In brief: loan document terms in USA

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Loan document terms

Standard forms and documentation

What forms or standardised terms are commonly used to prepare the bank loan documentation?

The Loan Syndications and Trading Association (LSTA), a not-for-profit organisation that was formed to develop standardised market practices to improve the liquidity of the secondary trading market for corporate loans, maintains model terms for bank loan agreements, as well as forms of certain ancillary bank loan documentation, that are commonly recognised by investors as the market norm. The model terms for bank loan agreements are limited to certain loan mechanics provisions and boilerplate provisions, such as the defaulting lender provisions and provisions regarding capital requirements, and do not extend to the commercial terms of the bank loan agreements – in particular, the covenants and default provisions.

Most agent banks maintain their own internal forms of bank loan documentation that incorporate (with slight variance) most of the provisions proposed by the LSTA in its model terms. Generally, the initial drafts of the bank loan documentation are prepared using the internal form of the applicable agent bank, although for many financial sponsor-led acquisition financings, a market practice has developed whereby the initial draft of the bank loan documentation is prepared using precedent documentation from one or more previous transactions led by the applicable financial sponsor, with modifications to take into account, among other items, the debtor's size and industry and any applicable changes in law.

Pricing and interest rate structures

What are the customary pricing or interest rate structures for bank loans? Do the pricing or interest rate structures change if the bank loan is denominated in a currency other than the domestic currency?

For bank loans denominated in US dollars, the most common interest rate structures are the following.

- Base rate interest, which floats on a daily basis and is typically defined as the greatest of:
  - the ‘prime rate’ offered by the agent bank (or otherwise quoted in a publicly available source, such as the *Wall Street Journal*);
  - the average rate at which banks with Federal Reserve surpluses are willing to lend such surpluses on an overnight basis to other banks to satisfy reserve requirements, plus 50 basis points; and
  - one-month LIBOR plus 100 basis points; and
- LIBOR (or eurodollar) interest, which is fixed for a period specified by the debtor (referred to as the interest period and which is usually one, two, three or six months or, if agreed by the participating lenders, 12 months) and is determined by reference to a screen quote from a market quotation service (such as Reuters) of the offered rate for borrowing US dollars in the London interbank deposit market for the specified interest period.

In each case, a market-driven interest rate ‘spread’ or ‘margin’ will be added to the underlying interest rate, with the spread for LIBOR interest conventionally being 100 basis points greater than the spread for base rate interest, given that the base rate interest already has a profit component built into it. The debtor will have the option, during the term of the bank loan agreement, to choose to apply either base rate interest or LIBOR interest to the bank loans and to alternate between the two types of interest by written notice to the agent bank.

For bank loans denominated in a currency other than US dollars, the bank loan documentation will provide for interest rate mechanics that are customary for bank loans denominated in that currency. For currencies that are available in the London interbank deposit market, the bank loan documentation will typically include a LIBOR-based interest rate. A variation of base rate interest is also made available for bank loans denominated in certain currencies, such as Canadian dollars.

Have any procedures been adopted in bank loan documentation in your jurisdiction to replace LIBOR as a benchmark interest rate for loans?

In November 2020, several governmental regulators issued a joint statement that they do not intend on recommending a specific credit-sensitive rate for use in place of LIBOR. They recommended that financial institutions use any reference rate for its loans that the bank determines to be appropriate for its funding model and customer needs. Historically, many existing loan documents include a fallback to the Prime Rate if LIBOR ceased to be available. The Alternative Reference Rates Committee (ARCC), established by the Federal Reserve System’s board of governors and the Federal Reserve Bank of New York, has identified the Secured Overnight Financing Rate (SOFR) as the replacement for LIBOR as a benchmark interest rate for loans. SOFR is published daily by, and administered by, the Federal Reserve Bank of New York and is determined based on transactions in the US Treasury repurchase market, where banks and investors borrow or loan US Treasuries overnight. ARCC has recommended ‘fall-back language’ to be inserted in credit agreements that will become effective upon certain agreed upon trigger events (eg, LIBOR is no longer available). The most common approaches in loan documents used are the ‘amendment approach’ pursuant to which the parties agree that decisions relating to the replacement rate and the spread adjustment are to be made in the future and often require the borrower’s consent. An alternative approach is for parties to use the ‘hardwired approach’. In the hardwired approach language is built into the original loan agreement so that upon a rate switch trigger event, the loan rate will automatically convert to a new rate either chosen by or acceptable to the parties. ARCC has recommended that it is a best practice of including hardwired fallback language in all syndicated loan originations going forward. ARCC has recommended specific provisions for both the ‘amendment approach’ and the ‘hardwired approach’ that should be included in credit agreements.

