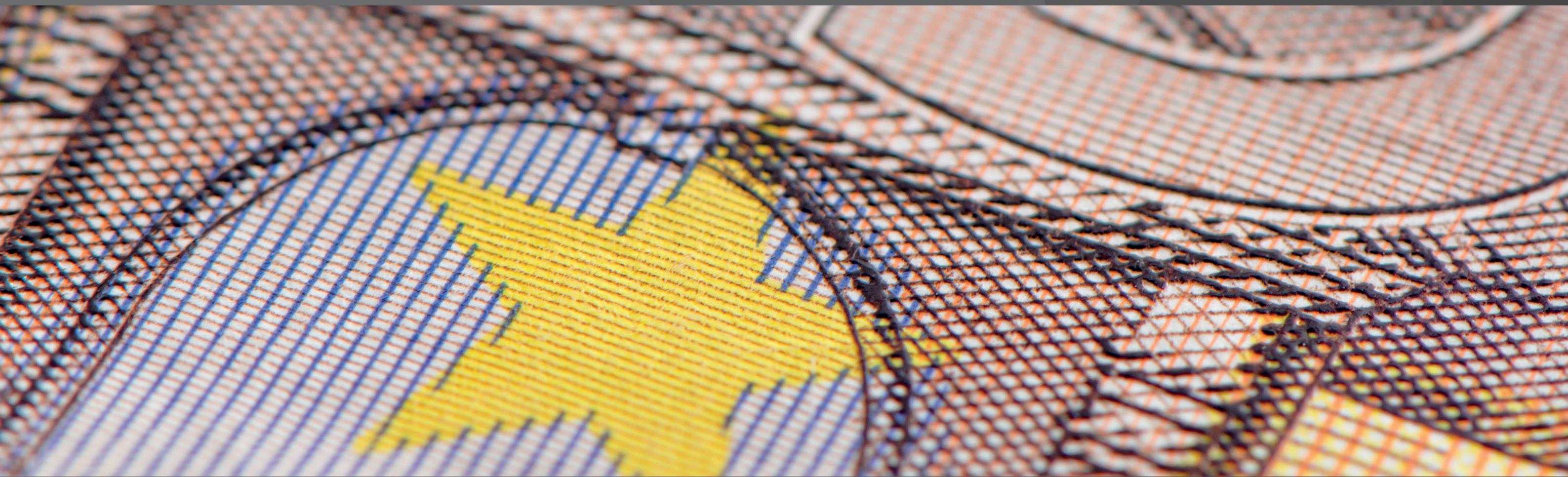
# International Comparative Legal Guides



# Lending & Secured Finance 2020

A practical cross-border insight into lending and secured finance

**Eighth Edition**

## Featuring contributions from:

Allen & Overy LLP
Anderson Mori & Tomotsune
Asia Pacific Loan Market Association
Astrea
Baker & McKenzie LLP
Bravo da Costa, Saraiva – Sociedade de Advogados
Cadwalader, Wickersham & Taft LLP
Carey
Carey Olsen Jersey LLP
Cleary Gottlieb Steen & Hamilton 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
Fellner Wratzfeld & Partners
Freshfields Bruckhaus Deringer LLP
Fried, Frank, Harris, Shriver & Jacobson LLP
Holland & Knight
HSBC
Jadek & Pensa
Latham & Watkins LLP
Laurence Khupe Attorneys (inc. Kelobang Godisang Attorneys)
Law firm Trpenoski
Lee and Li, Attorneys-at-Law
Loan Market Association
Loan Syndications and Trading Association
Loyens & Loeff Luxembourg S.à r.l.
Macesic & Partners LLC
Maples Group
McMillan LLP
Milbank LLP
Morgan, Lewis & Bockius LLP
Morrison & Foerster LLP
Nielsen Nørager Law Firm LLP
O'Melveny & Myers LLP
Orrick, Herrington & Sutcliffe LLP
Pestalozzi Attorneys at Law Ltd
PLMJ Advogados, SP RL
Proskauer Rose LLP
Rodner, Martínez & Asociados
Sardelas Petsa Law Firm
Seward & Kissel LLP
Shearman & Sterling LLP
Skadden, Arps, Slate, Meagher & Flom LLP
SZA Schilling, Zutt & Anschütz Rechtsanwaltsgesellschaft mbH
TTA – Sociedade de Advogados
Veirano Advogados
Wakefield Quin Limited
Walalangi & Partners (in association with Nishimura & Asahi)
White & Case LLP

LSTA CELEBRATING 25 YEARS
APLMA
ICLG.com

## Editorial Chapters



## Expert Chapters

# Expert Chapters Continued



# Q&A Chapters

# Q&A Chapters Continued

# 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 a number of similarities in the general approach taken in relation to drafting and negotiating documentation governing European and U.S. leveraged loan transactions. In 2019, falling interest rates with respect to bank debt and concerns over default rates have caused U.S. investors to look towards equities and fixed-income bonds at the expense of loans. Institutional leveraged loan issuances in the U.S. dropped approximately 29% from 2018.[1] In Europe, leveraged loan issuances also declined, albeit less dramatically than in U.S., dropping 10% by the third quarter of 2019 when compared to the same period in 2018.[2] Notwithstanding a smaller appetite from leveraged loan investors, the supply of leveraged loans in both markets in 2019 generally kept up with demand. Alternative markets continue to develop for borrowers to obtain financing in both the U.S. and Europe, including from hedge funds, private-equity funds and even insurance firms acting as direct lenders.[3] As a result, even though supply has decreased, sponsors continue to reach for aggressive terms and push for covenants that are increasingly borrower-friendly. Recently, however, investors in both the U.S. and European loan markets have pushed-back in certain areas on the expanded boundaries of once standard lender protections, especially through the exercise of "flex" terms. This push-back has been particularly prevalent in the case of non-sponsor-backed deals and lower quality credits.

