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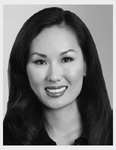
Analysis and Update on the Continuing Evolution of Terms in Private Credit Transactions

Proskauer Rose LLP



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Introduction

For the past 13 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 the current trends and deal terms in private credit transactions closed by The Private Credit Group at Proskauer Rose LLP in 2023 and may not be indicative of broader market trends.

Our data demonstrates that, over the past 13 years, the middle market has experienced a continued influx of financing terms that were traditionally featured in large cap financings. As was the case in the past several years, 2023 appeared to be no exception; large cap financing terms continued to appear in middle market transactions in a manner generally consistent with prior years. However, significant economic uncertainty arising towards the end of 2022 and continuing through the beginning of 2023 brought about changes in documentation that the market has not seen in recent years. During this time, certain lenders (e.g., lenders able to fill large capital needs at closing or as part of an ongoing growth strategy, and lenders able to invest at higher closing leverage levels) enjoyed some increased negotiating leverage and in some cases showed a willingness to walk away from, or decrease investments in, transactions with unfavourable terms. Lenders focused on obtaining more meaningful financial covenant protections, tightening debt incurrence, reducing capacity to engage in transactions (including making investments and dividends) that decrease the value of lenders' collateral, and removing borrowers' flexibility to restructure debt in a manner that decreases the position of current lenders' *vis-à-vis* other classes of creditors. Given that the large cap terms assume a profitable, durable business model and stable economic climate, this lender sentiment was unsurprising even if it represented a significant deviation from trends in preceding years. However, whatever ground gained by the lenders during this period was quickly lost towards the latter half of 2023. Lenders need to deploy capital coupled with a weak mergers and acquisitions ("M&A") market enhanced competition amongst the lenders which brought back a loosening of the same terms that were recently tightened. We expect some continued insistence for lender protections in deals with large cap financing terms, in light of the cautious economic outlook, but anticipate this sentiment to remain in tension with lenders' need to remain competitive on deal terms as the M&A market opens back up in 2024.

Although middle market lenders' appetite for certain large cap financing terms differs based on institutional biases and the nature of specific investment opportunities, the treatment of large cap financing terms in credit documents can be evaluated in light of the size of the borrower's consolidated EBITDA. As a general matter, 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/or additional lender protections intended to mitigate the inherent risks in such terms becomes more prevalent. This allows us to divide the middle market into "lower middle market", "traditional middle market" and "upper middle market" bands for purposes of this analysis and discussion.

This chapter will highlight notable current events in the private credit market as well as examine certain key financing terms and trends across the lower, traditional and upper middle market bands using Proskauer's proprietary data. The analysis will also discuss the related market drivers and trends influencing the continuing evolution of private credit deal terms.

Background

The private credit market has been making headlines for some time due to its rapid expansion, fuelled by a growing investor base, a surplus of available capital and a compelling yield proposition. In 2020 through 2022, the private credit market demonstrated resiliency in the post-COVID environment, which bolstered further interest in the asset class. Investors continued to enjoy durable interest rates and low levels of default across existing credits. While investors navigated a temporary slowdown in Q1 2020, the number of new financing opportunities coming to market quickly rebounded, despite the economic uncertainty of those years.

The private credit market remained somewhat strong for the duration of 2020. The year 2021 was a standout year for the asset class, with our data showing a 55% increase in deal activity as compared to the prior year. Deal activity in 2022 returned to 2020 levels, according to our data, but remained strong in the face of economic uncertainty and predictions by many experts that COVID-19 would lead to one of the deepest recessions in U.S. history. As we closed out 2022, cautious predictions of economic growth and a continued expansion of the current credit cycle turned to bleaker predictions and fears of a recession for some. Persistent high inflation, crippling housing prices, increasing interest rates, gross domestic product slowdown and ongoing crisis in Ukraine (among other factors) impacted markets and the economy in 2022 and left investors with significant uncertainty for 2023.

During 2020 and 2021, many industries (e.g., delivery services, online retailers, online entertainment and tech) were unaffected by or even expanded as a result of COVID-19, which helped to quell fears of an impending economic crash and high rates of default for existing credits. In 2020, our data revealed that events of default in active deals (i.e., deals previously closed by Proskauer that remained active in that year) was 5.45%, and payment defaults accounted for only 1.65% of that total. According to our data, events of default in active deals then decreased to 1.56% in 2021 (with payment defaults accounting for only 0.48% of that total) and remained at a similar level in 2022, with events of default in active deals measuring at 1.48% (and with payment defaults accounting for only 0.27% of that total).

These numbers demonstrate, in light of the state of the economy, that borrowers reaped the benefits of flexible loan documentation. In prior years, many deals were done as covenantloose or covenantlite transactions. Documentation also contained features such as borrower-favourable addbacks to consolidated EBITDA and fulsome provisions for curing financial covenant breaches in consecutive quarters. These features helped to lessen the impact on financial ratios of quarter-over-quarter decline in performance and helped borrowers avoid defaults altogether, especially in the upper middle market deals. Another focus for borrowers was to build cash reserves and maintain strong liquidity positions in anticipation of deteriorating leverage and financial performance. They were able to draw down on previously committed revolving facilities, which customarily have no leverage conditions to borrowing and no anti-cash-hoarding protection.

In the cases where borrowers' financial performance faltered in breach of financial maintenance covenants, lenders generally showed a willingness to rely on out-of-court solutions for temporary and structural relief. Many lenders offered covenant holidays, additional addbacks to bolster consolidated EBITDA and leverage levels in the short term, and even deferred or accepted PIK interest payments on the loans. Lenders also showed a willingness to step in with capital infusions that helped keep defaults and bankruptcy proceedings to a minimum.

