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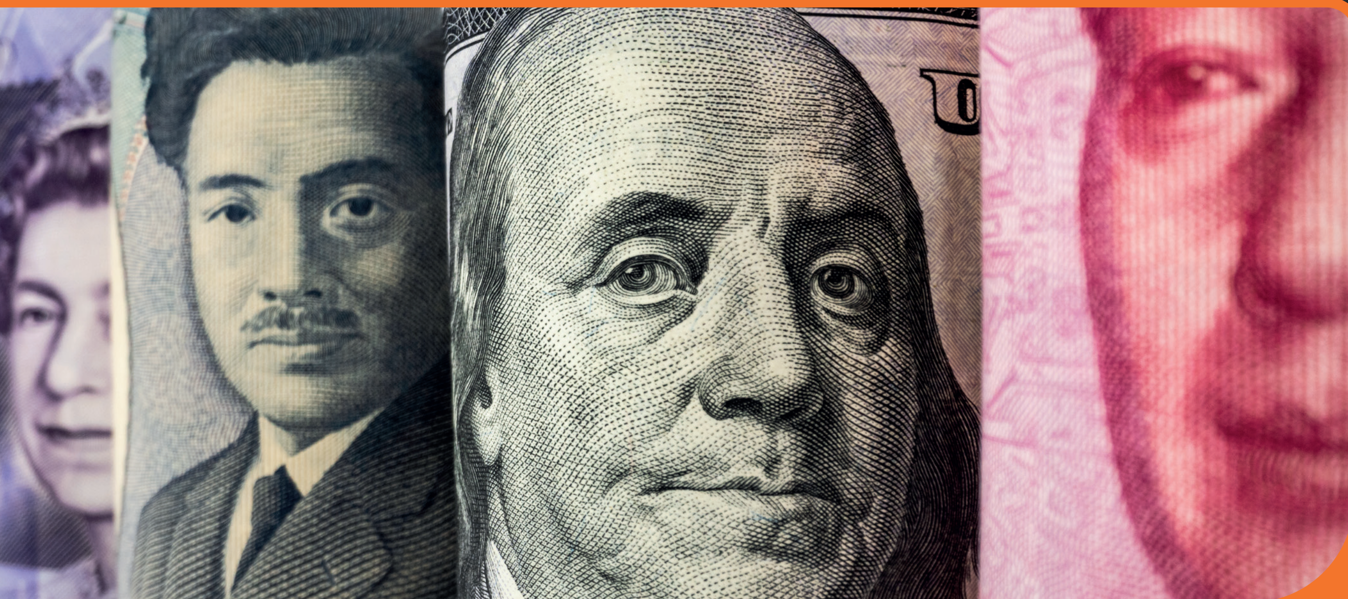

Practical cross-border insights into lending and secured finance

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Morgan, Lewis & Bockius LLP

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Analysis and Update on the Continuing Evolution of Terms in Private Credit Transactions

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Introduction

For the past 11 years, The Private Credit Group at Proskauer Rose LLP has tracked deal data for private credit transactions (our "data"). The data referred to in this chapter reflects trends and evolving terms in private credit transactions closed by The Private Credit Group at Proskauer Rose LLP in 2021 and may not be indicative of overall market trends.

The rapidly emerging private credit market has been making headlines for some time due to the market's compelling yield proposition and perceived permanence. The last decade has brought magnificent expansion in terms of a growing investor base and surplus funds earmarked for investment in the asset class. Additionally, in 2020, the private credit market demonstrated an exceptional durability in a post-COVID environment which further bolstered interest in the asset class. While many financings in the pre-commitment stage came to a halt in Q1 2020 and the market experienced a slowdown in the number of new financing opportunities coming to market, this proved to be only temporary. Despite the economic uncertainty (and predictions by many experts that COVID-19 would lead to one of the deepest recessions in U.S. history), the private credit market quickly rebounded and remained strong for the duration of 2020. It also became apparent that many industries (e.g., delivery services, online retailers, online entertainment and remote workforce solutions) would be unaffected by or even expand as a result of COVID-19 and an economic crash was unlikely. In light of this, many lenders viewed decreases in their borrowers' financial performance (if any) in 2020 as a fleeting issue and showed a willingness to work on out-of-court solutions in cases where credit defaults were impending or likely to occur. Lenders also showed a willingness to step in with amendments and capital infusions that helped keep defaults and bankruptcy proceedings to a minimum. In many cases, borrowers were also able to utilise the flexibility inherent in modern middle market credit documentation in the early part of 2020 to build cash reserves in anticipation of deteriorating leverage and financial performance (e.g. drawing down on previously committed revolving facilities, which customarily have no leverage conditions to borrowing and no anti-cash-hoarding protection). Our 2020 data showed that events of default under active deals (i.e., deals closed by Proskauer that remained active in 2020) remained at only 4% and payment defaults accounted for only 1.4% of that total. Despite all that occurred in the financial markets in 2020, the asset class continued to perform well and competition to place capital remained high in light of a limited supply of investment opportunities.

In 2021, lenders continued to contend with a growing investor base, a surplus of dry powder and a limited supply of attractive investment opportunities in a persistent low-yield environment. As a result, lenders were still seeing an increasing competition to place capital in the private credit market despite significant deal flow. Our 2021 data demonstrates just how significant of an uptick in the market we experienced over the course of the year – pulling from 317 private credit transactions (*vs.* 204 transactions in 2020). Lenders also made headlines with record-breaking jumbo unitranche financings that notably provided solutions to middle market borrowers that historically could have only been found in the syndicated market. Economic activity over the past year has quelled fears of a crash and many now cautiously predict economic growth and an expansion of the current credit cycle in the year ahead. In fact, 2021 data showed that events of default under active deals decreased to only 1.04% and payment defaults accounted for only 0.12% of that total. Our data demonstrates that, over the past 11 years, the middle market has experienced a continued influx of financing terms that are traditionally a feature of large cap financings. 2021 was no different; large cap financing terms continued to appear in middle market transactions in a manner generally consistent with prior years. Given that large cap terms tend to assume a profitable, durable business model and stable economic climate, 2021 results are generally unsurprising. Given the stronger economic outlook and significant investor interest in the asset class, we expect the influx of large cap financing terms to continue.

