What's Market: 2019 Mid-Year Trends in Large Cap and Middle Market Loans

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Samantha, Judson, and Jay explore MFNs, EBITDA addbacks, and documentary protections in loan agreements against potential suits by lenders.

What borrower flexibility are you continuing to see in the large cap market? Have any of these terms made their way into the middle market?

The MFN provision continues to be a key focus for both lenders and borrowers and, for some market participants, is the single biggest negotiation point (aside from pricing and fees). For borrowers, the ability to avoid the application of the MFN has proven to be extremely valuable, especially in distressed situations. Consequently, borrowers have negotiated significant carve-outs to the application of the MFN in the form of "sunsets" and other exceptions.

Many large cap deals include an MFN "sunset" - a period after which MFN protection no longer applies. While sunsets have often been flexed out during syndication, the percentage of loans with MFN sunsets has increased since the fourth quarter of 2018 (though this percentage remains below the level seen in the third quarter of 2018). Among those loans with MFN sunsets, 12-month sunsets have been more common in 2019 than the more lender-friendly 18-and-24-month sunsets seen in prior markets.

Other exceptions to MFN protection continue to expand in large cap deals, and often include, in general terms:

- Debt other than pari passu secured "broadly syndicated" term B loans (therefore allowing borrowers to incur additional pari passu secured debt in the form of bonds without tripping the MFN).
- Use of the fixed dollar or ratio basket, as determined by the borrower.
- Incremental loans incurred in connection with an acquisition or investment.
- Incremental loans that mature after a specified period (usually one to two years) following the maturity of the existing loans.
- A specified dollar amount of incremental loans.

MFN sunsets and exceptions are also found in middle market deals, with a few notable differences. First, while some large caps deals have cleared the market with a 75 bps MFN, MFN protection higher than 50 bps remains far less common in middle market deals, given that underwriting banks in that market remain extremely reluctant to market or agree to an MFN greater than 50 bps (even with flex). Second, inside maturity exceptions subject to a dollar cap appeared in about 30% of middle market deals, compared to 70% of large cap deals. Lastly, middle market deals with six-month sunsets continue to remain more atypical than six-month sunsets for large cap deals (with twelve-month sunsets being the most common sunset for both).

Another way in which deal terms continue to give borrowers sufficient flexibility to operate their businesses is with respect to EBITDA addbacks. Given that EBITDA is used in the calculation of financial ratios and tests including various leverage-based baskets, adjustments to EBITDA are an important area of focus for borrowers and lenders.

Much of the negotiation between lenders and borrowers around EBITDA centers on certain "run-rate" cost-savings and synergies that are prospective in nature and added back to EBITDA on a pro forma basis. These negotiations often revolve around the following questions:

- **What is the scope of cost-savings/synergies that may be added back?** While the addback for cost-savings/synergies was historically limited to an identifiable transaction (for example, an acquisition), many large cap deals have cleared the market with an expanded cost-savings/synergies addback that includes operational improvements (for example, from entry into new contracts) and revenue synergies.
- **Should the addback for "run-rate" cost-savings/synergies be capped?** Uncapped adjustments continue

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to appear in about two-thirds of large cap sponsor deals and about a third of middle market sponsor deals. In middle market deals and large cap deals with a cap, caps range from 15-35% of EBITDA, with around 20-25% being the most common cap. In certain instances where a cap is agreed, adjustments of the type found in the sponsor model, quality-of-earning report, and Regulation S-X are generally not subject to the cap.

- **When can a borrower give effect to prospective add-backs?** Most large cap and middle market deals permit borrowers to add back cost savings after steps have been implemented, are expected to be implemented, or when substantial steps have been taken. It is operationally important for borrowers not to have to wait for cost savings to be realized (or to be expected to be realized) before making the adjustment, as time periods for realization cannot be easily determined.
- **Should the addback be limited by a "look-forward" period?** In large cap transactions, the "look-forward" period within which substantial steps toward cost saving must be taken is often subject to negotiation. Twenty-four months is a common look-forward period for pro forma adjustments, with stronger borrowers often getting 36 months. In middle market transactions, look-forward periods are similar, though in some cases the look-forward period will apply to the realization of cost savings, compared to the implementation or taking of substantial steps in large cap transactions.

