Early 2011 Trends in Loan Agreement Terms

Due to the improving credit markets, more competition from lenders and a more favorable economic outlook, terms in loan agreements continue to be increasingly borrower-friendly. Early 2011 loan term trends have included:

Modified Pricing Provisions

LIBOR floors, which became prevalent during the financial crisis at around 2% to 3%, dropped in 2010 to around 1.5% to 1.75% as the credit markets became more liquid. Some recent loans have been issued without LIBOR floors and many LIBOR floors are currently at 1.00%. In light of these trends, there is speculation that LIBOR floors may no longer be incorporated in future loan documentation.

Examples of announced deals with no LIBOR floors include:

- Regal Entertainment
- Kraton Polymers

While the use of LIBOR floors in loan documentation faces an uncertain future, the trend in the definition of base rate to include a floor based on a spread over LIBOR (usually one-month LIBOR plus 1%) seems to be here to stay. This floor ensures that if the base rate drops below market LIBOR again, as it did during the financial crisis, interest rates based on base rates will remain higher than rates for LIBOR loans.

Original issue discount (OID) has also tightened from levels following the financial crisis due to the recovery in secondary loan market prices and increased liquidity in the credit markets. While OID had reached 85% in some cases, it is currently around 99%, with some loans being issued without OID. Some market watchers speculate that OID may no longer be incorporated in future loan documentation.

Recent examples of announced deals without OID include:

- Burger King Corporation
- Spectrum Brands

There has also been a recent surge in loan repricings, as borrowers seize the opportunity to exert their improved bargaining power with lenders and obtain lower interest rates and fees on their loans.

Recent examples of announced repricings include:

- Denny's
- TransDigm

Call Premiums

Incorporation of call premiums in loan agreements has continued in 2011, with a premium of 1% in the first year of a loan being common. In addition, 2011 has seen an increase in the number of deals with call premiums of 1% for six months.

This increase in call premiums is a response to lender concerns that their loans may be refinanced with more cheaply available financing as interest rates fall. In addition, call protection may have increased to compensate for tightened OID levels in new deals. According to *Leveraged Finance News*, 67% of deals included a call premium by January 2011.

Recent examples of announced deals with call premiums (each at 1%) include:

- CommScope, one year
- J.Crew, six months

Incremental and Refinancing Facilities Incorporated

Incremental facilities are being incorporated into loan documentation more frequently than in the aftermath of the financial crisis, but now may:

- Include a most favored nations provision so that the interest rate on the existing loans is increased to be no more than 25 to 50 basis points less than the new incremental loan.

- Be subject to a leverage ratio test.

Recent examples of loan agreements with most favored nations provisions for incremental facilities include:

- Rovi Solutions Corporation
- TransDigm

Some loan agreements now include a refinancing facility (which may be in addition to an incremental facility). This type of facility permits a borrower to refinance loans either with new tranches under the loan documents or additional debt outside of the loan agreement that either shares *pari passu* in the loan document collateral or is secured by a second lien (usually a silent second lien) on that collateral. These facilities do not require unanimous consent. While incremental facilities are often subject to most favored nations provisions and leverage conditions, refinancing facilities typically have neither requirement.

Recent examples of loan agreements with refinancing facilities include:

- Avaya
- Clear Channel Communications

Dividend Recaps

After reappearing in 2010, dividend recaps are still being used in 2011, with over $3 billion of dividend deals in the second week of February alone, according to *Leveraged Finance News*. Sponsors use dividend recaps to recover some portion of their investments in portfolio companies without having to sell their interests in those companies. The mechanism can be attractive to private equity fund investors because they may be able to improve the return on their equity investment if the portfolio company's capital structure has a greater amount of debt and less equity. Dividend recaps are typically done on a best efforts basis and are not fully underwritten, therefore sponsors may find it difficult to successfully complete these deals in some instances.

Recent examples of announced dividend recap deals include:

- AVG Technologies
- Carestream Health

Asset-based Lending

During 2011, asset-based lending (ABL) has remained strong. The use of ABL is a response to a shortage of credit available to middle market companies. As lender appetite for cash flow deals decreased with the financial crisis, some middle market companies with significant asset bases in need of working capital looked to ABL deals as an alternative, even though they are more expensive and have greater ongoing reporting requirements.

