Loan Documentation and Legal Terms (Private Credit)

Interview preparation summary · PC track

IN THIS SUMMARY

- The credit agreement
- Security and the lender group

INT.CL.1.a · The credit agreement

Read the EBITDA and net debt definitions of a credit agreement clause by clause, separate uncapped from capped add-backs, and compute how a cap and its drafting change covenant leverage and real headroom.

Almost every number in a credit agreement hangs off a few defined terms: the leverage covenant, the ratio baskets, the margin ratchet and the sweep all use defined EBITDA and defined net debt, so the definitions carry the economics. Sort the add-backs into three groups: one-off items already paid in cash (restructuring, transaction costs), non-cash items (impairments, share-based pay) and projected items (run-rate cost savings, synergies, pro forma earnings of acquired businesses). Lenders usually accept the first two if they are itemised, and limit the third with a cap, often a percentage of EBITDA (market practice varies widely), a look-forward window in which the action must be taken, and a requirement that the figure is reasonably identifiable and supportable. Check whether the cap is measured before or after the add-back, because the circular version lets more through. Then read net debt: is cash netting capped, and what counts as debt? The usual mistake is to test headroom on defined EBITDA without asking how much of it is a forecast. Interviewers want to hear that the definition is negotiated and that it is the real covenant.

WORKED EXAMPLE: READING AN EBITDA DEFINITION FOR HALVERN CASTINGS

Halvern Castings is an invented foundry group with reported EBITDA of 18.0m and net debt of 96.0m. The sponsor's definition adds back 1.2m of plant-closure costs (uncapped) and claims 4.8m of projected items: 3.0m of run-rate savings from the closure and 1.8m of synergies from a bolt-on. Projected items are capped at 15% of EBITDA. The maximum net leverage covenant is 5.50x. Compare leverage and headroom with the cap measured before the add-back, with the cap measured after it (circular) and with no cap, and say how much headroom is real if none of the projected 4.8m arrives. Ignore tax and timing.

Answer: Leverage runs from 4.00x with no cap to 4.35x with the tightest cap, and headroom from 27.3% down to 20.9%, but only 9.1% of the headroom is earned if the projected 4.8m never arrives.

> **Interview tip:** Say it as: the cap wording is worth a quarter of a turn of leverage here, and I would look at headroom on the earned number before I accept a covenant level.

INT.CL.1.b · The credit agreement

Explain how debt, restricted-payment and investment baskets, grower and builder features, ratio tests and incremental facilities with an MFN stack together, and compute the capacity and cost they create.

Negative covenants say what the borrower cannot do without consent, and baskets are the exceptions that let it do things anyway. Know the main types. Fixed baskets give a set amount; grower baskets are the greater of a fixed amount and a percentage of EBITDA, so they rise with earnings; ratio baskets allow an action if pro forma leverage after it is below a level, tested only when the action is taken (an incurrence test). A builder basket accumulates capacity for dividends and investments, often from a share of cumulative consolidated net income plus equity contributions; the lender should check whether losses are deducted. Incremental or accordion facilities add debt, usually through a free-and-clear amount plus a ratio amount, with an MFN that lifts the existing margin if new debt is priced more than a cushion above it, counting original issue discount. Watch for stacking, reclassification and language that disregards one basket when testing another. The usual mistake is to read each basket alone. Interviewers want the total capacity on day one, its effect on leverage and recovery, and the asks you would make.

WORKED EXAMPLE: DIVIDEND CAPACITY AT CORVANE FASTENERS

Corvane Fasteners is an invented fastener maker with EBITDA of 36.0m. The restricted payment covenant has a starter basket of the greater of 12.0m and 40% of EBITDA, plus a builder basket of 50% of cumulative consolidated net income plus equity contributions. Net income was +7.0m in year one, +9.0m in year two and -4.0m in year three. The sponsor put in 5.0m of new equity in year two. The sponsor wants to pay a 26.0m dividend after year three. Compare the lender's draft (cumulative net income, losses deducted) with the borrower's draft (50% of profitable years only). Ignore the no-default and ratio conditions for now.

