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

Tracey L. Chenoweth

Clive J. Wells

Skadden, Arps, Slate, Meagher & Flom LLP

Introduction

There are a number of similarities in the drafting and negotiating of documentation governing U.S. and European leveraged loan transactions. Notwithstanding the economic disruption caused by the COVID-19 pandemic, both the U.S. and European leveraged loan markets experienced a buoyant year in 2021. In Europe, the leveraged loan market commenced the year very strongly, with total loan volume for the first quarter of 2021 aggregating €40.5 billion – the market's third largest ever quarterly volume, behind the first and second quarters of 2007 (occurring just prior to the global financial crisis).[1] This trend continued throughout the second quarter of 2021, sustained by significant buyout activity from private equity sponsors, and by 30 June 2021 the half-year's total leveraged loan volume was already higher than the full year's volume for 2020.[2] Despite a modest reopening of the European leveraged loan market following the summer,[3] issuances remained steady throughout the latter half of 2021 despite the emergence of the Omicron variant of COVID-19 in November.[4]

Despite the prospect of increasing interest rates in the U.S., the leveraged loan market experienced a sharp increase in the volume of leveraged loan issuances in 2021. Total institutional loan volume in the U.S. through 31 December 2021 reached a record high, reversing a five-year downward trend since the last spike in 2017.[5] High yield bond issuances also had a record year, continuing their strong performance from 2020, with issuances increasing 6.9% to $465 billion. A substantial proportion of this deal flow was associated with refinancing, so, despite a near-doubling in deal volume, the amount of outstandings increased more slowly (albeit still to a record high).[6] After two record years, the volume of high yield bond issuances is expected to decrease in 2022, while still remaining elevated compared to historical levels. Leveraged loan issuance volume, meanwhile, is expected to remain relatively stable, and, as a result, the ratio of high yield bond issuances to leveraged loan issuances is expected to return to a level more consistent with what has been seen historically, driven in part by anticipated strong M&A activity and rising interest rates.[7]

During the year, the alternative markets (in addition to the roster of traditional lenders, which consists largely of banks and institutional investors) continued to develop for borrowers in both the U.S. and Europe, with the sources of financing including hedge funds, private equity funds, insurance firms and other non-traditional lending institutions acting as direct lenders. In the U.S., the ability of private credit providers to close financings with speed and flexibility continues to be an important resource for borrowers, particularly for midmarket companies, although traditional credit sources are now once again providing funding consistent with pre-COVID timelines.[8] Private credit assets under management grew again in 2021 to $1.1 trillion, and the category is expected to remain robust during 2022.[9] In Europe, the trajectory of the direct lending market largely mirrored the wider leverage loan market in 2021, with leveraged buyouts driving deal activity at records rates and at pre-COVID-19 levels of confidence among alternative lenders.[10] In the midmarket space, the direct lending market in Europe was even thought to have outpaced traditional bank lenders.[11]

After some tightening on documentary terms in the European market towards the start of 2020, the surge in deal volume in the last half of 2020 and early 2021 swung the pendulum back in favour of sponsors and borrowers, with European documentary terms reverting to pre-pandemic norms (and in some cases, going even further). The U.S. market experienced a similar trend during 2021, as investor demand for debt investments increased and markets recovered from the impact of the COVID-19 pandemic. This produced a banner year for the term loan market in 2021, with the U.S. market scales tipping back in favour of sponsors/borrowers – as of 4 October 2021, over 90% of the U.S. leveraged loans in 2021 were covenant-lite (a new record).[12]

Despite the various similarities, there continue to be significant differences in commercial terms and overall market practice in the U.S. and European leveraged loan markets. As sophisticated investors will seek out opportunities to access whichever market provides greater liquidity and/or better terms and conditions (including pricing) at any given time, it is important for all participants to understand where these markets have converged and where they continue to deviate.

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, focusing primarily on non-investment grade borrowers, and is intended to serve as an overview and a primer for practitioners. References throughout this chapter to "U.S. loan agreements" and "European loan agreements" should be taken to mean New York and English law-governed leveraged loan agreements, respectively.

This chapter is divided into four parts: Part A will focus on differences in documentation and facility types; Part B will focus on various operational 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 will greatly influence the final terms. In Europe, parties expect, historically, the starting point to be one of the very comprehensive "recommended forms" published by the Loan Market Association (the "LMA"), but it is more common to start with the borrower's or, if applicable, the sponsor's preferred prior transaction precedent document.

