Client Alert | Banking / Capital Markets

Calculating and Implementing Additional Debt Capacity

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This year European leveraged loan borrowers will test the terms of the additional debt provisions in their loan agreements and there is expected to be significant interest in how these provisions are interpreted. This article walks through some of the main considerations when calculating and implementing existing debt capacity in leveraged loan documentation, with particular focus on some of the more permissive terms often seen in syndicated deals.

When assessing debt incurrence provisions, some of the key questions to ask are:

1. Which baskets are being used and how is the capacity tested?
2. What conditions apply to those baskets/that type of debt and are there any exceptions?
3. How is the new additional debt going to be documented?

1. Which baskets are being used and how is the capacity tested?

Basket types and amounts will differ from deal to deal, but key pieces of structural debt typically need to be raised under certain common baskets.

Ratio capacity will, in most cases, represent the largest amount of available debt capacity, allowing a borrower to incur debt provided that a specific ratio or ratios are met, with the type of ratio often being determined by the priority of the debt that is being incurred:

a) a senior secured/first lien leverage ratio for senior secured/first lien debt;

b) a total secured leverage ratio for junior secured/second lien debt; and

c) a total leverage ratio and/or a 2:1 fixed charge coverage ratio for unsecured debt.

Although variations of ratio types will exist, particular attention needs to be paid to how each of these interact: the total leverage or fixed charge coverage ratios can act as total caps on ratio debt incurrence, or they may be more independent, adopting a cumulative approach that can lead to the total caps being overtaken. Certain deals will also allow ratios to be tested on a “no worse” basis - often only in the case of an acquisition, but sometimes more generally - allowing debt to be incurred provided that the leverage levels are no higher and/or the fixed charge coverage is no lower as a result of a particular transaction and the associated debt incurrence, which can also lead to total levels being exceeded. Ratios will always be tested on a pro forma basis for the incurrence of the additional debt and the intended purpose of the proceeds - further commentary

on how the scope of EBITDA add-backs can affect such calculations may be found in our recent article “Synergising Synergies” https://www.whitecase.com/publications/alert/synergising-synergies.

A **freebie/free-and-clear** basket will typically allow further debt not subject to the ratio caps and either will not count towards the ratio calculation if the drawing is made at the same time as the calculation for the ratio test, or sometimes will never need to be taken into account. Reclassification of the freebie basket whenever there is free ratio capacity has become common, allowing the free debt capacity to be refreshed and although some loan agreements will require lenders to be notified whenever reclassification takes place, this may lead to difficulties in being able to track what free capacity there is and where debt is being incurred.

Additional freebie capacity can often also be generated by a borrower prepaying or buying back term debt under the loan agreement (or sometimes other pari debt), permitted on the basis that the borrower has de-levered and should be able to re-draw up to the closing date levels. Prepayments of ratio debt, junior secured/second lien debt and unsecured debt will commonly be prevented from contributing to the prepayment freebie basket, to avoid removing the ratio test requirements from such capacity. Prepayments from the proceeds of other debt are also often prevented from contributing to this basket. Related fees including OID and call protection, as well as costs and expenses, may also contribute to the free capacity.

General debt baskets will typically be capable of either topping up senior secured debt capacity or of being secured on the transaction security. Traditional European loan agreements (those without high-yield covenants) commonly allow the general basket to be secured against other assets (by using available capacity in the general security basket, which is often the same size as the general debt basket for this reason). However, recent cov-lite deals that adopt high-yield covenants will allow the general debt basket to share in the main transaction security (by giving it a “Permitted Collateral Lien”) – the implementation of this will require entry into an intercreditor agreement, which could possibly be achieved through the wide authority granted to an agent (described further below).

Other baskets, such as those for capital leases, receivables/factoring and local facilities will add further debt capacity for specific purposes. Together with the general basket and any acquired debt basket (which would allow existing debt of a target to be grandfathered subject to a ratio test), these baskets can lead to lenders of additional debt being given direct access to assets held by companies lower down in the group than the existing debt, effectively giving them priority status in respect of those assets.