Although middle market lenders' appetite for certain large cap financing terms differ based on institutional biases and the nature of specific investment opportunities, the treatment of large cap financing terms in credit documents can be evaluated in light of the size of the borrower's consolidated EBITDA. As a general matter, our data shows that large cap deal terms become less prevalent as the consolidated EBITDA of a borrower decreases. In addition, as the consolidated EBITDA of a borrower decreases, the inclusion of large cap terms with conditionality and additional provisions intended to mitigate inherent risks in such terms becomes more prevalent. This allows us to divide the middle market into the "lower middle market", "traditional middle market" and the "upper middle market" for purposes of this analysis and discussion.

This chapter will highlight notable current events in the private credit market as well as examine certain key financing terms using Proskauer's proprietary data on the prevalence of such terms within the middle market. The analysis will also discuss the related market drivers and trends influencing such terms in light of the continuing evolution of private credit.

New Trends in 2021

The End of LIBOR

The impending transition away from LIBOR as a benchmark rate has been one of the many significant areas of focus for private credit lenders in 2021. The transition comes against the backdrop of the widely publicised 2012 LIBOR manipulation scandal and the more recent decline of an active underlying market which has raised serious questions about the reliability and sustainability of the LIBOR benchmark. In November of 2020, the International Exchange Benchmark Administration (the administrator of LIBOR) announced that all tenors of LIBOR would cease to be published on 30 June 2023. In addition to this, various agencies (the Board of Governors of the Federal Reserve System, the Office of the Controller of the Currency and the Federal Deposit Insurance Corporation) jointly required regulated banks to cease entering into new contracts using LIBOR as a reference rate by 31 December 2021. Although direct lenders in the private credit market are not generally subject to the agencies' regulations and requirements, many are being forced to confront the issue in other contexts. For instance, lenders that employ the use of subscription facilities or have other financing sources provided by regulated banks will have the challenge of aligning their costs of capital with the interest rates achieved on their investments. Additionally, direct lenders providing a second lien or other junior tranche of debt behind a bank-lead or syndicated senior facility are likely to face pressure to follow suit and transition away from LIBOR in advance of its drop-dead date. Finally, as banks continue to make inroads into in the private credit market, club deals with bank lenders that cannot lend in LIBOR after 31 December 2021 will also present challenges for direct lenders.

The Alternative Reference Rates Committee ("ARRC"), a group of private-market participants convened by the Federal Reserve Board and the New York Fed, put forth two alternatives addressing the transition away from LIBOR in credit agreements. The "hardwired approach" provides for the automatic transition to SOFR upon certain events or triggers. In contrast, the "amendment approach" allows for a future agreement on the replacement benchmark rate and benchmark rate conforming changes that may be appropriate in light of the approach in the syndicated market at the time of the replacement. In 2021, the market coalesced around SOFR as the best alternative and many private credit lenders have adopted the ARRC "hardwired approach" provisions into their credit documentation. However, a current point of negotiation for lenders is the "spread adjustments" that will be applied to SOFR following the transition. Spread adjustments are a basis point value calculated by taking into account the historical rate differences between tenors of SOFR and LIBOR. The adjustment is designed to ensure a lender is not economically disadvantaged following the transition away from LIBOR. The ARRC "hardwired approach" provisions include 11, 26 and 42 basis point adjustments for one-, three- and six-month tenors of SOFR, but borrowers began to challenge this as the gap between SOFR and LIBOR showed signs of narrowing towards the end of 2021. Borrowers are pressing for a more conservative adjustment (e.g. 10, 15 and 25 basis point adjustments for one-, three- and six-month tenors of SOFR) or no spread adjustment at all. To date, lenders have generally had success in maintaining the ARRC spread adjustment recommendations. However, during the end of 2021 borrowers gained traction around more conservative adjustments in competitive upper middle market deals. We anticipate this situation will continue to evolve in light of, and in large part be dictated by, the approach taken in the syndicated market for new SOFR-based credits in the beginning of 2022.

"Serta" Provisions

Borrowers in Serta Simmons, Boardriders and TriMark looking to maximise their liquidity created some controversial transactions in mid to late 2020. These transactions involved amendments where super priority debt was permitted to be incurred by the borrower and the lenders' liens in the credit parties' assets were subordinated to the liens of the newly permitted super priority debt. Traditionally, the list of amendments that require all lender or affected lender consent does not include the subordination of the lenders' liens. The amendment to subordinate the lenders' liens would, as a result, be subject to the consent of a majority of the lenders. In 2021, a large number of credit agreements included the requirement that any subordination of the obligations or the lenders' liens be subject to either an all lender consent or an affected lender consent. With the addition of this "sacred" consent right, several exceptions to this right evolved and became accepted as the market standard for larger transactions. The most common exceptions for this "sacred" consent right are (a) a lender who is given the opportunity to participate in the transaction triggering a subordination of the obligations or the lenders' liens is deemed to have consented regardless of whether such lender participates in the new super priority debt transaction, and (b) the subordination of the obligations or the lenders' liens in connection with a debtor-in-possession debt financing.

Erroneous Payment Provisions

In early 2021, the U.S. District Court for the Southern District of New York ruled that the erroneous payments made by Citibank (the agent in the Revlon credit facility) to the lenders were protected by New York's "discharge-for-value" rule and, as a result, the lenders were entitled to keep the money. Since then, most credit agreements now include "Erroneous Payment" provisions, which state that (a) the agent has the sole discretion to determine whether a payment was made in error, (b) regardless of whether the lenders are aware of the error, the agent is entitled to and has the ability to claw back such payments, (c) the lenders are required to pay back such payments plus accrued daily interest, and (d) the lenders waive the any claim such lender may have of "discharge for value" or any other claim of entitlement to the erroneous payments.