The LMA (comprised of more than 770 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 and 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 private placement transactions. 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 transition away from LIBOR, the Sustainability Linked Loan Principles and the Green Loan Principles, the impact of the COVID-19 pandemic and the United Kingdom's withdrawal from the European Union); its influence and authority is significant.

In Europe, commercial dynamics will dictate whether the financing documentation is based on a precedent document or the more lender-friendly LMA form. Lenders of unitranche financings (discussed in more detail below) tend to have more influence to require that LMA documentation is used as the starting point, and sponsors and borrowers are accustomed to this. Conversely, on a syndicated leverage financing, top-tier and many midmarket sponsors expect to use their own precedent as the documentation starting point.

In the U.S., although the Loan Syndications and Trading Association (the "LSTA"), an organisation of banks, funds and other financial institutions, has published a form loan agreement for investment grade transactions and standard forms of a more limited set of provisions (which are generally limited to tax provisions, mechanical provisions (such as rights of set-off), lender voting provisions and operational matters) to be included in agreements governing non-investment grade transactions, it is unusual for such forms to be the starting point for drafting. Instead, the parties usually identify a "documentation precedent" – an existing deal on which the loan documentation will be based. In the case of sponsor-backed deals, the proposed precedent is usually based on the applicable sponsor's form, whereas a corporate borrower will either use the company's existing credit documentation or publicly available documentation for a similarly situated borrower.

In addition, it has become common in the U.S. for counsel to sponsors and borrowers to "hold the pen" for the production of the first draft of the documentation, which is notable because this initial draft will often influence the final outcome and, at a minimum, put the borrower in a position of leverage during negotiations. While sponsor-backed borrowers have been able to designate their counsel as being in control of the loan documents for a number of years, this is becoming increasingly common for corporate borrowers as well. While key economic terms, covenant baskets and thresholds and financial definitions are often negotiated at the term sheet stage (which the sponsor/borrower counsel will often draft as well), sponsor/borrower control over the definitive documentation generally leads to a more borrower-friendly starting (and therefore ending) point, particularly with respect to prepayment provisions, amendment flexibility and information undertakings, as well as assignment provisions and rights to replace lenders. Sponsor control over documentation has also led to an increase, in the European syndicated leverage finance market, of loan agreements that include a wholesale adoption of a New York law-governed, high yield bond-style covenant package and related definitions, alongside limited English law-governed covenants. Typically, a version of the English law-governed LMA form is used for the body of the loan agreement (including the springing financial covenant and the LMA form of boilerplate language) and New York law-governed covenants and related definitions are included as schedules to the loan agreement.

Sponsors and borrowers are keen to embrace the style of New York law-governed, broadly syndicated loan documentation, as it originates from a liquid public market (in contrast to the European syndicated loan market, which is private and materially less liquid) and, as a result, is more permissive than the LMA standard form drafting. Many sponsors also expect that improvements included in the documentation for any deal within their investment portfolio will thereafter be incorporated in future documents for borrowers in their portfolio, resulting in a precedent that is continually updated to include "top of market" terms that achieves a "best-of-all-worlds" scenario for sponsor-backed borrowers. This approach is converging with the selection of "documentation precedent" commonly seen in the U.S.

Conversely, the historically widespread use of the LMA standard forms has resulted in good familiarity and comprehension within the European investor market, and lenders tend to be more comfortable with an English law-governed loan agreement, based on an LMA standard form, as compared to a document with New York law-governed, high yield bond-style provisions. Despite this, in 2021 the European syndicated leverage loan market has continued to move away from the use of LMA standard form documentation, with such form used in less than a quarter of 2021 deals (as at 21 October 2021).[13]

In relation to market and regulatory developments that could affect both loan markets as a whole, it is worth noting that the LSTA and LMA often cooperate and coordinate their approach in issuing guidance and recommended language. By way of example, in February 2021[14] and May 2021,[15] respectively, the LMA and LSTA (in conjunction with the Asia Pacific Loan Market Association) published guidance documents aimed at growing and developing the global market for green and sustainability linked loan products.

Facility Types

The basic facility types in 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, if both are included, are most often secured on a *pari passu* basis (unless it is an "asset backed" facility, in which case both facilities will be first lien facilities but there will be "split priority" arrangement with respect to the collateral; such facilities are outside of the scope of this chapter).

In both the U.S. and Europe, loan agreements usually provide for uncommitted "incremental facilities", which can take the form of additional term loans or an increase of the existing revolving credit commitments. Some agreements permit the addition of new tranches of loans and/or commitments. The borrower will have to satisfy certain customary conditions to obtain these incremental facilities (including obtaining commitments from existing lenders or other entities that would be eligible assignees of existing loans), but the consent of lenders not providing the incremental debt is not required for the incremental facilities (which increase the overall facility size), subject to the limitations set forth in the loan agreement, which are discussed in more detail below in Part B.

