Dealing with Difficult Conditions in the Term Loan B Market

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Much of the “term loan B” or “TLB” market operates on an “arrange-to-distribute” model. In the acquisition finance context, a small group of initial lenders will commit to provide the financing subject to negotiated terms and conditions[1]. These initial lenders, or one of their affiliates, will then proceed to arrange, or market, the financing, selling the loan exposure to institutional and other lenders prior to funding, so that the initial lenders themselves are fully “derisked.” If the syndication is unsuccessful, the initial lenders will still be obligated to fund the financing; a successful syndication is not a condition precedent to the initial lenders’ obligation to fund. However, retaining these loans can be expensive for initial lenders. They will seek to reduce the risk that they end up holding significant TLB exposure, and agree on how they will share that risk among the other initial lenders. Market volatility and the delayed or failed syndications in late 2018 remind us that these loss mitigation techniques are important and have real consequences to lenders and borrowers alike.

Enhanced Focus on Deal Terms While Committing

Against the backdrop of volatile or uncertain market conditions, or just a long-dated commitment that increases the risk that uncertainty may emerge or conditions deteriorate during the term of the commitment, an initial committing lender will focus on both pricing and other material terms that may affect syndication. Even a term or feature that may have easily cleared the market in recent financings can, in the light of a weak debt market, seem aggressive to a suddenly more cautious investor. While this risk is ever-present, in the context of uncertain markets and longer commitments, the parties will increasingly focus on their “market flex” rights and exceptions or flexibility on their commitment to new or unusual terms in the “documentation precedent.”

Market flex provisions

Market flex provisions are ubiquitous in committed acquisition financings. They allow the initial lenders to modify certain deal terms in consultation with, but without the consent of, the borrower to the extent necessary or desirable in order to achieve a “successful syndication.” A successful syndication of a TLB is typically deemed to have occurred if the initial lenders hold $0 of the TLB at closing. Most commitment letters also permit flex to be exercised at closing if a successful syndication has not been accomplished by such date or, in limited cases, where it is determined that a successful syndication cannot be accomplished. This allows the arrangers to take the debt onto their balance sheet on the fully flexed terms, maximizing the likelihood that the initial lenders can sell down the debt post-closing and minimizing any write-down. Borrowers and lenders sometimes debate whether the flex should be exercised only if “necessary” to achieve successful syndication or also if “advisable to facilitate” a successful syndication. The latter formulation is viewed by arrangers as preferable, as filling out a book is often more of an art than a science; it is difficult to determine precisely what combination of price and terms will result in a fully allocated book, and the psychology of the market at any given time can determine the success or failure of a syndication effort. Though it is easy to see the borrowers objection that this appears to offer the arrangers too much latitude. In practice, in most cases, arrangers consult with the borrower or financial

[1] The “initial lenders” are the lenders that commit to provide the TLB. The “arrangers” are the initial lenders or affiliates of the initial lenders that arrange or syndicate the TLB. In this note, these terms are used interchangeably.

sponsor prior to exercising flex and receive a general agreement on the combination of terms to go to market with to ensure a success for both the arranger and borrower and it is only when syndications go particularly poorly that arrangers force flex terms on a borrower

The terms that are permitted to be modified pursuant to the market flex provisions, though often extensive, are typically carefully negotiated and strictly limited. Key among them are pricing flex provisions, which allow the arrangers to increase the interest rate margins by a negotiated amount, and permit a portion of that increase to take the form of additional original issue discount or "OID". In longer dated commitments, the permitted amount of this increase may step up if a successful syndication has not been accomplished within certain periods following the signing date. It would be typical, for example, to provide for a 25-basis-point step-up at the end of 120 days and/or 180 days after signing if a successful syndication has not been accomplished by those dates (some or all of which may be permitted to take the form of additional OID). In addition, in some deals where credit ratings may be uncertain, arrangers may have the right to increase pricing by 25 bps if debt ratings come in below assumed levels.

