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A Comparison of Key Provisions in U.S. and European Leveraged Loan Agreements

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While there are many broad similarities in the approach taken to European and U.S. leveraged loan transactions and an increasing convergence of terms (and, indeed, convergence with high-yield bond terms for larger leveraged transactions) dominating documentation trends, there remains a number of significant differences in commercial terms and overall market practice. The importance for practitioners and loan market participants to understand the similarities and differences of both markets has grown in recent years as European and U.S. borrowers increasingly broaden their horizons and seek to access whichever market may provide greater liquidity (and potentially more favourable pricing and terms) at any given time.

This chapter will focus only on a number of the more significant key differences between practice in the United States and Europe that may be encountered in a typical leveraged loan transaction, and is intended to serve as an overview and a primer for practitioners. References throughout this article to "U.S. loan agreements" and "European loan agreements" should be taken to mean New York law-governed and English law-governed leveraged loan agreements, respectively.

Divided into four parts, Part A will focus on differences in documentation and facility types, Part B will focus on various provisions, including covenants and undertakings, Part C will consider differences in syndicate management and Part D will focus on recent legal and regulatory developments in the European and U.S. markets.

Part A – Documentation and Facility Types

Form Documentation

In both the European and U.S. leveraged loan markets, the standard forms used as a starting point for negotiation and documentation greatly influence the final terms. In Europe, both lenders and borrowers, through conduct adopted over a number of years, expect the starting point to be one of the very comprehensive "recommended forms" published by the LMA (or, to give it its formal title, the Loan Market Association) unless exceptional circumstances merit a more bespoke approach. However, in the United States, such practice has not emerged and the form on which the loan documentation will be based (as well as who "holds the pen" for drafting the documentation) – which may greatly influence the final outcome – will be the subject of negotiation at an early stage.

The LMA (which comprises more than 600 member organisations, including commercial and investment banks, institutional investors, law firms, service providers and rating agencies) has achieved widespread acceptance of its recommended forms as a result of the breadth of its membership and the spread of constituencies represented at the "board" level. Formed initially with the objective of standardising secondary loan trading documentation, the LMA now plays a "senior statesman" advisory role in the European loan market by producing, updating and giving guidance on key provisions in its recommended forms for, amongst other things, investment grade loan transactions, leveraged acquisition finance transactions, developing market and commodity finance transactions, real estate finance transactions and most recently, the growing European private placement market. The LMA plays an active role in monitoring developments in the financial markets, responding to regulatory consultation requests and giving guidance on appropriate approaches in documentation in response to market, regulatory and political developments (indeed, most recently in the context of the outcome of the United Kingdom's referendum to leave the European Union): its influence and authority is significant.

The widespread use of the LMA standard forms has resulted in good familiarity by the European investor market which, in turn, has added to the efficiency of review and comprehension not just by those negotiating the documents but also by those who may be considering participating in the loan. The LMA recommended forms are only a starting point, however, and whilst typically, the "back-end" LMA recommended language for boilerplate and other non-contentious provisions of the loan agreement will be only lightly negotiated (if at all), the provisions that have more commercial effect on the parties (such as mandatory prepayments, business undertakings, financial covenants, representations and warranties, conditions to drawdown, etc.) remain as bespoke to the specific transaction as ever.

Similar to the LMA in Europe, the Loan Syndications and Trading Association (the "LSTA") in the United States (an organisation of banks, funds, law firms and other financial institutions) was formed to develop standard procedures and practices in the trading market for corporate loans. One of the main practical differences from the LMA, however, is that although the LSTA has developed recommended standard documentation for loan agreements, those forms are rarely used as a starting draft for negotiation. Instead, U.S. documentation practice has historically been based on the form of the lead bank or agent although many banks' forms incorporate LSTA recommended language. In relation to market and regulatory developments that could affect both loan markets as a whole, the LSTA and LMA often cooperate and coordinate their approach in issuing guidance and recommended language. Most recently, for example, the LSTA and LMA worked closely in preparing and publishing the recommended form provisions to address the recent

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"EU contractual recognition of bail in" directive (considered in further detail below).

Whilst traditionally, the lender side has "held the pen" on documentation, there is a growing trend, both in the United States and Europe, for the larger sponsor borrowers to insist on taking control of, and responsibility for, producing the key documents which, inevitably, leads to a more borrower-friendly starting point.

Facility Types

The basic facility types in both U.S. and European leveraged loan transactions are very similar. Each may typically provide for one or more term loans (ranking equally but with different maturity dates, amortisation profiles (if amortising) and interest rates) and a *pari passu* ranking revolving credit facility. Of course, depending on the nature of the borrower's business and objectives, there could be other specific, standalone facilities, such as facilities for acquisitions, capital expenditure and letters of credit.

In the United States, as in Europe, typically all lenders in a given facility share the same security package, the same ability to enforce such security and the same priority in relation to payments and the proceeds from the enforcement of security. In the U.S., as in Europe, however, an alternative to the typical structure is the first lien/second lien structure, in which the "first lien" and "second lien" loans are secured by the same collateral but the liens of the second lien lenders are subordinated to those of the first lien lenders (i.e., no collateral proceeds may be applied to any second lien obligations until all first lien obligations are repaid). First lien/second lien structures were traditionally treated as essentially two separate loans, with two sets of loan documents and two agents, with the relationship between the lenders set out and governed under an intercreditor agreement. In the U.S., however, over recent years, a market trend has developed for certain transactions (typically the smaller deals) to instead effect a "first lien/second lien" structure through a unitranche facility: a single loan with two tranches, a first out tranche and a last out tranche, so there is only one set of loan documents, one agent, one interest rate and one set of lenders. A separate agreement among lenders ("AAL") governs the rights and obligations of the first out and last out lenders and also the division of the interest receipts between the lenders (the borrower pays a blended rate and the lenders decide how much of that is paid to the first out lenders and how much to the last out, depending on the market appetite for the different levels of risk). One unknown with respect to unitranche facilities was whether a court presiding over a borrower's bankruptcy could construe and enforce an AAL even though borrowers are not party to AALs. The *In re RadioShack Corp.* bankruptcy litigation largely resolved this question by implicitly recognised the court's ability to interpret and enforce an AAL.