Despite the various 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 differences between market practice in the U.S. 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 (as is now typical for sponsor-backed deals). Conversely, in the U.S., although the Loan Syndications and Trading Association (the "LSTA") recently published a form loan agreement for investment grade transactions and has published standard forms of certain miscellaneous and operational provisions to be included in agreements governing non-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 agreement is no less favourable to the borrower than such precedent. In the case of sponsor-backed deals, the proposed precedent is usually based on the applicable sponsor's form. 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, both in the U.S. and Europe, sponsor-backed borrowers continue to insist on taking control of, and responsibility for, producing the key documents, and this is becoming increasingly common for corporate borrowers as well. While key economic issues remain within the control of arrangers marketing newly issued loans, particularly through the exercise of "flex" terms, sponsor control over documentation generally 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 (comprises 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 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 United Kingdom's withdrawal from the European Union, the updates to the European "bail-in" legislation, and the impact on the European loan market of the transition away from 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 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 U.S. (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 between the LSTA and the LMA is that the LSTA forms are rarely used as a starting draft for negotiation, and the LSTA form documentation for U.S. loan agreements is generally used only with respect to certain mechanical and "miscellaneous" provisions of the loan agreements, such as "defaulting lender" provisions, European Union "bail-in" provisions, LIBOR replacement mechanisms, QFC stay terms, 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 that is no longer the case, as the parties almost always identify 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. Notwithstanding this trend, arranger banks remain focused on "flex" terms to mitigate the marketing impact of borrower-friendly provisions in the borrower's preferred documentation.

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. By way of example, rather than providing alternative drafting or commentary in respect of the U.S. QFC Stay Rules, the LMA issued a guidance note in May 2019 which included a link to the corresponding LSTA market advisory (as discussed further below).[4] The LMA note expressly stated that the precedent language contained in the LSTA market advisory should be adapted for inclusion in facility documentation based on the LMA's recommended forms.

## 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. 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, local lines of credit governed by foreign law and/or letters of credit, but such facilities are beyond the purview of this article. In the U.S. (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 (including obtaining commitments from entities that would be eligible assignees), the consent of existing lenders is not required to increase the overall size of the credit facilities and implement the additional loans and/or commitments.

In the U.S. and in Europe, all lenders (whether revolving credit lenders or term loan lenders) in first lien facilities (other than asset-backed revolving loans, which often share liens on a split-priority basis with the term loans, an arrangement not covered in this article) or unitranche facilities 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 junior 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 (unless, in the case of prepayments, there is basket availability)). 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., certain transactions (typically smaller deals) are structured as a unitranche facility, rather than as separate first lien and second lien facilities, 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 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. The *In re RadioShack Corp.* bankruptcy litigation largely resolved any 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) 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 (and are continuing to demonstrate) their ability to do much larger financings. Despite an overall decrease in European deal volume through the first half of 2019, direct lending activity climbed 107% as compared to the same period in 2018.[5] 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 English courts, cases (such as *Re Apcoa Parking Holdings GmbH & Ors*)[6] suggest that unless creditors can demonstrate that their distinct economic rights are also accompanied by corresponding legal rights enforceable against the borrower (which will not typically be the case where the borrower is not party to the AAL), it is likely to be difficult for junior creditors to maintain that they should form a separate class in a scheme of arrangement (and, as such, forfeiting the potential hold-out value that may entail during the course of a borrower's restructuring).

In the case of European borrowers with both high-yield bond debt and bank debt (usually revolving credit facilities) in their capital structures, so called "super senior" structures are also very common. In such structures, both the lenders under the revolving credit facility and the high-yield noteholders rank equally in regards to payment and the security package (where the notes are secured). However, the lenders under the revolving credit facility are "super senior" in that they take priority over the noteholders in relation to the proceeds of recovery from any enforcement action (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 U.S. to traditional banking institutions, who typically require a five-year maturity, higher amortisation (which generally starts at 1% per year but increases to 5% or 10% per year during subsequent years) and include at least one, if not multiple, financial covenants, which are tested quarterly. Term B loans, which comprise a large percentage of the more sizeable leveraged loans (especially in the U.S.), are typically held by institutional investors. As a result, term B loans are more likely to be governed by "covenant-lite" agreements, so that there will be only a single leverage covenant with respect to which only the revolving credit facility benefits, and such covenant is only tested if revolving credit usage exceeds a certain percentage of the revolving credit commitments – typically 25% to 35%). 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. First lien term B loans typically require amortisation in an annual amount equal to 1% of the original principal amount thereof. To compensate for these more borrower-friendly terms, term B loans usually 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.[7] Beginning with the end of 2018, the trend towards increasingly relaxed terms faced some resistance, when sharp declines in the trading prices of existing leveraged loans began to prompt more investor-friendly terms (in the form of higher spreads and tighter covenants)[8] on a limited supply of new issuances of debt in response to a lower risk appetite for investors. Noteworthy is the fact that this sharp decline occurred notwithstanding the number of performing credits and low default rates. In many cases, lenders pressured high-yield borrowers to tighten leverage covenants and otherwise "flex up" terms (including pricing). Toward the end of 2019, an important distinction developed between the U.S. and European markets, as the U.S. loan market became increasingly focused on fundamental creditworthiness when determining which borrowers can continue to avoid being subject to more traditional lender protections in their credit documentation. More highly rated loans throughout 2019 still contained more aggressive terms and encountered less pressure to "flex up".[9] As a result, the U.S. loan market has become more bifurcated towards the end of 2019, reflecting greater appetite for higher quality credits and greater selectivity for lower-rated issuances.

