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CLIENT MEMORANDUM

October 4, 2022

Evaluating Financing Proposals and Lender Protections to Accommodate New Debt

Amid a shift to private credit providers who are ready, willing and able to fill the gap left by traditional lenders, understanding the universe of incremental debt and ratio debt rules is important to limit surprises for sponsors, companies and lenders. We highlight these provisions, including key protections and other considerations that each side should take into account as incremental financing opportunities and new debt commitments are pursued in the current credit environment.

Overview

As the leveraged finance landscape continues to face headwinds from rising interest rates, inflation and other macroeconomic trends, private equity funds and their portfolio company borrowers are seeking additional ways to obtain liquidity for acquisitions and working capital while complying with existing debt documents. At the same time, debt investors are looking for new ways to deploy funds in search of desired yield while safeguarding their investments. In light of this backdrop and the dislocation of the syndicated debt market, a window of opportunity has opened for private credit funds to amplify their market position by providing funds into existing syndicated credit structures.

The shift to private credit providers who are ready, willing and able to fill the gap left by traditional lenders has raised new and interesting credit compliance questions. Adjustments to existing debt agreements are becoming more typical (and perceived as necessary) to obtain financing. The permitted scope of these adjustments, and whose consent is required to make them effective, often centers on syndicated credit agreements' incremental provisions and ratio debt exceptions, which allow companies to incur significant amounts of additional secured indebtedness subject to certain conditions.

This memorandum highlights certain considerations that borrowers and creditors should take into account in analyzing this type of debt incurrence. It explains the strong value these provisions afford to borrowers and the inherent risks to existing creditors that may not be focused on their existence until subsequent debt is incurred. It also will be useful for incoming lenders looking for elegant solutions to lend on more favorable terms than may be available under the accordion by relying on the incremental-in-lieu or other ratio debt baskets discussed below.

Structuring Considerations

At a high level, two overarching structuring considerations with incremental debt and ratio debt are: (a) whether the debt will be slotted in as incremental loans under an existing credit agreement and, if so, will it be an *identical* tranche or have *different* economic and/or non-economic terms, and (b) whether the debt will be incurred under a *separate* debt agreement and, if so, how will the terms vary from the original loan.

There are times when a borrower and lender will prefer to pursue incremental financing and ratio debt with identical terms to existing debt. Speed and efficiency are often paramount, and the accordion mechanics found in many credit agreements allow for new financing to be injected in a structure with a pari passu lien without documenting a new loan agreement, collateral agreements or intercreditor arrangement. A new lender can therefore benefit in the payment waterfall as if it had signed up to the deal from day one and save time and money by foregoing complex negotiations related to new debt agreements. Another benefit of increasing an existing tranche is that the new debt may be fungible from a trading and tax standpoint (depending on certain attributes and fees, especially OID), increasing the liquidity on the secondary market and ease of syndication.

On the other hand, especially given current volatility, new financings are seeing a scaling back of the pre-2022 sponsor terms in favor of pro-creditor changes. Relative to existing debt, creditors may now require higher pricing, larger fees, greater amortization, additional guarantees and collateral, earlier maturity, enhanced voting protection and one or more financial maintenance covenants. Depending on which existing debt basket is relied upon, these credit enhancements may be obtainable without existing lender or agent consent, all while granting the new lender a pari passu lien on the collateral. These enhancements may be structured to exclusively benefit the new lender or may be required to benefit all lenders, depending on the applicable provisions in the existing credit agreement. Advance notice to the existing lenders may not even be required. A company and its equity holders may be willing to accept more restrictive terms if it will induce a lender to provide much-needed capital in support of an add-on acquisition, enhanced liquidity or refinancing of debt with a looming maturity.

Types of Incremental Financings and Ratio Debt

Will the new debt be identical to, or different from, existing debt? How widely may the terms vary with (or without) existing lender consent? Which protections for existing lenders are most effective against different lending structures? These questions require careful analysis of the incremental and ratio prongs.

Syndicated credit agreements negotiated in the most recent borrower-friendly credit cycle frequently contain four related debt baskets: (i) the accordion, (ii) the incremental-in-lieu basket (usage of which reduces accordion capacity on a dollar-for-dollar basis), (iii) the ratio debt basket and (iv) the acquisition debt basket.

Rules governing these baskets are often in unexpected places, separate and apart from the debt baskets themselves. It is incumbent on readers to familiarize themselves with the relevant definitions and component defined terms, the rules of construction, the lien covenant if secured debt is being incurred, other sections within the document related to new facilities and the company’s other debt agreements, especially any intercreditor agreement, to ensure the additional facility is permitted on the desired terms.