Answer: Capacity is 25.4m on the lender's draft and 27.4m on the borrower's, so the loss deduction decides whether the 26.0m dividend can be paid without consent.

Interview tip: Say it as: I would add up every basket the dividend could use, and I would insist that a loss in one year reduces the builder, because otherwise earlier profits fund payments after the business has deteriorated.

INT.CL.1.c · The credit agreement

Explain events of default, grace periods, cross-default and cure rights, and the excess cash flow sweep, change of control and portability terms, and compute a sweep and the cost of portability.

An event of default is the trigger that lets lenders accelerate, so its drafting decides how early they get a seat at the table. Typical triggers are non-payment (often no grace beyond a short administrative window), breach of financial covenants, breach of other obligations with a remedy period, misrepresentation, cross-default or cross-acceleration to other debt above a threshold, insolvency and sometimes a material adverse change. Cross-default is lender-friendly; cross-acceleration waits for another creditor to act. An equity cure lets a sponsor inject equity after a covenant breach, usually deemed to be EBITDA, with limits on frequency, amount and use. Mandatory prepayments include asset sale proceeds, insurance and an excess cash flow sweep, often a percentage that steps down as leverage falls, with credit for voluntary prepayments and a de minimis amount. Change of control normally triggers prepayment; portability lets the loan stay with a new owner if tests are met. The usual mistake is to treat these as boilerplate. Interviewers want the economics of each term.

WORKED EXAMPLE: EXCESS CASH FLOW SWEEP AT PENNICK PLASTICS

Pennick Plastics is an invented plastics group. In the year: EBITDA 40.0m, cash interest 14.0m, cash taxes 5.0m, capital expenditure 8.0m, increase in working capital 2.0m and scheduled term loan repayments 3.0m. Net debt at year end is 130.0m. The sweep is 50% of excess cash flow, stepping down to 25% if net leverage is 3.5x or less and to 0% at 3.0x or less. Voluntary prepayments of 1.5m made in the year are credited pound for pound against the sweep. Sweeps below 1.0m are not required. Compare this with a flat 50% sweep with no credit. Ignore timing.

Answer: The sweep is 1.625m under the negotiated terms and 4.0m under a flat 50% with no credit, a difference of 2.375m a year.

Interview tip: Say it as: the percentage is only one input, so I check the step-down levels, what is deducted from excess cash flow and whether voluntary prepayments earn credit.

INT.CL.2.a · Security and the lender group

Explain the guarantee and security package and an intercreditor agreement (ranking, standstill, turnover, enforcement instructions and purchase option), and compute what each class receives and what a purchase option costs.

A lender's claim is only as good as the assets it can reach. The package usually has guarantees from the main operating subsidiaries and security over shares, bank accounts, receivables and other assets, with limits that vary by jurisdiction (corporate benefit, financial assistance rules, cost and perfection formalities, tax). A guarantor coverage test, often a percentage of group EBITDA or assets, checks the package reaches enough of the business, and anything outside it is structurally behind the guaranteed debt. Where there is more than one class of creditor, an intercreditor agreement sets ranking, who instructs enforcement, a standstill during which junior creditors cannot act, turnover of payments received in breach, and often a purchase option letting a junior buy out the senior at par plus accrued amounts. Super senior revolvers and hedging usually share the senior security, with ranking set by the agreement. The usual mistake is to read ranking without asking who controls enforcement. Interviewers want the waterfall, the control rights and the number.

WORKED EXAMPLE: INTERCREDITOR MECHANICS AT MARLOWE COLD STORAGE

Marlowe Cold Storage is an invented cold-chain group with a 15.0m super senior revolver, a 70.0m first-lien term loan and a 25.0m second-lien loan, all sharing the same security. Enforcement proceeds are 80.0m. The second-lien lender received 3.0m of interest in breach of a payment block and has turned it over. The senior lenders are also owed 1.1m of accrued interest and 0.4m of costs, ignored in the waterfall but not in the purchase price. The second-lien lender believes a patient sale would raise 110.0m. Show the waterfall, the effect of turnover, the purchase option price and the second-lien lender's outcome if it exercises.