Whilst historically 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 to participate in the European loan market 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 U.S., 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, a detailed term sheet will be attached to the commitment letter that will outline agreed-upon key terms and other important concepts to be included in the final loan documentation (including a definitive list of what representations, warranties, covenants and events of default will be included and the definition of EBITDA, including "add-backs"). Such detailed term sheets 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 U.S., 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 satisfying collateral requirements and, in some cases, providing guarantees. Usually, closing requirements are limited to filing Uniform Commercial Code financing statements and delivering stock certificates (and related stock powers) of the borrower (if not a public company) and material U.S. restricted subsidiaries (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 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 their subsidiaries and other affiliates 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 from any leverage or interest coverage calculation. 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. Neiman Marcus's 2017 transfer of its MyTheresa brand to a subsidiary beyond creditor reach and PetSmart's 2018 transfer of over a third of its Chewy.com equity to separate entities represent other recent notable examples of collateral leakage. In response to the high-profile clash between J Crew Group and its credit agreement investors, some investors have been particularly focused on including a specific prohibition on transfers of material intellectual property to an unrestricted subsidiary – commonly known as the "J Crew blocker".[10] These examples aside, a recent study sampling more than 120 credit agreements in the U.S. with effective dates ranging from 2017 through the beginning of 2019 found that, even when focused on sectors that were more likely to have high concentration of core assets in intellectual property, only 17% included direct blocking language.[11] Whilst not historically a feature of the European loan market, the use of the "restricted/unrestricted" subsidiary construct is now also seen in the majority 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 of third parties that otherwise constitute 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" for debt (which can take the form of a fixed amount or may also include a "grower" component based on a percentage of total assets or EBITDA), an "incurrence-based" basket, which requires compliance with a given leverage or fixed charge ratio, and a basket for indebtedness incurred, acquired and/or assumed in connection with permitted acquisitions. These other baskets will be sized based on the borrower's business and risk profile and, if applicable, the lead bank's relationship with the sponsor or the borrower, as applicable. Reclassification provisions (allowing the borrower to utilise one debt basket and then, later, reclassify such debt as being incurred under a different debt basket) are also becoming more common in the U.S.; for example, 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. 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. These reallocation provisions have the effect of allowing borrowers to reclassify transactions that were incurred under a fixed, dollar-based basket as having been incurred under an unlimited leveraged-based basket if the borrower de-levers or if its 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). Initially, the incremental facilities were limited to a fixed dollar amount (typically sized at 50% to 100% of closing date EBITDA), 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 lien 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×). Some deals include increased ratio incremental capacity for acquisitions by providing that the borrower may incur incremental debt even if the closing date leverage ratio would be exceeded, so long as *pro forma* leverage does not increase as a result of the acquisition.

Most U.S. loan agreements permit borrowers to simultaneously use the free-and-clear basket and the leveraged-based incremental basket without the former counting as leverage for purposes of the ratio test. Borrowers have also become more creative with provisions that allow for increases to the free-and-clear basket over the life of the loan, including *pro rata* increases in free-and-clear baskets upon voluntary prepayments of existing loans and/or voluntary reductions in revolving commitments and by adding a "grower" component to the free-and-clear basket that increases as the borrower's EBITDA (or total assets) grows.

Typically, incremental facilities have a most favoured nations ("MFN") 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 MFN 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 that continued through 2019 saw such "sunset" provisions being flexed out of deals). Such sponsor-friendly agreements often incorporate further provisions aimed at eroding MFN protection, such as (i) limiting MFN protection to incremental term loans borrowed using the free-and-clear capacity or incremental term loans that mature within a certain period (usually, 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. The latter 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. Notwithstanding recent investor resistance to the trend of looser terms in U.S. loan agreements, many borrowers continue to benefit from innovative tinkering with the concept of refinancing debt. 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.

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).

However, whilst uncapped, leverage ratio-based incremental debt capacity is a standard feature of many recent large-cap European loan agreements, the number of European agreements featuring a further "freebie" or "free-and-clear" amount is decreasing. Through the first half of 2019, 77% 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), down from 90% in the first half of 2018.[12] Most of these "freebies" remained soft-capped grower baskets, determined by reference to EBITDA, but the prevalence of "freebies" soft-capped to 100% EBITDA has also reduced, from 68% and 60% in 2017 and 2018 respectively, to just over 50% through the first half of 2019. This trend reflects the increased scrutiny of "freebie" baskets by investors in the European market (predominantly driven by push-back during the syndication process), and indicates a notable difference between European and U.S. terms.