Events of default in 2023 under active deals was 1.70%, with payment defaults accounting for only 0.2% of that total. Our data is consistent with year-end default rates reported by Fitch (3.04%) (as of 12/20/2023) and S&P Global Ratings (4.36%) (as of 11/30/2023). While these rates remain low, in part because of the continued flood of new deals into the data set (as well as the flexible financial covenants and loan documentation discussed above), we believe the levels are an accurate portrayal of the relative health and resiliency of the private credit market. In 2023, lenders continued to show flexibility in out-of-court solutions to covenant breaches and liquidity shortfalls. Our 2023 data set covers 67 restructuring transactions, which are further discussed below.

Over the last few years, the asset class continued to perform well in light of the economic climate. We saw an expanding investor base, growing allocations to private credit strategies, significant amounts of available capital and fierce competition in the face of a limited supply of attractive investment opportunities. Non-bank lenders made headlines with record-breaking jumbo unitranche financings. Bank lenders took an interest in lower priced "super-priority" revolving facilities, which allow them to be repaid first in a downside scenario and effectively de-risk the higher leverage levels found in private credit transactions. Given all of this, competition to place capital remained high despite significant deal flow. Data from 2021 demonstrated the significant uptick in deal flow, pulling from 317 private credit transactions (*vs.* 204 transactions in 2020).

The year 2022 ushered in the end of the persistent low-yield environment. The Federal Reserve bank increased interest rates in March of 2022, and again on 10 other occasions. The private credit market responded and started to slow in 2022, with our 2022 data pulling from 250 private credit transactions.

The year 2023 was disruptive in many ways. Demand for financing transactions in the broader market appears to have dropped. However, despite rates remaining high and an overall slowdown of M&A activity, our data set grew dramatically from prior years. Our 2023 data includes 359 private credit transactions, a significant increase compared to previous years (noting that this deal count includes 178 incremental loans and a significantly higher number of restructuring transactions than in years past).

As we close out 2023, the market continues to grapple with a high cost of financing, geopolitical tensions, fear of recession and an upcoming presidential election. Despite this, many lenders still feel that the private credit market continues to hold significant opportunities. Allocations to the asset class remain strong given reduced competition from traditional lenders, high interest rates and opportunities in distressed credits. Many feel that the M&A market will soon stabilize, and optimistically predict deal activity will recover in 2024 despite the challenging headwinds.

Emerging Developments in 2023

Liability management transactions

Liability management transactions – transactions that allow an issuer to refinance or restructure its outstanding obligations, often without the consent of lenders – continued to be a significant focus for lenders in 2023. Liability management transactions are most often consummated when a borrower's financial performance and/or liquidity position has deteriorated. As a result, the borrower's existing loans may be trading at a steep discount and the borrower is likely in default or contending with impending defaults under its loan documentation. Given the current economic climate, borrowers may be looking for creative ways to restructure debt, increase liquidity and avoid defaults under existing loan documentation. This section covers a handful of recent transactions and resulting changes to loan documentation.

"Serta" protections

In 2020, borrowers in Serta Simmons, Boardriders and TriMark consummated controversial transactions that subordinated lenders' loans with only the consent of the majority holders (or "Required Lenders") rather than all lenders. Since this time, minority lenders have successfully pushed for protective provisions in loan documentation (commonly referred to as "Serta" protections) to avoid a similar result. In 2023, lenders continued focus on and advocated for the retention of these protections in loan documentation across the middle market. In the most lender favourable formulation, the "Serta" protections require that any amendments or other modifications to the loan documentation that subordinated the lenders' liens or payments on the lenders' obligations to other debt be approved by all lenders. Borrower favourable formulations of the "Serta" protections will only require lender consent from those lenders who were not given a *bona fide* opportunity to participate in the priming debt on a *pro rata* basis. In this formulation, if a lender is given the opportunity to participate in the new transaction but refuses, such lender is not needed to approve the amendment or modification. Borrowers may also enjoy additional carve outs to the "Serta" protections (e.g., they do not apply to DIP facilities, they do not apply to certain other types of priming debt like capital leases or purchase money debt, and backstop fees (or fees generally) do not need to be offered *pro rata*). In all cases, the "Serta" protections will only address the risk of contractual subordination of the lenders' loans. We contrast this with structural subordination of loans (i.e., non-guarantor entities in a borrower's organizational structure incur debt directly following a permitted investment by the borrower or a guarantor to such non-guarantor entity in the form of assets that were previously collateral for existing loans), which is an equally problematic result for existing lenders (see "Envision" Protections below).

"Serta" protections must be accompanied by minority lender protections against the Required Lenders amending or eliminating provisions in loan documentation that provide for *pro rata* sharing of loan payments, *pro rata* application of collateral proceeds and set out the payment waterfall following an event of default. In 2017, the borrower in Not Your Daughters Jeans ("NYDJ") entered into back-to-back amendments to its loan documentation that: (i) first, provided for an additional $20 million of incremental financing and eliminated the financial covenant; and (ii) second, amended the waterfall and *pro rata* sharing provisions in the credit agreement in order to elevate the payment priority of the new $20 million incremental financing and the existing term loans held by the majority lenders that approved the first and second amendments, which then came ahead of all other existing term loans held by the minority lenders. In this loan documentation, the waterfall could be modified by the Required Lenders and the *pro rata* sharing provisions could be modified by a majority of the adversely effected class (which, in this case, meant a majority of the holders of the sole class of term loans under the credit agreement). Minority lenders were not offered any opportunity to participate in the priming transaction. This priming transaction is different than what occurred in Serta because the subordination is done within the confines of the existing loan documentation, rather than pursuant to a separate credit facility. However, the effects on minority lenders' loans are the same; they end up with subordinated loans. Since the NYDJ case, which was ultimately settled without a ruling, it has become more common in all parts of the middle market for modifications to *pro rata* sharing and payment provisions and waterfalls to be sacred rights (i.e., to require the consent of all lenders or all adversely effected lenders). Minority lenders continued to push for these sacred rights in 2023 and will most likely continue to do so in the future.

