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The International Comparative Legal Guide to:

## Lending & Secured Finance 2017

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A practical cross-border insight into lending and secured finance

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**Publisher**  
Rory Smith

**Published by**  
Global Legal Group Ltd.  
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Fax: +44 20 7407 5255  
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# Debt Retirement in Leveraged Financings



David A. Brittenham



Scott B. Selinger

Debevoise & Plimpton LLP

A company borrows money. It would like to avoid any requirements to mandatorily prepay the debt before its maturity, such as on the occurrence of some event or contingency, in order to retain the economic benefits of that arrangement and avoid the need to raise or deploy cash to meet a required prepayment. At the same time, it would like to maximise its flexibility to voluntarily prepay the debt before its maturity, such as to refinance at a cheaper cost of capital, or to obtain less restrictive terms.

An investor lends money. It would like to ensure that it can have the debt prepaid if an event or contingency affecting the credit occurs, such as an asset disposition or change of control. At the same time, it would like to protect itself against an unexpected prepayment of the debt at the company's election, forcing the investor to redeploy its capital and lose the benefit of its investment.

The interplay between these competing goals of a borrower and its creditors shapes the prepayment requirements and protections in financing agreements. These provisions further evolve over time with changes and developments in financing markets and products. This article will discuss prepayment requirements and protections in leveraged financing agreements, as well as prepayment and refinancing techniques employed by borrowers, focusing principally on custom and practice in the United States leveraged financing markets for large cap transactions.

## Mandatory Prepayment Requirements<sup>1</sup>

*Syndicated Term Loans.* Traditionally, syndicated term loans in leveraged financings have had a number of mandatory prepayment requirements. Like other features, these requirements have evolved over the years as the syndicated term loan product and debt capital structures have changed and become more complex. The syndicated term loan market has changed fairly dramatically over the last three decades, moving from a market characterised by relatively modest sized loans made and held by commercial banks to one dominated by sizable loans arranged and sold to institutional investors. Given these changes, this article will focus principally on current market practice and recent developments with respect to common mandatory prepayment requirements for syndicated term loans.

Syndicated term loans typically require prepayment with the net proceeds of specified asset dispositions and recovery events with respect to property, commonly after a period during which the borrower is entitled to apply the proceeds to reinvest in its business or repair or replace property, and subject to monetary thresholds. Over the years, the feature has evolved to provide the borrower with greater flexibility to reinvest in its business and to exclude various types of transactions from the prepayment requirement. Its basic

purpose, however, remains the same: to protect the investor against substantial changes in the assets of the business that may negatively affect the credit.

Term loans also commonly require a percentage of "excess cash flow" to be applied to prepay the loans, with the percentage varying with a leverage-based financial ratio, commonly beginning with 50%, and declining to zero when an agreed ratio is met. Excess cash flow is calculated for each fiscal year and any prepayment is made annually. The excess cash flow calculation can start either with net income and add back non-cash deductions, or with EBITDA and subtract non-cash additions. The former approach has become more common in recent years. The calculations have become increasingly complex, particularly for larger and more complex businesses. In addition, excess cash flow calculations now commonly take into account and deduct not only prior prepayments during the measurement period on the term loans themselves, but also on other debt secured with equal priority by the same collateral package, further adding to the complexity of the calculation. The excess cash flow prepayment requirement allows an investor to share in the cash flow generated by the business's performance in a good year, as a hedge against performance in a bad year. For a borrower, on the other hand, the excess cash flow prepayment requirement presents potential risk: if the calculation formula has missed something significant, the borrower could be facing a prepayment requirement that it is not anticipating or prepared for. In addition, paying out cash after a good year may result in a leaner cushion if performance declines in a future period. A borrower thus has a substantial incentive to try to shape the excess cash flow formula in a way that minimises the amount calculated. Term loans traditionally have offered a countervailing incentive, by allowing the borrower to increase "basket" capacity to make dividends and investments and take other actions by the amount of excess cash flow retained by the borrower. More recently, term loans have evolved to increase basket capacity by other means – for example, a percentage of consolidated assets, or 12-month EBITDA – and in some instances have moved entirely away from the retained excess cash flow construct.

