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The International Comparative Legal Guide to:

Lending & Secured Finance 2019

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A practical cross-border insight into lending and secured finance

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EDITORIAL

Welcome to the seventh edition of *The International Comparative Legal Guide to: Lending & Secured Finance*.

This guide provides corporate counsel and international practitioners with a comprehensive worldwide legal analysis of the laws and regulations of lending and secured finance.

It is divided into three main sections:

Three editorial chapters. These are overview chapters and have been contributed by the LSTA, the LMA and the APLMA.

Twenty-five general chapters. These chapters are designed to provide readers with an overview of key issues affecting lending and secured finance, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in lending and secured finance laws and regulations in 51 jurisdictions.

All chapters are written by leading lending and secured finance lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor Thomas Mellor of Morgan, Lewis & Bockius LLP for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.com.

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Developments in Delayed Draw Term Loans

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Background – Delayed Draw Term Loans

As the number and volume of leveraged buyouts ("LBOs") by private equity sponsors have increased over the past few years, the financing structures for LBOs have continued to evolve, primarily to maximise the capital structure flexibility of the sponsor. While the fundamental loan components of any LBO continue to be term loans funded at closing (the "Closing Date") together with a revolving credit facility for liquidity and other needs, there has been a significant rise in the use of delayed draw term loans ("DDTLs"): loans which, similar to revolving facilities, are available to the borrower for drawing after the Closing Date but which, similar to term loans, may not be re-borrowed following prepayment. DDTLs must be drawn, if at all, during a specified commitment period following the funding of the initial term B loan ("TLB") on the Closing Date for the LBO. If drawn, the DDTL will mature on the maturity date for the initial TLB,[1] but, if not drawn during such period, any unused DDTL commitments will automatically terminate.

DDTLs have historically been a feature more characteristic of the middle market, with a sponsor/borrower seeking committed financing for an identified pending acquisition on a future date without incurring interest expense on that portion of the financing until actually needed and drawn. Since 2016, however, there has been a significant increase in the use of DDTLs in the large-cap syndicated leveraged loan market, with DDTLs being used to finance a broad range of transactions, including multiple opportunistic acquisitions. A number of factors appear to be driving this trend. First, private equity sponsors are increasing employing "buy and build" or "rollup" strategies, in which the sponsor purchases a "platform" company in a given industry with an experienced management team and developed infrastructure and then leverages those capabilities to consummate a series of "tack-on" acquisitions of industry competitors to build out a broad platform. Second, private equity sponsors have sought to utilise the momentum and fees of the LBO financing process to obtain committed financing for post-closing acquisitions and other activities without undergoing the time, expense and inconvenience of undertaking a new syndication soon after the initial closing – or, alternatively, borrowing an excess amount of TLBs on the Closing Date and paying the funded cost on the additional loans even before they are put to use.

The increasing demand for DDTLs from private equity sponsors has resulted in a renewed focus on the terms and economics of DDTLs. This article discusses several primary features of DDTLs in the syndicated leveraged loan market and explores issues to consider in this context.

Primary Features of DDTLs and Issues to Consider

Commitment Length and Use of Proceeds

Up until recently, if a DDTL appeared in the financing package for an LBO it would typically be to finance, or make payments in respect of, a single acquisition that had been disclosed to the lenders pursuant to an acquisition agreement in effect as of the Closing Date. In other words, the purpose of the DDTL was to bridge timing differences between the primary acquisition and a related but ancillary acquisition by the newly acquired company. Because the closing timing of the related acquisition was known as of the Closing Date, the DDTL commitment period was set to match the necessary timing (typically not more than three months) and the DDTL was limited to a single drawing during the commitment period to consummate the later acquisition.

In recent years, however, the permitted uses of a DDTL facility have greatly expanded to include: (i) financing multiple acquisitions, whether or not identified or identifiable to the lenders prior to the Closing Date; (ii) refinancing existing debt of the borrower maturing after the Closing Date but during the DDTL commitment period; (iii) financing unspecified capital expenditures/projects of the borrower; and (iv) replenishing balance sheet cash and/or repaying revolving facility borrowings previously used for any of the above purposes. As a result of this broader set of uses, commitment periods have correspondingly increased to as long as 18 months, with a typical DDTL commitment having a period of nine months. Moreover, while DDTLs historically were required to be drawn substantially contemporaneously with the acquisition, sponsors/borrowers have sought to maximise their flexibility by negotiating the ability to draw DDTLs so long as there is a "good faith expectation" that the proceeds will be used for a permitted acquisition.[2] To accommodate these multiple and sometimes evolving purposes that DDTLs now serve, sponsor/borrowers have sought the ability to borrow the DDTL facility in multiple drawings during that extended period to enable flexibility around the use of proceeds.

