Expert Insights: Recent Trends in Incremental Loan Facilities

A Lexis Practice Advisor® Practice Note by
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This practice note discusses trends in incremental loan provisions and incremental equivalent debt facilities that are commonly included in loan agreements in large cap and upper middle market deals, and also appear in some traditional middle market deals.

This note addresses the following topics:

- Incremental Loan Terms
- Incremental Debt Capacity
- Conditions to Incremental Debt Facilities

Incremental loan facilities afford a borrower the ability to incur additional term loans or revolving loan commitments under an existing loan agreement without the consent of the existing lenders, subject to certain conditions and within negotiated limitations. These facilities enable the borrower to efficiently access additional funding if current and/or new lenders agree to provide it. Typically, only a simple amendment is needed, making incremental facilities an attractive option for borrowers—particularly for follow-on acquisition financing. Incremental equivalent debt (or “sidecar” facilities) uses the incremental debt capacity but is incurred as a separate facility outside the loan agreement, subject to customary conditions including an acceptable intercreditor agreement. Incremental equivalent debt may consist of first lien secured notes, junior lien or unsecured loans and notes, and (sometimes) first lien loans.

While incremental loan provisions and incremental equivalent debt routinely have been included in large cap loan agreements, they are now common in upper middle market deals and also appear in some traditional middle market deals (generally with tighter terms). In large cap and upper middle market deals, incremental facilities can be structured as either increases to an existing class of term loans or revolving loan commitments or as one or more additional classes of term loans or revolving loan commitments. Although the same flexibility may be provided in traditional middle market deals, sometimes only increases to existing classes of term loans or revolving loan commitments are permitted.

INCREMENTAL LOAN TERMS

Customarily, the terms of incremental loans are substantially similar to those of the existing loans, except for pricing, fees, amortization and maturity. Incremental term loans generally:

- 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, particularly in the traditional middle market, must rank pari passu both in right of payment and security)
- 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
- 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 or conform to the more restrictive terms of the incremental debt that do not apply at the time to the existing term loan facility (e.g., a financial maintenance covenant or component definitions relating to such covenant)

Recently, sponsors in large cap deals have been pushing to exclude a negotiated amount of incremental term loans (the “inside maturity carveout amount”) from the standard 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 (with such carveout subject to flex provisions).

MFN Provisions

Pricing, interest rate margins, rate floors, discounts, premiums, and fees for incremental term loans are determined by the borrower and the lenders providing the incremental facility. To protect the current term lenders from significantly higher priced incremental debt, most favored nation (MFN) provisions customarily apply for pari passu incremental term loans so that only a limited increase in pricing (conventionally 50 basis points however increasingly borrowers are seeking a 75 basis point differential) from pricing on the existing 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. Borrowers commonly seek to have the MFN protection “sunset” after a set time period (often 12 but sometimes 6 months) from incurrence of the existing term loans. An MFN sunset almost always is a focus of lender attention and may be lengthened or eliminated during syndication.

Recent years have seen a significant erosion of MFN protection. In addition to an increase in the frequency of MFN sunsets, borrowers are pushing for limitations on the types of incremental term loans that trigger MFN protection for the existing lenders. For example, MFN protection may be excluded for incremental term loans that (1) mature more than two years (sometimes one year) after the latest maturity date of the existing term loans, (2) are incurred other than in reliance on the ratio-based portion (or alternatively, the “free and clear” portion) of the incremental capacity (described below), (3) are incurred to finance a permitted acquisition or similar investment, or (4) are not syndicated term loans. MFN protection also may be excluded for a negotiated dollar amount of incremental term loans. The parameters of MFN protection are highly negotiated and typically subject to flex provisions, and removal or modification of sunsets and aggressive exclusions during syndication is not unusual depending on the market. Although MFN protection sometimes applies to incremental equivalent debt in the form of pari passu term loans, it invariably does not apply to other types of incremental equivalent debt.

Incremental Revolving Loan Commitments

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 regularly are permitted in large cap deals, incremental revolving loan commitments sometimes are available only 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. With some exceptions, existing revolving lenders usually do not have MFN protection with respect to incremental revolving loan commitments.

INCREMENTAL DEBT CAPACITY

Historically, the borrower's ability to incur incremental debt was limited to a fixed dollar amount and was conditioned on pro forma compliance with the maintenance covenant leverage ratio. While this is still the case in the lower middle market, borrowers and sponsors in larger deals 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 standard in large cap and upper middle market deals: capacity based on a "free and clear" fixed dollar basket plus a ratio-based basket, reclassification of free and clear incremental debt as ratio-based debt, and limited conditionality for incremental debt incurred to finance an acquisition.

