MANDATORY PREPAYMENTS

General

A credit agreement often requires mandatory prepayment of outstanding loans. In a typical non-investment grade secured credit, three general types of events might trigger loan repayment: asset dispositions, capital raising activities and receipt of excess cash flow. Asset dispositions include both voluntary sale transactions and involuntary casualty events. Capital raising activities include both debt issuance and equity issuance. Lenders compute excess cash flow repayment amounts by converting the accrual based accounting concept of "income" earned in a period as reported in a borrower's financial statements into an amount representing cash on hand available to repay debt in that same period. In general, this requires that the borrower add-back non-cash charges and deductions used to compute income in order to determine the prepayment amount. Examples of such non-cash charges include depreciation and amortization.

Lenders might require that borrowers apply 100% of the proceeds or excess cash flow received, or some lesser percentage, such as 75% or 50%. This is a matter left for negotiation.

Net Payments

In the case of asset dispositions and capital raising activities, lenders require repayment of an amount equal to the "net" amount received by the borrower, after expenses associated with the event. In the case of a voluntary asset sale, lenders compute the amount "net" of the selling expenses. The treatment of taxes payable in connection with gains on an asset disposition often is negotiated and the outcome may depend on the tax posture of the borrower. The possible deduction for taxes is discussed as a separate topic below. In the case of a casualty event, lenders compute the amount received from insurance as "net" of the cost of repair or replacement—provided, that is, that the borrower applies the proceeds of insurance relatively promptly to the repair or replacement. (Tax issues may arise in the case of casualty losses as well, though often these issues are completely ignored in negotiations and drafting.) In the case of a capital raising event, lenders require repayment of an amount equal to the "net" proceeds received from the debt or equity issuance, deducting such items as commitment and underwriting fees.

Excluded Asset Dispositions

Borrowers take care to exclude certain assets sales from the reach of the prepayment obligation. First, in a long term facility, it makes no sense for the borrower to apply proceeds received from the ordinary course of business sale of inventory to repayments of loans. The borrower needs proceeds received from the sale of inventory to reinvest in new inventory and to pay its other costs and expenses. Think of the retailer who buys a jacket for $60 at wholesale and sells the jacket for $100 at retail. The retailer uses $60 to purchase a new article of inventory and uses the $40 received in gross margin to pay its

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rent, salaries and other expenses. Second, the borrower might use proceeds received from the sale of worn-out or obsolete equipment to purchase new equipment. Or, the borrower simply might trade-in older equipment for new equipment, receiving a credit upon a trade-in to a dealer or cash upon a sale to another third party. These types of dispositions typically do not trigger a repayment obligation. At least, if the parties discussed the matter, they would agree that these disposition transactions fall outside the intended scope of any mandatory prepayment provision. A third, more negotiated, situation arises with the sale of permitted investments in a borrower's ongoing trading activities. At one end of the spectrum might be the sale of a cash equivalent investment, converting it to actual cash. Typically, this would not trigger a prepayment obligation. However, borrowers may hold minority investments in a portfolio of companies. Often, these investments were acquired as extra or "kicker" consideration from past asset sales. If the asset sale was completed during the life of the credit agreement, then, when the equity is converted to cash, that cash typically would be treated as net cash proceeds received from an asset sale and subject to prepayment. If, however, the borrower acquired a portfolio of minority interests in companies prior to the execution of the credit agreement, often it is not clear how to treat proceeds received from trading activities in these investments. An asset sale prepayment clause should clearly address proceeds received from such trading activities if the borrower engages in them.

Excluded Capital Raising

Borrowers also take care to exclude certain capital raising activities from the reach of the prepayment obligation. Often other existing debt obligations mature prior to the maturity date of loans under a credit facility. Borrowers often receive permission to refinance such maturing debt on substantially the same terms as the debt being refinanced. Lenders exclude such a "permitted refinancing" from the scope of the prepayment obligation, allowing the new capital raised by the borrower to replace the maturing capital. Less common would be permission to retire preferred equity interests that might have a redemption date prior to the expiration of a credit facility. However, if preferred equity interests have scheduled redemption or "maturity" dates prior to the maturity date of the credit facility, the parties should agree expressly on the intended treatment of these equity interests. A related question arises if the borrower has outstanding obligations that require sinking fund or similar payments.