In Europe, driven by the rising prominence of debt funds and alternative capital providers, unitranche and direct loan facility structures are playing a much more significant role in the debt market, particularly in the sub £250m deal bracket. Similarly to U.S. unitranche structures, European unitranche structures also utilise an AAL, which typically the borrower will not be party to. In a restructuring context, European unitranche structures have also raised their own issues – in particular, questions around whether the first out and last out creditors comprise a single class for the purposes of an English law scheme of arrangement under Part 26 of the Companies Act 2006, notwithstanding the various creditors' distinct economic positions and interests as set out in the AAL. Whilst unitranche structures and the rights of unitranche creditors in a scheme of arrangement have not been directly considered by the courts, recent cases suggest that unless creditors can demonstrate that their distinct economic rights are also accompanied by corresponding legal rights enforceable against the borrower (which will not typically be the case where the borrower is not party to the AAL), it is likely to be difficult for junior creditors to maintain that they should form a separate class in a scheme of arrangement (and, as such, forfeiting the potential hold-out value that may entail during the course of a borrower's restructuring).

In the case of European borrowers with both high-yield bond debt and bank debt (usually revolving credit facilities) in their capital structures, so called "super senior" structures are also very common. In such structures, both the lenders under the revolving credit facility and the high-yield noteholders rank equally in regards to payment and the security package (where the notes are secured). However, the lenders under the revolving credit facility are "super senior" in that they take priority over the noteholders in relation to the proceeds of recovery from any enforcement action.

Term Loan Types

The terms of a financing are influenced not just by the size and nature of the transaction but also to a large extent by the composition of the lending group. Term A loans are syndicated in the United States to traditional banking institutions, who typically require the amortisation and tighter covenants characteristic of Term A loans. Term B loans, which comprise a large percentage of the more sizeable leveraged loans (especially in the United States), are typically held by investors who also participate in high-yield debt instruments and so are generally comfortable with no financial maintenance covenants and greater overall covenant flexibility. Term B loans have a higher margin and other economic protections (such as "no-call" periods) not commonly seen in Term A loans to compensate for these more "relaxed" terms.

Whilst in the past European sponsors and borrowers unable to negotiate sufficiently flexible or desirable loan terms with their usual relationship banks had to resort to U.S. Term B loans and the U.S. high-yield bond market in order to achieve the flexibility they desired, the growth of debt funds, direct lenders and U.S. institutional investors in the European loan market – (who now vigorously compete with banks and other traditional lending institutions) has led to the evolution of the English law "European TLB" market. Indeed, the European TLB market is now an established and attractive funding option for borrowers in larger leveraged transactions (£250m of debt or greater), albeit that some terms are not yet quite as flexible as those seen in the U.S. Term B loan market. For example, most European TLB instruments are still likely to contain guarantor coverage tests, higher lender consent thresholds, more expansive events of default and mandatory prepayment provisions and generally have smaller permitted baskets when compared to their U.S. counterparts.

Certainty of Funds

In the United Kingdom, when financing an acquisition of a UK incorporated public company involving a cash element, the City Code on Takeovers and Mergers requires purchasers to have "certain funds" prior to the public announcement of any bid. The bidder's financial advisor is required to confirm the availability of the funds and, if it does not diligence this appropriately, may be liable to provide the funds itself should the bidder's funding not be forthcoming. Understandably, both the bidder and its financial advisor need to ensure the highest certainty of funding. In practice, this requires the full negotiation and execution of loan documentation and completion of conditions precedent (other than

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those conditions that are also conditions to the bid itself) at the point of announcement of the public bid.

Whilst not a regulatory requirement, the concept of "certain funds" has also permeated the private buyout market in Europe, so that sponsors are (in practice) required to demonstrate the same level of funding commitment as if they were making a public bid, albeit that this is not a legal or regulatory requirement in a private bid.

In the United States, there is no regulatory certain fund requirement as in the United Kingdom and, typically, only commitment papers, rather than full loan documents, are executed at the time when the bid becomes binding on the bidder (that is, upon execution of a purchase agreement). In the U.S., though, it has become more common for parties to agree on terms while negotiating the commitment letter that traditionally were not settled until negotiation of the definitive loan documentation, such as the definition of EBITDA and related terms, baskets and specified levels for negative covenants and incurrence tests for debt, restricted payments and investments. Ordinarily, when commitment papers are conditioned on the negotiation of definitive loan documentation, they contain "*SunGard*" clauses that limit the representations and warranties made by the borrower and the delivery of certain types of collateral required by the lenders on the closing date of the loan. In practice, given the level of commitment implicit in NY law commitment papers and the New York law principle of dealing in good faith, there is probably little difference between "certain funds" and SunGard commitment papers though it is still most unlikely that SunGard would be acceptable in a City Code bid.

Part B – Loan Documentation Provisions

Covenants and Undertakings

Whilst the dominant theme of recent years has been the increasing European adoption from the U.S. of more flexible, borrower-friendly loan provisions – or "convergence" as it is commonly referred to – there still remain many differences between U.S. and European loan agreements in the treatment and documentation of covenants (as such provisions are termed in U.S. loan agreements) and undertakings (as such provisions are termed in European loan agreements). This Part B explores some of those differences.

Both U.S. and European loan agreements use a broadly similar credit "ring fencing" concept, which underpins the construction of their respective covenants/undertakings. In U.S. loan agreements, borrowers and guarantors are known as "loan parties", while their European equivalents are known as "obligors". In each case, loan parties/obligors are generally free to deal between themselves as they are all within the same credit group and bound under the terms of the loan agreement. However, to minimise the risk of credit leakage, loan agreements will invariably restrict dealings between loan parties/obligors and other members of the borrower group that are not loan parties/obligors, as well as third parties generally. In U.S. loan agreements there is usually an ability to designate members of the borrower's group as "unrestricted subsidiaries" so that they are not restricted under the loan agreement. However, the loan agreement will then limit dealings between members of the restricted and unrestricted group and the value attributed to the unrestricted group might not be taken into account in calculating financial covenants. Borrowers are negotiating for more flexibility with respect to unrestricted subsidiaries but lenders have been pushing back due to recent attempts by borrowers to use these unrestricted subsidiaries to consummate transactions not intended to be permitted.

