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Implementing "Fungible" Incremental Term Loans

Lauren Hanrahan, Andrew R. Walker, Eschi Rahimi-Laridjani, Meir S. Hornung, and Charles Stern*

This article explores the key issues to be considered in connection with implementing fungible incremental term loans.

In many cases, borrowers and arrangers of incremental term loans desire that the incremental term loans be "fungible" with an existing tranche of term loans. In this context, "fungibility" means that (1) from a tax perspective, the incremental term loans will be treated as part of the same "issue" as the existing tranche of term loans, (2) under the loan documents, the incremental term loans will be treated as part of the same tranche as the existing tranche of term loans (and, from an administrative perspective, the administrative agent will not need to track the incremental term loans separate and apart from the existing tranche of term loans) and (3) the terms of the incremental term loans will be identical to those of the existing tranche of term loans (with the exception of original issue discount ("OID") and upfront fees). From a commercial perspective, a lender should be indifferent as to whether it holds the existing tranche of term loans or the incremental term loans. This article explores the key issues to be considered in connection with implementing fungible incremental term loans.

REASONS FOR DESIRING FUNGIBILITY

Borrowers and arrangers often desire fungibility if the proposed amount of the incremental term loans is small, because "tacking on" the incremental term loans to an existing tranche of term loans (as opposed to establishing a new and separate tranche of incremental term loans) will increase the liquidity of the incremental term loans and thereby facilitate a successful syndication of the incremental term loans (benefiting the borrower, the arranger and the incremental term lenders). Of course, fungibility may not be achievable in all cases—for example, if the proposed interest rate of the incremental term loans

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is expected to be greater than the interest rate of the existing term loans, then achieving fungibility in this case would require the borrower to increase the interest rate of the existing term loans to match that of the incremental term loans (which may be prohibitively costly for the borrower).

IMPLEMENTING FUNGIBILITY—TAX FUNGIBILITY

As noted in the introductory paragraph of this article, in order to achieve overall fungibility, the incremental term loans must be treated as part of the same "issue" as the existing tranche of term loans from a tax perspective. This requirement is complex and fact-specific, and tax counsel should be consulted with respect to achieving tax fungibility.[1]

Generally, unless the incremental term loans and the existing term loans are treated as part of the same "issue" of debt under U.S. federal income tax regulations, the amount of original issue discount, as determined for U.S. federal income tax purposes ("Tax OID"), must be determined separately for each of them. In the event that the incremental term loans and the existing term loans have different amounts of Tax OID, then they would not be fungible from a U.S. federal income tax perspective because an incremental term lender and an existing term lender might have to accrue different amounts into taxable income under the rules governing Tax OID and the borrower would be required to track the incremental term loans and the existing term loans separately to comply with its U.S. federal income tax reporting obligations.

In order to determine whether the incremental term loans and the existing term loans are fungible for U.S. federal income tax purposes, the existing term loans and the incremental term loans must have the same credit and payment terms and, generally, the incremental term loans must meet one of the following three tests:

1. The incremental term loans are incurred within six months after the closing date of the existing term loans *and* the yield on the incremental term loans (taking into account economic yield resulting from any issuance discount) does not exceed 110 percent of the yield on the existing term loans (taking into account economic yield resulting from any non-de minimis Tax OID) (the "110 Percent Yield Threshold");
2. The incremental term loans are incurred more than six months after the closing date of the existing term loans *and* the yield on the incremental term loans (taking into account economic yield resulting

[1] The discussion in this article relates to U.S. federal income tax law only.

from any issuance discount) does not exceed 100 percent of the yield on the existing term loans (taking into account economic yield resulting from any non-de minimis Tax OID) (the "100 Percent Yield Threshold"); *or*

3. Regardless of when the incremental term loans are incurred, the incremental term loans have "de minimis" Tax OID. (Generally, a loan is deemed to have "de minimis" Tax OID if the total Tax OID is less than the product of (x) the weighted average life to maturity of the loan (as determined for U.S. federal income tax purposes) and (y) 25 basis points.)

Note that if the *existing* term loans have de minimis Tax OID, this can have adverse implications for purposes of the tests described under 1. and 2. in the preceding paragraph, due to what may be an unintended technical rule in U.S. Treasury regulations. In this case, the calculation of the 110 percent Yield Threshold or the 100 Percent Yield Threshold, as applicable, is made as if the existing term loans had zero issuance discount. Therefore, in determining whether the incremental term loans are within the 110 Percent Yield Threshold or the 100 percent Yield Threshold, as applicable, the incremental term lenders would look only at the interest rate on the existing term loans (which, as discussed herein, must be the same as the interest rate on the incremental term loans).

