

Proskauer University

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So, You Thought You Were First: Senior Debt Incurrence

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Proskauer University: Private Credit Building Blocks Series

- **Program 1**
 - Introduction to Private Credit: Deal Process, Documentation, and Structure Considerations
- **Program 2**
 - Leverage Ratios: Fundamentals and Pitfalls
- **Program 3 | Wednesday, March 29, 2023**
 - **So, You Thought You Were First?**
- **Program 4 | Wednesday, April 26, 2023**
 - Leakage: Plug The Holes BEFORE The Flood
- **Program 5**
 - Structural Risks: Sneaky Shenanigans
- **Program 6**
 - Key Market Terms and Commitment Letter Basics
- **Program 7**
 - Practical Exercise: Tricks to Quickly Spot Issues in Financing Grids

Overview

We will cover three related topics today:

1. Additional debt that is permitted to rank *pari passu* (equal) with the senior credit facility
2. Debt of specific types that is permitted to rank senior to the senior credit facility with respect to certain assets of the business
3. Additional borrowed debt that can rank senior to the senior credit facility with respect to certain assets of the business or entities in the corporate structure – even if not expressly stated

I. Permitted Pari Passu Debt

Basics of Incremental Facilities

- What are Incremental Facilities?
 - Additional uncommitted loan facilities in the form of an increase to an existing class of loans or a new class of loans
 - Term loan facilities, revolving loan facilities or delayed draw term loan facilities
 - Documented under the initial credit agreement
- Incremental facilities are permitted to rank *pari passu* basis with the initial credit facilities
 - May also be secured on a junior lien basis or be unsecured

Who Provides Incremental Facilities?

- Existing lenders may (but are not required to) provide incremental facilities
 - Existing lenders sometimes receive a right of first offer
- New lenders may also provide incremental facilities
 - Third-party lending institutions
 - Sponsor-affiliated lenders
 - In the case of incremental facilities, limitations on sponsor-affiliated lenders should apply
 - In the case of sidecar debt, such limitations may not apply

Incremental Incurrence

Term	Lender-Favorable	Middle	Borrower-Favorable
1. Free and Clear	Fixed dollar amount	Fixed dollar amount + grower	Fixed dollar amount + grower + reallocation of general debt basket
2. Voluntary Prepayment	None	Credit for prepayments and repurchases of <i>pari passu</i> debt	Credit for prepayments and repurchases of <i>pari passu</i> debt and of junior secured or unsecured debt incurred using free & clear basket
3. Effective Maturity Extension	None	Limited to extensions of the maturity of existing debt secured on a <i>pari passu</i> basis	May also include extensions of existing debt secured on a junior basis or that is unsecured

Incremental Incurrence

Term	Lender-Favorable	Middle	Borrower-Favorable
4(a) Unlimited - Leverage Ratio Test	<p><i>Pari Passu</i> – Total Leverage</p> <p>Junior – Total Leverage</p> <p>Unsecured – Total Leverage</p>	<p><i>Pari Passu</i> – First Lien Leverage</p> <p>Junior – Secured Leverage</p> <p>Unsecured – Total Leverage</p>	<p><i>Pari Passu</i> – First Lien Leverage</p> <p>Junior – Secured Leverage</p> <p>Unsecured – Total Leverage (in some cases, a fixed charge coverage test may be available)</p>
4(b) Unlimited – Incurrence Levels	<p><i>Pari Passu</i> – Closing date leverage</p> <p>Junior – Closing date leverage</p> <p>Unsecured – Closing date leverage</p>	<p><i>Pari Passu</i> – Closing date leverage</p> <p>Junior – 0.25x outside closing date leverage</p> <p>Unsecured – 0.50x outside closing date leverage</p>	<p><i>Pari Passu</i> – Closing date leverage</p> <p>Junior – 0.50x outside closing date leverage</p> <p>Unsecured – 1.00x outside closing date leverage (typically 2.0x FCCR test)</p> <p>“No worse than” prong may be available in connection with an acquisition or similar investment</p>

