CAPITAL MARKETS
DEBT AND LENDING

Rethinking bridge loan facilities

New participants and challenging markets test the existing model

What is a bridge loan facility, and what purpose does it serve?

Bridge loan commitments address a gap between two competing goals in an acquisition financing. Borrowers often seek to issue long-term, fixed-rate debt securities as part of the post-acquisition capital structure, the final terms of which are generally not set until the securities are formally marketed to investors.

But they also require "certainty of funds" when signing an acquisition (well in advance of any such marketing) to ensure they meet customary requirements and standards. One solution would be for financial institutions or other investors to commit to purchase an agreed principal amount of securities at closing at an agreed price (and on agreed terms), subject to customary (limited) conditions precedent.

But for regulatory, capital and liability reasons, financial institutions (and many other investors) will generally not provide such "forward purchase" commitments. Instead this gap is commonly addressed through a committed bridge loan facility, which is an agreement to fund a short-term extendable loan at closing upon satisfaction of customary (limited) conditions, to the extent that the intended long-term securities have not then been issued.

Bridge loans are structured to incentivize the issuance of the intended securities at closing in lieu of funding the bridge (*e.g.* by charging a "funding" fee solely if the bridge is actually funded) or, if the bridge is funded, to encourage the prompt refinancing of the bridge (*e.g.* by providing for interest rates that increase with the passage of time and tighter operating covenants during the bridge period). Bridge lenders are also separately granted the right to "demand" securities at or after closing to replace or refinance the bridge facility.

What is a securities demand?

A securities demand is the right of one or more bridge loan arrangers (typically exercised by a "majority in interest") to "demand" that the borrower issue debt securities (the "demand securities") in place of (at closing) or to refinance (post-closing) the bridge facility. The fundamental terms of the securities which may be demanded are carefully negotiated, and include a maximum yield (or "total cap"), minimum issue price, minimum maturity, maximum call protection and covenant parameters (which may include a specified indenture precedent). Importantly, bridge facility arrangers typically have the right to demand the issuance of such demand securities on the closing date in lieu of funding the bridge loans. This is a change from pre-2008 bridges, which commonly provided borrowers with a "post-closing holiday" before a securities demand could be issued.

The securities demand right serves two primary functions. First, it provides the bridge arrangers with a mechanism to discourage market timing by the borrower. They can demand the borrower "go to market" at a time the high-yield bond market is "open" but may not be as favorable as the borrower would like. Second, it lets the bridge arrangers demand that the borrower issue securities to the applicable arrangers (or their underwriting affiliates) at the agreed maximum yield, even if the high-yield bond market is "closed", which the arrangers may then distribute as securities markets improve.

It is a common misconception that a securities demand right empowers bridge arrangers to force the borrower to issue securities. In fact, borrowers may refuse to (or be unable to) issue securities, even when a valid demand is exercised. That refusal or inability would constitute a "demand failure event" and trigger specified economic consequences to the borrower.

The customary economic consequences of a "demand failure" by a borrower are limited to amending the bridge loans to increase the interest rate to a fixed rate equal to the "total cap" (*i.e.* the maximum yield the bridge arrangers are permitted to demand), add bond-style ("no-call") call protection, remove borrower consent rights to assignments and require the borrower to pay a "conversion fee" (typically equal to the agreed underwriting fee that would have been payable were the demand securities to have been issued). In other words, certain fundamental features of the bridge facility are adjusted to replicate more closely the corresponding terms of the demand securities had they been issued. However, the demand failure will not result in an event of default or relieve the bridge arrangers (or their lending affiliates) of their obligation to fund the bridge loan at closing.

How effective are securities demands?

The issuance of a securities demand is also subject to conditions which may undermine the effectiveness of the demand from the arrangers' perspective. For example, most securities demand provisions are conditioned on the borrower first having had an opportunity to participate in a customary roadshow with respect to the demand securities, unless the borrower determines a roadshow would be commercially futile. Where the market for high yield bonds is closed, the borrower's ability to require such a marketing process – even in the face of the arrangers' advice that there is no market for the securities – and its control of the financial information necessary to conduct such a roadshow, can frustrate the timely exercise of the securities demand.

Moreover, when a securities demand is made, it is typically the intention of the arrangers to distribute the demand securities to third-party investors. In a functioning market, the offering memorandum and related financial information delivered prior to closing permits the issued securities to be immediately sold to third-party investors at closing. However, where there is insufficient third-party demand for the demand securities, the arrangers (or their broker dealer affiliates) may hold the securities on balance sheet, with the intention to sell them in the future. Such a subsequent sale will, in most cases, constitute an underwriting and require the borrower to, among other things, deliver an updated offering memorandum and historical and pro forma financial information, to cooperate in the arrangers bringing down due diligence and cause its auditors to deliver comfort letters – all of which require the cooperation of the borrower.

Securities demand provisions historically contained detailed post-closing cooperation covenants addressing this very issue. In more recent transactions, however, such cooperation obligations (if any) tend to be formulated at a high level, and do not cover all the information and assistance which would be required for a post-closing securities distribution. Even where such cooperation language is included, the sole consequences of a failure by the borrower to comply is often limited to the occurrence of a demand failure event. In circumstances in which either the demand securities have already been issued to replace the bridge (so there is no bridge for the demand failure consequences to attach to) or the bridge was funded following a demand failure (so the demand failure consequences have already attached to the bridge), the demand failure remedies are entirely illusory.

Another important limitation on the exercise of the securities demand is the tax-related exception. The demand provisions often excuse a borrower from complying with a *post-closing* securities demand if it determines (often at its sole discretion) that such issuance may result in adverse tax consequences to the borrower or its affiliates. The "adverse tax consequence" contemplated here is cancellation of debt income (CODI). CODI may arise when the bridge loan is, or is deemed to be, prepaid at price below its tax issue price, as could be the case if a bridge loan made at par is deemed to have been exchanged for demand securities issued at a discount to par.