In a difficult market, visibility as to the most attractive form of the debt, and likely sources of demand, is more limited. For example, in several early 2019 transactions, syndication was greatly assisted by moving a portion of the contemplated TLB into secured bonds. Arrangers may therefore see so-called "structure flex" as providing meaningful protection – the ability to move a portion of the underwritten debt into a different instrument, such as a bond or holdco note, or simply to reallocate debt between underwritten tranches. Borrowers, of course, will need to carefully weigh the appropriateness of, for example, adding call protected fixed rate debt in their capital structure. They will also want protection as to the aggregate cost of debt across the capital structure, and may seek to impose a weighted average cap and/or specific caps for each potential debt tranche. Finally, structure flex to a wholly different instrument not included in the underwritten capital structure can add meaningful cost and complication to the process due to the need to negotiate detailed terms of the new instrument.

Finally, arrangers will seek to ensure they have the ability to modify terms that are aggressive by comparison with similar transactions, or that are new or untested. In this sense, the market flex provision plays a "market testing" role in modern commitment paper negotiations. The borrower can use the availability of flex to encourage arrangers to under-write more aggressive terms, on the basis that if they do not "clear the market," the arranger can adjust those terms through flex. If those terms do clear the market, they become precedent for the next transaction. One relatively recent phenomenon is the explosion in the number and availability of services that publish detailed covenant analysis for financing transactions. This creates a feedback loop as market participants seek to ensure criticized terms do not find their way into new transactions, and arrangers seek to protect themselves against this buy side pushback through flex.

Committing to a documentation precedent

In a difficult syndication, it may be desirable to make certain changes to the document that are not specifically enumerated in the flex provisions. The arrangers ability to make such changes without the borrowers consent is usually strictly limited. First, term sheets can be very detailed, setting forth all material terms. Second, to the extent not expressly set forth in the term sheet (and the flex provision), terms are often limited by reference to an underwritten "documentation precedent." The most common sponsor formulation requires that the terms be substantially the same as (or no less favorable than) both the target's (or, if applicable, the buyer's) existing credit agreement and an identified documentation precedent (subject to certain agreed adjustments). The only permitted deviation from the terms set forth in the term sheet and the documentation precedent are those enumerated in the flex provision.

A looser document underwriting standard (e.g., "customary documentation for similarly situated borrowers"), which might offer the arranger greater flexibility, can be a double edged sword. Borrowers and lenders can disagree on what terms satisfy that standard, which can lead to disputes as to whether parties are negotiating in good faith and fulfilling their contractual obligations. The safer approach is to agree to the stricter version of the underwritten documentation standard. That places an enormous amount of pressure on ensuring that the documentation precedent is carefully vetted and all unusual or aggressive terms, or terms that may just not be appropriate from one deal or company to the next, are considered and, where appropriate, added to the list of items that can be modified through flex. And the provisions that require this level of scrutiny may need to be revisited over time based on real world experiences.

Special Features for Long-Dated Commitments

Long-dated commitments (here, six months or longer) raise particular syndication and market risks: there is simply more time for something to go wrong. Accordingly, lenders will frequently seek additional features to protect against these risks (in addition to the step-ups to pricing flex noted above). Two of most common features are “ticking fees” – fees used to compensate syndicate lenders for holding unfunded exposure in advance of closing – and funding into escrow in advance of closing of the acquisition.

Ticking fees

A long-dated commitment will concentrate the mind of both arranger and borrower on the desirability of syndicating and allocating loans while markets are strong, which might be a considerable period of time prior to closing. Investors will typically demand to be compensated for holding commitments to purchase these loans for periods longer than a month or so, and a borrower will want to balance the increased certainty of early syndication against this cost. That tension is the starting point for any discussion of ticking fees. Often the start date for the accrual of such fees is the earlier of a fixed date after signing and the date of allocation of the loans to investors following the completion of syndication (sometimes after an additional fee holiday). The “earlier of” formula is designed to ensure both that investors are compensated for holding loans for extended periods, and that the borrower has an incentive not to delay syndication beyond a fixed date. The ticking fee is calculated as a percentage of outstanding commitments that ratchets over time through closing. A common formula would be 0% for the first 30 days after the start date, then 50% of the interest margin for the next 30 days, then 100% of the interest margin (often plus the floor) thereafter. Many deals include “no deal, no fee” clauses, which provide that fees (including any ticking fees) are not payable by the borrower unless the closing date occurs. While this formulation is customary in financial sponsor transactions for arrangement and most other up-front fees, the ticking fee is intended to compensate investors for holding commitments over a longer period (and the opportunity cost of not investing those reserved funds elsewhere).

