ICLG

The International Comparative Legal Guide to:

Lending & Secured Finance 2019

7th Edition

A practical cross-border insight into lending and secured finance

Allen & Overy LLP
Anderson Mori & Tomotsune
Asia Pacific Loan Market Association (APLMA)
Astrea
Baker & McKenzie LLP
Bravo da Costa, Saraiva – Sociedade de Advogados
Cadwalader, Wickersham & Taft LLP
Carey
Carey Olsen Jersey LLP
Cordero & Cordero Abogados
Criales & Urcullo
Cuatrecasas
Davis Polk & Wardwell LLP
Debevoise & Plimpton LLP
Dechert LLP
Dillon Eustace
Drew & Napier LLC
E & G Economides LLC
E. Schaffer & Co.
Fellner Wratzfeld & Partners
Freshfields Bruckhaus Deringer LLP
Fried, Frank, Harris, Shriver & Jacobson LLP
Gonzalez Calvillo, S.C.
Haynes and Boone, LLP
Hogan Lovells International LLP
Holland & Knight
HSBC
IKT Law Firm
Jadek & Pensa
JPM Janković Popović Mitić
Kelobang Godisang Attorneys
King & Wood Mallesons
Latham & Watkins LLP
Lee and Li, Attorneys-at-Law
Lloreda Camacho & Co.
Loan Market Association
Loan Syndications and Trading Association
Loyens & Loeff Luxembourg S.à r.l.
Macesic & Partners LLC
Maples Group
Marval, O'Farrell & Mairal
McMillan LLP
Milbank LLP
Morgan, Lewis & Bockius LLP
Morrison & Foerster LLP
Nielsen Nørager Law Firm LLP
Norton Rose Fulbright US LLP
Orrick Herrington & Sutcliffe LLP
Pestalozzi Attorneys at Law Ltd
Pinheiro Neto Advogados
PLMJ Advogados
Ploum
Proskauer Rose LLP
Rodner, Martínez & Asociados
Sardelas Liarikos Petsa Law Firm
Seward & Kissel LLP
Shearman & Sterling LLP
Skadden, Arps, Slate, Meagher & Flom LLP
Škubla & Partneri s. r. o.
SZA Schilling, Zutt & Anschütz Rechtsanwaltsgesellschaft mbH
Trofin & Asociații
TTA – Sociedade de Advogados
Wakefield Quin Limited
Walalangi & Partners (in association with Nishimura & Asahi)
Weil, Gotshal & Manges LLP
White & Case LLP

Contributing Editor
Thomas Mellor, Morgan, Lewis & Bockius LLP

Publisher
Rory Smith

Sales Director
Florjan Osmani

Account Director
Oliver Smith

Senior Editors
Caroline Collingwood
Rachel Williams

Editor
Sam Friend

Group Consulting Editor
Alan Falach

Published by
Global Legal Group Ltd.
59 Tanner Street
London SE1 3PL, UK
Tel: +44 20 7367 0720
Fax: +44 20 7407 5255
Email: info@glgroup.co.uk
URL: www.glgroup.co.uk

GLG Cover Design
F&F Studio Design

GLG Cover Image Source
iStockphoto

Printed by
Stephens & George
Print Group
April 2019

Copyright © 2019
Global Legal Group Ltd.
All rights reserved
No photocopying

ISBN 978-1-912509-65-2
ISSN 2050-9847

Strategic Partners

Editorial Chapters:

1 **Loan Syndications and Trading: An Overview of the Syndicated Loan Market** – Bridget Marsh & Tess Virmani, Loan Syndications and Trading Association 1

2 **Loan Market Association – An Overview** – Nigel Houghton & Hannah Vanstone, Loan Market Association 6

3 **Asia Pacific Loan Market Association – An Overview** – Andrew Ferguson, Asia Pacific Loan Market Association (APLMA) 12

General Chapters:

4 **An Introduction to Legal Risk and Structuring Cross-Border Lending Transactions** – Thomas Mellor & Marcus Marsh, Morgan, Lewis & Bockius LLP 15

5 **Global Trends in the Leveraged Loan Market in 2018** – Joshua W. Thompson & Korey Fevzi, Shearman & Sterling LLP 20

6 **Developments in Delayed Draw Term Loans** – Meyer C. Dworkin & Samantha Hait, Davis Polk & Wardwell LLP 26

7 **Commercial Lending in a Changing Regulatory Environment, 2019 and Beyond** – Bill Satchell & Elizabeth Leckie, Allen & Overy LLP 30

8 **Acquisition Financing in the United States: Will the Boom Continue?** – Geoffrey R. Peck & Mark S. Wojciechowski, Morrison & Foerster LLP 34

9 **A Comparative Overview of Transatlantic Intercreditor Agreements** – Lauren Hanrahan & Suhrud Mehta, Milbank LLP 39

10 **A Comparison of Key Provisions in U.S. and European Leveraged Loan Agreements** – Sarah M. Ward & Mark L. Darley, Skadden, Arps, Slate, Meagher & Flom LLP 46

11 **The Global Subscription Credit Facility and Fund Finance Markets – Key Trends and Forecasts** – Michael C. Mascia & Wesley A. Misson, Cadwalader, Wickersham & Taft LLP 59

12 **Recent Developments in U.S. Term Loan B** – Denise Ryan & Kyle Lakin, Freshfields Bruckhaus Deringer LLP 63

13 **The Continued Growth of European Covenant Lite** – James Chesterman & Jane Summers, Latham & Watkins LLP 70

14 **Cross-Border Loans – What You Need to Know** – Judah Frogel & Jonathan Homer, Allen & Overy LLP 73

15 **Debt Retirement in Leveraged Financings** – Scott B. Selinger & Ryan T. Rafferty, Debevoise & Plimpton LLP 82

16 **Analysis and Update on the Continuing Evolution of Terms in Private Credit Transactions** – Sandra Lee Montgomery & Michelle Lee Iodice, Proskauer Rose LLP 88

17 **Secondments as a Periscope into the Client and How to Leverage the Secondment Experience** – Alanna Chang, HSBC 95

18 **Trade Finance on the Blockchain: 2019 Update** – Josias Dewey, Holland & Knight 98

19 **The Global Private Credit Market: 2019 Update** – Jeff Norton & Ben J. Leese, Dechert LLP 104

20 **Investment Grade Acquisition Financing Commitments** – Julian S.H. Chung & Stewart A. Kagan, Fried, Frank, Harris, Shriver & Jacobson LLP 109

21 **Acquisition Financing in Latin America: Navigating Diverse Legal Complexities in the Region** – Sabrena Silver & Anna Andreeva, White & Case LLP 114

22 **Developments in Midstream Oil and Gas Finance in the United States** – Elena Maria Millerman & John Donaleski, White & Case LLP 121

23 **Margin Loans: The Complexities of Pre-IPO Acquired Shares** – Craig Unterberg & LeAnn Chen, Haynes and Boone, LLP 127

24 **Credit Agreement Provisions and Conflicts Between US Sanctions and Blocking Statutes** – Roshelle A. Nagar & Ted Posner, Weil, Gotshal & Manges LLP 132

25 **SOFR So Good? The Transition Away from LIBOR Begins in the United States** – Kalyan ("Kal") Das & Y. Daphne Coelho-Adam, Seward & Kissel LLP 137

Continued Overleaf →

Further copies of this book and others in the series can be ordered from the publisher. Please call +44 20 7367 0720

Disclaimer
This publication is for general information purposes only. It does not purport to provide comprehensive full legal or other advice.
Global Legal Group Ltd. and the contributors accept no responsibility for losses that may arise from reliance upon information contained in this publication.
This publication is intended to give an indication of legal issues upon which you may need advice. Full legal advice should be taken from a qualified professional when dealing with specific situations.

glg
global legal group

General Chapters:

