International
Comparative
Legal Guides

Lending & Secured Finance 2021

A practical cross-border insight into lending and secured finance

Ninth Edition

Featuring contributions from:

Allen & Overy LLP
Asia Pacific Loan Market Association
Astrea
Bär & Karrer Ltd.
Cadwalader, Wickersham & Taft LLP
Carey
Carey Olsen Jersey LLP
Cleary Gottlieb Steen & Hamilton LLP
Criales & Urcullo
Cuatrecasas
Davis Polk & Wardwell LLP
Dechert LLP
Dillon Eustace
Drew & Napier LLC
Fellner Wratzfeld & Partners
Freshfields Bruckhaus Deringer LLP
Fried, Frank, Harris, Shriver & Jacobson LLP
Gonzalez Calvillo
Holland & Knight
Latham & Watkins LLP
Lee and Li, Attorneys-at-Law
Loan Market Association
Loan Syndications and Trading Association
Loyens & Loeff Luxembourg S.à r.l.
Macesic and Partners
Maples Group
Marval O'Farrell Mairal
McMillan LLP
Milbank LLP
Morgan, Lewis & Bockius LLP
Mori Hamada & Matsumoto
Morrison & Foerster LLP
O'Melveny & Myers LLP
Orrick Herrington & Sutcliffe LLP
Proskauer Rose LLP
Rodner, Martínez & Asociados
S. Koukounis & Partners LLC
Sardelas Petsa Law Firm
Seward & Kissel LLP
Shearman & Sterling LLP
Sidley Austin LLP
Skadden, Arps, Slate, Meagher & Flom LLP
SZA Schilling, Zutt & Anschütz Rechtsanwaltsgesellschaft mbH
Veirano Advogados
Wakefield Quin Limited
Walalangi & Partners (in association with Nishimura & Asahi)
White & Case LLP

LSTA   LMA Loan Market Association   APLMA Asia Pacific Loan Market Association

ICLG.com

Editorial Chapters

Expert Analysis Chapters

Q&A Chapters

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

Sandra Lee Montgomery

Proskauer Rose LLP

Michelle L. Iodice

Introduction

For the past 10 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 chapter reflects trends and evolving terms in over 204 private credit transactions closed by The Private Credit Group at Proskauer Rose LLP in 2020 and may not be indicative of overall market trends.

Our data shows that over the past 10 years, the middle market has experienced an influx of financing terms traditionally found only in large cap financings, albeit with a middle market orientation in many cases. During these years, lenders have faced increased competition for deal origination resulting from a growth of direct lending by unregulated financial entities, a surplus of dry powder and a limited supply of attractive investment opportunities. We saw a slight slowdown in this trend in 2018 in light of speculation around the end of the current credit cycle but in 2019, data demonstrated that these large cap financing terms appeared in the middle market at an increased pace as compared to 2018. Given that large cap terms assume a profitable, durable business model and stable economic climate, it may have seemed inevitable to many that lenders in 2020 would reject any further influx large cap financing terms into middle market transactions and attempt to unwind any previously adopted provisions. Cases like Serta, Boardriders and Trimark (in which borrowers were able to exploit favourable documentation to subordinate existing lender debt to new lender debt to achieve restructurings without the consent, and to the detriment, of existing lenders) were also fresh in lenders' minds and highlighted the risk inherent in allowing large cap terms in middle market credit documents.

Nevertheless, the private credit market continued to demonstrate its durability in 2020 against a backdrop of economic uncertainty and the devastating effects of the COVID-19 pandemic. Our data shows that in 2020, large cap financing terms continued to appear in middle market financings in a manner generally consistent with prior years. A discussion of the factors leading to this result follows.

The private credit market enjoyed a strong start to 2020. Despite the persisting uncertainty of many around the end of the current credit cycle, lenders continued to bring a surplus of dry powder to the market and competition for investment opportunities remained high. As Q1 came to a close, it became clear that the COVID-19 pandemic would irreparably leave its mark on the world economy. Financial reporting from borrowers that would follow in the coming weeks showed the first effects of declining revenues. The mining, oil, transportation, employment services, travel, leisure and hospitality industries were particularly hard hit, but borrowers in a myriad of industries began to feel the fallout from this pandemic. Q2 brought more of the same for borrowers, and with the benefit of strong financial performance from prior quarters rolling off borrowers' books, speculations began to run high that many borrowers would soon face payment and financial covenant defaults under their credit documents and need to restructure their current credit facilities. At the end of Q1 and the beginning of Q2, many financings in the pre-commitment stage also came to a halt and the private credit market experienced a temporary slowdown in the number of new financing opportunities coming to market. However, despite the economic uncertainty (and predictions by many experts that COVID-19 would lead to one of the deepest recessions in U.S. history), the private credit market quickly rebounded and remained strong for the duration of 2020.

