A Slice Of MFN With That Incremental Loan

In recent trends, borrowers have been negotiating expansive exceptions to most favored nation ("**MFN**") clauses for incremental loans in order to optimize flexibility and minimize costs for future financings. As described herein, the ever-lasting issuers' market has emboldened borrowers and developed the precedent for a growing list of MFN exceptions.

Against this backdrop, lenders recognize that incremental facilities provide a borrower with quick access to liquidity that can be utilized for value-maximizing or liability-managing purposes (such as acquisitions or refinancings) that may benefit the ultimate recoveries of such lenders. In addition, an incremental facility may provide a future investment opportunity for existing lenders hungry for paper in a market with little net new money. Notwithstanding such benefits, lenders remain sensitive to the threat that any new incremental debt carrying higher pricing may pose to the price of their existing paper. Incremental loans with steeper interest rates are analogous to the release of new car models and the resultant devaluation of previous editions. As a result, lenders typically negotiate for MFN clauses that require an automatic increase in pricing of the existing loans so that they remain at all times within a prescribed margin (typically 50 basis points) of any new incremental loans. Such MFN clauses, at their core, protect the value and tradability of the original debt in the secondary market.

Nonetheless, with ever expanding bargaining leverage, borrowers are negotiating creative ways to minimize MFN and related incremental loan protections. Some of the key MFN exceptions borrowers have been pursuing in recent periods include the following:

Basket and Fixed Carve-Outs

By way of background, incremental debt capacity typically consists of (i) a fixed (or "freebie") dollar amount, plus (ii) the amount of indebtedness voluntarily prepaid and commitments permanently reduced (i.e., "dry powder"), plus (iii) an unlimited amount so long as a leverage ratio test is satisfied. In the large-cap market, debt capacity under the fixed incremental basket has been recently set at or around 0.85x of pro forma opening leverage and the unlimited ratio-based basket has been set at, in respect of first lien incremental debt, approximately opening first lien net leverage levels.[1]

Notably, large cap and sponsor-owned borrowers often enjoy the right to reclassify/toggle their use of incremental baskets as they so choose and as their leverage permits to recharge capacity for future debt incurrence. In addition to such flexibility, strong borrowers have been successful in limiting MFN protection based on the specific incremental basket utilized or a designated amount expressly excepted from the MFN. For example, in such credits the MFN clause might be triggered only through the

---

1 As reported by Covenant Review (as of around the date of this publication), incremental free-and-clear capacity averaged 0.86x for M&A-related loans and 0.74x for all leveraged loan transactions (including dividend recaps, refinancing, etc.). Other trends by strong credits including to negotiate for (i) a "grower" component to the freebie basket so that incremental debt capacity may increase based on a percentage of the borrower's EBITDA levels and (ii) a "no worse than" alternative to the ratio-based basket so that capacity would not be affected if the borrower's leverage remained the same following an incurrence (typically in connection with an acquisition).

incurrence of an incremental loan under the ratio-based basket (and not the freebie or dry-powder baskets and not a loan reclassified from either to the ratio basket). At the same time, the borrower could seek to exempt such incremental borrowing from the MFN up to an agreed amount. In such cases, the existing lenders assume the risks of the issuance of such incremental loans with higher and more attractive pricing.

Higher Spreads

The year 2017 has introduced efforts in the U.S. to expand the traditional 50 basis point pricing buffer to 75 basis points (and in at least one reported case 100 basis points). Such higher spreads are common in Europe, but not in the U.S. What this means is that if the overall yield on a new incremental loan (which typically considers interest rates, interest floors, original issue discount and fees shared with all lenders) is between 0 and 75 basis points higher than the yield on the existing loans, then the MFN does not kick in and the existing lenders keep their original lower pricing. Notably, in most test cases, syndicated lenders have successfully rejected proposals seeking to increase the MFN spread above the classic 50 basis points; however, at least some have passed through the U.S. market.[2]

Priority and Syndication Exceptions

It has become more and more common for borrowers to negotiate a limit on the nature of incremental debt that will be subject to the MFN provision. To this end, borrowers may propose that only incremental debt in the form of "senior secured term loans" and (in some newer examples) that are "widely syndicated" to investors will trigger MFN protection on the existing senior secured term loans. In such cases, any incremental debt that is not senior secured or that is in the form of direct loans or notes or other debt instruments (even if, in substance, functioning like term loans) would technically circumvent the MFN clause. In addition, the terms "widely" or "broadly" syndicated/marketed could be loosely interpreted to allow borrowers to strategically coordinate an incremental borrowing from a smaller set of lenders. Notwithstanding the potential loopholes created, it is not unusual to see these MFN requirements/qualifications (relating to loan priority and, at least proposed by borrowers, relating to wide syndication) in the current market.