Overview of Proskauer Rose LLP Private Credit Transactions in 2021

The top five industries represented in middle market transactions, as shown by our data, include (a) business services, (b) consumer products and services, (c) healthcare, (d) financial services, and (e) software and technology. These primary industries comprise 68% of our deals in 2021. Business services was the leading industry for transactions in 2021 (overtaking technology) and accounted for 18% of deals, up from 14% in 2020. First lien, second lien and senior secured transactions remained high for the year, whereas mezzanine loan transactions represented 1% of all deals in 2021 (generally consistent with 0% in 2020, but markedly decreased from 5% in 2018). Interest rate margins (the percentage points added to a benchmark rate for purposes of calculating a floating or variable rate) across all deal

types in our data have trended lower since 2015 (with a slight increase in interest rate margins in 2020). In 2015, only 16.7% of deals had margins less than 7.0%. The percentage of deals having margins less than 7.0% increased to 76% (in contrast to 64.1% in 2020). With the exception of 2019–2021, the impact to lenders of decreasing interest rate margins in past years was partially offset by a strong LIBOR benchmark. In 2021, lenders would need to rely on the protection of a negotiated "LIBOR floor" which typically does not exceed 0.75%–1% in middle market transactions. With respect to commitment fees and original issue discounts (OID), in 2021, 69% of commitment fees and OID were between 2.0%–2.49% of the principal amount of the loans and commitments at closing, with a decrease in commitment fees and OID over 2.49% in 2021.

Closing leverage for middle market transactions in our data decreased from 5.33× in 2020 to 5.1× in 2021. Fifty-seven per cent of deals had a closing leverage between 4.00× and 6.99× (lower than 64% of deals in 2020, indicating that closing leverage varied more across transactions in 2021 than in previous years). Trends in closing leverage should also be considered in light of parameters relating to the calculation of consolidated EBITDA across the middle market. In transactions with EBITDA greater than $50MM, 44% of them had a cap on general non-recurring expenses as an add-back to EBITDA (which is significantly more lender favourable than 25% in 2020). Given this tighter restriction in the calculation of consolidated EBITDA as compared to the prior year (which can effectively increase closing leverage multiples and results in less forgiving financial covenants), it is possible that the closing leverage has decreased more than the data shows on its face. In transactions with EBITDA that is less than $50MM, 62% of them had a cap on general non-recurring expenses (which is consistent with 67% in 2020). Add-backs for run-rate cost savings/synergies and restructuring costs continue to be more or less ubiquitous in the middle market. Similar to the cap on addbacks for general non-recurring expenses, the cap on restructuring costs tends to fall away in larger deals (although even in larger deals, lenders have shown an appetite to push for a cap on this addback in 2021). We continue to see a negotiated cap on the addback for cost savings/synergies across the middle market. This cap applies with increasing frequency only to cost savings/synergies applicable to acquisitions and restructuring activities after the initial closing date of a financing (but not to cost savings/synergies applicable to closing date transactions) and in upper middle market deals is often expanded in scope to allow for the addback of "revenue enhancements".

Covenant lite deals, meaning deals that do not contain a typical financial maintenance covenant, remained at 7% in 2021 (*vs.* 7% in 2020) in deals with EBITDA greater than $50MM. However, we have seen an increase to 73% of deals with EBITDA greater than $50MM in our data of transactions that are covenant loose, meaning with financial covenant cushions equal to or greater than 40% against a borrower's model. Although the financial covenant is typically limited to a total leverage ratio test (or, less frequently, to a first lien leverage ratio test), in 2021 a small 12% minority of our deals also included a fixed charge coverage ratio test. This is down from 17% in 2020, and has been steadily falling in recent years. Of the transactions with financial covenants, 39% of them had five or more covenant step-downs (down from 44% in 2020). Of transactions with step downs, 86% of them had EBITDA of less than $50MM. Step-downs all but fall away in transactions with EBITDA over $50MM.

The general trend towards borrowers' counsel controlling the drafting process at both the commitment papers stage and the definitive deal documentation stage continued in 2021. In most circumstances, the borrower will also select the precedent credit agreement to be used as a starting point for definitive deal documentation in a particular transaction. Frequently, the lender will not have participated in the prior transaction or the proposed precedent document will reflect a more upper market orientation than the current deal. As a result, and in light of frequently time-sensitive commitment periods and healthy competition for investment opportunities in the current market, lenders often agree to work with these proposed precedent credit agreements and accommodate terms that are more typically found in larger transactions.

Debt Incurrence

Flexibility for a borrower to incur additional debt (both as an upsize debt incurred pursuant to an existing credit agreement, and as new debt pursuant to a "side car" or other debt incurred pursuant a new credit agreement) was one of the most transformative structural changes to make its appearance in the middle market. Consistent with 2020, incremental facilities, incremental equivalent facilities, ratio debt and acquisition debt continue to be customary features of upper middle market and traditional middle market financings. However, following the pandemic, lenders in traditional middle market financings have had some success in excluding incremental equivalent facilities from new financings (and, to a much lesser degree, other forms of ratio-based indebtedness).

Incremental Facilities and Incremental Equivalent Facilities

An incremental facility (also referred to as an "accordion") allows a borrower to incur additional term loans or revolving loan commitments under an existing credit agreement subject to certain limitations and conditions without the consent of the existing lenders. Incremental equivalent debt typically has the same features as an incremental facility except that the debt is incurred outside the existing credit documentation, either pursuant to a separate credit agreement or through the issuance of notes outside of the credit agreement (either issued in a public offering, Rule 144A or other private placement).

Additional debt facilities appearing in the middle market can be summarised as follows: (a) the upper middle market will typically accommodate both incremental facilities and incremental equivalent facilities; (b) the traditional middle market will generally accommodate incremental facilities and is increasingly accommodating incremental equivalent facilities (subject, however, to stricter conditions, as discussed below) but remains stratified with respect to incremental equivalent facilities in approach depending on the consolidated EBITDA and the leverage of the borrower and its subsidiaries; and (c) lower middle market deals sometimes include incremental facilities but generally do not provide for incremental equivalent facilities. Our data shows that 97% of traditional middle market deals include incremental facilities, which is up from 77% in 2020. Additionally, 49% of traditional middle market deals include both incremental facilities and incremental equivalent facilities, consistent with 47% in 2020.