In both the U.S. and in Europe, all lenders (whether revolving credit lenders or term loan lenders) in first lien facilities 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" or other super priority structure, which, as discussed below, is sometimes used in the U.S.). Alternatively, a financing transaction may adopt a first lien/second lien structure, in which the "first lien" and "second lien" term loans are secured by the same collateral, but the liens of the second lien lenders are junior to those of the first lien lenders. In this structure, subject to limited exceptions, no collateral proceeds or prepayments may be applied to any second lien obligations until all first lien obligations have been repaid. If there is a revolving credit facility, this will be secured on a *pari passu* basis with the first lien term loans. In addition to being secured on a junior lien basis to the first lien facilities, the second lien facility will be a term loan with no amortisation payments. First lien/second lien structures treat the first lien lenders and second lien lenders as being providers of two separate loans, each with its own administrative/collateral agent, and will be governed by separate loan and security documents. The relationship between the two lender groups with respect to payments and collateral proceeds and the exercise of remedies will be set out in, and governed by, an intercreditor agreement entered into between the respective agents on behalf of the two lender groups.

In both the U.S. and Europe, certain transactions (historically 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). Usually, in U.S. unitranche transactions, a separate agreement among lenders (an "AAL") governs the rights and obligations of the first out and last out lenders, including voting rights, and the allocation of interest between the lenders. Alternatively, and as is the customary approach in Europe, the allocation of rights and obligations among the lenders may be included in the loan agreement itself and an intercreditor agreement (to which the borrower is also a party), which borrowers may prefer, as it gives them better visibility on where the control of the voting rights sits in the lender group. That said, the *In re RadioShack Corp.* litigation in the U.S. Bankruptcy Court for the District of Delaware 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, so either construct should be acceptable.

In Europe, driven by the rising prominence of debt funds and alternative capital providers, unitranche and direct loan facility structures play an increasingly significant role in the debt market, which, while historically more common in the smaller to midmarket transactions, funds are keen to emphasise (and are continuing to demonstrate) their ability to do much larger financings. It is worth noting that debt funds and alternative capital providers may not always have the capacity to provide working capital (e.g. revolving credit) facilities to borrowers and as such, they may "club" with commercial banks to provide that component of the financing. In such instances, the commercial bank's super senior revolving credit facility and the direct lender's senior facility will typically rank *pari passu* but, in terms of distribution of enforcement proceeds, these are to be applied (after payment of enforcement costs and expenses) first in payment of the commercial bank's super senior revolving facility and secondly the direct lender's senior facility.

In the restructuring context, European unitranche structures have come under scrutiny – 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*)[16] suggest that unless creditors can demonstrate that their distinct economic rights are also accompanied by corresponding legal rights, that are enforceable against the borrower (which is not the case if 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, the junior lenders may forfeit any potential hold-out value that may rise during the course of a borrower's restructuring). In June 2020, a new form of restructuring plan was introduced under Part 26A of the Companies Act 2006 (pursuant to the Corporate Insolvency Governance Act 2020) (a "Part 26A Plan"). A Part 26A Plan offers companies experiencing financial difficulty (who fall within the jurisdiction of the English courts) an alternative to a traditional scheme of arrangement. Whilst a detailed summary is beyond the scope of this chapter, it is worth noting that the Part 26A Plan introduces a novel concept into English restructuring law – the court-sanctioned "cross-class cram-down" – drawing inspiration from U.S. Chapter 11 proceedings. Whilst a scheme of arrangement requires the approval of 75% (in value) of *each class* of creditors (granting them a *de facto* veto), an English court may force that same group to accept a Part 26A Plan – provided certain conditions are met. Consequently, even if unitranche creditors were to be considered a separate class in a European restructuring context, the application of a Part 26A Plan "cross-class cram-down" would limit their influence significantly. The English courts' power to sanction a Part 26A Plan and enforce a "cross-class cram-down" is discretionary – a power first exercised on 13 January 2021 in relation to a Part 26A Plan proposed by the DeepOcean group. Whilst the English court's willingness to apply a "cross-class cram-down" on a dissenting class of DeepOcean's creditors is a notable step, the concept remains in relative infancy and is likely to develop significantly in the coming years.