We expect these borrower-friendly MFN and EBITDA trends to continue as the market continues to lean in favor of borrowers. These trends will also continue and expand in the middle market space as traditional large cap sponsors look for opportunities in the middle market.

What documentary protections are borrowers seeking in response to the recent increase in lender mobilization and litigation? Do you expect these trends to continue?

As distressed borrowers continue to engage in various forms of liability management transactions, individual lenders have increasingly turned to litigation in which they allege, among other things, that certain covenants have been breached or will be breached because of a borrower's actions.

In response to this increasing lender litigation, borrowers are seeking to ensure that existing and new loan documentation contains adequate protections against potential suits by lenders seeking to invalidate or prevent certain actions. Towards this end, borrowers increasingly seek to do the following:

Negative Covenants

- Eliminate all references to "directly or indirectly" in the lead-in to all negative covenants where the language appears, as each covenant and its corresponding baskets are intended to stand on their own. One potential consequence of this language is that investors may challenge a particular action (for example, a restricted payment) on the grounds that, for example, the borrower used investment capacity and not restricted payment capacity to indirectly make the restricted payment (despite having the requisite restricted payment capacity).
- Eliminate any restriction on refinancing indebtedness being secured by senior liens, as any such restriction would unfairly prohibit the incurrence of senior liens even where a borrower otherwise has capacity under its lien covenant.

Amendments

- Ensure that amendments to the loan documents are subject solely to the consent of the borrower and the required lenders (or (i) in the case of certain "sacred rights", all lenders or all affected lenders and (ii) in the case of incremental amendments, incremental lenders), and not the administrative agent. Borrowers also increasingly seek to limit the number of historically "sacred rights" subject to 100% lender consent, including, without limitation, the right to amend the pro rata sharing provisions and payment waterfall.
- Limit the voting rights of lenders that are "net short".

Agency Provisions

- Have the lenders authorize the agent to:
  - sign release documentation to evidence any automatic lien release (while expressly providing in the loan agreement that the agent's failure to sign such release documentation will not affect the automatic release of collateral in accordance with the loan documents); and
  - rely on a borrower's certification in signing such release documentation.
- Require the agent to sign release documentation upon the borrower's delivery of such certification.
- Expand the "collective action" provisions to ensure that (i) lenders are unable to sue the borrower on an individual basis and (ii) similar to the rights of lenders to exercise remedies with respect to collateral and events of default, all litigation be brought solely by the required lenders, or the administrative agent at the direction of the required lenders. An expanded version of the more customary "collective action" provision is currently in the market and prohibits lenders from hindering the automatic release of any security interest.
- Have the right to approve any replacement administrative agent even during a payment or bankruptcy event of default.

Events of Default/Exercise of Remedies

- Where a Default or Event of Default is triggered by the giving of notice by the administrative agent, include a statute of limitations (for example, two years) on the administrative agent's ability to send such a notice. Such a statute of limitations serves to prevent opportunistic lenders from enforcing a particular covenant many months or years after a borrower allegedly breached such covenant (and such breach became known to lenders).
- Ensure that the administrative agent does not have any discretion over the exercise of remedies upon an Event of Default and that such exercise be solely at the discretion of the required lenders.

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Intercreditor Agreements: Often the incurrence of future debt requires the administrative agent or the existing lenders to enter into an intercreditor agreement.

- Negotiate forms of pari passu and junior lien intercreditor agreements at the closing of the initial financing, even when no such debt exists at the time of the initial financing, in order to eliminate potential obstacles to future debt incurrence.
- Include an express authorization from the lenders for the administrative agent to enter into additional intercreditor agreements on behalf of the lenders, including in the event that the general debt and liens baskets are utilized by the borrower for the incurrence of additional first lien or junior lien debt.
- Clarify that the consent of the administrative agent is not required for the effectiveness of additional first lien or junior lien debt incurred via the general debt and lien baskets, including that any failure on the part of administrative agent to enter into an intercreditor agreement does not impact the effectiveness thereof.

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