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The New Normal In Acquisition Finance Commitments

Law360, New York (August 26, 2010) -- It has been three years since rumblings of syndication difficulties in bank loans and high-yield bonds presaged the credit crisis and just under two years since Lehman Brothers' dramatic collapse and the virtual shutdown of the global credit markets.

Now, as "green shoots" begin to emerge in the acquisition finance market, it is becoming clear that while some of the most aggressive terms that prevailed in the heady froth of the recent peak did not survive the downturn (or, at least, are yet to peek up from the still substantial ground cover), the ability of lenders to require circa-2003 commitment terms from their best customers has subsided.

Rather, we are seeing the development of a new concept of what is "market" that retains much of the borrower-favorable technology of the late boom while limiting or eliminating the excesses of that exuberant time.

This article discusses some key provisions from a selection of recent sponsored and major public company deals and outlines where we have ended up and where we might be going.

Limiting Conditionality By Tracking Acquisition Agreement Conditions

In recognition of borrowers' (and sellers') need for certainty of funding, "SunGard unconditionality" remains a near-universal feature in commitment letters.

SunGard provisions limit the representations and warranties (other than certain "specified representations" relating solely to the buyer, with the exception of the now-common inclusion of a representation as to the solvency of the combined company post-closing) to be made by the borrower to the lender on the closing date, which would ordinarily include all representations and warranties contained in the definitive credit documentation, to those required to be made by the seller in the associated acquisition agreement and that, if not true and correct, would give the borrower the right not to close the acquisition.

Matching up the representations limits the risk that the borrower will be unable to make a representation required by the lenders at closing (and unable to obtain the committed financing), but remain obligated to close the acquisition under the terms of the acquisition agreement (which, the seller will insist, will not provide the buyer a financing contingency).

“Material adverse change” (MAC) conditions — which allow a lender to terminate its commitment if a MAC occurs with respect to the borrower (including the target company) following the making of the commitment—are also usually conformed to those contained in the associated acquisition agreement.

MAC clauses in acquisition agreements replace, at closing only, the lender’s (usually broader) MAC condition. This varies in acquisitions where the buyer is itself an operating company (and not a shell).

In such transactions, lenders often attempt to apply the MAC condition to both buyer and target (with the justification that no lender wants to lend to a deteriorating buyer even if the target is healthy), but the market is not settled on this point.

Despite the continuing instability in the financing markets, lenders generally are not insisting on “market MAC” clauses, which allow lenders to withdraw their financing commitments following the occurrence of a material adverse change in the financing or syndication markets. These clauses were essentially banished during the boom as anathema to sellers and buyers, but had re-appeared right after the credit crisis.

Finally, the inclusion of other conditions, such as maximum leverage ratios, minimum EBITDA and requirements that ratings be obtained, vary from deal to deal, but borrowers often have been successful in limiting closing conditions to customary documentation and information matters, the representations discussed above and the satisfaction of acquisition agreement conditions (including absence of a MAC with respect to the target). Nonetheless, several recent transactions include maximum leverage ratio and/or minimum EBITDA conditions.

Limiting Conditionality by Increasing Specificity of Commitment Letters

A firm commitment is of limited use if the lender is free to negotiate terms that might render the transaction uneconomic or unpalatable through the definitive documentation. To mitigate this risk, and avoid the disadvantage of negotiating up from lender forms (or relying on vague standards such as “customary market practice” or “customary sponsor precedent”), sponsors have successfully insisted on specifying a particular precedent transaction in recent deals as the basis for definitive documentation. Doing so limits negotiation of points won in the precedent deal.

The credit crisis also brought to the fore fears that failure to make commitment letters highly specific would render them “agreements to agree” and thus too vague to enforce.

Borrowers have responded by seeking increased specificity within commitment letters, especially regarding the terms of financial covenants (including extensive annexes of financial definitions), exceptions to negative covenants (such as specifying standards for incurring debt, making acquisitions and use of an “available amount basket” built with unswept excess cash flow and equity proceeds to pay dividends, make investments and prepay junior debt) and even setting covenant levels.

These features make negotiating commitment letters almost as time-consuming as negotiating definitive documents, but eliminate much conditionality and uncertainty that would otherwise be present. In addition, some commitment letters now contain an express obligation of the parties to negotiate in good faith to enter into financing documents consistent with the terms of the commitment letter.

Changes to Commercial Terms

In addition to maintaining the basic structure of the "limited out" commitment letter, borrowers have been successful in obtaining incremental financing provisions, as well as equity cure rights, with some tightening over terms available at the height of the market. Lenders, for their part, have reintroduced financial covenants and held the line on excess cash flow sweeps, as well as extensive market flex provisions.

The "accordion" feature remains in recent commitment letters, but accessing additional credit has become more difficult. Recent commitment letters have specified that borrowers are prohibited from incurring incremental credit under the accordion if doing so would raise their leverage ratio beyond the ratio on the closing date.

This prevents a borrower from closing at a set leverage ratio and then tapping the incremental facility shortly post-closing to bring leverage up to a higher level. Moreover, "most favored nations" clauses have re-emerged. These provisions require that the pricing on an incremental tranche of debt is no more than a certain amount (usually 25 or 50 basis points) higher than that on the corresponding existing debt under the credit agreement and provide for repricing of existing debt to maintain such pricing parity.

