THREE YEARS LATER: THE NEW NORMAL IN ACQUISITION FINANCE COMMITMENTS

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), lenders have not been successful in imposing circa-2003 commitment terms on their best customers. Rather, we are seeing the development of a new concept of what is "market" that retains much of the most-valuable technology of the late boom while limiting or eliminating the excesses of that exuberant time. The following paragraphs discuss some of the key provisions of a selection of recent sponsored and major public company deals and show where we have ended up and where we might be going. It is not intended to provide a comprehensive survey.

Conditionality—The SunGard Also Rises

The "Certain Funds" provisions that developed during the boom years and were demanded by sponsors and targets alike have survived the intense litigation of the last several years essentially unscathed.

Lenders have continued to provide "SunGard unconditionality," meaning that the representations and warranties (other than certain "specified representations") to be made by the borrower on the closing date, which would ordinarily include all representations and warranties contained in the definitive credit documentation, are limited to those that are 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. This limits the risk that the borrower will be unable to make a representation demanded by the lenders at closing (and thus unable to obtain the committed financing), but will remain obligated to close the acquisition under the terms of the acquisition agreement, which, at the seller's insistence, generally would not allow the buyer a financing contingency. These provisions are often named "Certain Funds" provisions.

"Material adverse change" or "MAC" conditions—which allow a lender to pull its commitment if a material adverse change occurs with respect to the borrower (including the target company) following the making of the commitment—continue to be conformed to those contained in the associated acquisition agreement. Because acquisition agreements tend to have highly negotiated MAC clauses, it is important to ensure that the lender's (usually broader) MAC condition is not required to be satisfied on the closing date. Lenders have generally allowed a conforming condition.

Some variation in MAC conditions arises in acquisitions where the buyer is itself an operating company (and not a shell). In such transactions, lenders often attempt to make the MAC condition apply to both buyer and target, taken as a whole (with good reason, as no lender wants to lend to a deteriorating buyer even if the target is healthy). Because acquisition agreements seldom contain an "out" arising from a material adverse change at the buyer, however, such a provision could give rise to a scenario where the buyer cannot access the financing but is still required to close under the terms of the acquisition agreement. For this reason, MAC conditions including the buyer are fiercely resisted. Lenders have shown some flexibility with operating companies, but the market is not settled on this point. This remains the case when the merger documentation contains a reverse break-up fee payable by the buyer in the event it is unable to access its financing.

Consistent with pre-credit crisis deals, lenders have continued to insist on certain "specified representations" from the credit agreement being made on the closing date, even though the "specified representations" are not typically to be found in the acquisition agreement. These "specified representations" typically relate to such matters as corporate existence; power and authority; due authorization; execution, delivery and enforceability of credit documentation; Federal Reserve margin regulation compliance; the inapplicability of the Investment Company Act of 1940; creation of security interests (with specific language, as discussed below, permitting post-closing perfection steps to avoid closing being delayed because of less material defects in perfection) and solvency. The matter of whether the borrower is required to represent as to its solvency, which was widely debated pre-credit crisis, seems to have been resolved in favor of the borrower making such a representation, despite the complications of the Huntsman/Hexion litigation.

It is notable that, despite the continuing instability in the financing markets, lenders 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. So far, lenders seem to accept that such clauses are no longer "market," despite the market's continued choppiness.

The Certain Funds provisions still permit a deferral to post-closing of actions necessary to put the collateral package in place (other than the filing of Uniform Commercial Code financing statements and delivery of stock certificates), but there appears to be an increasing tendency to include a deadline (able to be extended by the Administrative Agent) for taking the actions.

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

Syndication—Lenders Maintain Control

Although lenders have become comfortable specifying that syndication of financing is not a condition precedent to the funding of the loans on the closing date, they have made it clear that they are unwilling to entertain the type of significant borrower interference with syndication that was permitted during the crest of the boom. Borrowers and sponsors may be able to specify certain lenders that are "disqualified," but arrangers are generally unwilling to give borrowers and sponsors veto rights on the composition of a syndicate. Moreover, "clear market" provisions have tightened, such that competing issuances require arranger consent if the arrangers (often "in their sole discretion") could reasonably expect a competing offering to impair syndication.

In some cases commitment lenders include a requirement that the arrangers be afforded a 30-consecutive-day marketing period prior to closing (with appropriate blackout periods).

