IFLR
INTERNATIONAL FINANCIAL LAW REVIEW

BANKING & PROJECT FINANCE
ACQUISITION FINANCE

A fresh look at acquisition finance

Partners from Davis Polk's New York office explain certain aggressive terms found in BSL facilities in 2019 and this year.

As significant uncertainty and sustained volatility return to the debt markets for the first time since the financial crisis, we take this opportunity to reflect on some of the private equity sponsor and borrower-friendly terms that have become increasingly common in broadly syndicated loan (BSL) facilities, as well as certain themes that emerged in 2019 and early 2020. The most striking development has been the dramatic increase in the number and size of facilities that direct lenders have been willing to underwrite.

These alternative lenders are not only committing to take all or a large portion of the junior capital in a structure underwritten by BSL arrangers, but are now competing directly with arrangers on ever larger financing transactions. The cross-pollination of terms that results from this competition makes the trends described below relevant not just to the BSL market but also to alternative lending.

Leverage

- **First lien debt capacity:** In many credit facilities, the general debt basket is permitted to be secured on a pari passu basis—either expressly in the debt negative covenant or indirectly through general provisions that allow (or require) the administrative or collateral agent to enter into intercreditor arrangements to the extent "not prohibited" by the credit facility. Many credit facilities also expressly allow the general debt basket to be reallocated to the incremental "starter" or "freebie" basket. This flexibility may be compounded by aggressive "stacking" provisions that allow the borrower to ignore debt incurred under a fixed basket (or a revolving credit facility) regardless of when that debt was incurred.
  Refinancing provisions in some credit facilities also allow first lien debt to be incurred in connection with prepayments of junior indebtedness. This means that junior lien or unsecured debt may be incurred based on compliance with a fixed charge coverage or total leverage ratio test and then refinanced with first lien debt without ever testing or complying with a first lien or other secured leverage ratio test. These provisions must be closely scrutinised as a package in formulating a

complete view of first lien debt capacity, which can be much greater than at first appears.

- **Structurally senior debt capacity**: Traditionally, the amount of ratio-based debt that could be incurred (or guaranteed) by non-guarantor subsidiaries of a borrower was subject to a cap, designed to limit the amount of structurally senior ratio debt to the credit facility. Borrowers have increasingly sought to eliminate any non-guarantor cap, partly to preserve flexibility to incur debt (and take interest deductions) in higher tax jurisdictions (since, due to recent tax law changes, the US has become a relatively low corporate tax jurisdiction).
  When taken together with secured indebtedness definitions that exclude debt secured by non-collateral assets, the result in some BSL documents is an unlimited ability to incur structurally senior debt. A related development is borrowers' efforts to eliminate, or create a basket exception to, the prohibition on incurring ratio debt with a maturity that is earlier than, or weighted average life that is shorter than, that of the credit facility. The ability to incur this "inside maturity" debt further erodes secured lenders' traditional expectation that their loans occupy the most senior position in the capital structure.
- **RP debt capacity**: Increasingly, availability under restricted payment baskets may be used to incur debt, often on a secured basis. Depending on the "contribution debt" formulation, the amount of debt that can be incurred may be two times the amount of reallocated restricted payment capacity. The rationale for this flexibility is that if a dividend could be paid by the borrower to the private equity sponsor and then contributed back by the sponsor to the borrower to create capacity under the "contribution debt" basket, the borrower should be permitted to skip the round tripping and build the debt capacity directly. Arrangers view this argument as flawed on the basis that to pay a dividend, the borrower needs sufficient cash, which it does not need to create this debt capacity directly.
  One consideration for lenders is whether the conditions precedent to utilisation of the restricted payments (RP) basket (other than the amount) need to be satisfied to incur such debt. In some formulations, for example, capacity under the "cumulative credit" or "available amount" builder basket may be used to incur debt without having to satisfy any applicable ratio compliance or absence of a default condition.
- **Financial definitions**: Borrowers have continued to seek additional incurrence ratio and financial covenant flexibility through the inclusion of more aggressive EBITDA and consolidated net income (CNI) "add-backs." Run rate "synergy" and "cost saving" addbacks are often uncapped, with unlimited or very long (e.g., 36 month) look forward periods, which allow borrowers to take the full pro forma benefit of projected cost savings so long as any action to achieve such cost savings is expected to be taken at any point within the period.
  Addbacks for items "of a type" set forth in the quality of earnings report, sponsor model and/or marketing materials in connection with the financing or set forth in any quality of earnings report provided in connection with any future acquisition have become common. Increasingly, revenue-based addbacks (e.g., for new or improved contracts) are included, sometimes without a cap. The inclusion of any of these provisions means that a borrower's "actual" leverage may differ significantly from its leverage as calculated under the credit agreement.
- **MFN**: We have seen several new fronts open up in the ongoing debate between borrowers and lenders as to the applicability of most-favored nations (MFN) pricing protections. Borrowers continue to seek a long list of exceptions to the MFN. While many of these do not typically clear the market, there are certain exceptions that have demonstrated staying power, for example exceptions for incremental facilities incurred to finance an acquisition or with maturities that are more than 1-2 years outside the maturity of the existing term loans.
  In addition, in a number of deals the MFN applies only to incremental (and sometimes incremental equivalent) debt, but not other forms of pari passu sidecar term loans (whether incurred under the ratio debt, acquisition debt or general debt baskets). Other limitations, such as those restricting the MFN to "syndicated term loans," have opened the door for direct lenders (who will generally not syndicate) to provide incremental financing, sometimes in note form rather than term loan form, without triggering the MFN.
  The calculation of "yield" for MFN purpose has also come under scrutiny. In some transactions, MFN is calculated based on interest rate margin, rather than all-in yield, meaning that ordinary issue discount (OID) is ignored. Where OID is taken into account, an interesting question has arisen as to whether this should be construed as the OID paid by the borrower or the total discount to par reflected in the allocation price, and whether customary fees paid to the arrangers should be taken into account. There has been disagreement in recent transactions on how the yield calculation should be made, underscoring the importance of clear documentation.

