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Country Question and Answer Chapters:

Escrow Funding in the Term Loan B Market


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Background – Escrow Funding

The concept of "funding into escrow" has long been familiar to participants in the high-yield bond market. Whether to bridge the uncertainty of a closing date (*e.g.*, awaiting satisfaction of a regulatory condition with a timeline outside of the parties' control) or to seize on favourable terms and pricing then available in the capital markets, companies have for many years issued bonds pursuant to escrow arrangements in advance of their actual need for the proceeds. Such escrow arrangements generally include the issuance by the issuer of the bonds (either the company or, as discussed below, a special purpose subsidiary used for the escrow period) against the deposit of the proceeds with an escrow agent, which proceeds are typically pledged to the bondholders. The issuer will usually be required to prefund the escrow with some amount of interest and, if relevant, any special redemption premium that might be due upon breaking of the escrow without closing. Upon the satisfaction of specified escrow release conditions, the escrow agent releases the proceeds to the issuer and, if the issuer was initially a subsidiary, the company merges with the issuing subsidiary or otherwise assumes all of the issuing subsidiary's obligations under the bonds, the indenture and any other issuer documents. If the escrow release conditions are not satisfied prior to the agreed outside date (or any other escrow termination event occurs), the escrow agent will return the proceeds to the bondholders on behalf of the issuer in the form of a special redemption. Whether the special redemption includes a redemption premium is the subject of negotiation, but importantly, any negotiated premium will be significantly less than a "make-whole" payment.

Escrow arrangements have proved to be especially useful, and have therefore become common, for high-yield bonds issued to finance an acquisition. In this case, the relevant considerations include: that a road show will often begin before the parties have certainty as to when the final conditions to closing the transaction will be satisfied, with investors expecting an issuance to occur promptly after the end of that road show; that pricing and availability in the high-yield bond market have historically proved to be volatile; and that the acquisition agreement will almost never include a true "financing-out" (*i.e.*, a condition to closing the acquisition that financing is, in fact, available to the Buyer). To eliminate the risk that a Buyer is required to close a previously agreed acquisition at a time the capital markets for bonds have deteriorated or even "closed", the Buyer may choose to strike while the proverbial iron is hot, taking advantage of favourable market conditions, even if the Buyer has a committed "bridge" financing to backstop any ultimate unavailability. Bondholders are generally willing to permit escrow fundings, as interest accrues on the bonds while held in escrow even though the issuer has no access to the bond proceeds (which, as noted above, typically collateralise the issuer's obligations to redeem the bonds upon escrow termination without closing).

The issuance of term B loans ("TLB") into escrow in the acquisition financing context is a more recent innovation and remains significantly less common. An increasing number of recent TLB acquisition financings with commitments of six months or longer, however, have provided the committing lenders with the right to demand the funding of the committed TLB into escrow no later than an agreed date if the related acquisition hasn't closed – and the TLB hasn't been funded to the borrower – prior to such date (the "Required Escrow Funding Date").

In contrast to the use of escrow funding in the bond context, which, as noted above, may be driven by uncertainty of timing for closing or an issuer's desire to take advantage of favourable market conditions, a TLB escrow funding is most typically intended to permit the initial committing lenders to, in effect, replace their funding commitments by syndicating a funded TLB to institutional and other investors prior to the closing of the acquisition and expiration of the long-dated commitment period. As in the capital markets context, the escrow approach creates little practical risk to the funding TLB lenders as, once funded, the TLB proceeds are held by the escrow agent in the escrow account (subject to the lien in favour of the lenders), and either released to the Buyer upon the closing of the acquisition or, if the acquisition is terminated or does not close by the agreed outside date, repaid to the TLB lender.

Despite the increasing frequency of escrow demand rights in commitment letters, TLB arrangers have in practice seldom had cause to use them. Given the relatively low usage of escrow arrangements in the TLB context, the precise mechanics of a TLB escrow funding (other than with respect to basic economic terms and, sometimes, conditionality) are not typically specified in the related commitments letters. Instead, such commitment letters most typically require that the TLB be funded into escrow on the Required Escrow Funding Date on "customary" terms and conditions to be reasonably agreed by the parties prior to such date. This article discusses several common issues that arise when parties seek to implement TLB escrow funding arrangements.