In the case of European borrowers with both secured high yield debt and 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 regard to payment and the security package. However, the lenders under the revolving credit facility will rank "super senior" in that they take priority over the noteholders in relation to the proceeds of recovery from any enforcement action. In exchange for this the high yield noteholders typically will have the ability to enforce and/or direct enforcement, 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 (under what are most commonly referred to as "TLA facilities") are syndicated in the U.S. market to traditional banking institutions, who typically require a five-year maturity and higher amortisation rates (which may start at 1% per year, but will likely increase to 5% or 10% per year during subsequent years – compare this to a "Term B" loan, which, as noted below, typically has a scheduled amortisation of 1% per year for life) and include at least one, if not multiple, financial covenants, which are tested quarterly regardless of the amount, if any, drawn. TLA facilities are not commonly used on new money leverage financings in Europe and tend only to be advanced in special situations or on a deal specific basis. "Term B" loans (under what are most commonly referred to as "TLB facilities") comprise a large percentage of the more sizeable leveraged financings and are typically held by institutional investors. First lien TLB facilities typically require amortisation in an annual amount equal to 1% of the original principal amount. TLB facilities are more likely to be governed by "covenant-lite" agreements, under which there will be a single leverage covenant that benefits the revolving credit facility only, and such covenant is only tested if revolving credit usage exceeds a certain percentage of the revolving credit commitments as of the last day of a fiscal quarter or year. The threshold at which the covenant, which will be a leverage covenant (total, secured or fist lien), is tested has risen from a range of 25% to 35% of revolving commitments to up to 40% of the revolving commitments in the U.S., the latter of which is consistent with the typical threshold in Europe. Any amendments to or waivers of the leverage covenant (including changes to the financial definitions contained there) in a covenant-lite deal will only require the consent of a majority of the lenders under the revolving facility (any term lenders will not get a vote on such matters). In addition, if an event of default with respect to the financial covenant occurs, the term loan lenders will not have the right to accelerate their debt or exercise any other remedies unless and until the revolving lenders terminate their commitments. The maturity dates of TLB facilities are also longer than a term "A" loan – typically, six or seven years if it is a first lien TLB facility, and up to eight years for a second lien TLB facility. To compensate for these more borrower-friendly terms, TLB facilities usually have a higher interest rate margin and other economic protections (such as "soft-call" repricing protection, "excess cash flow" mandatory prepayment provisions and, in the case of second lien term loans, "no-call" periods) that are not commonly seen in TLA facilities.

Whilst historically European sponsors and borrowers unable to negotiate sufficiently flexible or desirable loan terms with their usual relationship banks had to resort to the U.S. TLB and high yield bond markets 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 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. TLB facility 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 through the adoption of New York law-governed, high yield bond-style covenants and related definitions (bringing improvements for borrowers in areas such as debt capacity, payments to equity holders, disposals and acquisitions)), although most European TLB instruments are still likely to contain guarantor maintenance coverage tests (requiring the accession of additional guarantors and the provision of security by such new guarantors, if the required test thresholds are not met), and to have higher lender consent thresholds.

Certainty of Funds

In the United Kingdom, when acquiring a UK listed public company in a transaction in which all or part of the consideration is cash, the City Code on Takeovers and Mergers (the "Code") 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 negotiation and execution of loan documentation and fulfilment of the conditions precedent (other than those conditions that are also conditions to the bid itself) at the point of announcement of the public bid. The conditions to drawdown, and the lenders' rights to enforce during the period in which the bid is ongoing, are also significantly limited by the Code – only in very limited circumstances (relating to the bidder and not the target or its group) can the lenders decline to lend or accelerate and enforce.

Whilst not a regulatory requirement, "certain funds" are also an expected feature of private buyouts in Europe. In order to present the strongest bid possible, sponsors are keen 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 for a private bid.

In the U.S., there is no regulatory certain funds requirement and, unless the acquisition is a simultaneous "sign and close", 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). 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 consolidated adjusted EBITDA, including "add-backs" and other financial definitions). 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. A conditions annex will set forth, in detail, the conditions to closing which, except for a few customary exceptions (e.g. lender KYC), will closely match those in the acquisition agreement. They will not include a leverage test or similar condition not within the borrower's control. In the U.S., commitment papers for an acquisition financing will contain customary "SunGard" provisions (so named because the 2005 acquisition of SunGard Data Systems by a consortium of private equity firms was the first public transaction to contain such "limited conditionality", as it is also known) 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 date collateral 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, the detail laid out in the attached term sheet and the New York law principle of dealing in good faith, the difference, as a practical matter, between European "certain funds" and U.S.-style "limited conditionality" provisions is not as significant as it may appear; however, as a legal matter, the approach used in the U.S. would not be acceptable in a Code-regulated public bid.