"Envision" protections

In 2022, the borrower in Envision Healthcare highlighted the flexibility for structural subordination of loans by a series of transactions that permitted it to obtain new financing not otherwise permitted under the loan documentation. In order to achieve this result, Envision Healthcare designated a large portion of its profitable ambulatory surgery ("AmSurg") business as an unrestricted subsidiary under the credit agreement (the result being that the assets were no longer collateral and the entity was no longer bound by the terms of the loan documentation, including the limitations on debt and lien incurrence). The unrestricted subsidiary then incurred a total of $2.6 billion in first and second lien senior secured financings using the AmSurg business as collateral. This was done alongside an uptier exchange transaction approved by the existing Required Lenders, resulting in three priming tranches of debt and leaving the existing minority lenders with fourth priority debt secured by a stripped-down collateral package.

This transaction hinged on Envision Healthcare's material capacity to make investments in and to designate unrestricted subsidiaries. In response to this, lenders are showing a renewed interest in placing limitations around the total capacity for unrestricted subsidiaries in a borrower's organizational structure. Lenders may push for the inclusion of a *pro forma* leverage test for the designation of entities as unrestricted subsidiaries and be more restrictive about the capacity for investments in unrestricted subsidiaries. That can be accomplished by limiting designations of/investments in unrestricted subsidiaries to a specific negotiated investment basket for that purpose, rather than allowing a borrower to stack available investment baskets and permitting reclassifications of prior uses of investment baskets to free up maximum capacity at any given time. In some deals, lenders may also seek to cap the total size of unrestricted subsidiaries (typically expressed as a percentage of the total consolidated EBITDA and assets of the restricted group) at the time any entity is designated as an unrestricted subsidiary or, in tighter deals, at all times during the life of existing loans. Finally, lenders have showed a renewed interest in including the full suite of lender favourable "Chewy" protections into loan documentation. "Chewy" protections, in part, restrict unrestricted subsidiaries from owning equity of, or holding debt of or liens on the assets of, entities that constitute the restricted subsidiaries (including the borrower and the guarantors of the existing credit facility), and have been watered down in larger deals following their introduction in 2019. While these lender protections are common features of the unrestricted subsidiary concept in traditional middle market financings, they have started to creep back up into the larger deals in some cases.

Interest payments and MFN protections

In December 2022, Diebold Nixdorf made headlines for a creative play that circumvented the standard sacred right preventing an extension of a scheduled payment of interest under the credit agreement without the consent of all lenders. Credit agreements are typically structured so that a borrower is in "default" if it misses an interest payment but an "Event of Default" does not occur until the passing of a short grace period for the borrower to correct the late payment. The grace period is typically three to five business days but will vary across the middle market, and the "default" will go away if the borrower makes the interest payment before the expiration of the grace period. In this case, the borrower extended the grace period applicable to interest payments on its 8.5% bonds until the bond maturity date in 2024. The borrower did not waive or extend the interest payment but extended the grace period for as long as the bonds were outstanding so no "Event of Default" would ever occur from the non-payment of the interest. Grace periods applicable to any type of default (including a payment default) can be modified by Required Lenders in virtually all middle market loan documents. This extension mechanic has since been deployed by other borrowers in the market. While the market has not yet coalesced around a solution to this minority lender issue, lenders are becoming more focused on the loophole and may seek to close it in transactions where they have negotiating power.

Pricing MFN provisions also became a significant focus in 2023. Credit agreements customarily provide some form of pricing protection in the form of a "pricing MFN" (which may have a range of carve outs and limitations). This concept is discussed in further detail in the "Debt Incurrence" section of this chapter. Typically, the pricing MFN will require that the all-in yield of the closing date loans is increased to match (less a differential, e.g., 50 basis points) the all-in yield of any new incremental or other loan that is *pari passu* in payment and lien priority. The calculation of all-in yield takes into account interest rate and certain types of closing fees associated with new debt incurrences. The pricing MFN will not be triggered if the existing loans are priced higher than the new loans, if the new and existing loans are priced the same, or if the new loans are priced higher than the existing loans but not greater than the agreed differential (e.g., not more than 0.50% higher than the existing loans). Historically, borrowers have been able to issue incremental financing under an existing credit agreement on consistent pricing terms as compared to the original loans. On a market level, borrowers enjoyed a strong economy and a large base of investors eager to deploy capital into attractive investment opportunities. Sustained growth and high lender competition helped to stabilize pricing at favourable levels for borrowers. As the economy faltered and rates increased in 2022 and 2023, borrowers frequently needed to obtain additional financing under existing credit agreements at higher interest rates. In order to preserve liquidity and keep the costs of the existing loans down, borrowers prefer not to trigger the pricing MFN. Existing lenders may increasingly find that the lenders providing the new loans to a borrower agree to structure their fees in a way that does not trigger the pricing MFN even though they are receiving additional compensation for the new loans that effectively creates a significant difference in yield. This is often a minority lender issue because the lenders that provide new loans to an existing borrower are most frequently the lenders holding the largest amounts of the existing loans or Required Lenders. Required Lenders may also elect to waive the application of the pricing MFN in connection with new loans issuances that they provide or otherwise support. The pricing MFN can be modified by Required Lenders in virtually all middle market loan documents. While we have not seen a market shift away from this construct in most middle market documents, lenders are starting to request fulsome definitions of all-in yield that more accurately capture different forms of yield and limit a borrower's ability to structure around the pricing MFN.