A third common prepayment requirement relates to the incurrence of debt: A borrower must prepay its term loans if it incurs debt other than debt that is permitted by the term loan credit agreement. The evolution of debt incurrence features in credit agreements in recent years, providing enhanced flexibility to incur debt, including adding additional secured debt to the same collateral package, has made this prepayment requirement in many cases largely meaningless, and as a practical matter merely a way of refinancing the term loans without resorting to the voluntary prepayment features.



Syndicated term loans commonly give the investor the option to decline mandatory prepayments from the proceeds of asset dispositions and recovery events, or from excess cash flow. If the investor is happy with the investment and comfortable with the continuing credit, it may want to keep the investment and decline the prepayment. If, on the other hand, the term loan is trading at a significant discount, the prospect of a prepayment at full principal amount can create an incentive for investors to closely scrutinise a borrower's calculation of amounts subject to mandatory prepayment and enhance the need for the borrower to exercise care in that calculation.

Although not structured as a prepayment provision, syndicated term loans effectively require prepayment on the occurrence of a change of control, which typically constitutes an event of default entitling the lenders to require prepayment. How a change of control is determined, and what constitutes a change of control, has evolved over the years. Some term loans deem the change of control default to be waived or otherwise not to occur if the borrower has offered to prepay the term loans and has done so for all term loans tendered for prepayment, a construct that in effect is similar to the option to decline prepayment from asset proceeds or excess cash flow.

**High-Yield Bonds.** Since the early days of the high-yield bond market, high-yield bonds have required the borrower to offer to prepay bonds from the proceeds of specified asset dispositions, typically after complying with any requirement to prepay any more senior debt, and after a period of time to reinvest the proceeds in the business. For high-yield bonds, the prepayment requirement is coupled with the covenant restriction on asset dispositions. This provision requires that, if a specified asset disposition occurs, the borrower must receive fair value, the consideration must largely consist (commonly, 75%) of cash or the equivalent, or other specified types of consideration, and the net proceeds must be applied to reinvest in the business or to prepay more senior debt, and after a period of time to make an offer to prepay the bonds. As with the similar requirement for syndicated term loans, the bond prepayment requirement has evolved over the years to take into account increased business complexities and to provide the borrower with greater flexibility to make changes in its business without being required to prepay debt. The range of transactions excluded from the asset disposition restriction, the items that count toward the consideration percentage requirement or are deducted in calculating net proceeds, and the time period in which the borrower can otherwise apply the net proceeds, have all expanded substantially over the years. The application of proceeds "waterfall" has become more complex to take into account the potential for multiple bond and other financings with similar application and prepayment requirements. Recently, a feature has begun to appear that is reminiscent of the early days of high-yield bonds, providing that under certain circumstances, the application of proceeds requirement does not apply to a specified portion of the net proceeds of an asset disposition. In the early days, the provision might only cover 80% of the net proceeds absent default. Under the modern construct, the percentage steps down from 100% to a lesser percentage or to zero if a financial ratio is met. This provision thus can effectively suspend the operation of the asset disposition covenant restriction and prepayment requirement so long as the borrower meets a specified ratio. In addition, the asset disposition provision, including the proceeds application and prepayment requirements, is often one of a number of high-yield bond covenant restrictions that are suspended upon achievement of investment grade ratings.

A second prepayment provision that has long been a feature of high-yield bonds requires the borrower to offer to prepay the bonds, typically with a 1% premium, if a change of control occurs. As with syndicated term loans, how a change of control is determined,

what constitutes a change of control, and the range of permitted transactions and equity holders, have evolved considerably over the years, in part to account for the complexity of the "beneficial ownership" concepts under US federal securities law that underlie the typical change of control test in high-yield bonds. The so-called "portability" construct that has become common in European high-yield bonds, permitting an acquirer to assume the bonds if specified financial or other requirements are met, has not gained traction in the US market. However, some US high-yield bonds, particularly those that are higher rated, require that a ratings downgrade occur in addition to a change of control, before the prepayment offer is required to be made. While offering an additional measure of protection to the borrower, the additional ratings downgrade requirement does not necessarily make things easier for an acquirer: the downgrade often can occur during a period of time after the change of control and still trigger the prepayment offer requirement, which may complicate an acquirer's financing plans.<sup>2</sup>