Part B – Loan Documentation Provisions

Covenants and Undertakings

Whilst the dominant theme of recent years has been the increasing inclusion in European deals 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 they are known in U.S. loan agreements) and undertakings (as they are referred to in LMA-style, English law-governed loan agreements). This Part B explores some of those differences.

Both U.S. and European loan agreements use a "ring fencing" concept to identify the credit group, which underpins the construction of their respective covenants/undertakings. In U.S. loan agreements, borrowers and guarantors are most commonly referred to as "loan parties", whilst their European equivalents are known as "obligors". In each case, the loan parties/obligors are generally free to deal between themselves, as they are all within the credit group and provide collateral support for the loan, *versus* other subsidiaries of the borrower, which, while bound by the covenants in the loan documentation, do not provide credit support. Conversely, to minimise the risk of credit leakage, transactions between the loan parties/obligors and their subsidiaries and other affiliates that are not part of the credit group (i.e., non-loan parties/obligors) will typically be subject to additional restrictions that are similar to (although generally not as restrictive as) restrictions binding on credit group transactions with third parties generally. However, dealings entirely amongst non-loan parties/obligors are typically granted broader discretion, as such entities are not a source of credit support for the transaction, and lenders are not concerned with collateral leakage.

In U.S. loan agreements, there is usually an ability to designate members of the borrower's group as "unrestricted subsidiaries" (subject to customary conditions, including sufficient investment capacity, *pro forma* financial covenant compliance and the absence of any default or event of default both before and after giving effect to the designation). The covenants, representations and warranties do not apply to members of the unrestricted group (other than, in some cases, certain fundamental matters, such as anti-money laundering and anti-terrorism provisions), and assets of unrestricted subsidiaries are not included in the collateral package. Also, debt of unrestricted subsidiaries is excluded from leverage calculations. In exchange for such freedom, the loan agreement will limit dealings between members of the restricted group and those entities within the unrestricted group – in effect, treating the latter as though they were true third parties. In addition, income and EBITDA attributable to the unrestricted group is not included in ratio tests (whether it is an incurrence test or for purposes of financial covenant compliance) and is not taking into account determining the size of the "builder basket", unless distributed to a member of the restricted group. In recent years, there have been some high-profile transactions that have led to lenders adding constraints on the ability of the credit group to interact with unrestricted subsidiaries, even if the transaction would fit in the investment basket capacity and is otherwise permitted. One notable example of such a manoeuvre came in December 2016 when J Crew Group, which owned its domestic trademarks through a restricted subsidiary, transferred a significant interest in those trademarks to a foreign restricted subsidiary, which, in turn, transferred it to an unrestricted subsidiary (and subsequent transfers were made to other unrestricted subsidiaries). In response to the high-profile clash between J Crew Group and the relevant lenders, lenders focused on including a specific prohibition on transfers of material intellectual property to an unrestricted subsidiary – commonly known as the "J Crew blocker".[17] Despite this focus, each of Travelport, Cirque du Soleil and Party City utilised the terms of their existing credit documentation in 2020 to designate entities with material assets as unrestricted subsidiaries.

Other "trap doors" that could be used to strip value from the collateral and guarantee package have since been exposed, such as the ability to transfer nominal amounts of equity issued by a guarantor to a third party (which may or may not be affiliated with the restricted group). Since many agreements include an automatic release mechanism that frees what becomes a non-wholly owned subsidiary from its guarantee obligations (and also releases its assets from the security interest granted to secure the debt), while, technically permitted, the result was something that agents and lenders had not previously anticipated. PetSmart, Inc., sought to take advantage of such a provision when it transferred equity from its recently acquired, wholly owned subsidiary Chewy to its ultimate parent holding company (that was not a loan party) and to an unrestricted subsidiary. This triggered the automatic release provisions under PetSmart's credit agreement, meaning that Chewy was no longer a guarantor of the credit agreement and the liens over Chewy's assets were released. This resulted in litigation that was ultimately settled in anticipation of Chewy's IPO.[18] In reaction to this, lenders began inserting provisions prohibiting transfers of equity to non-loan parties for the purposes of avoiding the guarantee and/or collateral requirements.

