PRACTICE NOTE

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PIK Interest: Negotiation and Documentation Considerations

by Meyer C. Dworkin and Matthew J. Wiener of Davis Polk & Wardwell LLP

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A Practice Note providing an overview of payment-in-kind (PIK) interest, with particular focus on PIK toggles. This Note looks at the different formulations and specific characteristics of PIK interest, highlights negotiation and documentation considerations for practitioners, and introduces the concept of synthetic PIK.

Payment-in-kind (PIK) provisions in loan agreements permit borrowers to capitalize (or add to the principal balance of their loans) all or a portion of their accrued interest, rather than making current cash payments to their lenders. Historically, associated with junior, distressed and highly structured financings, PIK interest features have in recent years become more popular in a wider range of financing transactions, including senior secured loan facilities in the private credit market.

The flexibility to service at least some of their interest expense by payment in-kind is important to businesses and private equity sponsors in the current economic environment, characterized by high interest rates and elevated valuation multiples for acquisition targets, because the resulting interest expense burden from an acquisition might otherwise reduce the amount of debt that could be utilized in structuring a leverage buyout. A PIK interest option in a loan, however, permits sponsors and borrowers to incur their desired leverage level without overburdening their liquidity position, an attractive proposition which continues to drive this trend in the market.

It is therefore increasingly important for finance attorneys and businesspeople to understand potential issues and pitfalls in PIK interest provisions in loan agreements. This Note discusses the primary features of PIK interest, including the recent innovation of synthetic PIK, and highlights several areas of consideration in negotiating and documenting PIK interest provisions.

Variations of PIK Interest

While there are many permutations, the three primary forms of PIK interest are:

- True PIK, in which the full interest margin (or in some cases all interest expense) on a loan is automatically capitalized throughout the life of the loan.
- Contingent PIK, in which an agreed portion of interest is capitalized unless certain conditions (for example, a minimum liquidity test) are satisfied, after which a borrower may (or shall) service such interest in cash.
- PIK toggle, in which a borrower may elect whether, and typically how much, of an agreed portion of interest to PIK or pay in cash. In a PIK toggle loan, the borrower can alternate back and forth between PIK and cash interest payments during the term of the loan.

Of these options, PIK toggle is by far the most prevalent in the corporate loan market.

Key Features of PIK Toggle

Several features of PIK toggle provisions are common across loan facilities. The right of a borrower to PIK is usually limited to a specified PIK period (often up to two or, less frequently, three years) following the closing date of the loan (see PIK Period). Thereafter, all interest on the loan is required to be paid in cash. Senior secured lenders generally resist longer PIK periods on the basis that PIK is intended to provide a temporary, post-closing opportunity for borrowers to manage liquidity during the immediate post-closing

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period when leverage is typically highest, including by ramping up cash flow from operations.

Another feature included in nearly all PIK provisions is the additional risk premium payable by borrowers to the extent they elect to PIK interest (see PIK Premium). This premium is structured as an agreed step-up in the interest rate margin for the applicable period on the loans subject to the PIK election. The PIK premium may either be:

- A flat amount (such as, 50 basis points (bps) of additional margin) independent of the portion of interest capitalized.
- More often, a range of interest rate step-ups based on the interest amount subject to PIK, such as:
  - 25 bps premium, if 25% or less of interest rate margin is elected as PIK; and
  - 50 bps premium, if more than 25% of the margin is PIK.

PIK provisions also typically include limitations on the maximum amount of interest that may be paid in-kind or the minimum interest amount that must be paid in cash (see Limitations on PIK Amount). The maximum PIK amount is expressed as either a percentage of the interest rate (for example, up to 50% of the interest accrued in the applicable period may be capitalized) or an absolute amount of the interest (for example, not more than 2.50% of such interest may be subject to PIK). The minimum cash amount, in contrast, is more commonly set as a percentage of either the margin or the entire interest rate and is primarily used in financings with a leverage-based pricing grid to ensure a meaningful portion of interest continues to be paid in cash at all times. Importantly, while in some circumstances, including holdco loans, a PIK loan will permit all interest to be capitalized, it is much more common in the current senior secured market to require that the portion of interest attributable to SOFR or another benchmark rate be paid in cash.

Drafting Considerations

Those negotiating and documenting PIK provisions should be mindful of the pitfalls discussed in more detail below, as imprecise drafting and ambiguity may have unintended consequences.