Issues to Consider in TLB Escrow Fundings

Fees and Interest

Instead of escrow funding, TLB acquisition financings with medium-dated commitments of three months or more most typically require that the borrower pay the committing TLB lenders a "ticking fee" that accrues on the undrawn and unfunded TLB commitments. This fee permits the lead arrangers of such financings to syndicate the commitments to institutional lenders and other investors (at favourable pricing) in advance of closing and hold that syndicate together by compensating the TLB lenders for the period before the actual funding. Ticking fees usually begin to accrue 30–60 days following allocation of the TLB commitments to such investors[1] until the earliest of (i) the date the TLB is funded into escrow (at which point interest on the TLB accrues) (the "Escrow Funding Date"), (ii) the closing of the acquisition and the initial funding of the TLB to the borrower (the "Closing Date"), and (iii) the termination of the TLB commitments.[2] The ticking fee percentage generally steps up every 30–60 days from an initial percentage – often 50% – of the interest rate margin applicable to the TLB to 100% of such margin *plus* then-applicable LIBOR (sometimes inclusive of any applicable LIBOR "floor"). If the ticking fee begins before full allocation of commitments (and therefore before the pricing terms of the TLB have finally been determined), the calculation of the applicable margin may give effect to any potential increase in spread after application of any available "market flex" provided for in the fee letter. While such ticking fees apply to medium-dated commitments whether or not an escrow funding of the TLB is contemplated, in transactions where the escrow demand right exists, a possible consequence of a borrower's failure to comply with an escrow demand from the committed lenders on the Required Escrow Funding Date is that (i) the ticking fee is further increased to the maximum spread permitted pursuant to "market flex" provisions in the fee letter plus, to the extent not already included in the calculation of the ticking fee, any applicable LIBOR floor, and (ii) the borrower will be required to pay the TLB underwriting fee on such date.

A second fee payable to lenders in nearly every TLB is an upfront fee calculated on the principal amount of the TLB actually funded to the borrower. Upfront fees are generally reflected as "original issue discount" on the loan or documented as a fee paid by the borrower but, in practice, such fees are paid through "net-funding", whereby each lender reduces the amount actually advanced to the borrower by the upfront fee payable to it. In either case, the borrower owes the full stated principal amount of the TLB to the lender. In the escrow funding context, it is most typical that the TLB is net-funded into escrow, with each lender retaining any upfront fee payable to it. Assuming the acquisition closes and the escrow proceeds are released to the borrower, the usual rules apply and the borrower is liable for the full stated principal amount of the TLB. In contrast, where the escrow terminates and the escrow proceeds are instead returned to the lenders, the most common approach – reflecting the commercial understanding that upfront fees are payable solely upon the funding of the TLB to the borrower – is that the return of the net-funded escrow proceeds to the lenders (plus accrued interest) is deemed to be a repayment in full of the TLB. Of course, as with some bond escrow arrangements, the parties might decide to negotiate a premium payable to the lenders upon this "special prepayment".

In addition, TLB lenders expect interest – including both the applicable LIBOR or base rate and margin – to accrue on their loans from the Escrow Funding Date and throughout the escrow period. As a result, borrowers are required to either (i) pre-fund the maximum amount of interest payments that may accrue during the escrow period, or (ii) periodically pre-fund such additional interest payments to the escrow account, with a break of escrow and return of funds to the lenders if the borrower does not satisfy its pre-funding obligations.[3] Many escrow agreements permit the proceeds of the TLB and any pre-funded interest payments to be invested in United States treasuries or other short-term, high-grade investments during the escrow period to allow a minimum return to the borrower. If so, the related escrow agreement will require the borrower (or, in the case of a borrower that is a special purpose vehicle ("SPV") or unrestricted subsidiary, as discussed below, a creditworthy affiliate) to "top up" the amounts on deposit in the escrow account to account for any losses on investment. Accrued interest on the TLB held in the escrow account is then paid to the lenders upon the earlier of release of the escrow proceeds to the borrower in connection with the closing of the acquisition and the date the escrow terminates (if the acquisition terminates) and the TLB are repaid to the lenders.

Existing Indebtedness

The creation of a TLB escrow structure is relatively straightforward in the context of a private equity sponsored acquisition, in which the acquisition entity/borrower (the "Buyer") is a newly established entity formed solely for purposes of consummating the acquisition and related financings. Such SPV will generally have no existing indebtedness or other arrangements that would limit its ability to fund the TLB into escrow. In contrast, where the Buyer in an acquisition financing is a company with existing indebtedness ("Existing Debt"), the initial borrowing and funding into escrow must be permitted by the terms of such Existing Debt.[4] Especially if the Existing Debt is non-investment grade, with covenants strictly limiting the incurrence of new debt and liens, the Buyer may be prohibited from incurring such additional acquisition financing and is almost certainly prohibited from pledging the escrow account to secure its repayment obligations on the escrowed TLB.[5] To address this complication, and where available, the most common solution is for the initial "borrower" during the escrow period to be an "unrestricted" subsidiary of the Buyer (the "Escrow Borrower"), similar to the practice in high-yield bonds as described above. Such "unrestricted" Escrow Borrower is excluded from the "restricted group" that is governed by the debt, liens and other negative covenants in the Existing Debt and may, therefore, incur the escrowed TLB and pledge the escrow account to the TLB lenders without violating the terms of such Existing Debt.[6] To ensure that the TLB lenders are ultimately secured and guaranteed on a *pari passu* basis with the lenders under the Existing Debt of the Buyer, at the closing of the acquisition, the Escrow Borrower will generally merge with and into the Buyer, with the Buyer and its other restricted subsidiaries surviving as the obligors of the TLB.