As in the case of U.S. loan agreements, European loan agreements with incremental facility provisions will invariably contain MFN protections. Indeed, 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 any incremental debt incurred in a different currency, or any incremental debt incurred in other forms (such as bonds) from MFN protection. Other loan agreements contained a *de minimis* threshold for incremental debt (beneath which no MFN protection is afforded to the lenders). Whilst sunset provisions have also become the norm in the Europe, market investors began to push-back on the certain terms during 2019. The majority of European loan agreements provided for 100bps protection with a 12-month sunset period, but six-month sunset periods became a common "flex" item in European deals, featuring in just 25% of European loan agreements in the first half of 2019, compared to 40% in 2018. 17% of deals in the third quarter of 2019 featured no sunset period at all.[13]

## 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 that is based on a fixed dollar amount and may also include a "grower" component based on a percentage of consolidated total assets or EBITDA. This "general basket" for liens is often tied to the size of the general debt basket. 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 MFN 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.

## 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. Depending on the borrower's business, particularly the size of its foreign operations, if any, and credit profile, loan parties may be permitted to invest significant 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, permitted acquisitions 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 including a "grower" concept based on a percentage of EBITDA or total assets.

Investment covenant exceptions in U.S. deals have become fairly permissive, and the tightening and exercise of "flex" seen with respect to other provisions has not had a notable impact on the investment covenant in loan agreements. Deals still 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. Increasingly, all restricted payment and restricted debt payment capacity may be reallocated and 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 now more common for borrowers to choose from a variety of investment baskets for investments in unrestricted subsidiaries, including the general basket, the builder basket and the ratio basket. Some credit facilities also include baskets for investments in similar businesses and/or joint ventures. As discussed earlier in this Part B, some lenders are including a specific prohibition on transfers of material intellectual property to an unrestricted subsidiary. However, despite the media attention, the majority of credit agreements (even those in sectors with valuable intellectual property) still do not include direct blockers.

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). It is also now 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). With increasing frequency, European loan agreements are also permitting unlimited acquisitions provided the acquired entity becomes a "restricted subsidiary".[14] Soft-capped baskets for acquisitions and investments (where the monetary limit is

(i) based on the greater of a fixed amount and a percentage of earnings or asset value, and (ii) increasingly often, 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 (all referred to as "restricted payments"), and from making payments on subordinated and/or junior lien 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. U.S. deals are incorporating increasingly permissive restricted payment baskets, which mirrors investor comfort with expansive permitted investment capacity. For example, it is becoming more common (especially with better-rated credits) to allow loan parties to make a dividend consisting of equity in unrestricted subsidiaries. Such a basket, together with the 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 in 2018 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.[15] As noted previously in this chapter, these more borrower-friendly terms continue to gain traction in the market, but lenders have become more wary in extending such favourable treatment to lower quality credits.

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.

## Builder Baskets

Most U.S. loan agreements also include a "builder basket", which is typically referred to as a "Cumulative Credit" or an "Available Amount" and represents an amount the borrower can utilise for investments, restricted payments, junior debt prepayments or other purposes. Traditionally, the builder basket begins with a fixed-dollar amount and "builds" based on the portion of excess cash flow not required to be used to prepay the term loans. Increasingly, borrowers are gaining the flexibility to have their builder baskets grow based on 50% of consolidated net income, rather than excess cash flow. 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. Use of the builder basket is often subject to compliance with a certain financial ratio test, especially when used for restricted payments or for junior debt prepayments.

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 12 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 70% of European senior secured leveraged loans through the first half of 2019 (up 4% on 2018 and 19% on 2017). Of these, almost all 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)[16] that are funded with the proceeds of a refinancing or re-pricing of the original term loans at a lower rate are common in the U.S. loan market. In some large cap deals, there are exceptions to call protection premiums for prepayments made 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 permit the borrower to offer to repurchase loans rateably 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. Many loan agreements also permit loan buybacks 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 purchased by sponsors or other affiliates that are not subsidiaries of the borrower may remain outstanding. Loan agreements often cap the amount that sponsors and such affiliates may hold and also restrict the right of such sponsors or affiliates (that are not *bona fide* debt funds) 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 term 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 (though less and less frequently), issuances of equity to third parties. If the agreement is for term B loans, as mentioned above, there will be an excess cash flow sweep, and the percentage of excess cash flow that is required to be used to prepay such term loans will decrease as leverage decreases. 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 of asset sales to prepay loans as leverage declines and allow the borrower to use asset sale proceeds to rateably 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. As a result, the "dead hand" proxy put is disappearing in the U.S. market.

Mandatory prepayment provisions continue to shift in the European loan market, as borrowers and lenders seek greater flexibility. 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.[17]

## 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. Now, it is usually only agreements that govern a term A loan facility that contain an interest coverage or fixed charge coverage test.

In the U.S., "covenant-lite" loan agreements continue to dominate the leveraged loan market. However, data from S&P Global Market Intelligence suggests that these issuances may have peaked at the end of 2018 where they set record highs and accounted for almost 80% of outstanding loans. This portion of the market had increased steadily from approximately 64% in August 2015 but has inched lower since that peak in the fourth quarter of 2018. A covenant-lite loan agreement typically 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 and letters of credit are outstanding at the testing date (25%–35% is fairly typical, but this can be as high as 40%). 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; it merely reduces flexibility by limiting basket use.