Restrictions on Indebtedness

U.S. and European loan agreements include an "indebtedness covenant" (in U.S. loan agreements) or a "restriction on financial indebtedness" undertaking (in European loan agreements) which prohibits the borrower (and usually, its restricted subsidiaries) from incurring indebtedness unless explicitly permitted. Typically, "indebtedness" will be broadly defined in the loan agreement to include borrowed money and other obligations such as notes, letters of credit, contingent and lease obligations, hedging liabilities (on a mark-to-market basis), guaranties and guaranties of indebtedness.

In U.S. loan agreements, the indebtedness covenant prohibits all indebtedness, then allows for certain customary exceptions (such as the incurrence of intercompany debt, certain acquisition debt, certain types of indebtedness incurred in the ordinary course of business or purchase money debt), as well as a specific list of exceptions tailored to the business of the borrower. The indebtedness covenant will also typically include an exception for a general "basket" of debt, which can take the form of a fixed amount or a formula based on a ratio or a combination, such as the greater of a fixed amount and a ratio formula. Reclassification provisions (allowing the borrower to utilise one type of permitted debt exception and then reclassify the incurred permitted debt under another exception) are also becoming more common in the United States. A recent trend in U.S. loan agreements is for reclassification provisions in lien covenants in addition to indebtedness covenants, permitting borrowers to reclassify transactions that were permitted under a fixed basket as permitted under an unlimited leveraged-based basket after the borrower's financial performance improves.

The loan agreements of large cap and middle market U.S. borrowers also typically provide for an incremental facility allowing the borrower to incur additional debt (on top of any commitments the credit agreement originally provided for) under the credit agreement, or in certain cases additional *pari passu* or subordinated secured or unsecured incremental debt outside the credit agreement under a separate facility (known as "sidecar facility" provisions). Traditionally the incremental facilities were limited to a fixed dollar amount, referred to as "free-and-clear" tranches, but now many borrowers can incur an unlimited amount of incremental loans so long as a *pro forma* leverage ratio or secured indebtedness ratio (if the new debt is to be secured) is met. The recent trend is toward increasingly borrower-friendly incremental provisions. It is becoming more common for borrowers to have both a free-and-clear incremental basket and unlimited incremental capacity subject to a ratio test. Some such borrowers have negotiated the ability to refresh a free-and-clear basket by redesignating debt originally incurred under the free-and-clear basket as debt incurred under the leverage-based incremental capacity. Another new development is permitting borrowers to simultaneously use the free and clear basket and the leveraged-based incremental basket without the former counting as leverage for purposes of the ratio test. Borrowers have also become more creative with provisions that allow for increases to the free-and-clear basket over the life of the loan, including *pro rata* increases in free-and-clear baskets upon voluntary prepayments of existing loans and/or voluntary reductions in revolving commitments and free-and-clear baskets with an EBITDA grower providing for an increase in the amount of the free-and-clear basket in tandem with increases in the borrower's EBITDA.

Most incremental facilities have a most favoured nations clause that provides that, if the margin of the incremental facility is higher than the margin of the original loan, the original loan's margin will be increased to within a specific number of basis points (usually 50 bps) of the incremental facility's margin. Sponsor-friendly loan

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agreements often include limitations with respect to most favoured nation clauses, usually a "sunset" restricting its application to a certain timeframe, typically 12 to 18 months following closing (although the average duration of the "sunset" has been decreasing). Recently, such sponsor-friendly agreements have incorporated further provisions aimed at eroding MFN protection, including (i) limiting MFN protection to incremental term loans borrowed using the free-and-clear capacity, refinancing incremental term loans or incremental term loans that mature within a certain period (say, two years) of the latest-maturing existing term loans, and (ii) setting a threshold amount of incremental term loans that may be borrowed without triggering MFN protection.

U.S. loan agreements also typically include an exception to the debt covenant for refinancing debt. Historically, refinancing debt was subject to limitations as to principal amount, maturity, weighted average life to maturity, ranking and guarantees and security. The trend of looser terms in U.S. loan agreements is evident in some recent innovative tinkering with the concept of refinancing debt, though. Traditionally borrowers could incur at most refinancing debt in a principal amount not to exceed the principal amount of the old debt plus accrued interest, fees and costs. But creative drafters have changed that limitation so that the principal amount of the refinancing debt can exceed the principal amount of the old debt (plus interest, fees, etc.) by up to the amount of any unused commitments. Borrowers can obtain commitments that they cannot immediately use because there is no capacity under any of their debt baskets, so this formulation can result in problems – e.g., consider a first lien loan agreement that permits second lien refinancing debt in an amount equal to the old debt plus incremental debt permitted by the second lien loan agreement. The borrower could obtain commitments for second lien refinancing debt exceeding the principal amount of its old second lien debt and then refinance and fully borrow under all the commitments it obtained, sidestepping its incurrence test and any need for first lien lender consent.

The restriction on financial indebtedness undertaking typically found in European loan agreements is broadly similar to its U.S. covenant counterpart and usually follows the same construct of a general prohibition on all indebtedness, followed by certain "permitted debt" exceptions (both customary ordinary course type exceptions as well as specifically tailored exceptions requested by the borrower). A notable recent trend in the European loan market (particularly in larger leveraged transactions) has been the relaxations around the ability of borrowers to incur additional debt. There is now a definitive trend towards U.S. style permissions, such as "permitted debt" exceptions based on a leverage and/or secured leverage (and sometimes interest coverage) ratio test combined with a general fixed permitted basket where such additional (or incremental) debt may be incurred within the loan agreement by way of an accordion facility, or outside the loan agreement by way of a separate side-car facility (demonstrated in the fact that the LMA now includes incremental facility language in its standard form documentation). Indeed, uncapped, leverage ratio-based incremental debt capacity is now a common feature of many recent large-cap European loan agreements. As in the case of U.S. loan agreements, the vast majority of European loan agreements with incremental facility provisions will also contain MFN protections, and in most cases, such MFN protections will usually be expressed to sunset (or expire) after 12 to 18 months.