A. Accordion (aka Incremental Financing)

The accordion is probably the most well-known provision for raising additional indebtedness under an existing credit agreement. The accordion or so-called incremental provisions provides the borrower flexibility to increase the aggregate amount of debt available under a facility or to establish a new facility, so long as a lender is willing and able to provide such financing. It is not a commitment to provide debt, but allows funded debt to be incurred efficiently. The full contours of the accordion are outside the scope of this memo, but the provisions will often include (a) a free and clear basket that allows pari passu secured debt to be incurred without a leverage condition (and may allow for capacity under the so-called “General Debt” basket to be reallocated under the accordion), (b) a ratio prong permitting uncapped debt subject to satisfying certain financial ratios on a pro forma basis for the new incurrence and (c) a prepayment prong that gives a dollar-for-dollar credit for certain voluntary prepayments. The provisions will be subject to a litany of criteria designed to balance the need for a borrower to have freedom to contract with incremental lenders while protecting existing lenders through restrictions related to quantum, maturity, weighted average life to maturity, pricing, guarantees and collateral, mandatory prepayments and certain other terms.

B. Incremental-in-Lieu Debt (aka Incremental Equivalent Debt)

Although relied on less frequently than the accordion, the incremental-in-lieu basket can offer a powerful alternative. At a high level, it allows a company to use available incremental capacity in lieu of the accordion to incur equivalent amounts of debt pursuant to a new debt agreement (aka a “sidecar facility”); the rub is that it may be subject to less stringent rules than the accordion. The new debt can often take a variety of forms – loans, notes, debentures or other debt securities – whereas the accordion is limited to loans. The diversity it offers in terms of the *form* of new debt may have important implications for pricing as detailed below.

Another implication of a sidecar facility is that a new lender will likely have greater control and influence on voting (as a substantial holder under a separate debt document, as opposed to being a minority holder under an existing credit agreement). Loan agreements typically require at least 50.1% consent thresholds to give effect to an amendment or waiver, except for certain sacred rights. A new lender will have more confidence that the terms of its deal will not be altered if it can remain at the helm and not be diluted by the loans of other holders.

C. Ratio Debt

Similarly, another carve-out under the negative covenants – the ratio debt basket – may exclude lender protections found in the accordion. Syndicated credit agreements will generally allow the ratio debt basket to be used for pari first lien debt subject to the same ratio levels as those in the incremental provisions. However, the ratio debt basket may be subject to fewer rules, particularly related to maturity. Other differences may lurk upon deeper inspection.

D. Acquisition Debt

The acquisition debt basket is similar to the ratio debt basket but the use of proceeds is limited to debt incurred to finance a permitted acquisition or investment. Few, if any, intended differences may exist between the acquisition and the ratio debt basket, but it is not uncommon for contrasts to emerge compared to the accordion.

Key Protections for Lenders under Incremental and Ratio Debt Provisions

The guardrails that existing lenders look to install with respect to incremental and ratio debt may result in strong but inconsistent protections among the baskets described above. The nuances will be critical to a borrower when it is in need of capital. Pre-wired mechanics may authorize the collateral agent (or require the collateral agent) to enter into a pari passu intercreditor agreement or another form of acceptable intercreditor agreement that elevates new debt to a senior or equal position in the capital structure, further making the nuances among the baskets essential to evaluate.

1. MFN on Pricing

The key economic protection for existing lenders is the "most favored nation" or pricing MFN provision that provides that additional debt incurred within some time period (often between 6 and 24 months, though sometimes with no sunset) cannot have an "effective yield" in excess of the "effective yield" of the existing debt by a negotiated amount, often 50 basis points (or 75-100 basis points in certain sponsor-favorable deals). The pricing MFN could include a number of exceptions that render it inapplicable to certain categories of debt: for example, debt to finance a permitted acquisition, debt with a fixed rate (*e.g.*, bonds), debt that is not widely syndicated, debt denominated in currencies other than U.S. dollars, debt with a maturity longer than one or two years after the latest maturity of the existing debt, debt secured on a junior lien basis and/or debt incurred under the accordion's free-and-clear basket. Or there may be no exceptions at all, meaning existing creditors may generally expect bulletproof pricing MFN protection.

A borrower may be able to avoid triggering the pricing MFN provision based on how it structures a transaction. If the MFN provision includes an exception for incremental debt that is not widely placed, obtaining debt from a direct lender would generally be treated as meeting that exception. The source of capital can therefore be decisive to determining the applicability of the MFN. Similarly, many credit agreements do not include pricing protection with respect to incremental in-lieu debt (and ratio debt baskets) or may exclude it in the case of in-lieu debt in the form of notes or high yield bonds or any type of junior lien or unsecured debt. Let's assume a borrower raising $300 million has incremental capacity to do so, subject to a 50 bps MFN under its accordion, and will need to issue the debt at a premium to the original loans. To avoid ratcheting up the pricing of the existing loans, a company could potentially seek first lien debt in an equivalent amount, without triggering the MFN, pursuant to the in-lieu basket by memorializing the terms under a separate loan agreement or a note purchase agreement or Rule 144A offering. In this way, the incremental-in-lieu debt (or ratio debt) may offer a vehicle for financing a transaction that would be prohibitively expensive under the accordion.