Whilst not historically a feature of the European loan market, the use of the "restricted/unrestricted" subsidiary construct now tends to be included in European loan agreements. Of particular concern to lenders has been the increasing number of European leveraged loan agreements permitting unlimited transactions (e.g., loans, disposals, guarantees) between "restricted" subsidiaries, irrespective of whether those "restricted" subsidiaries are guarantors. This trend, coupled with the shift away from caps on obligor to non-obligor leakage and increasingly large non-obligor debt baskets, has increased lenders' exposure in the most aggressive sponsor-backed deals. Accordingly, and whilst there are some differences between European and U.S. loan agreements when it comes to papering the "restricted/unrestricted" construct, the substantive concerns of lenders with respect to leakage on both sides of the Atlantic are aligned (albeit with fewer high-profile examples in the European leveraged loan market to date).

Restrictions on Indebtedness

Leveraged loan agreements include an undertaking or covenant (referred to as an "indebtedness covenant" in U.S. loan agreements and some European loan agreements or a "restriction on financial indebtedness" undertaking in traditional English law-governed European loan agreements), that prohibits the borrower and its restricted subsidiaries from incurring indebtedness, subject only to limited exceptions. Typically, "indebtedness" of a person will be broadly defined in the loan agreement to include debt for borrowed money and other obligations, such as notes, letters of credit, financing 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.

Some of the exceptions to the indebtedness covenant are customary, such as intercompany loans, non-speculative hedging obligations and debt to fund capital expenditures (up to an agreed cap), but others will be tailored to the business of the borrower. In addition, there are other baskets, such as the "general basket" for debt, which will include a fixed amount, and will often include a "grower" component based on a percentage of total assets or consolidated adjusted EBITDA that increases and decreases as the assets or EBITDA of the business changes (but the fixed amount serves as a "floor" for the minimum basket size). In addition, an "incurrence-based" basket, which requires *pro forma* compliance with a specified leverage or fixed charge ratio, and a basket for indebtedness incurred, acquired and/or assumed in connection with permitted acquisitions will usually be included. These other baskets will be sized based on the borrower's business and risk profile and the lead bank's or underwriters' 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 common in the U.S. and in high yield bond-style European loan agreements. It is increasingly common for borrowers to have negotiated the ability to refresh their general basket (which can be used regardless of the borrower's leverage ratio) by re-designating debt originally incurred under the general basket as debt incurred under the leverage-based incurrence basket if the borrower meets the applicable test at a later date (and in many agreements, this reclassification is automatic). Some U.S. loan agreements and high yield bond-style European 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 even 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.

In the U.S. (and also for European high yield bond-style loan agreements), most loan agreements allow the borrower to incur an incremental facility, or, in *lieu* thereof, additional *pari passu* or subordinated incremental debt (which may be secured or unsecured) outside the loan 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 consolidated adjusted EBITDA), referred to as "free-and-clear" baskets, 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 2.0x). 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 and high yield bond-style European 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. A loan agreement may also provide for increases to the free-and-clear basket over the life of the loan, such as dollar-for-dollar increases based on the principal amount of any voluntary prepayments of existing term loans and other third-party debt secured on a *pari passu* basis with the term loan facility and/or voluntary reductions in revolving commitments and/or providing that incremental debt that effectively extends the maturity of the existing facilities adds to capacity.

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 applying to the loans under the original facility by a specified number of basis points (usually 50 basis points in the U.S., but increasingly the permitted spread is 75 basis points in the U.S., or 100 basis points in European high yield bond-style loan agreements) of the incremental facility's margin, the original facility margin will be increased to be within such spread of the new incremental facility. Borrower-friendly loan agreements often include limitations with respect to MFN clauses, usually a "sunset" restricting their application to a certain timeframe, typically six to 12 months following closing. Such borrower-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 and/or incremental term loans that mature within a certain period (usually, 12 months) 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. Alternatively, some U.S. deals and some European deals that adopt high yield bond-style covenants limit MFN protection to incremental term loans incurred under the ratio incremental capacity. This approach, combined with the ability to reclassify debt, 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 and European high yield bond-style 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 (i.e., not to exceed the principal amount of the old debt *plus* accrued interest, fees and costs), maturity, weighted average life to maturity, ranking, guarantees and security. It is now common for the cap to also include the amount of any unused commitments and for there to be exceptions for bridge facilities that convert into longer-term debt if not repaid.

The restriction on financial indebtedness undertaking typically found in traditional LMA-style 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 subject to certain "permitted debt" exceptions (both customary ordinary course type exceptions as well as specifically tailored exceptions, requested by the borrower). The European loan market as a whole is open to the concept of borrowers being permitted to incur additional debt. Even in traditional LMA form documentation there are now enhanced permissions, such as "permitted debt" exceptions based on a leverage and/or secured leverage 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 incremental facility, or outside the loan agreement by way of a separate side-car facility.

