Recent Trends in Incremental Loan Facilities

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Incremental loan facilities afford a borrower the ability to incur additional term loans or revolving loan commitments under an existing loan agreement if current and/or new lenders agree to provide them. These facilities enable the borrower to efficiently access additional funding because incremental debt incurrence requires the consent of only the lenders providing the financing and the administrative agent. Majority lender consent is not required. Rather, typically only a fairly simple amendment is needed – making incremental facilities an attractive option for borrowers, particularly for follow-on acquisition financing.

While incremental loan provisions traditionally have been included in large cap loan agreements, they are now common in larger middle market deals and also appear in a limited number of smaller middle market deals (generally with tighter terms). In large cap deals, incremental facilities can be structured as either an increase to an existing class of term loans or revolving loan commitments or as one or more additional tranches of term loans or revolving loan commitments. Typically the terms of incremental loans are substantially similar to those of the existing loans, except for pricing, fees, amortization and maturity.

Customarily, incremental term loans:

- cannot have a final maturity date earlier than the existing term loan maturity date;
- cannot have a weighted average life to maturity shorter than the weighted average life to maturity of the existing term loans;
- rank *pari passu* with the existing loans or junior in right of payment and/or security or are unsecured (but sometimes must rank *pari passu*);
- are not secured by any additional collateral or guaranteed by any additional guarantors than the existing term loans;
- participate pro rata or less (but not greater) than pro rata with the existing term loans in mandatory prepayments; and
- have covenants and events of default identical to or not materially more restrictive to the borrower than those in the existing term loan facility, except to the extent such terms apply only after the latest maturity date of the existing term loans or (sometimes) if the loan agreement is amended to add a "previously absent financial maintenance covenant" (any financial maintenance covenant either not included in the existing term loan facility or having more restrictive covenant levels and component definitions (to the extent relating to such financial maintenance covenant)).

In some recent deals, top tier sponsors have succeeded in excluding a negotiated amount of incremental term loans (the "incremental maturity carveout amount") from the customary requirement that an incremental term loan facility not have an earlier maturity date or a shorter weighted average life to maturity than the existing term loan facility.

Pricing, interest rate margins, rate floors, discounts, premiums and fees for incremental term loans are determined by the borrower and the lenders providing such incremental term loans. To protect the current term lenders from significantly higher pricing for the incremental loans, most favored nation (MFN) provisions customarily apply so that only a limited increase in pricing (usually 50 basis points) for *pari passu* incremental term loans is permitted without requiring an interest rate increase on the existing term loans to the extent necessary to eliminate the greater pricing differential. The MFN protection applies to all-in yield which includes interest rate margin and floors, original issue discount, and upfront or similar fees, but excludes any arrangement fees, structuring fees or other fees that are not shared with all lenders. MFN protection may "sunset" after a set time period (frequently 12 or 18 months) from incurrence of the existing term loans, however, the MFN sunset is an issue for negotiation and may be lengthened or eliminated during syndication if lenders resist. Lenders frequently push back on MFN sunsets and removal of the sunset from MFN clauses during syndication is fairly common.

Recently, borrowers and sponsors have sought to limit the scope of MFN clauses by restricting the types of incremental term loans that would result in the existing term lenders having the benefit of MFN protection. In these deals MFN protection may be excluded with respect to incremental term loans (i) that mature more than two years (sometimes one year) after the latest maturity date of the existing term loans, or (ii) that are incurred in reliance on the ratio-based portion, or alternatively the "free and clear" portion (described below), of the incremental capacity. MFN protection also may be excluded for incremental term loans incurred to finance a permitted acquisition or similar investment, or a specified negotiated dollar amount of incremental term loans may be excluded.

Incremental revolving loan commitments usually are required to have substantially the same terms as the existing revolving loan commitments, other than pricing, fees, maturity and other immaterial terms that are determined by the borrower and the lenders providing such incremental revolving loan commitments. Although additional tranches sometimes are permitted in large cap deals, incremental revolving loan commitments frequently are provided as increases to the existing revolving loan commitments and may be combined with an extension of maturity of the existing revolving facility. If provided as a new tranche, incremental revolving loan commitments may not mature earlier than the existing revolver maturity date or be secured by additional collateral or guaranteed by additional guarantors than the existing revolving credit facility. More often than not, existing revolving lenders do not have MFN protection with respect to incremental revolving loan commitments.

Traditionally, the borrower's ability to incur incremental debt was limited to a fixed dollar amount and was conditioned on *pro forma* compliance with a maximum leverage ratio (typically the financial maintenance covenant leverage ratio). With the highly liquid loan market in recent years, borrowers and sponsors have been able to successfully negotiate maximum flexibility in loan agreements to incur debt and implement changes in the borrower's capital structure. This flexibility is reflected in several incremental facility terms that are now common in large cap deals -- "free and clear" incremental debt baskets, reclassification of free and clear incremental debt as ratio-based debt, incremental equivalent debt and limited conditionality for incremental debt incurred to finance an acquisition.