Escrow funding

While less common than ticking fees, some acquisition financings with prolonged commitment periods also provide committing lenders with the right to require the funding of the committed loans into escrow on or after a certain date even though the acquisition has not closed by that date (an “**Escrow Demand**”). The proceeds of the funding are held in an escrow account and subject to release to the borrower in the event the acquisition closes. If the acquisition does not close by a certain date and time, the funds are returned to the applicable lenders. An escrow funding allows arrangers to syndicate funded debt instruments to investors (who typically have limited appetite for holding unfunded commitments for extended periods). Arrangers will typically require that, upon the escrow funding, their commitments are reduced dollar-for-dollar by the aggregate principal amount of loans funded (and borrowers will agree to that only if the conditions to release of the funds from escrow match the “certain funds” conditionality of the initial financing commitment).

In escrow funding situations, the TLB is typically net-funded into escrow, with each lender retaining any upfront fee payable to it. Assuming the acquisition closes and the escrow proceeds are released to the borrower, the borrower’s repayment obligation is equal to the full stated principal amount of the TLB. In contrast, where the escrow terminates and the escrow proceeds are returned to the lenders, the most common approach – reflecting the commercial understanding that upfront fees are payable solely upon the funding of the TLB to the borrower – is that the return of the net-funded escrow proceeds to the lenders (plus accrued interest) is deemed to be a repayment in full of the TLB. Effectively, the OID is only paid if the acquisition is consummated, and it is relatively rare in the TLB context (unlike the bond context) to require any other premium to be paid upon if the escrow breaks and the escrow loans are prepaid. In addition, TLB investors expect interest – including both the applicable LIBOR or base rate and margin – to accrue on their loans from the escrow funding date and throughout the escrow period. As a result, borrowers are typically required to either (i) pre-fund the maximum amount of interest payments that may accrue during the escrow period or (ii) pre-fund interest payment for a pre-agreed period, with additional pre-funding at regular intervals throughout the escrow period. Consideration should also be given to the consequences for non-compliance with any Escrow Demand. To the extent a demand failure penalty is considered appropriate, options include the acceleration of certain fees that would otherwise only be payable upon closing, or the accrual of a ticking fee on the aggregate amount of the financing commitments until the Escrow Demand is satisfied (or commitments terminated).

Finally, when considering an escrow funding solution it is important to diligence whether the borrower's existing debt documents permit the incurrence of these loans (even in escrow). This is less of an issue when the borrower is a special purpose entity that is created by a sponsor for the purposes of the contemplated acquisition. On the other hand, if the borrower is an operating company with existing indebtedness, incurring this new indebtedness may conflict with the debt and lien negative covenants and other provisions of the existing indebtedness. One common solution is to use an unrestricted subsidiary as the escrow borrower during the escrow period, since the activities of unrestricted subsidiaries are typically carved out of covenant restrictions in the borrowers existing debt. However the documents for the borrower's existing indebtedness would need to be carefully reviewed to make sure this is permitted.

Protections for Syndication after Closing

In the event that, notwithstanding the protections above, the TLB is not successfully syndicated at closing, and the syndication is "hung," arrangers may need to take a number of steps to mitigate losses and ensure they are positioned to sell down their exposure as promptly as possible following closing.

Post-closing flex

As noted above, most commitment papers allow the arrangers to exercise flex at closing if a successful syndication has not been achieved at closing. Letters may also provide the arrangers with the right to elect to exercise flex during a post-closing period. Even where that flexibility is not expressly provided, the borrower and the lender may prefer to negotiate a deferral of the exercise of flex for some period post-closing. After all, many market slow-downs or disruptions have proved to be short-term, and circumstances that have dampened investor appetite can change quickly. Sometimes the initial lenders/arrangers may find it acceptable to defer the exercise of flex for an agreed period while they assess the results of ongoing syndication efforts.