In most cases, borrowers did not default on principal and interest payments. Our data shows that, as of December 31, 2020, a payment default had occurred in only 1.4% of active deals. Many borrowers fully drew down on previously committed revolving facilities to build cash reserves. The borrowing conditions for these revolving facilities are limited to basic items (such as no event of default, a bring down of representations and warranties that are qualified by materiality, and delivery of a borrowing notice) so they are easy for a borrower to access. Credit documents also do not typically contain anti-cash hoarding covenants. As a result, borrowers had flexibility to access the full capacity of their revolving facilities for working capital purposes in anticipation of falling financial performance and tightening liquidity. In addition to this, many borrowers also took the opportunity to draw down on pre-committed delayed draw term loan facilities. This afforded borrowers a secure financing source for future acquisitions and investments. Although slightly more onerous than for revolving facilities, the borrowing conditions for delayed draw facilities are still limited to basic items (such as no event of default, a bring down of representations and warranties that are qualified by materiality, *pro forma* compliance with a leverage ratio, and delivery of a borrowing notice). Credit documents do not typically require that the proceeds of delayed draw loans be drawn and concurrently applied to fund the applicable transaction. As a result, borrowers were able to draw on the delayed draw facilities while their leverage ratios remained low and retain the cash proceeds on their balance sheets for future use in anticipation of deteriorating leverage and financial performance.

Borrowers were also able to maintain healthier-than-expected leverage ratios and, in many cases, avoid financial covenant breaches altogether. Our data shows that, as of December 31, 2020, a financial covenant default had occurred in only 2.1% of active deals. Following years of fierce competition for a limited supply of financing opportunities, borrowers have been able to negotiate credit documents that are covenant lite or covenant loose (discussed below). A borrowers' earnings can deteriorate significantly before the total net leverage financial covenant typically found in middle market credit documents is breached and many borrowers' strong pre-pandemic fiscal quarters buoyed declining financial performance in the short term. In addition, these credit documents also typically have flexible definitions of Consolidated EBITDA (a component of the total net leverage covenant). For instance, Payment Protection Program loans and other government grants provided during the pandemic were reported as net income in certain instances. The effects of extraordinary and non-recurring losses and restructuring costs incurred as a result of changing business landscapes were also added back to income, often in uncapped amounts. As a result, net income for purposes of testing financial covenants was often inflated as compared to net income prepared in accordance with GAAP and not necessarily reflective of a borrower's current performance.

Because borrowers were able to avoid defaulting on their credit facilities in many cases, debt restructurings occurred at a level that was lower than many expected. Our data shows that events of default under active deals (i.e., deals closed by Proskauer that remained active in 2020) remained low in 2020, at around 4% of all active deals. As 2020 progressed, it also became apparent that modern medicine was likely to provide economic relief from the pandemic in the near future. In light of this, many lenders viewed decreases in their borrowers' financial performance as a temporary issue and showed a willingness to work with their borrowers on out-of-court solutions in cases where credit defaults were impending or likely to occur. As a result, many borrowers avoided bankruptcy proceedings and in-court restructurings remained lower than expected.

It also became apparent that many industries (e.g., delivery services, online retailers, online entertainment and remote workforce solutions) would be unaffected by or even expand as a result of COVID-19. This quelled fears for many of a complete economic crash. Although new deal activity had slowed slightly for a time, the market for new financing opportunities did pick up and remained competitive through the end of the year. Borrowers also remained active raising incremental loan facilities (discussed below) from the lenders of their existing credit facilities to finance acquisitions of new target companies to add to their existing corporate structures. Lenders showed interest in committing this additional capital. Closing leverage measures remained generally consistent with those in 2019, and deal terms did not change materially in many cases (although our data shows a slight increase in interest rate margins in 2020). Our 2020 data demonstrates that large cap financing terms continue to appear in middle market financings, and, despite all that occurred in the financial markets in 2020, lenders had a limited ability to unwind this trend. To the extent that the economy continues to weather the COVID-19 pandemic, we expect the influx of large cap financing terms to continue.

Although middle market lenders' appetite for certain large cap financing terms differ based on institutional biases, the treatment of such terms in credit documents can be summarised by the size of the borrower's consolidated EBITDA. As a general matter, our data shows that large cap deal terms become less prevalent as the consolidated EBITDA of a borrower decreases. In addition, as the consolidated EBITDA of a borrower decreases, the inclusion of large cap terms with conditionality and additional provisions intended to mitigate inherent risks in such terms becomes more prevalent. This allows us to divide the middle market into the "lower middle market", "traditional middle market" and the "upper middle market" for purposes of this analysis and discussion. This chapter will examine the continuing evolution of certain key financing terms in the private credit middle market, and set forth proprietary data pertaining to the usage of such terms within the middle market. The analysis will also discuss the related market drivers and trends influencing such terms in light of the continuing evolution of private credit.