IMPLEMENTING FUNGIBILITY—CLASSIFICATION

As noted in the introductory paragraph of this article, another key requirement for achieving overall fungibility is that the incremental term loans must be treated as part of the same tranche as the existing term loans under the loan documents.

Implementing this requirement involves a review of the loan documents and, in the amendment or other agreement establishing the incremental term loans, effecting any necessary amendments to the provisions of the loan documents. Particular attention should be paid to the definitions of the terms "Class," "Tranche," "Term Loan," and/or "Incremental Term Loan" (and other related terms and provisions) in the credit agreement and the implementing provisions of incremental commitments and loans in the credit agreement (any of which, without effecting amendments thereto, may require the incremental term loans to be treated as a separate class or tranche from the existing term loans). Note that some credit agreements contemplate the establishment of fungible incremental term loans (often referred to as increases in existing term loans) and may not need to be amended in connection with establishing fungible incremental term loans.

Many existing credit agreements permit the borrower, the administrative agent and the incremental lenders to amend the loan documents (without the consent of existing lenders that are not providing the incremental term loans) to facilitate the establishment of incremental commitments or loans. This provision would likely permit technical amendments of the type described above. However, in the absence of this provision, amendments to the loan documents to facilitate the implementation of fungible incremental term loans would be subject to the general consent requirements for amendments to the loan documents (which would likely require the consent of certain existing lenders that are not providing the incremental term loans).

Additionally, achieving overall fungibility also requires the incremental term loans to be treated as part of the same tranche as the existing term loans for trading purposes. Among other things, the incremental term loans must have the same CUSIP as the existing term loans. The operations teams of the arranger and the administrative agent should be consulted to ensure that this requirement is met.

The primary effects of the incremental term loans being treated as part of the same tranche as the existing term loans are that (1) as a general matter, principal, interest and other payments made by the borrower in respect of the tranche of term loans will be applied to the tranche of term loans on a pro rata basis and (2) the lenders holding term loans within the tranche of term loans must participate in "borrowings" thereunder on a pro rata basis.[2]

IMPLEMENTING FUNGIBILITY—IDENTICAL TERMS

As noted in the introductory paragraph of this article, another key requirement for achieving overall fungibility is that the terms (including interest rate, amortization and maturity) of the incremental term loans and the existing term loans must be identical (with the exception of OID and upfront fees). As a practical matter, this requirement principally implicates (1) the interest rate of the incremental term loans and (2) the amortization schedule of the incremental term loans. Additionally, although this requirement does not affect the OID or upfront fees on the incremental term loans, such OID and upfront fees may be limited by, and may have future implications for, the "MFN" provisions of the credit agreement (as further described below).

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[2] In this article, a "borrowing" refers to a group of term loans within a tranche of term loans that bear interest by reference to the same base interest rate (e.g., ABR / LIBOR) and, in the case of LIBOR borrowings, for the same LIBOR interest period.

Interest Rate

To be fungible with an existing tranche of term loans, the incremental term loans must have the same base interest rate (e.g., ABR / LIBOR) (including, if applicable, the same base interest rate "floor") and interest rate margin as the borrowing(s) under the existing term loans. There are multiple approaches to achieve this matching.

One approach is for the borrower to, as of the closing date of the incremental term loans (the "Incremental Closing Date"), terminate the existing ABR and LIBOR borrowings, pay LIBOR breakage costs associated with the termination, pay accrued interest on all borrowings of the existing term loans (including both ABR and LIBOR borrowings) and, after giving effect to the effectiveness of the incremental term loans, commence a new borrowing of the term loans (which would include the existing term loans and the incremental term loans) from the Incremental Closing Date. On the Incremental Closing Date, the LIBOR breakage costs and accrued interest would be paid to the lenders of the existing term loans (in respect of such term loans), and would not be shared with the incremental term lenders.

In addition to the approach described above, alternative approaches may be available depending on the flexibility provided by the credit agreement to (1) amend the credit agreement to facilitate the implementation of incremental term loans and (2) elect non-standard LIBOR interest periods.

An alternative approach is for the borrower to maintain the ABR and LIBOR borrowings under the existing term loans as of the Incremental Closing Date, to elect for the same ABR and LIBOR interest rates to apply to proportionate borrowings under the incremental term loans (for the "stub period" between the Incremental Closing Date and the next interest payment date(s) following the Incremental Closing Date) and, on the Incremental Closing Date, to either pay or not pay accrued interest on the existing term loans. If the borrower pays accrued interest on the existing term loans on the Incremental Closing Date, then on the next interest payment date(s) following the Incremental Closing Date, the borrower and the administrative agent would pay interest on the borrowings (under the existing term loans and the incremental term loans) on a pro rata basis. If the borrower does not pay accrued interest on the existing term loans on the Incremental Closing Date, then on the next interest payment date(s) following the Incremental Closing Date, the borrower and the administrative agent would pay interest separately on the borrowings under the existing term loans and the borrowings under the incremental term loans.