Conditions Precedent

Until recently, the use of DDTL proceeds was conditioned upon (i) the absence of any payment or bankruptcy event of default, (ii) the accuracy of customary "specified" representations and "acquisition agreement" representations, (iii) the substantially contemporaneous consummation of the acquisition being financed with the DDTL

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proceeds (and, if applicable, any equity contribution in connection therewith), and (iv) often, compliance with a maximum total and/or first lien net leverage ratio (most typically set at the level as of the Closing Date). Because, as noted above, DDTL proceeds were historically used to consummate an acquisition (pursuant to an existing acquisition agreement soon after the Closing Date), these standard conditions precedent made sense for both lenders and sponsors as they reflected the limited conditionality necessary to consummate such acquisition. Moreover, the presence or absence of a leverage ratio was less controversial for both lenders and sponsors/borrowers. From the lenders' perspective, because the acquisition structure and timing was known on the Closing Date, it was not unreasonable for lenders to forego any maximum leverage ratio condition. From the sponsor's/borrower's perspective, it was similarly, relatedly innocuous to agree to a maximum leverage ratio condition where the DDTL commitment period was relatively short, and therefore the ability to satisfy the leverage requirements was more certain.

More recently, however, the expanding uses of DDTL proceeds and corresponding lengthening of the DDTL commitment period have led to increased negotiation over the formerly customary conditions precedent to DDTL draw. On the one hand, given that in many transactions DDTL proceeds may now be used for a broad range of purposes other than acquisitions, lenders will want to ensure that, in such circumstances, conditions to the use of the DDTL include the making and accuracy of all representations and the absence of any event of default. On the other hand, the lengthening of the commitment period and the potential for borrowers to use DDTL proceeds for such broader purposes, including multiple, unspecified acquisitions, has led to increasing demand by sponsors to remove any maximum leverage ratio condition given that the ability to comply with such ratio, and thus access the DDTL, is at best uncertain (and more likely unknown) at the time of closing. Unsurprisingly, recent deals are mixed on the scope of representations and defaults and on whether compliance with a maximum leverage ratio is required to use DDTL proceeds.

Ticking Fees

As DDTL commitment periods continue to lengthen, there has been an increased focus on the economics of DDTL arrangements, most notably the structure of the "ticking fees". DDTL ticking fees are similar to revolving facility commitment fees in that they accrue on the undrawn portion of the DDTL commitment until the earliest to occur of (i) the date the DDTL facility is fully utilised, (ii) the date the borrower terminates the DDTL commitments, and (iii) the last day of the DDTL commitment period (on which the DDTL commitments automatically terminate) (such earliest date, the "DDTL Termination Date"). DDTL ticking fees are most typically paid quarterly in arrears following the Closing Date and on the DDTL Termination Date.[3] The primary purpose of ticking fees is to provide arrangers of DDTL financings with sufficient economics to syndicate the DDTL commitments to institutional lenders in advance of the funding of the DDTL (the "DDTL Funding Date") and hold the syndicate together through the availability period. Ticking fees most typically accrue following a 30–60-day "holiday" following the Closing Date and through the DDTL Termination Date. The ticking fee percentage generally steps up every 30–60 days from an initial level of 50% of the interest rate margin that would apply to a funded DDTL to 100% of such margin *plus* then applicable LIBOR (often inclusive of any applicable LIBOR "floor"). In many transactions, arrangers will, as part of any implementation of their "market flex" rights, require that the DDTL ticking fee (i) step up immediately to 100% (rather than 50%) of the interest rate margin following the specified holiday, (ii) be subject to an accelerated schedule of step-ups to 50% and 100%, and/or (iii) not be subject to any holiday. In the event the syndication of the TLB (and DDTL commitments) extends beyond the Closing Date (and the Closing Date, therefore, occurs before the pricing of the DDTL has been finally determined), the calculation of the interest rate margin will often give effect to the maximum potential increase in the spread after exercise of any available "market flex" rights.