Incremental amount

- In large cap and upper middle market transactions, and increasingly in the traditional middle market, credit documents will permit the incurrence of an incremental facility up to (1) a fixed incurrence amount (known as a "starter basket" or "free and clear basket"), plus (2) an unlimited incurrence amount, subject to compliance with one or more leverage ratios as further discussed below. The fixed

amount will generally be no greater than 1.0× of consolidated EBITDA and will often have a "grower" component (e.g., the greater of (i) a fixed dollar amount, and (ii) the corresponding percentage of consolidated EBITDA measured as of the closing date). Our data shows that 51% of traditional middle markets deals with incremental facilities contain a starter basket for the incremental facility equal to or greater than 1.0× of consolidated EBITDA, compared to 38.3% in 2020. Depending on the structure of the original transaction (i.e. senior secured, first lien/second lien or senior/mezzanine) and what type of incremental debt is being incurred (i.e. debt *pari passu* to the senior secured, first lien or senior facility, debt that is junior to the senior secured, first lien or senior facility but *pari passu* with the second lien/mezzanine facility (if any), or unsecured debt), the type of leverage test will be different (i.e. first lien leverage test *vs.* secured leverage test *vs.* total leverage test).

- The level of the ratios will often be set at the closing date leverage multiple or, in the case of unsecured incrementals, up to 1.00× outside the closing date leverage multiple in larger deals. In larger deals, there may also be an alternative test for the incurrence of incremental facilities used to fund permitted acquisitions and other permitted investments. In such instances, the leverage ratio condition will be compliant with the leverage ratio of the borrower immediately prior to giving effect to such acquisition or investment. Additionally in larger deals, borrowers will frequently push for a fixed charge coverage ratio test (of no less than 2×) *in lieu* of the ratio-based test for unsecured incrementals. The upper middle market generally follows the larger deals in terms of how the incremental amount is capped (although the aforementioned alternative test for permitted acquisitions and permitted investments is not widely adopted and the middle market has showed a continued aversion to the use of an interest coverage test for unsecured incrementals).
- Data reveals a continuing trend in the traditional middle market to allow for both a starter basket and an unlimited amount, with 87% of traditional middle market deals in 2021 permitting both components of incremental facilities, which is generally consistent with 90% in 2020. In many lower middle market financings, incremental facilities are still only permitted up to a fixed dollar amount (with no unlimited incurrence amount). In such cases, the incurrence of incremental debt under the fixed cap will be subject to an incurrence leverage test (and less frequently, *pro forma* compliance with the financial maintenance covenants in addition to such leverage test).
- Borrowers prefer to use different leverage tests to govern incurrence of different types of incremental debt (i.e., first lien leverage ratio for the incurrence of first lien debt, a senior secured leverage ratio for the incurrence of second lien debt and a total leverage ratio for the incurrence of unsecured debt) rather than the total leverage ratio test originally used as a leverage governor for all tranches of incremental facilities. This approach allows a borrower to incur a total amount of debt in excess of the total leverage test.
  - For example, the indebtedness included in calculating a total leverage ratio would typically include all funded indebtedness of the applicable credit parties and those subsidiaries included in the consolidated financial metrics of the credit parties. The indebtedness included in calculating a first lien leverage ratio would be limited to funded indebtedness subject to a first lien security interest on the assets of the credit parties. As a result, a borrower could (i) first incur unsecured indebtedness up to the total leverage ratio cap, and (ii) second incur additional first lien indebtedness up to the first lien leverage ratio cap. In this example, since the incurrence of first lien incremental facilities is governed by a first lien leverage ratio (rather than a total leverage ratio), that debt incurrence would not be prevented because the first lien leverage ratio does not include the unsecured indebtedness previously incurred by the borrower. However, if the incurrence of first lien incremental facilities was governed by a total leverage ratio, second debt incurrence would exceed the total leverage ratio cap and be prohibited.
- The approach described above is accepted in the upper middle market and is becoming more commonplace in traditional middle market transactions. More conservative deals in the traditional middle market will apply a total leverage ratio test for all types of incremental loans (or will apply a total leverage ratio test in addition to the first lien leverage ratio/senior secured leverage ratio tests described above).
- In large cap, upper middle market and traditional middle market transactions, borrowers will also seek the ability to (a) elect to use the ratio-based unlimited incremental amount prior to the fixed amount, (b) reclassify (at their discretion or automatically) incremental debt which was originally incurred under the fixed amount as incurred under the ratio-based unlimited amount (thereby reloading the fixed amount capacity), and (c) in instances where an incremental loan is incurred based on both the fixed amount and the unlimited amount, not take the fixed amount into account when testing leverage under the unlimited amount. These features allow a borrower to incur debt at any time (and from time to time) in an amount that exceeds the ratio-based leverage test by the fixed amount. The traditional middle market has largely accepted these conventions as stacking and reclassification concepts move down market; however, lenders in more conservative deals may resist a borrower's ability to automatically reclassify incremental debt originally incurred under the fixed amount as incurred under the ratio-based unlimited amount or may request the borrower notify the lender of any such automatic reclassification to address the challenges around tracking incurrence capacity on an ongoing basis.
- In large cap, upper middle market and larger traditional middle market transactions, incremental capacity is also increased (over and above the fixed starter basket and ratio-based unlimited incremental amount) by an amount equal to: (a) in the case of an incremental facility that effectively replaces any existing revolving commitment terminated or term loan retired under the "yank-a-bank" provisions, an amount equal to the portion of such terminated commitments or retired loans; (b) in the case of an incremental facility that effectively replaces any term loans that were repurchased by the borrower and immediately cancelled, an amount equal to the portion of such repurchased and cancelled term loans; (c) in the case of an incremental facility that serves to effectively extend the maturity of an existing facility, an amount equal to the amount of loans and/or commitments, as applicable, under that existing facility to be replaced with such incremental facility; and (d) all voluntary prepayments of the existing term loans, previously incurred incremental term loans and incremental equivalent loans and voluntary permanent commitment reductions of the revolving facilities (except to the extent funded with the proceeds from an incurrence of long-term indebtedness (other than revolving

indebtedness)) (and sometimes limited in traditional middle market transactions to such loans and commitments that are *pari passu* to the loans/commitments being prepaid or terminated). The incremental amount caps and limitations will also govern incremental equivalent facilities. The establishment of an incremental facility (or the incurrence of incremental equivalent debt) will result in a dollar-for-dollar reduction of the amount of indebtedness that may be incurred pursuant to the other facility. In this regard, the upper middle market is generally consistent with the larger deals. However, the traditional middle market will again differ in that the additional amounts that increase the incremental capacity (over and above the fixed starter basket and ratio-based unlimited incremental amount) will most frequently be limited to the amounts described in clauses (a), (b) and (d) above.

