of

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transactions. However, as these large cap concepts and provisions are adopted in the middle market, lenders' ability to unwind such change is, for the most part, limited. And as noted above, the growing use by borrowers and middle market lenders of credit documents from a prior transaction, or a precedent selected by the borrower, as the basis for the documentation of a new transaction should continue to solidify certain new concepts and provisions.

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