DRAFTING AND NEGOTIATING CORPORATE AGREEMENTS

Credit Agreements and Indentures

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Credit Agreements/Indentures

Overview:
- Structure of Financing (Type of credit facility, identification of credit parties): What type of transaction (Acquisition Financing, ABL, etc.?)
- First Steps
- Documentation
- Terms of credit agreement/indenture
- Specific Focus on Covenants
Credit Agreements

Example of a Leveraged Transaction in an M&A Context:

- Lender makes loan to Borrower (shell acquisition subsidiary)
- Borrower distributes proceeds to shareholders of target
- Target merges into Borrower, with target as the surviving entity
- Target / Borrower repays loans with operating profit
Credit Agreements (cont’d)

Example of a Financing in an ABL Context:
- Company borrows based on quality of “current assets” – Inventory and/or Accounts Receivable
- Often used for working capital purposes
- Also can be part of financing for an acquisition
- Specific focus on the quality of the current assets

Example of a Debtor-in-Possession (DIP) Financing
- To be used by a Company in Bankruptcy
- Borrowings to be used for operations, funding expenses during pendency of a bankruptcy
- Different types of covenants and terms than other facilities
- Must be approved by Bankruptcy Court
- Refinanced by “exit facility” upon emergence of bankruptcy
First Steps: Commitment Letter / Term Sheet

- Sets out terms of the particular financing/structure of the financing
- Commits the lender(s): fully underwritten vs. best efforts
- For M&A Transactions:
  - Simultaneous with purchase agreement
  - Conditionality
  - Financing out
  - Diligence out
- MAE clauses
  - Align MAE condition with MAE in purchase agreement
Basics

Different types of loans:

- Revolving Loan: fixed amount of funds that can be borrowed, paid back and re-borrowed during the term of the loan. Used mainly for working capital.
- Term Loan: a fixed amount of funds borrowed for a fixed amount of time, which once repaid cannot be re-borrowed. Used to fund an acquisition or refinance existing debt.
Basics

Different Types of Loans (continued):

- **Bilateral Loan** – one Lender, (at least) one Borrower.
- **Syndicated Loan** – many Lenders (a syndicate), one or more Borrowers and an Agent.
- **Secured Loan** – A loan in which the Borrower pledges some asset as collateral for the loan.
- **Unsecured Loan** – A loan where there is no such collateral and the Lender’s only recourse is to the Borrower (junior debt with warrants and/or PIK)
- **Bonds/Notes**: High yield: often issued in conjunction with bank debt. Can be secured senior/junior/various levels of priority of debt/liens. (Debt Subordination vs. Lien Subordination)
- **Non-Recourse Loan** – a secured loan where the collateral is the only security or claim the Lender has against the Borrower (real estate loan).
Secured Loans/Bonds

- If the Borrower cannot pay, the Lender can look to collateral to recover on the loan.
- Primary recourse for lender are the assets of the borrower and often its subsidiaries.
- Such collateral may include:
  - Inventory
  - Equipment
  - Deposit or Securities Accounts (i.e. Cash/Securities)
  - Real Estate
  - Equity interests
  - Intellectual Property
  - Accounts Receivables
  - Artwork
  - Jewelry
  - Livestock
  - Ships
- Different means of perfection (UCC, state and federal law) depending on asset
Documentation

- Term Sheets/Commitment Letter
- Bank Loans: Credit Agreement or Loan Agreement
  - Should be tailored to particular transaction
- Bonds/Notes: Indenture / Note Purchase Agreement
- Security Agreement/Pledge Agreement
- Guaranty
- Intercreditor agreement (governing relationship among different classes of debt/levels of lien priority)
Provisions of a Credit Agreement/Indenture

- Credit Agreement: The Loans – the basics of the loan, including whether it will be a revolving loan or a term loan, the term of the loan, any mandatory repayments, details about interest, taxes, how payments will be made, fees.