"Double dips"

Over the last handful of years, the risks of dropdowns (e.g., J. Crew, PetSmart, Neiman Marcus, Revlon, Envision) and non-*pro rata* uptiers (e.g., Serta, Boardriders, TriMark, Incora, Envision) have received significant publicity. Lenders have become savvy about how permissive loan documentation can be and, in many cases, insist on fulsome sacred rights and tighter controls around value shifting away from the collateral pool, either at the outset of a loan transaction or in connection with the tightening of loan documentation in a distressed credit scenario. In 2023, the market saw a reintroduction of the "double dip" transaction, which gained some traction as a more lender favourable alternative than the drop-down and uptier structures. Cases like At Home, Wheel Pros, Sabre and Trinseo made headlines. In a "double dip" transaction, new lenders will have two independent claims (or avenues for recovery) against an existing borrower's organizational structure through a combination of direct security and guarantees and an intercompany loan. Most frequently, an entity in the organizational structure that is a restricted subsidiary (but not a borrower or guarantor under the existing loans) or an unrestricted subsidiary (the "New Money Borrower") will borrow new loans from a new lender (the "New Money Lender"). In the first "dip", the New Money Borrower will grant the New Money Lender a standard security package in its own assets. In the second "dip", in some cases, the new loans may also be directly secured and guaranteed by the borrowers/guarantors under the existing loans on a *pro rata* basis with the existing loans. In an alternative formulation of the second "dip", the New Money Borrower would upstream the proceeds from the new loans in the form of an intercompany loan to the borrowers/guarantors under the existing loans in exchange for an intercompany loan receivable that is then pledged to the New Money Lender as security for their loans. This intercompany loan would be secured by the assets of the existing borrower and guarantors on a *pari passu* basis with the existing loans. In this second scenario, the intercompany loan would be permitted under provisions in the credit agreement that permit the incurrence of *pari passu* loans outside of the existing credit agreement (i.e., ratio debt, discussed in more detail in the "Debt Incurrence" section of this chapter). The *pari passu* debt incurrence provisions are most typically used to raise additional debt from institutional lenders but often do not prevent intercompany loans. In contrast to an uptier transaction, the new loan does not prime the existing loans. The *pari passu* secured claims of the New Money Lender dilutes the claims of the existing lenders. In contrast to a dropdown, no assets are transferred away from the collateral package supporting the existing loans. However, the "double dip" transaction can be done in conjunction with a drop-down of assets to the New Money Borrower or an uptier transaction by the existing borrower (i.e., the existing borrower uses a portion of the intercompany loan proceeds to buy back existing loans at a discount on a non-*pro rata* basis, which may be loans of New Money Lender in its capacity as an existing lender). "Double dip" transactions can also be done with a "*pari* plus" structure whereby the new loans benefit from additional guarantees from the New Money Borrower's subsidiaries (which would not be borrowers/guarantors under the existing loans).

The capacity for "double dip" transactions in any particular deal hinges on the overall capacity and flexibility in many areas of the loan documentation. The following baskets and features all work together to create opportunities for these transactions: the ability to make investments in restricted subsidiaries that are not borrowers/guarantors and in unrestricted subsidiaries, significant debt and lien incurrence capacity of restricted subsidiaries that are not borrowers/guarantors; the absence of "Chewy" protections that prevent unrestricted subsidiaries from holdings debt and liens of restricted subsidiaries (including the borrower and any guarantor); and "*pari* plus" debt capacity whereby *pari* debt that is permitted under the credit agreement can also benefit from additional collateral and guarantees not provided to existing lenders. Lenders may also consider including overriding provisions in loan documentation that require any intercompany debt be unsecured and subject to a customary subordination agreement (given that the typical formulation of "ratio debt" does not include any restrictions on it being provided by a non-guarantor restricted subsidiary).

Restructuring trends

While the US economy avoided a recession in 2023, many borrowers struggled to maintain financial performance and liquidity against the backdrop of rising inflation and borrowing costs and a slowdown in growth. Our data shows 67 restructuring transactions in 2023, which comprise capital infusions, debt to equity exchanges, refinancings of existing loans, "amend and extend" transactions and other material amendments to loan documentation in connection with a default or potential default under existing loan documentation. In 30% of restructuring transactions, lenders extended the maturity date of their loans. Given the current high cost of capital (especially for a struggling borrower) and the lower number of investment opportunities in 2023, maturity extensions or "amend and extend" transactions can be a good outcome for both borrowers and lenders. Our data showed that of the maturity extension transactions, most of the extensions were for at least one year. In 35% of these cases, maturity was extended by at least one year but not more than two years. A total of 40% of the extensions were for two or more years.

In restructuring transactions that included capital infusions, lenders overwhelmingly stepped up and provided additional capital in 90% of cases. In 58% of these cases, the additional debt was *pari passu* (or treated on an equal and *pro rata* basis in terms of lien and payment priority) with the existing loans. Lenders provided, 26% of the time, additional capital in the form of a super senior tranche of debt to mitigate their risk of recovery from a declining business. We saw that in the large majority of cases, specifically in instances where the borrower's issues were viewed to be temporary, the lenders did not require borrowers or their private equity sponsor to provide additional collateral or guarantees. Closing fees on new capital infusions remained in the range of closing fees for new transaction loans, with 2%–3% closing fees in 48% of the lender-provided capital infusions. However, 14% of these transactions came with closing fees in the 3%–4% range which is higher than what our data typically shows for closing fees on new financings. In a minority of these transactions (and typically where liquidity was at issue), fees for lenders would be paid in kind and added to the principal of the outstanding loans or structured as an "exit fee", which defers cash payment until the repayment of the loans.