Leakage

- **Paydowns:** Mandatory prepayment provisions have continued to weaken. Asset sale sweeps are often limited to non-ordinary course sales of collateral made in reliance on a very limited subset of asset sale baskets. The percent of such asset sale proceeds that are required to be swept or reinvested is increasingly subject to leveraged based step-downs and reinvestment rights have become more permissive (e.g., including "look-backs") and longer dated (e.g., 540 days).
  Excess cash flow (ECF) sweeps increasingly allow "dollar for dollar" credit to be given to restricted payments, investments and other transactions. In both cases, these provisions may result in leakage in the form of additional RP capacity, either directly, as retained asset sale proceeds build RP capacity in many credit facilities, or indirectly by building the "cumulative credit" basket with the retained portion of ECF.
- **Unlimited ratio capacity:** A term loan B (TLB) will typically include the ability to make unlimited restricted payments, investments and junior debt prepayments subject to satisfaction of a maximum leverage ratio that requires some deleveraging from closing date levels. In a limited number of transactions, sponsors have successfully sought to permit unlimited investments so long as, after giving effect to the investment, the applicable leverage ratio is "no worse than" prior to the investment.
  While these conditions are normally set as "total leverage" ratio tests, they have in a minority of deals cleared as "first lien leverage" ratio tests and, in the case of investments, with little or no deleveraging required (meaning, in essence, that the investment covenant offers no protection on, for example, investments in unrestricted or non-loan party subsidiaries to the extent the borrower remains at or below closing

date first lien leverage levels).

- **Flexibility to invest in non-loan parties and unrestricted subsidiaries:** Many deals permit unlimited investments in restricted subsidiaries, whether or not loan parties. While these provisions have been under a spotlight for some time, strong market conditions have permitted borrowers to obtain this flexibility with regularity. Certain credit facilities continue to include language that allows restricted subsidiaries to invest amounts received from loan parties without restriction, including in unrestricted subsidiaries. The combination of this language and the absence of a cap on investments in non-loan party restricted subsidiaries creates an unlimited unrestricted subsidiary investment basket, which has found its way into some credit facilities.
- **Reallocation of capacity**: It is increasingly common in TLBs to allow capacity under the RP, investment or junior debt prepayment covenants to be reallocated amongst one another, mirroring the approach of high-yield bonds, in which all are subject to a single covenant. The key point for arrangers is that these exceptions not be allowed to flow "upstream"; while arrangers are typically comfortable with restricted payment capacity being used for investments, they are not with investment or junior debt prepayment capacity being used for restricted payments.
- **Release of guarantors/collateral**: It has long been the case that domestic subsidiaries are released from their guarantees of the credit facility upon ceasing to be a wholly owned subsidiary of the borrower. This means that a borrower may sell or distribute a small minority interest in a valuable subsidiary to a third party (or even affiliate) and have that subsidiary released from its guarantee and collateral obligations under the credit facility. There has been a recent focus on this issue, with mixed results.