Recent examples of loan agreements with ABL components include:

- Elizabeth Arden
- Lexington Realty Trust

Covenant-lite Loans

Covenant-lite loans basically disappeared with the onset of the financial crisis, but have now reemerged. According to *Thomson Reuters LPC*, covenant-lite issuance reached $4.75 billion in January 2011, compared with $5.6 billion of issuance in 2010. However, several recent deals were refinancings of existing covenant-lite loans and others are held by high-yield bond investors who are accustomed to investing in deals with minimal covenants. It remains to be seen how common covenant-lite loans will become in the future.

Recent examples of announced covenant-lite deals include:

- Axcan Intermediate Holdings
- J.Crew

Net Leverage Ratios and EBITDA Addbacks

A number of borrower-friendly trends are increasingly seen in the way the borrower's financial performance is measured in loan agreement covenants. In some transactions, especially sponsored deals, financial covenants are limited to one net leverage ratio that permits broad EBITDA addbacks and a 25% to 30% cushion over financial model projections. However, in other transactions, lenders insist that permitted adjustments to EBITDA and net debt calculations are limited to:

- Only netting amounts above working capital needs.
- Capping certain EBITDA addbacks and netted amounts.
- Allowing netting only if control agreements are in place.

Reappearance of Equity Cure Rights

Equity cure rights, which allow sponsors to inject equity capital into a borrower to remedy financial covenant non-compliance, have begun to reappear, but are now often capped and only permitted to be used a limited number of times.

Recent examples of loan agreements with equity cure rights include:

- Clear Channel Communications
- Momentive Performance Materials

Second Lien Financings

Second lien deal flow continues to recover in 2011. As the credit markets continue to improve, second lien deal volume will likely increase as investors look for investment opportunities with increased yields.

Recent examples of announced second lien deals include:

- Arrowhead General Insurance Agency
- Attachmate Corporation

Addressing the Dodd-Frank Act and Basel III

As regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) are proposed and Basel III comes closer to being implemented, changes in law based on these regulations are increasingly being expressly incorporated as triggering events for payments under increased costs provisions in loan agreements.

Recent examples of loan agreements incorporating Dodd-Frank Act or Basel III language include:

- Rovi Solutions Corporation
- Toyota Motor Credit Corporation

Documenting Credit Bidding Rights

Credit bidding is the right of a secured creditor to offset, or bid, its secured allowed claim against the purchase price in a sale of its collateral under section 363(b) of the Bankruptcy Code. However, if not expressly documented in loan agreements, conflicts among the administrative agent and various groups of lenders can arise. To clarify when credit bidding is permitted, parties began to expressly outline in loan documentation whether, and under what circumstances, the lenders or the administrative agent, or both, have the right to credit bid. This trend has continued into 2011.

Recent examples of loan agreements with credit bidding language include:

- American Pacific Corporation
- Vigor Industrial LLC

FATCA Provisions

Foreign Account Tax Compliance Act (FATCA) provisions are appearing more frequently in loan agreements even though not effective until January 1, 2013. FATCA imposes a new system of information reporting and a new 30% FATCA withholding tax on "withholdable payments" (which include interest payments) made after the effective date by US persons (including US borrowers) to "foreign financial institutions" and certain other non-publicly traded foreign entities, which may include a foreign lender.

FATCA provisions currently appearing in loan agreements include:

- A carve-out from the tax gross-up obligation for the 30% FATCA withholding tax.
- A requirement that foreign lenders provide FATCA documentation so that US borrowers can comply with their FATCA withholding obligations.

Recent examples of loan agreements that address FATCA include:

- AmTrust Financial Services
- Rovi Solutions Corporation

Continued Trends: Amend & Extends, Loan Buybacks, Defaulting Lenders

New loan agreements continue to be drafted to include loan buyback mechanics and allow amend & extends with limited consent requirements and modified sharing provisions. Finally, the trend toward a robust treatment of defaulting lender issues continues and prompted the Loan Syndications and Trading Association to update its Model Credit Agreement Provisions to include a standardized defaulting lender definition and related loan agreement provisions.

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An updated version of this article discussing mid-year trends in loan agreements will appear in the July/August 2011 edition of *Practical Law The Journal*, the companion to Practical Law online.

In compiling this article, we have relied, in some cases, on market data provided by *Churchill — On the Left, Leveraged Finance News, S&P's Leveraged Commentary & Data* and *Thomson Reuters LPC*.

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