Maturity Exceptions

Some strong borrowers have negotiated for additional MFN flexibility in respect of the tenor of incremental loans. Specifically, incremental loans maturing outside a certain period of time after the maturity of the existing term loans (e.g., two years) will not be subject to the MFN. Borrowers may argue that later-maturing incremental loans pose lesser valuation and recovery risks for existing lenders. But in such a scenario the MFN protection is lost for the entirety of the facility, including overlap with the existing loans. The impact on the price of the affected loans is something that has not been tested, but may negatively impact the trading price of the existing paper. Borrowers may also pursue the right for a certain amount of incremental debt to mature earlier than the existing senior secured term loans, along with an MFN exception for such indebtedness. Unlike the later maturity feature described above, earlier-maturing debt presents a form of subordination for the existing term lenders that may have a direct impact on the value and tradability of the existing loans. As a result, lenders will typically oppose this feature or, at a minimum, negotiate a hard cap on the amount of debt permitted under any such maturity exception.

Sunsets

One of the classic features of the MFN protection is how long it lasts. Virtually all new debt issuances that include incremental loans will propose a sunset on MFNs, typically from 6 to 18 months following the closing date. Once the MFN protection period expires, a borrower may tap its incremental loan capacity without the risk of incurring increased costs on the existing loans.

---

2 Covenant Review and LevFin Insights reported that seven deals have cleared market with MFNs of 75bps or higher in 2017 (through around the date of this publication).

From the borrowers' perspective, lenders that have agreed to certain pricing at the outset should not get the benefit of higher pricing later on or the ability to retrade their deal. The higher pricing might also reflect different credit markets or temporary unfavorable performance. Nonetheless, despite borrowers' stronger bargaining power as of late, lenders have been fairly successful in rejecting MFN sunsets in most syndications. Indeed, the permanency of MFN clauses is sacrosanct for many banks and loan investors. In the face of other MFN exceptions, lenders remain steadfast in preserving the duration of one of their most important sources of economic protection, particularly when interest rates are expected to rise in the near future. As such, only a small percentage of leveraged loans have closed with an MFN sunset this year.[3]

Other Exceptions/Issues

One MFN exception sometimes arises outside the incremental loan section of the credit agreement. As borrowers achieve more and more flexibility in the document, the debt covenant section can often provide expansive capacity to incur indebtedness, including in the form of term loans. Whether through unawareness or commercial agreement, the debt covenant may omit MFN protection for any future incurred senior secured term debt under an applicable basket. The rationale for including MFN protection in the incremental loan section holds the same weight in the debt covenant. Thus, parties should afford the same attention to the terms of any incremental term loans that may be incurred in any part of a credit agreement.[4] Another MFN exception arises when (again, at times because of unawareness) the MFN applies only to the initial term loans and, effectively, only the initial (and not subsequent) incremental loan incurrence. Lenders' counsel may scrutinize such drafting issues to ensure the proper scope of the MFN to meet the lenders' expectations.

In summary, the evolution of MFN protection has always been a product of loan market conditions. The strong issuers' market over the last year (and growing) has inspired innovative ways to facilitate more flexibility for future financing options. The MFN exceptions above are just examples of this trend and there may be more to come down the road.

Authors

Daniel Winick
Partner
T: +1 212 878 4918
E: daniel.winick
@cliffordchance.com

Andrew Young
Senior Associate
T: +1 212 878 8012
E: andrew.young
@cliffordchance.com

---

[3] LevFin Insights reported that only 27 deals have cleared with MFN sunsets in 2017 (through around the date of this publication).

[4] At the same time, borrowers may negotiate to extend application of the same MFN and maturity exceptions in the debt covenant that they received in the incremental loan section.

US Leveraged Finance Contacts

Charles Adams
Partner
T: +1 212 878 3415
E: charles.adams
@cliffordchance.com

Gary Brooks
Partner
T: +1 212 878 8242
E: gary.brooks
@cliffordchance.com

Evan Cohen
Regional Managing Partner
(Americas)
T: +1 212 878 8518
E: evan.cohen
@cliffordchance.com

Jay Gavigan
Partner
T: +1 212 878 8531
E: jay.gavigan
@cliffordchance.com

Tom Schulte
Senior Counsel
T: +1 212 878 8403
E: thomas.schulte
@cliffordchance.com

Daniel Winick
Partner
T: +1 212 878 4918
E: daniel.winick
@cliffordchance.com