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 2019 revealed that nearly 90% of loan transactions were "covenant-lite" (up from 81% 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.[18] In European loan "covenant-lite" agreements, springing covenants are typically tested only when the revolving facility is 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 excluded any revolving facility drawings made in connection with acquisitions or investments, or any closing date utilisations, from the calculation of the test trigger.

In the U.S., 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 2019 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 the continued success of higher-quality credits 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. In recent years, both U.S. and European loan documents have included broader and more numerous add-backs including transaction costs and expenses, restructuring charges, payments to sponsors and costs and expenses related to certain extraordinary and/or non-recurring 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 not-yet-realised 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 savings add-backs without a requirement relating to when the savings materialise. However, lenders in both the U.S. and in Europe are beginning to resist the expansion/flexibility of add-backs.

In the U.S., the Leveraged Lending Guidance and the federal regulatory agencies enforcing it (discussed further in Part D) have suggested 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 in 2019 for projected improvements in operating results, resulting in more frequent use of limits on the timing for the realisation of anticipated synergies and percentage caps on savings and synergies add-backs, typically 20%–35% of EBITDA in the U.S. As a result, some borrowers and sponsors turned to alternative lenders to whom such regulatory oversight does not apply.

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 20% in 2019.[19] However, lenders in the European market are increasingly aware of the pitfalls of including uncapped EBITDA add-backs in their loan documents. Indeed, the first half of 2019 saw a continuation of the decrease in the number of European deals containing uncapped add-backs (from 47% in 2017 and 33% in 2018 to 25% through the third quarter of 2019).[20]

Some U.S. deals do not limit the time period during which such cost savings must be realised or expected to be realised; however, it is typical for deals to include a time period ranging from 18 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 needs only to expect to have taken substantial steps toward realising such cost savings within the period.[21] These developments are further evidence of loosening loan terms and the power of sponsors, especially to the extent they can successfully market their deals as supported by a higher-quality credit. 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 "synergies" and "initiatives"). All this being said, arrangers in the U.S. have been successful through 2019 in relying on the market and general investor sentiment to limit lower-rated borrowers from taking advantage of this increased flexibility.

## Equity Cures of Financial Covenants

For the majority of sponsor deals in the U.S., loan agreements that contain financial maintenance covenants (whether or not "covenant-lite") 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 some cases, arrangers have been successful in restricting the ability of sponsors to provide an equity cure in consecutive quarters.

In Europe, equity cure rights have been extremely common for many years. As in the U.S., 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 the first half of 2019, more than 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 U.S. in respect of the frequency and absolute number of times an equity cure right may be utilised. In Europe, the frequency has traditionally been lower (and usually, an equity cure could not be used in consecutive periods) and was 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 the majority of European loan agreements permitting consecutive cures in 2019 (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 continues to integrate "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.

The LSTA continues to explore alternatives for the actual replacement rate, but attention has largely focused on variations of SOFR. This is based on the LSTA's and ARRC's belief that SOFR is a secured risk-free rate that has a liquid and deep basis in treasury repurchase agreements. Currently, there are more than $1 trillion of underpinning trading activity. Some variations of SOFR are more similar to LIBOR, such as Forward Looking Term SOFR and SOFR Compounded in Advance, while others are less similar to LIBOR, such as SOFR Compounded in Arrears and Simple SOFR in Arrears. Following ARRC's September 2018 market consultation, it published final recommended fallback language in April 2019 providing that, upon a trigger event, a successor rate would be determined in accordance with certain specified rate and spread adjustment waterfalls. A survey of LIBOR fallback provisions in 132 new issue and amended institutional loans during the fourth quarter of 2019 indicated that ARRC's recommended approach is less common in the syndicated loan market than in the floating rate notes market, with only 33% of the loans reviewed following suit. Despite indications from ARRC that the "amendment" approach may not be operationally feasible on a large scale and that the predetermined terms may provide additional comfort to borrowers and the market, none of the reviewed deals used the ARRC's "hardwired" approach. The majority of deals – 69 deals in this sample – continues to provide for objection rights to the required lenders following an agreement between the borrower and the administrative agent on a successor reference rate. Less than 10% of the loans reviewed expressly provided that a new rate would not require lender consent, and only 1% provided that a new rate would require affirmative lender consent.[22]

In Europe, the LMA has continued to be proactive in preparing for the discontinuation of LIBOR by encouraging both borrowers and lenders to consider the implications of such a change in their loan documents. The LMA has produced a number of reports to supplement the precedent "Replacement of Screen Rate" clause and User Guide pertaining to the same, last updated in October 2018. In 2019, the LMA has focused in particular on the proposed adoption of two alternative risk-free reference rates: the Sterling Overnight Index Average ("SONIA") and the Euro Short-Term Rate ("€STR").[23] The LMA's "Replacement of Screen Rate" clause (or analogous provisions) appeared in almost all European loan agreements in 2019. However, the substance of these provisions were heavily negotiated, with more than half of the European first-lien loan agreements including substantive variations from the LMA precedent. The most prominent inconsistency between market participants concerns a difference in opinion as to which loan parties are required to consent to the replacement the existing screen rate. There are also notable differences in how any consequential adjustments to loan documents (necessary by virtue of the adoption of an alternative screen rate) should be effected. For example, whilst the LMA "Replacement of Screen Rate" provision specifically authorises adjustments to margin in conjunction with changing the benchmark rate, a significant number of alternative provisions in European loan agreements simply make generic reference to "consequential or incidental changes" as a result of a change in the benchmark rate.