Excess Cash Flow

Even though lenders require that borrowers build up their reported net income amounts by adding back non-cash charges in order to compute "excess cash flow," borrowers also take care to deduct from this calculation required expenditures that do not reduce net income. Examples include the scheduled repayment of principal and permitted capital expenditures. Other candidates for exclusion might include amounts posted as bond or security under various contracts. To win a construction job or to commission construction of an asset, a borrower might need to make a deposit. Similarly, if a borrower has entered into a derivatives transaction, the borrower might need to post collateral from time to time to cover market moves, particularly if the borrower's

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derivative position is out of the money. Any of these uses of cash reduces the amount of cash available to repay loans but the usage would not reduce the net income of the borrower. To avoid rendering the borrower so cash poor that the borrower is unable to meet its obligations and run its business, lenders allow borrowers to negotiate for deductions in the computation of "excess cash flow" so that they can make these necessary payments.

As in the case of asset sale prepayments, a tax issue lurks in the definition of excess cash flow. In brief, the typical definition of excess cash flow starts with the concept of "net income" taken from the borrower's accrual based financial statements. Net income is computed, in part, by making a deduction for taxes attributable to the activity during the period. However, not all of the taxes deducted during the period in arriving at net income for financial accounting purposes were, in fact, paid either during the period or on April 15 of the following year. In fact, the payment of some accrued taxes may be indefinitely postponed. Thus, the question for any definition of "excess cash flow" is whether and to what extent the reality of deferred taxes from a financial accounting standpoint should be corrected for as part of the contract negotiation in which an accrual based determination of net income is converted by formula into a measure of the cash available to the borrower for loan repayment. In fact, lenders and borrowers often deal in mere approximations—with those negotiating the provisions only dimly aware of the complex issues lurking behind a few simple words in a definition or family of definitions in a loan agreement. Some of these complexities are hinted at in the discussion of "Taxes Payable" below.

Taxes Payable

If a borrower has unused NOL carryforwards available in the period in which an asset is sold that generates a gain, my understanding is that the NOL may be used so that the borrower does not, in fact, pay any tax out-of-pocket in respect of the gain on the sale. That is to say, the borrower does not make a cash tax payment to the IRS for the realized gain on the sale. Further, it is my understanding that, having used the NOL, the borrower will never be asked to make a cash payment to the IRS in the future in respect of the sale. Thus, if a borrower has available and unused NOLs, allowing a deduction for taxes payable in respect of the sale may leave the borrower with cash burning a hole in the borrower's pocket, so to speak. The reason is that a tax is payable in respect of the sale—it is just that application of the NOL reduces taxable income for the period so that no tax is paid in cash. A similar problem can arise if the borrower has capital loss carryforwards available to offset a capital gain on an asset sale. The problem further is compounded because of the corporate AMT (or alternative minimum tax). NOLs may be used to offset 90% of the corporate AMT and, NOLs are computed and tracked somewhat differently depending on whether they are used to reduce taxable income or AMT. Thus, a fair amount of calculation and assumption is needed if a lender wants to give a borrower credit for cash taxes actually paid in respect of particular transaction.

The large message here is that period based accounting (whether financial or tax) often does not mesh well with assessment of the impact of a transaction occurring at a point in

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time. The small message here is that lenders need to consider the tax posture of their borrowers before automatically agreeing to a deduction for taxes payable in respect of asset sales when computing the "net proceeds" realized from the asset sale. One can imagine a host of other issues of tracing, one example being a transaction in which some asset sales trigger prepayments while others do not. What if a loss is generated on the exempt asset sales and a gain is generated on an asset sale that requires prepayment of proceeds (or vice versa). For now, it is sufficient to recognize the issues. The problem is compounded by the fact that asset sales take place in the middle of periods and the tax posture of the borrower for the period will be determined only after this period is completed.

[**FOR THE TAX LLM's IN THE CLASS**: Prior to the second class you should write up a short note for the rest of the class explaining the current treatment of NOL's and AMT as they might impact the computation of net proceeds if a provision for taxes is allowed. See also the Tax LLM note below.]