Whilst uncapped, leverage ratio-based incremental debt capacity has become a standard feature of high yield bond-style European loan agreements, there has been a little to-and-fro on this over recent years. Initially, in early 2019, lenders sought to counterbalance their exposure by resisting the inclusion of any additional "freebie" or "free-and-clear" amount. However, as 2019 progressed lenders' resistance began to crumble – with a "freebie" featuring in nearly 90% of European loan agreements by year end.[19] Most of these "freebies" remained soft-capped "grower" baskets, determined by reference to EBITDA. In 2020 and also 2021, rather than pushing-back on the overarching concept of "freebies" as they had in early 2019, lenders focused their attention on resisting the prevalence of "freebies" soft-capped at 100% EBITDA. In 2021, lenders on some transactions were successful in reducing caps to 50–75%.[20] Whilst it remains the case that "freebie" baskets are scrutinised further by investors in the European market as compared to their U.S. counterparts (predominantly driven by historic push-back during the syndication process), there was a notable shift towards convergence of European and U.S. terms with respect to "freebie baskets" in 2020 and 2021 (reversing the trends seen in early 2019).

As in the case of U.S. loan agreements, European loan agreements with incremental facility provisions will invariably contain MFN protections. However, MFN protections are one aspect of European loan agreements that have changed significantly in recent years. Changes have included a deletion or a reduction in the amount of debt not subject to MFN protection, references to "margin" being flexed to "yield" (so as to take advantage of interest rate floors and original issue discounts), and the deletion of carve-outs for MFN protection for debt incurred under "permitted" baskets. As in 2020, 2021 also saw a number of MFN protections under European loan agreements extended from six months to 12 months (and even so far as 24 months in the case of U.S. dollar denominated incremental facilities in European leveraged loans).[21]

Restrictions on Granting Security/Liens

U.S. loan agreements and European high yield bond-style loan agreements will also invariably restrict the ability of the loan parties/obligors (and, usually, their restricted subsidiaries) to incur liens. A typical U.S. loan agreement and European high yield bond-style loan agreements 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 subject to certain typical exceptions, which often permit liens securing permitted refinancing indebtedness, purchase money liens, statutory liens, liens on acquired assets (to the extent such liens were incurred in contemplation of the acquisition) 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 consolidated adjusted 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, if such debt is in the form of term loans, an MFN clause in order to prevent a borrower from incurring priming or dilutive debt.

The European equivalent used in standard LMA documentation, 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 an 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 and high yield bond-style European 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 (but increasingly contain a "grower" component). 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, officers and directors, 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 and high yield bond-style European loan agreements also include a general basket, sometimes of a fixed amount, but increasingly including a "grower" concept based on a percentage of consolidated adjusted EBITDA or total assets.

Investment covenant exceptions in U.S. deals and high yield bond-style European loan agreements are fairly permissive, and the tightening of covenants in syndication and exercise of "flex" seen with respect to other provisions has not had a notable impact on the investment covenant in loan agreements. This makes sense, as investments generally are seen as an expansion of the business – compare that to a cash dividend, which is taking cash out of the credit group (often without anything in return). Some deals still include an unlimited ability to invest in and acquire non-guarantor restricted subsidiaries or provide that capacity for investments in non-loan parties can be re-designated to the general basket, increasing general investment capacity. Increasingly, loan agreements provide that 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, in which 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 common for borrowers to have the choice of a variety of investment baskets for investments in unrestricted subsidiaries, including the general basket, the builder basket and the ratio basket. Some loan agreements 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, many loan agreements (even those in sectors with valuable intellectual property) still do not include direct blockers of such transfers.

Traditional LMA-style 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), subject to customary exceptions, a capped basket and (unless the company is underperforming) a "grower" basket based on a percentage of consolidated adjusted EBITDA or total assets.

Whilst historically restricting acquisitions through ratio tests alone was not the norm 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 of the previously customary additional conditions on acquisitions). With increasing frequency, European loan agreements also permit unlimited acquisitions provided the acquired entity becomes a "restricted subsidiary".[22] 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 consolidated adjusted EBITDA) are also now more commonplace in the European market. A number of European loan agreements in 2021 tailored soft-grower baskets to incorporate "high-water marking" language – removing the floor from the basket's fixed value limb (i.e., limb (i) above). Rather than incorporate this limb as a fixed amount from the outset, the "high-water mark" language ties the fixed amount figure to the "peak" of consolidated adjusted EBITDA from time to time, irrespective of any subsequent decrease (by virtue of a downturn, asset sale or otherwise). This shift undermines certainty otherwise afforded to lenders by inclusion of the fixed amount. In 2021 some lenders successfully pushed back on this language, though in other cases it was accepted and marks a notable sponsor-friendly shift.