Restrictions on Granting Security/Liens

U.S. loan agreements will also invariably restrict the ability of the borrower (and usually, its subsidiaries) to incur liens. A typical U.S. loan agreement will define "lien" broadly to include any charge, pledge, claim, mortgage, hypothecation or otherwise any arrangement to provide a priority or preference on a claim to the borrower's property. This lien covenant prohibits the incurrence of all liens but provides for certain typical exceptions, such as liens securing permitted refinancing indebtedness, purchase money liens, statutory liens and other liens that arise in the ordinary course of business, as well as a general basket based on a fixed dollar amount or a percentage of consolidated total assets to secure a specified amount of permitted indebtedness. In some large cap deals, both in the U.S. and in Europe, borrowers are able to secure permitted indebtedness based on a total leverage ratio or senior secured leverage ratio.

The European equivalent, known as a "negative pledge", broadly covers the same elements as the U.S. restriction on liens (with the same business driven exceptions), but typically goes further and restricts "quasi-security" where the arrangement or transaction is entered into primarily to raise financial indebtedness or to finance the acquisition of an asset. "Quasi-security" includes transactions such as sale and leaseback, retention of title and certain set-off arrangements.

Restriction on Investments

A restriction on the borrower's ability to make investments is commonly found in U.S. loan agreements. "Investments" include loans, advances, equity purchases and other asset acquisitions. Historically, investments by loan parties in non-loan parties have been capped at modest amounts. In some recent large cap deals, however, loan parties have been permitted to invest uncapped amounts in any of their restricted subsidiaries, including foreign subsidiaries who are not guarantors under the loan documents. Other generally permitted investments include short-term securities or other low-risk liquid investments, loans to employees and subsidiaries, and investment in other assets which may be useful to the borrower's business. In addition to the specific list of exceptions, U.S. loan agreements also include a general basket, sometimes in a fixed amount, but increasingly based on a flexible "builder basket" growth concept.

The "builder basket" concept, typically defined as a "Cumulative Credit" or an "Available Amount", represents an amount the borrower can utilise for investments, restricted payments (as discussed below), debt prepayments or other purposes. Traditionally, the builder basket begins with a fixed-dollar amount and "builds" as retained excess cash flow (or in some agreements, consolidated net income) accumulates. Some loan agreements may require a borrower to meet a *pro forma* financial test to use the builder basket. If the loan agreement also contains a financial maintenance covenant (such as a leverage test), the borrower may also be required to satisfy a tighter leverage ratio to utilise the builder basket for an investment or restricted payment. Some sponsors have also negotiated loan documents that allow the borrower to switch between different builder basket formulations for added flexibility. Another new borrower-friendly development is the use of adjusted EBITDA to determine the seeded amount of the builder basket. In another example of convergence with high-yield bond indentures, recently builder baskets that use 50% of consolidated net income (including the proceeds of equity issuances and equity contributions) rather than retained excess cash flow and an interest coverage ratio rather than a leverage ratio have become more common. This approach gives borrowers more flexibility because a basket using consolidated net income is usually larger and an interest coverage ratio is usually easier to comply with than a leverage ratio.

European loan agreements will typically contain stand-alone undertakings restricting the making of loans, acquisitions, joint ventures and other investment activity by the borrower (and other

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obligors) and commonly restricted such activity by way of fixed cap baskets and other additional conditions. While the use of builder baskets is still not the norm in European loan agreements, often acquisitions will be permitted if funded from certain sources, such as retained excess cash flow.

Whilst (historically) reference to ratio tests alone was not commonly seen in European loan agreements, it is now common for borrowers to be permitted to make acquisitions subject to satisfying a *pro forma* leverage ratio test (with fewer additional conditions on acquisitions generally). For stronger borrowers, it is becoming more common for there to be no restrictions on their ability to acquire entities that will become wholly owned subsidiaries (as opposed to acquisitions of interests in joint ventures and other investments). Soft-capped baskets for acquisitions and investments (where the monetary limit is based on the greater of a fixed amount and a percentage of earnings or asset value) are also now more commonplace in the European market.

Restricted Payments

U.S. loan agreements will typically restrict borrowers from making payments on equity, including repurchases of equity, payments of dividends and other distributions, as well as payments on subordinated debt. As with the covenants outlined above, there are typical exceptions for restricted payments not materially adverse to the lenders, such as payments on equity solely in shares of stock, or payments of the borrower's share of taxes paid by a parent entity of a consolidated group.

In European loan agreements, such payments are typically restricted under separate specific undertakings relating to dividends and share redemptions or the making of certain types of payments to non-obligor shareholders, such as management and advisory fees, or the repayment of certain types of subordinated debt. As usual, borrowers will be able to negotiate specific carve-outs (usually hard capped amounts) for particular "permitted payments" or "permitted distributions" as required (for example, to permit certain advisory and other payments to the sponsor), in addition to the customary ordinary course exceptions.

In U.S. loan agreements, a borrower may use its "builder basket" or "Available Amount" (increasingly based on consolidated net income rather than retained excess cash flow as discussed above) for restricted payments, investments and prepayments of debt, subject to annual baskets based on either a fixed-dollar amount or compliance with a certain financial ratio test. In some recent large cap and sponsored middle market deals in the United States, borrowers have been permitted to make restricted payments subject only to being in *pro forma* compliance with a specific leverage ratio, rather than meeting an annual cap or basket test.

European loan agreements typically have not provided this broad flexibility, although this is changing in the context of large-cap deals and the increasing role of the European TLB market. Whilst strong sponsors have typically been able to negotiate provisions permitting payments or distributions from retained excess cash flow, subject to satisfying a certain leverage ratio, deal trends over the last year have revealed that the U.S. approach towards allowing restricted payments is now being accepted in Europe: in particular, consolidated net income-based "builder baskets" are now commonly seen in larger transaction, as well as uncapped upstream payment ability, subject to satisfaction of a *pro forma* leverage test, further illustrating the convergence of terms between the U.S. and European markets.

Call Protection

In both European and U.S. loan agreements, borrowers are commonly permitted to voluntarily prepay loans in whole or in part at any time. However, some U.S. loan agreements do include call protection for lenders, requiring the borrower to pay a premium if loans are repaid within a certain period of time (the "call period"). While "hard call" premiums (where term loan lenders receive the premium in the call period for any prepayment, regardless of the source of funds or other circumstances) are rare, "soft call" premiums (typically 1%) on prepayments made within a certain period (typically six months to a year after closing although 18 months has been becoming more common[1]) and funded from a refinancing or re-pricing of loans are common in the U.S. loan market. In some recent large cap deals, though, lenders waived call protection premiums in connection with a refinancing in connection with any transaction that would constitute an initial public offering, a change of control, or a transformative acquisition.