Prior to the effectiveness of the proposed alternative rate of interest (but only if LIBOR is not then available or published on a current basis), bank loans denominated in US dollars would be priced using base rate interest. Loans that are denominated in a currency other than US dollars would either be priced using the local jurisdiction’s equivalent of base rate interest, if any, or be required to be prepaid.

Other loan yield determinants

What other bank loan yield determinants are commonly used?

Term loan facilities – in particular, tranche B term loan facilities – are often issued with original issue discount, while the lenders participating in revolving credit facilities often receive an up-front fee at closing.

The interest rate for tranche B term loan facilities may also be subject to a pricing floor, whereby the minimum LIBOR will be a specified percentage and, by convention, the minimum base rate interest will be 100 basis points greater than corresponding minimum LIBOR.

Yield protection provisions

Describe any yield protection provisions typically included in the bank loan documentation.

The yield protection provisions customarily included in the bank loan documentation are as follows.

- Increased costs: this provision protects the lenders from increases in the cost of making or maintaining LIBOR loans resulting from changes in law occurring after the closing of the bank loan facility (eg, from the implementation of a reserve requirement with respect to deposits held by the London branches of the lenders). The affected lenders are permitted to make a request on the debtor to reimburse the lenders for such costs, and the determination of the amount of such increased costs by the lenders is deemed to be conclusive, absent manifest error.
- Capital costs: similarly, if a lender determines that a change in law regarding capital or liquidity requirements will have the effect of reducing the rate of return on the lender's capital, or on the capital of the lender's holding company as a consequence of the bank loan documentation or the commitments or loans thereunder, then the lender can request that the debtor compensate the lender for such a reduction.
- Tax gross-up: the lenders are entitled to a gross-up by the debtor with respect to certain 'indemnified' taxes. The 'indemnified' taxes include basically all taxes incurred by the lenders with respect to payments made under the bank loan documentation, other than income taxes and withholding taxes paid by the debtor on interest payments on the bank loan facilities (unless such withholding taxes are instituted after the date on which the applicable lender acquires its interest in the bank loan).
- Break-funding: if the debtor fails to borrow a LIBOR loan after submitting a borrowing request, or prepays a LIBOR loan on any day other than the last day of the interest period for such LIBOR loan, then the debtor is required to reimburse the lenders for the redeployment costs of the proceeds of such LIBOR loan.

Typically, the lenders will have an obligation to mitigate the costs that are reimbursable by the debtor under the increased costs, capital costs and tax gross-up provisions, including by designating a new lending office if the effect of doing so would be to reduce the reimbursable costs. If a lender requests compensation from the debtor under the increased costs, capital costs or tax gross-up provision, the debtor will have the option to force the lender to assign its loans and commitments to an eligible assignee so long as the assignment would result in a material reduction in the debtor's reimbursement obligation under such provision.

Accordion provisions and side-car financings

Do bank loan agreements typically allow additional debt that is secured on a pari passu basis with the senior secured bank loans?