26	**Developments in the Syndicated Term Loan Market: Will Historical Distinctions from the High-Yield Bond Market Be Restored?** – Joseph F. Giannini & Adrienne Sebring, Norton Rose Fulbright US LLP	141
27	**Green Finance** – Alex Harrison & Andrew Carey, Hogan Lovells International LLP	144
28	**U.S. Tax Reform and Effects on Cross-Border Financing** – Patrick M. Cox, Baker & McKenzie LLP	149

Country Question and Answer Chapters:

29	**Angola**	Bravo da Costa, Saraiva – Sociedade de Advogados / PLMJ: Bruno Xavier de Pina & Joana Marques dos Reis	159
30	**Argentina**	Marval, O'Farrell & Mairal: Juan M. Diehl Moreno & Diego A. Chighizola	165
31	**Australia**	King & Wood Mallesons: Yuen-Yee Cho & Elizabeth Hundt Russell	174
32	**Austria**	Fellner Wratzfeld & Partners: Markus Fellner & Florian Kranebitter	183
33	**Belgium**	Astrea: Dieter Veestraeten	193
34	**Bermuda**	Wakefield Quin Limited: Erik L Gotfredsen & Jemima Fearnside	199
35	**Bolivia**	Criales & Urcullo: Andrea Mariah Urcullo Pereira & Daniel Mariaca Alvarez	207
36	**Botswana**	Kelobang Godisang Attorneys: Wandipa T. Kelobang & Laone Queen Moreki	214
37	**Brazil**	Pinheiro Neto Advogados: Ricardo Simões Russo & Leonardo Baptista Rodrigues Cruz	221
38	**British Virgin Islands**	Maples Group: Michael Gagie & Matthew Gilbert	230
39	**Canada**	McMillan LLP: Jeff Rogers & Don Waters	237
40	**Cayman Islands**	Maples Group: Tina Meigh	247
41	**Chile**	Carey: Diego Peralta	255
42	**China**	King & Wood Mallesons: Stanley Zhou & Jack Wang	262
43	**Colombia**	Lloreda Camacho & Co.: Santiago Gutiérrez & Juan Sebastián Peredo	269
44	**Costa Rica**	Cordero & Cordero Abogados: Hernán Cordero Maduro & Ricardo Cordero B.	276
45	**Croatia**	Macesic & Partners LLC: Ivana Manovelo	284
46	**Cyprus**	E & G Economides LLC: Marinella Kilikitas & George Economides	292
47	**Denmark**	Nielsen Nørager Law Firm LLP: Thomas Melchior Fischer & Peter Lyck	300
48	**England**	Allen & Overy LLP: David Campbell & Oleg Khomenko	307
49	**Finland**	White & Case LLP: Tanja Törnkvist & Krista Rekola	316
50	**France**	Orrick Herrington & Sutcliffe LLP: Emmanuel Ringeval & Cristina Radu	324
51	**Germany**	SZA Schilling, Zutt & Anschütz Rechtsanwaltsgesellschaft mbH: Dr. Dietrich F. R. Stiller & Dr. Andreas Herr	335
52	**Greece**	Sardelas Liarikos Petsa Law Firm: Panagiotis (Notis) Sardelas & Konstantina (Nantia) Kalogiannidi	344
53	**Hong Kong**	King & Wood Mallesons: Richard Mazzochi & Khin Voong	352
54	**Indonesia**	Walalangi & Partners (in association with Nishimura & Asahi): Luky I. Walalangi & Siti Kemala Nuraida	360
55	**Ireland**	Dillon Eustace: Conor Keaveny & Richard Lacken	366
56	**Israel**	E. Schaffer & Co.: Ehud (Udi) Schaffer & Shiri Ish Shalom	375
57	**Italy**	Allen & Overy Studio Legale Associato: Stefano Sennhauser & Alessandra Pirozzolo	381
58	**Ivory Coast**	IKT Law Firm: Annick Imboua-Niava & Osther Tella	390
59	**Japan**	Anderson Mori & Tomotsune: Taro Awataguchi & Yuki Kohmaru	396
60	**Jersey**	Carey Olsen Jersey LLP: Robin Smith & Laura McConnell	404
61	**Luxembourg**	Loyens & Loeff Luxembourg S.à r.l.: Antoine Fortier-Grethen	414
62	**Mexico**	Gonzalez Calvillo, S.C.: José Ignacio Rivero Andere & Jacinto Avalos Capin	422
63	**Mozambique**	TTA – Sociedade de Advogados / PLMJ: Gonçalo dos Reis Martins & Nuno Morgado Pereira	430

Continued Overleaf →

Country Question and Answer Chapters:

64	**Netherlands**	Ploum: Tom Ensink & Alette Brehm	437
65	**Portugal**	PLMJ Advogados: Gonçalo dos Reis Martins	445
66	**Romania**	Trofin & Asociații: Valentin Trofin & Mihaela Atanasiu	452
67	**Russia**	Morgan, Lewis & Bockius LLP: Grigory Marinichev & Alexey Chertov	462
68	**Serbia**	JPM Janković Popović Mitić: Nenad Popović & Nikola Poznanović	470
69	**Singapore**	Drew & Napier LLC: Pauline Chong & Renu Menon	477
70	**Slovakia**	Škubla & Partneri s. r. o.: Marián Šulík & Zuzana Moravčíková Kolenová	487
71	**Slovenia**	Jadek & Pensa: Andraž Jadek & Žiga Urankar	494
72	**South Africa**	Allen & Overy LLP: Lionel Shawe & Lisa Botha	504
73	**Spain**	Cuatrecasas: Manuel Follía & Iñigo Várez	514
74	**Sweden**	White & Case LLP: Carl Hugo Parment & Tobias Johansson	525
75	**Switzerland**	Pestalozzi Attorneys at Law Ltd: Oliver Widmer & Urs Klöti	532
76	**Taiwan**	Lee and Li, Attorneys-at-Law: Hsin-Lan Hsu & Odin Hsu	541
77	**UAE**	Morgan, Lewis & Bockius LLP: Victoria Mesquita Wlazlo & Amanjit K. Fagura	549
78	**USA**	Morgan, Lewis & Bockius LLP: Thomas Mellor & Rick Eisenbiegler	564
79	**Venezuela**	Rodner, Martínez & Asociados: Jaime Martínez Estévez	576

EDITORIAL

Welcome to the seventh edition of *The International Comparative Legal Guide to: Lending & Secured Finance*.

This guide provides corporate counsel and international practitioners with a comprehensive worldwide legal analysis of the laws and regulations of lending and secured finance.

It is divided into three main sections:

Three editorial chapters. These are overview chapters and have been contributed by the LSTA, the LMA and the APLMA.

Twenty-five general chapters. These chapters are designed to provide readers with an overview of key issues affecting lending and secured finance, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in lending and secured finance laws and regulations in 51 jurisdictions.

All chapters are written by leading lending and secured finance lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor Thomas Mellor of Morgan, Lewis & Bockius LLP for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.com.

Alan Falach LL.M.
Group Consulting Editor
Global Legal Group
Alan.Falach@glgroup.co.uk

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

Sarah M. Ward

Mark L. Darley

Skadden, Arps, Slate, Meagher & Flom LLP

There are many broad similarities in the general approach taken to European and U.S. leveraged loan transactions, and terms in the documentation of U.S. and European leveraged loans continue to converge with one another (and, in the case of larger leverage transactions, with high-yield bond terms). Notwithstanding a year-end slowdown in the U.S. debt market, the supply of leveraged loans in both markets in 2018 generally continued to lag behind the growing demand of leveraged loan investors, resulting in terms that have become even more borrower-friendly, as deals are consistently oversubscribed. Sponsors and borrowers in both the U.S. and European loan markets have been increasingly successful in pushing the boundaries of once standard lender protections, although the second half of 2018 did lead to successful investor push-back in some areas and with some consistency. Despite these similarities, there are also significant differences in commercial terms and overall market practice in the U.S. and European leveraged loan markets. The importance for practitioners and loan market participants to understand the similarities and differences across the markets has grown in recent years as sophisticated investors now routinely seek to access whichever market may provide greater liquidity and, potentially, more favourable pricing and less risky terms (from the investor's perspective) at any given time.