2. What conditions apply to those baskets/that type of debt and are there any carve-outs?

Specific conditions will apply to any new additional debt before it can be incurred, although there has been an **increasing amount of limitations or carve-outs**. We have picked some of the key conditions and some specific carve-outs below:

- **Pricing protection** is achieved by way of the MFN (“most favoured nation”) protection, requiring additional debt to be priced within a “cushion” outside the price of the existing debt if raised within a “sunset” period of time after closing. Borrowers will seek to limit the application of the MFN so that it only applies narrowly to debt that competes with the liquidity of the existing debt, primarily incremental facility debt raised under the ratio basket (and so may not apply to debt raised under the general or “other” baskets mentioned above), but also with further caveats so that the protection only applies to widely syndicated, pari passu term debt of the same currency and which matures within a similar period of time as the existing debt.
- **Maturity and amortisation restrictions** protect the seniority and the liquidity of the existing debt, preventing scheduled repayments (sometimes above a certain level, such as 5% per annum) and final maturity repayments, prior to the maturity of the existing debt. Loan agreements can often permit these to be circumvented if existing lenders are offered the same terms or sometimes with deemed consent provisions dragging non-responding lenders. The emergence of “inside maturity” baskets also now provides for fixed baskets of debt, often pari passu but sometimes of junior secured/second lien debt, which can mature inside the existing debt maturity.

- **Intercreditor accessions** will often be required where new lenders who are not already in the existing syndicate are providing the additional debt. Whether a creditor in respect of a certain type or amount of debt needs to accede to the intercreditor agreement should be analysed carefully, as any creditor that is not subject to the intercreditor agreement may not be contractually subordinated or subject to payment restrictions (other than those imposed on the group by the loan agreement) or turnover requirements and that debt will not easily be released on an enforcement. Additional senior secured/first lien debt and junior secured/second lien debt typically needs to accede to the intercreditor agreement, but accession requirements for unsecured or other non-transaction secured debt will often be subject to "de minimis" levels, only requiring accession above a threshold. Any debt incurred at an opco (in particular, for debt raised under the "other" baskets described above), will often not be required to accede to the main intercreditor agreement at all.

3. How is the new additional debt going to be documented?

As is now common, additional debt can take two forms: as an incremental new tranche or facility under the existing loan agreement and documented by way of an additional facility notice or under separate "side-car" documentation. Additional facility notices will be relatively straightforward (which is in all parties' interests) given the terms should follow the existing loan agreement, whereas side-car documentation will usually allow for greater divergence, despite being subject to restrictions in the loan agreement.

Unless the additional debt provisions provide for a right of first refusal for existing lenders to take part in the new additional debt (something which has largely disappeared from top-tier/large-cap deals, but can still occur in the mid-market and/or private credit loans), the existing syndicate may first learn of the new additional debt when the additional facility documents are posted on the lender portal by the agent. This approach will likely be consistent with the terms of most recent loan agreements, which will provide that as long as the debt meets the capacity limits and conditions for additional debt, as determined by the parent (and sometimes with a formal certification requirement), the consent of an existing lender is not required and the agent is authorised to accept (and sign) any additional debt documentation delivered to it. If changes are required to be made to the loan documentation to accommodate such additional debt, the agent and security agent will also be authorised (and such authorisation will have been granted to them by the other finance parties in the loan agreement) to enter into any amendments or new documentation reasonably requested by the parent in order to facilitate the establishment of the new additional debt. This can include the taking and re-taking of security, often provided that the interests of the secured parties are not materially adversely affected (which may reset hardening periods and this may not constitute a "material adverse effect").

Whether an agent acts upon the discretion granted to it to by accepting a confirmation from the parent that conditions have been complied with, or enters into additional documentation in order to implement the terms of such additional debt which are permitted (or in some cases, not prohibited) by the loan agreement, will depend on each agent in each specific circumstance.

Although some loan agreements will also provide that additional debt cannot benefit from representations, undertakings and events of default more extensive than the existing debt, the new additional debt may still have preferential terms, especially when taking into account the various carve-outs from any additional debt conditions. In these circumstances, particularly where additional debt is being incurred as a tranche of an existing facility, attention will be drawn to how the new additional debt may be structured, in order to avoid secondary trading and/or ratings issues in situations where it is either more attractive to potential investors than the existing debt or is inadvertently detrimental to the whole facility.

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