2. MFN on Terms

Depending on the precedent and prior negotiations, existing lenders may benefit from a seldom discussed but powerful "terms MFN" provision. A terms MFN provision restricts the extent to which *overall* terms of a new financing can deviate from existing debt unless the existing debt similarly benefits, subject to pre-agreed carve-outs. Carve-outs will often include several fundamental terms, such as pricing, rate floors, fees, amortization, collateral, guarantees and prepayment provisions. The exact carve-outs and the standard for determining compliance have important ramifications. Is it the borrower in good faith who determines whether the provision is satisfied or perhaps the borrower and the required lenders?

Subtle differences in phrasing have far-reaching impact – whether written as the new financing cannot be more favorable, *taken as a whole*, to the existing lenders, cannot be *materially* more favorable or must be *substantially consistent* with the existing terms can be determinative of whether non-conforming adjustments are acceptable (including as it relates to borrower's counsel's ability to issue a "no conflicts" opinion). Some credit agreements allow for any adjustments under this provision if deemed to reflect the "current market" at the time of issuance (often as determined in good faith by the borrower). Under this construct, a borrower has significant flexibility in structuring its new debt while limiting the impact on existing debt based on the terms' MFN provision.

3. Maturity and Weighted Average Life to Maturity

A common perception among creditors is that new pari debt cannot mature prior to the existing syndicated debt or have a shorter weighted average life to maturity. This is often the case with debt incurred under the accordion, subject to any inside maturity basket. In addition, the incremental in-lieu of basket and other ratio debts basket may not specify any maturity limitations. Therefore, in a difficult credit environment in which a lender seeks a short-term facility, the ratio debt basket may facilitate a transaction that would be rendered implausible based on other debt baskets or the accordion.

4. Guarantees and Collateral

Similarly, existing creditors may expect guarantees and collateral to remain as robust as any credit support being assigned to a new lender. That is often the case with the accordion that requires incremental debt to be secured by a lien on the collateral ranking pari passu or junior to the lien securing the existing obligations (or such debt may be unsecured). That protection may not carry over to the ratio or acquisition debt baskets. Further, the incremental in-lieu basket may have rules about guarantees and collateral, but may include room for asymmetric credit support, such as allowing holding companies or sister silos to pledge assets in favor of a new lender that would not be permitted under the accordion.

5. Non-Guarantor Sub-limits

One of the negotiated points that may surface with acquisition debt (and other incremental and ratio debt prongs) is the extent to which *non-guarantor subsidiaries* may incur incremental financing, given existing lender concern over structural subordination to such utilization. As a compromise to lenders, non-guarantor sub-limits may be inserted that cap the amount of debt available to non-guarantors. In more lender-favorable constructs, "shared" sub-limits are inserted, which require aggregating the debt accessible to non-guarantors among different baskets. Consistent with one of the overarching themes of this memo, these restrictions on non-guarantor incurrence may apply to certain ratio baskets but not all.

6. Mandatory Prepayments

It is common in syndicated deals for existing holders to be assured that new debt will not have greater than pro rata rights with respect to mandatory prepayments. The new creditors may share pro rata or less than pro rata, but not greater than pro rata. While the accordion and incremental-in-lieu baskets would be expected to contain these restrictions, the ratio and acquisition debt basket may not expressly feature them, although protections on this point may exist outside the negative covenants (such as in the mandatory prepayment section or pre-agreed form intercreditor agreement).

7. Financial Maintenance Covenants

For investors focused on financial covenants, provisions in credit agreements may prevent new more restrictive financial covenants unless all lenders are beneficiaries. This protection may be caveated, however. The credit document may provide that if a financial covenant is only added for the benefit of new revolving lenders, as is often the case, then such new financial covenant will benefit existing *revolving* lenders. Term lenders may wind up as indirect beneficiaries in the event of a default if the revolving lenders accelerate the obligations, but otherwise would not have a seat at the negotiating table in the event of a breach of the financial covenant.