Overview of Proskauer Rose LLP Private Credit Transactions in 2020

The top five industries represented in middle market transactions, as shown in our data, include (a) business services, (b) consumer products and services, (c) healthcare, (d) financial services, and (e) software and technology. These primary industries comprise 62% of our deals in 2020. Technology was the leading industry for transactions in 2020 (overtaking healthcare) and accounted for 22% of deals, up from 19% in 2019. First lien, second lien and senior secured transactions increased for the year, whereas mezzanine loan transactions represented 0% of all deals in 2020 (declining from 3% in 2019 and 5% in 2018). 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 (with a slight increase in interest rate margins in 2020). In 2015, only 16.7% of deals had margins less than 7.0%. The percentage of deals having margins less than 7.0% decreased from 71.4% in 2019 to 64.1% in 2020. The impact to lenders of decreasing interest rate margins in past years was partially offset by a strong LIBOR benchmark. In 2019 and 2020, LIBOR has fallen dramatically. With respect to commitment fees and original issue discounts (OID), in 2020, 53% of commitment fees and OID were between 2.0%–2.49% of the principal amount of the loans and commitments at closing, with a slight increase in commitment fees and OID over 2.49% in 2020.

Closing leverage for middle market transactions in our data remains stable with only a slight decrease from 5.40× in 2019 to 5.33× in 2020. Sixty-four percent of deals had a closing leverage between 4.00× and 6.99× (lower than 72% of deals in 2019, indicating that closing leverage varied more across transactions in 2020 than in previous years). Trends in closing leverage should also be considered against the backdrop of the loosening of parameters relating to the calculation of consolidated EBITDA across the middle market, which effectively lowers closing leverage multiples and results in more forgiving financial covenants. In transactions with EBITDA greater than $50MM, only 25% 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, 67% of them had a cap on general non-recurring expenses (which is fairly consistent with 29% and 63%, respectively, in 2019, but is lower than in prior years). Additionally, add-backs for run-rate cost savings/synergies and restructuring costs have become almost ubiquitous and negotiated caps apply with increasing frequency only to cost savings/synergies applicable to acquisitions and restructuring activities after the initial closing date of a financing (and not to cost savings/synergies applicable to closing date transactions or to any restructuring costs).

Covenant lite deals, meaning deals that do not contain the usual protective covenants that benefit lenders, decreased in 2020 to 7% (*vs.* 10% in 2019) in deals with EBITDA greater than $50MM according to our data. However, we have seen an increase to 61% of deals with EBITDA greater than $50MM in our data of transactions that are covenant loose, meaning with financial covenant cushions equal to or greater than 40% against a borrower's model. Although financial covenants typically include a total leverage ratio test, in 2020, 17% of our deals also included a fixed charge coverage ratio test (up 15% from 2019), showing a turning of the tides on this term, which has been steadily falling out of credit documents in recent years. Of the transactions with financial covenants, 44% of them had five or more covenant step-downs (down slightly from 48% in 2019). Of these transactions, 86% of them had EBITDA of less than $50MM. Step-downs will fall away in transactions with EBITDA over $50MM.

The general trend towards borrowers' counsel controlling the drafting process at both the commitment papers stage and the definitive deal documentation stage continued in 2020. In most circumstances, the borrower will also select the precedent credit agreement to be used as a starting point for definitive deal documentation in a particular transaction. Frequently, the lender will not have participated in the prior transaction or the proposed precedent document will reflect a more upper market orientation than the current deal. As a result, and in light of frequently time-sensitive commitment periods and healthy competition for investment opportunities in the current market, lenders often agree to work with these proposed precedent credit agreements and accommodate terms that are more typically found in larger transactions.

Debt Incurrence

Flexibility for a borrower to incur significant additional debt facilities (both within and outside the applicable loan facility) was one of the most transformative structural changes to make its appearance in the middle market. Consistent with 2019, incremental facilities, incremental equivalent facilities, ratio debt and acquisition debt continue to be customary features of upper middle market and traditional middle market financings. However, following the pandemic, lenders have been more successful in excluding incremental equivalent facilities from new financings and, to a lesser degree, other forms of ratio-based indebtedness.

Incremental Facilities and Incremental Equivalent Facilities

An incremental facility (also commonly referred to as an "accordion") allows a borrower to incur additional term loans or revolving loan commitments under an existing credit agreement subject to certain limitations and conditions without the consent of the existing lenders. Incremental equivalent debt typically has the same features as an incremental facility except that the debt is incurred outside the existing credit documentation, either pursuant to a separate credit agreement 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 typically accommodate both incremental facilities and incremental equivalent facilities; (b) the traditional middle market will generally accommodate incremental facilities and is increasingly accommodating 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 and the leverage of the borrower and its subsidiaries; and (c) lower middle market deals sometimes include incremental facilities but generally do not provide for incremental equivalent facilities. Our data shows that 77% of traditional middle market deals include incremental facilities, which is down from 94% in 2019. Additionally, 47% of traditional middle market deals include both incremental facilities and incremental equivalent facilities, consistent with 47% in 2019.

