Proskauer

Private Credit Deep Dives –

Going Exclusive (Europe)

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In recent months, market participants have become increasingly optimistic about the probability of a “soft landing” in the US economy, whereby tight monetary policy is shown to have tamed inflation whilst avoiding triggering a recession in the broader economy. The market is, despite inflation proving slightly stickier than expected, still (for now at least) forecasting multiple Fed rate cuts during the course of 2024 as the rate of price increases steadily slows. This has encouraged a bullish outlook on the part of investors in risk assets, which has led to a rally in equity markets and rapidly tightening spreads in the credit markets, not just in the US but on a global basis. As investor demand has returned, the banks have once again become willing to underwrite new transactions, and the syndicated markets for leveraged credit (which had almost entirely seized up in mid-2022 and remained largely shut in the intervening period) have made a relatively strong comeback in the European market, despite the subdued M&A environment.

As has been much heralded in the press, private credit funds have enjoyed a “golden age” in recent years, experiencing rapid growth in the mid-market before stealing significant market share from the banks in the large cap space when the liquid markets were closed. With the syndicated markets now functional, quality businesses that borrowed in the private credit market over the last couple of years are considering refinancing those borrowings with the cheaper debt that may now be available in the public markets. Much press coverage recently has focused on which private credit financings are still within their “non-call period” (i.e., whether or not a make-whole or other form of call protection still applies if the loans are prepaid), and are therefore protected to a degree, and which are beyond that period, and are therefore vulnerable to a refinancing. However, there are other private credit lenders that may also be a little nervous against this backdrop for a different reason – those that have previously committed to finance a deal but, due to waiting for regulatory approvals or other closing conditions to be met, that deal has not yet closed. No make-whole or call protection concept applies before a loan has actually been advanced, so lenders in such a position will be considering what protection they have in the documentation. They will want to ensure the deal is not “shopped” to other credit providers, having expended a great deal of their own time and effort (and perhaps balance sheet) underwriting the deal in the first place. This deep dive with Daniel Hendon (Partner) and Phil Anscombe (Associate), lawyers in Proskauer’s Private Credit Group in London, will assess how lenders can protect themselves in such circumstances in the European market, considering various options, ranging from formal contractual exclusivity and economic disincentives through to non-binding forms of “soft comfort.”

Background

It is first worth considering what debt commitment letters typically say on this matter and also to address a couple of common misconceptions. In a commitment letter, a lender or lending institution will (together with any other commitment parties executing the documents as at signing) often be appointed as sole/exclusive provider of the facilities or instruments set out in the letter. This, coupled with the fact that the company usually cannot unilaterally terminate the commitment letter prior to its scheduled termination date (save where the lender is in material breach or has refused to accommodate reasonable amendments that are required in order to complete the acquisition), sometimes leads lenders to think they have achieved exclusivity. There are, however, two issues with this. Firstly, that grant of exclusivity applies only to the facilities/instruments set out in the letter and only to their financing of the acquisition as specifically described therein (not to other forms of finance or similarly structured acquisitions of the same target business). Secondly, there are a variety of trigger events that can lead to termination of a commitment letter (often including termination of the SPA), and these do not always definitively mean that the transaction that underlies it is off the table (e.g., it could be switching from share purchase to asset purchase). For these reasons, this typical language does not entail “exclusivity” in the sense in which lenders generally think of it. It is not that the language itself is deficient – more that its origins in the market were to protect mandated lead arrangers from the risk of other banks being brought in alongside them to share the deal and associated fees (rather than to reduce the risk of altogether separate financing being obtained).

Exclusivity

Where true exclusivity has been commercially agreed, an additional clause should be inserted and several matters pertaining to the scope of that exclusivity should be addressed:

1. **Beneficiaries** – It should be made clear exactly which persons who are being granted exclusivity. Typically, this would be the relevant debt commitment parties and their affiliates and/or related funds.
2. **Form of Finance** – The clause should specify the type of financing with respect to which exclusivity is being granted. Sponsors will try to keep this as narrow as possible, but lenders will look to extend this to debt financing of any kind and whether loans or bonds or otherwise; third-party equity financing (including preferred equity) is typically outside of the scope of the exclusivity provision but

would be a negotiation point.

3. **Transaction** – The clause should describe the transaction with respect to which financing exclusivity is being granted. Again, sponsors will try to keep this narrow, while lenders will look to reference not only the acquisition as currently contemplated but any similar transaction (so including any other acquisition of material assets/shares of the target group or any refinancing of existing target group debt) including any refinancing of such a transaction that has already completed using equity bridge funding.
4. **Commencement** – It should be made clear the date on which exclusivity becomes effective. This will typically be the date of countersignature of the commitment letter by the company and it's worth noting there would be no protection in the intervening period which could be multiple weeks depending on what is agreed as a countersignature deadline.
5. **Termination** – The clause should detail the date on which exclusivity expires. Lenders will want to ensure this is a fixed long-stop date that applies irrespective of whether the commitment letter itself terminates in advance of that date and (for that reason) any survival clause should expressly reference the exclusivity clause. The period before the long-stop date is a commercial point but would commonly be in the 3–12-month range depending on the wider commercial context.

"Soft Comfort"

It is worth noting that in the bank-led financing market, exclusivity is an uncommon feature. While it is indeed more prevalent in the private credit world (given the bilateral and more bespoke nature of certain transactions within that market), some sponsors remain very reluctant to include exclusivity provisions within their documents. Even where it is conceptually agreed, such sponsors may ask lenders to rely on the "soft comfort" afforded by the sponsor's verbal assurances, rather than include anything within the documentation. Part of the sponsor argument is often that this form of exclusivity only cuts one way – lenders can (and regularly do) back multiple bidders for the same asset rather than tie themselves to one counterparty. Some lenders do indeed get comfortable with this "soft comfort" where they have a strong relationship with the sponsor in question.

Economic Disincentives

The alternative option for a lender to consider is to live without exclusivity but request some form of compensation that remains payable to it even if the deal is ultimately closed with alternative financing. This is usually referred to as a “deal away fee” or “alternative transaction fee” and is a prevalent feature of the US market but remains relatively uncommon in Europe outside of the bridge-to-bond bank market. The same considerations around scope will apply as set out for exclusivity above. The quantum of any such fee would be a matter of commercial negotiation, but it is commonly 50% of the up-front fee that would otherwise be payable to the lender at closing (e.g., missing out on an OID/upfront fee of 250bps would lead to an alternative transaction fee of 125bps if the borrower closed the deal with other financing). Clearly, this does not actually give assurances to the lender that it will in fact finance the deal (and if market pricing is subsequently materially lower, it may still be in the sponsor’s interest to reconfigure the financing and take the hit on paying the extra fee), but it at least assures a reasonable level of compensation for that unfunded commitment.

The private credit market remains highly relationship-driven and the appropriate approach to this matter is likely to vary from deal to deal, depending on the parties involved and the commercial backdrop. However, with recent macroeconomic factors reigniting the competitive tension between products within the leveraged finance market, it is certain that private credit lenders will show renewed focus in doing all they can to execute upon any transaction for which they have reached the point of delivering a binding commitment. For any related questions on this topic, please reach out to your contact within Proskauer’s Private Credit Group.

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