- Term loan: typically drawn entirely at close; sometimes are multiple draws (“Delayed Draws”)

- Revolver: ABL / commitment provisions: provide for borrowings, prepayments and re-borrowings

- Indenture: Issuance of Bonds at closing
Representations and warranties:

- **Representations & Warranties** – Statements of fact Borrower makes on the closing date, which may be reaffirmed or “brought down” at a later date (i.e. on a subsequent borrowing date or at times when financials are delivered, etc.)

- **Purpose:** Informational/Disclosure: Also “weeds” out issues up front to be resolved prior to close

- **Typical representations and warranties:**
  - Valid organization
  - Enforceability
  - Compliance with laws and agreements
  - Taxes
  - Disclosure
  - No Default
  - Use of proceeds
  - Solvency
Credit Agreement/Indenture

- Conditions precedent:
  - Note: Identify those which take time to satisfy, with particular attention on third party actions
    - General Conditions:
      - Execution of Documents
      - Corporate Authority Actions
      - Opinions
      - Perfection of Collateral
        - Payment of fees
        - Lien Searches
        - Payoff of existing debt
      - Minimum Financial Requirements
        - Threshold EBITDA
        - Threshold Availability of Loans
      - Consents
      - Landlord Waivers
Credit Agreement/Indenture

- M&A transactions:
  - Consummation of acquisition
  - Receipt of certain amount of cash by Borrower (from sponsor in exchange for Holdco stock)
  - Issuance of other debt (notes, 2nd lien etc.)
  - Fees and expenses
  - Termination of existing credit agreement
  - Consents / approvals

- Asset Based Loans:
  - Appraisals
  - Security Interests
Covenants – These are the rules the Borrower must adhere to during the term of the Credit Agreement / Indenture:

- Affirmative Covenants – affirmative obligations of the Borrower such as the delivery of financial reports, compliance with laws, maintenance of adequate books and records, maintenance of adequate insurance, use of the loan proceeds only in the manner dictated by the Credit Agreement, etc.
Negative Covenants – restrictions upon the activities of the Borrower. Generally, each one begins with a blanket prohibition and then lists exceptions to such general prohibition:

- Examples: Debt Covenant
- “The Borrower will not incur any Indebtedness...except:
  (a) Indebtedness existing on the closing date and listed on Schedule X
  (b) Indebtedness incurred in the ordinary course of business including open accounts extended by suppliers on normal trade terms
  (c) Other Indebtedness not otherwise permitted hereunder in an aggregate principal amount not to exceed $XXX”
Lien Covenant:
- “The Borrower will not permit any liens on any of its assets...except:
  (a) Liens existing on the closing date and listed on Schedule X
  (b) Liens securing certain permitted indebtedness
  (c) Carriers’, warehousemen’s, mechanics’ and other like liens imposed by law
  (d) Easements, rights-of-way and similar encumbrances on real property”

The Schedules are an important part of the Credit Agreement.
- Generally included in representations and warranties and covenants
- Important Supplement to the document:
  - Contains exclusions and exceptions
In many form Credit Agreements and Indentures the Affirmative Covenants and Negative Covenants are split into two separate sections. Additionally, some credit agreements may have a third section of covenants entitled “Financial Covenants.” In other forms you may see financial covenants incorporated within the other covenant sections.

Examples of financial covenants are:
- Leverage Ratio
- Interest Coverage Ratio
- Fixed Charge Coverage Ratio
- Minimum EBITDA
- Capital Expenditures
Events of Default: Result From failure to comply

Typically, a “Default” is an event or condition that, with notice or the passage of time, would become an “Event of Default”.

- For example, Borrower fails to make an interest payment, but there is a 3 day grace period in relation to this covenant. This is a Default. Once the 3 days have passed, this is an Event of Default.
Events of Default may include:

- Non-payment of interest, principal or fees
- Breach of a covenant
  - Breaches of certain covenants are immediate Events of Default
  - Certain covenant breaches are subject to a cure period
- Bankruptcy filing (voluntary or involuntary)
- Cross-default to other material indebtedness: Concern with “domino effect” of default
- Change of Control
- Material Adverse Change

Rights and Remedies of Lender(s)/Agent:

- Once an Event of Default has occurred the Lender (or in some instances the Agent, if there is an Agent) will have certain rights and remedies to take action against the defaulting Borrower. These rights and remedies are normally set forth at the very end of the list of “Events of Defaults.”
Credit Agreement/Indenture

- Remedies of Lenders:
  - Declare all outstanding obligations to be immediately due and payable.
  - Terminate the commitment in the event of a delayed draw loan or a revolving loan.
  - Pursue remedies available at law (the Lender can sue the Borrower).
  - Foreclose on the collateral.

