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Beware Shifting Provisions In Middle-Market Loan Documents

By **Rick Hyman, Kevin Rubinstein and Scott Lessne** (June 12, 2024, 5:57 PM EDT)

Since the recovery from the financial crisis of 2008-2010, the role of sponsors in the leveraged loan markets has grown exponentially. With that growth, members of the sponsor community have been well-positioned to take advantage of their leverage with eager lenders.

Rick Hyman

This shift may have started with so-called covenant-light facilities, but it didn't end there. Many provisions in credit facilities that had been considered market standard for decades were negotiated, often turning in favor of borrowers.

Other provisions were added anew, providing extraordinary flexibility for borrowers, leaving lenders with few avenues of recourse. For many years, these provisions were usually limited to very large syndicated financings. More recently, however, these provisions have found a home in many middle-market transactions.

Kevin Rubinstein

Interest rates have remained high since the dramatic increases of 2022. Those higher rates, combined with the loss of stimulus payments that were made available during the pandemic, are now to taking their toll on many borrowers in the middle market. As a result, middle-market credits have been finding their way to workout groups at a higher pace, landing on the desks of workout officers who may be facing some of these borrower- and sponsor-friendly provisions for the first time.

Scott Lessne

Here, we provide a high-level summary of just a few examples of provisions that have drifted down to middle-market loan documents and that workout officers and their restructuring counsel should be on the lookout for.

Incremental Facilities

Incremental loan facilities — or accordions — allow a borrower the opportunity to layer additional terms and revolving debt into a credit facility from existing or new lenders.

Eliminating the need for separate loan documents, incremental loans can be implemented with an amendment, joining the new debt as an increase to an existing tranche or as a new tranche. While the new debt is added to the existing credit agreement, economic terms such as the interest rate may differ.

Importantly, the incremental facilities will typically rank on equal footing with the existing debt and may have consequences on voting rights, particularly when new lenders are joined. In certain cases, borrowers are permitted to incur incremental facilities with maturities that are earlier than those in the existing facility, which essentially allows such incremental debt to rank ahead of the existing loans.

Incremental facilities have rarely been accessed in the middle market, particularly where the borrower's business is challenged. Nonetheless, the risk to existing lenders remains in the current environment where defaults may be difficult to find despite signals of distress.

Default Rate

Typically, upon the occurrence and during the continuance of an event of default, interest on the obligations accrues at an enhanced rate, often 2% above the otherwise applicable rate. This may happen automatically or require notice from the lender.

The nature of the event of default is irrelevant in these common formulations — a lender could apply the rate following a breach of financial covenants or the failure to deliver financial reporting following a cure period. This may be implemented as an economic enhancement or to incentivize the borrower toward a desired outcome.

In more recent credit agreements, however, a lender's rights to trigger the default rate may be much more limited. Those defaults that trigger the enhanced rate may be limited solely to payment defaults and insolvency events, for example.

The borrower's obligations that are subject to the default rate may be further limited to late payments rather than the entirety of the outstanding debt. In each case, unless the lender is prepared to accelerate the borrower's obligations, the default rate will be of less value, both monetarily and as a disincentive to avoid default, or quickly return to compliance.

Leakage

Sponsor-friendly covenants are becoming more common in the middle market and can result in an extraction of value outside of the credit group in the form of dividends, priming debt and prepayments of subordinated debt, to name a few.

Covenant baskets may be structured as the greater of a fixed amount and a percentage of earnings before interest, taxes, depreciation and amortization, with EBITDA often including a number of aggressive, subjective add-backs such as the ability to include anticipated cost savings and synergies projected to be realized from specified transactions. Such formulations of EBITDA can significantly increase a borrower's ability to incur additional debt or make restricted payments, including management fees.

The use of unrestricted subsidiaries has also made its way into middle-market loan documents and lenders must appreciate the ability of borrowers to move key assets to unrestricted subsidiaries or other nonguarantors by aggregating various investment and restricted payment baskets. In times of distress, borrowers will typically exhaust all avenues of covenant flexibility in loan documents before seeking amendments, often to the detriment of the lender.

Liability Management Transactions

Over the last several years, increasingly flexible loan documentation and weakening lender protections have enabled borrowers and sponsors to engage in a variety of liability management transactions, arguably at the expense of nonparticipating minority lenders. These priming transactions accelerated during the pandemic and have recently migrated into middle-market deals.

The list of sacred rights once thought to protect senior lenders against such transactions has narrowed in many deals and could be used by borrowers during times of distress to raise priming debt as a source of liquidity. It is critical for lenders to pay close attention to the range of transactions that are permitted under their loan documentation as well as the borrower's ability to seek amendments in the future with the consent of only a majority of the lenders.

Assignments

A lender's ability to sell its debt in the secondary market has traditionally been an important alternative when assessing options in a difficult credit. That path has narrowed greatly in many credit agreements, beginning with mega deals and now creeping into middle-market credit facilities.

Where lenders previously had relatively free rein to assign their loans, they may now be faced with fulsome disqualified lender lists delivered by or on behalf of the borrower at or around closing. Those lists may include financial players as well as competitors and may be supplemented from time to time post-closing. Restrictions may continue to apply following a default and even following an insolvency event.

Frequently, disqualified lender lists are not attached as a schedule, but rather may be delivered to the agent from time to time. While participations may present an opportunity to skirt these restrictions in some facilities, others bind participants to the same extent.

For workout officers and restructuring counsel that operate in the middle market, the lesson is clear: Make no assumptions. The examples above are just a sampling of those provisions where surprises may be lurking. A close review of the operative documents may require a shift in strategy from those traditionally used in workout 101 in order to protect the lender against aggressive tactics more commonly used by borrowers and their sponsors.

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