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Private Credit Loan Transactions

A Practical Guidance® Practice Note by M. Shams Billah, Barnes & Thornburg LLP, New York

M. Shams Billah
Barnes & Thornburg LLP, New York

This practice note discusses guidance for borrowers and private equity sponsors entering into private credit loans with nonbank lenders in the middle to lower-middle market space. This practice note discusses the background and benefits of private credit transactions as compared to public credit, as well as best practices for approaching the private credit market, key negotiation points, and recent market trends.

For information on syndicated loan agreements generally, see Credit Agreement Resource Kit.

Private Credit vs. Public Credit

Private credit (also known as direct lending) has certain distinct characteristics that enable it to be a strong value proposition compared to public credit for market participants looking to incur loans. Private credit direct loans are provided by nonbank lenders, often on a bilateral (single-lender) basis or in a small club deal, to borrowers directly rather than through a widely syndicated process run by commercial banks. These types of loans are not publicly traded. This is in contrast to public credit syndicated loans and bonds that trade in debt capital markets. The greater reliance of public credit on public markets is part of the reason for the recent exponential growth of private credit and the related benefits that private credit has to offer as further discussed below.

Recent Rise in Private Credit Transactions

The rise in private credit transactions began following the financial crises of 2008 when public debt markets tightened and essentially closed up and regulations were introduced through the Dodd-Frank Act that severely hindered the ability of banks to provide leveraged loans to middle market companies. At that time, the latest vintage of private credit funds formed to fill the gap created by the shrinkage in traditional bank lending. Portfolio companies of sponsors and founder-owned small to mid-market companies, each of which were squeezed out of the traditional bank debt markets, turned to the private credit market, which was not subject to the same regulatory requirements of traditional banks. For more information on the Dodd-Frank Act, see Dodd-Frank Enhanced Prudential Standards Roadmap and Dodd-Frank Act Bank Capital Requirements.

Benefits and Downsides of Direct Lending

The accelerated rise of direct lending is in part due to the following unique features of direct lending transactions.

Benefits of Direct Lending

Certainty and Speed of Execution

As mentioned above, direct loans are either bilateral facilities or closely held by a small club of lenders. This is in contrast to broadly syndicated loans, in particular in the term loan B market where loans are held by hundreds of different funds and lenders. The bilateral or club nature of direct lending transactions allows direct lenders to be more nimble and often faster in closing deals and providing

responsive, flexible, and bespoke solutions to the needs of borrowers and private equity sponsors. This is one of the reasons sponsors and first-time borrowers often turn to and prefer nonbank lenders to finance their transactions.

Non-reliance on Public Markets

Private credit is less affected by public market price volatility because direct loans are usually held for investment through the tenor of the loan and are not traded, unlike broadly syndicated loans and corporate bonds that trade frequently on public markets. This lack of reliance on public markets allows borrowers and sponsors to feel more comfortable that their financing windows are not too affected by macroeconomic shocks, like the COVID-19 pandemic or the 2023 regional bank crises during which private credit lenders continued to provide credit to the market in a resilient manner. In addition, lenders in the private credit market do not have to consider as heavily what the market may accept for terms and hence are not subject to market "flex" provisions as much. For more information on market flex provisions, see Fees in Loan Transactions and Fee Letter Considerations.

Downsides of Direct Lending

The downsides of direct lending are often offset by the benefits noted above. More importantly though, most middle market companies are not in a position to access public bonds and so the issues noted below are typically not relevant for middle market companies who may only have access to private credit debt or commercial bank loans. Some of the downsides of direct lending compared to public corporate bonds are as follows:

Floating Rates

Unlike bonds that are primarily fixed interest rate instruments, private credit debt often has an interest rate composed of a floating rate (typically tied to a benchmark such as Term SOFR, often with a rate floor) and a fixed margin rate. Many loans also have a variable interest rate grid, which allows the "fixed" component of the interest rate to change based on pre-defined thresholds such as a leverage ratio. While borrowers may not prefer floating interest rates, this grid methodology can be attractive to borrowers because it allows the interest rate to adjust to positive (but also negative) changes to the credit risk profile of such borrower without the need for renegotiations or amendments in the future.