**Other Leveraged Financing Products.** Other leveraged financing products include such financing types as second lien term loans, as well as so-called "mezzanine" debt, which may be subordinated contractually in right of payment to other senior debt, or subordinated structurally by having been borrowed by a parent of the borrower of other debt. These products generally will provide for prepayment requirements similar to those for syndicated term loans and high-yield bonds. Second lien term loan provisions commonly will parallel those applicable to the syndicated term loans having first lien priority. Mezzanine debt may follow either a term loan or bond construct or a mix of both.

### Protections Against Voluntary Prepayment by Borrower

**Syndicated Term Loans.** Traditionally, syndicated term loans have generally been prepayable without premium, on relatively short notice. This relative lack of prepayment protection is coupled with the variable interest rate nature of this financing product, which provides the investor with a rate of return that continually adjusts to the current interest rate environment.

In recent years, the syndicated term loan market has evolved, with institutional investors dominating the buy side, and opportunistic repricings and refinancings becoming more common. Prepayment protections too have evolved, with a relatively modest premium (typically 1%) being payable in connection with refinancings and amendments aimed at achieving a lower interest rate and thus a cheaper cost of capital. This so-called "soft call" protection will commonly fall away after a period of time, giving the investor some period in which it has some assurance that it will realise the benefit of its investment, while at the same time preserving for the borrower the flexibility to refinance or reprice on better terms after the soft call expires.

**High-Yield Bonds.** Traditionally, debt securities such as bonds have provided investors with a substantially greater degree of prepayment protection, corresponding to the generally fixed interest rate nature of this financing product. The fixed rate provides the investor with a predictable rate of return over a period of time, and the prepayment protection provides a degree of assurance that the investor will continue to receive that return over time, or an enhanced return in the form of a premium payable on prepayment of the investor's bond investment.

Investment grade bonds commonly have relatively long maturities, few covenant restrictions, and if they are prepayable at all, are prepayable only at a premium calculated at a so-called "makewhole" formula that typically results in a very expensive, if not prohibitive,

refinancing cost. The effectively permanent nature of this capital is acceptable to the borrower because the covenant restrictions on the operation of its business are few and relatively benign.

In contrast, below investment grade, or high-yield, bonds typically have a maturity not exceeding 10 years – eight years is very common in the current market – and a significantly broader array of covenant restrictions aimed at protecting the investor against a wider scope of possible changes to the business and its creditworthiness that may be of greater concern given the lower credit quality of the borrower. The greater potential for these covenant restrictions to interfere with the evolution of the borrower's business and its owners' goals for their investment give the borrower a greater interest in being able to prepay its high-yield bonds at a reasonable cost: the more restrictive the contract, the more the borrower is incentivised to have the flexibility to terminate the contract and free itself from those restrictions.

High-yield bond prepayment protections have evolved over the years. In the early days of the high-yield bond market, bonds commonly were not prepayable at all for a period of time, and thereafter would become prepayable at a fixed premium that declined to zero over time. That prepayment feature has remained a common term, but has undergone some changes. For many years, the so-called "call schedule" would begin at the midpoint of the life of the bond – for an eight-year bond, after four years; for a 10-year bond, after five years – and the initial "call" premium would be one-half the interest rate, scaling down ratably to zero for repayments made within two years of maturity. More recently, as the market has moved to an eight-year senior unsecured bond paradigm, the call schedule has moved to begin three years out instead of four, with an initial "call" premium that at first was set at three-quarters of the interest rate, but now may be seen beginning at one-half the interest rate as in the earlier call schedule construct.