Documentation Generally—Increasing Specificity

Sponsored borrowers have been able to specify a precedent transaction in recent deals, rather than relying on vague standards such as "customary market practice" or "customary sponsor precedent." In many cases, commitment letters and related term sheets provide far more detail regarding the terms of financial covenants and exceptions to negative covenants than in prior years in response to fears of borrowers during the credit crisis that failure to do so would render commitment letters too vague to enforce even with a comforting reference to "customary sponsor precedent." 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.

Incremental Facilities—More Is Better

The recent downturn has not eliminated the "accordion" feature in recent commitment letters, but accessing additional loans or commitments has become more difficult. First, recent commitment letters have specified that borrowers are prohibited from incurring incremental loans or commitments if doing so would raise their leverage ratio beyond the ratio in effect on the closing date. This prevents a borrower from closing at a leverage ratio of, for example, 3.0 to 1.0, and then tapping the incremental shortly thereafter to bring leverage up to 3.5 to 1.0. 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 and provide for repricing of existing debt to maintain such pricing parity.

Incremental facilities remain controversial, however, and are a frequent subject of market flex provisions, which may provide for the reduction or elimination of incremental facility availability if deemed necessary or advisable to achieve a successful syndication.

Refinancing Facilities and Amend and Extend Provisions—Planning for Maturity

In addition, borrowers have been successful in gaining the right to refinance portions of their credit agreement debt with other (presumably lower-priced) 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.

The choppy financing markets have made it difficult for many borrowers to refinance their maturing debt. As a consequence, it has become quite common to "amend and extend" existing debt—that is, to extend the maturity of existing debt while adjusting terms to reflect current market and borrower conditions (by, for instance, increasing pricing and recalculating financial covenants to reflect revised projections). These "amend and extend" transactions sometimes are complicated by the terms of the underlying credit facilities, which generally require consent of a majority of all lenders plus each extending lender for any extension of maturity. An emerging trend is thus to allow any lender to extend the maturity of its loans, without the consent of the majority of all lenders.

Excess Cash Flow Sweeps

While mandatory prepayments from proceeds of equity issuances remain uncommon, and sweeps of debt proceeds are commonly neutered by exclusion from the sweep of all debt permitted to be incurred under the credit agreement, excess cash flow sweeps remain the norm in term loan deals. Recent transactions have started with 50% of excess cash flow required to be swept, with stepdowns to 25% and 0% based on achievement of certain leverage ratios. It should be noted, however, that 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% of excess cash flow to enhance syndication.

Recent deals have allowed mandatory prepayments to be applied to installments under the loans in direct order of maturity.

Interest Conventions—Limited Innovation

Low LIBOR rates have resulted in the reinvention of the LIBOR floor. It remains to be seen whether LIBOR floors will survive the inevitable recovery in LIBOR, but they are currently common though not universal. Some sponsors and borrowers are attempting to push the market to apply LIBOR floors only to term loans, which are sold to lenders that cannot borrow at LIBOR, and not revolving loans, whose lenders, which are banks, presumably can take advantage of low LIBOR to borrow cheaply. In addition, the much-discussed third prong of the base rate (set at 100 basis points over LIBOR), introduced when the prime rate briefly dipped below LIBOR, appears to have become permanent and serves essentially as a base rate floor.

Sponsor deals have continued to provide that default interest is payable only on overdue amounts, and not on the entire loan balance, following an event of default. Essentially, this formulation requires the lenders to accelerate prior to the imposition of the default rate on the entire loan.

Covenants—Financial Covenants Return (Along with Equity Cures)

Covenant-lite credit agreements, under which borrowers were blissfully free of financial maintenance covenants (much to the chagrin of lenders during the downturn), have yet to re-emerge in the marketplace. 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% to 30% versus projected EBITDA. In addition, some commitment letters have attached extensive annexes of financial definitions and covenant levels. These features make negotiation of commitment letters almost as time-consuming as negotiating definitive documents, but eliminate much of the conditionality and uncertainty that would otherwise be present.

Despite repeated grumbling 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 covenant compliance) has survived, at least in some form, into this next phase. Common limitations in the latest version of the equity cure provisions include limits on the number of equity cures permitted overall (with three to five being common), limits in the number of fiscal quarters per year in which a cure may be exercised (two per year is a common limit) and requirements that the reduction in debt associated with the paydown from the equity cure be deemed not to reduce calculated leverage, at least in the quarter when made (avoiding the borrower getting double credit for the same cure in both the numerator and denominator of the leverage ratio). Borrowers have also clarified in some commitment letters that lenders cannot act on a missed covenant prior to the lapse of the sponsor's right to cure such covenant breach with equity.