Covenant Heavy

Unlike unsecured high-yield bonds, private credit loans are typically first lien or second lien facilities secured by substantially all of the assets of the borrower group and have a number of covenants to protect such collateral. In general, these loans have more covenants, including financial maintenance covenants, that provide strong structural protections to lenders, much to the chagrin of borrowers compared to covenant-lite public debt facilities or bonds. The extensive set of covenants in private credit loan transactions typically results in lenders having a greater say in the borrower's affairs, especially during difficult financial times and restructurings.

Higher Premiums/Fees

Although direct loans have shorter maturities of five to six years compared to long-dated corporate bonds, direct loans are often repaid or refinanced prior to maturity, but at a cost to borrowers. In such situations, nonbank lenders often earn additional returns in the form of call protection or amendment fees (which occur less frequently with bonds).

Documentation Best Practices

The negotiation process between a borrower and a lender should, in theory, be a relatively cordial experience as both parties are receiving a mutual benefit. The borrower receives an infusion of cash to support its daily operations, refinance existing debt on better terms, or fund an acquisition or investment to expand its business, and the lender receives certain fees and interest. Here are documentation best practices to make the process as seamless as possible and to avoid extensive negotiations:

- **Term sheet/grid.** Before diving into any private credit facility negotiation, the borrower should typically either first draft a term sheet or request a term sheet from the lender containing the key economic terms. Term sheets can be as simple as one page listing out key points such as the total amount of the loans being requested, the maturity date of the loans, the interest rate and margin, and fees, or a lengthy document listing out in detail all the expected terms of the credit agreement, like affirmative and negative covenants, prepayment mechanics, and events of default. It may seem obvious, but putting pen to paper to establish prior agreed key terms makes the later negotiation process run much smoother with far less pain points. You need only refer to the prior agreed points in the term sheet rather than renegotiate items previously agreed to on the phone or via email.

  In short, a term sheet level sets for all the parties involved and puts to rest potential issues in the negotiation process. For borrowers or sponsors that are shopping around different private credit lenders, consider drafting a debt grid summarizing ideal asks

and circulating it to each potential lender to see if they can meet those asks. This allows borrowers to receive bids and make an apples-to-apples comparison before making a decision about which lender to engage. Large cap sponsors often use this grid or "tree" methodology, but it can be applied on a smaller scale cost-effectively in the middle to lower-middle market as well.

- **Credit agreement precedent.** When negotiating a draft of a credit agreement, and assuming there is no prior credit agreement relationship between the parties, the best place to start is to use a market standard template to compare provisions and terms. An excellent resource is the Loan Syndications and Trading Association (LSTA), which provides its members with standard credit agreement templates for various facility types, like bilateral facilities (where the loan agreement is between a single lender and the borrower(s)) or syndicated facilities (where the loan agreement may be among a group of lenders and the borrower(s)), that are generally accepted in the direct loan market. Having a common template allows for proper expectations in the negotiation process around what is generally a "market" ask in any given provision or term. For a bilateral loan template, see Loan and Security Agreement (Bilateral). For credit agreement clauses for a syndicated facility, see Credit Agreement Resource Kit.

  In addition, for an analysis on market terms, please refer to Market Standards, the searchable database from Practical Guidance of publicly filed credit agreements and commitment letters that enables users to search, compare, and analyze credit agreements using approximately 90 detailed deal points and commitment letters using approximately 70 deal points to filter search results. For more information on Market Standards, click here.