Documentation and Conditionality

Where the Buyer is an SPV established solely for purposes of consummating a private equity sponsored acquisition and the relating financing, the borrower and lenders will generally enter into the definitive credit agreement on or prior to the Escrow Funding Date. Such credit agreement will include the agreed mechanics for the escrow funding, as well as the specific terms governing the TLB during the escrow period (which terms will include customary negative covenants and events of default with respect to the Escrow Borrower). In contrast, where the TLB is issued by an "unrestricted" subsidiary of the Buyer that is not subject to the Existing Debt of the Buyer (but that will later become subject to such Existing Debt via merger with and into the Buyer), the terms of the escrowed TLB may be evidenced pursuant to a short-form credit agreement or promissory note (the "Short Form Credit Documentation").

In utilising this latter approach, it is important to note that such Short Form Credit Documentation does not typically include the customary covenants and events of default found in a fully negotiated credit agreement. Nevertheless, TLB lenders have generally become comfortable with such lack of detailed and specific covenants and events of default on the basis that the Escrow Borrower is, during the escrow period, simply a shell entity with no operations, assets or liabilities other than the escrowed funds. As such, so long as (i) the Escrow Borrower agrees to be subject to a customary "HoldCo" negative covenant prohibiting it from engaging in any activity other than performing its obligations under the escrow agreement and incidental activities, and (ii) the TLB proceeds are held in the escrow account pursuant to the escrow agreement, TLB lenders are adequately protected. Still, certain lenders have sought to have the Escrow Borrower become subject to some (if not all) of the covenants under the Existing Debt of the Buyer by incorporating such covenants into the Short Form Credit Documentation.

Whether the escrowed loans are evidenced by a credit agreement or pursuant to Short Form Credit Documentation, the conditions to escrow release should be identical to the conditions to funding the TLB directly to the borrower set forth in the commitment letter. The one notable exception is that, in the escrow context, the escrow agent will require a certification that the conditions to the release of the escrowed TLB to the borrower have been satisfied. To ensure lender control over the escrow release process, while such certification is in addition to what is required for customary "SunGard" limited conditionality, borrowers generally accept that this incremental conditionality is necessary to effect the escrow construct.

TLB Commitment Termination

Just as commitments under a credit facility terminate upon the funding of the TLB to the borrower, committing lenders in the escrow context likewise seek to ensure that their commitments to the borrower under a commitment letter terminate upon the funding of the TLB into escrow. If the TLB Commitments do not terminate upon escrow funding, the initial committing lenders will effectively have double exposure (and potentially be required to maintain excess regulatory capital) as the TLB has been funded into escrow (including by such lenders) but the initial committing lenders remain committed to fund the TLB on the Closing Date if the escrowed proceeds are for any reason unavailable to the Buyer. In contrast, Buyers in the escrow context may argue that the TLB commitments of the committing lenders should remain outstanding until the TLB proceeds are released from escrow to the Buyer. Such argument is based on the fact that the Buyer has contracted with the committing lenders for the TLB to be available to consummate the acquisition on the Closing Date and any risk around the escrow structure should be borne solely by the initial lenders. As a contractual matter, the best way for lenders to protect themselves against this "double counting" risk is to specify in the commitment letter that the TLB commitments thereunder are reduced on a dollar-for-dollar basis by the principal amount of the TLB funded into escrow. While many commitment letters are silent on this issue, Buyers have, where pushed, generally accepted such reduction language so long as the commitment letters also specify that the conditions to the release of TLB proceeds from the escrow account are identical to (or no more onerous than) the conditions precedent to the funding obligations of the TLB lenders under the commitment letters on the Closing Date. Buyers have, in most cases, been successful in resisting any incremental conditionality in the escrow context (with the one ministerial exception of certification to the escrow agent noted above).

