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Update

"Amend and Extends" Emerge as New Trend in U.S. Loan Markets

A current and anticipated future lack of refinancing sources for maturing loans, coupled with the recent surge in secondary loan market prices, have lead to a new trend in U.S. loan markets: the so-called "amend and extend" transaction or "A&E." At least 15 A&Es of U.S. credit facilities have been executed since March 2009, when this nascent trend began.

A&Es are non-pro rata extensions of the maturity of revolving credits, term loans, or both. A "non-pro rata maturity extension" means that the maturity of the loans of *certain* lenders under a credit agreement is extended, while that of other lenders under the agreement is left unchanged. This is often accomplished by amending the credit agreement to bifurcate an existing facility into two tranches – one whose maturity is extended normally by at least one year (and at increased, current-market pricing), and the other whose maturity (and pricing) is left unchanged. Alternatively, an A&E may effectively be accomplished through the exercise of a credit agreement's existing "accordion" feature (as described below).

WHY CARRY OUT AN A&E? WHY THE NEW TREND?

A&Es permit borrowers to reduce their refinancing risk by extending the maturity of a portion of their loans. These transactions are effected in lieu of full refinancings (i.e. new credit agreements) which are generally more expensive. Importantly, as majority (rather than unanimous) lender consent amendments, A&Es do not provide non-consenting lenders with the opportunity they would otherwise would have in the context of a full refinancing effected prior to maturity to exit the credit facility altogether.

Besides these obvious benefits to borrowers, the recent surge in average secondary loan market bid prices – to the low to mid 80s from the low 60s following Lehman Brothers' bankruptcy – has also contributed to the nascent trend toward A&Es. This is because the pricing of the extended loan tranche is generally marked to market at the closing of the A&E and, in general, the nearer a below-par loan is trading to par, the lesser the pricing increase necessary to mark the loan's pricing to market. This makes A&Es easier for borrowers to bear than was the case when secondary loan market prices were at their depths in late 2008 and early 2009 (during which time loan buybacks were more attractive to borrowers and A&Es were less attractive).

In addition (and as described below), a number of A&Es have been driven by borrowers' desire to avoid anticipated future dislocations in U.S. credit markets. Furthermore, recent changes to U.S. tax law (also described below) may decrease the potential U.S. tax cost of A&E transactions occurring in 2009 and 2010.

For extending lenders, A&Es create an opportunity to increase margin and generate upfront fees. Consenting lenders (whether extending or not), and occasionally even non-consenting lenders, may also receive amendment fees. All lenders may benefit from other amendments made in the A&E, such as those tightening up existing covenants – although some borrowers have used A&Es to loosen covenants.[1]

EXPLICIT OR IMPLICIT BIFURCATION OR NEW TRANCHE

A key consideration in many A&Es is how to effect a bifurcation of loans into extended and non-extended maturities. One approach is to make the bifurcation explicit. For example, the A&E may involve the creation of two tranches of loans out of a single, original tranche. Or, bifurcation of the loans may be implicit. For example, the A&E may involve the addition of a mechanism to pay down the loans of non-extending lenders on their original maturity date and simply extend the maturity date of the loans of extending lenders. Alternatively, an A&E may effectively be accomplished by having extending lenders agree to make a new tranche of longer maturity loans under a credit agreement's existing "accordion" feature and having the borrower use the proceeds to pay off the extending lenders' original, shorter maturity loans.[2]

SQUARE PEGS: IMPLEMENTING NON-PRO RATA EXTENSIONS WITHIN PRO RATA CREDIT AGREEMENT ARCHITECTURE

In analyzing A&Es, it is important to keep in mind that U.S. credit agreements are almost universally designed to treat lenders on a pro rata basis. For instance, most U.S. credit agreements contain so-called "pro rata payment" provisions requiring payments to be made to the lenders on a pro rata basis (e.g. in accordance with outstanding amounts or amounts due and payable), and so-called "sharing" provisions requiring lenders to share any amounts received in excess of their pro rata share with the other lenders. Similarly, mandatory prepayment provisions normally require prepayments to be made to the lenders on a pro rata basis. Bifurcating loans into different maturities, or adding a new tranche of longer maturity loans, will often represent a departure from the pro rata treatment of lenders inherent in many U.S. credit agreements.

[1] See "*The Risk of Junk Upends Leverage*," New York Times, July 6, 2009.

[2] This would still likely require an amendment to the credit agreement, since "accordion" provisions generally permit increases in existing facilities only on the facilities' original terms (i.e. such provisions do not provide for extensions of maturity or for increases in pricing).