As is expected, lenders generally looked for enhanced economics to compensate them for the higher risk of continuing to lend (and for making more loans) to a faltering borrower. In 56% of the restructuring transactions, lenders increased the interest margins on their loans. A breakdown of the amount of such increase across our data set is as follows: (i) 0.5% or less in 21% of cases; (ii) more than 0.5% but not more than 1% in 48% of cases; (iii) more than 1% but not more than 3% in 18% of cases; and (iv) more than 3% in 12% of cases. Our data demonstrates that lenders showed flexibility in their approach to enhanced pricing and gave support to borrowers with liquidity concerns. In restructuring transactions with an increased interest rate margin, 59% contained a PIK feature which allowed at least some portion of interest on the loans to be paid in kind (and 35% of these deals with PIK features permitted the borrower to pay the entire interest payment in kind).

Financial covenants were a focal point for lenders in restructuring transactions. In 74% of cases, the financial covenants were modified (i.e., reset or enhanced with additional tests). As discussed herein, the most common type of financial covenant in private credit loan documentation is a leverage test. Where modified in restructuring transactions, lenders gave borrowers temporary relief from the leverage covenant 80% of the time. A breakdown of the length of time that relief was given in these transaction is as follows, but relief timeframes generally take into account the projections for a specific borrower's performance: (i) less than six months in 10% of cases; (ii) six months or more, but not more than one year, in 21% of cases; (iii) one year or more, but not more than two years, in 33% of cases; and (iv) two years or more in 36% of cases. In restructuring transactions with leverage covenant relief, a full covenant holiday (i.e., no leverage covenant tested for the relief period) was given 32% of the time. In the other cases the leverage covenant was readjusted based on the borrower's leverage level and current and projected financial performance. Where financial covenants were modified, the definition of Consolidated EBITDA made less borrower favourable in 27% of cases. Limiting or removing addbacks in the definition of Consolidated EBITDA would lead to an increased leverage ratio, so this change to the loan documentation would generally be made in conjunction with resetting the leverage covenant in order to prevent an overall tightening of the leverage covenant at a time where the borrower needs relief. Additionally, where financial covenants were modified, our data showed 46% added or tightened the terms of an existing liquidity covenant. Most commonly, liquidity was tested on a monthly basis or a minimum liquidity level was required to be complied with by a borrower at all times.

Lenders also included reporting covenants into loan documentation in order to keep a pulse on the borrowers' financial performance. A total of 46% of the restructuring transactions included a 13-week cash flow deliverable. This is a cash flow model that provides visibility on a weekly basis into the projected liquidity of a borrower and 28% of the restructuring transactions required borrowers to provide periodic budget variance reporting. In 29% of cases lenders received a right to monthly calls with management, and in 26% of cases lenders received board materials.

Finally, our data showed that the loan documentation for the restructuring transactions generally included less flexibility than the pre-restructuring loan documentation. Lenders may remove or limit a borrower's access to discretionary baskets for dividends and junior debt payments. They may also increase restrictions on additional debt incurrence and a borrower's ability to make investments. Lenders also typically revisit the existing loan documentation in the restructuring process to ensure that the typical loopholes for liability management transactions are closed. A discussion on selected liability management transactions is included above.

Overview of Proskauer Rose LLP Private Credit Transactions in 2023

The top five industries represented in middle market transactions, as shown by our data, include: (a) Business Services; (b) Health Care/Life Sciences; (c) Consumer Goods & Services/Retail; (d) Construction; and (e) Technology. These primary industries comprise 68% of our deals in 2023. Business Services was the leading industry for transactions in 2023 (overtaking Health Care/Life Sciences) and accounted for 21% of deals, up from 8% in 2022. First lien, second lien and senior secured transactions remained high for the year, whereas mezzanine loan transactions represented 2.65% of all deals in 2023 (slightly up from 1% in 2022, but markedly decreased from 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 recent years). In 2015, only 16.7% of deals had margins less than 7%. In 2023, the percentage of deals having margins less than 7% was 60% (in contrast to 87% in 2021 and 68% in 2022). In light of the increased liquidity burden on borrowers from rising interest rates in 2023, lenders in certain transactions were willing to receive a portion of the interest payments in kind. Our data showed that the "PIK" feature may be structured as a static percentage of the overall margin or as a toggle feature whereby a borrower can elect to pay the interest in cash or in kind, with the rate for in kind payments being higher than the cash pay rate. With respect to commitment fees and original issue discounts (OID), in 2023, 26% of commitment fees and OID were between 2%–2.49% of the principal amount of the loans and commitments at closing, with 67% in commitment fees and OID over 2.49% in 2023. Overall, rates of OID were higher in 2023 than in the previous year.