PIK Period

One of the most common concerns is that the borrower may be permitted to PIK for longer than the contemplated post-closing period. This often occurs where the loan agreement fails to specify whether the borrower may PIK until the last day of the specified PIK period or the end of the applicable interest period following such PIK period end date, which may be up to three to six months following such date. For example, a recent loan agreement provides that:

"From and after the Closing Date to and including the date that is two (2) years following the Closing Date, the Borrowers may, at their option, by prior written notice to the Administrative Agent prior to the first day of the applicable Interest Period, elect to pay accrued interest by capitalizing such interest."

While the commercial intent of the parties appears to be to allow the borrower to PIK interest solely for the first two years after closing, the borrowers under this formulation may argue that so long as the applicable interest period has commenced, and the borrower has delivered the required notice, within two years of the closing date, interest may be PIK through the end of the chosen interest period. Put simply, in this example, the actual PIK period may be two years plus the longest available interest period.

A related issue arises where the PIK period is formulated as a specified number of full fiscal quarters following closing which, depending on the timing of the closing date, may allow for up to an additional three months of PIK flexibility. To avoid any ambiguity on the desired length of the PIK period, parties could expressly provide that the PIK period may end in the middle of an interest period to more accurately reflect the commercial understanding. For example:

"Solely with respect to the Term Loans and the **portion of any Interest Period ending on or prior to the date that is the third anniversary** of the Closing Date, at the election of the Borrower, interest accrued during such period may be capitalized."

Two additional related issues are:

- Whether a PIK election notices must be delivered prior to the start of an interest period or may be delivered at any time prior to the applicable interest payment date.
- The consequence of a borrower failing to deliver a PIK election and whether such failure should be a deemed election to pay interest in cash, to continue the same as in the prior interest period, or to PIK interest at the maximum PIK amount.

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PIK Premium

There are two documentation issues related to the drafting of the PIK premium. The first is whether the premium is payable in kind, in cash, or a combination of the two. Requiring the PIK premium to be payable in cash may, from the borrower's perspective, run contrary to the rationale for PIK interest, minimizing its debt service. Lenders, in contrast, may take the view that, even if interest is partially cash-pay, the borrower still benefits in the aggregate from a reduction in its overall debt service. In either event, it is imperative that the commercial agreement be clear on this point.

The following example of a PIK provision reflects a common drafting concern where ambiguity can arise by providing that:

". . . up to 50.0% of the Applicable Rate accruing with respect to the Term Loans may be paid in kind and not in cash, subject to **an additional 0.50% per annum** in excess of the interest rate otherwise charged (the foregoing described interest so elected to be paid in kind, together with **the additional 0.50% per annum rate** applicable to such paid-in-kind interest, the "PIK Interest")."

While the parenthetical at the end of this clause suggests the drafters intended for the PIK premium to be paid in-kind in full, lenders may argue that notwithstanding the defined term, only 50% of the Applicable Rate, as increased by the 0.50% premium, may be PIK (in other words, only 50% of the PIK premium may be so capitalized). Specifying that the entire PIK premium may be paid in-kind (and clarifying that 50% of the Applicable Rate is determined before giving effect to that premium), assuming that reflects the parties' commercial intent, eliminates any ambiguity on this point.

The second loan documentation issue is whether the PIK premium applies to the entire principal amount of a loan or only the portion on which interest is paid in-kind. The following sample provision illustrates the drafting challenges:

". . . the Borrower may elect (such election, a "PIK Election") to pay a portion of the then-applicable Applicable Rate not to exceed 2.25% per annum in kind on the applicable Interest Payment Date by capitalizing the amount thereof and adding such amount to the outstanding principal amount of the Closing Date Term Loan on and as of such date; *provided* that in the event of a PIK Election in respect of any Interest Period then the Applicable Rate for such Interest Period shall be increased by 0.225% per annum."

More precise drafting would instead specify in the proviso that in the event of a PIK election, the applicable rate in respect of either the entire outstanding amount of the term loans or the portion of the term loans for which the PIK election has been made, depending on the commercial intent of the parties, shall be increased by 0.225% per annum.