Bank loan agreements typically include an incremental facility provision, which allows the debtor to increase the size of the existing revolving credit commitments or of the existing term loans, or, in some transactions, to create additional tranches of revolving credit commitments or term loans under the bank loan agreement, up to a cap without requiring the consent of the existing lending group. Such incremental facilities typically share ratably, on a pari passu basis with the existing bank loan facilities, in any guarantees and collateral supporting the obligations in respect of the existing bank loan facilities. The availability of the incremental facilities may be subject to, among other things, the accuracy of the representations and warranties, the absence of defaults and, in many deals, pro forma compliance with a financial covenant. Furthermore, the incremental facilities are generally subject to limitations on maturity date and weighted average life to maturity and, 'most favored nation' pricing.

Bank loan agreements also often permit the debtor to utilise availability under the incremental facility provision to incur indebtedness outside of the bank loan agreement in the form of debt securities and, in some cases, stand-alone bank loan facilities, although in certain loan documentation the lenders will require that stand-alone bank loan facilities be secured on a junior basis to the obligations under the bank loan agreement. These facilities are generally also subject to limitations on maturity date and weighted average life to maturity, but depending on the loan documentation may not trigger most favored nation pricing.

Financial maintenance covenants

What types of financial maintenance covenants are commonly included in bank loan documentation, and how are such covenants calculated?

The two most common financial maintenance covenants included in bank loan documentation are leverage covenants and coverage covenants. In today's leveraged market, financial maintenance covenants generally apply only to the tranche A facilities and revolving facilities, and are rarely included in tranche B facilities.

A leverage covenant requires that the ratio of the debtor's indebtedness (which may be total indebtedness, senior indebtedness or priority lien indebtedness, as agreed by the debtor and the creditors) on the test date to its EBITDA for the applicable testing period (usually the four fiscal quarters of the debtor most recently ended) does not exceed a maximum level. In certain deals, the maximum level specified for the leverage covenant will reduce pursuant to an agreed-upon schedule, forcing the debtor to deleverage as the bank loan facility matures. In addition, the creditors will often agree to permit the debtor to net against the indebtedness component of the ratio any cash or cash equivalents held by the debtor and its subsidiaries so long as such cash is 'unrestricted' (ie, it is not subject to a lien in favor of any other creditor). However, the amount of cash and cash equivalents permitted to be netted may be subject to a cap.

A coverage covenant requires that the ratio of the debtor's EBITDA for the applicable testing period (again, usually the four fiscal quarters of the debtor most recently ended) to either interest expense or fixed charges (which is often defined to include interest, taxes, maintenance capital expenditures and scheduled amortisation of indebtedness) for the testing period exceeds a minimum level. The minimum level specified for the coverage covenant is most often fixed for the life of the bank loan facility.

Financial maintenance covenants are typically tested on the last day of each fiscal quarter of the debtor, and a failure to comply with any financial maintenance covenant as of such day results in an automatic event of default under the bank loan documentation. Where the equity interests of the debtor are held by a financial sponsor or are otherwise privately held, the debtor may negotiate for an 'equity cure', which permits the holder or holders of such equity interests to make a cash equity contribution to the debtor in an amount necessary to cause the debtor to be in compliance with the breached covenant (with such cash being equated to EBITDA for purposes of the relevant calculation). The debtor is permitted to exercise the 'equity cure' no more than twice in any four fiscal quarter period, and the number of 'equity cures' permitted during the life of the bank loan facility is usually capped at five. Furthermore, the cash received by the debtor in connection with an 'equity cure' is not permitted to reduce the indebtedness of the debtor for purposes other than curing the financial covenant, including for calculating the leverage covenant for incurrence purposes.

Other covenants

Describe any other covenants restricting the operation of the debtor's business commonly included in the bank loan documentation.

Bank loan documentation for debtors that do not have investment grade ratings commonly includes covenants that limit the incurrence of indebtedness, the incurrence of liens, the making of investments, the sale of assets, the payment of dividends and other distributions in respect of equity interests, the prepayment of subordinated indebtedness, limitations on sale or leaseback transactions, limitations on mergers, consolidations and other fundamental changes to the debtor's business, limitations on amendments to organisational documents and material agreement, and limitations on changes in fiscal periods.