This chapter will focus on certain 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 form of documentation chosen as a starting point for negotiation and documentation (whether a market form or precedent transaction) will 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), even if the actual form is a tailored, prior transaction precedent. Conversely, in the United States, although the Loan Syndications and Trading Association (the "LSTA") recently published a form agreement for investment grade transactions, the form on which the loan documentation will be based will be the subject of negotiation at an early stage. Sponsors and borrowers will look to identify a "documentation precedent" – an existing deal on which the loan documentation will be based – and come to an agreement with the arranger banks that the final outcome of negotiations is no less favourable to the borrower than such precedent. In addition, there will be negotiation as to who "holds the pen" for drafting the documentation, as this may also influence the final outcome. Traditionally, the lender side has "held the pen" on documentation, but there is a growing trend, both in the United States and Europe, for the larger sponsor-backed borrowers to insist on taking control of, and responsibility for, producing the key documents which, inevitably, leads to a more borrower-friendly starting point. This trend has further expanded and now often applies to middle-market sponsor-backed borrower deals and larger corporate borrowers.

The LMA (comprised of more than 660 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, the update to the EU Blocking Regulation following U.S.-imposed sanctions on Iran, and the decision to phase out LIBOR): 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

© Published and reproduced with kind permission by Global Legal Group Ltd, London

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, transfer restrictions, conditions to drawdown, etc.) remain as bespoke to the specific transaction as ever.

Similar to the LMA in Europe, 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 recently published a form of investment grade credit agreement and has developed some recommended standard documentation for leveraged loan agreements, those forms are rarely used as a starting draft for negotiation, and the form documentation for leveraged loan agreements is largely limited to the mechanical and "miscellaneous" provisions of the loan agreements, such as assignment documentation, EU "bail-in" provisions and tax provisions. Historically, U.S. documentation practice was based on the forms of the lead bank or agent (which may have, in fact, incorporated at least some of the LSTA recommended language), but there has been a shift to identifying a "documentation precedent". In the case of a corporate borrower, this may be the borrower's existing credit agreement or that of another similarly situated borrower in the same industry. A sponsor-backed borrower will likely identify existing documentation for another portfolio company of the sponsor, which puts the onus on the lead bank to identify any provisions that may negatively impact syndication.

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.

Facility Types

The basic facility types in both U.S. and European leveraged loan transactions are very similar. Typically, a loan agreement will provide for a term loan facility and/or a revolving credit facility, which are most often secured on a *pari passu* basis. In addition, in the United States (and increasingly in Europe), loan agreements may also provide for uncommitted "incremental facilities", which can take the form of additional term loans or revolving credit commitments. While the borrower will have to satisfy certain customary conditions to obtain these incremental facilities (in addition to obtaining commitments), the consent of existing lenders is not required. 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 expenditures and letters of credit, but such facilities are beyond the purview of this article.

In the United States and in Europe all lenders (whether revolving credit lenders or term loan lenders) in a first lien or unitranche facility will 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, unless there is a "first in last out" structure, which, as discussed below, is sometimes used in the U.S. Alternatively, a transaction may be effected through a 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 or prepayments may be applied to any second lien obligations until all first lien obligations are repaid). If there is a revolving credit facility, this will be included in the first lien facilities. The second lien facility will be a term loan with no interim amortisation payments. First lien/second lien structures are treated as essentially two separate loans, with two sets of loan documents and two agents, with the relationship between the two lender groups 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 smaller deals) to instead effect a "first lien/second lien" structure through a unitranche facility, in which there is a single loan with two tranches – a first out tranche and a last out tranche. In such a facility, there is only one set of loan documents, one agent, one set of lenders and, from the borrower's perspective, one interest rate (because the borrower pays a blended rate, and, depending on the market appetite for the different levels of risk, the lenders decide the allocation of interest between the first out lenders and the last out lenders). A separate agreement among lenders ("AAL") governs the rights and obligations of the first out and last out lenders, including voting rights, and also the previously mentioned allocation of interest between the lenders. Alternatively, the allocation of rights and obligations among the lenders may be included in the loan agreement itself, which borrowers may prefer, as it gives them insight into voting rights. Previously there was a question as to whether a court presiding over a borrower's bankruptcy could construe and enforce an AAL in the bankruptcy (even though borrowers are not party to AALs); the *In re RadioShack Corp.* bankruptcy litigation largely resolved this question by implicitly recognising 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 also playing a much more significant role in the debt market, primarily in the smaller to mid-market transactions, though funds are keen to emphasise their ability to do much larger financings. It is worth noting that debt funds and alternative capital providers may not always have the capacity to provide lines of working capital to prospective borrowers and as such, they may "club" with commercial banks to provide this component of the financing. In such instances, the commercial bank may retain a senior ranking over the debt fund/alternative capital provider.

Similarly to U.S. unitranche structures, European unitranche structures also utilise an AAL, to which typically the borrower will not be party. 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 (such as *Re Apcoa Parking Holdings GmbH & Ors*)[1] 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).

Following a notable increase in the number of European middle market unitranche loan structures backed by private debt funds, many traditional banks have responded by forming partnerships with alternative lenders. These alternative lenders typically offer Payment in Kind ("PIK") loans to compliment the senior bank loan, raising leverage on the overall financing and ensuring the banks are able to

© Published and reproduced with kind permission by Global Legal Group Ltd, London

remain competitive with the private debt funds. Whilst historically PIK loan instruments have been suited to larger companies with high levels of liquidity, the number of PIK loans extended to the middle market increased during 2018.[2] It is worth noting, however, that the extension of these highly subordinated PIK loans to smaller (often less liquid) companies is still treated with caution by many lenders.

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 (the exchange for this typically being that the high-yield noteholders have the ability to enforce and direct enforcement first, for a certain period of time).

Term Loan Types

The terms of a financing are influenced not just by the size and nature of the transaction but also by the composition of the lending group. Term A loans are syndicated in the United States to traditional banking institutions, who typically require a five-year maturity, higher amortisation (which may be up to 5% or 10% per year) and tighter covenants characteristic of Term A loans. In leveraged lending, Term A loans will include one or more financial maintenance covenants, typically leverage tests and a fixed charge or interest coverage test, that are tested quarterly. 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. As a result, Term B loans are more likely to be governed by "covenant-lite" agreements (in which only the revolving credit facility has the benefit of the financial maintenance covenant, and the covenant is only tested if usage exceeds a certain percentage of the revolving credit commitments – typically 25% to 35%) and provide greater overall covenant flexibility. The maturity date of Term B loans will also be longer – six or seven years is typical, and a second lien Term B loan may even have an eight-year maturity. To compensate for these more borrower-friendly terms, Term B loans have a higher interest rate margin and other economic protections (such as "soft-call" and "no-call" periods and "excess cash flow" mandatory prepayment provisions) not commonly seen in Term A loans. The high demand by Term B loan investors, often enticed by the floating-rate component of leveraged loans and their seniority over unsecured bonds, has resulted in an increasing willingness to accept fewer protections in the loan documentation. This trend has caused some concerns regarding the erosion of key covenants, such as restrictions on asset transfers and prohibitions on borrowers selling collateral prior to repayment of their loans, that may significantly affect the probability of recovery rates in default scenarios.[3] However, the trend to increasingly relaxed terms faced some resistance near the end of 2018, when sharp declines in the trading prices of existing leveraged loans, notwithstanding performing credits and low default rates, began to prompt more investor-friendly terms (in the form of higher spreads and tighter covenants)[4] on a limited supply of new issuances of debt in response to a lower risk appetite for investors. In some cases, lenders were able to pressure borrowers to tighten leverage covenants and otherwise "flex up" terms (including pricing). Other deals that were underwritten at the market peak have been postponed as volatility increased during the year-end period.[5] A key question for the beginning of 2019 will be for market participants to determine how long this volatility will continue.

