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Pro Rata Sharing Provisions in Credit Agreements: What Lenders and Loan Investors Need to Know

By Nicholas A. Whitney and Marina Zelinsky

Recently, the amendment to NYDJ Apparel, LLC’s, credit agreement put pro rata sharing to the forefront and highlighted what a loan investor needs to look out for when reviewing the sacred right protections related to pro rata sharing. The authors of this article discuss credit agreements and pro rata sharing provisions.

One of the most fundamental provisions in a credit agreement is the concept that amendments of each lender’s “sacred rights” cannot be effected by a simple majority vote of the lenders, but rather, such amendments require the consent of each lender affected by such amendment. “Sacred rights” include reductions in principal amounts and/or interest rates, reductions in amortization and extensions of the maturity date. Sometimes, a credit agreement may include as a sacred right changes to provisions which require lenders to share payments made by the loan parties on a pro rata basis. While most of these sacred rights are self-explanatory, a question has arisen as to what it means to amend the “pro rata” sharing requirements. Recently, the amendment to NYDJ Apparel, LLC’s credit agreement put pro rata sharing to the forefront and highlighted what a loan investor needs to look out for when reviewing the sacred right protections related to pro rata sharing.

REQUIRED CONSENT—WHO AND WHEN?

Absent an exception requiring unanimous or affected lender consent, amendments to credit agreements require the consent of lenders holding a simple majority of the outstanding loans and unused commitments (typically referred to as “Required Lenders” or “Majority Lenders”). This construct is needed because borrowers require the flexibility to amend loan documents without having to coalesce their entire lender group. While all amendments

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may be important (for example, amendments to the negative covenant baskets),
the market acceptance has long been that the simple majority can drag along
the minority lenders unless the amendment involves a sacred right.

As noted above, amendments to “sacred rights” are excepted from the simple
majority rule and require that all lenders or, in some cases, those lenders that are
adversely affected by the proposed amendment, must provide their consent.
Sometimes included within the sacred rights is an amendment to the definition
of “Pro Rata Share” and all provisions related thereto. The pro rata sharing
provisions require that any payment received by a lender from a loan party on
any particular tranche is paid ratably to each lender of that tranche in
accordance with each lender’s percentage of holdings of that tranche. Pro rata
sharing has been included as a sacred right to prevent one lender from receiving
a greater benefit than another, similarly-situated lender. While many lenders
may expect that changes to pro rata sharing provisions cannot be made without
its consent, recently there has been a shift away from this protection.
Consequently, the exceptions from the simple majority vote regarding amend-
ments to pro rata sharing provisions are either left out entirely or materially
weakened. In some cases, only a majority of the lenders adversely affected by an
amendment to the pro rata sharing provisions are required to consent to a
change to the pro rata sharing provisions. The specific language matters and, in
certain cases, the exception to the general majority rule will not provide
sufficient protection to minority lenders.

**NYDJ AMENDMENT**

Recently, NYDJ Apparel, LLC (“NYDJ” or the “Company”) and two of its
lenders holding a majority of the outstanding term loans (collectively, the
“Majority Lenders”) under NYDJ’s Term Loan Credit Agreement (the “Credit
Agreement”) negotiated an amendment to the Company’s Credit Agreement
(the “Amendment”), for the purpose of amending a potential covenant and
refinancing the Majority Lenders’ loans with a new “first-out” term loan. In
order to effectuate the Amendment, the Company and the Majority Lenders
relied on the amendment provisions in the Credit Agreement which only
required Majority Lenders to amend the pro rata sharing and repayment
provisions of the Credit Agreement.

Prior to the Amendment, the Credit Agreement had outstanding a single pari
passu tranche of $150 million term loans (the “Original Term Loans”). In a deal
reached with the Company to stave off a near term covenant default, the
Majority Lenders agreed to provide a new $20 million add-on term loan so long
as the new term loan provided for a first-out repayment, prior to the repayment
of any of the Original Term Loans. The Company and the Majority Lenders
also agreed that the proceeds of the new $20 million term loan would be used to (a) repurchase the minority lenders’ Original Term Loans for a price no greater than 60 cents on the dollar and (b) any proceeds not used to repurchase the Original Term Loans after 180 days, would be used for working capital purposes. In addition, the amendment provided that the repayment of the Original Term Loans would be effectively split, with the Majority Lenders’ Original Term Loans being placed in a second-out position and the minority lenders’ Original Term Loans being placed in a third-out position. By subordinating the Original Term Loans of the minority lenders to a payment position behind the Original Term Loans of the Majority Lenders, the Majority Lenders effectively amended the Credit Agreement to permit the Majority Lenders to receive payments that would not have to be shared on a pro rata basis with the Original Term Loans held by the minority lenders. Many of the minority lenders did not learn of the Amendment until after it had been consummated and were surprised that the Amendment was able to be effected without their consent.

CONCLUSION

NYDJ’s ability to amend its Credit Agreement in a way that disparately impacted minority lenders should serve as a reminder to lenders that amendment provisions, which are often overlooked in primary syndication negotiations and secondary trades, may have significant consequences. It is critical for lenders to be aware of protections (or lack thereof) available to minority lenders in a given credit. Proper review of the amendment section is required in order to determine whether the pro rata sharing provisions are included as a sacred right and if so, whether they are broad enough to protect the minority lenders from a NYDJ scenario.