For instance, a "pro rata payment" provision which requires all payments to be made to the lenders on a pro rata basis in accordance with outstanding amounts (as opposed to amounts due and owing) would be violated if non-extending lenders are repaid on the original maturity date but extending lenders are not. If such a provision is capable of being amended only with 100% lender consent (which is the case for most "pro rata payment" provisions), the result may be to effectively prohibit the A&E, since obtaining 100% lender consent is very often a practical impossibility. By contrast, if the provision is capable of being amended with majority lender consent, an A&E may be feasible. Of course, if the provision required payments to be applied on a pro rata basis in accordance with amounts due and payable, rather than outstanding amounts, an A&E would be possible without making any amendments to the provision.

There are other examples of A&Es' departure from the normal pro rata treatment of lenders. These transactions may involve altering the pro rata application of payments contemplated in a credit agreement's mandatory prepayment provisions (such as to disentitle extending lenders from sharing in mandatory prepayments prior to the maturity of the non-extended loans) or may involve permitting (or prohibiting) future, non-pro rata optional prepayments. For example, the borrower may wish to have the right to optionally prepay (or the lenders may wish to prohibit the borrower from optionally prepaying) the more expensive extended loans without prepaying the less expensive unextended loans on a pro rata basis. Or, extending lenders may make their agreement to extend the maturity of their loans conditional on the borrower prepaying a portion of their loans (and permanently reducing associated commitments) without making any corresponding prepayment of the unextended loans (or correspondingly reducing the unextended loan commitments).

Each credit agreement and transaction is unique, and careful consideration must be given to the precise language of the agreement and the percentage of lenders whose vote is required to amend provisions that would otherwise restrict the A&E or affect the intended application of payments among loan tranches. Even increasing the pricing of the extended loans may trigger unexpected lender consent requirements, such as where the credit agreement requires "affected lender" consent for any changes (rather than just decreases) in interest rates.

The form of maturity extension selected for an A&E (i.e. implicit or explicit bifurcation or creation of a new tranche) will be based, in large part, on the parties' expectations regarding whether future loan drawdowns and prepayments will be made on a pro rata basis, and whether non-extended and extended loans will share the same interest periods. Secondary market loan trading issues may also factor into the analysis, since implicit bifurcation could significantly complicate loan trading by adding confusion over whether what is being traded is an extended or non-extended loan.

It is also of note that many A&E amendments permit assignees to extend their loans, providing additional potential tenor benefits to borrowers following the closing of an A&E.

MAJORITY VERSUS UNANIMOUS LENDER CONSENT

As is the case with loan buybacks, it is critical to structure A&Es as majority (rather than unanimous) lender amendments, since unanimous lender amendments are often a practical impossibility. In obtaining majority lender consent, it is important to keep in mind that not all consenting lenders need agree to extend their loans. For instance, one might effect an A&E with 51% lender consent, but with only 25% of the lenders agreeing to extend the maturity of their loans.

LENDER QUID PRO QUOS

Besides fees, extending lenders may demand quid pro quos for agreeing to extend the maturity of their loans, such as the tightening of existing financial covenants or the insertion of new ones, the granting of collateral security or (as described above) a reduction in the amount of the loans and commitments of the extending lenders.

RECENT A&ES AND WHAT THE FUTURE MAY HOLD

Although some A&Es have involved loans maturing sooner, a number of A&Es have involved borrowers extending the maturity of loans that would otherwise not mature until 2012 or later. These borrowers have sought to "sidestep what is likely to be the biggest-ever wave of loan refinancing of risky companies as $440 billion in debt becomes due in a span of three years [2012-2014]," representing about 85% of the $518 billion in current leveraged loans outstanding, according to Standard & Poor's Leveraged Commentary & Data.[3] This surge in leveraged loan refinancing needs, described by the Loan Syndications and Trading Association (LSTA) as the upcoming "refinancing cliff" in light of its graphical representation, stems from the U.S. lending bubble that occurred from 2005 to 2007. A&Es are expected to effectively refinance a portion of the refinancing cliff, although under some scenarios at the apex of the cliff in 2013, there may be up to US$125 billion in maturing, non-defaulted leveraged term loans with no reasonably likely source of refinancing (such as A&Es, new bank or institutional leveraged loans or high yield bonds). And, the ramp-up to and ramp-down from the apex of the refinancing cliff may involve hundreds of billions more.

So far, A&Es have largely involved higher-rated leveraged credits. However, as A&Es continue to be used in the market, it is foreseeable that they will become a viable refinancing alternative for lower-rated leveraged credits as well. Indeed, at least one A&E has been executed on a covenant-lite credit facility. In addition, at least one Canadian borrower has closed an A&E of its U.S. credit facilities and it is foreseeable that A&Es will also be executed in Canadian loan markets as well.