However, the European market does seem to be making significant strides towards the adoption of LIBOR alternative rates. Further to the LMA's discussion paper on market conventions for referencing SONIA (published in conjunction with the Working Group on Sterling Risk-Free Reference Rates in March 2019), NatWest and National Express entered into the first revolving facility referencing SONIA.[24] The revolving facility circumvented the fact that SONIA is only available as a historic rate (on a T+1 basis) by applying a daily compounded rate with a five day reset lag, tracking the approach previously adopted in the bond and derivative market.[25] NatWest doubled-down on this approach, publishing the first online compounded SONIA, SOFR and €STR calculator (in response to a call for such a calculator from the Bank of England) in July 2019.[26] On 23 September 2019, the LMA also produced exposure drafts of: (i) a compounded SONIA-based sterling term and revolving facilities agreement; and (ii) a compounded SOFR-based dollar terms and revolving facilities agreement (the "Exposure Drafts").[27] The LMA is very keen to stress that the Exposure Drafts are not LMA recommended forms. They cite "*insufficient established market practice or infrastructure*" as the key reason for why the Exposure Drafts can only be considered "*focal points for consideration*", and note that the Exposure Drafts contain a greater number of blank placeholders and optional provisions than the LMA's recommended forms. However, the LMA does note that it is for market participants themselves to determine to what extent the Exposure Drafts are suitable as the basis for preparing loan documentation for transactions, and note that they envisage producing recommended forms as market practice and infrastructure develops in the relevant areas. The LMA is also explicitly seeking feedback from market participants on the Exposure Drafts, as the European market gears up to the transition away from LIBOR by the end of 2021.

### 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.

### QFC Stay Provisions

In May 2019, the LSTA published a market advisory regarding the U.S. QFC Stay Rules and their application to U.S. global systemically important banking organisations ("GSIBS").[28] The rules also apply to worldwide subsidiaries of GSIBs and U.S. subsidiaries, branches and agencies of foreign GSIBs. At a high level, the rules require GSIBs to include new language in certain credit agreements if the loan documents also support the borrower's obligations under swaps or other qualified financial contracts. The LSTA has proposed model language, which is loosely analogous to the Contractual Recognition Provision required by the EU Bail-in Rule (discussed in detail below), and it is becoming more common for leveraged loan agreements in the U.S. to include the model language. As referenced above, the LMA produced a guidance note to its members on the U.S. QFC Stay Rules incorporating a link to the LSTA model language.

### EU Bail In Legislation

On 28 January 2019, the LMA published a revised version of its user guide pertaining to EU Bail In Legislation.[29] The updates were largely mechanical, following the adoption of enacting legislation relating to Article 55 of EU Directive 2014/59 in Norway and Lichtenstein. Of the 33 EEA states required to enact domestic implementing legislation pursuant to Directive 2014/59, 32 have now done so, with only Iceland outstanding. The LMA user guide provides market participants with guidance on the terms of the LMA Bail In Clause, together with guidance on the requirements under Article 55. The LMA has also updated its recommended form of the Bail In Clause (within section 3 of the user guide). EU Directive 2014/59 (also referred to as the Bank Resolution and Recovery Directive, "BRRD") contains broad powers for EEA regulators to facilitate the rescue of failing EEA financial institutions. The BRRD confers power on the EEA regulators to write down and/or convert into equity failing institutions' liabilities. As a matter of law, those powers will be effective in respect of any liabilities under a document governed by the law of an EEA country, regardless of the terms of the relevant document. Article 55 of the BRRD speaks specifically to a scenario where an EEA financial institution assumes liabilities under a document which is governed by the law of a non-EEA country. Article 55 requires EEA financial institutions to include special terms into almost every document to which they are a party, in circumstances where that document is governed by the law of a non-EEA country. Under those special terms, the EEA financial institution's counterparties acknowledge that the financial institution's liabilities under that document are subject to an EEA regulator's powers of write down and conversion, (the "Article 55 Requirement"). The Article 55 Requirement applies to any loan market documentation governed by the law of any non-EEA country to which an EEA financial institution is a party, irrespective of the institution's capacity. In the context of European-based lending transactions, the most likely documents to be affected are security documents governed by the law of a non-EEA country. EEA financial institutions active in the U.S. are therefore likely to be impacted by the Article 55 Requirement, to the extent their documentation is governed by New York law.

## Part C – Syndicate Management

### Voting Thresholds

Traditionally 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. 2019 marked a tipping-point in the European market where, for the first time, more than half of European loan agreements defined "majority lenders" as a simple majority (as opposed to the traditional "two-thirds" 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 the U.S., the LSTA has recommended, and most loan agreements include, "deemed consent" of a borrower where a borrower does not object to proposed assignments within a period of 10 business days, which is the same position taken in the European market; however, it is increasingly common for "deemed consent" provisions to apply only to funded term loans. Similar to stronger European borrowers and sponsors who are able to negotiate a "blacklist" (as discussed below), most borrowers and sponsors in the U.S. 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 potential 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 U.S. 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. Borrowers generally have limited success in arguing that they should retain consent rights regardless of whether an event of default exists, but, in many cases, they retain the consent right unless the existing event of default is a payment, bankruptcy or solvency event of default.