New prepayment features have appeared over the years, principally aimed at mitigating the impact of the absolute prepayment, or "noncall", protection during the early life of the bond. First, high-yield bonds came to incorporate a provision permitting the borrower to prepay up to a specified percentage of the outstanding amount of bonds using proceeds of a new equity issuance received by the borrower at a premium lower than a makewhole-based premium, so long as a minimum amount of bonds remains outstanding to assure sufficient liquidity for secondary trading. Initially the feature was focused on public equity offerings, on the theory that going public and paying down debt would be a credit enhancing event and accordingly one that merited allowing the borrower to make a partial prepayment at a lower premium than a makewhole. The feature now commonly applies to any equity issuance by or contribution to the borrower. Typically the so-called "equity claw" can only be exercised during the first three years of the life of the bond, at a premium equal to the interest rate – more expensive than the premium payable when the call schedule becomes available, but less expensive for most if not all of the first three years than the makewhole feature now common in high-yield bonds, as discussed below.<sup>3</sup> For many years, the equity claw typically was exercisable for up to 35% of the outstanding amount of bonds, so long as 65% remained outstanding thereafter. More recently, the feature increasingly has permitted up to 40% to be prepaid, so long as 50% or sometimes 60% remains outstanding.

A second prepayment feature that has become common permits prepayment during the "noncall period" at a premium calculated at a makewhole formula, similar to the feature found in investment grade bonds. Early versions of the provision were commonly limited to voluntary prepayment upon a change of control, but it evolved to permit prepayment at the makewhole premium without restriction. The refinancing cost using the makewhole feature, while still

substantial, is less prohibitive than for an investment grade bond, initially because of the shorter maturity of a high-yield bond, and later because the makewhole formula became tied to the prepayment amount payable at the first date on the call schedule rather than at maturity; that significantly reduces the makewhole premium because the amount payable at that first call date is significantly less than what would be payable at that date using a makewhole formula.

A third prepayment feature that has gained some currency is typically seen only in a secured bond context. It permits the borrower to prepay up to 10% of the outstanding amount of bonds in any 12-month period at a 3% premium, and again typically can only be exercised during the first three years of the life of the bond. The feature is based on the theory that secured bonds are incurred as a substitute for secured term loans, which as previously noted are generally prepayable without any premium, and accordingly the borrower should have some enhanced flexibility to prepay this alternative type of secured debt.

A final prepayment feature that has appeared more recently permits the borrower to prepay any bonds remaining outstanding after a tender offer has been made for the bonds in which at least 90% of the bonds have been tendered for payment, at the same price as paid in the tender offer. Thus, if for example the borrower has made an offer for its bonds following a change of control as required by their terms, typically at a 1% premium, and at least 90% have been tendered, the borrower can prepay the remaining bonds at the same premium.

*Other Leveraged Financing Products.* Prepayment protections for alternative lending products, such as second lien term loans and mezzanine debt, can vary to a greater extent than for syndicated term loans or high-yield bonds, but generally tend to be fairly modest in comparison to high-yield bond protections. These products often can be prepaid immediately or after a short period of time at modest premiums that decline fairly quickly to zero. The relatively benign prepayment cost involved makes these products attractive to borrowers.

## Prepayment and Refinancing Techniques

The preceding section, in describing prepayment protections, also summarised a number of features permitting a borrower to voluntarily prepay its debt. This section will discuss the ways in which these provisions can be used by the borrower, as well as other features of the financing agreement and approaches external to the agreement that can be deployed to prepay, reprice, extend or otherwise retire debt.

*Syndicated Term Loans.* Syndicated term loans typically can be voluntarily prepaid on short notice, generally three business days in the case of loans bearing interest at a rate based on LIBOR. Traditionally, that notice was irrevocable, but when lending syndicates were relatively small and made up of commercial banks, it was generally feasible and accepted practice to obtain a so-called "payoff letter" that waived the notice requirement. In addition, in the case of a complete refinancing, the requirement to mandatorily prepay the term loans with the proceeds of a debt financing not otherwise permitted could be used to effectively sidestep the notice requirement. As term loans and lending syndicates became larger and the market moved to an institutional investor base, it became increasingly important to the borrower that it have the ability to revoke its prepayment notice if some contingency did not occur, such as the closing of a refinancing or of an acquisition of or by the borrower. It is now common for term loans to allow the borrower to give prepayment notice on a conditional basis, permitting the notice to be withdrawn if a given condition does not occur.

