

Using Incremental Facilities to Exchange Bond Indebtedness

By Nicholas A. Whitney and Douglas R. Plante

At the top of the credit cycle, companies freely borrowed to finance leveraged buyouts and other transactions. Refinancing this debt was not an immediate concern because funds were flowing freely from financial institutions. Now, as the turmoil in the credit markets continues, a highly-levered borrower without access to external refinancing sources may attempt to reduce its overall indebtedness by exploiting the arbitrage between the discounted market prices of different debt obligations within its own capital structure.

One of the methods a borrower may attempt to use is to exchange its bond indebtedness for other debt within its capital structure. The new indebtedness may provide an improved (senior or senior secured) position within the borrower's capital structure in order to encourage existing bondholders to accept such an exchange.¹

To create the more desirable debt necessary to induce bondholders to participate in an exchange, a company may issue senior or senior secured debt under the company's incremental or "accordion" facility contained within a credit agreement.²

Because this technique is arguably a fortuitous (for the borrower) and perhaps unintended use of the accordion facility, one must review several sections of the applicable credit agreement and bond indentures to determine whether the agreements permit a company to exchange its bonds for indebtedness incurred under an incremental facility. These sections are highlighted in this memo.

Increment Loan Provisions

Incremental facilities typically provide the company with the opportunity to either borrow new term loans or increase its revolving commitment up to a maximum specified amount. When considering an exchange of bond indebtedness for debt under the credit agreement, the company will most likely rely on the use of incremental term loans. The availability of the incremental loans may be conditioned upon the company being in pro forma compliance with its financial covenants, or if a credit agreement does not contain any financial covenants, a specific debt incurrence test. In some credit agreements, the use of an incremental facility may not be predicated on any incurrence test whatsoever.

If the ability to access incremental loans is predicated upon the satisfaction of a leverage ratio, the leverage ratio calculation may measure (i) all outstanding indebtedness (both secured and unsecured), (ii) all secured indebtedness (both on a first lien and second lien basis) or (iii) only the company's first lien secured indebtedness. While most credit agreements will require incremental loans to contain terms and security that are identical to the existing term loans, a credit agreement may provide the company with the flexibility to borrow the incremental loans on a second lien basis. In the event that the incurrence test only measures a first lien leverage ratio, then the company may be able to avoid violating the test by borrowing incremental loans on a second lien basis, while still providing bondholders with an improved position within the company's capital structure.

Memorandum

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“ . . . to induce bondholders to participate in an exchange, a company may issue senior or senior secured debt under the company's incremental or “accordion” facility . . . ”

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¹ A current example of this type of transaction is the proposed exchange by Realogy Corporation.

² Another method that a company may have at its disposal is the ability to purchase, or have its sponsor purchase, its indebtedness at a discount. For a more detailed discussion and analysis on this topic please see our memo: “Purchases of Bank Loans by a Borrower or its Sponsor”, dated March 2008 and available on our website at <http://www.rkollp.com/publications.php>.

In order to effect an exchange of bonds with incremental loans, the company may have to provide the bondholders with an interest rate on the incremental loans that is higher than the pricing on the existing term loans. While some incremental facilities may include a Most Favored Nation (or “MFN”) provision requiring the interest rate on the incremental loans to be the same or within a range of basis points of the interest rate on the existing term loans, other credit agreements do not contain this restriction. In the event that the incremental facility does not contain an MFN restriction, the company will have the flexibility to price the incremental loans at a higher interest rate in order to make the exchange of the bonds more attractive.³

Restrictions Contained in a Credit Agreement’s Negative Covenants

Credit agreements often contain a negative covenant that restricts the payment of other indebtedness. An exchange of a company’s bonds for incremental loans would likely be considered a “payment” on the bonds. In order to effect the exchange, the company will need to rely on an exception to this negative covenant. Generally, the negative covenant restricting payments on debt will contain a general basket in order to permit repurchases of other indebtedness. These general baskets may be capped either at an aggregate dollar amount or perhaps at a percentage of excess cash flow or consolidated net income. The size of this exception will dictate the amount of bonds, and in particular subordinated bonds, that may be exchanged into incremental loans. Another common exception on which the company may rely is the basket permitting “Permitted Refinancings” of existing indebtedness.

Most credit agreements permit “Permitted Refinancings” of existing indebtedness as an exception to the negative covenant restricting the repurchase of other indebtedness. The Permitted Refinancing exception generally contains restrictions on the terms

of the new refinancing indebtedness. Some of these restrictions will provide that the refinancing indebtedness (i) be in the same dollar amount as the debt being refinanced, (ii) must provide for an identical (or later) maturity date to the debt being refinanced and (iii) be incurred by the same issuer as the existing indebtedness. In addition, the negative covenant may restrict the company’s ability to grant a security interest on debt that is refinancing unsecured indebtedness, unless the lien is otherwise permitted by the credit agreement. In these circumstances, a party must review the lien covenant to determine whether there is an exception that will permit the security interest. The security interest may be granted as part of a general exception, or more likely, the liens will be included within the exception that permits liens supporting the obligations incurred under the credit agreement, which would include the incremental loans.

In addition, the covenant exception typically only permits the refinancing of subordinated indebtedness with the proceeds from other subordinated indebtedness. In this circumstance, the company would not be permitted to refinance subordinated bonds with the loans provided under the incremental facility. Rather, to effect an exchange, the company would have to rely on the general exception to the covenant, which permits payments on other indebtedness.

Bond Indentures

Even if the credit agreement provides for the possibility of exchanging bond indebtedness for incremental loans, a review of the relevant bond indentures is also required. In particular, it is important to review the indenture governing the unsecured bonds as it relates to the contemplated exchange of the subordinated bonds into incremental loans. Senior bond indentures often contain a covenant restricting the company’s ability to make payments on subordinated debt. In most cases, the bond indenture will contain exceptions

³ For a more detailed discussion and analysis on the impact of incremental facilities on a company’s existing credit agreement please see our memo “Incremental Loan Facilities: Key Provisions”, dated November 8, 2007 and available on our website at <http://www.rkollp.com/publications.php>.

to this covenant that are similar to the exceptions contained in the credit agreement. These exceptions may include a general basket permitting payments on the subordinated debt up to a certain amount and a refinancing basket requiring that the subordinated debt be refinanced only with the proceeds from new subordinated debt. The company will need to comply with these exceptions in order to effect the exchange of the subordinated bonds for incremental loans.

Conclusion

The exchange of bonds that trade at a discount to par into incremental loans is currently a topic of great interest and examination. Some parties may argue that this use of the incremental loans is an efficient method for reducing a company's credit exposure, while others may argue that incremental loans were never intended to be used as a tool to coerce bondholders to exchange their bonds at a deep discount. This method is controversial and it will be interesting to see how these exchanges play out going forward.⁴ Regardless, when considering whether an exchange offer may be consummated, credit agreements should be reviewed carefully to determine the incurrence test for the incremental loans as well as the restrictions contained in the negative covenants. It is important to remember that credit agreement provisions vary and subtle differences may ultimately permit or prohibit a company from using its incremental loans to exchange bond indebtedness.

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⁴ Note that parties may make extra-contractual arguments against an exchange such as fairness or fraud. See, e.g., Plaintiffs' Complaint, The Bank of New York Mellon and High River Limited Partnership v. Realogy Corporation (Del. Ch. 2008) (*available at* <http://www.scribd.com/doc/8612154/Bank-of-New-York-and-Icahns-Suit-Against-Realogy>).