Rate and maturity

- Incremental term loans generally: (a) cannot have a final maturity date earlier than the existing term loan maturity date (and may also require a 91-day maturity setback for subordinated, junior lien and unsecured incremental loans); (b) cannot have a weighted average life to maturity shorter than the weighted average life to maturity of the existing term loans; (c) rank *pari passu* with the existing loans or junior in right of payment and security or are unsecured; (d) are not secured by any collateral other than collateral securing the existing term loans or guaranteed by any guarantors not guaranteeing the existing term loans; (e) participate *pro rata* or less than (but not greater than) *pro rata* with the existing term loans in mandatory prepayments; (f) have covenants and events of default substantially similar, or no more favourable, to the lenders providing such incremental term loans than those applicable to the existing term loans, except to the extent such terms apply only after the latest maturity date of the existing term loans or if the loan agreement is amended to add or conform to the more favourable terms for the benefit of the existing term lenders; and (g) if incremental equivalent debt is permitted, such incremental equivalent debt is subject to customary and satisfactory intercreditor arrangements to the extent it is secured. Some borrowers in the upper middle market deals (but not traditional middle market deals) have been successful in negotiating a carve-out from the maturity requirement which would allow the borrower to incur incremental term loans with earlier maturities, up to a maximum amount governed by a fixed dollar basket, often with a grower component.

  These terms have been adopted in the upper middle market. The traditional middle market does not contain significant variations but more conservative deals may also contain additional restrictions on greater than *pro rata* voluntary prepayments with the existing term loans (but not restrictions on *pro rata* or less than *pro rata* voluntary prepayments). The lower middle market may only allow for the incurrence of incremental debt that is *pari passu* with the existing loans. In some respects, allowing a borrower to incur lien subordinated or unsecured incremental facilities instead of *pari passu* incremental facilities may benefit the existing lenders since those junior and unsecured lenders would not share on a priority basis in the proceeds of collateral in an enforcement scenario. Despite this, the lower middle market often resists allowing different types of debt due to a desire to maintain a simpler capital structure (especially in credit transactions where there are no other financings).

- The interest rate provisions applicable to incremental facilities customarily provide some form of pricing protection. Typically, the protections require that the all-in yield of the credit facility extended on the original closing date is increased to match (less 50 basis points) any new incremental facility that is *pari passu* in claim and lien priority to the existing credit facility to the extent that such incremental facility has an all-in yield was greater than 50 basis points above the existing credit facility. This differential can be 75 basis points in large cap and certain upper middle market transactions. These provisions are generally referred to as the "MFN" or most favoured nations provisions. In large cap and certain upper middle market transactions, the MFN provision often contains a "sunset", meaning that the pricing protection is not applicable to any incremental facilities that are incurred following a period of time. This period ranges from 12 months to 18 months (some with sunset periods as short as six months). The sunset provision, however, may be eliminated altogether or flexed out, depending on market conditions. As the ability to designate incrementals (or incremental equivalent debt) with different payment and lien priorities has become commonplace in large cap, upper middle market and traditional middle market transactions, borrowers typically push for additional provisions that erode MFN pricing protections. These additional exceptions to the MFN provisions include (i) additional carve-outs to the calculation of all-in yield for amounts that do not clearly constitute "one-time" fees or fees payable to lenders generally (for example, OID and upfront fees), thereby making it easier to remain below the MFN trigger threshold, and (ii) excluding from the MFN provisions incrementals (or incremental equivalent debt) that (A) are incurred in reliance on the starter basket amount, (B) are utilised for specific purposes (e.g., for permitted acquisitions), (C) are structured as an issuance of notes (whether issued in a public offering, Rule 144A or other private placement) as opposed to loans, (D) mature later than the latest maturity date of any other term loans under the credit facility or which are bridge-financings, and (E) are within a certain capped amount. Of particular concern for lenders is the exclusion in (ii)(A) above. Without adding further protections, this has the potential of eliminating the MFN treatment altogether in deals where the borrower has the ability to redesignate starter basket incrementals as leveraged-based incrementals (subject to sufficient capacity to redesignate borrowings to the ratio-based unlimited incurrence amount) because borrowers are able to effectively reload the starter basket over and over.

  The traditional middle market takes a somewhat consistent approach to the upper middle market's treatment of the MFN provision. For the most part, *pari passu* debt issued in reliance upon the incremental provisions (or the incremental equivalent provisions) is subject to the MFN provisions (unless, in the case of an incremental equivalent facility, issued in the form of syndicated high yield notes). However, lenders in the traditional middle market typically push back on the multitude of carve-outs and exceptions discussed in the paragraph above. In addition, the lower middle market may also require that the impact of the MFN provisions apply to all debt outstanding under the credit facility, including incremental loans previously funded (*vs.* only the closing date borrowing). Traditional middle market lenders have historically had significant success maintaining the MFN provisions without a sunset and have recently been even more sensitive to any erosion of their pricing protections. 2021 data shows that only 4% of traditional middle market deals with MFN provisions include a sunset period, which is a decrease from 10% in 2020.

Use of proceeds

- In large cap, upper middle market and traditional middle market transactions, proceeds from the incurrence of incremental and incremental equivalent debt may generally be used for any purpose not otherwise prohibited by the existing credit documentation. Our data continues to show a clear migration of the large cap and upper middle market flexibility with respect to the use of incremental/incremental equivalent proceeds filtering down to the traditional middle market and even the lower middle market in some cases. As a result, specific limitations placed on the use of proceeds for incremental/incremental equivalent loans are typically only seen in lower middle market deals. If a lower middle market financing permits all such uses of proceeds, uses like restricted payments (i.e., dividends) and payments of junior debt may be conditioned by stricter leverage tests. In the alternative, in lower middle market deals, the use of proceeds may even be restricted to permitted acquisitions and similar investments and permitted capital expenditures.