Incremental amount

- In large cap and upper middle market transactions, and increasingly in the traditional middle market, credit documents will permit the incurrence of an incremental facility up to (1) a fixed incurrence amount (known as a "starter basket" or "free and clear basket"), plus (2) an unlimited incurrence amount, subject to compliance with one or more leverage ratios as further discussed below. The fixed amount will generally be no greater than 1.0× of consolidated EBITDA and will often have a "grower" component (e.g., the greater of (i) a fixed dollar amount, and (ii) the corresponding percentage of consolidated EBITDA measured as of the closing date). Our data shows that 38.3% 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 31.2% from 2019. Depending on the structure of the original transaction (i.e. senior secured, first lien/second lien or senior/mezzanine) and what type of incremental debt is being incurred (i.e. debt *pari passu* to the senior secured, first lien or senior facility, debt that is junior to the senior secured, first lien or senior facility but *pari passu* with the second lien/mezzanine facility (if any), 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).
- The level of the ratios will often be set at the closing date leverage multiple or, in the case of unsecured incrementals, up to 1.00× outside the closing date leverage multiple in larger deals. Historically, the traditional and lower middle market also required *pro forma* compliance with the financial maintenance covenants as a condition to using the unlimited incurrence amount. Our data shows that this has become rare, except in smaller deals. However, this protection is less relevant as financial maintenance covenants loosen and are less likely to step down below the closing leverage level in all but the smaller deals. In larger deals, there may also be an alternative test for the incurrence of incremental facilities used to fund permitted acquisitions. In such instances, the 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 (although the aforementioned alternative test for permitted acquisitions is not widely adopted).
- Data reveals a continuing trend in the traditional middle market to allow for both a starter basket and an unlimited amount, with 90% of traditional middle market deals in 2020 permitting both components of incremental facilities, compared to 85% in 2019. In many lower middle market financings, incremental facilities are still only permitted up to a fixed dollar amount (with no unlimited incurrence amount). In such cases, the incurrence of incremental debt under the fixed cap will be subject to an incurrence leverage test (and less frequently, *pro forma* compliance with the financial maintenance covenants in addition to such leverage test).
- Borrowers prefer to use different leverage tests to govern incurrence of different types of incremental debt (i.e., first lien leverage ratio for the incurrence of first lien debt, a senior secured leverage ratio for the incurrence of second lien debt and a total leverage ratio for the incurrence of unsecured debt) rather than the total leverage ratio test originally used as a leverage governor for all tranches of incremental facilities. This approach allows a borrower to incur a total amount of debt in excess of the total leverage test.

  - For example, the indebtedness included in calculating a total leverage ratio would typically include all funded indebtedness of the applicable credit parties and those subsidiaries included in the consolidated 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 security interest 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, since the incurrence of first lien incremental facilities is governed by a first lien leverage ratio (rather than a total leverage ratio), that debt incurrence would not be prevented because the first lien leverage ratio does not include the unsecured indebtedness previously incurred by the borrower. However, if the incurrence of first lien incremental facilities was governed by a total leverage ratio, second debt incurrence would exceed the total leverage ratio cap and be prohibited.
- This approach is accepted in the upper middle market but is frequently rejected in traditional middle market transactions. Traditional middle market deals will usually apply a total leverage ratio test for all types of incremental loans (or will apply a total leverage ratio test in addition to the first lien leverage ratio/senior secured leverage ratio tests described above).
- In large cap, upper middle market and traditional 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 under the unlimited amount. These features allow a borrower to incur debt at any time (and from time to time) in an amount that exceeds the ratio-based leverage test by the fixed amount. The traditional middle market has largely accepted these conventions as stacking and reclassification concepts move down market; however, lenders often resist a borrower's ability to automatically reclassify incremental debt originally incurred under the fixed amount as incurred under the ratio-based unlimited amount.
- In large cap, upper middle market and larger traditional middle market transactions, incremental capacity is also 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 or term loan retired under the "yank-a-bank" provisions, an amount equal to the portion of such terminated commitments or retired loans; (b) in the case of an incremental facility that effectively replaces any term loans that were repurchased by the borrower and immediately cancelled, an amount equal to the portion of such repurchased and cancelled term loans; (c) in the case of an incremental facility that serves to effectively extend the maturity of an existing facility, an amount equal to the amount of loans and/or commitments, as applicable, under that existing facility to be replaced with such incremental facility; and (d) all voluntary prepayments of the existing term loans, previously incurred incremental term loans and incremental equivalent 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)) (and sometimes limited in traditional middle market transactions to such loans and commitments that are *pari passu* to the loans/commitments being prepaid or terminated). The incremental amount caps and limitations will also govern incremental equivalent facilities. 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 pursuant to 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 the additional amounts that increase the incremental capacity (over and above the fixed starter basket and ratio-based unlimited incremental amount) will most frequently be limited to the amounts described in clauses (a) and (d) above.