While call protection is relatively rare in the European market for senior (bank held, term loan A) debt, soft call protections are not unusual in European loans that have been structured to be sold or syndicated to institutional investors (for example, TLBs). Hard call protection provisions are more commonly seen in the second lien tranche of European loans and mezzanine facilities (typically containing a gradual step down in the prepayment premium from 2% in the first year, 1% in the second year, and no call protection thereafter).

Voluntary Prepayments and Debt Buybacks

Although debt buybacks have been less frequent in recent years, the provisions allowing for such prepayments are typically found in both U.S. and European loan agreements.

U.S. loan agreements typically require the borrower to offer to repurchase loans ratably from all lenders, in the form of a reverse "Dutch auction" or similar procedure. Participating lenders are repaid at the price specified in the offer and the buyback is documented as a prepayment or an assignment. Loan buybacks may also take the form of a purchase by a sponsor or an affiliate through non-*pro rata* open market purchases. These purchases are negotiated directly with individual lenders and executed through a form of assignment. Unlike loans repurchased by the borrower and then cancelled, loans assigned to sponsors or affiliates may remain outstanding. Lenders often cap the amount that sponsors and affiliates may hold and also restrict the right of such sponsors or affiliates in voting the loans repurchased.

Similarly, in European loan agreements, "Debt Purchase Transaction" provisions have been included in LMA recommended form documentation since late 2008. The LMA standard forms contain two alternative debt purchase transaction provisions – one that prohibits debt buybacks by a borrower (and its subsidiaries), and a second alternative that permits such debt buybacks, but only in certain specific conditions (for example, no default continuing, the purchase is only in relation to a term loan tranche and the purchase is made for consideration of less than par).

Where the loan agreement permits the borrower to make a debt purchase transaction, to ensure that all members of the lending syndicate have an opportunity to participate in the sale, it must do so either by a "solicitation process" (where the parent of the borrower or a financial institution on its behalf approaches each term loan lender to enable that lender to offer to sell to the borrower an amount of its participation) or an "open order process" (where the parent

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of the borrower or financial institution on its behalf places an open order to purchase participations in the term loan up to a set aggregate amount at a set price by notifying all lenders at the same time).

Both LMA alternatives permit debt purchase transactions by the sponsor (and its affiliates), but only subject to the disenfranchisement of the sponsor (or its affiliate) in respect of the purchased portion of the loan.

Mandatory prepayments and change of control

U.S. borrowers are typically required to prepay loans incurred under their loan agreements using the net proceeds of certain asset sales, term debt not permitted to be incurred under the applicable loan agreement and issuances of equity. Recently, though, mandatory prepayment provisions relating to asset sales have provided greater flexibility for borrowers by carving out more types of dispositions from the definition of asset sale, expanding the duration and scope of reinvestment rights, increasing the threshold amount under which the borrower need not use the proceeds to prepay, adding step-downs permitting borrowers to apply increasingly lower percentages of the net proceeds to prepayment as increasingly tighter leverage ratios are met and allowing the borrower to use asset sale proceeds to ratably repay *pari passu* debt.

In U.S. loan agreements, a change of control triggers an event of default rather than a mandatory prepayment as is commonly seen in European loan agreements. Recent Delaware Court of Chancery cases have applied increasing scrutiny to the continuing director change of control provisions. The issues raised in the cases include whether a change of control provision may restrict the ability of the existing board of directors to approve a dissident slate; whether a director breaches his fiduciary duty by failing to approve a dissident slate where such failure causes a change of control event of default under an existing credit agreement or indenture; and whether the administrative agent of a company's credit facility aids and abets a breach of fiduciary duty by such company's board due to adoption of a credit agreement containing a change of control provision restricting the ability of existing directors to approve a dissident slate.[2]

Financial Covenants

Historically, U.S. leveraged loan agreements contained at least two maintenance financial covenants: total leverage; and interest coverage, typically tested at the end of each quarter.

In the United States, "covenant-lite" loan agreements containing no maintenance or ongoing financial covenants comprised more than 60% of outstanding S&P/LSTA loans and have found their way into many middle market deals (after a poor showing in late 2014 and fiscal year 2015, the volume of covenant-lite middle market deals increased again in 2016). In certain transactions, the loan agreement might be "quasi-covenant-lite" meaning that it contains only one financial maintenance covenant (usually a leverage covenant) which is applicable only to the revolver and only when a certain percentage of revolving loans are outstanding at the testing date (15–25% is fairly typical, but has been as high as 37.5%). Covenant-lite (or quasi-covenant-lite) loan agreements may nonetheless contain other financial ratio incurrence tests – used merely as a condition to incurring debt, making restricted payments or entering into other specified transactions. Unlike maintenance covenants, incurrence-based covenants are not tested regularly and a failure to maintain the specified levels would not, in itself, trigger a default under the loan agreement.

European loan agreements historically included a full suite of ongoing financial maintenance covenants. However, in the first half of 2016, only around 10% of European deals were "fully covenanted". With the influx of institutional investors and increased demand generally affording borrowers increased bargaining power, "covenant-lite" and "covenant-loose" deal structures are much more prevalent, especially where it is intended that the loan will be syndicated to an institutional investor base. European deal activity in 2016 revealed that just over 40% of loan transactions were "covenant lite", meaning that the facility contained only a single financial covenant for the revolving facility lenders (usually a leverage ratio covenant tested on a springing basis) or contained no maintenance financial covenant at all.

In the United States, the leverage covenant historically measured consolidated debt of the Borrower and all its subsidiaries. Today, leverage covenants in U.S. loan agreements frequently apply only to the debt of the Borrower and its restricted subsidiaries. Moreover, leverage covenants sometimes only test a portion of consolidated debt – sometimes only senior debt or only secured debt (and in large cap deals of top-tier sponsors sometimes only first lien debt). Lenders are understandably concerned about this approach as the covenant may not accurately reflect overall debt service costs. Rather, it may permit the borrower to incur unsecured senior or subordinated debt and still remain in compliance with the leverage covenant. This is not a trend that has yet found its way over to Europe.