Types of Leverage Ratios

- First Lien Leverage Ratio measures either:
 - Funded Debt secured on a first-lien basis by the Collateral, or
 - Funded Debt secured on a first-lien basis by any assets of the Consolidated Group
- Secured Leverage Ratio measures either:
 - Funded Debt secured (with any priority) by the Collateral, or
 - Funded Debt secured (with any priority) by any assets of the Consolidated Group
- Total Leverage Ratio measures either:
 - Funded Debt that is not secured by the Collateral, or
 - Funded Debt that is unsecured

- In each case, the first option is more Borrower-favorable, and the second option is more Lender-favorable

Stacking and Reclassification

- Stacking:
 - For purposes of testing pro forma leverage for the leverage-based basket, concurrent use of the fixed baskets will be disregarded
- Reclassification:
 - Debt incurred under a fixed basket may later be reclassified as having been incurred under the leverage-based basket if the borrower subsequently de-levers and can meet the applicable incurrence test
 - In most cases, reclassification occurs automatically

Incremental Equivalent and Ratio Debt

- Incremental Equivalent Debt (“IED”): Debt incurred as a separate credit facility (sidecar) outside of the credit agreement
 - In addition to term loans or revolving commitments, can include notes and bridge loans
 - All incurrence baskets are shared with the incremental facilities
- Ratio Debt: Debt incurred as a separate credit facility outside of the credit agreement
 - Incurrence will be subject to the same pro forma leverage levels as apply under the leverage-based incurrence basket, but typically without the free & clear basket or other builders
 - In return, certain terms are looser – including a basket for non-Loan Party debt
- In lender-favorable credits, incremental facilities will be limited to *pari passu* debt, and IED and Ratio Debt will be limited to junior debt

Comparison of Key Features

Term	Incremental Facility	Incremental Equivalent Debt	Ratio Debt
Documented in initial credit documents	YES	NO	NO
Free and Clear basket available	YES	YES	NO
May rank <i>pari passu</i> with initial facility	YES	Sometimes	Sometimes
May rank junior to initial facility	Sometimes	YES	YES
Pricing MFN for <i>pari passu</i> debt	YES	Usually	Sometimes
Terms MFN	YES	Usually	Sometimes
Obligors must only be Loan Parties	YES	YES	NO – \$ sub-cap
Security is limited to Collateral	YES	YES	NO – \$ sub-cap
Intercreditor Agreement required	NO	YES	YES

Pricing MFN

- Typically triggered if a *pari passu* incremental term facility has an “all-in yield” 50-75 bps higher than the existing facility
- All-in Yield:
 - Always includes interest rate margins & floors, OID and upfront fees
 - **Commonly excludes amendment, consent, ticking, arrangement, commitment, structuring and underwriting fees (sometimes, only if not paid to all incremental lenders)**
- Pricing MFN will not apply to all incremental facilities; some common exclusions are:
 - Incremental issued more than 6 months-2 years from closing (“sunset”)
 - All notes, or broadly syndicated high-yield notes (Rule 144A)
 - A dollar-capped basket
 - If incurred through the free and clear basket
 - If incurred in connection with a permitted acquisition or similar investment
 - If maturing 1-2 years after the existing term maturity date
 - Denominated in other currencies

Discussion of Certain Material Terms

- Terms MFN: Terms may not be materially more favorable to the lenders providing the incremental, with exceptions for:
 - Terms that reflect market terms at the time the incremental is incurred
 - Terms satisfactory to the agent
- No earlier maturity or shorter weighted average life-to-maturity than the existing facilities
- No greater than pro rata participation in mandatory prepayments, but sometimes *pari passu* incremental debt may receive voluntary prepayments on a greater than pro rata basis

Refinancing Facilities

- Refinancing Debt partially replaces existing debt under the credit agreement up to the outstanding principal amount of the refinanced debt plus outstanding interest, fees and premiums
 - May be provided by existing lenders, additional third-party lenders or sponsor-affiliated lenders
- Uptiering risk exists if express protection is absent