The CODI rules are quite complex, and views differ on whether a typical securities demand issuance will trigger CODI. Formulations that give the issuer the discretion to make this determination, however, serve to further weaken the efficacy of arrangers' post-closing demand rights. It is worth noting that in the past, this tax exception was subject to a 30-90-day sunset period, after which securities demands were permitted to proceed regardless of the tax consequences to the borrower. That sunset has been absent in more recent bridge financings.

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The arrangers' perspective: choosing between demand securities and bridge loans

The prevailing wisdom since the 2008 crisis has been that financial institutions, given the choice, would always prefer to purchase securities at closing rather than fund the bridge loan, even if it means taking those securities onto their own balance sheets. But recently, institutions have questioned (and in some cases upended) those expectations.

They've been electing, in consultation with the borrower, to fund the bridge loan rather than demand and purchase securities. Factors they'll weigh when making this determination include:

- **Liquidity:** The high-yield bond market has historically been thought to be more liquid than the (bridge) loan market, and therefore securities have been easier to distribute than bridge loans. The growth in the syndicated loan market and the increased appetite and flexibility of private credit lenders have challenged this proposition. More importantly, as described above, post-closing distribution of securities by underwriters requires issuer cooperation -- including the production of an offering memorandum, updated financial information, diligence and auditor comfort. In circumstances where the issuer is unable or unwilling to provide prompt cooperation when a market opportunity presents itself, the underwriters will be unable to effect a distribution, so the expected liquidity may be limited. In contrast, the lower amount of cooperation and information required from the borrower to syndicate loans is less likely to be a roadblock.

-**Flexibility:** Where there is insufficient market for an issuer's securities and it is unclear what the most efficient permanent capital structure will be, funding a bridge loan (without "call protection") may offer all parties greater and lower cost flexibility (*e.g.* to pursue a term loan B refinancing or other structured solution) than issuing call-protected securities.

- **Limits on post-closing demand rights:** If arrangers are concerned about the ability to effectively exercise demand rights after closing, they may feel compelled to issue a securities demand at closing, at which time certain demand conditions will either not apply (*e.g.* the adverse tax consequences condition) or will already have been satisfied (*e.g.* delivery of offering memoranda and related financial information).

- **Underwriter group dynamics:** While the decision to issue a securities demand is typically controlled by a bridge arranger majority, it is important to note that no individual arranger can be forced to participate in the purchase of those securities. Some arrangers – particularly private credit and other non-traditional bridge parties – prefer loans, because of internal structure or investment policy, the higher cost of holding securities (rather than loans) and internal accounting policies that may produce different results depending on the instrument and the entity acquiring it. Even arrangers willing to take securities in a demand cannot be forced to participate in the distribution of the securities in accordance with the majority arranger's expectations. Where some underwriters propose to hold – rather than distribute – the securities, that may need to be disclosed, and may result in market "overhang" (as the market anticipates additional supply becoming available just as prices recover). Such differing views within the arranger group as to whether to hold or sell securities will influence the majority arrangers' decision over pursuing a securities demand.

- **Economics:** Funded bridge loans accrue interest at a floating rate equal to SOFR plus an agreed margin, which increases by 50 basis points every 90 days until the rate hits the total cap. If arrangers issue a securities demand and there is a demand failure event, the interest rate on the bridge will immediately increase to a fixed rate equal to the total cap. Securities, on the other hand, will have fixed rate of interest, and in a distressed market, that rate may be up to the total cap. This creates an incentive for the arrangers to issue a securities demand so that, one way or another, they are holding an instrument accruing interest at the total cap. As demonstrated in several recent transactions, however, in a rising rate environment, it is possible that, due to an increase in SOFR or another market dislocation, the bridge loan may at closing already be accruing interest at or near the total cap. In that case, at least from a yield perspective, arrangers may be indifferent toward the choice between funding the bridge or purchasing securities. If the yield outcome is neutral, the arrangers may be motivated to fund the bridge loan (and receive the corresponding funding fee, which could be used to offset losses) rather than securities (which do not attract a similar fee).

- **Borrower dynamics:** Arrangers demanding securities in the face of a borrower's reluctance or inability to issue them may create friction in the ongoing business relationship with the borrower (and related sponsor, if applicable). It is also often the case that the arrangers rely on the borrower to provide accommodations or other concessions that go beyond the strict terms of the financing commitment in order to syndicate the overall financing package (or at least mitigate losses). Issuing a securities demand contrary to the wishes of a borrower may dampen its enthusiasm for such cooperation.

Where does this leave us?

Modern bridge financings have been predicated on two underlying assumptions: that arrangers always prefer to hold securities at closing, and that they can force (or effectively incentivize) borrowers to issue securities at closing through securities demand rights. Recent experience has challenged both these assumptions. The lessons for arrangers of a bridge facility are (at least) twofold. First, demands of securities and demand failure remedies should be closely scrutinized to ensure they properly balance the competing interests of the borrower and the arrangers, and that the rights and remedies of each party are fully understood.

This may include revisiting (and limiting) some of the conditions to the securities demand, expanding demand rights to include loan demands (with less onerous disclosure requirements) and reassessing and, where appropriate, reinforcing demand failure consequences. Second, as bridge facilities are more likely to be (involuntarily) funded in a distressed market, more attention may need to be paid to the terms of the bridge facility itself, such as including more specificity as to the more restrictive covenants that apply during the bridge period and ensuring bridge pricing (and its intended incentives) properly reflects the expectation of the parties, particularly in a rising interest rate environment.

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