For debtors that have investment grade ratings, the negative covenant package is less restrictive and is typically limited to limitations on priority indebtedness (eg, indebtedness that is structurally senior to the bank loan obligations), limitations on liens on the debtor and the guarantors, limitations on sales of all or substantially all assets, limitations on sale or leaseback transactions, and limitations on mergers, consolidations and other fundamental changes to the debtor's business.

Mandatory prepayment

What types of events typically trigger mandatory prepayment requirements? May the debtor reinvest asset sale or casualty event proceeds in its business in lieu of prepaying the bank loans? Describe other common exceptions to the mandatory prepayment requirements.

Bank term loans are typically required to be prepaid from the following sources:

- net cash proceeds from non-ordinary course asset sales, casualty events and condemnation proceedings. This prepayment requirement is often limited to events that result in net cash proceeds that exceed a minimum threshold, both on an individual basis and on an aggregate basis for each fiscal year. The debtor will have the option to reinvest the net cash proceeds of any such event in assets that are used or useful in the debtor's line of business, so long as such net cash proceeds are reinvested within a specified period of time after the event occurs (normally, 365 days or, if the debtor has contracted to reinvest the net cash proceeds during the 365-day period, within 180 days after the end of such 365-day period);
- Net cash proceeds from the incurrence of indebtedness that is not permitted under the terms of the bank loan documentation; or
- a percentage of the amount by which the debtor's operating cash flow for any fiscal year exceeds certain of the debtor's operating cash expenditures for that fiscal year (or excess cash flow), where the percentage – typically, 50 per cent (which percentage could be reduced based on the debtor's leverage ratio – is reduced if the debtor's ratio of indebtedness to EBITDA at the end of the applicable fiscal year is at or below a specified ratio.

The bank loan documentation will often include an exception for prepayments with the net cash proceeds from non-ordinary course asset sales, casualty events and condemnation proceedings involving the assets of subsidiaries organised in any non-US jurisdiction if the repatriation of the non-cash proceeds from such jurisdiction would result in adverse tax consequences to the debtor or would be limited by the laws of such jurisdiction. Many bank loan financings will extend this exception to the excess cash flow prepayment requirement.

Debtor's indemnification and expense reimbursement

Describe generally the debtor's indemnification and expense reimbursement obligations, referencing any common exceptions to these obligations.

The debtor typically indemnifies each agent and lender against all losses, claims, damages and expenses (including legal expenses) incurred by or asserted against those entities arising in connection with, among other items, the arrangement and syndication of the bank loans, the preparation and administration of the bank loan documentation, and the performance by the parties to the bank loan documentation of their respective obligations thereunder. The debtor's indemnification obligation extends to any litigation, investigation or other proceeding relating to these matters, regardless of whether that action is initiated by a party to the bank loan documentation or by a third party and regardless of whether the indemnified entity is a party to that action. Customary carve-outs from the debtor's indemnification obligation include losses, claims, damages and expenses resulting from:

- the wilful misconduct, bad faith or gross negligence of the indemnified entity, as determined in a final and non-appealable judgment of a court of competent jurisdiction;

- a claim brought by the debtor against the indemnified entity for a material breach in bad faith of the indemnified entity's obligations under the bank loan documentation, as determined in a final and non-appealable judgment of a court of competent jurisdiction; or
- a proceeding not involving an act or omission by the debtor that is brought by one indemnified entity against another indemnified entity, other than a proceeding brought against any agent or arranger under the bank loan documentation in its capacity as an agent or an arranger.

The debtor is also responsible for reimbursing, upon written demand, the reasonable and documented out-of-pocket expenses of the agents and the arrangers under the bank loan documentation in connection with the structuring, arrangement and syndication of the bank loans, and the preparation, administration and enforcement of the bank loan documentation.

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Give the date on which the above content is accurate.

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