Bankruptcy Considerations

While, as noted above, both Buyers and lenders benefit from the use of escrow fundings in the TLB context, such escrow arrangements do introduce additional risk to the committed acquisition financing arising from the Escrow Borrower's or even the escrow agent's potential filing of a Chapter 11 bankruptcy case.

In the event of a bankruptcy filing by the escrow agent, both the Escrow Borrower and lenders will seek to ensure that the TLB escrow structure remains in place. Under a valid escrow arrangement, upon deposit of funds into an escrow account, (i) legal title to the escrow remains with the grantor (here, the lenders) until the satisfaction of the release conditions specified in the escrow agreement, and (ii) the grantee (here, the Escrow Borrower) has only an equitable interest in the escrow arrangements, obtaining legal title only upon satisfaction of such conditions precedent.[7] Because, in such a valid escrow arrangement, the escrow agent does not hold a legal or equitable interest in the escrowed funds, such funds are not considered property of the escrow agent's bankruptcy estate[8] and, upon court order, should be released to the Escrow Borrower (upon satisfaction of the escrow release conditions) or returned to the lenders upon escrow termination.

In the event of a bankruptcy filing by the Escrow Borrower, the TLB lenders may seek to argue that the TLB proceeds never constituted property of the Escrow Borrower – that they remained property of the lenders subject to the escrow arrangements – and, as such, the escrow agent should immediately and directly return such proceeds to the lenders. Such a result would be extremely advantageous to lenders as they would receive a timely repayment of the TLB in full without having to navigate the lengthy and often contentious Chapter 11 process (as would be the case without an escrow arrangement, even for a creditor fully secured by cash). A potential challenge to such an argument is that a "valid" escrow arrangement for purposes of the bankruptcy code is one in which the proceeds are held in a "neutral" account in the name of an escrow agent (similar to an attorney's escrow account in the residential real estate context). In TLB fundings, in contrast, the escrow account is generally opened by the escrow agent in the name of the Escrow Borrower and subject to investment at its direction. While there is no direct case law on point, it is unclear whether a bankruptcy court would deem such arrangement to be a valid escrow arrangement or recharacterise this as a classic financing secured by a pledge of the Escrow Borrower's deposit account at the escrow agent.

Conclusion

Given that funding a TLB into escrow is a useful way for committing lenders to practically (or, ideally, contractually) reduce exposure with respect to long-dated commitments with little added risk for Buyers, we expect to see more committing lenders asking for escrow demand features to help defray or reduce their exposures. With the increasing frequency of TLB escrow arrangements, we can also expect further consensus among market participants on how to address the issues discussed in this article, including creative solutions addressing potential conflicts with existing debt documents – we have already begun to see the beginnings of a trend in credit documentation of including express provisions permitting future escrow arrangements – and final resolution of whether TLB commitments terminate upon escrow funding.

Endnotes

1. Note that some borrowers may seek to have the ticking fee begin to accrue only following allocation of all of the commitments (or following 30–60 days after allocation of all of the commitments). While less common, some lenders have addressed this request by (i) having the ticking fee begin to accrue upon the earlier of (x) the date on which all of the TLB commitments have been allocated to the market, and (y) an outside date, or (ii) allowing the ticking fee to accrue only on the allocated portion of the TLB commitments.

2. Note that in certain transactions, ticking fees, similar to commitment and upfront fees, are payable by the borrower solely to the extent the Closing Date occurs (or the TLB are funded into escrow).
3. Another, less common, approach is to permit the borrower to provide other satisfactory credit support for future interest payments (including, for example, equity commitment letters from a related private equity sponsor).
4. We assume for the purposes of this article that, as is often the case, the Existing Debt may not be amended to expressly permit the escrow funding.
5. Note that even where the Buyer has sufficient capacity under the debt and lien negative covenants of the Existing Debt to incur the escrowed loans and pledge the escrow account, there may be other limitations on entry into the escrow funding (e.g., if the Buyer is seeking to use "incremental" debt capacity to incur the escrowed loans, the customary requirement that incremental loans not be secured by any collateral that does not secure the Existing Debt would be violated by this structure).
6. The creation and designation of a subsidiary as "unrestricted" under Existing Debt may be subject to various conditions. Where there is no capacity under such Existing Debt to designate an "unrestricted subsidiary" for this purpose, a less common, but equally effective solution may be to use a sister company or other affiliate of the Buyer that is likewise outside the scope of the "restricted group", which upon closing similarly merges with and into the Buyer.
7. *See* In re TTS, Inc., 158 B.R. at 585–88. *See also* 28 Am. Jur. 2d *Escrow* § 18 (2007).
8. In re Dreier LLP, 527 B.R. 126, 132 (S.D.N.Y. 2014).

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