Modern syndicated term loans commonly provide a number of other options for prepaying, repricing, extending or otherwise retiring that debt, which have generally appeared over the last decade or so. One of the earliest features to appear is a set of provisions providing a fairly elaborate mechanic for the borrower to make an offer to prepay some or all of its term loans, open to all lenders, at a stated price or range of prices, similar to a tender offer for bonds or other securities. While this feature remains common in syndicated term loans, it has fallen into disuse as other debt retirement options have developed. In particular, syndicated term loans now often allow the borrower and its affiliates to acquire loans in open market purchases from individual lenders, without the need to make a prepayment offer to all lenders. Loans acquired by the borrower are generally required to be retired, while loans acquired by an affiliate such as a private equity sponsor are generally subject to certain restrictions, such as a limit on the amount of loans the affiliate can hold and on what voting rights the affiliate can exercise. The open market purchase option is generally faster, cheaper and more efficient than resorting to the prepayment offer mechanics.

Syndicated term loans now often allow for partial or full prepayment from a permitted refinancing facility created under the same term loan agreement. This feature will often impose a number of requirements that the permitted refinancing will have to meet. Perhaps in part as a result, the feature has not proven as popular in the context of a complete refinancing as another option, the uncommitted “incremental facility” feature. This provision allows the borrower to add new term loans under the existing term loan agreement subject to a monetary limit or compliance with a leverage-based financial ratio, the calculation of which will give *pro forma* effect not only to the incurrence of the new incremental term loans but also to the prepayment of the existing term loans with the proceeds. The new term loans often will be offered first to existing term lenders, and then to new investors. Some existing lenders for internal reasons may want to exchange their existing term loan for a new term loan, rather than fund cash and then be repaid, in a so-called “cashless rollover”. The cashless rollover raised complications under some older term loans, but more recent term loans often expressly allow for it. The incremental refinancing may be used simply to “reprice” the borrower’s term loans – that is, to obtain a lower interest rate but make little or no other changes – or it may be used to extend the maturity of the borrower’s term loans and make other changes to the agreement.<sup>4</sup>

A simple term loan repricing can also be done by an amendment to the term loan agreement that just changes the interest rate. While such an amendment requires all lenders to consent, term loans today typically permit the borrower to require non-consenting lenders to assign their loans to another party once a majority of lenders have consented to the amendment – the so-called “yank a bank” mechanism – which will allow the borrower to obtain the necessary consent. However, the repricing amendment approach tends to be disfavoured by financial institutions engaged by borrowers to assist in effecting the repricing, because it makes arranging and allocating the repriced loans more complicated in practice than an incremental refinancing to effect the same repricing.

Syndicated term loans commonly allow for an amendment to extend the maturity of the existing term loans, instead of incurring new debt with a longer maturity to refinance the old debt. The extension amendment can be effective for only a portion of the outstanding term loans. It can also make other changes to the agreement that would otherwise be permissible with necessary lender consent, and the yank a bank mechanism can be deployed once a majority of lenders have consented. Again, however, arranging financial institutions favour using the incremental option to effect a complete refinancing or repricing, because the latter facilitates bringing in new investors more easily.

*High-Yield Bonds.* As discussed in the previous section, high-yield bonds give the borrower a number of options to prepay, or “redeem”, the bonds at varying costs depending on when and how the prepayment is made. Traditionally, notice of prepayment had to be given at least 30 days and not more than 60 days in advance, and once given was irrevocable. The inability to revoke the notice once given meant that many transactions, such as those financing an acquisition of the borrower and the repayment of the bonds, had to be structured in other ways, often to provide instead for a tender offer for the bonds, or for a “redemption and discharge”, as discussed below. In the late 1990s, our firm introduced a “conditional redemption” feature to the high-yield bond market, giving the borrower the ability to give the notice of prepayment of the bonds but subject to the satisfaction of one or more conditions. The prepayment still had to be made not less than 30 days and not more than 60 days after notice, but the borrower had the flexibility to delay the prepayment within that 30-day period to permit the specified conditions to be met. This innovation allowed the borrower to effect the prepayment with a relatively simple notice, without the cost and complexity of a tender offer. This feature has become increasingly common in the high-yield bond market, as borrowers have come to appreciate its efficiency and cost-effectiveness. It has further evolved in recent years, allowing notice to be given as little as 10 or 15 days in advance, and for the prepayment date to be extended beyond the traditional 60-day limit as needed to satisfy the specified conditions, in a manner similar to how a tender offer can be conducted. The ability to extend beyond 60 days makes it unnecessary to revoke the notice and issue a new notice, starting the clock over.