Erosion of Remedies

- **"Cured default" provisions**: Some borrowers have sought to include language in credit facilities that allow it to retroactively cure any default (including payment, bankruptcy, financial covenant or notice delivery) at any time without a waiver or consent from the lenders. In the case of a prohibited transaction, such cure may involve unwinding the prohibited transaction or would occur automatically if such previously prohibited transaction would be permitted if entered into at a later time.
  In the case of failing to take a required action, the cure would automatically occur when the action is ultimately taken, regardless of any applicable time period for taking such action. Where these provisions are accepted, and arrangers tend to be very resistant, they are typically subject to parameters that include such cure not having an adverse impact on the collateral or the agent and the prohibited action not having been taken in knowing contravention of the credit facility. A further variation of these provisions from the UK market allows a financial covenant breach to be cured upon delivery of financial information and certificates confirming compliance as of a subsequent fiscal quarter.
- **Collective action:** Provisions have increasingly been included in credit facilities that prohibit individual lenders from taking actions other than through the administrative or collateral agent and with the consent of the required lenders. There is considerable controversy as to the scope of these restrictions. If limited to taking actions against the collateral pursuant to the loan documents, they are relatively uncontroversial. However, broader formulations, which seek to undermine an individual lender's right to individually bring a fraudulent conveyance or similar claim, for example, are more problematic.
- **Cure period/statute of limitations:** Language has recently been included in credit facilities that does two things. First, it allows a court to toll a grace period while litigation as to the occurrence of a default is pending (so that, following a decision as to the existence of a default at the end of the applicable proceeding, the borrower will still have the benefit of an unexpired grace period in which to cure the default). Second, it prohibits lenders from claiming the existence of an event of default more than two years following the public disclosure, or disclosure to lenders, of the circumstances giving rise to the alleged default. Both provisions address real-world experiences, and lenders have largely been willing to entertain variations of them.
- **Net short lenders**: Similarly, in response to the increase in debt and default activism, provisions have been added to a number of credit facilities that disenfranchise lenders with a "net short" position in the borrower. Some aspects of these provisions have become relatively well established — they typically will not apply to regulated lenders or closing date revolving lenders — and their main function is to ensure net short lenders are not entitled to vote on amendments or in directing the exercise of remedies.
  However, the market for these protections is still developing. For example, expanding "net short" lenders to cover lender affiliates seems sensible from a borrower's perspective, but that expansion can cause significant compliance and monitoring challenges for lenders, and inappropriately capture hedging, market making activities or activities of screened affiliates that are acting independently of the lender. There is also an ongoing debate as to the scope of appropriate remedies available to the borrower for net short lenders, the right of the borrower to seek supporting information or to challenge a lender's representation that it is not net short, the role of the administrative agent in the event there is a dispute between the borrower and a net short lender and even how to determine whether a lender is "net short." We expect each of these issues to be addressed, and language to become more standardised, in 2020.

The context for ever more borrower-friendly terms over the last five years has been a highly liquid and functioning syndicated loan market where demand for the loans significantly outstripped supply, particularly for higher rated leveraged credits. As we enter a period of heightened volatility, buy-side investors and alternative lenders are likely to look for ways to, if not reset, at least to mitigate certain of the more aggressive terms described above. This process will require careful analysis of complex documentation and thoughtful balancing of competing interests between lenders and borrowers.


Jason Kyrwood
Partner
Davis Polk & Wardwell,
New York


James A. Florack
Partner
Davis Polk & Wardwell,
New York


Meyer C. Dworkin
Partner
Davis Polk & Wardwell,
New York