Lenders have tended to view equity cures with suspicion, and therefore arrangers frequently reserve the right to restrict or eliminate them as part of their market flex provisions.

Negative Covenants—Keeping Options Open

While it remains somewhat uncommon to specify all carve-outs and baskets under negative covenants in the commitment letter and term sheet, borrowers often specify the most significant carve-outs so that there is no debate when it comes time to negotiate the credit documentation. These include specifying that acquisitions are permitted so long as no default is continuing and the borrower would remain in compliance with its financial covenants after giving effect to the proposed acquisition (and not otherwise capping acquisition amounts), and providing financial tests specifying when the borrower is permitted to incur or assume debt in connection with such acquisitions. In addition, the concept of an "available amount basket" built with equity contributions and unswept excess cash flow, among other minor items, and available to pay dividends, make investments and prepay junior debt, continues to be a feature in sponsor deals.

Unrestricted Subsidiaries

Although lenders have begun to clamp down on the worst abuses of the concept of unrestricted subsidiaries (regarding designation as an unrestricted subsidiary and redesignations as restricted subsidiaries), the concept of unrestricted subsidiaries remains a feature of recent commitment letters.

Sub-par Repurchases

Borrowers and sponsors were often frustrated during certain periods over the past several years by their inability to capitalize on sub-par trading prices for their loans and repay debt at a discount. 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 pro rata 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 have tended to view buyback provisions with suspicion, and therefore arrangers frequently reserve the right to restrict or eliminate them as part of their market flex provisions.

Fees

In addition to underwriting, bridge funding and rollover fees, ticking fees have become more common, especially for long commitments.

Market Flex Provisions—When All Else Fails

Despite the appearance of normalcy presented by the retention of many features of pre-credit crisis commitment letters, arrangers remain extremely concerned with their ability to syndicate their loan exposure to investors. One reaction to this concern is the close control arrangers maintain over the syndication process as discussed above.

Another reaction is the reservation of rights 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 relatively low-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 of affiliates or the borrower to repurchase loans on a sub-par basis; increase the excess cash flow sweep percentage to 75%; impose prepayment penalties on senior credit facilities for the first two years following closing; impose a “ticking fee” if demanded by lenders; 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 investors based on aggressive borrower-favorable terms—even if they are willing to test the market with such provisions.

Securities Demands

The securities demand in a bridge financing provides lenders with an escape valve in the unfortunate event that a bridge facility is required to be funded by requiring the borrower, upon demand of some subset of the bridge lenders (borrowers push for a majority, lenders for the right of any lender) to issue debt securities governed by terms described in the relevant securities demand paragraph in exchange for bridge loans. Such securities invariably carry a much higher interest rate than the bridge facility.

A key current issue with securities demands is whether the demand is exercisable before closing (requiring securities to be delivered in escrow, rather than taking any risk that a bridge will be funded) or the lenders may exercise the demand only on or after closing, which lowers costs for the borrower. This is not a universally settled concept, though borrowers obviously push for securities demands to be exercisable at closing at the earliest. In addition, technical changes to the securities demand language are generally warranted to prevent bridge funding fees from being collected prior to a securities demand by the bridge lenders. Finally, certain tax consequences that may arise from the exercise of a securities demand in favor of the bridge lenders (and not a new group of investors) should be considered in drafting securities demand provisions.

Indemnification

In response to real issues arising from credit crisis 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 be protected against special, indirect, consequential or punitive damages or lost profits. Borrowers remain, in some transactions, able 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.

Defaulting Lender Provisions

The Lehman Brothers collapse has led to lenders seeking stronger rights against other lenders that fail to fund required amounts under the credit documentation, 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 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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If you wish to obtain additional information regarding this case or intercreditor and subordination provisions generally, please contact William N. Dye (212-728-8219, wdye@willkie.com), William E. Hiller (212-728-8228, whiller@willkie.com), Leslie M. Mazza (212-728-8245, lmazza@willkie.com), Michael I. Zinder (212-728-8298, mzinder@willkie.com), Jeffrey M. Goldfarb (212-728-8507, jgoldfarb@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

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