Incremental Versus Refinancing Facilities

Term	Incremental Facility	Refinancing Facility
Documented in initial credit documents	YES	Not required
No earlier maturity or shorter WALM	YES	YES
Pricing MFN	YES	Sometimes
Terms MFN	YES	Sometimes
Obligors must only be Loan Parties	YES	YES
No greater security	YES	YES
Intercreditor Agreement	N/A	YES
No uptiering	N/A	<u>Should be included</u>
Participate in voluntary prepayments on a greater than pro rata basis	Sometimes	Sometimes

Hedging & Cash Management Obligations

- Hedging Agreements
 - In most credit agreements, broadly defined to include all currency and interest rate swaps, hedges and similar derivative transactions
 - May not include a dollar cap or other limitation
 - Permitted if ordinary course and/or not for speculative purposes
- Cash management services include banking services, corporate credit cards, etc.
- Upon notice to Agent, these obligations often receive *pari passu* treatment under the credit documents, including sharing a lien on collateral
- Importantly, holders of these obligations are not “Lenders” and do not vote

II. Permitted Priming Debt

Purchase Money Debt and Capital Leases

- Purchase Money Obligations
 - A lender makes a loan to a customer to purchase an asset and takes a security interest solely in the asset
 - The purchase money security interest will take priority in the subject asset even if another secured party has a prior lien on such asset
- Capital Leases
 - The current cash equivalent of the lease payments is treated as debt
 - Lien on the asset acquired will be permitted
- The senior creditors will generally subordinate, release, or never have liens on assets that secure purchase money debt or capital leases

Letters of Credit and Surety Bonds

- Letter of Credit
 - Instrument issued by a financial institution that guarantees a specified payment will be made to a beneficiary upon demand
- Surety Bond
 - Bond backed by a “surety” – usually an insurance company – that guarantees future work performance by a business to a third party
- Both letters of credit and surety bonds are backstopped on a senior basis by cash and potentially other assets (including, possibly all the assets) of the company

Factoring Financing & Securitizations

- Forms of liquidity transactions whereby future cash flow is converted into current cash flow
- Factoring
 - A party sells all or certain of its receivables to a third-party factor, which purchases the receivables at a discount to the receivables' face amount
- Securitizations
 - An SPV purchases a pool of receivables assets with defined or identifiable associated cash flows
- Factoring programs and securitizations may be uncapped, and the related dispositions often will not be subject to a mandatory prepayment requirement

Assumed Debt

- Debt of an acquisition target or debt attaching to assets being acquired that is not paid off at the acquisition closing and is assumed (together with any associated liens) by a member of the credit group
- Incurrence of assumed debt will often be subject to guardrails such as:
 - Dollar cap (with grower) or pro forma leverage (sometimes at the closing level, often at the financial covenant level)
 - Prohibitions on additional guarantees or liens by Loan Parties or liens on additional assets