Limitations on PIK Amount

Another common issue in PIK provisions relates to applicability of the PIK feature to the full interest amount of a loan (including the portion relating to the applicable benchmark), rather than solely the margin component. As noted, the ability to PIK such full amount is generally in conflict with the commercial intent of the parties, especially for loans by private credit lenders who require payment of minimum cash interest for purposes of either internal investment guidelines, to satisfy the eligibility criteria of their financing sources or simply to service their own internal financing requirements. For example, one recent loan agreement provides that:

". . . with respect to any Interest Payment Date occurring on or before the second anniversary of the Closing Date, the portion of such accrued and unpaid interest as set forth in the relevant election (which shall not exceed 50% of **the aggregate amount** of such accrued and unpaid interest) shall be paid in kind."

The expression of the maximum PIK amount as a percentage of the aggregate accrued and unpaid interest on the loan, arising from both the benchmark and margin components, may (depending on the then-applicable benchmark rate) permit a portion of the benchmark rate to be paid in kind. A better formulation would refer in the parenthetical to accrued and unpaid interest rate margin, so that the 50% cap on PIK applies solely to interest margin, leaving 100% of the benchmark rate required to be paid in cash.

Another common drafting pitfall presents in formulations of the maximum amount of PIK interest as an absolute amount (rather than a percentage) of the then-applicable interest rate. The following example of this type of provision creates uncertainty by permitting the borrower to pay:

". . . up to an amount equal to **2.50% of the Applicable Margin** of such accrued interest in kind; *provided* that in no event shall the amount of interest

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paid in cash for any Interest Period **be less than Term SOFR for such Interest Period plus 3.00%**."

A plausible reading of this provision is that the amount of interest the borrower may capitalize is capped at the product of 2.50% **multiplied by** the interest rate margin, which is clearly not the intent of the parties. More precise language would instead specify that a portion of the then-applicable interest rate margin not to exceed 2.50% per annum could be paid in kind. Note, however, that this provision does provide that interest relating to the benchmark rate, **in addition to** 3%, must be paid in cash.

Synthetic PIK

A recent innovation in the private credit loan market is synthetic PIK. This involves the borrower paying cash interest due and payable to its lenders on each interest payment date in respect of a primary loan facility by drawing on a secondary delayed draw facility provided by the same lenders. The sole use of proceeds of the second facility is payment of interest on the primary loan facility. The drawn portion of the delayed draw term facility may be fungible with and effect an increase of the outstanding principal amount of the primary facility. In sum, the borrower services its interest expense with funds provided by the lenders in exchange for the lenders holding additional loans in the amount of such funding. The overall result is nearly identical to traditional PIK structures from the standpoint of a lender holding both the primary and secondary facility. However, synthetic PIK technically satisfies the current cash interest payment requirements of institutional investor guidelines for the primary facility, as well as the eligibility criteria of collateralized loan obligations and similar warehouse financings.

Numerous considerations arise in connection with synthetic PIK structures. Lenders typically receive closing fees for providing delayed draw commitments and undrawn fees in respect of unutilized delayed draw commitments from the closing date until such commitments are terminated. In addition, as noted, lenders require payment of a risk premium for permitting borrowers to PIK interest. The economics of synthetic PIK, in which a borrower may be required to pay both traditional delayed draw closing and commitment fees and higher interest rates due to a PIK premium, may, unless waived by the lenders, be less attractive to borrowers than more traditional PIK arrangements. Lenders may also be unwilling to reserve the capital against the unfunded synthetic PIK commitments for periods of more than two years, whereas borrowers may seek the flexibility to PIK for longer (including, in some instances, the six- or seven-year life of a loan). In addition, satisfaction of a net leverage condition is commonly a condition precedent to borrowing under a delayed draw term loan facility. Because a synthetic PIK facility will result in a new incurrence of indebtedness on each PIK payment date, the parties should determine in advance whether use of that facility is subject to customary leverage governors or whether those governors simply do not apply to drawings under the synthetic PIK facility. The parties may also consider whether the synthetic PIK facility is deemed to be fully drawn on the closing date for purposes of testing leverage ratios and incurrence tests on the closing date and not tested again thereafter.

Such considerations raise novel questions as to whether the dedicated delayed draw commitments to provide synthetic PIK should properly be viewed by lenders as the economic equivalent of traditional PIK. That is, a synthetic PIK facility in which the proceeds of the delayed draw loans are automatically returned to the lenders providing such loans should arguably be viewed no differently than a typical PIK facility in which such interest payments are deemed to be made by capitalizing accrued interest. To the extent that lenders are able to reach this conclusion, for both economic and organizational document purposes, the terms of the two structures will continue to converge making synthetic PIK a more palatable option for both borrowers and lenders.

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