In the event a U.S. loan agreement contains a leverage covenant, it invariably uses a "net debt" test by reducing the total indebtedness (or portion of debt tested) by the borrower's unrestricted cash and cash equivalents. Lenders sometimes cap the amount of cash a borrower may net out to discourage both over-levering and hoarding cash. The trends with regard to netting illustrated borrowers' rapidly increasing success in pushing for greater flexibility prior to the market downturn that began in late 2014. The LSTA[3] reported that, in the third quarter of 2013, a sample of leveraged loan agreements revealed that nearly half had a fixed capped and the rest had unlimited netting – only a year later, in the third quarter of 2014, loan agreements with an unlimited cap had increased to three quarters of the sample. Although, in 2015, lenders were more resistant to uncapped netting, a survey of leveraged loans issued in 2016 found that 80% of such loans had uncapped netting, even higher than the 2014 sample.[4]

In Europe, the total net debt test is tested on a consolidated group basis, with the total net debt calculation usually including the debt of all subsidiaries (excluding intra-group debt). Unlike the cap on netted cash and cash equivalents in some U.S. loan agreements, European borrowers net out all free cash in calculating compliance with the covenant.

With strong sponsor backing, borrowers have increasingly eased the restriction of financial covenants by increasing the amount of add-backs included in the borrower's EBITDA calculation. Both U.S. and European loan documents now include broader and more numerous add-backs including transaction costs and expenses, restructuring charges, payments to sponsors and certain extraordinary events. Recently many borrowers have negotiated add-backs (generally to the extent reasonably identifiable and factually supportable) for projected and as-yet unrealised cost savings and synergies. Add-backs have also become increasingly vague and flexible – for example, addbacks 'of a type' similar to those in the model delivered to arrangers during syndication or cost savings addbacks without a requirement relating to when the savings materialise. The Leveraged Lending Guidance and the federal regulatory agencies enforcing it (discussed further in Part D), though, suggest that regulators may apply heightened scrutiny to definitions of EBITDA that provide for add-backs without "reasonable support". This regulatory scrutiny has led to greater negotiation of EBITDA add-backs for projected improvements in operating results, resulting in more frequent use

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of limits on the timing for the realisation of anticipated synergies, administrative agent approval of add-backs and caps on savings and synergies add-backs, either by reference to a fixed amount or a certain percentage of EBITDA, typically around 15–20% in the United States (although in 2016 one study found that an increasing number of loans had a 25% cap) and 5–20% in Europe (although uncapped add-backs are becoming more common both in the U.S. and European markets in spite of regulatory scrutiny).

In Europe, the European Central Bank (the "ECB") has published draft leveraged lending guidelines (discussed further in Part D). Whilst still in the consultation process (as at the time of writing), the ECB guidelines (unlike its U.S. counterpart) currently intend to test leveraged transactions by reference to "unadjusted" EBITDA, meaning "*realised EBITDA over the previous 12 months with no adjustments made for non-recurring expenses, exceptional items and other one-offs*".

Equity Cures of Financial Covenants

For a majority of sponsor deals in the United States, loan agreements that contain a financial maintenance covenants also contain the ability for the sponsor to provide an "equity cure" for non-compliance. The proceeds of such equity infusion are usually limited to the amount necessary to cure the applicable default, and are added as a capital contribution (and deemed added to EBITDA) for this this purpose. Because financial covenants are meant to regularly test the financial strength of a borrower independent of its sponsor, U.S. loan agreements increasingly place restrictions on the frequency (usually no more than two fiscal quarters out of four) and absolute number (usually no more than five times over the term of the credit facility) of equity cures.

In Europe, equity cure rights have been extremely common for many years. As in the United States, the key issues for negotiation relate to the treatment of the additional cure equity; for example, whether it should be applied to increase cash flow or earnings, or to reduce net debt (and, if so, whether it should also be applied in prepayment of the facilities). While historically, it was restricted to the latter, European deal activity over the last couple of years has revealed a definitive trend towards "EBITDA cures" – that is, cure amounts being treated as an increase in earnings rather than as a reduction in net debt. In 2016, over half of all loan agreements with equity cures allowed for such EBITDA cures. Similar restrictions apply to equity cure rights in European loan documents as they do in the United States in respect of the frequency and absolute number of times an equity cure right may be utilised – however, in Europe the frequency is typically lower (and usually, an equity cure cannot be used in consecutive periods) and is subject to a lower overall cap (usually, no more than two or three times over the term of the facility). Another key difference between the U.S. and European approaches to equity cures is that, unlike in U.S. loan agreements, "over-cures" are typically permitted in European loan agreements (that is, the ability to inject more equity proceeds than is actually required to cure any financial covenant non-compliance). Such an ability is advantageous to some borrowers by allowing them to obscuring any possible future underperformance. From a documentation perspective, it is also important to note that there is no LMA-recommended equity cure language.

Sanctions, Anti-Money-Laundering and Anti-Bribery Provisions

A recent trend in both European and U.S. loan agreements is the increasing expansiveness of (and lender focus on) the representations, warranties and covenants relating to anti-bribery, anti-money-laundering and sanctions laws locally and abroad (the "Anti-Corruption/Sanctions Laws") coupled with lenders' increasing rigidity and resistance to negotiation with regard to these expansive Anti-Corruption/Sanctions Laws provisions. In the U.S. market context, additional evidence of this trend is that *SunGard* provisions (discussed in Part A) increasingly identify representations with respect to Anti-Corruption/Sanctions Laws as specified representations. Similarly in the European market, lenders invariably insist on such representations being characterised as "major representations" for certain funds purposes. Negotiation of these provisions may focus on whether it is appropriate to limit these provisions by materiality and/or by knowledge. Both European and U.S. borrowers are often concerned about their ability to fully comply with broadly drafted provisions without some form of knowledge, scope and/or materiality qualifiers.

