An Expert's View: Current Developments in Commitment Letter Negotiations

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Janet Vance of Gibson, Dunn & Crutcher LLP examines current developments in commitment letter negotiations, including issues concerning incremental loan provisions and MFNs, the use of grids, and flex provisions.

What are currently the main areas of concern for borrowers and sponsors in commitment letter negotiations?

Borrowers and sponsors are intensely focused on preserving flexibility and expanding their runway to be well positioned to execute business plans and be opportunistic regarding future transactions. As a result, provisions that directly or indirectly restrict the ability to do acquisitions and other investments, execute IPOs, return money to shareholders through dividend recapitalizations, refinance debt to reduce cost of capital, and similar activities are hotly negotiated provisions. Some specific examples include:

- Call protection and repricing provisions are being bombarded with carve-out requests and demands, such as IPO or other change of control, transformative acquisitions, and amendments that lenders decline to approve. Borrowers and sponsors seek every opportunity to avoid paying costly premiums on events that could prove attractive. In some instances, the payment of a premium could make or break the analysis of whether a particular deal works.
- Grower baskets are all the rage. Baskets used to be fixed in size, with company growth sometimes permitted through ratio tests or available amount calculations such as company retained portions of excess cash flow. Now borrowers and sponsors are insisting on more aggressive metrics for basket growth, such as increases proportional to EBITDA or total asset growth. These baskets are frequently used for investments, distributions or debt incurrence in connection with acquisitions.
- Multiplying the practical effect of the bloated baskets is the current concept of basket switches which borrowers and sponsors are pursuing. This is the ability to reallocate covenant basket capacity among investment, junior debt payment, and restricted payment covenants as desired, allowing capacity to be aggregated and diverted to the area of need. That helps with the inability to have a crystal ball and know where opportunities will lie, but it also exposes creditors to greater risk.
- Future debt capacity (important to facilitate acquisitions) is an area of intense interest. Borrowers and sponsors are demanding expansions of permitted incremental debt facilities and ratio debt incurrences. The golden rule used to be that deleveraging from closing date leverage was required. Now borrowers and sponsors are going beyond closing date leverage for unsecured debt and there is the addition of a leverage neutral prong which permits unsecured or secured incurrences even when leverage is above the agreed level. The market is also testing the addition of a new prong for incurring unsecured debt based on a fixed charge test rather than leverage metrics. Maybe most useful of all to a borrower or sponsor – the increase of free and clear (not subject to ratio tests) baskets of permitted incremental facilities is high on the list.

Will the longstanding MFN provisions regarding incremental facilities finally fall away in this liquid market?

The erosion is happening, and happening fast. The sunsets for the MFN provisions are being addressed and there are more and more overall carve outs requested from the MFN, such as pari passu debt outside the credit agreement, incremental facilities for permitted acquisitions and incremental facilities maturing more than two years after the initial credit facility. Also, there is a movement to disconnect covenants in addition to the economic terms from the initial credit facility. The carve-outs are getting close to swallowing any lender goodies from the MFNs.

Experts have observed that instead of signing commitment letters, borrowers and lenders have moved toward using grids. Based on your experience, has this been the case? What have been the advantages and disadvantages of this trend?

Grids, which contain multiple columns summarizing competing financing proposals point by point on a comparative basis, have become critical in the ability of borrowers and sponsors to quickly distill key terms. These comparisons are efficient and enable

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borrowers and sponsors to revert quickly to multiple lenders to push for the best possible terms. There is cherry picking of best provisions from different proposals as sponsors work hard to get to the minimum set of restraints and cost that will allow a deal to clear the market for them.

Using grids to facilitate selection of capital providers and test the market is extremely widespread but does not substitute for signed commitment papers with attached term sheets. The term sheets will incorporate the important issues which have been the subject of intense negotiation which was aided by the grids. The grids themselves do not provide certainty of funds or protection for borrowers or sponsors, who will seek to obtain signed commitments with attached term sheets from capital providers in most circumstances for their own protection. The attached term sheets will adapt the terms developed through the grid negotiation process.

Since borrower and sponsor negotiating leverage is at its strongest before selection of a capital provider, increasing levels of detail are being developed during this competitive phase of the deal. We see grids and term sheets now that are longer than 50 pages. This did not happen before this market environment.

In a borrower-friendly market, arrangers remain concerned with their ability to syndicate the loans. Therefore, they protect their interests through the ability to flex terms to adjust loan terms. In your experience, what are market flex provisions? Has this list expanded in recent years and, if so, what are new market flex provisions?

Flex terms originally focused on rate, and rate is the most significant tool in stimulating weak syndication. At one time, lenders had tried to expand flex terms to type of loan ("structural flex") and maturity/amortization terms, but borrowers and sponsors for the most part successfully rejected those terms and drove them out of the mainstream market long ago.

Today rate flex remains and non-economic flex has become a tool of compromise as a way of allowing aggressive borrower and sponsor-friendly terms to test the market, which satisfies the borrowers and sponsors, while allowing arrangers to pull back the most aggressive terms (such as those discussed above relating to basket expansion, the incremental MFN, and so on) to the extent that the market rejects the terms and/or the syndication is difficult.

We also see broader flex protection for arrangers in commitments of longer duration (more than three to four months) since unpredictability and market volatility are inherently greater risks over longer periods of time. So, yes, we see the list of flex items expanding to the extent that borrower and sponsor demands continue to expand, but these expansions are not generally related to core accepted and expected market terms (those terms are not eroding for borrowers and sponsors through flex).

The uncertainty borrowers and sponsors experience due to flex is very real and has largely driven the emergence of direct lenders, who hold the loans they make and do not require flex provisions since flex is used to sell down exposure. However, those direct lenders may be less willing to take the risks of some of the most aggressive demands of borrowers and sponsors since they will be carrying the loans and the risks themselves rather than selling the loans in the market like arrangers for syndicated loans.

The lending climate is generous to borrowers and sponsors today (there is a lot of liquidity and appetite by capital providers to lend). But keep watching and managing long term expectations. Nothing lasts forever and world events affect debt markets dramatically. That is why borrowers and sponsors push hard for the best terms they can lock in for long term capital, and also why arrangers sprinkle money around and collect fees while holding the insurance of flex as a safety valve in their pockets.

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