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 the enthusiasm of U.S. institutional investors in the European loan market to participate 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 with terms frequently as flexible (and sometimes more flexible) than those seen in their U.S. Term B loan equivalent. Many larger borrowers and sponsors in the European TLB market have been very successful in negotiating generous borrower-friendly relaxations in their loan covenants (in particular relating to debt capacity, permitted disposals and acquisitions, and financial covenant cure rights, to the extent the loan is not "covenant-lite"), although most European TLB instruments are still likely to contain guarantor maintenance coverage tests (requiring the accession of additional guarantors and the provision of additional security if the required test thresholds are not met), and to have higher lender consent thresholds.

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 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 funds 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, merger agreement or other acquisition agreement). Despite the absence of a regulatory requirement, the parties will largely agree on terms of the final loan documentation while negotiating the commitment letter (including a definitive list of what representations, warranties, covenants and events of default will be included and the definition of EBITDA, including "add-backs"). Increasingly, commitment letters include more detailed term sheets that set forth specific baskets and thresholds for covenants and events of default and identify leverage levels for the incurrence tests for debt, restricted payments, restricted debt payments and investments. In the United States, commitment papers for an acquisition financing will contain customary "SunGard" provisions that limit the representations and warranties that are required to be accurate, and, in some cases, those that are required to be made by the loan parties, at closing and provide a post-closing period for the delivery of certain types of collateral and related documentation and, in some cases, guarantees. Typically, only Uniform Commercial Code financing statements and stock certificates (and related stock powers) of the borrower and material U.S. restricted subsidiaries are required by the

© Published and reproduced with kind permission by Global Legal Group Ltd, London

lenders on the closing date of the loan (and, then, only to the extent actually received from the target). Given the level of commitment implicit in New York law commitment papers and the New York law principle of dealing in good faith, there is probably little difference as a practical matter between European "certain funds" and SunGard commitment papers, but 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 of U.S.-style loan provisions that are more flexible and borrower-friendly – or "convergence" as it is commonly referred to – many differences remain 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 that underpins the construction of their respective covenants/undertakings. In U.S. loan agreements, borrowers and guarantors are known as "loan parties", whilst 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 subject to the covenants of the loan agreement, do not make the representations and warranties in the loan documents, and do not guarantee the borrower's obligations. In exchange for such freedom, the loan agreement will limit dealings between members of the restricted and unrestricted group. In addition, EBITDA attributed to the unrestricted group likely will not be taken into account in calculating financial covenants (unless distributed to a member of the restricted group), and debt of the unrestricted group is similarly excluded. 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. One notable example of such a manoeuvre came in December 2016 when J Crew Group, which owned its domestic trademarks through a restricted subsidiary, transferred a significant interest in those trademarks to a foreign restricted subsidiary, which in turn transferred it to an unrestricted subsidiary and subsequent transfers were made to other unrestricted subsidiaries. In response to the high-profile clash between J Crew Group and its credit agreement investors, there is a limited trend toward including a specific prohibition on transfers of material intellectual property to an unrestricted subsidiary – commonly known as the "J Crew blocker".[6] Whilst not historically a feature of the European loan market, the use of the "restricted/unrestricted" subsidiary construct is now also sometimes seen in European loan agreements, particularly in the context of European TLB instruments.

Restrictions on Indebtedness

Leveraged loan agreements include a covenant, referred to as an "indebtedness covenant" in U.S. loan agreements and a "restriction on financial indebtedness" undertaking in European loan agreements, that prohibits the borrower and its restricted subsidiaries from incurring indebtedness other than certain identified permitted indebtedness. Typically, "indebtedness" of a person 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) and guarantees of obligations otherwise constituting indebtedness, as well as indebtedness of third parties secured by assets of such person.

In U.S. loan agreements, the indebtedness covenant prohibits all indebtedness with baskets allowing for specific types and/or amounts of indebtedness. Some of these exceptions are customary, such as loans to entities within the credit group, non-speculative hedging obligations and capital expenditures (up to an agreed upon cap), but others may be tailored to the business of the borrower. In addition, there are other baskets, such as the general "basket" of debt (which can take the form of a fixed amount or a formula based on a percentage of total assets or EBITDA or a combination, such as the greater of a fixed amount and a percentage formula), an "incurrence-based" basket, which requires compliance with a given leverage or fixed charge ratio, and a basket for indebtedness acquired and/or assumed in connection with permitted acquisitions. These other baskets will be sized based on the borrower's business and, if applicable, the lead bank's relationship with the sponsor or the borrower, as applicable. 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. Some U.S. loan agreements contain reclassification provisions applicable to other covenants (such as the lien and investment covenants, and, in more aggressive deals, the restricted payment and restricted debt payment 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. Some agreements allow borrowers to use restricted payment and restricted debt payment capacity to incur debt or make investments. This is part of a more general trend of giving borrowers flexibility to use a basket designated for a specific purpose for other purposes.

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 under the credit agreement (on top of any commitments the credit agreement originally provided for), or, in *lieu* thereof, additional *pari passu* or subordinated secured or unsecured incremental debt outside the credit agreement under a separate facility (known as "incremental equivalent" 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 is met (which will be a first lien secured or total leverage test, depending on whether the new debt is to be secured on a *pari passu* or junior basis or is unsecured). These levels are generally set to require compliance with closing date leverage levels or, in the case of unsecured debt, with a specified interest coverage ratio (typically 2.0×). The use of an interest coverage ratio for debt incurrence borrows from the high-yield bond world. Some deals include increased ratio incremental capacity for acquisitions by providing that the borrower may incur incremental term loans either if the borrower complies with a specified *pro forma* leverage test or if *pro forma* leverage does not increase as a result of the acquisition.

Some borrowers have negotiated the ability to refresh their free-and-clear basket by redesignating debt originally incurred under the free-and-clear basket as debt incurred under the leverage-based incremental capacity. Most U.S. loan agreements permit borrowers

© Published and reproduced with kind permission by Global Legal Group Ltd, London

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 having the size of the free-and-clear basket increase as the borrower's EBITDA grows.

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 basis points but aggressive sponsors increasingly seek 75 basis points) of the incremental facility's margin. Sponsor-friendly loan agreements often include limitations with respect to most favoured nation clauses, usually a "sunset" restricting its application to a certain timeframe, typically six to 18 months following closing (although the tightening of the U.S. debt market in 2018 saw such "sunset" provisions being flexed out of deals). Such sponsor-friendly agreements often incorporate 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. Rather than providing that the MFN provision is limited to incremental loans incurred under the free-and-clear incremental basket, some U.S. deals provide that MFN protection is limited to incremental term loans incurred under the ratio incremental capacity. This allows borrowers to incur incremental debt under the free-and-clear incremental basket and then reclassify such debt as incurred under the ratio incremental capacity, thereby avoiding the MFN provision and refreshing their free-and-clear incremental capacity.