[3] "*Rates Low, Firms Race to Refinance Their Debts*," Wall Street Journal, June 26, 2009.

FORWARD START FACILITIES – THE EUROPEAN ANALOGUE TO A&ES

Unlike in the U.S., where it is often possible to effect an A&E with majority (rather than unanimous) lender consent, most European credit agreements would require 100% lender consent to effect an A&E. As a consequence, borrowers and lenders under European credit facilities have arrived at a different creative solution to address borrowers' desire to reduce refinancing risk: the "Forward Start Facility" or "FSF."

Unlike A&Es, which involve an amendment to an existing credit agreement, FSFs involve entering into a new, longer-tenored credit agreement which sits alongside with, and is ultimately drawn upon to refinance, an existing credit agreement. The pricing of FSF lenders' original loans is effectively (i.e. through fee arrangements) marked to market upon execution of the FSF, and FSFs provide borrowers with some protection against refinancing risk in the form of a pre-committed source of refinancing for at least a portion of the borrower's existing loans. FSFs implemented to date have primarily involved investment-grade borrowers.

Importantly, FSFs generally involve conditions precedent to drawing such as (potentially) the absence of a material adverse change. This means that FSFs may be less advantageous to borrowers than A&Es, under which the extension of maturity is fully accomplished at inception. (FSFs involve a number of other complexities and are generally outside the scope of this Osler Update. The authors are not aware of any FSFs implemented to date with respect to U.S. credit facilities.)

CERTAIN U.S. TAX CONSIDERATIONS OF A&ES

Amending existing indebtedness to extend its maturity date can have U.S. tax consequences for both borrower and lender. If an existing debt instrument is "significantly modified," it is generally treated as exchanged for a new debt instrument for U.S. tax purposes.

Extensions of a maturity date can, in certain circumstances, result in significant modifications (and, thus, deemed exchanges) of debt. Under applicable regulations, however, deferrals that extend scheduled payments within a safe-harbor period until the end of the safe-harbor period are not generally treated as significant modifications. The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50 percent of the original term of the instrument.

Even if the extension fits within this safe-harbor period, other changes to the agreement between the borrower and the lender, such as changes in yield and/or fee payments, can nevertheless result in a significant modification and a deemed exchange. In addition, as a result of the A&E, the borrower's *unmodified* debt (whether under the same credit facility as the A&E or another credit facility) might be deemed exchanged if the payment expectations of the lenders on that debt change from being speculative to adequate or adequate to speculative.

If a debt exchange is deemed to occur for U.S. tax purposes, the lender may recognize a gain or loss equal to the difference between the fair market value and the lender's tax basis in the debt instrument. Recognition of gain for the lender may be avoided, however, if the "old" and "new" instruments both qualify as "securities" for tax purposes and the deemed exchange qualifies as a tax-free recapitalization.

On the other hand, and regardless of whether the deemed debt exchange is taxable or tax-free for U.S. tax purposes, the borrower may be required to recognize cancellation of indebtedness income if the issue price of the new debt instrument is less than the adjusted issue price of the old debt instrument.[4] Income recognition where the borrower continues to be obligated to pay the same principal amount may be a surprising result to many borrowers and, in the event there is tax payable on such income, these increased, non-ordinary course tax outlays may cause lenders concern about the borrower's ability to repay. However, under *The American Recovery and Reinvestment Act of 2009* (the stimulus package signed into law by U.S. President Obama on February 17, 2009), the tax payment date for cancellation of indebtedness income arising in connection with certain qualifying transactions occurring in 2009 and 2010 may be substantially deferred, thus potentially mitigating some of the adverse U.S. tax implications of A&E transactions.[5]

Given these complex U.S. tax rules, borrowers and lenders considering A&Es need to closely analyze whether a deemed exchange is likely to be triggered for U.S. tax purposes resulting from modifications to the debt pursuant to the A&E. If a deemed exchange is likely to occur, the parties should also consider whether any taxable gain or income might result, as well as whether tax payable on any income to the borrower might qualify for deferral under the new tax rules described above. Even so, with careful U.S. tax planning, A&Es will often serve the goals of borrowers and lenders alike.

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[4] The term "adjusted issue price" is a tax concept, and if either the old debt or new debt is deemed to be publicly traded, generally equals the debt's fair market value. Under existing U.S. Treasury Regulations, determining whether a particular issue is publicly traded can be difficult, and it is possible that some syndicated loans not typically thought of as publicly traded may nevertheless fall within this definition (particularly if those loans are listed on quotation media such as Bloomberg).

[5] For a more detailed explanation of the tax provisions in the U.S. stimulus package, see the Osler Update of February 18, 2009.