Part C – Syndicate Management

Voting Thresholds

In U.S. loan agreements, for matters requiring a vote of syndicate lenders holding loans or commitments, most votes of "required lenders" require only a simple majority of lenders (that is, more than 50% of lenders by commitment size) for all non-unanimous issues. In European loan agreements, most votes require 66.67% or more affirmative vote of lenders by commitment size. In some, but not all, European loan agreements, certain votes that would otherwise require unanimity may instead require only a "super-majority" vote, ranging between 85–90% of lenders by commitment size. Such super majority matters typically relate to releases of transaction security or guarantees, or an increase in the facilities (though not an increase that might result in an obligation to fund on the part of the non-consenting lender).

"Unanimous" decisions in U.S. loan agreements are limited to fundamental matters and require the consent only of affected lenders (and are not, therefore, truly unanimous), while in European loan agreements (except where they may be designated as a super majority matter), decisions covering extensions to commitment periods, payment dates and reductions in amounts payable (even certain mandatory prepayment circumstances), changes to currencies and commitments, transfer provisions and rights between lenders all require the unanimous consent of lenders (not just those affected by the proposed changes).

Because of its adherence to requiring 100% lender consent to extend, the European market does not typically provide for amend and extend provisions that permit borrowers to extend their loan's maturity with only the consent of the extending lenders (which is not unusual in the U.S.). Instead, European borrowers have turned to the forward start facility, which is structured as a new loan agreement that sits beside the existing loan agreement but is not drawn until the existing facility matures. The forward start facility is used solely to refinance the indebtedness outstanding under the existing loan agreement.

Yank-a-Bank

U.S. loan agreements often contain provisions allowing the borrower to remove one or more lenders from the syndicate in certain circumstances. A borrower may, for example, remove a lender where such lender refuses to agree to an amendment or waiver requiring the unanimous consent of lenders, if the "required

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lenders" (typically more than 50% of lenders by commitment) have consented. Other reasons a borrower may exercise "yank-a-bank" provisions are when a lender has a loss of creditworthiness, has defaulted on its obligations to fund a borrowing or has demanded certain increased cost or tax payments. In such circumstances, the borrower may facilitate the sale of the lender's commitment to another lender or other eligible assignee. In most European loan agreements, yank-a-bank provisions are also routinely included and are similar in mechanism and trigger events. However, the threshold vote for "required lenders" is typically defined as at least 66.67% of lenders by commitment.

Snooze-You-Lose

In addition to provisions governing the required votes of lenders, most European loan agreements will also contain "snooze-you-lose" provisions, which favour the borrower when lenders fail to respond to a request for an amendment, consent or waiver. Where a lender does not respond within a specific time frame, such lender's commitment is ignored when calculating whether the requisite vote percentage have approved the requested modification. Similar provisions are rare in U.S. loan agreements.

Transfers and Assignments

In European loan agreements, lenders may assign their rights or otherwise transfer by novation their rights and obligations under the loan agreement to another lender. Typically, lenders will seek to rely on the transfer mechanism, utilising the standard forms of transfer certificates which are typically scheduled to the loan agreement. However, in some cases, an assignment may be necessary to avoid issues in some European jurisdictions which would be caused by a novation under the transfer mechanic (particularly in the context of a secured deal utilising an English-law security trust, which may not be recognised in some European jurisdictions).

Generally, most sub-investment grade European deals will provide that lenders are free to assign or transfer their commitments to other existing lenders (or an affiliate of such a lender) without consulting the borrower, or free to assign or transfer their commitments to a pre-approved list of lenders (a white list), or not to a predetermined list of lenders (a blacklist). Restrictions on transferring commitments to "competitors" of the borrower are also now common in European loan agreements. For stronger borrowers in both Europe and the United States, the lenders must usually obtain the consent of the borrower prior to any transfer or assignment to a lender that is not an existing lender (or affiliate).

In the United States, the LSTA has recommended "deemed consent" of a borrower where a borrower does not object to proposed assignments within five business days, which is the same position taken in the European market. Similar to stronger European borrowers and sponsors who are able to negotiate a "blacklist", stronger borrowers in the United States, or borrowers with strong sponsors, often negotiate a "DQ List" of excluded (disqualified) assignees. Recently in the United States, large cap borrowers have pushed for expansive DQ lists and the ability to update the list post-closing (a development not seen in European loan agreements). In both the European and U.S. contexts, the DQ List or blacklist helps the borrower avoid assignments to lenders with difficult reputations. In the U.S. market, exclusion of competitors and their affiliates is also negotiated in the DQ List.

Part D – New Regulatory and Legal Developments in the Loan Market

Leveraged lending guidance

U.S. federal bank regulators indicated during the third quarter of 2014 that they would more carefully scrutinise leveraged lending issuances following their determination that a third of leveraged loans they reviewed did not comply with the Leveraged Lending Guidance (the "US Guidance") issued in March 2013 by the Federal Reserve, the OCC and the FDIC. The U.S. Guidance provides, among other things, that a leverage level in excess of 6× total debt over EBITDA will raise regulatory concern for most industries and may result in the loan being criticised (as discussed further in in Part B). In addition, the U.S. Guidance provides that a borrower should be able to amortise its senior secured debt or repay half its total debt with five to seven years of base cash flows.

Regulators have identified some specific ways the U.S. Guidance may affect credit agreement provisions or features. For example, regulators have said they will be critical of credit agreement terms that allow for the material dilution, sale, or exchange of collateral or cash flow-producing assets without lender approval. Sidecar loan agreements or accordion features that allow borrowers to incur more debt without protecting the existing lenders may attract regulatory scrutiny. EBITDA adjustments must be supported by third-party due diligence and a "large-percentage" adjustment will attract regulators' suspicion. Regulators have said that because refinancings or modifications count as originations to which the U.S. Guidance applies, any refinancings or modifications of non-pass loans must show meaningful improvements to structure or controls to avoid being criticised. Such improvements might be new or tightened covenants, additional collateral or restrictions on acquisitions.

Supplementary regulatory commentary provides that failure to adhere to these requirements is not a bright line bar to an issuance if there are other mitigating factors. The lack of a bright line rule may permit some loan issuances that do not achieve complete compliance, but it also introduces significant uncertainty into the process of underwriting a loan issuance for sponsors, borrowers and lenders alike. Experts predicted that the U.S. Guidance could result in more borrowers electing to use non-regulated institutions as agents and lenders, and, as predicted, since 2015, non-regulated financing sources have been more active with respect to loans that might have been criticised. This trend is not without problems. Sponsors are wary of trusting the execution of large deals to non-regulated financing sources, and borrowers are hesitant to rely on revolving commitments from them. Also, overreliance on non-regulated financing sources could create a liquidity problems in a few years when borrowers seek to refinance (regulators have indicated that the U.S. Guidance may be applied to a refinancing). Regulators are considering regulations to address the non-regulated financing sources loophole.