Rate and maturity

- Incremental term loans generally: (a) cannot have a final maturity date earlier than the existing term loan maturity date (and may also require a 91-day maturity setback for subordinated, junior lien and unsecured incremental loans); (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, 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 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 to the extent it is secured. 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 been adopted in the upper middle market. The traditional middle market does not contain significant variations, but very conservative deals may only allow for the incurrence of incremental debt that is *pari passu* with the existing loans. The traditional middle market may also contain additional restrictions on greater than *pro rata* voluntary prepayments with the existing term loans (but not *pro rata* or less than *pro rata* voluntary prepayments) and will not permit earlier maturities of incremental loans. In some respects, allowing a borrower to incur lien subordinated or unsecured incremental facilities instead of *pari passu* incremental facilities may benefit the existing lenders since those junior and unsecured lenders would not share on a priority basis in the proceeds of collateral in an enforcement scenario. Despite this, the traditional middle market often resists allowing different types of debt due to 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. Typically, the protections require that the all-in yield of the existing credit facility is increased to match (less 50 basis points) any new incremental facility that is *pari passu* in claim and lien priority to the existing credit facility to the extent that such incremental facility has an all-in yield greater than 50 basis points above the existing credit facility. This differential can be 75 basis points in large cap transactions. These provisions are generally referred to as the "MFN" or 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 not applicable to any incremental facilities that are incurred following 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 (or incremental equivalent debt) with different payment and lien priorities has become commonplace in large cap, upper middle market and some traditional middle market transactions, borrowers typically push for additional provisions that erode MFN pricing protections. These additional exceptions to the MFN provisions include (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 not any prior incremental loans), and (iii) excluding from the MFN provisions incrementals (or incremental equivalent debt) that (a) are incurred in reliance on the starter 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 date of any other term loans under the credit facility or which are bridge-financings, and (e) are within a certain capped amount. Of particular concern for lenders is the exclusion in (iii)(a) above. Without adding further protections, this has the potential of eliminating the MFN treatment altogether in deals where the borrower has the ability to redesignate starter basket incrementals as leveraged-based incrementals (subject to sufficient capacity to redesignate borrowings to the ratio-based unlimited incurrence amount) because borrowers are able to effectively reload the starter basket over and over.

  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 (or the incremental equivalent 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 and typically push back on the multitude of carve-outs and exceptions discussed above. Traditional middle market lenders have had significant success maintaining the MFN provisions without a sunset. 2020 data shows that only 10% of traditional middle market deals with MFN provisions include a sunset period, generally consistent with 9% in 2019.

Use of proceeds

- In large cap, upper middle market and traditional 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 existing credit documentation. In some more conservative traditional middle market financings, all such uses of proceeds may be permitted, but subject to stricter leverage tests for purposes such as making restricted payments (i.e., dividends) and payments of junior debt. Our data continues to show a clear migration of the large cap and upper middle market flexibility with respect to the use of incremental/incremental equivalent proceeds filtering down to the traditional middle market and even the lower middle market in some cases. As a result, specific limitations placed on the use of proceeds for incremental/incremental equivalent loans are typically only seen in lower middle market deals. In those lower middle market deals, the use of proceeds may be restricted to permitted acquisitions and similar investments and permitted capital expenditures.

Ratio Debt

In addition to the incremental and incremental equivalent facilities described above, large cap, many upper middle market, and a growing number of traditional middle market transactions include "ratio debt" provisions. These provisions, which can be traced back to the high-yield bond market, allow a borrower or any of its subsidiaries to incur additional indebtedness so long as the borrower meets the applicable leverage ratio test (and subject to a cap on ratio debt incurred by subsidiaries that are not guarantors of the existing credit facilities). An interest coverage ratio test may also be applied in place of a leverage ratio for unsecured ratio debt, but this test is typically only accepted in large cap and larger upper middle market financings. If the ratio debt is leverage-based, the leverage rest is typically set at the same level required for incurrence of incremental and incremental equivalent debt. In upper middle market transactions that permit ratio debt, 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. However, lenders in the traditional middle market 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 may be conditioned on such debt being subordinated in right of payment to the credit facility or being unsecured. Additionally, where the traditional middle market allows for ratio debt, it requires that any MFN provisions applicable to incremental and incremental equivalent debt also apply to ratio debt that is *pari passu* to the credit facility obligations. Notably, this protection has migrated up market as upper middle market deals have increasingly adopted MFN protection in respect to ratio debt. Our data shows that 47% of traditional middle market deals permitted ratio debt, compared to 44% in 2019. Lower middle market transactions generally do not provide for ratio debt.