Closing leverage for middle market transactions in our data dropped to 4.6× in 2023 (*vs.* 5.1× in 2022). A total of 67% of deals had a closing leverage between 4.00× and 6.99× (higher than 57% of deals in 2021 and 48.7% in 2022, indicating that closing leverage was more closely concentrated in this range and varied less across the data set than in prior years). Trends in closing leverage should also be considered in light of parameters relating to the calculation of consolidated EBITDA across the middle market. In transactions with EBITDA greater than $50MM, 61% of them had a cap on general non-recurring expenses as an addback to EBITDA (up compared to 2021 (at 44%) and 2022 (at 51%) and still significantly more lender favourable than 25% in 2020). In transactions with EBITDA that is less than $50 million, 67% of them had a cap on general non-recurring expenses (which is fairly consistent with 62% in 2021 and 66% in 2022). Addbacks for run-rate cost savings/synergies and restructuring costs continue to be more or less ubiquitous in the middle market. Similar to the cap on addbacks for general non-recurring expenses, the cap on restructuring costs tends to fall away in larger deals (although even in larger deals, lenders have shown an appetite to push for a cap on this addback in 2023). We continue to see a negotiated cap on the addback for cost savings/synergies across the middle market. This cap applies with increasing frequency only to cost savings/synergies applicable to acquisitions and restructuring activities after the initial closing date of a financing (but not to cost savings/synergies applicable to closing date transactions). While lenders in certain upper middle market deals may also agree to expand the scope of the addback to allow for the inclusion of "revenue enhancements" (contrasted with cost savings), lenders have generally shown a greater focus on tightening the EBITDA definition in loan documentation and this has not been accepted as a common term in 2023.

Covenant lite deals, meaning deals that do not contain a typical financial maintenance covenant, dropped to 8% (*vs.* 7% in 2021 and 51% in 2022) in deals with EBITDA greater than $50 million. Respectively for this EBITDA band, our data shows covenant loose transactions comprise 42% (which is also down from 71% in 2022). Although the financial covenant is typically limited to a total leverage ratio test (or, less frequently, to a first lien leverage ratio test), in 2023, 30.19% of our deals also included a fixed charge coverage ratio test. This is up from 12% in 2021 and 21% in 2022. Of the transactions with financial covenants, 24% of them had five or more covenant step-downs (down from 35% in 2021 and similar to 23% in 2022). Of transactions with step-downs, 64.79% of them had EBITDA of less than $50 million. Step-downs tend to fall in transactions with EBITDA over $50 million but may still be present. This data shows that protections around financial covenants have shifted in favour of lenders in 2023.

The general trend towards borrowers' counsel controlling the drafting process at both the commitment papers stage and the definitive deal documentation stage continued in 2023. 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 good 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 additional debt (both as an upsize debt incurred pursuant to an existing credit agreement, and as new debt pursuant to a "side car" or other debt incurred pursuant a new credit agreement) was one of the most transformative structural changes to make an appearance in the middle market. Consistent with 2022, 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, lenders in traditional middle market financings have had some success in excluding incremental equivalent facilities and other forms of ratio-based indebtedness from new financings.

Incremental facilities and incremental equivalent facilities

An incremental facility (also 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).

Additional debt facilities appearing in 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 69.91% of traditional middle market deals include incremental facilities, which is down from 75.71% in 2022. Additionally, 43% of traditional middle market deals include both incremental facilities and incremental equivalent facilities, down from 64% in 2022.

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 traditional middle markets deal with incremental facilities will contain a starter basket for the incremental facility equal to 1.0× of consolidated EBITDA. 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. In larger deals, there may also be an alternative test for the incurrence of incremental facilities used to fund permitted acquisitions and other permitted investments. In such instances, the leverage ratio condition will be compliant with the leverage ratio of the borrower immediately prior to giving effect to such acquisition or investment. Additionally in larger deals, borrowers will frequently push for a fixed charge coverage ratio test (of no less than 2×) *in lieu* of the ratio-based test for unsecured incrementals. 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 and permitted investments is not widely adopted and the middle market has showed a continued aversion to the use of an interest coverage test for unsecured incrementals).
- Data reveals a continuing trend in the traditional middle market to allow for both a starter basket and an unlimited amount. 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.
- 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.
- The approach described above is accepted in the upper middle market and is becoming commonplace in traditional middle market transactions. More conservative deals in the traditional middle market will 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, most often, automatically) incremental debt which was originally incurred under the fixed amount as incurred under the ratio-based unlimited amount (thereby reloading the fixed amount capacity); 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 in more conservative deals may resist a borrower's ability to automatically reclassify incremental debt originally incurred under the fixed amount as incurred under the ratio-based unlimited amount or may request the borrower notify the lender of any such automatic reclassification to address the challenges around tracking incurrence capacity on an ongoing basis.
- 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 permanent 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), (b) 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 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 the upper middle market deals (but not traditional middle market 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, often with a grower component.

  These terms have been adopted in the upper middle market. The traditional middle market does not contain significant variations but more conservative deals may also contain additional restrictions on greater than *pro rata* voluntary prepayments with the existing term loans (but not restrictions on *pro rata* or less than *pro rata* voluntary prepayments). The lower middle market may only allow for the incurrence of incremental debt that is *pari passu* with the existing 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 lower 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 (generally referred to as the "MFN" or most favoured nations provisions). The protections typically require that the all-in yield of the credit facility extended on the original closing date 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 was greater than 50 basis points above the existing credit facility. This differential can be 75 basis points in large cap and certain upper middle market transactions. In large cap 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. Traditional middle market lenders have historically had significant success maintaining the MFN provisions without a sunset and have recently been even more sensitive to any erosion of their pricing protections. In 2023, our data showed only rare occurrences of the MFN sunset in middle market transactions. When we did see it, the period ranged from 18 to 24 months. In 2022 and 2021, approximately 60% of the traditional middle market deals with MFN provisions include a sunset period. The stark change we see in 2023 compared to previous years hints at the collective outlook of lenders on the future of the market.