Answer: At 80.0m the term loan recovers 97.1% after turnover and the second lien nothing; the purchase option costs 86.5m and returns 23.5m net if the 110.0m view is right.

Interview tip: Say it as: I rank the claims, then ask who controls enforcement and whether a junior can buy the senior out, because the number depends on who runs the sale.

INT.CL.2.b · Security and the lender group

Apply amendment and waiver voting thresholds, sacred rights, affiliate voting limits, yank-a-bank, transfer restrictions and agency provisions to decide who can pass or block a change.

A loan agreement is only as strong as the vote needed to change it. Most amendments and waivers need Required Lenders, often more than 50% of commitments or loans, sometimes 66 2/3% for items such as releasing collateral. Sacred rights, such as extending maturity, reducing margin or principal, changing currency or pro rata sharing, need the consent of each affected lender. Documents often disregard votes held by sponsor affiliates, which changes the arithmetic. Work out blocking positions: the smallest holding that stops a vote is just over one minus the threshold. Yank-a-bank clauses let the borrower replace a lender that will not consent, usually at par plus accrued amounts and subject to conditions. Transfer provisions set who may buy the loan, with borrower consent rights, disqualified lender lists and limits on sponsor affiliates. The agent acts on instructions, and its duties are narrow. The usual mistake is to forget the denominator. Interviewers want the sums, and what hold size means for influence.

WORKED EXAMPLE: WHO CONTROLS THE VOTE AT TESSEL SOFTWARE

Tessel Software is an invented software group with a 200m term loan held by A 62m, B 38m, C 30m, D 24m, E 20m, F 14m (a sponsor affiliate) and G 12m. Required Lenders means more than 50% of the loans held by lenders entitled to vote, and sponsor affiliates are disregarded. Extending the maturity is a sacred right. Work out who can pass an ordinary amendment, who can block, what happens if C refuses an extension, and what it would cost to replace C at par plus 30 days of accrued interest at 8.0%. Use a 360-day year.

Answer: The pool is 186m, A and B can pass an ordinary amendment, C can refuse the extension and can be replaced for 30.2m at par plus accrued.

Interview tip: Say it as: I write down the denominator, the threshold and who is excluded before I say who can win a vote.

INT.CL.2.c · Security and the lender group

Spot documentation red flags that allow asset leakage, uptiering and priming, quantify their effect on recovery and name the protections a lender would ask for.

Liability management transactions use gaps in the documents to move value between creditors. The main forms are a drop-down or J.Crew-style transfer, where valuable assets move to an unrestricted or non-guarantor subsidiary under investment baskets and can then support new debt; an uptier, where a majority of lenders amends the documents to exchange into debt that ranks ahead of the minority; and priming or layering, where new debt ranks ahead of or alongside existing debt. The red flags to look for are broad unrestricted subsidiary designation rights, large grower and builder baskets for investments, transfers of assets valued by the borrower, amendments to ranking or security needing only Required Lenders, and non-pro rata open-market or exchange offers. Protections are blockers on material IP and designations, caps on investments in non-guarantors, sacred rights for ranking, liens and pro rata sharing, anti-layering and offers open to all lenders. The usual mistake is to rely on a covenant. Interviewers want a recovery number and the clause that prevents it.

WORKED EXAMPLE: A DROP-DOWN AT QUILLON RETAIL

Quillon Retail is an invented retailer with a 150.0m first-lien term loan, EBITDA of 30.0m (5.0x) and an enterprise value of 210.0m (7.0x). Its main brand, held in one subsidiary, is worth 60.0m. The documents let the borrower invest in unrestricted subsidiaries up to the greater of 20.0m and 75% of EBITDA, plus a 10.0m builder amount, and value each transfer at the board's good-faith fair value. In a downside the group is worth 120.0m. Show whether the transfer fits the baskets, the recovery before and after, and what the new lenders get if 50.0m is raised against the brand.

Answer: The first-lien recovery falls from 80% to 57.1% and new money secured on the brand recovers 68.6%, because a basket and a borrower-set valuation let 60.0m of value leave for 30.0m.

> **Interview tip:** Say it as: I read the investment baskets and the designation clause together, ask what the most valuable asset is and where it could go, and put a number on the recovery.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.