Ratio Debt

In addition to the incremental and incremental equivalent facilities described above, large cap, many upper middle market, and a growing number of traditional middle market transactions include "ratio debt" provisions. These provisions, which can be traced back to the high-yield bond market, allow a borrower or any of its subsidiaries to incur additional indebtedness so long as the borrower meets the applicable leverage ratio test (and subject to a cap on ratio debt incurred by subsidiaries that are not guarantors of the existing credit facilities in almost all cases). An interest coverage ratio test may also be applied in place of a leverage ratio for unsecured ratio debt, but this test is typically only accepted in large cap and larger upper middle market financings in cases where this type of test appears for unsecured incremental facility incurrence. If the ratio debt is leverage-based, the leverage test is typically set at the same level required for incurrence of incremental and incremental equivalent debt. In upper middle market transactions, the conditions for incurrence (other than the applicable leverage or interest coverage test) may be looser than the conditions to incurrence of incremental and incremental equivalent debt. For instance, there may be no requirement that covenants and events of default be substantially similar, or no more favourable, to the lenders providing such ratio debt than those applicable to the existing loans. However, lenders in the traditional middle market have had some success in standardising the conditions across the different types of permitted debt incurrence. To the extent ratio debt provisions appear in traditional middle market transactions, the incurrence of such debt may be conditioned on such debt being subordinated in right of payment to the credit facility or being unsecured but this restriction typically only appears in the more conservative deals. Additionally, the traditional middle market will almost always require that any pricing MFN provisions applicable to incremental and incremental equivalent debt also apply to ratio debt that is *pari passu* to the credit facility obligations. As noted above, lenders have recently shown an increased sensitivity to erosion of pricing protections and this term is notably migrating up market and appearing with increasing frequency in upper middle market financings. Our data shows that 65% of traditional middle market deals now permit ratio debt, compared to 57% in 2020. Lower middle market transactions generally do not provide for ratio debt.

Acquisition Indebtedness

Credit agreements generally allow the borrower to incur certain indebtedness solely to fund permitted acquisitions and permitted investments, referred to as an "acquisition debt". The terms and conditions discussed above (i.e., conditions for incurrence, etc.) with respect to ratio debt in a particular credit agreement will also typically apply to acquisition debt in that same credit agreement. Larger deals will commonly allow a borrower to incur acquisition indebtedness in an unlimited amount subject to *pro forma* compliance with a leverage test (typically the same tests applicable to ratio debt). As with ratio debt, an interest coverage ratio test may also be applied in place of a leverage ratio for unsecured ratio debt in the upper market in cases where this type of test appears for unsecured incremental facility incurrence. The upper middle market takes a similar approach to the large cap market (other than allowing an interest coverage ratio test), and the traditional middle market take a similar (but more restrictive) approach to the upper middle market. These approaches will typically be consistent with what is permitted in respect of ratio debt in a particular credit agreement. Similar to ratio debt, it is not common for this type of indebtedness to be permitted in the lower middle market. In lower middle market deals, there is still a preference for only allowing indebtedness that is assumed in connection with permitted acquisition or similar investment (rather than incurred to finance it) and only up to a fixed dollar cap. Similar to the approach for ratio debt, where the traditional middle market allows for acquisition indebtedness, it requires that any applicable MFN provisions apply to any acquisition indebtedness that is *pari passu* to the existing credit facilities on the same basis as ratio debt would. Upper middle market deals have also increasingly adopted this protection with respect to acquisition debt.

Limited Condition Transactions

One of the best-known outcomes of the loosened credit markets in 2005 was the introduction of the concept of "certain funds" or "limited conditionality" to US acquisition financings by way of the transaction commonly referred to as "SunGard" (although the certain funds concept frequently appeared prior to this in European transactions). This technology was proposed by sellers in order to ensure that potential buyers had financing locked down. "Certain funds provisions" align the funding conditions set out in financing commitment papers as closely as possible to the closing conditions in an acquisition agreement in order to minimise the risk of a lender having a right not to fund upon the desired closing of an acquisition. Specifically, certain funds provisions (or SunGard provisions) provide that, except as expressly set forth in a conditions annex to the commitment papers, there can be no other conditions precedent to the closing and funding of the credit facility in the definitive loan documentation. It also limits the representations and warranties required to be true and correct (and in some cases even made at all) at closing to certain material representations set forth in the acquisition agreement that give the buyer or its affiliates a right to terminate the transaction (the "acquisition agreement representations") and a narrow set of additional "specified representations". Further, it limits the actions required to be taken by a borrower at closing to perfect security interests in the collateral to certain essential actions, with all other actions required to be taken on a post-closing basis. This assures buyers and sellers that, so long as the conditions to closing under an acquisition agreement are met, lenders do not have an "out" beyond a narrow set of conditions in the conditions annex. This is important for both sellers and buyers because a buyer is typically still responsible for funding the purchase price of an acquisition at closing even if its lender refuses to fund.

Acquisition financings, regardless of the market, have generally adopted SunGard provisions. The most typical formulation in upper market transactions, with respect to representations and warranties, are that the only representations and warranties required to be both made and accurate at closing are "specified representations" and certain representations in the acquisition agreement as described above. The other representations and warranties in the credit agreement that are deemed to be less material are not made at closing (so even if the other representations would not have been true, the borrower would not be in default immediately post-closing). In facilities with revolving credit facilities (which require a re-making of representations and warranties in connection with borrowings), the lender is likely to receive the benefit of the full set of representations and warranties soon after closing. However, in financings without revolving credit facilities, these other representations and warranties may not ever be made and would have limited utility to a lender. The upper middle market generally follows the larger deals in this respect. In smaller or less competitive transactions, the other less material representations and warranties in the credit agreement may also be made at closing, but their truth and accuracy are not conditions to closing. Even if such representations and warranties are not true and correct, the lenders will be required to fund, but with a default immediately following the closing. The traditional middle market has started to adopt the requirement that only specified representations and acquisition agreement representations should be made at closing (but not without objection, especially in transactions without revolving credit facilities).

Certain funds is now applicable to the conditions to borrowing incremental facilities, incremental equivalent facilities, ratio debt and acquisition debt incurred to finance a limited condition acquisition or investment. These features provide a borrower comfort that financing for follow-on acquisitions and investments will be available. In larger deals, borrowers have been successful in extending this "limited condition acquisition" protection to all acquisitions and investments using such financing sources, regardless of whether there is a financing condition in the underlying acquisition documentation. The applicability of the certain funds provisions has been further broadened to include the paydown of indebtedness and the making of restricted payments with features of limited conditionality (i.e. that require irrevocable advanced notice). Within the middle market, only the lower middle market still shows resistance to the broader applicability of the certain funds provisions.