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, guarantees and security. The trend of looser terms in U.S. loan agreements is evident in innovative tinkering with the concept of refinancing debt, though. Traditionally borrowers could incur refinancing debt in a principal amount not to exceed the principal amount of the old debt plus accrued interest, fees and costs. It is now common for the cap to also include 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. For example, 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. Then, the borrower could 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 definite 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 standard feature of many recent large-cap European loan agreements, and most such agreements will also provide for a further "freebie" or "free-and-clear" amount. Through the first half of 2018, 90% of European loan agreements featuring incremental debt capacity also provided the borrower with a "freebie" (the use of which was not conditional upon the borrower's ability to meet the relevant incremental debt ratio test). Most of these "freebies" were soft-capped grower baskets, determined by reference to EBITDA (with three quarters of the "freebies" measured at 100% of EBITDA, though many were subsequently reduced to 75% and 50%).[7] As in the case of U.S. loan agreements, European loan agreements with incremental facility provisions will invariably also contain MFN protections. Over the past year, almost all European loan agreements provided MFN protection for existing term lenders. However, half of those provisions included limitations on the MFN protection. A number of European loan agreements excluded from MFN protection any incremental debt incurred in a different currency, or any incremental debt maturing more than 12 months after the original loan. Other loan agreements contained a *de minimis* threshold for incremental debt (beneath which no MFN protection is afforded to the lenders). Sunset provisions have also become the norm in the European loan market, with 12-month and six-month periods present in 41% and 45% of European loan agreements in the first half of 2018 respectively.[8]

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 or EBITDA 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 first lien leverage ratio or senior secured leverage ratio. The provisions that permit such indebtedness typically will provide that the additional indebtedness may be secured on a *pari passu* basis, subject to a prohibition on earlier maturity and a most favoured nations clause in order to prevent a borrower from incurring priming or dilutive debt.

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.

© Published and reproduced with kind permission by Global Legal Group Ltd, London

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 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 investments 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, 50% of consolidated net income) accumulates. Some loan agreements may require a borrower to meet a *pro forma* financial test to use the builder basket for restricted payments or debt prepayments. The use of 50% of consolidated net income rather than retained excess cash flow as the "builder" component of the basket is an example of convergence with high-yield bond indentures. This approach gives borrowers more flexibility because a basket using consolidated net income is usually larger – borrowers seek to have excess cash flow to be zero to eliminate any mandatory prepayment, but that also results in zero retained excess cash flow.

Investment covenant exceptions in U.S. deals are becoming increasingly permissive. Deals sometimes include unlimited ability to invest in and acquire non-guarantor restricted subsidiaries or provide that capacity for investments in non-loan parties can be redesignated to the general basket, increasing general investment capacity. Another new creative investment covenant change is to provide that all restricted payment and restricted debt payment capacity may be used for investments. This has its roots in the high-yield bond market where investments are treated as a type of restricted payment.

One area where there has been noticeable loosening of investment capacity is with respect to investments in unrestricted subsidiaries. It is becoming more common to be able to use an increasing number of investment baskets for investments in unrestricted subsidiaries, including the general basket, the available amount basket, the ratio basket and the similar business basket. Some agreements further allow non-guarantor restricted subsidiaries to use any proceeds they receive from investments under other investment baskets to invest in unrestricted subsidiaries, converting all other investment baskets into unrestricted subsidiary investment capacity. All this increasing investment capacity, particularly regarding investments in unrestricted subsidiaries, can be problematic for the lenders to a borrower in need of cash because it allows the borrower to use its large amount of investment capacity to invest in an unrestricted subsidiary and then have that subsidiary borrow additional secured debt. Excessive investment capacity in unrestricted subsidiaries can also be used to increase the available amount restricted payment capacity upon the sale or redesignation of any investments in unrestricted subsidiaries. As discussed earlier in this Part B, some lenders are including a specific prohibition on transfers of material intellectual property to an unrestricted subsidiary.

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 obligors) and commonly restricted such activity by way of fixed cap baskets and other additional conditions. The prevalence of builder baskets in European loan agreements continues to increase, and whilst they remain less common than in U.S. 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 were 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 standard 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, and increasingly, fixed at a percentage of EBITDA) 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, 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. Similar to the trend toward broadening investment capacity, U.S. deals are incorporating increasingly permissive restricted payment baskets. For example, it is becoming more common to allow loan parties to make a dividend consisting of equity in unrestricted subsidiaries. Such a basket, together with the increasingly borrower-friendly investment covenant baskets described above which permit larger investments in unrestricted subsidiaries, give borrowers greater flexibility to move assets outside the credit group, such as by contributing assets to an unrestricted subsidiary using their broad investment capacity and then dividending the unrestricted subsidiary to the borrower's shareholders. Under the terms of agreements with these provisions, lenders would have no consent rights over such a transaction and no ability to exercise remedies as a result, even though the collateral package was negatively affected. Another trend is the removal of event of default conditions on the use of baskets such as the available amount basket and the ratio restricted payment basket or the limiting of an event of default condition to only payment defaults and bankruptcy defaults. A recent innovation seen in at least one U.S. deal would permit the borrower to offer to make voluntary prepayments of term loans on a *pari passu* basis at any time, and any declined proceeds could be used to make restricted payments.[9]

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.

© Published and reproduced with kind permission by Global Legal Group Ltd, London

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, which may be subject to compliance with a certain financial ratio test (typically closing date leverage for investments, half a turn inside closing date leverage for restricted payments and a quarter turn inside closing date leverage for junior debt prepayment).

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 and borrowers 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 18 months have revealed that the U.S. approach towards allowing restricted payments is now being accepted in Europe. "Builder baskets" analogous to those in U.S. loan agreements were present in nearly two thirds of European senior secured leveraged loans through the first half of 2018 (up 15% on 2017). Of these, 80% contained "builder baskets" calculated upon 50% consolidated net income (with the remainder based on retained excess cash flow). This trend, in addition to the prevalence of loan agreements containing an uncapped upstream payment ability (albeit subject to satisfaction of a *pro forma* leverage test), further illustrates 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"). Whilst "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 in the first lien Term B loan market, "soft call" premiums (also known as "repricing protection" and typically 1% of the amount repriced) on prepayments made within a certain period (typically six months to a year after closing, although 18 months has been becoming more common)[10] and funded from a refinancing or re-pricing of loans at a lower rate are common in the U.S. loan market. In some large cap deals, though, there are exceptions to 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. Some deals include no call protection at all.

Whilst call protection is relatively rare in the European market for senior (bank held, term loan A) debt, soft call protections (usually 1% in the first six-month call protection) are now common 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 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 (which are required to be 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 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 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, debt not permitted to be incurred under the applicable loan agreement and, in some cases, issuances of equity to third parties. Often, the asset sale prepayment provisions carve out certain types or sizes of dispositions from the sweep, include generous reinvestment rights, and/or include a threshold amount under which the borrower need not use the proceeds to prepay. Some U.S. loan agreements include step-downs permitting borrowers to apply increasingly lower percentages of the net proceeds to prepay loans as leverage declines and allow the borrower to use asset sale proceeds to ratably prepay *pari passu* debt.

In U.S. loan agreements, a change of control usually 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, particularly "dead hand" proxy put 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.[11]

Mandatory prepayment provisions continue to shift in the European loan market, as borrowers and lenders seek greater flexibility.