III. Permitted Structural Priming Debt

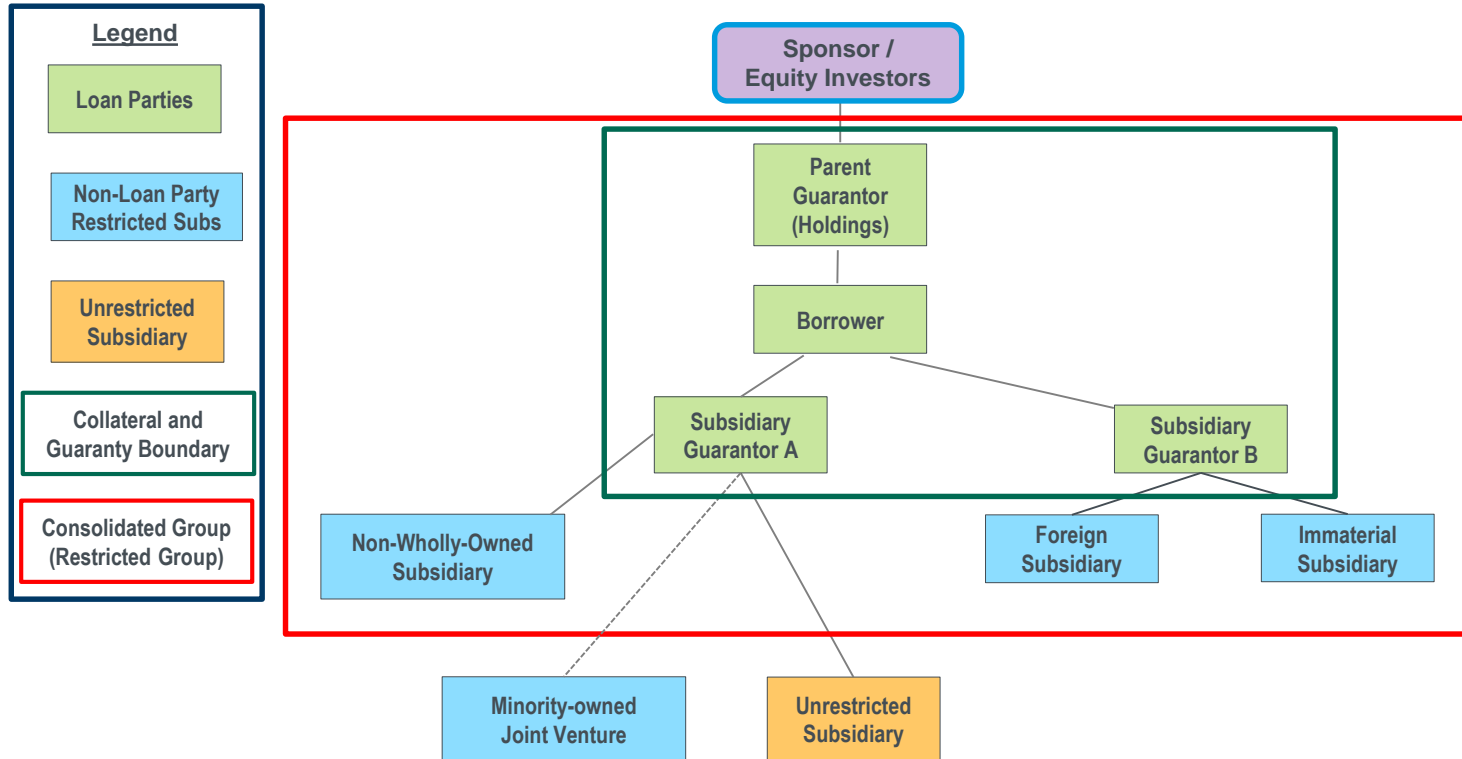
Excluded Subsidiaries and Assets

- For a typical senior secured credit facility, lenders receive a perfected first-priority security interest in substantially all of the assets of the Loan Parties
- But lenders don't receive:
 - A lien or guaranty from *entities* in the corporate structure that are not Loan Parties; or
 - A lien on *all assets (no exceptions)* of the Loan Parties
- This means that the senior lenders may not be the only lenders with a first lien on assets of the company – they may rank *pari passu* with, or junior to, other creditors with respect to certain entities and assets

Excluded Subsidiaries

- Excluded Subsidiaries:
 - **Borrower friendly**: All non-wholly owned subsidiaries
 - **Lender friendly**: JVs with third parties for bona fide business purposes
 - **Borrower friendly**: All foreign subsidiaries
 - **Lender friendly**: All foreign subsidiaries unless domiciled in a material jurisdiction
 - **Borrower friendly**: Unrestricted subsidiaries
 - **Lender friendly**: Unrestricted subsidiaries not recognized as a construct

Loan Parties and Excluded Subsidiaries



Excluded Assets

- Excluded Assets: Certain assets are excluded from collateral for legal or tax reasons and others as a matter of convenience or cost
 - **Borrower-favorable**: “Immaterial” owned real property; vehicles; all cash other than collateral proceeds; equity of certain subsidiaries; assets in non-U.S. jurisdictions
 - **Lender-favorable**: Minimized excluded asset categories and/or low dollar amount thresholds above which otherwise excluded assets must be included within the collateral pool

Why Does it Matter?