- Other ramifications:
  - Shuts off ability to consummate certain actions otherwise permitted under the covenants.
Some very important provisions are contained in the Miscellaneous section, including:

- Notice information
- Amendments and Waiver requirements, including voting
- Expenses and indemnity provisions
- Assignment requirements
- Setoff rights
- Governing law provision
Credit Agreement/Indenture

In a Bilateral Loan, any amendment or waiver must generally be executed by the Borrower and the Lender.

In a Syndicated Loan, most amendments/waivers require the consent of a certain percentage of Lenders:
  - Called “Required Lenders” or “Requisite Lenders”
  - Usually either 50.1% (majority) or 66 2/3% (super majority)

Syndicated Loan Amendments
  - Certain amendments will require the consent of all Lenders or all affected Lenders such as amendments to:
    - Increase the commitment of any Lender
    - Reduce the principal amount or the interest rate of any Loan
    - Postpone any scheduled date of payment
    - Amend the definition of Required Lenders
    - Release all or substantially all of the Collateral
Covenants

- Benchmarks of performance by Borrower and protection of Lenders/Bondholders.

- Types: Affirmative Covenants:
  - Require certain actions, performance.

- Negative Covenants:
  - Prohibitions and restrictions on certain actions.
  - Protect assets, cash outflows, collateral.

- Financial Covenants:
  - Measure financial performance (“Early Warning Signs” of Trouble and Financial Instability).
  - Ensure Lender some degree of financial health of its Borrower.
  - Maintenance covenants.
  - Incurrence covenants.
Detailed Covenant Discussion

- **Typical Affirmative Covenants**
  - Delivery of Financial Statements (note: form basis of compliance with financial tests)
  - Notices of Default, Litigation, Material Adverse Changes
  - Delivery of Borrowing Base Certificate (for ABL facilities)
  - Payment of Taxes and other obligations
  - Maintenance of Business, Properties, etc.
  - Insurance requirements
  - Inspections of Collateral/Business
  - Formation of New Subsidiaries” Requirements to become a Loan Party
  - Cash Management: Typically in ABL facilities: Blocking Events upon “Cash Dominion” (based on excess availability)
  - Appraisals
Detailed Covenant Discussion

- Typical Negative Covenants
  - Indebtedness: prohibition on incurrence of debt
  - Typical “baskets”
    - “Ratio Debt” (i.e. permit incurrence up to a certain Leverage Ratio)
    - Specific baskets
      - Capitalized Leases and Purchase Money
  - Junior Debt
  - Unsecured Debt
  - Acquired Debt (debt that is acquired/assumed upon on acquisition)
  - Intercompany Debt (subordinated if incurred outside credit group)
  - Guaranties of non-debt obligations
  - Existing Debt
  - General Basket
Detailed Covenant Discussion

- Liens: prohibitions on liens on assets
  - Carve-Outs: “typical” permitted liens to enable borrower to carry out day to day activities
    - Finite Capitalized Lease/Purchase Money Lien Basket
    - Capped “general” Basket
    - Minor Encumbrances; Deposits, Statutory Liens
    - Easements
Detailed Covenant Discussion

- Dividends, Redemptions, Restricted Payments:
  - Carve-outs
    - Finite Dollar Baskets
    - Use from proceeds of sale of assets (limited)
    - “Cumulative Credit” concept
    - Purchases from retirees
    - Management Fees (capped)
    - Payments on Subordinated Debt
    - Payments to shareholders/members to pay taxes

- Investments, Acquisitions, limitations on use of cash to make acquisitions, make other investments.
  - Carve-outs
    - “Permitted Acquisition” concept
    - Limited amount
    - Accretive
    - Target becomes a Credit Party
    - Pro Forma Compliance
    - “Cumulative Credit” concept
Detailed Covenant Discussion

- Asset Sales: Limitation on transfer, sales of assets outside ordinary cause of business (i.e. inventory).
  - Carve-outs:
    - Permit sales up to certain amount of proceeds and to repay loan or reinvest in other assets.
    - Transfers among Credit Parties.
    - Sales of obsolete equipment, assets.
    - Finite annual aggregate basket.