Incremental debt capacity in the large cap market and higher end of the middle market now usually consists of the sum of (i) a "free and clear" dollar amount, (ii) the amount of prior voluntary term loan prepayments not funded with long term debt and permanent revolver commitment reductions, and (sometimes) prior cash payments made for loan buybacks and purchases, and (iii) unlimited debt subject to *pro forma* compliance with a maximum net leverage ratio (frequently set at closing date leverage but sometimes tighter). To the extent proceeds of ratio-based incremental debt are being used to finance an acquisition, as an alternative to a maximum net leverage ratio the leverage test sometimes requires only no increase after giving effect to the incremental debt incurrence from the leverage ratio immediately prior to such incurrence. For purposes of calculating incremental ratio-based capacity, such incremental commitments are assumed to have been fully funded at closing, and the proceeds of such incremental loans being incurred are not cash netted from total debt for purposes of determining the net leverage ratio.

The "free and clear" fixed amount is available to the borrower without regard to leverage and sometimes contains a "grower" component so that the basket is the greater of a fixed dollar amount and a specified percentage of LTM EBITDA at the time of incurrence. It is not unusual for the fixed dollar amount to be reduced, or the grower component dropped, during syndication if there is lender resistance. The ratio-based capacity may be deemed to be used before, or together with, the free and clear basket, in which case any amount concurrently incurred in reliance on the free and clear basket does not count in the leverage calculation for purposes of testing ratio-based capacity. In many large cap deals, the borrower can initially utilize the free and clear basket to incur incremental debt that does not at the time satisfy the leverage test and subsequently reclassify that debt (or sometimes the debt is automatically deemed reclassified) as ratio-based debt when the leverage test is met, having the effect of refreshing the free and clear basket.

The ability to incur incremental equivalent debt (or "sidecar" facilities) is now common in large cap deals. Sidecars use the incremental debt capacity (including the free and clear basket), but are incurred as a separate facility outside the loan agreement, subject to customary conditions including an acceptable intercreditor agreement. Sidecars may include first lien secured notes, junior lien or unsecured loans and notes, and (to a lesser extent) first lien loans. An issue for negotiation will be the application of MFN protection to any permitted sidecar first lien loans, however MFN protection invariably does not apply to other sidecar debt.

Customarily, conditions to incremental debt incurrence have included material accuracy of representations and warranties, absence of default or event of default, and *pro forma* compliance with the existing financial covenant (if any), each tested at the time of incurrence of the incremental debt. In recent years, borrowers and sponsors have succeeded in limiting conditionality for incremental debt incurred primarily to finance an acquisition, thereby diminishing financing risk for follow-on acquisitions. As it has become common for acquisition agreements to not contain a financing condition, this development enables buyers to assure sellers of the certainty of funding.

Limited conditionality for incremental acquisition financing in large cap deals now frequently incorporates so-called "Sungard" (or "certain funds") conditionality, under which incremental debt incurred primarily to finance an acquisition is conditioned on a bringdown of only (i) those representations and warranties in the acquisition agreement relating to the target that are required to be true at closing and (ii) certain agreed "specified representations," limited to fundamental corporate status and authority, compliance and regulatory issues (*i.e.,* margin regulations, Investment Company Act of 1940, anti-terrorism and money laundering laws), enforceability of the loan documents, no conflicts with law, solvency and status of liens (subject to limitations). Also, the absence of defaults condition is limited to the absence of payment or bankruptcy default. As an alternative, some incremental facility provisions provide for testing of the absence of all defaults condition, and (sometimes) the bringdown of all representations, at the time of signing of the acquisition agreement rather than at closing. This limited conditionality may be set forth expressly in the loan agreement or may be subject to the agreement of the lenders providing the incremental facility.

In addition, many large cap loan agreements now permit a borrower that has committed to an acquisition without a financing commitment to elect the date of the acquisition agreement (instead of the closing date) as the date of determination for purposes of calculating *pro forma* leverage ratios in order to test ratio-based incremental debt capacity. Testing of the leverage ratio at signing eliminates the risk of a decline in EBITDA of the borrower and the target between signing and closing, when the ratio otherwise would be tested. This risk is of special concern in deals involving a lengthy delay between signing and closing due to regulatory approvals.

While many large cap and upper middle market deals reflect this flexibility for incremental debt and limited conditionality for incremental acquisition financing, incremental loan provisions in smaller middle market deals remain more traditionally restrictive. Many lower middle market agreements do not permit incremental debt at all and lenders frequently resist lower middle market borrowers' requests to include incremental facilities. When permitted, lower middle market deals invariably permit incremental loans only up to a fixed dollar amount and frequently impose a limit on the number of times that incremental debt can be incurred over the term of the loan agreement (usually three to five times). Limited conditionality for incremental debt used for acquisitions does not apply in lower middle market deals and *pro forma* compliance with the financial covenants (and sometimes with a tighter leverage ratio) in the agreement typically is required.

Frequently, lower middle market incremental debt consists only of increases in the amount of revolving loan commitments or *pari passu* new tranches of term loans with identical terms (other than fees), including maturity, to the existing loans. Pricing sometimes may be permitted to differ, however any increase in interest rate may have to be matched for the existing loans. Other restrictions may apply, such as a maximum amount for each incremental loan incurrence. In some lower middle market loan agreements, incremental financing may be limited to increases in commitments in an existing tranche of revolving loans, and incremental term loans are not permitted.