- **Third-party-related documents.** Outside of the main deal documents, lenders will often require further steps to perfect or otherwise secure their collateral package. Some examples include:

  - **Certificates of insurance and endorsements.** These will be provided by the borrower's insurance broker and will both list out existing insurance policies and add the lender as an additional insured or lender's loss payee to such polices. Lenders generally have specific insurance requirements that need to be met for these certificates and endorsements.

  - **Control agreements.** These are agreements that grant the lender control over bank accounts, securities accounts or commodities accounts in certain scenarios (generally, after an event of default). The forms will be provided by the depository banks or securities intermediary where the borrower's existing accounts (whether deposit accounts, securities accounts (including crypto accounts), or commodities accounts) are located .

  - **Collateral access agreements or landlord waivers.** These forms allow the lender to have access to the collateral located on real estate property that is being leased from a landlord. Similar to the control agreements noted above, these agreements only grant access after an event of default.

  These three items often have a long lead time to complete as they require negotiations with various third parties in addition to the borrower and lender. After the engagement with a lender has started and a term sheet is agreed upon that requires these three items as conditions precedent to effectiveness of the credit facility, the borrower should consider communicating with the lender and its counsel to request the lender's insurance requirements and form of collateral access agreement in order to start the process with its insurance broker and commercial landlord. Similarly, once a borrower has determined whether a control agreement will be needed for any of its various deposit or securities accounts, it is best to reach out to the borrower's depositary bank and/or securities intermediary for their forms of control agreement.

  While lenders often allow each of these items to be done on a post-closing basis, it is often more cost-effective to get started on these early rather than having it linger on a post-closing checklist as discussed immediately below.

- **Closing items vs. post-closing items.** While it would be the preference for all parties to have the deal finalized and all documents and requirements met at the initial closing, that is often not feasible given the amount of time required to satisfy certain items and the limited bandwidth of senior management that may be negotiating the credit facility. To the extent possible, borrowers should work to have as many items completed at closing as possible. Once closing has occurred, any of the remaining requirements, which often include mortgages, insurance requirements, landlord waivers, and control agreements as discussed above, can drag on as the impetus to complete those items lessens considerably after the initial loan has funded.

Frequent Negotiation Points

After a choppy two years, market participants continue to be bullish about mid-market M&A activity, which is fueling

private credit lending activity as confirmed by Barnes & Thornburg's annual report on the 2024 Investment Funds Outlook. The report confirmed that 93% of participating funds have either implemented, are implementing, or are considering implementing a private credit strategy. While the market for the first half of 2024 has seen an uptick in private credit activity compared to 2023, like in 2023, we expect the bulk of deal volume to close in the fourth quarter following anticipation of another Federal Reserve interest rate cut in September 2024 and following the uncertainty around the U.S. presidential election in November 2024. As the Federal Reserve continues to ease its monetary policy, the SOFR component of the loan benchmark continues to decline and lenders continue to fight for deals by pricing more aggressively. From the start of the year, margins have decreased in the core middle market by over 200 basis points. Credit funds are continuing to compete with one another this year on not just pricing, but also on terms as we have seen lighter covenant restrictions in documentation compared to 2023. Outlined here are some of the points negotiated frequently in private credit transactions:

- **EBITDA add-backs.** When calculating the company's earnings before interest, taxes, depreciation and amortization (EBITDA), lenders often allow borrowers to adjust or ''add-back'' certain items to their net income as enumerated in the definition of Consolidated Adjusted EBITDA in a loan agreement. These add-backs play a crucial role in builder baskets, ratio-based baskets, and financial covenants, such as a leverage ratio where greater EBITDA often results in a lower leverage ratio, which then allows for lower interest margins under the pricing grid approach described above. For these reasons, adjustments to EBITDA are a hot topic for negotiations. These add-backs can generally be separated out into standard add-backs, like taxes, interest expense, depreciation, and amortization, which are fairly common in any given credit agreement, and more company-specific or one-time add-backs, like transaction costs in connection with a permitted acquisition, costs, or expenses incurred in connection with a specific contract or certain run-rate savings, which will generally require more negotiation.