© Published and reproduced with kind permission by Global Legal Group Ltd, London

Historically, a mandatory prepayment of the loan facilities triggered by a change of control event would be a standard feature of European loan agreements. This provision would provide relative inflexibility for certain syndicated lenders in the context of an acquisition, effectively imposing prepayment upon them (as a waiver of the borrower's prepayment would typically require all lender consent). However, there has been a notable rise in the inclusion of "put right" provisions for lenders in European loan agreements, akin to the change of control provisions commonly found in high-yield bonds. Whilst the practice of the "put right" provisions in the context of leveraged loans is relatively untested (and the inclusion of a 1% prepayment premium as is common in high-yield bonds remains atypical), these "put right" provisions effectively grant the lenders and borrowers greater flexibility to negotiate terms prior to a contemplated change of control.[12]

The use of controversial "portability" features (present in 11% of European loan agreements in 2017) saw a dramatic decrease in 2018. As with "put right" provisions, the portability concept migrated to the leveraged loan market from high-yield bonds (where greater liquidity serves, in part, to mitigate associated risks for bondholders). In essence, "portability" features permit borrowers to circumvent the usual mandatory prepayment upon a change of control if certain conditions are met. The most common condition dis-applying the change of control mandatory prepayment is a ratio test, whereby prepayment is only required should the borrower not meet the *pro forma* leverage ratio identified in the loan documentation. Through the first half of 2018, just two senior facility agreements contained portability features (and both were restatements of facilities which had previously included the "portability" concept). "Portability" features were also proposed in a small number of European loan agreements through the first half of 2018, but none of these survived the marketing and syndication process.[13]

Similar "portability" provisions are sometimes seen in U.S. loan agreements, but they often require the debt to maintain a given rating (and not be downgraded as a result of the transaction) and/or for the new parent to have a certain market capitalisation in order to avoid the transaction constituting a change of control and, as a result, causing an event of default.

Financial Covenants

Historically, U.S. leveraged loan agreements contained at least two maintenance financial covenants: a leverage test (total, first lien or secured, depending on whether the facility was unitranche or a first lien/second lien deal) and an interest coverage or fixed charge coverage test, each typically tested at the end of each quarter.

In the United States, "covenant-lite" loan agreements (which contain no maintenance or ongoing financial covenants) continue to dominate the leveraged loan market. Through the third quarter of 2018, these loan agreements set record highs and accounted for almost 80% of outstanding loans according to data from S&P Global Market Intelligence. This portion of the market has increased steadily from approximately 64% in August 2015. 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 revolving credit facility and only when a certain percentage of revolving loans are outstanding at the testing date (20%–30% 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. 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 2018 revealed that just over 80% of loan transactions were "covenant-lite" (consistent with the proportion of "covenant-lite" agreements in the previous year), 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. Springing covenants are typically tested only when the revolving facility is between 30% and 40% drawn (excluding backstopped letters of credit, non-backstopped letters of credit up to a threshold and, for a year or two after closing, closing date revolving borrowings up to a threshold amount). Some more aggressive deals include no cap on the exclusion of letters of credit.

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 (and, as a result, the EBITDA of unrestricted subsidiaries is not included either, unless distributed to the borrower or a restricted subsidiary). 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 trend has not yet found its way over to Europe.

In the event a U.S. loan agreement contains a leverage covenant, it likely will be a "net debt" test that reduces the total indebtedness (or portion of debt tested) by the borrower's and its restricted subsidiaries' unrestricted cash and cash equivalents. Some aggressive deals in 2018 did not include certain debt (such as purchase money and capital lease obligations, all subordinated debt, or even any debt up to a fixed dollar amount) in the portion of debt tested. 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.

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. Most borrowers have negotiated add-backs (generally to the extent reasonably identifiable and factually supportable and achieved within a certain time period) for projected and as-yet unrealised cost savings and synergies. Add-backs have also become increasingly vague and flexible – for example, add-backs "of a type" similar to those in the model delivered to arrangers during syndication or cost

© Published and reproduced with kind permission by Global Legal Group Ltd, London

savings add-backs 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 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 15%–25% in the United States. In Europe, similar percentage caps on cost synergy add-backs have generally increased in recent years, from 5%–10% of unadjusted EBITDA in 2015, to 15%–20% in 2018.[14] However, despite this increase, lenders in the European market are becoming acutely aware of the pitfalls of including uncapped EBITDA add-backs in their loan documents. Indeed, the first half of 2018 saw a 10% decrease in the number of European deals containing uncapped add-backs, credited in part to increased regulatory scrutiny by the European Central Bank ("ECB") (discussed further in Part D).

Some U.S. deals with uncapped cost savings add-backs further provided for no time period during which such cost savings must be realised; however, it is typical for deals to include a time period ranging from 12 to 24 months (occasionally 36 months). There may be some negotiation over whether the cost savings must be reasonably expected to be realised during this "look forward" period or whether the borrower only must have taken substantial steps toward the action (instead of the full action) expected to result in such savings within the period.[15] These developments are further evidence of loosening loan terms and the power of sponsors. There has also been a trend of increasingly broad and vague language in EBITDA add-backs (such as the inclusion of all "business optimisation" expenses and references to "cost savings initiatives") which is potentially fertile ground for inflating EBITDA with arguable add-backs. These vague and broad add-backs, together with the uncapped add-backs that may never be realised within the term of the agreement and the other pro-borrower developments regarding add-backs, may weaken the ability of maintenance covenants to protect lenders and artificially permit borrowers even more flexibility to use both their "ratio" baskets.

Equity Cures of Financial Covenants

For the majority of sponsor deals in the United States, loan agreements that contain 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 purpose. Because financial covenants are meant to regularly test the financial strength of a borrower independent of its sponsor, U.S. loan agreements 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). Whilst 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 2018, nearly 90% 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. 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). However, these restrictions are loosening, with over a third of European loan agreements permitting consecutive cures in 2018 (following the U.S. loan market construct by allowing up to two cures in any four-quarter period). One of the key differences which has remained unchanged 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 obscure any possible future underperformance. Another borrower-friendly trend which has emerged in the European loan market in the last two years has been the "prepayment cure", which allows a borrower to avoid being tested against a springing financial covenant by simply prepaying its revolving loans to a level below the relevant springing test threshold (which, as noted above, is typically set at the revolving facility being over 40% drawn). In most cases, a "prepayment cure" will not require the borrower to cancel the facility by the amount prepaid, and the borrower will not be prohibited from redrawing the prepaid amounts after the (avoided) test date. From a documentation perspective, it is also important to note that there is no LMA recommended equity cure language.

LIBOR Successor Rate Provisions

Notwithstanding the fact that U.S. leveraged loan agreements already include a prime rate interest rate alternative to LIBOR, the loan market began to introduce "fallback" language into loan documentation to enable the transition to a new rate in anticipation of the discontinuation of LIBOR. The LSTA has been working with the Alternative Reference Rates Committee (the "ARRC"), the body tasked with replacing U.S. dollar LIBOR, to develop more robust mechanisms for such fallback provisions. These provisions have three components: the trigger event (such as LIBOR cessation) that causes the transition to a replacement rate; the actual replacement rate and adjustment to the interest rate spread; and any required amendment process. In September 2018, the ARRC released a consultation that explored two approaches to fallback provisions. Similar to what occurs in the loan market today, the "amendment" approach involves the borrower and agent identifying a replacement rate and spread (subject to the negative consent of the required lenders under the loan agreement). The "hardwired" approach automatically incorporates a waterfall of replacement rates and spreads upon the trigger event.[16] Market feedback to the ARRC consultation indicated that 46% of respondents identified the hardwired approach as the ultimate preference, 41% preferred the amendment approach, and 14% chose both approaches.[17]

In Europe, the LMA also has been proactively preparing for the possible discontinuation of LIBOR beyond 2021 by encouraging both borrowers and lenders to consider the implications of such a change in their loan documents. Working in conjunction with the Sterling Working Group, the LMA have substantively revised their precedent "Replacement Screen Rate" clause, and published a comprehensive User Guide pertaining to the same in October 2018. The expanded provision actively encourages parties to European loan agreements to consider and negotiate scenarios in which replacement rates for LIBOR may be triggered, as well as hard-wiring the subsequent steps into their loan documentation. Approximately 92% of European loan

© Published and reproduced with kind permission by Global Legal Group Ltd, London

agreements through the first half of 2018 included LIBOR successor rate language, reflecting the market's awareness of the potential consequences of a discontinuation of LIBOR.[18]

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

Both European and U.S. loan agreements include representations, warranties and covenants relating to anti-bribery, anti-money-laundering and sanctions laws locally and abroad (the "Anti-Corruption/Sanctions Laws"). In the U.S. market context, SunGard provisions (discussed in Part A) identify representations with respect to Anti-Corruption/Sanctions Laws as specified representations, though these sometimes have "use of proceeds" qualifications. 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 often are 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 outstanding loans and unused commitment size) for all non-unanimous issues. In European loan agreements, most votes typically require a voting threshold of two-thirds through it is increasingly common to see this reduced to a simple majority. 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 (other than voting provisions and *pro rata* sharing provisions) require the consent only of affected lenders (and are not, therefore, truly unanimous), whilst 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 typically 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 (or all affected lenders), if the "required lenders" 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 reimbursement for certain increased cost or tax payments. In such circumstances, the borrower may require the sale of the lender's commitment and loans to another lender or other eligible assignee, and some loan agreements will permit the borrower to repay loans and terminate commitments of such lenders on a non-*pro rata* basis. In most European loan agreements, yank-a-bank provisions are also routinely included and are similar in mechanism and trigger events.