Summary of key lender protections in the context of incremental and ratio debt:

Type of Protection	Explanation
1. MFN on Pricing	The effective yield of certain new debt may not exceed a negotiated amount (perhaps 50 bps or more) relative to the existing loans, unless the pricing on the existing debt is increased to retain the negotiated cushion. The protection is often subject to carve-outs and may be subject to a sunset provision.
2. MFN on Terms	Terms and conditions of the new debt cannot be materially more favorable to the new lenders than (or more favorable, taken as a whole, or must be substantially consistent with) those of the existing loans, subject to certain carve-outs. A terms MFN may be inapplicable (a) to periods after the existing debt's maturity, (b) if the existing lenders receive the benefit of such favorable terms and conditions, (c) if the terms are reasonably satisfactory to the agent and/or (d) if the terms and conditions reflect then current market terms and conditions at the time of the incurrence.
3. Maturity Limitations	New debt cannot have an earlier maturity, except perhaps customary bridge loans and loans pursuant to an inside maturity basket.
4. Weighted Average Life to Maturity	New debt cannot have a shorter weighted average life to maturity, subject to any inside maturity basket. Otherwise, amortization may differ, or may not exceed some annual percentage.
5. Collateral and Guarantees	No subsidiary of a borrower can be a guarantor of the new debt if it is not a guarantor of the existing debt, and no asset can be encumbered as collateral in support of the new debt if not collateral for the existing debt. If secured, an intercreditor agreement is typically required.
6. Non-Guarantor Sub-Limits	The amount of ratio debt available to non-guarantors may be subject to a sub-limit. Shared sub-limits may be inserted.

	Type of Protection	Explanation
7.	***Mandatory Prepayments***	New lenders may participate in mandatory prepayments on a pro rata basis or less than pro rata basis (but no greater than pro rata basis).
8.	***Financial Covenants***	No new financial maintenance covenant may be permitted, except if added for the benefit of the existing lenders with certain qualifications.

The existing lender protections summarized above are sometimes negotiated points or may exist based on the agreed precedent used in a given credit agreement. The differences may be principled in basis: for example, pricing MFN protection may be sensible for syndicated debt under the accordion but less applicable under the incremental-in-lieu basket (*i.e.*, different circumstances and not comparable markets), all the more so in connection with unitranche financing, a shareholder loan or bond offering. Other differences may evolve as legacy items that are not at the time considered material.

Notable Adjustments to the Accordion and Ratio Debt Prongs

When direct lenders consider investing into an existing structure, they may insist on a host of amendments to more firmly entrench their long-term interests and to limit dilution.

Syndicated credit agreements will likely give the borrower and new lenders the latitude to make lender-favorable adjustments subject to the terms' MFN provision and other protections discussed above, even if such incoming lenders will not constitute "Required Lenders" and hold a majority position of the loans. To preserve their likelihood of recovery and their tier in the capital structure, well-advised lenders will scrutinize whether amendments are appropriate; for example, by focusing on ratio levels, EBITDA adjustments, financial covenants, leakage to non-guarantors (including material intellectual property), anti-layering, guarantee/collateral release provisions and perhaps ROFOs with respect to incremental debt. Direct lenders may also wish to alter the voting provisions in relation to the payment waterfall and pro rata sharing provisions and seek additional consent requirements for potential priming transactions in connection with repurchases of debt on a non-pro rata basis. The list of potential changes is varied and deal specific.

Assuming a general willingness to accommodate more restrictive terms, borrowers are often successful in the current credit climate countering with compromise language for operational and structural reasons and to prevent trip-wire defaults. For instance, in response to "J. Crew" blockers on transferring material intellectual property, "Material IP" could be limited to a main brand of the company or defined to be the material IP of the company and its subsidiaries, taken as a whole (as determined by the borrower in good faith) with other carve-outs that satisfy both parties' concerns. As another example, instead of a blanket sub-limit, new caps on non-guarantor debt can be confined to *debt for borrowed money* to afford foreign subsidiaries (outside the credit group) further room to incur capital leases. As part of discussions to add voting requirements, the parties may agree on certain "Serta" exceptions, including where existing lenders are offered a bona fide opportunity, on a pro rata basis, to provide additional debt on the same terms and conditions as new lenders. Application of other protections – such as maturity restrictions or a pricing MFN provision – could be tied to new debt in excess of an agreed threshold, as opposed to any debt under the accordion and ratio baskets.

Conclusion

Existing investors may expect certain protections built into the credit agreement from the original closing to keep them on an even keel with new lenders. Negotiated carve-outs and exceptions under the accordion and the negative covenants may belie those expectations. An important example is pricing MFN protection that may not translate into corresponding protection under other baskets. The same may be true for other protections that may not apply equally across the accordion, incremental in-lieu basket, ratio debt basket and acquisition debt basket, affording a borrower critical flexibility to structure a debt investment, including vis-à-vis a sidecar facility discussed above.

Direct lenders have been gaining leverage to obtain more attractive terms in light of today's challenging financing markets. As they collaborate to provide larger loans, they are seeing increased traction among both mid-size private equity firms and large-cap sponsors. As a general matter, direct lenders may expect different terms as part of their loans. Existing syndicated terms with respect to rules governing incremental and ratio debt have attracted a brighter spotlight as a consequence. Understanding the universe of incremental provisions and ratio debt will limit surprises for companies and lenders.

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