  Recent negotiations involve lenders pushing back against uncapped adjustments to EBITDA (now limited to shared caps in the range between 10% to 30%) and long forward-looking periods for adjustments to apply (which are now typically between 12 to 18 months rather than 18 to 24 months previously). When negotiating these specific add-backs, the best way to approach the issue is to have records reflecting the items being requested to be added back with support from a quality of earnings report, if possible, along with a business reason in the financial model for why such items should be added back.

- **Capital structures.** We are seeing more complex capital structures appear in private credit transactions, such as split ABL revolvers and term loan, as well as greater inclusion of unsecured mezzanine debt. Sponsors increasingly want the ability to raise junior capital within their portfolio company's capital structure. This results in more complex and protracted intercreditor and subordination negotiations, which have to be factored into the timeline for closing. For instance, we have seen an increase in borrowers requesting the ability to repay junior capital in more circumstances, resulting in private credit senior lenders scrutinizing and tightening the permissions for restricted debt payments.

- **Negative covenant flexibility.** Negative covenants in credit agreements typically have several detailed exceptions and baskets that allow borrowers to operate their businesses while remaining in compliance with the terms of the credit agreement. The primary negative covenants include restrictions on debt, liens, investments, dispositions, and restricted payments. While borrowers have been able to negotiate a great deal of operational flexibility within and across these negative covenants, the biggest source of negotiations we have seen this past year is the introduction of grower baskets for such negative covenants in the lower middle market. A grower basket is a type of soft cap basket that has the potential to grow in line with EBITDA so that borrowers do not have to renegotiate basket sizes as their business grows. Such grower baskets are common in large cap sponsor deals, but as such large cap sponsors are doing more and more deals in the lower middle market to core middle market, they often request private credit lenders in this space to adopt such large cap terms. We suspect this trend will continue as more sponsors enter the core middle market and lower middle market.

- **Delayed draw term loans.** Usually, a borrower in the direct lending space is trying not only to fund an acquisition at the initial closing of the loan but also will be looking ahead for potential future acquisitions and the ability to have credit available in such situations. For this reason, we have seen an increase in the use of delayed draw term loans that allow borrowers to draw on a term loan over time. In the lower middle market, these delayed draw term loans are sometimes uncommitted but in most core middle market deals, the delayed draw term loan facility is a committed facility that provides sponsors and borrowers with certainty of funding. The biggest points of negotiation here are the

additional conditions required to be satisfied to draw on the delayed draw term loan facility, often a leverage ratio that is some turn under closing leverage.

- **Earn-outs.** Delayed draw term loans are often used to pay earn-outs in acquisitions. An earn-out is a provision in acquisition agreements stating that the seller of a business will obtain additional compensation if the business meets specified financial targets in the future. How earn-outs are treated in loan agreements has seen increased scrutiny from lenders given the greater use of earn-outs in M&A transactions to help bridge valuation gaps. More and more lenders, especially in the lower middle market and core middle market, are requesting earn-out subordination agreements in respect of sizeable earn-outs.