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).

Historically, most sub-investment grade European deals provided that lenders were 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). However, over the course of 2017 and 2018, there has been a marked trend in transfer restrictions. Indeed, restrictions on transferring commitments to "competitors" of the borrower were present in more than 80% of European loan agreements through the first half of 2018, usually without any reasonableness qualification (a level consistent with the same period in 2017). Another trend has been the increasing restrictions on transfers to loan-to-own and distressed investors, which in 2018 was seen in two thirds of large-cap 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, and most loan agreements include, "deemed consent" of a borrower where a borrower does not object to proposed assignments within five to 10 business days, which is the same position taken in the European market. Similar to stronger European borrowers and sponsors who

© Published and reproduced with kind permission by Global Legal Group Ltd, London

are able to negotiate a "blacklist", most borrowers and sponsors in the United States negotiate a "DQ List" of excluded (disqualified) assignees. 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, competitors and their affiliates are often included in the DQ List. Sponsor-backed and large cap borrowers in the United States commonly push for expansive DQ lists and the ability to update the list post-closing (but lenders try to limit these updates to competitors and new affiliates). However, this development has not made its way to European loan agreements. The ability to update the DQ List post-closing could present problems in a workout scenario by giving the borrower veto power over any assignments or sales by lenders to third parties. On the other hand, deals frequently provide the borrower no consent rights over lender assignments following an event of default which can also be problematic if lenders desire to sell the loan to a "loan to own" fund.

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 "U.S. 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 6.0× 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 continued to be 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 add-backs to EBITDA. Further, part of the decrease in non-pass originations is attributable to the liberal use of add-backs that increase EBITDA substantially, thereby decreasing the leverage ratio below 6.0×. For example, when the Ultimate Fighting Championship put itself up for sale, add-backs to its EBITDA increased its earnings from $170 million in the initial calculation to $300 million in the presentation given to debt investors (which decreased its leverage ratio to 6.0×). 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, add-backs increased Blue Nile's EBITDA from approximately $19 million to approximately $45 million, dropping its leverage ratio from 9.0× to 4.0×. 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.

In February of 2018, Comptroller of the Currency Joseph Otting confirmed, at the SFIG Vegas conference, that the U.S. Guidance was intended to be just that – guidance – and not a rule or regulation.[19] Further, in May of 2018, he went on to say that, as a result, he did not see a reason to amend the U.S. Guidance – lending outside of that guidance is acceptable, as long as an institution is doing so in a prudent manner.[20] Not surprisingly, adjusted leverage levels in the United States have increased and larger adjustments to EBITDA have increased unadjusted leverage even higher. In 2018, 30% of all deals were levered 6.0× or more, and 28% included add-backs in an amount greater than 50% of unadjusted EBITDA. A notable share (13%) in this sampling had adjustments above the 100% mark.[21] Recent trends indicate that the U.S. Guidance, while not being ignored, may be losing some of its power as total leverage in 2018 reached record highs since 2007.[22] The Federal Reserve's November 2018 Financial Stability Report indicated that systemic risk and overall vulnerabilities in the financial system are at moderate levels.[23]

Similar leveraged lending regulations have recently been introduced in Europe. On May 16, 2017, the ECB published its long-awaited guidance to banks regarding leveraged transactions (the "ECB Guidance"), effective November 2017. Whilst the ECB Guidance is not legally binding, affected institutions are expected to incorporate the ECB Guidance into their internal lending policies (in line with the size and risk profile of each banks' leveraged transaction activities relative to their assets, earnings and capital). The guidance outlines the ECB's expectations regarding risk management and reporting requirements, with a stated aim of providing senior management a comprehensive overview of the bank's leveraged lending activities.[24] The ECB Guidance applies to all "significant credit institutions" supervised by the ECB under the "Single Supervisory Mechanism". It does not, however, 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).

© Published and reproduced with kind permission by Global Legal Group Ltd, London

For the purposes of the ECB Guidance, a "leveraged" transaction includes all types of loans or credit exposure 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 exposure 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 a similar vein to the U.S. Guidance).

However, the effectiveness of the ECB Guidance remains in question. Since the guidance became effective in November 2017, several European loan transactions have exceeded the 6.0× recommended limit, with deals featuring leverage of up to 8.0×. It remains to be seen whether the ECB Guidance can withstand continuing borrower-pressure for more favourable terms, as well as its own operational shortcomings.[25]

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. Whilst 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.

For further information in relation to any aspect of this chapter, please contact Sarah Ward in New York by email at sarah.ward@skadden.com or by telephone at +1 212 735 2126 or Mark Darley in London by email at mark.darley@skadden.com or by telephone at +44 20 7519 7160.