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 whitelist), or not to a predetermined list of lenders (a blacklist). However, over the course of 2018 and 2019, there has been a marked trend in transfer restrictions. Indeed, restrictions on transferring commitments to "competitors" of the borrower were present in more than 84% of European loan agreements through the first half of 2019, usually without any reasonableness qualification (a slight increase on the same period in 2018). Another trend has been the increasing restrictions on transfers to loan-to-own and distressed investors, which in 2019 was seen in 84% of large-cap European loan agreements. For stronger borrowers in both Europe and the U.S., 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).

## 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.[30] 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.[31] Not surprisingly, adjusted leverage levels in the U.S. have increased and larger adjustments to EBITDA have increased unadjusted leverage even higher.

In June of 2019, a subcommittee of the House Financial Services Committee held a hearing to examine whether leveraged loans are systemically risky. There was no conclusion in the testimony as to whether loans currently pose systemic risk. However, the testimony brought light to concerns about whether loans could pose such a risk in the future and whether the loan market is too opaque for banking regulators to effectively monitor the inherent risks. Some of these concerns drew parallels to the financial crisis as certain Congressmen seemed to imply that the unexpected and massive failure of CDOs could repeat itself with CLOs and leveraged loans in the absence of effective regulation. Other Congressmen noted that these concerns are unfounded. The LSTA also considered the concerns to be misplaced given the historical performance of CLOs and their underlying loans as well as the structural protections for investment CLO securities. While it seems unlikely that proposed legislation in this domain will move forward in the immediate future, the LSTA will continue to follow the issue closely as Congressional leaders and community members continue to question the nature of the risk in the loan market.[32]

Similar leveraged lending regulations have 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.[33] 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).

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).

Whilst the full effectiveness of the guidance remains in question, the level of supervision from the ECB has certainly increased since its introduction in 2017; banks were required to provide an internal assessment of their implementation of the guidance in November 2018, the ECB has started collecting quarterly data from the 18 most active supervised banks and a multi-year programme of on-site inspections was launched in January 2019. However, despite an improved effort from banks to implement the guidance, the ECB still regards excessive leverage as a key supervisory concern and will expect banks to implement more rigorous risk management practices in order to achieve full compliance with the ECB's risk management expectations.[34]

## Net-Short Debt Activism

A recent development in the U.S. loan market has seen documentary protections introduced against activist investors holding net short positions, given the economic incentive for those investors to trigger manufactured defaults while maintain substantial positions in credit default swaps. However, some investors have resisted these protections, also known as "anti-net-short provisions" in light of the broader market trend towards borrower-friendly loan agreements and arguments that these restrictions negatively impact liquidity.[35]

The genesis of anti-net-short provisions in loan documentation followed the bankruptcy of Windstream Holdings, a communications firm, in February of 2019. Aurelius Capital Management became the holder of more than 25% of Windstream's senior unsecured notes, while holding a material net short position. Aurelius then issued a default notice attributable to the breach of a sale-leaseback covenant, which pushed Windstream further into distress and left Aurelius with a return on its short position.

As a general matter, anti-net-short provisions involve adding lenders who have been identified as net short (including, in some cases, lenders whose affiliates are found in such a position) to the deal's DQ list. Some investors resist these provisions on principle, while others credibly claim that representations covering affiliates are unworkably broad and logistically difficult to make. However, covering affiliates may be the most effective way for borrowers to root out activists from their lender group. As a result, borrowers now frequently push for this protection and will continue negotiating with arrangers to find a palatable balance for the market.