Covenant-lite credit agreements, under which borrowers were blissfully free of financial maintenance covenants (to the chagrin of lenders), have yet to become commonplace (though SkillSoft secured a covenant-lite term loan in May 2010) in the market.

In their place, borrowers have insisted on specifying that all covenants (typically limited to maximum leverage, minimum interest coverage and, where meaningful, maximum capital expenditures) will be calculated based on a specified cushion ranging from 20 percent to 30 percent versus projected EBITDA.

Despite repeated concerns raised by lenders throughout the credit crisis, the equity cure (which allows sponsors to cure financial covenant defaults by contributing capital to the borrower, which is then deemed to be EBITDA for the purpose of calculating financial covenant compliance) has survived, with limitations, into this next phase.

Common limitations include a fixed number of (typically non-consecutive) permitted equity cures (three to five is common) or cures per fiscal year (two is common) and requirements that debt reduction associated with equity cures be deemed not to reduce calculated leverage.

Excess cash flow sweeps remain the norm in term loan deals. Recent transactions have started with 50 percent of excess cash flow required to be swept, with stepdowns to 25 percent and 0 percent based on achievement of certain leverage ratios. Nonetheless, excess cash flow sweeps remain common targets of flex provisions, which sometimes specify that the arrangers have the right to raise the starting point to 75 percent of excess cash flow to enhance syndication.

Arrangers remain concerned with their ability to syndicate their loan exposure. One reaction to this concern is that lenders continue to resist any form of sponsor or borrower control over the syndication process, but the most visible reaction is the reservation of rights through flex terms to adjust loan terms in material ways to assist in syndication.

These market flex provisions include, but are not limited to, the rights to increase the interest rate spread, original issue discount, LIBOR floor or upfront fees on loans by several percentage points, which is significantly more than was common during the height of the market; reallocate portions of lower-cost senior secured loans to higher-priced notes or bridge loans; impose limits on or eliminate equity cure provisions and incremental commitments; eliminate the ability to repurchase loans on a sub-par basis; increase the excess cash flow sweep percentage to 75 percent; impose prepayment penalties on senior credit facilities for the first two years following closing; impose a “ticking fee”; impose significant amortization on term loans; and eliminate the ability to designate unrestricted subsidiaries.

It is clear that arrangers are approaching the market very conservatively and are unwilling to lose possible lenders based on aggressive borrower-favorable terms — even if they are willing to test the market with such provisions. As a result, some of the trends listed above may not make it into definitive documentation.

Changes Based on Lessons Learned

Commitment letters have shown some movement directly related to the market turmoil of the last few years. Both borrowers and lenders have been successful in adding provisions that mitigate some of the less desirable consequences of precredit crisis documentation, and commitment periods have been kept on the shorter side.

Borrowers and sponsors were often frustrated during periods when loans were trading at large discounts to par by their inability to capitalize on low debt prices and retire debt at a discount.

Some recent commitment letters have hardwired this capacity into transactions so that, if it is attractive to the sponsor or the borrower, either may offer to purchase/repay debt at below par.

Alternatively, some commitment letters provide that amendments to the ratable sharing provisions of the credit agreement will require majority (rather than unanimous) consent of lenders. This at least enhances the ability of the borrower to amend the credit agreement in the future to permit sub-par purchases.

Lenders tend to view buyback provisions as undesirable, and therefore arrangers frequently reserve the right to restrict or eliminate them as part of their market flex provisions.

Borrowers have been successful in gaining the right to refinance portions of their credit agreement debt with other debt under new unsecured or subordinated credit facilities or notes without the consent of the majority lenders. This allows borrowers to take advantage of favorable pricing in the marketplace even if a full refinancing is unattractive or unavailable.

It has also become quite common to “amend and extend” existing debt—that is, to extend the maturity of existing debt while adjusting covenants, pricing and other terms to reflect current market and borrower conditions. An emerging trend is thus to allow any lender to extend the maturity of its loans, without the consent of the majority lenders.

In response to real issues arising from litigation, some arrangers have adjusted the indemnification language in commitment letters. Significant changes include requests for caps on lender liability for breaches of the commitment letter, waivers by the borrower of the right to compel lenders to fund via specific performance and inclusion of provisions limiting the ability of the borrower to settle claims against the lender without consent.

Lenders continue to include provisions protecting them against claims for special, indirect, consequential or punitive damages or lost profits.

Borrowers are able, in some transactions, to avoid indemnification if it can be shown that the damages for which indemnity is sought arose from the material breach of the commitment letter or credit documentation by the party seeking indemnity.

The Lehman Brothers collapse has led to lenders seeking stronger rights against other lenders that fail to fund required amounts under the credit documentation (“defaulting lenders”), including setoff against fees owed and other punitive measures. These have become relatively routine, though much harsher than corresponding provisions in pre-Lehman credit agreements.

Conclusions

While it is certainly too early to establish what will be “market” going forward, it seems clear that the marketplace will continue to require that lenders offer acquisition commitment letters with a minimum amount of conditionality.

As for other provisions of commitment letters and credit agreements, time will tell, but we would expect that as conditions improve and the market heats up, there will be increased pressure for commitment letters to become more borrower-favorable and revert to circa-2007 terms and conditions, without requirements for extensive flex provisions and other lender protections.

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