- Transactions with Affiliates
  - Prevent “sweetheart” deals
  - Ensure arms-length
  - Ensure Board Approval (over certain size)
  - Carve-outs:
    - Transactions among Credit Parties
    - Management agreement arrangements
    - Shared Services Arrangements
Implementation of Financial Covenants in Certain Loan Documentation:

- Credit Agreements (bank type loans: have maintenance as well as incurrence).
- Indentures – typically only incurrence type covenants
Detailed Covenant Discussion

- Maintenance Covenants
  - Financial tests; tested quarterly (often on a “TTM basis”)
    - Sometimes a single quarterly test.
    - Sometimes an “at all times” test.
    - Tied into financial statement delivery requirements.
  - Purpose: Measure of financial health; monitor trouble in financial health.
    - Also used to determine pricing (i.e., margins over Prime Rate / Libor Rate)
      - If stronger financial-wise, lower interest rate.
‘Quasi’ Maintenance/Incurrence

- Pro forma compliance of maintenance covenant for certain actions – i.e. acquisitions – to ensure the transaction is accretive (as opposed to a cash flow negative transaction)

- Certain credit agreements have more limited maintenance tests: ABL agreements often become effective at certain times – i.e. trigger of a Fixed Charge Coverage Ratio. Concern of too much outstandings as compared to borrowing base. Triggered when availability is less than a certain threshold.
Detailed Covenant Discussion

- **Typical Maintenance Covenants**
  - Minimum EBITDA (measurement of cash flow)
  - Leverage Ratio (Debt to EBITDA)
  - “Coverage” Ratios
    - Interest Coverage (measures interest charges to EBITDA)
    - Fixed Charge Coverage (measures other “fixed” charges to EBITDA)

- **Incurrence Tests:**
  - Need to be satisfied before a certain action can be taken.
    - Incurrence (typical in Indentures)
    - Investments
    - Dividends, Redemptions and other Restricted Payments
    - Incurrence of Liens
Detailed Covenant Discussion

- Unusual Baskets / Carve-outs: More in strong “sponsored” deals/private equity:
  - Flexibility
  - Large Baskets
  - No Control agreements to perfect accounts/cash
  - No lien on cash

- Ratio Debt Baskets in Credit Agreements

- Re-loading of Investments Basket –
  - Allowing transfer to Unrestricted Subsidiaries so asset out of reach; then redesignating it as a Restricted Subsidiary and “re-load” basket.

- Contributions/Licensing of Intellectual Property to joint marketing arrangements

- Unusual voting: permit Borrower affiliates to buy up debt (i.e. at a discount) and then vote for amendments, etc.
Financial Definitions / Issues. EBITDA: (earnings before interest, taxes, depreciation, amortization): Issue is what other “add backs” are included to increase EBITDA:

- Transaction costs
- “Synergies”/Cost Savings (Actual/Projected)
- Integration Costs
- Reorganization Costs
- Effect on Excess Cash flow calculation
- Provide pro forma compliance to “anticipated” transactions – i.e. restructurings that Borrower has determined to make
Detailed Covenant Discussion

- **Leverage Ratio**
  - “Debt to EBITDA”
    - Senior Debt
    - Total Debt
    - Net Debt

- **Interest Coverage Ratio**
  - EBITDA to Interest

- **Fixed Charge Coverage Ratio**
  - EBITDA to “Fixed Charges”; interest, amortization, restricted payments, taxes, management fees

- **Capital Expenditures**
  - Ability for carryover amounts
Refinancings (low interest rates; a lot of financings maturing).
- Dividend Recaps
- Second-lien financings
- Covenant lite
- Equity cures