It is worth noting that this "holiday-then-step-up" structure of any post-Closing Date DDTL ticking fee may create some interesting anomalies in the overall ticking fee structure. For example, LBOs with commitments of six months or longer typically require that the borrower pay committing TLB lenders a ticking fee on the undrawn commitments ***prior*** to the Closing Date (following a similar holiday and step-up schedule). Similar to ***post-closing*** DDTL ticking fees, the pre-closing ticking fees are intended to compensate institutional lenders for providing commitments at preferential pricing (well) in advance of the Closing Date. Where there is a DDTL in the financing structure, any pre-closing ticking fee will similarly be payable on the undrawn DDTL commitments. In that case, a lender who has been accruing a ticking fee on its DDTL commitment equal to, say, 100% of the DDTL interest rate margin on the day before the Closing Date may find that it is receiving no ticking fee on that same DDTL commitment for the next 30–60 days after the Closing Date.

Upfront Fees

Upfront fees are payable to lenders on the Closing Date of nearly every TLB financing as a percentage of the principal amount of the TLB actually funded to the borrower. Upfront fees are either reflected as "original issue discount" on the TLB or as a separate fee paid by the borrower, but, in practice, are paid through a "net-funding" mechanism, whereby lenders reduce the amount actually advanced to the borrower by the upfront fee. Under either structure, the borrower owes the full stated principal amount of the TLB to the lender at maturity.

In the DDTL context, deals are mixed as to whether DDTL upfront fees are paid on the Closing Date (similar to customary commitment fees) or only on, and subject to the occurrence of, funding on any DDTL Funding Date. In transactions where DDTL upfront fees are payable on amounts funded on a DDTL Funding Date, such fees are netted against the portion of the DDTL facility actually funded on the DDTL Funding Date.[4] This arrangement reflects the usual practice for paying upfront fees on term loans in LBO finance: that the borrower pays upfront fees only when those term loans are actually funded.

Where DDTL upfront fees are payable on the Closing Date, both the upfront fee on the initial TLB and on the DDTL are netted against the initial TLB funded at closing. In contrast to the general rule stated above – upfront fees on LBO term loans are payable only when those term loans are funded – lenders retain the full DDTL upfront fee even where the DDTL facility ultimately may not be drawn in full (either because the borrower elects to terminate DDTL commitments prior to the DDTL Funding Date or the commitment period expires prior to the funding in full of the DDTL). While borrowers often agree to pay DDTL upfront fees on the Closing Date as a necessary condition to obtaining DDTL commitments, this may result in a potential windfall to lenders who are paid upfront fees on DDTL commitments that may never be funded. Nevertheless, given the fact that, in recent deals, both the initial TLB and DDTL are almost always syndicated simultaneously to the same institutional lenders, arrangers will often insist that DDTL upfront fees be payable on the Closing Date in order to ensure a successful syndication process by guaranteeing lenders a minimum level of economics on both tranches of term loans.

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Fronting Arrangements

Traditionally, where more than one arranger commits to provide a TLB in advance of closing, the actual funding of the TLB on the Closing Date will be "fronted" by the administrative agent (the "Fronting Lender") on behalf of the other arrangers (the "Other Arrangers"). The fronting mechanism is particularly useful in the LBO context, where there are often multiple arrangers and the TLB proceeds are needed early on the Closing Date to meet the acquisition closing timing. Such fronting arrangements are typically documented pursuant to a "fronting letter", under which the Fronting Lender agrees to fund the entire TLB in exchange for the agreement of each Other Arranger to purchase its *pro rata* portion of the TLB after a specified period (typically 30–45 days) following the Closing Date to the extent that the Fronting Lender has been unable to assign any portion of the TLB to institutional lenders who had agreed, prior to the Closing Date, to purchase their allocated portion of the TLB.[5]

The increasing presence of DDTLs in financing structures for LBOs has led to practical questions regarding how the DDTL in any LBO should be funded. Historically, arrangers held the DDTL commitments until the applicable DDTL Funding Date. In such cases, consistent with the Closing Date arrangements, the Fronting Lender "fronted" the DDTL on behalf of the Other Arrangers pursuant to either (i) the Closing Date fronting letter, which applied to both the initial TLB and DDTL commitments, or (ii) a separate fronting letter entered into on the DDTL Funding Date applicable solely to the funded DDTL.[6] Each of these approaches was effective, in part, because, while the TLB was assigned to institutional lenders shortly following the Closing Date, the DDTL commitments were retained by the Fronting Lender and the Other Arrangers until the DDTL Funding Date.