The federal regulators noted in a 2016 review that the banks have made progress in compliance with the U.S. Guidance as the number of non-pass loan originations in the U.S. market reached *de minimis* levels. But the regulators cautioned that some weaknesses in underwriting practices still exist, including liberal repayment terms, structures with "ineffective or no covenants", incremental debt provisions that allow for debt to a level that inhibits deleveraging capacity and dilutes senior secured creditors and unreasonable addbacks to EBITDA. Further part of the decrease in non-pass originations is attributable to the liberal use of

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addbacks that increase EBITDA substantially, thereby decreasing the leverage ratio below 6×. For example, when the Ultimate Fighting Championship put itself up for sale recently, addbacks to its EBITDA increased its earnings from $170,000,000 in the initial calculation to $300,000,000 in the presentation given to debt investors (which decreased its leverage ratio to 6×). This large increase in EBITDA would permit substantially more debt to be incurred in connection with the sale. Regulators caught on and cautioned Goldman Sachs, the arranger. When Bain Capital decided to buy online jeweller Blue Nile, addbacks increased Blue Nile's EBITDA from approximately $19,000,000 to approximately $45,000,000, dropping its leverage ratio from 9× to 4×. The concern of regulators is that, regardless of the decrease in non-pass originations, this type of creative accounting does not represent true progress toward tighter underwriting practices.

Similar leveraged lending regulation is likely to be introduced in Europe shortly. On 23 November 2016, the ECB published (for consultation purposes) an initial draft guidance to banks regarding leveraged transactions, which is intended to apply to all "significant credit institutions" supervised by the ECB under the Single Supervisory Mechanism (the "ECB Guidance"). The ECB Guidance will not apply to "credit institutions" based in member states outside the Single Supervisory Mechanism and not directly supervised by the ECB (such as the United Kingdom, although the Bank of England has itself from time to time considered leveraged lending levels). Although the ECB Guidance will not be legally binding, affected institutions are expected to incorporate the ECB Guidance as part of their internal lending policies, which will undoubtedly affect credit and lending decisions once the ECB Guidelines are finalised and implemented.

For the purposes of the ECB Guidance, a "leveraged" transaction will include all types of loans or credit exposures where the borrower's post-financing level of leverage (i.e. the ratio of total debt to EBITDA) exceeds 4.0× as well as all types of loan or credit exposures where the borrower is owned by one or more financial sponsors. Under the ECB Guidance, affected credit institutions are expected to ensure that transactions which have a "high level" of leverage – meaning transactions where the ratio of total debt to EBITDA exceeds 6.0× at the time of deal inception, remain "exceptional" (in similar vein to the U.S. Guidance). As mentioned above, the ECB Guidance proposes to test leveraged transactions by reference to "unadjusted" EBITDA, unlike the U.S. Guidance which acknowledges adjustments to EBITDA. At the time of writing, the ECB Guidance was still in the consultation phase and far from being finalised, and so whilst it will be certainly significant from a compliance and risk perspective, the real impact on deal levels and loan terms cannot be meaningfully determined at this stage.

Changes in LIBOR administration

In response to the LIBOR-rigging scandal that was exposed in 2012, extensive LIBOR reforms were adopted, including discontinuation of certain rates and the addition of confidentiality restrictions on each bank's LIBOR submission. One documentation issue the reforms have raised is determining LIBOR for interest periods that have been discontinued. Some U.S. loan agreements have taken the approach of approximating LIBOR for an interest period for which it is not available by interpolating on a linear basis the rates for the next longest and next shortest interest period for which LIBOR is available. Others have taken the approach of using an alternative benchmark in the event that a particular LIBOR rate is unavailable. Some use a hybrid of the two approaches – if the requisite LIBOR rate is unavailable, then an alternative benchmark is to be used and, if that is not available, an interpolated rate is to be used. The LMA's suggested provision uses linear interpolation. Banks have also questioned whether the new confidentiality rules could affect reference banks or restrict the provision of internal rates. The opinion of the LMA is that this is not an issue, but some banks remain concerned about liability for quoting their internal rates or acting as a reference bank.

European contractual recognition of bail-in

As part of a series of recently implemented European banking reforms, the EU Bank Recovery and Resolution Directive (or "**BRRD**") has empowered European bank regulators to facilitate the rescue of a failing financial institution incorporated in the European Economic Area (or "**EEA**") – these include powers to write-down and/or convert into equity certain unsecured liabilities of a failing EEA financial institution.

As a result of the BRRD, where an EEA financial institution has entered into a contract governed by the law of a non-EEA country (for example, a New York law credit agreement), the EEA financial institution is required to include a "recognition of bail in" clause through which the counterparties to that contract (for example, borrowers in a loan transaction) are required to expressly acknowledge that the EEA financial institution's obligations under that document are subject to the write-down and conversion powers provided for under the BRRD. Where an EEA financial institution has entered into a contract governed by the law of an EEA country (such as an English law credit agreement), no such "recognition of bail in" clause is required as any bail-in powers under the BRRD will be effective as a matter of law, regardless of the terms of the document.

Both the LMA and the LSTA have published recommended form language to be included in loan agreements governed by non-EEA law, which can be used to the extent a transaction involves an EEA financial institution.

Conclusion

As highlighted in this article, it is important for practitioners and loan market participants to be aware of the key differences in the commercial terms and market practice in European and U.S. leveraged loan transactions. While there are many broad similarities between the jurisdictions, borrowers and lenders that enter into either market for the first time may be surprised by the differences, some of which may appear very subtle but which are of significance. As more and more borrowers are prepared to look beyond their domestic market and willing to seek access to whichever debt market (whether U.S. or European) offers greater liquidity and more favourable pricing and terms at any given time, and as a wider range of alternative and non-bank investors are attracted to the investment opportunities presented by both the European and U.S. loan markets, the importance of having a general understanding of the differences is now even more critical.

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