Acquisition Indebtedness

Credit agreements generally allow the borrower to incur certain indebtedness solely to fund permitted acquisitions and similar investments, referred to as "acquisition debt". The terms and conditions discussed above (i.e., conditions for incurrence, etc.)

with respect to ratio debt in a particular credit agreement will also typically apply to acquisition debt in that same credit agreement. Larger deals will commonly allow a borrower to incur acquisition indebtedness in an unlimited amount subject to *pro forma* compliance with a leverage test (typically the same tests applicable to ratio debt). As with ratio debt, an interest coverage ratio test may also be applied in place of a leverage ratio for unsecured ratio debt in the upper market. The upper middle market takes a similar approach to the large cap market (other than allowing an interest coverage ratio test), and the traditional middle market take a similar (but more restrictive) approach to the upper middle market. The traditional middle market may also require that, after giving effect to the acquisition indebtedness, the borrower is in *pro forma* compliance with the financial covenants. It not common for this type of indebtedness to be permitted in the lower middle market. In lower middle market deals, there is still a preference for allowing acquisition indebtedness that is assumed (rather than incurred to finance the permitted acquisition or similar investment) and only up to a fixed dollar cap. Similar to the approach for ratio debt, where the traditional middle market allows for acquisition indebtedness, it requires that any applicable MFN provisions apply to any acquisition indebtedness that is *pari passu* to the existing credit facilities. Upper middle market deals have also increasingly adopted this protection with respect to acquisition debt.

Serta Protections

Allowing a borrower to incur additional indebtedness through incremental facilities, incremental equivalent facilities, ratio debt and acquisition indebtedness creates concerns for existing lenders beyond lending into complicated and highly levered capital structures and sharing in a limited collateral pool in smaller proportions. Many credit documents in the upper middle market and traditional middle market (although less frequently) permit the required lenders (i.e., lenders holding more than 50% of the loans and commitments under an existing credit agreement) to subordinate the payments on and liens securing an existing facility without obtaining the consent of each lender in such existing facility. As touched on above, the required lenders in the Serta financing simultaneously provided additional indebtedness on a senior basis (with both new money and in exchange for existing debt) and subordinated the existing lender debt over the objections of minority lenders that did not receive a piece of the new senior facility. Lenders, especially those that anticipate being a minority holder, may now require a right of all applicable lenders to approve any amendment or other modification of the credit documents that subordinates the payments on or liens securing a class of debt. Another more borrower-friendly formulation of the "Serta provision" requires that a borrower offer on a *pro rata* basis to all applicable lenders the opportunity to participate in any modification in respect of the subordination of the payments on or liens securing a class of debt, and if the lender elects not to participate they will not have any right to consent to any such modification. These provisions have not been widely adopted into credit documents, and lenders do not always push for their inclusion, given that the provisions cut both ways for lenders. They can provide protection or limit a lender's flexibility to provide additional indebtedness with more favourable priority in a particular transaction (depending on whether such lender is a minority or majority holder, respectively).

Limited Condition Transactions

One of the best-known outcomes of the loosened credit markets in 2005 was the introduction of the concept of "certain funds" or "limited conditionality" to US transactions by way of the transaction commonly referred to as "SunGard". This technology was proposed by sellers in order to ensure that potential buyers had financing locked down, although the certain funds concept frequently appeared prior to this in European transactions. "Certain funds provisions" align the funding conditions set out in financing commitment papers as closely as possible to the closing conditions in an acquisition agreement in order to minimise the risk of a lender having a right not to fund upon the desired closing of an acquisition. Specifically, certain funds provisions (or 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. This assures buyers and sellers that, so long as the conditions to closing under an acquisition agreement are met, lenders do not have an "out" beyond a narrow set of conditions in the conditions annex. This is important for both sellers and buyers because a buyer is typically still responsible for funding the purchase price of an acquisition at closing even if its lender refuses to fund.

