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Middle Market Loan Update

The Effect of the Financial Crisis on Middle Market Loan Terms

Part 1. Loan Buybacks

In addition to providing an object lesson in the dangers of lax lending standards, the global financial crisis of 2008 gave rise to a host of new borrower/lender issues. This three-part series will address three now-common credit agreement provisions that were developed to solve problems born of the financial crisis and that since their development have gained traction in the middle market: **Loan Buybacks**, **Amend and Extend** and **Equity Cures**. Like many sponsor-friendly credit agreement provisions, these terms were first developed in the "big-sponsor" market but are now generally accepted by most middle-market lenders.

Loan Buybacks

As markets slowed and revenues fell through 2008 and into 2009, borrowers and sponsors became frustrated that certain provisions in their credit agreements prohibited opportunistic debt buyback. The credit crisis created attractive pricing (from a buyer's perspective) in the secondary market and offered an opportunity, even for relatively strong borrowers, to de-lever at a significant discount. Such was the downward pressure in the loan-trading market that a company, even though it had enough unrestricted balance sheet cash to consider buying back its debt (and thus was presumably a relatively healthy company) saw its outstanding loans trade a significant discount to par. The benefits of a buyback to borrowers and sponsors were obvious: a chance to reduce interest payments and increase covenant compliance at a discounted rate when compared to at-par optional prepayments.

Types of Buybacks

A buyback comes in one of two forms (i) a borrower buyback, in which the borrower itself purchases the loan directly from a lender or (ii) a sponsor buyback, in which the sponsor or some other affiliate of the borrower (normally a subsidiary or newly formed super holdco of the borrower) purchases the loan from a lender. These two scenarios shared common problems but also gave rise to their own unique challenges.

- **The Borrower Buyback:** When outstanding debt is purchased directly by the borrower it is akin to a non-pro-rata prepayment of the loan at a discount to par (almost all credit agreements permit the borrowers to prepay the loan at par on a pro-rata basis). As in the case of a prepayment, once a borrower buyback is completed, the corresponding portion of the loan purchased by the borrower is cancelled. The cancellation of the debt benefits both the remaining lenders and the borrower. The borrower has reduced the debt component of its leverage ratio calculations as well as the fixed

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charge component of its fixed charge coverage ratio. Because the purchased debt is cancelled, the remaining lenders do not have to contend with thorny intra-lender issues that would arise if the borrower were a member of the lending syndicate. Additionally, the remaining lenders see their share of the collateral grow because overall debt declines by an amount greater than the assets used to pay it off.

- **The Sponsor Buyback:** When outstanding debt is purchased by the sponsor or another borrower affiliate, the debt is not extinguished and remains outstanding. In this scenario the buyback is viewed as a sale or assignment of the debt rather than a non-pro-rata prepayment.

The Old Technology Created Problems

Putting aside initial Lender objections to the perceived unfairness of debt buybacks (the primary complaint being that the borrower is permitted to benefit from adverse market conditions), a number of more substantive technical problems were uncovered that prevented willing participants from engaging in buybacks.

The two major impediments to conducting a buyback were the "Eligible Assignee" definition and the pro-rata sharing requirements among lenders. While certain other provisions (for example, excess cash flow sweep calculations, affiliate transactions, and permitted investments) also created issues, the above two stumbling blocks were the primary impediments in preventing willing borrowers and lenders from engaging in buybacks absent an amendment to the credit agreement.

- **Eligible Assignee:** Many credit agreements expressly excluded the borrower (and often any borrower affiliate or sponsor) as an eligible assignee of the loan. This prohibition was often a direct roadblock to either type of buyback. To the extent the credit agreement was silent on the sponsor as an eligible assignee, and only prohibited borrower buybacks (which was a common scenario), administrative agent consent became an issue. In the leveraged-loan market, administrative agent consent is virtually always required for an assignment to a third party that is not a lender or a lender affiliate. Administrative agents were thus put in a difficult position of being asked to consent to a sponsor buyback that might offend members of the syndicate, or decline consent and risk offending the sponsor.

- **Pro Rata Sharing Requirements:** One of the basic tenets of the syndicated lending market is that all lenders are to be treated equally and ratably as among themselves. The credit agreement provision that implements this intra-lender agreement is the "pro-rata sharing" requirement. Certain intra-lender "turn-over" provisions effectively implement this concept. In its simplest form, the pro-rata sharing requirement requires any Lender that receives a payment in excess of its pro-rata share of the credit to turn over such excess to the other lenders. This mechanism prevents a borrower from favoring one lender to the detriment of the rest of the syndicate. Because it resulted in a non-pro-rata

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prepayment, the borrower buyback concept ran afoul of the pro-rata sharing requirement, and the selling lender would have to redistribute its loan sale proceeds to the other lenders in exchange for a portion of the loan it had just sold.

So the desired economics could not be reached without Lender consent, and because the pro-rata sharing requirements often required unanimous Lender consent to amend, chances of a successful amendment were remote.

State of Play as of 2013

To solve this problem, borrowers and sponsors began demanding that newer credit agreements be hardwired for debt buybacks on day one. Lenders, realizing that buybacks could benefit themselves as well as their borrowers, have often agreed to this request but have included various lender safeguards to ensure protection of the remaining lenders.

Primary Lender Safeguards

- The buyback offer must be made to all lenders. The two most common methods for conducting a buyback are a straight tender offer, in which each lender can either accept or reject the buyback in its discretion, or a reverse Dutch Auction, in which the borrower designates a fixed amount of debt it wants to pay off, solicits various lender offers, and then determines a price that clears the market.
- The borrower must retire any loans it purchases.
- The sponsor cannot hold more than a set percentage of the outstanding loan amount (customary permitted hold amounts are usually between 20% and 25% of the outstanding loan amount).
- The sponsor cannot vote on amendments and waivers to the loan agreement or other matters requiring lender consent, other than amendments or waivers affecting certain "sacred rights" (generally agreed to be the economics and the maturity date of the credit). This voting restriction is implemented by distributing sponsor votes in accordance with the votes cast by the non-affiliate Lenders.
- The sponsor's right to vote a plan in bankruptcy is either stripped or limited unless the sponsor would be affected in a disproportionately adverse manner.
- Except where the borrower participates, the sponsor cannot participate in lender meetings.
- The sponsor waives its rights to bring an action against the Administrative Agent or the other lenders in its capacity as a lender.
- Proceeds of a revolving loan borrowing cannot be used to fund the purchase.

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While far from boilerplate, loan buybacks have gained some measure of acceptance in the middle market. Sponsors and borrowers have come to appreciate the flexibility such provisions provide, and Lenders have developed a series of safeguards to protect their interests and get the deal done.

This document is intended to provide you with general information regarding loan buybacks. The contents of this document are not intended to provide specific legal advice. If you have any questions about the contents of this document or if you need legal advice as to an issue, please contact one of the attorneys listed below or your regular Brownstein Hyatt Farber Schreck, LLP attorney. This communication may be considered advertising in some jurisdictions.

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