  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 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 or fees payable to lenders generally (for example, OID and upfront fees), thereby making it easier to remain below the MFN trigger threshold; and (ii) 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 (ii)(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 (unless, in the case of an incremental equivalent facility, issued in the form of syndicated high-yield notes). However, lenders in the traditional middle market typically push back on the multitude of carve-outs and exceptions discussed in the paragraph above. In addition, the lower middle market may also require that the impact of the MFN provisions apply to all debt outstanding under the credit facility, including incremental loans previously funded (*vs.* only the closing date borrowing).

  A new area of focus for lenders across the middle market in 2023 was how the MFN provisions are applied when the interest rate applicable to existing loans is leverage based (i.e., fluctuates based on the current leverage ratio of the borrower) and the interest rate applicable to the incremental financing has a fixed margin, or *vice versa*. Middle market loan documentation does not expressly address this construct and takes the measurement of the yield differential at the time the incremental loans are incurred. This can lead to perverse outcomes in pricing grids and missed opportunities for lenders to further enhance interest rates on existing debt. Illustrative examples are included below.

  A lender has an existing loan governed by the following pricing grid. Level 2 is currently applicable. The borrower incurs a *pari passu* incremental facility with a 6.75% pricing margin. Pursuant to the 50-basis point MFN protection for an existing loan, the borrower is required to adjust the margin of the existing loan up to 6.25% and applies that margin increase to Level 2 of the pricing grid. Levels 1 and 3 are not changed, given they are not currently in play. In this case, the borrower actually enjoys a margin *decrease* to 5.75% if its leverage increases over 5.25:1.00.

Pricing Level	Total Net Leverage Ratio	Pricing Margin
1	> 5.25:1.00	5.75%
2	**≤ 5.25:1.00 but > 4.75:1.00**	**5.50%**
3	≤ 4.75:1.00	5.25%

In a second scenario, a lender has an existing loan with a 5.25% pricing margin. The borrower incurs a *pari passu* incremental facility governed by the following pricing grid. Level 3 is currently applicable. Pursuant to the 50-basis point MFN protection for existing loan, the borrower does not have to make any adjustments to the margin of the existing loan since it is within the 50-basis point differential at the current time. However, if leverage later increases over 5.25:1.00, the incremental facility would have a pricing margin that is 0.75% higher than the existing loans.

Pricing Level	Total Net Leverage Ratio	Pricing Margin
1	> 5.25:1.00	6.00%
2	≤ 5.25:1.00 but > 4.75:1.00	5.75%
3	**≤ 4.75:1.00**	**5.50%**

Lenders have started to push for the inclusion of language that clarifies the MFN treatment in cases like those highlighted above. One common formulation is that, to the extent that any adjustment is effectuated pursuant to the "pricing MFN" provision and the applicable existing loans are subject to a pricing grid, the applicable yield differential will be applied to each "level" in that pricing grid in a manner such that the relevant rate differential among each "level" in such pricing grid is maintained both prior to and after the application of such "pricing MFN" adjustment. In our first example, each level of the pricing grid would be increased by 0.75%. In addition, to the extent that the applicable existing loans are not subject to a pricing grid but the applicable incremental facility is subject to a pricing grid, the "pricing MFN" provision will apply to each level of such pricing grid. In our second example, the existing loans would benefit from a step up in pricing with a 5.75% margin in the case that the total net leverage ratio > 5.25:1.00. In light of the economic climate in 2023 and the beginning of 2024, we anticipate that lenders will continue to focus on tightening the MFN provisions in loan documentation.

Use of proceeds:

- In upper middle market and traditional middle market transactions, proceeds from incremental and incremental equivalent debt can be used for any purpose not prohibited by the existing credit agreement. Lower middle market deals may limit incremental/incremental equivalent use of proceeds (e.g., permitted acquisitions and similar investments and permitted capital expenditures). If a lower middle market financing permits all uses of proceeds, certain uses like dividends and payments of junior debt may be conditioned by stricter leverage tests.

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 in almost all cases). 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 (and only in in cases where this type of test appears for unsecured incremental facility incurrence). If the ratio debt is leverage-based, the leverage test is typically set at the same level required for incurrence of incremental and incremental equivalent debt. Lenders continue to be focused on the capacity of a borrower's subsidiaries that are not guarantors to incur ratio debt, with this cap being an area of significant negotiation in middle market loan documentation. In upper middle market transactions, 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. For instance, there may be no requirement that covenants and events of default be substantially similar, or no more favourable, to the lenders providing such ratio debt than those applicable to the existing loans. 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 but this restriction typically only appears in the more conservative deals. Additionally, the traditional middle market will almost always require that any pricing MFN provisions applicable to incremental and incremental equivalent debt also apply to ratio debt that is *pari passu* to the credit facility obligations. As noted above, lenders have recently shown an increased sensitivity to erosion of pricing protections and this term is notably migrating up market and appearing with increasing frequency in upper middle market financings. Our data shows that 46.9% of traditional middle market deals now permit ratio debt, compared to 65% in 2021 and 58.73% in 2022. 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 permitted investments, referred to as an "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 in cases where this type of test appears for unsecured incremental facility incurrence. 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. These approaches will typically be consistent with what is permitted in respect of ratio debt in a particular credit agreement. Similar to ratio debt, it is 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 only allowing indebtedness that is assumed in connection with permitted acquisition or similar investment (rather than incurred to finance it) 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 on the same basis as ratio debt would. Upper middle market deals have also increasingly adopted this protection with respect to acquisition debt.