Customarily, as noted above, conditions to incremental and incremental equivalent debt, ratio debt and acquisition debt incurrence typically include material accuracy of representations and warranties (in the case of incremental debt only), absence of default or event of default and meeting a specific leverage test, each tested at the time of incurrence of such additional debt. Limited condition acquisition provisions enable a borrower to elect the signing date (also known as the "effective date") of the acquisition agreement ("acquisition agreement test date") as the relevant date for meeting the required conditions. As a result, if the borrower made such an election then the combined conditions to accessing the additional financing and making the permitted acquisition (which may include no event of default and a leverage test) would be tested at the time the acquisition agreement is executed. The borrower would include the financial metrics of the target entity (i.e., EBITDA and existing debt that will remain outstanding after the acquisition) at the time of such testing even though the acquisition was not yet consummated. In traditional middle market transactions, a subsequent no payment or bankruptcy event of default test is generally also required upon the consummation of the transaction. However, the requirement for this subsequent test often falls away in larger transactions. Although the middle market has largely incorporated the limited condition acquisition protections, some lenders in lower middle market deals continue to push for a requirement that the relevant acquisition close within a period of time following the execution of the purchase agreement (usually not longer than 180 days), otherwise the limited condition acquisition protections fall away. In this case, in the event the acquisition does not close within the agreed-upon time frame, the limited conditionality is eliminated and the borrower would have to comply with all the conditions at the time of the incurrence of the additional financing and closing of the acquisition.

As discussed above, the limited conditionality provision permits a borrower to elect the effective date of the acquisition agreement (or the date of the agreement documenting the relevant investment, paydown of indebtedness or restricted payment) (instead of the closing date) as the date of determination for purposes of calculating leverage ratios in order to test ratio-based additional debt capacity (as well as other incurrence tests described below). Testing the leverage ratio at signing eliminates the risk of a decline in consolidated EBITDA of the borrower and the target between signing and closing (the period between execution of the acquisition agreement and closing date referred to as the "Intervening Period"), when the ratio would otherwise be tested. This risk is of special concern in deals involving a lengthy delay between signing and closing due to regulatory approvals.

Since the leverage test is intended to include the financials of the acquisition target on a *pro forma* basis, borrowers have further requested that any other incurrence-based leverage test (required in connection with any other investment, incurrence of debt, restricted payment, etc.) that is tested during the Intervening Period include the financials of the acquisition target on a *pro forma* basis. Generally, the markets have responded to this request in three different ways:

- *Most Borrower Favourable*: In large deals, any leverage test (including any financial maintenance covenant) required during the Intervening Period will be tested after giving *pro forma* effect to the acquisition. In the event the acquisition does not close, any leverage test applied during the Intervening Period will be deemed to be valid regardless of whether the borrower would have failed to meet the leverage test without giving effect to the acquisition target's EBITDA. The upper middle market has not yet fully embraced this approach, although we are seeing this construct more frequently.
- *Most Lender Favourable*: Any leverage test required during the Intervening Period will be tested on a stand-alone basis. An alternate formulation would be to test all incurrence leverage tests on both a *pro forma* and stand-alone basis. The lower middle market will generally take one of these approaches.
- *Compromise*: The financial maintenance covenant and any incurrence leverage test pertaining to the payment of restricted payments and junior debt payments are tested on a stand-alone basis, but the remaining incurrence leverage tests are tested giving *pro forma* effect to the acquisition. This application of the leverage test is often seen in the traditional middle market and upper middle market (but less frequently). A more borrower favourable version of the compromise position that is common in the upper middle market and with certain larger traditional middle market financings is to test the financial maintenance covenant on a stand-alone basis but test all incurrence leverage tests on a stand-alone basis.

Available Amount Basket

Once the leveraged financing markets revived following the downturn of the financial markets in 2008–2009, the high-yield bond concept of the "available amount basket" became increasingly prevalent in the middle market. The lower middle market has not fully embraced the inclusion of available amount basket but it does appear with a conservative formulation in many lower middle market deals. An available amount basket (also referred to as the "cumulative amount") automatically increases a borrower's ability to take actions under negative covenants that generally restrict cash outflow (i.e., investments, dividends and payment of junior indebtedness) to the extent a borrower has built up capacity of the available amount by increasing in profitability and taking other actions that are considered accretive to the business. In some upper market deals, the available amount also creates capacity for debt incurrence.

Lenders are willing to permit this as an attempt to recognise and reward the borrower for increased profitability and for taking such accretive actions. In some cases, lenders require that a borrower de-leverage before it can access the available amount. Our data shows that 85% of traditional middle market deals include the available amount basket concept, compared to 77% in 2020 and 91% in 2019, suggesting that any hesitancy to incorporate this historically upper market concept into credit document in view of the uncertain economic climate and certain headline-making cases highlighting the inherent risks of the available amount (discussed below) is starting to disappear again. Most famously, in the PetSmart/Chewy case, PetSmart accessed the available amount basket to (i) distribute 20% of the common stock of its new subsidiary, Chewy.com, to a parent entity outside of the borrower/guarantor group, and (ii) invest 16.5% of the common stock of Chewy.com to a newly formed unrestricted subsidiary. Lenders were then required to release their liens on Chewy.com, as it was no longer a wholly owned subsidiary of the borrower, and the borrower used the asset to secure new priority debt incurred in exchange for existing debt that was previously subordinated to such lenders.