Amortization

The existing term loans and the incremental term loans must share each prepayment—including amortization payments—on a pro rata basis. Additionally, in most credit agreements, amortization payments on the existing term loans may not be reduced without the consent of each existing term lender. Therefore, the amortization schedule for the existing term loans must be modified so that (1) the incremental term loans amortize at the same rate as the existing term loans and (2) the amortization payments on the existing term loans are not reduced (unless each existing term lender consents to such reduction).

If the Incremental Closing Date occurs after any amortization payment or other prepayment of the existing term loans, then establishing an amortization rate for the incremental term loans that is equal to the amortization rate of the existing term loans at the initial closing (e.g., 25 basis points per quarter) will likely result in either the existing term lenders receiving either less or more than their scheduled amortization payments (including if, for example, voluntary prepayments of the existing term loans have been applied by the borrower to eliminate upcoming amortization payments).

While the quarterly amortization payments on the existing term loans are often based on a percentage rate (e.g., 25 basis points per quarter) multiplied by the principal amount of the existing term loans at the initial closing, as the existing term loans are prepaid (and as amortization payments are reduced or eliminated, if applicable), the actual percentage obtained by dividing subsequent amortization payments by the outstanding principal amount of the existing term loans may exceed or be less than the amortization rate at the initial closing (e.g., 25 basis points).

Therefore, in order to achieve overall fungibility, each amortization payment on the existing term loans subsequent to the Incremental Closing Date must be adjusted by increasing such amortization payment by an amount equal to [Amount of Incremental Term Loans] x [Amount of Amortization Payment on Existing Term Loans] ÷ [Outstanding Principal Amount of Existing Term Loans] (in each case, as of the Incremental Closing Date). The resulting, adjusted amortization payments will often be unusual numbers.

Implications for OID / Upfront Fees

Although it is not necessary, in order to achieve fungibility, for the OID and upfront fees on the incremental term loans to be identical to the OID and upfront fees on the existing term loans, the OID and upfront fees on the

incremental term loans may be limited by (1) the requirement to achieve tax fungibility, as described above, and (2) the "MFN" provisions of the credit agreement (the "MFN Provision"). Additionally, the OID and upfront fees on the incremental term loans may have implications for the application of the MFN Provision in connection with subsequent incremental term loans.

The MFN Provision will often prohibit the "effective yield" of incremental term loans from exceeding an amount (typically, 50 basis points) above the effective yield of the existing term loans, unless the interest rate margin of the existing term loans is increased by the excess. (The "effective yield" typically includes, in addition to LIBOR (or, if greater, the LIBOR "floor") and the LIBOR interest rate margin, upfront fees and OID (typically converted to "yield" based on an assumed four-year life to maturity).) As a result, care should be taken to ensure that the OID and upfront fees on fungible incremental term loans do not trigger the application of the MFN Provision.

Additionally, if the amount of the OID and upfront fees on fungible incremental term loans is different (either greater or less) than the amount of the OID and upfront fees on the existing term loans, then a question may arise in connection with subsequent incremental term loans (whether or not such incremental term loans are intended to be fungible with an existing tranche of term loans): what is the "effective yield" of this tranche of term loans for purposes of determining whether the MFN Provision is triggered? This question arises because the determination of the "effective yield" of the tranche of term loans for purposes of the MFN Provision takes into account the amount of the OID and upfront fees thereon. For example, if the OID and upfront fees on fungible incremental term loans is less than the OID and upfront fees on the existing term loans, then using the OID and upfront fees on the incremental term loans as *the* OID and upfront fees on the entire tranche of term loans (for purposes of the MFN Provision) will result in a lower "effective yield" (which would result in the MFN Provision being more likely to be triggered in connection with subsequent incremental term loans) than if the OID and upfront fees on the existing term loans had been used for this purpose.

If this question is addressed specifically in the credit agreement, then its answer may be straightforward. However, if (as in many credit agreements) this question is not addressed specifically, then it is important to discuss this question with the parties (and their respective counsel) in order to determine the appropriate answer in the particular case.

CONCLUSION

In conclusion, although on its face implementing "fungible" incremental term loans appears to be straightforward, there are numerous considerations to

keep in mind to ensure that, from a commercial, tax, documentation and administrative perspective, the incremental term loans are indeed fungible with existing term loans.