There is a further secured transactions issue lurking in this last comment. Often, a borrower will want to hold back some amount for taxes that might be payable. After all, the borrower typically closes the transaction in the middle of a period and the results of operations for the period will not be known until after the period is closed. If the loan is a secured transaction, the proceeds received by the borrower will constitute proceeds of collateral in which the lenders have a continuing security interest. The security interest continues, however, only in "identifiable" proceeds.

There is no good solution here. The borrower likely will want to employ the proceeds received in the business (at least the retained, reserved portion of the proceeds) until the extent of tax is determined and the tax bill actually paid. This continuation of security interest may not happen unless the lenders require that the borrower segregate the asset sale proceeds in a separate account to maintain the identifiability of the proceeds.

If the asset sale proceeds are segregated in a separate account, the borrower will not have the use of the funds and, likely, will experience a negative spread between its own costs of funds with the lenders and the investment income it earns on the investment of the amounts deposited in the separate account. In some sense, the borrower might as well prepay the lenders. However, if the borrower does prepay the lenders and a tax is payable later in cash, the borrower may not have access to funds to pay the tax bill for several reasons. Typically, the prepayment of a loan is permanent. And, the borrower may not have unused capacity under its revolving credit lines. Further, the borrower can not be sure that it will satisfy its conditions to borrowing to access funds through the revolveing credit lines when a cash tax payment must be made. The alternative of giving the borrower discretion with the funds leaves the lenders at the risk of not fully realizing value from collateral. Beyond technical aspects of security interest law, the borrower simply may spend the funds and not generate enough income to replace the funds spent.

In addition to the carryforward of NOLs, a borrower may carryback NOLs to a prior period. If the borrower carrys NOLs back to a prior period, the borrower may be entitled

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to a tax refund for taxes paid in the prior period. The question arises as to how to treat such a receipt. In the draft language appearing below, the receipt of a tax refund is treated as an "extraordinary receipt" and would constitute net cash proceeds, triggering a required prepayment.

[**FOR THE TAX LLM's IN THE CLASS**: Prior to the second class you should add to your write up a short note for the rest of the class explaining the current treatment of carryback NOL's as they might impact the computation of net proceeds if a provision for taxes is allowed.]

Sample Defined Terms **(Included for teaching purposes only—not a precedent to be used for actual transactions)**

"**Net Cash Proceeds**" means, with respect to any person, the aggregate amount of cash or cash equivalents received from time to time (whether as initial consideration or through the payment or disposition of deferred consideration) by, on behalf of, or for the account or benefit of such person from any of the following transaction types: (i) any sale, lease, transfer or other disposition of any asset of any type in which such person has rights or the power to transfer rights (including, without limitation, transfers or dispositions of limited interests in assets) but excluding sales of inventory in the ordinary course of business, (ii) the incurrence of any debt or issuance of any debenture, guarantee, instrument, note or similar evidence of indebtedness or obligation, (iii) the sale or issuance of any equity interests, or receipt of any capital contributions (including, without limitation, the receipt of any capital contribution whether or not accompanied by issuance of shares or other evidence of ownership interest) or (iv) any extraordinary receipt, in each case of (i) through (iv) above, received by or paid to or for the account or benefit of such person, computed after deducting therefrom (without duplication) only the following amounts:

(a) reasonable and customary: brokerage commissions, finder's fees, investment banking fees, legal fees (including the allocated cost of in-house counsel), underwriting fees and discounts, and other similar fees and commissions (in each case, including, without limitation, reimbursement of out-of-pocket expenses and payment of charges and disbursements to the service provider) payable (or, in the case of in-house counsel, allocable if not payable) by such person;
(b) the amount of taxes payable by such person in connection with or as a result of such transaction;
(c) the amount of any debt secured by any charge, encumbrance or lien on such asset that, by the terms of the agreement or instrument governing such debt, is required to be repaid upon such sale, lease, transfer or other disposition (whether or not such debt is recourse to such person) payable by such person or from the proceeds of such sale, lease, transfer or other disposition;
(d) in the case of any sale, lease, transfer or other disposition of any asset, the amount required to be reserved, in accordance with generally accepted accounting principles as in effect on the date on which the computation is performed (and that

