Covenantive Easing (Second of a Series)

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Growing competitiveness in the buyout market is resulting in a variety of pressure points being applied by private equity sponsors to the lenders who finance their deals.

Lines are blurring in the steps between buyers and financing sources – term sheet to commitment letters to credit agreement. Today, corporate finance attorneys tell us, a detailed term sheet is attached to a definitive "no-outs" commitment.

"Minimal conditionality is fundamental to what's now being asked of lenders," one reported. "It syncs with conditions being required in the acquisition agreement. There's also assurance to the seller that the buyer's financing terms have been negotiated and are subject to limited conditionality.

To prevent misunderstandings with their lenders down the road, private equity sponsors seek to iron out most of the major negotiation of terms up front. In large part, while the scope of items like negative covenant exceptions, "baskets" and carve-outs may not be complete, the goal is to have as few outstanding points as possible.

A big competitive advantage lenders have is being familiar and comfortable with the so-called "precedent" document a given sponsor has used in prior transactions. That saves time and legal expenses and can help avoid open points that can cause a deal to get hung up. Which is why there's often so much fuss on both sides about new, lender-unfriendly terms. Once in a doc, they're tough to get out.

So what are the basic issues that arise in evaluating covenants? "The first is establishing the scope of which entities are covered by the covenants," another counsel told us. "There are levels, depending on the size of the deal. For the lower middle market, generally the borrowers and their subsidiaries are covered.

"For larger middle market deals, the only subsidiaries subject to the credit agreement covenants typically are those that are "Restricted" and "Material". They become further limited to 'Material Restricted Subsidiaries' in the broadly syndicated market. These distinctions are increasingly important because of certain well-publicized cases of borrowers moving assets to unrestricted subsidiaries."

Two of the higher profile names that sent tremors throughout the buyout community were J. Crew and PetSmart. In both cases borrowers used covenant carve-outs to move assets outside the collateral package lenders assumed they would have retained.

"In the case of J. Crew," one lawyer friend said, "intellectual property was transferred first to a non-guarantor restricted subsidiary and subsequently to an unrestricted subsidiary. The unrestricted subsidiary was then able to incur new debt secured by the IP. A key problem for lenders was a "trap door" that permitted the transfer of IP by the non-guarantor to the unrestricted subsidiaries."

"The PetSmart situation is another more recent example of collateral erosion. In this situation the obligor group relied on certain exceptions to restricted payment and investment covenants to distribute a portion of its valuable Chewy's equity to PetSmart's shareholders and transfer an additional portion to an unrestricted subsidiary, leaving Chewy’s as a non-wholly-owned subsidiary. Subsequently the obligors have argued that under the terms of the loan document, Chewy’s was no longer required to be a guarantor.”

Our friend concluded, “Situations like this demonstrate why lenders are now paying close attention to how their collateral value protections could be eroded in unforeseen ways.”