In recent years, however, given the lengthening of DDTL commitment periods, it has become increasingly common for arrangers to assign the DDTL commitments concurrently with the initial TLB to institutional lenders as part of a single "strip" following the Closing Date.[7] In such cases, practical issues arise at the time of each funding of the DDTL due to the fact that the lenders holding DDTL commitments on the DDTL Funding Date (the "DDTL Lenders") comprise a broad syndicate of institutional lenders. An institutional lender is often limited in its ability to fund its DDTL commitments on the DDTL Funding Date as a result of internal legal, regulatory and operational constraints. But even if the DDTL Lenders have no other limitations on their ability to fund on the DDTL Funding Date, the number of DDTL Lenders in a particular syndicate may make it impracticable to rely on the DDTL syndicate to fully fund the DDTL loan to meet the timing requirements of the borrower's related acquisition or other transactional need. If, as a consequence, one or more of the arranger banks or the administrative agent undertakes the responsibility to prefund the DDTL, that funding bank will in turn need an agreement with the DDTL Lenders to properly allocate the DDTL after its funding. A standard fronting letter among the arrangers will not be sufficient to facilitate fronting arrangements on the DDTL Funding Date as the DDTL commitments are held by the broader institutional lender syndicate, not the arrangers.

An approach to addressing these concerns is to include "fronting" language in the credit agreement itself permitting the administrative agent to act as a "fronting lender" for the DDTL commitments in the same way it customarily does for undrawn revolving commitments. Specifically, the administrative agent will make the DDTL on behalf of the DDTL Lenders and each DDTL Lender will, in turn, agree to fund its *pro rata* share of the DDTL borrowing (together with interest) to the administrative agent within a specified period (e.g., 10–15 business days) following the DDTL Funding Date. To the extent any DDTL Lender fails to fund its *pro rata* portion within that period, the credit agreement will require the borrower to prepay the fronted amount to the agent.[8] This arrangement is somewhat peculiar in that, unlike Closing Date fronting arrangements, the agent fronting a fully syndicated DDTL will have "de-risked" its DDTL exposure during the post-closing assignment process. The agent thus assumes the risk that a DDTL Lender will fail to fund its *pro rata* share of the borrowing and the borrower, in turn, will fail to reimburse the agent for the shortfall. A potential way to mitigate this risk is to have each Other Arranger agree to reimburse the agent for its *pro rata* share of the DDTL (calculated as of the signing date) to the extent both a DDTL Lender and the borrower fail to fund. It is important that any such "risk-sharing" arrangement be addressed in the Closing Date fronting letter when the agent and Other Arrangers still hold DDTL commitments, since, once the DDTL has been assigned in full, the Other Arrangers may have little incentive to agree to share the fronting risk of the DDTL.[9]

Conclusion

Given that DDTLs are an increasingly important financing tool for sponsors looking to consummate post-closing acquisitions and other activities, we expect to see a continued push of the historical boundaries in DDTL terms – including increasing the DDTL commitment length and expanding the scope of uses of DDTL proceeds – as well as a continued focus by market participants on whether DDTL upfront fees should be payable upon closing or funding. With the increasing frequency of DDTLs in financing structures and the market shifting towards a simultaneous assignment of the initial TLB and DDTL commitments to the same lenders, we also expect further consensus on how best to address DDTL funding arrangements.

Endnotes

1. In nearly all cases, upon funding, the DDTL will be required to have terms identical to, and be treated as a single "fungible" class with, the initial TLB.
2. Where lenders are reluctant to agree to such flexibility, a potential compromise is to require the prepayment of the funded DDTL to the extent the acquisition is not consummated within an agreed timeframe following the Closing Date.
3. We note that in a minority of transactions, ticking fees, similar to certain upfront fees, are payable by the borrower solely to the extent the DDTL is funded.
4. In such cases, lenders sometimes have the ability to make the DDTL upfront fee payable on the Closing Date instead of the DDTL Funding Date as part of implementing any "market flex".
5. In practice, arrangers will require the borrower to pre-consent to these assignments pursuant to a "master consent" entered into on the Closing Date, which lists all institutional investors forming part of the primary syndication of the TLB facility.
6. In either case, it is important that the borrower's consent to assignees of the initial TLB and DDTL on the Closing Date (pursuant to the master consent to assignment) apply during both the assignment process for the initial TLB following the Closing Date as well as the assignment process for the DDTL following the DDTL Funding Date.
7. Note that where both initial TLB loans and DDTL commitments will be syndicated simultaneously following the Closing Date, the master consent to assignments should expressly permit the assignment of both "loans" and "commitments" to the agreed assignees.

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8. Even without this specific language in the credit agreement, under certain credit agreements, parties may be able to rely on the standard credit agreement provision permitting the agent to front loans for other lenders (so long as such language is not limited to revolving borrowings).
9. Of course, Other Arrangers may object to participating in the agent's fronting risk with respect to the DDTL even in cases where they are asked to share such risk on the Closing Date, as their expectation is that they are fully de-risked of the DDTL as of such date.

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