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is so reserved), against liabilities under indemnification obligations, pension and other post-employment benefit liabilities or other similar contingent liabilities related to the asset subject to such sale, lease, transfer or other disposition that are required to be paid or provided for under the terms of the documentation for such sale, lease, transfer or other disposition; and

(e) proceeds of debt or equity applied in a permitted refinancing;

in each case of (a) through (e) above, to the extent, but only to the extent, that the amounts so deducted are properly attributable to such transaction or the asset that is the subject of such transaction and (1) in the case of clauses (a), (c) and (e) actually are paid in cash (or, in the case of in-house counsel, allocated) substantially contemporaneously with the receipt of cash or cash equivalents to a party who is not an affiliate of such person (except in the case of an allocation for in-house counsel, an allocation may be made or paid to an affiliate) and (2) in the case of clauses (b) and (d), either (A) actually are paid in cash substantially contemporaneously with the receipt of cash or cash equivalents to a party who is not an affiliate of such person or (B) so long as such person is not otherwise indemnified therefor by a non-affiliate, are reserved for in accordance with generally accepted accounting principles at the time of the receipt of cash or cash equivalents based upon a reasonable estimate of the taxes or contingent liabilities expected to be payable, as certified by the chief financial officer or treasurer of such person; *provided, however,* that if at the time such taxes or contingent liabilities actually are paid or satisfied (or if the reserve estimate is thereafter revised downward prior to payment or satisfaction), the amount of the reserve exceeds the amount paid or satisfied in cash (or is less than the amount previously reserved), then the amount of the excess shall constitute Net Cash Proceeds received by such person as of the date of such cash payment or satisfaction (or downward revision).

For purposes of the foregoing, "**extraordinary receipt**" means any cash received by or paid to, or for the account or benefit of, any person not in the ordinary course of business, including, without limitation, early termination of derivatives transactions, tax refunds, pension plan reversions, proceeds of insurance (including, without limitation, key man life insurance but excluding proceeds of business interruption insurance to the extent such proceeds constitute compensation for lost earnings), condemnation awards (and payments in lieu thereof), indemnity payments and any purchase price adjustment received in connection with any purchase agreement; *provided, however,* that an extraordinary receipt shall not include cash receipts received from the sale of obsolete equipment, proceeds of insurance, condemnation awards (or payments in lieu thereof) or indemnity payments to the extent that such receipts, proceeds, awards or payments (A) in respect of replacement, loss or damage to equipment, fixed assets or real property are applied (or in respect of which expenditures were previously made) to replace or repair the equipment, fixed assets or real property (so long as the person has, within 12 months after an event giving rise to a loss entered into a binding contract for repair or replacement, with a closing or application of such proceeds within 6 months thereafter) or (B) are received by such person in respect of any third party claim against such person and applied to pay (or to reimburse such person for its prior payment of) such claim and its costs and expenses related thereto.

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"**Excess Cash Flow**" means, for any period (without duplication), for the borrower: (a) the sum of (i) consolidated net income (or loss) of the borrower for such period, (ii) the aggregate amount of depreciation, amortization and all other non-cash charges deducted in arriving at such consolidated net income (or loss), and (iii) the amount, if any, by which Net Working Capital decreased, minus (b) the sum of (iv) the aggregate amount of all non-cash credits included in arriving at consolidated net income (or loss) of the borrower for such period, (v) the amount, if any, by which Net Working Capital increased, (vi) the aggregate amount of permitted capital expenditures paid in cash by the borrower and its consolidated subsidiaries (except to the extent financed by incurring obligations under capital leases, long-term debt incurrence or application of Net Cash Proceeds), (vii) the aggregate amount of cash consideration paid by the borrower and its consolidated subsidiaries to make acquisitions and other capital investments (except to the extent financed by long-term debt incurrence or application of Net Cash Proceeds), (viii) the aggregate amount of all regularly scheduled principal payments of funded debt made during such period, (ix) repayment of term loans under this Credit Agreement and (x) repayment of revolving loans under this Credit Agreement to the extent accompanied by a permanent commitment reduction.

"**Net Working Capital**" means, at any date: (a) the consolidated current assets of the borrower as of such date (excluding cash and cash equivalents) minus (b) the consolidated current liabilities of the borrower as of such date (excluding current liabilities in respect of debt).

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