The tender offer is the traditional alternative to the voluntary “redemption”, or prepayment, of high-yield bonds. Because bonds are securities, the tender offer is subject to rules governing debt tender offers under the US federal securities laws. These rules among other things require the offer to be held open for 30 days, but as a matter of interpretation allow the party making the offer to begin to accept tendered bonds for payment after 15 days, facilitating completion of the prepayment of the bonds more quickly than the 30-day minimum for a traditional voluntary prepayment discussed above. The tender offer also can be extended as necessary for any specified condition to be met, and is not subject to a set maximum limit on extensions similar to the 60-day maximum for a traditional voluntary prepayment discussed above. Holders of the bonds are not obligated to participate in the tender offer. However, the tender offer is typically coupled with a solicitation of consents to eliminate, or “strip”, essentially all the restrictive covenants with majority consent, as an inducement to participate in the tender offer. Once a majority have consented, the remaining investors must either tender or be left without covenant protections, and typically a very high percentage of the bonds wind up tendered. Pricing can be set, and later adjusted if need be, to achieve sufficient market acceptance. Equal treatment may be required contractually for consent payments, but tender offers can provide for differential consideration to different series of bonds based on differing bond values. The principal drawbacks to a tender offer are that the documentation is more complex and the costs greater for a tender offer than for a voluntary prepayment, making the modern “conditional redemption” feature discussed above an attractive alternative in many cases.

High-yield bonds commonly provide two other features that can be deployed in retiring that debt. First, high-yield bonds typically provide for the “satisfaction and discharge” of the bond agreement, or “indenture”, on payment in full of the bonds. Many high-yield bonds also allow satisfaction and discharge if the bonds will mature or can be “redeemed”, or prepaid, within the next year: the company simply deposits funds with the bond trustee to cover all future

payments due through maturity or prepayment, together with a notice of prepayment if the bonds will be prepaid prior to maturity. The discharge is then effective, and all covenant restrictions under the bonds terminate. A satisfaction and discharge can be coupled with a voluntary prepayment, or “redemption”. A “redemption and discharge” is fairly straightforward, and need not involve substantial out-of-pocket costs. But it may be more expensive than a simple redemption, because the company must deposit funds for a period of time prior to the redemption occurring, potentially increasing its interest expense or other cost of capital. In addition, the contractual conditions required to be met to effect the discharge need to be carefully assessed for practical concerns; for example, a requirement that no default exist could present an obstacle to a transaction should a default come to light at the last minute. Bonds called at a makewhole premium, or bearing interest at a variable or “floating” rate, may raise calculation issues with respect to determining the amount to be deposited, if the bonds have not expressly addressed that calculation in advance.

Second, high-yield bonds typically also provide for “defeasance” of bonds, by depositing funds with the trustee to cover all future payments through maturity or redemption. Defeasance is not limited to the one-year look forward limitation applicable to the discharge option – bonds can be defeased at any time. “Legal” defeasance terminates all substantive obligations, but is typically not possible as a practical matter because a common condition to legal defeasance requires delivery of a tax opinion that cannot be given under current US federal tax law. “Covenant” defeasance only terminates specified covenants and related defaults. It may be unattractive economically, and again the contractual conditions to covenant defeasance, such as absence of default, may pose practical concerns. Bonds called at a makewhole premium, or bearing interest at a “floating” rate, again may raise calculation issues with respect to determining the amount to be deposited.<sup>5</sup>