Regulations, Case Law, and Other Market Trends

- **Corporate Transparency Act.** On January 1, 2024, the Corporate Transparency Act (CTA) beneficial ownership information reporting rule issued by the U.S. Department of the Treasury's Financial Crimes Enforcement Network became effective. The CTA is aimed at promoting financial transparency for the U.S. government by establishing a national registry of beneficial owners of legal entities conducting business domestically. Market participants continue to assess how the CTA will affect loan documentation and we have not seen any changes other than the exclusion of the CTA from legal opinions provided by the borrower's counsel.
- **Liability Management Exercise.** Lenders continue to be focused on preventing liability management exercises by private equity firms that result in collateral leakage that have emerged since the litigation involving "Serta," "Chewy," "J.Crew," "Neiman Marcus," and "Revlon." These only present an issue in club deals or bilateral deals where there is a high likelihood that future lenders may join. In such situations, middle to lower-middle market borrowers typically accept such provisions as is, especially in light of the fact that courts have upheld these actions. However, these liability management exercises have not proven to be fully useful to sponsors other than temporarily extending the existence of their portfolio companies. For instance, the recent drop-down transaction done by Pluralsight's sponsor Vista Equity is expected to still result in Vista Equity ceding control of Pluralsight to its private credit lenders, which is expected to be one of the largest private credit deals to date to go bad, forcing lenders to equitize their loans and take the keys.
- **Loans Are Not Securities.** On the morning of February 20, 2024, the U.S. Supreme Court denied the petition for certiorari filed by Marc Kirschner, Trustee for the Millennium Labs Litigation Trust. Such action left in place the decision of the U.S. Court of Appeals for the Second Circuit that syndicated term loans are not securities and ends, once and for all, this protracted litigation.
- **UCC Amendments.** In 2022, the Uniform Law Commission, together with the American Law Institute, approved amendments to the Uniform Commercial Code (UCC) to deal with emerging technology and the treatment of digital assets, such as cryptocurrency. These UCC amendments are now being adopted by states in 2024. Thus far the District of Columbia and at least 24 states have enacted these UCC amendments, including California and Delaware, while 5 states are pending adoption of the legislation, including New York.

Predictions Looking Forward

Lending activity in the middle market is likely to continue the upward trend we have seen thus far for the first half of 2024. Like last year, there is ample dry powder to be deployed and lenders are looking for opportunities to put it to good use in the second half of 2024, especially the last quarter, which would be promising for borrowers and sponsors looking to tap into the private credit direct lending market.

Earlier this year our firm's aforementioned fund report found that tighter lending conditions and initially high interest rates fueled demand for private credit, with 63% of the credit-focused professionals surveyed saying that tighter bank lending standards have had a positive impact on the market. However, with recent decreased interest rates, more commercial banks have begun to win back deals from the private credit market, especially after now having sufficient time to bounce back from the regional banking crisis spun out of Silicon Valley Bank's failure in March 2023. Nonetheless, we still expect the private credit market to be resilient as borrowers will continue to tap into it for all the benefits described above.

This article should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult your own lawyer on any specific legal questions you may have concerning your situation.

M. Shams Billah, Partner, Barnes & Thornburg LLP, New York

Shams is the leader of Barnes & Thornburg's Private Credit team where he works alongside the Private Funds and Asset Management practice based in New York. He has deep and versatile experience advising credit funds and other global asset managers on a wide variety of corporate and finance matters, as well as advising private equity firms and their portfolio companies in a range of traditional middle-market acquisition and financing transactions. His work has earned him significant honors, including being named to Bloomberg Law's 40 Under 40 for Banking & Finance and being featured as a rising star corporate attorney by The Deal and Global Restructuring Review.

Shams leverages his broad market expertise in both buy and hold credit strategies and syndicated finance and bond transactions to guide clients on a variety of deals across a range of industries, including healthcare, media, software, technology, restaurants and other franchised business models, aviation and manufacturing. He advises clients on senior, mezzanine and subordinated loans; unitranche facilities; first lien/second lien facilities; cash flow, ABL and other working capital facilities; and indentures and convertible notes. He also negotiates complex intercreditor and subordination arrangements; supports clients on various debt restructurings and bankruptcies, including negotiating debtor-in-possession and exit facilities; and advises clients in connection with sharia compliance and Islamic finance matters, where he is a preeminent thought leader having published and lectured across the United States on the topic.

Shams comes to Barnes & Thornburg as a partner from an international law firm's New York office. He began his career not in law, but in investment banking at Lehman Brothers, where he developed his deep understanding of how banks and alternative lenders work and where he honed his commercial and business-minded approach to deal making and closings. Over his career, Shams has advised on well over $250 billion in transactions for lenders and corporate borrowers globally.

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