Acquisition financings, regardless of the market, have generally adopted SunGard provisions. The most typical formulation in upper market transactions, with respect to representations and warranties, are that the only representations and warranties required to be both made and accurate at closing are "specified representations" and certain representations in the acquisition agreement as described above. The other representations and warranties in the credit agreement that are deemed to be less material are not made at closing (so even if the other representations would not have been true, the borrower would not be in default immediately post-closing). In facilities with revolving credit facilities (which require a re-making of representations and warranties in connection with borrowings), the lender is likely to receive the benefit of the full set of representations and warranties soon after closing. However, in financings without revolving credit facilities, these other representations and warranties may not ever be made and would have limited utility to a lender. The upper middle market has generally followed the larger deals in this respect but not without objection, especially in transactions without revolving credit facilities for the reason described above. In smaller or less competitive transactions, the other less material representations and warranties in the credit agreement will also be made at closing, but their truth and accuracy are not conditions to closing. Even if such representations and warranties are not true and correct, the lenders will be required to fund, but with a default immediately following the closing. The traditional middle market has slowly started to adopt 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. Certain funds is now applicable to the conditions to borrowing incremental facilities, incremental equivalent facilities, ratio debt and acquisition debt incurred to finance a limited condition acquisition. 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 such financing sources, regardless of whether there is a financing condition in the underlying acquisition documentation. The applicability of the certain funds provisions has been further broadened to include other investments, paydown of indebtedness and restricted payments with features of limited conditionality. 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 and incremental equivalent debt, ratio debt and acquisition 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 such additional 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 additional financing and making the 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. The borrower would include the financial metrics of the target entity (i.e., EBITDA) at the time of such testing even though the acquisition was not yet consummated. In traditional middle market transactions, a subsequent no payment or bankruptcy event of default test is generally required upon the later consummation of the transaction. However, the requirement for this subsequent test often falls away in larger transactions. 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 period of time following the execution of the purchase agreement (usually not longer than 180 days), otherwise the limited condition acquisition protections fall away. In this case, 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 additional financing and closing of the acquisition.

As discussed above, the limited conditionality provision permits a borrower to elect the effective date of the acquisition agreement (or the date of the agreement documenting the relevant 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 additional 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.

Since 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 approach, 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. A compromise would be to test all incurrence leverage tests on both a *pro forma* and stand-alone basis. The lower middle market and traditional 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. This application of the leverage test is often seen in the traditional middle market and upper middle market (but less frequently). A more borrower favourable version of the compromise position that is common in the upper middle market and traditional middle market (but less frequently) is to test the maintenance financial covenant on a stand-alone basis but test all incurrence leverage tests on a stand-alone basis.

Available Amount Basket

Once the leveraged financing markets revived following the downturn of the financial markets in 2008–2009, the high-yield bond concept of the "available amount basket" became increasingly prevalent in the upper and traditional middle markets. The lower middle market has not fully embraced the inclusion of available amount baskets. An available amount basket (also commonly referred to as the "cumulative amount") automatically increases a borrower's ability to take actions under negative covenants that generally restrict cash outflow (i.e., investments, dividends and payment of junior indebtedness) to the extent a borrower has built up capacity of the available amount by increasing in profitability and taking other actions that are considered accretive to the business. In some upper market deals, the available amount also creates capacity for debt incurrence.

Lenders are willing to permit this increase in certain baskets in the negative covenants as an attempt to recognize and reward the borrower for increased profitability and for taking such accretive actions. In some cases, lenders require that a borrower de-leverage before it can access the available amount. Our data shows that 77% of traditional middle market deals include the available amount basket concept, compared to 91% in 2019, suggesting that lenders may be more hesitant to incorporate this historically upper market concept into their credit document in view of the uncertain economic climate and recent cases highlighting the inherent risks of the available amount. Most famously, in the PetSmart/Chewy case, PetSmart accessed the available amount basket to (i) distribute 20% of the common stock of its new subsidiary, Chewy.com, to a parent entity outside of the borrower/guarantor group, and (ii) invest 16.5% of the common stock of Chewy.com to a newly formed unrestricted subsidiary. Lenders were then required to release their liens on Chewy.com, as it was no longer a wholly owned subsidiary of the borrower, and the borrower used the asset to secure new priority debt incurred in exchange for existing debt that was previously subordinated to such lenders.

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" or "starter basket") generally determined on a case-by-case basis (which amount may be further increased by a grower basket in the larger deals). Unlike the incremental starter basket, this is not necessarily based on a percentage of the borrower's EBITDA. The starter basket amount is often 25%–50% of the borrower's EBITDA but can reach 100% of EBITDA in larger transactions. The available amount basket in upper and traditional middle market transactions (but less frequently in the lower middle market) will often include a starter basket amount. Our data shows that 82% of traditional middle market deals with the available amount basket include a starter basket amount, compared to 92% in 2019.
- *Retained Excess Cash Flow or a Percentage of Consolidated Net Income*: typically in upper market deals, the available amount basket will include a percentage of consolidated net income or retained excess cash flow, at the borrower's election. This is preferable for a borrower because it will have quicker access to the consolidated net income (while excess cash flow often will not be recognised until after the first full fiscal year following the closing date). 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. 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. Traditional middle market deals generally include such returns only to the extent they are in cash or cash equivalents, or limit this prong to returns on investments made using the available amount basket.
- *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.
- *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 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 with respect to a dividend or junior debt payment (but not investments). The conditions may include no payment or bankruptcy events of default as well as a specific leverage test set within the closing date leverage level (or at the closing date leverage level in larger deals). In an ever-growing number of cases, the leverage test will apply only to the retained excess cash flow or percentage of consolidated net income component of the available amount basket (and sometimes to the starter basket amount as well). 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 include a no event of default condition and *pro forma* compliance with a leverage ratio test (which, with respect to the payment of dividends or junior debt, is often well within the closing date leverage (by as much as 0.5× to 1.5×)).