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 middle market (including, more recently, in the lower middle market). An available amount basket (also 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 as an attempt to recognise 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 92% of traditional middle market deals include the available amount basket concept, compared to 90% in 2022, 85% in 2021 and 77% in 2020, despite headline-making 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). Although not necessarily based on a percentage of the borrower's EBITDA, the starter basket amount is often 25%–40% of the borrower's EBITDA. The available amount basket in upper and traditional middle market transactions (but less frequently in the lower middle market) will often include this starter basket amount. Our data shows that 100% of traditional middle market deals with the available amount basket include a starter basket amount, compared to 100% in 2022 and 93% in 2021.
- *Retained Excess Cash Flow or a Percentage of Consolidated Net Income*: typically in upper and middle market deals, the available amount basket will include a percentage of consolidated net income or retained excess cash flow, at the borrower's election. The consolidated net income option is preferable for a borrower because it will have immediate access to amount (while excess cash flow often will not be recognised until after the first full fiscal year following the closing date; provided that the gap on this point is closing and upper middle market credit agreements may provide for quarterly excess cash flow calculations for the sole purpose of increasing the available amount). The difference between using consolidated net income or retained excess cash flow 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 first full fiscal year following the closing date. In contrast, traditional middle market deals will generally only include retained excess cash flow. Recently, however, lenders are removing the borrowers' ability to choose between a percentage of consolidated net income or retained excess cash flow and requiring that retained excess cash flow be included instead.
- *Contributed Equity*: if the available amount basket is included in the financing, 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 (however, the concept of an amount being "not otherwise applied" will be construed differently depending on which part of the market a transaction is in). It is also commonly accepted that equity contributions made on the closing date of a transaction, in connection with an equity cure of the financial maintenance covenant, or to the extent in the form of "disqualified equity" 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 may include such returns only to the extent they are in cash or cash equivalents and/or only to the extent they do not otherwise build investment capacity pursuant to other provisions of the loan documentation. It is common in the middle market to 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 and the traditional middle market have generally accepted the addition of debt exchanged for equity in the calculation of the available amount basket.
- *Redesignation or Sale of Unrestricted Subsidiaries*: in upper middle market and traditional 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.

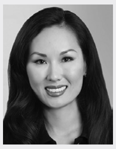
- *Other Builder Components in Upper Middle Market Financings*: in upper middle market transactions, borrowers may also push to include increases to the available amount basket for (i) the fair market value of any secured debt that has been contributed to the borrower or any of its restricted subsidiaries, and (ii) in cases where less than 100% of asset sale proceeds are required to be applied as a mandatory prepayment of the existing loans, the portion of such asset sale proceeds that are permitted to be retained by the borrower and its restricted subsidiaries. The upper middle market has not fully accepted these available amount basket components and lenders will frequently push back.

The conditions around the usage of the available amount basket vary greatly and the traditional middle market and lower 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 and many traditional 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 and larger traditional 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 most 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, but much less frequently, to the starter basket amount as well). In lower middle market deals and in smaller traditional middle market deals, the approach will typically 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. These conditions will include a no event of default condition and *pro forma* compliance with a leverage ratio test (which often does not apply to investments) which, depending on the proposed use of the basket, can be inside the closing date leverage by as much as 0.5× to 1.0×, and even up to 1.5× in more conservative transactions.

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 2023, our data generally demonstrated a continued adoption of large cap terms consistent with 2022 but with some restraint (and in some cases, enhancements of lender protections) in light of the increased risk of borrower defaults and the ripe climate for liability management transactions in an uncertain economy. This may be intuitive in light of the continued increase in competition to place capital in the private credit market. Lenders are likely to remain cautious and continue to advocate for lender protections in legal documentation but will need to weigh these considerations in the year ahead against remaining competitive on deal terms as the M&A markets begin to re-open. This influx of terms 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. Consistent with 2023, we expect new deal volume to remain depressed in the beginning of 2024. Lenders will nevertheless remain active and engaged as they make add on incremental financing to support existing portfolio investments and manage restructurings of older credits. The M&A market is anticipated to pick up midway through 2024, and we expect fierce competition among well capitalized lenders to win new investment opportunities.



Sandra Lee Montgomery is a partner in Proskauer's Private Credit and Finance Groups, a member of the Executive Committee and prior co-Chair of the New Business Committee. She is a recognized leader in banking & finance, having closed multiple billions of dollars in transactions for first- and second-lien senior lenders, mezzanine investors and equity sponsors across the United States. She advises on senior debt, mezzanine and private equity financing arrangements, particularly those involving private sources of capital. Her areas of focus include acquisitions, recapitalisations 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 deep experience in a wide range of businesses and has extensive knowledge of Article 9 of the Uniform Commercial Code and other laws that relate to secured transactions. She 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.

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The Private Credit Group at Proskauer is a unique finance practice with a breadth and diversity that is unmatched in the industry. We consistently close more than 200 deals a year, which provides us with a keen insight into market trends regarding deals of all sizes, structures and sectors. Over the past five years, Proskauer has been involved in over 1,200 deals for more than 100 private credit clients across the U.S. and Europe with an aggregate transaction value exceeding $350 billion. We are exclusively dedicated to private credit investors, representing credit funds, business development companies and other direct lending funds in connection with "clubbed" and syndicated credits, preferred equity, recurring revenue, special situations and alternative investments. Our technical strength, combined with our expansive experience, makes us the firm of choice for first-in-kind transactions. We have developed innovative structures such as upside-down unitranches and synthetic mezzanine and have migrated the bifurcated unitranche into the European market. For more than 20 years, we have been active in the market and participated in the evolution of a number of credit products, including senior-stretch loans, unitranche loans, second lien loans and secured mezzanine.

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