The available amount basket will be generally constructed to be the sum of the following:

- *Starter Basket Amount*: a starting amount (commonly referred to as a "starter" or "starter basket") generally determined on a case-by-case basis (which amount may be further increased by a grower basket in the larger deals). Although not necessarily based on a percentage of the borrower's EBITDA, the starter basket amount is often 25%–40% of the borrower's EBITDA, although it may be higher in larger transactions. The available amount basket in upper and traditional middle market transactions (but less frequently in the lower middle market) will often include this starter basket amount. Our data shows that 93% of traditional middle market deals with the available amount basket include a starter basket amount, compared to 82% in 2020.
- *Retained Excess Cash Flow or a Percentage of Consolidated Net Income*: typically in upper and middle market deals, the available amount basket will include a percentage of consolidated net income or retained excess cash flow, at the borrower's election. The consolidated net income option is preferable for a borrower because it will have immediate access to amount (while excess cash flow often will not be recognised until after the first full fiscal year following the closing date; provided that the gap on this point is closing and upper middle market credit agreements may provide for quarterly excess cash flow calculations for the sole purpose of increasing the available amount). The difference between using consolidated net income or retained excess cash flow is especially relevant in those transactions that close in the first half of a fiscal year since the borrower will not be able to build retained excess cash flow until the end of the first full fiscal year following the closing date. In contrast, traditional middle market deals will generally only include retained excess cash flow.
- *Contributed Equity*: if the available amount basket is included in the financing, then having it increased by the amount of equity contributions that are not otherwise applied under the credit agreement will be common regardless of the size of the deal. It is also commonly accepted that equity contributions made in connection with an equity cure of the financial maintenance covenant will be excluded from the available amount basket.
- *ROI on Investments Made With the Available Amount Basket*: larger deals and upper middle market deals will commonly permit an increase in the available amount basket by the amount of returns in cash, cash equivalents (including dividends, interest, distributions, returns of principal, profits on sale, repayments, income and similar amounts) or investments. Traditional middle market deals generally include such returns only to the extent they are in cash or cash equivalents, or limit this prong to returns on investments made using the available amount basket.
- *Declined Proceeds*: declined proceeds from mandatory prepayments required to be made by the borrower will commonly be included in the calculation of the available amount basket regardless of the size of the deal.
- *Debt Exchanged for Equity*: in larger deals, to the extent that any debt owed by the borrower is converted into equity, such amount will be included in the available amount basket. The upper middle market and the traditional middle market have generally accepted the addition of debt exchanged for equity in the calculation of the available amount basket.
- *Redesignation or Sale of Unrestricted Subsidiaries*: in upper middle market and traditional middle market transactions, in the event an unrestricted subsidiary is (i) redesignated as a restricted subsidiary, or (ii) the subject of a disposition, the fair market value (generally determined in good faith by the borrower) of the investments in such unrestricted subsidiary at the time of such redesignation (in the case of clause (i)) or the net proceeds of such sale actually received by a restricted subsidiary or the borrower in excess of the original investment in such unrestricted subsidiary (in the case of clause (ii)), will increase the available amount basket so long as such investments were originally made using the available amount basket.
- *Other Builder Components in Upper Middle Market Financings*: in upper middle market transactions, borrowers may also push to include increases to the available amount basket for (i) the fair market value of any secured debt that has been contributed to the borrower or any of its restricted subsidiaries, and (ii) in cases where less than 100% of asset sale proceeds are required to be applied as a mandatory prepayment of the existing loans, the portion of such asset sale proceeds that are permitted to be retained by the borrower and its restricted subsidiaries. The upper middle market has not fully accepted these available amount basket components and lenders will frequently push back.

The conditions around the usage of the available amount basket vary greatly and the traditional middle market takes a very different approach than the upper middle market. As noted, the purpose of the available amount basket was to increase the baskets pertaining to cash leakage such as investments, dividends and junior debt payments. The upper middle

market deals often place few conditions around the usage of the available amount basket. Such conditions may be further distinguished as follows.

In most upper middle market transactions and larger traditional middle market transactions, conditions for accessing the available amount basket will usually apply with respect to a dividend or junior debt payment (but not investments). The conditions may include no payment or bankruptcy events of default as well as a specific leverage test set within the closing date leverage level (or at the closing date leverage level in larger deals). In most cases, the leverage test will apply only to the retained excess cash flow or percentage of consolidated net income component of the available amount basket (and sometimes, but much less frequently, to the starter basket amount as well). In smaller traditional middle market deals, the approach will typically be to place conditions for the usage of the available amount basket for all investments, dividends and junior debt payments irrespective of which component of the available amount basket is being accessed. For the most part, these conditions include a no event of default condition and (other than for investments) *pro forma* compliance with a leverage ratio test (which can be inside the closing date leverage by as much as 0.5× to 1.0×, and even up to 1.5× in more conservative transactions).

Looking Ahead

The Private Credit Group data continues to show that, with each passing year, terms relating to debt incurrence, limited condition transactions and available amount baskets become more prevalent in the middle market as lenders adapt to the inclusion of what were once considered large cap terms. In 2021, our data generally demonstrated a steady pace of adoption consistent with 2020. This may be intuitive in light of the continued increase in competition to place capital in the private credit market, a recovering economy and predicted expansion in the current credit cycle. Interest in private credit as an asset class remains extremely strong and lenders remain willing to provide commercial and flexible deal terms to borrowers. Notably, we also saw a reversal of the 2020 retraction in the rate at which lenders incorporated available amount baskets into their credit documents. Consistent with 2021, lenders also achieved some success in flexing out more aggressive formulations of these terms during the primary syndication of transactions but have not achieved outcomes that are more favourable than what the market typically bears.

Our data continues to show that lenders' ability to unwind large cap concepts and provisions from credit documents is, for the most part, limited. As noted, the continuing trend of borrowers pushing to use precedent credit documents from larger transactions (or precedents with a borrower favourable upper market orientation) as the basis for the documentation of a new transaction should also continue to drive the adoption of upper market concepts and provisions into smaller transactions.

Many economists anticipate growth in 2022, but remain watchful in light of the highly contagious Omicron variant of COVID-19 and uncertainty around the Federal Reserve's next steps to address staggering inflation. Lenders are likely to remain cautious about their existing portfolios in the face of this risk and continue to be selective with respect to investment opportunities and, to some extent, legal documentation. However, competition to place capital in the private credit market shows signs of remaining high and this is likely to sustain the continued migration of large cap terms into middle market transactions in 2022. However, we expect that lenders will continue to bring a middle market orientation to these terms and push for conditionality to mitigate the risks inherent in such terms. This is expected to continue to occur to varying degrees based on the dividing lines of the lower middle market, traditional middle market and upper middle market.

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