Endnotes

1. *Re Apcoa Parking Holdings GmbH & Ors* [2014] EWHC 3899 (Ch.).
2. David Brooke, *'Unitranche killer' hits Europe's middle market*, Reuters Financial, October 9, 2018, available at https://uk.reuters.com/article/idUKL4N1WP4A9, (accessed December 5, 2018).
3. Colby Smith, *Red-hot leveraged loan market draws regulatory heat*, Financial Times, October 30, 2018, available at https://www.ft.com/content/6ee96af8-d79b-11e8-ab8e-6be0dcf18713 (accessed January 9, 2019).
4. *2018: U.S. Primary Loan Market Review*, The Loan Syndications and Trading Association, January 3, 2019.
5. Ioana Barza, *US syndicated lending reached US$2.6trn record in 2018 but pace slowed amidst volatility*, LPC, January 3, 2019.
6. Justin Smith, *J Crew Blocker: Don't Believe the Hype*, XtractResearch, May 11, 2018.
7. *Bonds & Loans The Covenant Trajectory: 5 Key Indicators*, XtractResearch, October 18, 2018.
8. Christine Tognoli, *European Leveraged Loan: 2018 Half-Year Review*, XtractResearch, August 20, 2018; and Debt Explained, *European Leveraged Loan Market Update: Q2 2018*.
9. Jenny Warshafsky, *October 2018 US Loan Trends: Aggressive Terms Proposed in Recent Draft Credit Agreements*, November 8, 2018.
10. *What's Market: 2015 Year-End Trends in Large Cap and Middle Market Loan Terms*, Practical Law Company, January 28, 2016.
11. *Kallick v. SandRidge Energy, Inc.*, C.A. No. 8182-CS, slip op. at 12 (Del. Ch. Mar. 8, 2013); *Pontiac Gen. Emps. Ret. System v. Healthways, Inc.*, C.A. No. 9789-VCL (Del. Ch. October 14, 2014).
12. David Billington and Ian Chin, *Mandatory means mandatory? Recent trends in leveraged finance prepayment clauses*, Journal of International Banking and Financial Law, October 2018.
13. *XtractResearch: European Leverage Finance – Loans vs. Bonds: Same Difference?*, XtractResearch Europe Special Reports, February 9, 2018.
14. Francis Booth and Susan Whitehead, *The evolving fiction of EBITDA in the European leveraged finance loans market*, Butterworths Journal of International Banking and Financial Law, November 2018.
15. Jenny Warshafsky, *Worst of Cost Savings Addbacks to EBITDA*, XtractResearch, December 18, 2018.
16. *LIBOR FAQs*, The Loan Syndications and Trading Association, December 20, 2018.
17. *LIBOR Fallbacks: The Market Responds*, The Loan Syndications and Trading Association, December 13, 2018.
18. *What's Market: 2018 Mid-Year Trends in Large Cap and Middle Market Loans*, Practical Law, July 19, 2018.
19. *OCC head says banks not bound by lending guidelines, expects leverage to increase*, Debtwire, February 27, 2018, available at https://www.debtwire.com/info/occ-head-says-banks-not-bound-lending-guidelines-expects-leverage-increase (accessed January 15, 2019).
20. Jonathan Schwarzberg, *OCC head says leveraged lending guidance needs no revisions*, Reuters Bonds News, May 24, 2018, available at https://www.reuters.com/article/llg-revisions/occ-head-says-leveraged-lending-guidance-needs-no-revisions-idUSL2N1SV24T (accessed January 15, 2019).
21. Colm Doherty and Adrian Lok, *Debtwire Par – Year-End 2018 US Leveraged Insights Report*, January 4, 2019, available at https://www.debtwire.com/intelligence/view/prime-2764355 (accessed January 9, 2019).
22. Luke Millar, *High-leverage deals proliferate as guidelines lose traction*, November 21, 2018, available at https://www.lcdcomps.com/lcd/n/article.html?aid=12440934&rid=30&t=1 (accessed November 26, 2018).
23. *Leveraged Lending: From The Regulators' Mouth(s)*, The Loan Syndications and Trading Association, December 6, 2018.
24. *ECB publishes guidance to banks on leveraged transactions*, European Central Bank, May 16, 2017, available at https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170 516.en.html (accessed December 5, 2018).
25. Max Bower, Claire Ruckin, *Buyout financings skirt ECB's lending rules*, Reuters, March 29, 2018, available at https://af.reuters.com/article/commoditiesNews/idAFL8N1RB58Y (accessed December 5, 2018).

Acknowledgment

The authors would like to acknowledge the assistance of their colleagues Tracey Chenoweth, Andrew Alvarez and Alexander Halms for their invaluable assistance in the preparation of this chapter.

© Published and reproduced with kind permission by Global Legal Group Ltd, London

Sarah M. Ward

Skadden, Arps, Slate, Meagher & Flom LLP
4 Times Square
New York, NY 10036
USA

Tel: +1 212 735 2126
Fax: +1 917 777 2126
Email: sarah.ward@skadden.com
URL: www.skadden.com

Sarah M. Ward serves as co-chair of Skadden's Legal Opinion Oversight Committee. She served as co-head of Skadden's Banking Group from 2009 to 2014 and is a former member of Skadden's Policy Committee, the firm's governing body. Ms. Ward focuses primarily on the representation of borrowers and lenders in acquisitions and other leveraged financings, as well as corporate restructurings and workouts. She has extensive experience representing large banks and other financial institutions such as Barclays, Citigroup, Goldman Sachs, Morgan Stanley and J.P. Morgan as well as PointState Capital and Contrarian Capital. Recent corporate representations include Advanz Pharma, Dentsply, Dynegy, Frontier Communications, Nasdaq and Travelport.

Ms. Ward is recognised as a leading attorney in *Chambers Global: The World's Leading Lawyers for Business* since 2012 and *Chambers U.S.A.: America's Leading Lawyers for Business*, since 2005, and has been singled out for her extensive experience in leveraged financing work. In 2015, Ms. Ward won the "Banking and Finance Award" at Euromoney's Americas Women in Business Law Awards and regularly appears in Euromoney LMG's Expert Guide for Banking. She also has been recommended in *IFLR1000* and *The Legal 500 United States* since 2013 and *The International Who's Who of Banking Lawyers* since 2014.

Mark L. Darley

Skadden, Arps, Slate, Meagher & Flom LLP
40 Bank Street, Canary Wharf
London, E14 5DS
United Kingdom

Tel: +44 20 7519 7160
Fax: +44 20 7072 7160
Email: mark.darley@skadden.com
URL: www.skadden.com

Mark Darley has led Skadden's European law banking practice since joining the firm in April 2002 and was appointed global co-head of Skadden's Banking Group in 2009. Throughout his career, Mr. Darley has focused particularly on leveraged finance, restructuring and project finance transactions. His practice embraces advising both lenders and borrowers, including international financial institutions, private equity houses, hedge and other funds, and investment grade corporates. Clients have included BAML, Citibank, Credit Suisse, Deutsche Bank, J.P. Morgan, RBS, SG, SEB, UCB SA, Joh. A. Benckiser, AbbVie, Apax, M7 Real Estate, Formation Capital, Ares Life Sciences, Jacobs Douwe Egberts, Pfizer Inc., News Corporation, Vue Cinemas, China Investment Corporation, Vitol, ATAS, Vivo Energy, ContourGlobal, J.C. Flowers, Doughty Hanson and Oaktree. Mr. Darley has been selected repeatedly for inclusion in *Chambers Global: The World's Leading Lawyers for Business*, *Chambers UK* and *Who's Who Legal – Banking.*

Skadden

Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates

Serving clients in every major international financial centre, Skadden, Arps is one of the leading law firms in the world, with 22 offices and more than 1,700 attorneys. Our diversified practice enables us to offer solutions to the most challenging legal issues in virtually every area of corporate law, providing the specific legal advice clients need to compete most effectively in a global business environment. We represent approximately 50 percent of the Fortune 250 industrial and service corporations, as well as financial and governmental entities; small, entrepreneurial companies; and cultural, educational and charitable institutions, advising on high-profile transactions, regulatory matters, and litigation and controversy issues.

Our Banking Group represents lenders and borrowers in complicated financing transactions. Our clients include some of the world's largest commercial and investment banks, insurance companies, finance companies, institutional lenders and investors, as well as LBO sponsors, private equity funds, hedge funds, strategic buyers, borrowers and issuers of securities.

© Published and reproduced with kind permission by Global Legal Group Ltd, London

Current titles in the ICLG series include:

- Alternative Investment Funds
- Anti-Money Laundering
- Aviation Law
- Business Crime
- Cartels & Leniency
- Class & Group Actions
- Competition Litigation
- Construction & Engineering Law
- Copyright
- Corporate Governance
- Corporate Immigration
- Corporate Investigations
- Corporate Recovery & Insolvency
- Corporate Tax
- Cybersecurity
- Data Protection
- Employment & Labour Law
- Enforcement of Foreign Judgments
- Environment & Climate Change Law
- Family Law
- Financial Services Disputes
- Fintech
- Franchise
- Gambling
- Insurance & Reinsurance
- International Arbitration
- Investor-State Arbitration
- Lending & Secured Finance
- Litigation & Dispute Resolution
- Merger Control
- Mergers & Acquisitions
- Mining Law
- Oil & Gas Regulation
- Outsourcing
- Patents
- Pharmaceutical Advertising
- Private Client
- Private Equity
- Product Liability
- Project Finance
- Public Investment Funds
- Public Procurement
- Real Estate
- Securitisation
- Shipping Law
- Telecoms, Media & Internet
- Trade Marks
- Vertical Agreements and Dominant Firms

glg global legal group

59 Tanner Street, London SE1 3PL, United Kingdom
Tel: +44 20 7367 0720 / Fax: +44 20 7407 5255
Email: info@glgroup.co.uk

www.iclg.com