- Subject to the credit agreement covenants:
 - Non-Loan Party Restricted Subsidiaries can incur debt and grant liens on their assets
 - Excluded Assets may become a different lender's collateral
- In most credit agreements, non-Loan Party debt baskets offer multiple pathways for companies to obtain meaningful debt for borrowed money outside of the credit agreement
- This debt is structurally senior to the senior credit facility to the extent of the entities and assets supporting it
- Unrestricted Subsidiaries have unlimited capacity to incur debt, subject only to limitations on Investments in the Unrestricted Subsidiaries
 - Functionally, their debt cap is the amount of permitted Investments multiplied the maximum loan-to-value that can be obtained against those assets

A Tale of Two Credit Agreements

- In the coming slides, we will talk about key baskets that a non-Loan Party Restricted Subsidiary may use to incur debt by giving examples as they appear in two credit agreements
 - Credit Agreement A – Company with \$35mm of closing date EBITDA
 - Credit Agreement B – Company with \$170mm of closing date EBITDA
- Baskets may be stacked and reclassified, as discussed earlier

A Tale of Two Credit Agreements

Basket	Credit Agreement A	Credit Agreement B
General Debt Basket	30% of EBITDA	60% of EBITDA
Non-Loan Party Debt Basket	15% of EBITDA	60% of EBITDA
Non-Loan Party Working Capital Debt Basket	Not included	15% of EBITDA
Foreign Subsidiary Debt Basket	Not included	40% of EBITDA

A Tale of Two Credit Agreements

Basket	Credit Agreement A	Credit Agreement B
Assumed or Incurred Acquisition Debt	Not included	50% of EBITDA
Assumed Acquisition Debt	15% EBITDA	20% of EBITDA, plus unlimited amounts up to a leverage cap
Purchase Money Debt and Capital Leases	20% EBITDA	45% of EBITDA, plus unlimited amounts up to a leverage cap

A Tale of Two Credit Agreements

Basket	Credit Agreement A	Credit Agreement B
Intercompany Debt	30% of EBITDA	Uncapped
Contribution Debt	Not included	Up to 200% of the principal amount of qualifying equity issuances

A Tale of Two Credit Agreements

- Ratio Debt Revisited
 - Credit Agreement A does not include a permitted ratio debt concept
 - Credit Agreement B permits incurrence of ratio debt by non-Loan Party Restricted Subsidiaries with no sub-cap
 - This is a top-of-market term; credit agreements will typically include a sub-cap on incurrence of ratio debt by non-Loan Party Restricted Subsidiaries

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Admissions & Qualifications

Illinois State Bar, 2015
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Evan Palenschat is a partner in the Corporate Department and a member of the Private Credit Group.

Evan Palenschat advises clients on private credit and special situations investing, with a particular focus on debt financings and specifically in the area of leveraged finance.

Evan has extensive experience advising private credit funds, financial institutions, private equity funds, hedge funds and public and private companies/borrowers/issuers, as well as alternative lending institutions. His practice involves all aspects of corporate transactional work. Evan also assists his clients in work-outs and other downside scenarios. Evan has represented his clients on countless transactions that include senior, second lien and subordinated financings, asset-based loans, work-outs, restructurings and bridge and mezzanine financings.

Evan received his J.D. from Columbia University School of Law and received his M.B.A. from the University of Illinois.

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Ms. Fischer's practice focuses on a variety of private credit transactions, including first and second-lien, unitranche and other forms of secured and unsecured financing arrangements in connection with leveraged buyouts, acquisition financings, recapitalizations and refinancing transactions, among other purposes.

Prior to joining Proskauer, Ms. Fischer was an associate in the banking group at a multinational law firm, where she managed a variety of financing transactions across a wide range of industries, representing banks, financial institutions, private equity sponsors and corporate borrowers.

Ms. Fischer was a Public Interest Law Initiative Graduate Fellow with the Torture Inquiry and Relief Commission with the State of Illinois. Ms. Fischer served as a judicial extern to the Honorable Judge Deborah Thorne in the U.S. Bankruptcy Court for the Northern District of Illinois in Chicago. Ms. Fischer was an Executive Editor of and published author in the Northwestern Journal of International Law and Business.

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