## Endnotes

1. Financing products use differing terminology for similar things. A company that incurs debt as a term loan is a “borrower”, but is an “issuer” if it incurs debt as a bond. A company “prepays” a term loan, but “redeems”, “repurchases” or “calls” a bond. Term loans are “borrowed” under a “credit agreement”, while bonds are “issued” under an “indenture”. For simplicity and clarity, this article will generally use the same terms regardless of which product is being discussed.
2. The requirement to make a change of control prepayment offer has made some inroads in the investment grade bond market, responding to investor pressure for an option to exit in the event of a leveraged acquisition or similar credit changing event.
3. For an eight-year bond that becomes prepayable after three years at half the interest rate (known as “8 noncall 3”), a makewhole prepayment may be less expensive during the final six months of the three-year period than an equity claw prepayment.
4. One constraint on the incurrence of incremental term loans is that, to the extent that existing term loans remain outstanding and the effective interest rate on the new loans exceeds that on the old loans by more than a stated differential (typically 0.5%, or 50 basis points), a “most favored nations” or MFN provision will typically require the old loans to be repriced to that differential. The MFN provision may be subject to a so-called “sunset”, and expire after a period of time. It would not in any event apply in the case of an incremental financing in which the old loans are repaid in full.
5. Under case law, an issuer cannot impose “in substance” defeasance absent a provision permitting defeasance. See *Rievman v. Burlington Northern Railroad Company*, 618 F. Supp. 592 (S.D.N.Y. 1985).



**David A. Brittenham**

Debevoise & Plimpton LLP  
919 Third Avenue  
New York, NY 10022  
USA

Tel: +1 212 909 6347  
Fax: +1 212 909 6836  
Email: [dabrittenham@debevoise.com](mailto:dabrittenham@debevoise.com)  
URL: [www.debevoise.com](http://www.debevoise.com)

David Brittenham is a corporate partner and the co-chair of the Finance Group at Debevoise. He focuses his practice on complex leveraged and acquisition financings, such as the \$15 billion acquisition of Hertz by The Carlyle Group, Clayton, Dubilier & Rice and Merrill Lynch Private Equity and the \$5.9 billion acquisition of King Digital by Activision Blizzard.

Mr. Brittenham is a contributing author of the *Debevoise & Plimpton Private Equity Report* and regular co-author of articles covering a range of finance-related topics, including alternative leveraged lending structures, high yield bond financings and financial restructurings. He has been a co-chair for PLI's Leveraged Financing and Private Equity Acquisition Financing Summit programs since 2006.

Mr. Brittenham is listed as a leading finance lawyer in *Chambers Global* (2016), *Chambers USA* (2016) and *The Legal 500 US* (2016).

**Scott B. Selinger**

Debevoise & Plimpton LLP  
919 Third Avenue  
New York, NY 10022  
USA

Tel: +1 212 909 6191  
Fax: +1 212 909 6836  
Email: [sbselinger@debevoise.com](mailto:sbselinger@debevoise.com)  
URL: [www.debevoise.com](http://www.debevoise.com)

Scott Selinger is a corporate partner and a member of the Finance Group and Private Equity Group at Debevoise, and focuses his practice on complex acquisition and leveraged finance transactions.

Mr. Selinger has extensive experience in syndicated bank loan and high yield bond transactions and regularly advises the firm's private equity and corporate clients in connection with the financing of acquisitions, investments and restructurings, including the \$2.73 billion acquisition of Local TV Holdings by Tribune Company, the \$2.5 billion joint acquisition of Brand Energy & Infrastructure Services and the infrastructure division of Harsco Corporation by Clayton, Dubilier & Rice, and the \$3.2 billion acquisition of Emergency Medical Services Corporation by Clayton, Dubilier & Rice.

Mr. Selinger is recognised as a leading finance lawyer by *Chambers USA* (2016) and is also recommended by *The Legal 500 US* (2016).

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**glg** global legal group

59 Tanner Street, London SE1 3PL, United Kingdom  
Tel: +44 20 7367 0720 / Fax: +44 20 7407 5255  
Email: [info@glgroup.co.uk](mailto:info@glgroup.co.uk)

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