If the arrangers choose the wait-and-see approach, they should still consider making certain technical adjustments to the flex provisions themselves through a supplement to the executed fee letter or by entering into a separate post-closing flex letter. For example, any increase in interest rate margins that was formerly permitted to be in the form of OID would need to be paid as an up-front fee, and arrangers should consider limiting the ability to finance any such upfront fees to drawing under the revolving credit facility (and not the issuance of additional term loans). Additionally, arrangers should consider clarifying as many of the flex provisions as possible. To the extent there are caps, ratios, step-downs or other items "to be agreed," these should be finalized. Furthermore, arrangers must ensure that the credit agreement contemplates the amendments necessary to implement any post-closing flex. In practice, the borrower and the arrangers may still negotiate over minor details or legal drafting, but the goal is for the arrangers to be able to implement the flex changes with as little input from the borrower as is possible. Finally, to the extent there is an integration clause in the credit agreement, it should include the fee letter.

Fronting letters

In a financing that involves multiple arrangers, the "fronting arranger" (customarily the "lead left" arranger), typically agrees to fund the entire amount of the loans to the borrower on the closing date on behalf of the other initial lenders. The fronting arranger then distributes the loan to the investors who received an allocation of loans in syndication. In the event that the assignment to any of those investors does not settle within an agreed period following the closing date, the other initial lenders agree to purchase their pro rata share of the loans fronted by the fronting arranger. This arrangement is documented in a fronting letter signed by the fronting arranger and the other initial lenders. In a deal that is fully allocated at closing, the price at which the other initial lenders are required to purchase the loans from the fronting arranger is known at closing and set forth in the fronting letter.

In a hung deal or a deal that is only partially syndicated at closing, the fronting letter takes on new significance. The first decision will be whether or not the lead left arranger should front at all. As to any portion of the TLB that has been syndicated to investors, it would make sense for the lead left arranger to front according to the typical arrangements. As for the unallocated portion, however, the lead left arranger may be willing to front for only a limited period, if at all, on the basis that, without a syndicate to distribute the loan to, each arranger should hold its own exposure. If the lead arranger does front, the OID that the market will receive may not be known, and so the price at which the other initial lenders should purchase that exposure cannot be specified. In that case, rather than stating a specific purchase price, the other arrangers will be obligated to purchase the loans at whatever the clearing price is (in accordance with the LSTA form). The fronting letter may also in these circumstance provide that if a full allocation is not accomplished within a certain period of time following closing, the other arrangers will purchase their pro rata share of the unallocated loans at the purchase price paid by the lead arranger (or its affiliate) in the initial funding. Those purchased loans will thereafter be subject to the sell-down letter described below, but no longer be subject to the fronting arrangements.

Sell-Down letters

Sell-down letters provide that, for some agreed period, no initial lender will "sell-down" (defined to refer to any sale, assignment, participation, syndication or transfer of loans) any loans without complying with the protocol set forth in the sell-down letter. That protocol provides that all sell-downs must be made pro rata based on the respective loans or commitments of the initial lenders, though the lead left arranger will give each initial lender an opportunity to decline to participate in such pro rata sell-down. Any initial lender can reject the opportunity to participate, but each subsequent sell-down will continue to be made on a pro rata basis based on the initial holds (so that the initial lenders are not incentivized to hold out on an earlier sell-down in favor of a subsequent better offer). The sell-down letter is intended to ensure an orderly post-closing syndication. It works in conjunction with the fronting letter: the sell-down letter will typically apply to the unallocated portion of the credit facility, while the fronting letter typically addresses the allocated portion of the credit facility (though as noted above, there is some overlap). One challenging issue that can arise is how to allocate any portion of the underwriting fees that is required to be used to successfully syndicate the transaction. Those fees are paid at closing, but to the extent it is needed to effectively offer additional OID to the market, a suitable mechanism for ensuring each arranger participates in passing through those fees needs to be incorporated into the sell-down letter.

Master consents

Assignments are typically subject to the consent, not to be unreasonably withheld, of the borrower. In a fully syndicated transaction, a master consent is executed by the borrower prior to closing approving all investors receiving an allocation. In a transaction that is not allocated at closing, those investors might not be known. Yet the arranger may be uncomfortable relying on the borrower's consent post-closing as a condition to assigning its now-funded loans. One way to address this is to allow the arrangers a post-closing period to assign the loans (other than to disqualified lenders) without borrower consent. If a borrower objects to this approach, an alternative is to get a borrower's pre-approval of likely investors by including those lenders in an executed master consent.

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