Generally, incremental debt capacity in the large cap market and upper middle market consists of the sum of (1) a "free and clear" dollar amount (frequently set at closing date consolidated EBITDA), and (2) unlimited debt subject to pro forma compliance with a maximum leverage ratio (frequently set at closing date leverage but sometimes tighter). For unsecured and (sometimes) junior lien debt, in some agreements a minimum fixed charge or interest coverage ratio test may be met as an alternative to satisfying the maximum leverage test. In many instances incremental capacity is increased by an amount equal to (1) 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 (2) in the case of incremental debt that serves to extend the maturity of existing loans, the amount of loans and/or commitments replaced by such incremental debt.

In larger deals to the extent proceeds of ratio-based incremental debt are being used to finance an acquisition, as an alternative to the maximum net leverage ratio test there may be a leverage neutral test -- incremental debt incurrence does not worsen the leverage ratio existing immediately before 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 the incremental loans being incurred are not cash netted from total debt in determining a net leverage ratio.

The "free and clear" fixed amount is available to the borrower without regard to leverage and in many instances contains a "grower" component so that the basket is the greater of a fixed dollar amount and an equivalent percentage of the last 12 months' (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. Depending on the type of incremental debt being incurred (first lien, second lien or unsecured), the leverage test applied will vary (first lien leverage, senior secured leverage, or total leverage). 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 and upper middle market deals, the borrower initially can utilize the free and clear basket to incur incremental debt that does not at the time satisfy the leverage test and subsequently elect to reclassify that debt (or the debt may be automatically reclassified) as ratio-based debt when the leverage test is met, thereby effectively refreshing the free and clear basket. Lenders in traditional middle market financings allowing for both fixed and ratio-based baskets conventionally have required the borrower to use the fixed basket first and did not permit reclassification but that construct has started to loosen as reclassification flexibility moves down market.

CONDITIONS TO INCREMENTAL DEBT FACILITIES

Traditionally, 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 to finance an acquisition, thereby diminishing financing risk for follow-on acquisitions. As acquisition agreements now rarely contain a financing condition, limited conditionality enables buyers to assure sellers of the certainty of funding and is important in an auction scenario.

Limited conditionality for incremental acquisition financing in large cap and many upper middle market deals now customarily incorporates so-called “SunGard” or “certain funds” conditionality, under which incremental debt incurred to finance an acquisition is conditioned on the accuracy of only (1) those representations in the acquisition agreement relating to the target that are required to be true at closing of the acquisition and (2) certain agreed “specified representations.” Specified representations are 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, for acquisition debt the absence of defaults condition frequently is limited to the absence of payment or bankruptcy default. Alternatively, some incremental facility provisions provide for testing of the absence of all defaults condition, and the bringdown of all representations, at the time of signing of the acquisition agreement rather than at closing, if the borrower elects such date as the test date. This limited conditionality may be established in the loan agreement or may be subject to the agreement of the lenders providing the incremental facility. Special Considerations in Acquisition Financings and SunGard Conditionality and SunGard Conditions Clauses (Commitment Letter).

In addition, many large cap loan agreements now permit a borrower that has committed to an acquisition without a financing condition to elect the date of the acquisition agreement (instead of the date of incremental debt incurrence) as the date of determination for purposes of calculating pro forma leverage ratios in order to test ratio-based incremental debt capacity. The borrower is permitted to include the EBITDA of the target at the time of such testing. 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 include flexibility in incremental debt provisions and limited conditionality for incremental acquisition financing, incremental facility provisions in lower middle market deals have been more traditionally restrictive. Many lower middle market agreements have traditionally not permitted incremental debt at all and lenders have resisted 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 sometimes impose a limit on the number of times that incremental debt can be incurred over the term of the loan agreement (e.g., three to five times). Limited conditionality for incremental debt used for acquisitions does not generally apply in lower middle market deals and pro forma compliance with the financial covenants (and sometimes with a tighter leverage ratio) in the agreement usually 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.

For a sample incremental facility provision, see Incremental Facility Clauses (Credit Agreement). For more on this topic, also see The Client Asks: How Do We Exercise an Incremental Facility?, and Incremental Term Loan Lender Agreement.

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