Looking Ahead

The Private Credit Group data continues to show that, with each passing year, terms relating to debt incurrence, limited condition transactions and available amount baskets become more prevalent in the middle market as lenders adapt to the inclusion of what were once considered large cap terms. In 2020, our data generally demonstrated a steady pace of adoption as compared to 2019 despite the COVID-19 pandemic and global economic slowdown. However, we did see some retraction in the rate at which lenders incorporated available amount baskets into their credit documents. Consistent with 2019, in many cases lenders achieve some success in flexing out more aggressive formulations of these terms during the primary syndication of transactions. Momentum had historically been supported by evolving markets, the entrance of new capital and institutions into the middle market, and a strong economy. The continued competition among lenders to place capital has helped to keep that momentum strong in 2020. Despite economic uncertainty, lender interest in private credit as an asset class remains strong.

Many economists anticipate growth in 2021, warning of fragility and remaining watchful for contractions in the first half of the year. Lenders are likely to remain cautious about their existing portfolios in the face of this risk and be more selective with respect to investment opportunities and, to some extent, legal documentation. Given these predictions for 2021, we expect a sustained migration of large cap terms into middle market transactions. However, we also expect that lenders will continue to push for conditionality in order to mitigate the inherent risks of such terms. This is expected to continue to occur to varying degrees based on the dividing lines of the lower middle market, traditional middle market and upper middle market.

Our data continues to show that lenders' ability to unwind large cap concepts and provisions from credit documents is, for the most part, limited. As noted above, the continuing trend of borrowers and middle market lenders using credit documents from prior transactions (or precedents with an upper market orientation selected by a borrower) as the basis for the documentation of a new transaction should also continue to drive the adoption of upper market concepts and provisions into smaller transactions.

Acknowledgment

The authors would like to thank Joseph Cheng, a business development manager in The Private Credit Group at Proskauer, for his invaluable contributions to this chapter.

Sandra Lee Montgomery is a partner in the Corporate Department and a member of The Private Credit and Finance Groups. Sandra represents first- and second-lien senior lenders, mezzanine investors, and equity sponsors in senior debt, mezzanine and private equity financing arrangements, particularly those involving private sources of capital. Her areas of focus include acquisitions, recapitalisation and other leveraged financings, cash flow- and asset-based financings, debtor-in-possession and exit financings, cross-border financings, unitranche and mezzanine financings, restructurings and other innovative, first-in-kind transactions. Sandra has industry experience in a wide range of business sectors including retail, technology, transportation, manufacturing, distribution, general industrial, import/export, agriculture and services. She has extensive knowledge of Article 9 of the Uniform Commercial Code and other laws that relate to secured transactions. Sandra has also handled numerous cross-border transactions involving Australia, Barbados, Brazil, Canada, the Cayman Islands, England, Hong Kong, Malaysia, Mexico, the Netherlands, Puerto Rico, Scotland and Singapore.

Proskauer Rose LLP
2029 Century Park East, Suite 2400
Los Angeles
CA 90067-3010
USA

Tel: +1 310 284 4573
Fax: +1 310 557 2193
Email: smontgomery@proskauer.com
URL: www.proskauer.com

Michelle L. Iodice is an associate in the Corporate Department and a member of The Private Credit Group. Michelle concentrates her practice on middle-market financing transactions, including senior, first and second-lien, secured and unsecured mezzanine, holdco, unitranche and other forms of private credit in connection with leveraged buyouts, acquisition financings, recapitalisations and refinancings, among other purposes. She has experience representing a diverse group of lenders in transactions across a wide range of industries.

Proskauer Rose LLP
One International Place
Boston
MA 02110-2600
USA

Tel: +1 617 526 9703
Fax: +1 617 526 9899
Email: miodice@proskauer.com
URL: www.proskauer.com

Proskauer is a leading international law firm focused on creating value. Our roots go back to 1875, when we were founded in New York City. With 725+ lawyers active in virtually every major market worldwide, we are recognised not only for our legal excellence, but also our dedication to client service.

The Private Credit Group is a unique middle market finance practice. The breadth and diversity of our practice is unmatched in the industry. The group was the first to dedicate its practice solely to representing providers of private credit. We represent over 75 clients, including private debt funds, business development companies, asset managers, finance companies and family offices. These lenders provide financings for transactions ranging from $10 million to more than $1 billion across a myriad of product types and industries.

www.proskauer.com

Proskauer