## 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. LCD Comps: "Amid thinner issuance, banks increase share of 2019 loan mart", 20 December 2019.
2. Debtwire: "Debtwire Par: 3Q19 European Leveraged Insights Report", 7 October 2019.
3. The Washington Post: "Why Direct Lending Is a Booming Part of Private Debt", 20 December 2019 (https://www.washingtonpost.com/business/why-direct-lending-is-a-booming-part-of-private-debt/2019/12/18/db88e0ae-21cc-11ea-b034-de7dc2b5199b_story.html).
4. Loan Market Association: "U.S. QFC Stay Rules and syndicated loans", 16 May 2019 (https://www.lma.eu.com/application/files/9815/5808/5934/LMA_note_on_QFC_Stay_Rules_and_syndicated_loans.pdf).
5. Debtwire: "European Chart of the Week: Unitranche share of direct lending activity climbs in 3Q19", 22 October 2019 (https://www.debtwire.com/intelligence/view/prime-2924229).
6. *Re Apcoa Parking Holdings GmbH & Ors* [2014] EWHC 3899 (Ch.).
7. Colby Smith, *Red-hot leveraged loan market draws regulatory heat*, Financial Times, 30 October 2018, available at https://www.ft.com/content/6ee96af8-d79b-11e8-ab8e-6be0dcf18713 (accessed 9 January 2019).
8. *2018: U.S. Primary Loan Market Review*, The Loan Syndications and Trading Association, 3 January 2019.
9. CR Trendlines Report: "Spirited Pushback Persists in November, Driving Significant Covenant Flex", 9 December 2019.
10. Justin Smith, *J Crew Blocker: Don't Believe the Hype*, XtractResearch, 11 May 2018.
11. S&P Global Market Intelligence: "S&P: Few leveraged loans protect against J.Crew-like collateral transfers", 26 September 2019, (https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/leveraged-loan-news/sp-few-leveraged-loans-protect-against-j-crew-like-collateral-transfers).
12. Christine Tognoli, European Leveraged Loan: 2019 Half-Year Review, XtractResearch, 8 August 2019.
13. Christine Tognoli, European Leveraged Loan: 2019 Half-Year Review, XtractResearch, 8 August 2019; and ReorgDebt Explained, "European Leveraged Loan Market Update: Q3 2019".
14. Christine Tognoli, European Leveraged Loan: 2019 Half-Year Review, XtractResearch, 8 August 2019; and ReorgDebt Explained, "European Leveraged Loan Market Update: Q3 2019".
15. Jenny Warshafsky, *October 2018 US Loan Trends: Aggressive Terms Proposed in Recent Draft Credit Agreements*, 8 November 2018.
16. *What's Market: 2015 Year-End Trends in Large Cap and Middle Market Loan Terms*, Practical Law Company, 28 January 2016.
17. David Billington and Ian Chin, *Mandatory means mandatory? Recent trends in leveraged finance prepayment clauses*, Journal of International Banking and Financial Law, October 2018.
18. ReorgDebt Explained, "European Leveraged Loan Market Update: Q3 2019".
19. Christine Tognoli, European Leveraged Loans: 2019 Half-Year Review, XtractResearch, 8 August 2019.
20. Christine Tognoli, European Leveraged Loans: 3Q19 Highlights, XtractResearch, 18 November 2019.
21. Jenny Warshafsky, *Worst of Cost Savings Addbacks to EBITDA*, XtractResearch, 18 December 2018.
22. Covenant Review: "Survey of LIBOR Fallback Provisions in Syndicated Institutional Loans (October 1, 2019 – December 31, 2019)", 15 January 2020 (https://covenantreview.com/reports/downloadProspectus/187837/dbec6d85-8cd0-4b60-b364-b6d5b6163c68).
23. Bart Capeci, Xtract Research, "LIBOR and EURIBOR Replacement – A Documentation Update Part 2 – The European Loan Market", 27 August 2019.
24. The Working Group on Sterling Risk-Free Reference Rates, "Discussion Paper: Conventions for referencing SONIA in new contracts", March 2019.
25. Philip Stafford, Financial Times, "Sonia rate makes loan debut with National Express deal", 30 June 2019 (https://www.ft.com/content/1ce74182-99a9-11e9-9573-ee5cbb98ed36).
26. https://nwm.realisedrate.com.
27. LMA, "Compounded SONIA Based Sterling Term and Revolving Facilities Agreement", September, 23 2019; and LMA, "Compounded SOFR Based Dollar Term and Revolving Facilities Agreement", 23 September 2019.
28. LSTA, "Application of the U.S. QFC Stay Rules to Credit Agreements", 6 May 2019, (https://www.lsta.org/content/qfc-stay-rules-2).

29. LMA, "The Recommended Form of Bail-In Clause and Users Guide", 28 January 2019.
30. *OCC head says banks not bound by lending guidelines, expects leverage to increase*, Debtwire, 27 February 2018, available at https://www.debtwire.com/info/occ-head-says-banks-not-bound-lending-guidelines-expects-leverage-increase (accessed 15 January 2019).
31. Jonathan Schwarzberg, *OCC head says leveraged lending guidance needs no revisions*, Reuters Bonds News, 24 May 2018, available at https://www.reuters.com/article/llg-revisions/occ-head-says-leveraged-lending-guidance-needs-no-revisions-idUSL2N1SV24T (accessed 15 January 2019).
32. LSTA, "Systemic Risk: Taking It To The House", 6 June 2019 (https://www.lsta.org/news-resources/systemic-risk-taking-it-to-the-house/).
33. *ECB publishes guidance to banks on leveraged transactions*, European Central Bank, 16 May 2017, available at https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170516.en.html (accessed 5 December 2018).
34. European Central Bank, "Keeping an eye on banks' leveraged lending", 15 May 2019 (https://www.bankingsupervision.europa.eu/press/publications/newsletter/2019/html/ssm.nl190515_2.en.html).
35. Mark Darley and Zoe Cooper Sutton, "Net-short debt activism", October 2019 (https://www.financierworldwide.com/net-short-debt-activism#.XgsOEVdKiUk).

## Acknowledgments

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

**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 financial institutions such as Barclays, Citigroup and Goldman Sachs, and companies such as Travelport, CIT and Exide.

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.


| | | |
|---|---|---|
| **Skadden, Arps, Slate, Meagher & Flom LLP** | Tel: | +1 212 735 2126 |
| 4 Times Square | Fax: | +1 917 777 2126 |
| New York, NY 10036 | Email: | sarah.ward@skadden.com |
| USA | URL: | www.skadden.com |


**Mark L. Darley** was Skadden's first European banking partner and was co-head of the Global Banking Group for 10 years until 2019. 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*, in addition to *IFLR1000* and in 2018 became a member of *The Legal 500's Hall of Fame*. Mr. Darley has been selected as Leveraged Finance Lawyer of the Year in England by Global Law Experts.


| | | |
|---|---|---|
| **Skadden, Arps, Slate, Meagher & Flom LLP** | Tel: | +44 20 7519 7160 |
| 40 Bank Street, Canary Wharf | Fax: | +44 20 7072 7160 |
| London, E14 5DS | Email: | mark.darley@skadden.com |
| United Kingdom | URL: | www.skadden.com |


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% 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.

**www.skadden.com**

Skadden

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