Restricted Payments

U.S. loan agreements and high yield bond-style European loan agreements will typically restrict borrowers from making payments to the holders of their 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 or stock, payments of the borrower's share of taxes paid by a parent entity of a consolidated group and share repurchases from directors and officers (subject to a cap). U.S. deals are incorporating increasingly permissive restricted payment baskets, reflecting investor comfort with expansive permitted investment capacity. For example, it is relatively common (especially with better-rated credits) to allow loan parties to make a distribution 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, as there is the potential for loan parties to move assets to an unrestricted subsidiary using their broad investment capacity and then distribute the unrestricted subsidiary to the borrower's (or a parent company's) shareholders. Under the terms of many loan 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 would be 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 limiting the condition to only the absence of payment and bankruptcy defaults. European deals with high yield bond-style loan agreements are also incorporating increasingly permissive restrictive payment baskets, with strong sponsors expecting large "starter amount baskets" (up to 40–50% EBITDA) in their documentation that allow upfront payments of cash to the sponsor regardless of the borrower's consolidated net income.

In traditional European loan agreements, payments to equity holders 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. Borrowers are 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 (otherwise restricted) purposes. Historically, in TLB facilities, the builder basket would grow over time based on the portion of excess cash flow not required to be used to prepay the term loans (often referred to as "retained" excess cash flow). Increasingly, borrowers are gaining the flexibility to have their builder baskets grow based on 50% of consolidated net income, rather than retained excess cash flow. For a borrower with positive consolidated net income, this will result in a larger basket, as borrowers seek to minimise the amount of excess cash flow – while that reduces the amount of any associated mandatory prepayment, it also reduced the "retained" amount. Use of the builder basket may subject to *pro forma* financial covenant, but, if included, this additional test generally only applies if it is being used for restricted payments or for junior debt prepayments.

Historically, 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 past few years have revealed that the U.S. approach towards allowing restricted payments is now being accepted in Europe (albeit that the European market uses the term "grower" basket as opposed to "builder" basket). In 2021, European high yield bond-style loan agreements typically include a "grower" basket for restricted payments, calculated upon 50% consolidated net income and subject to a zero floor. 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) and the aforementioned "starter amount baskets", 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 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"). "Hard call" protection provisions (where term loan lenders receive the premium in the call period for any prepayment, regardless of whether it is a voluntary or mandatory prepayment) are not common in the U.S. first lien loan market or the European loan market. They are more commonly seen in the second lien loan market 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). While some lower-ranked credits will contain a "no-call" period, during which any prepayment or repayment is subject to a "make-whole" provision, this is increasingly rare. On the other hand, "soft call" protection premiums (also known as "repricing protection" and typically 1% of the amount repriced) are more common in the U.S. and European TLB market, although they are by no means included in every transaction. These apply to prepayments made within a certain period (typically six months after closing) that are funded with the proceeds of term loans incurred for the primary purposes of refinancing the existing term loans with term loans bearing interest at a lower rate (or terms loans subject to an amendment that reduces the interest rate thereon). There are often exceptions to call protection premiums for refinancings or amendments made in connection with any transaction that would constitute an initial public offering, a change of control or a transformative acquisition (or otherwise not for the "primary purpose" of reducing the effective yield).

Voluntary Prepayments and Debt Buybacks

Provisions regulating debt buybacks are typically found in both U.S. and European loan agreements, but such provisions generally do not receive much attention. However, "super priority uptier exchanges" that can utilise these provisions recently came into the spotlight in the U.S. loan market. In 2020, a simple majority of first lien term loan lenders under the Serta, Boardriders and TriMark credit facilities approved amendments allowing for "super priority" debt capacity. In connection with their consent to the incurrence of such debt, such lenders exchanged their existing first lien term loans into new "super priority" term loans. Lenders that did not participate were left with effectively subordinated debt, and in the case of Boardriders[23] and TriMark,[24] they also lost the benefit of most (if not all) of the affirmative and negative covenants. In the U.S. market, lenders are increasingly often pushing to include language in the amendment provisions of their credit agreements specifying that any amendments that would cause payment or lien subordination of any lenders be approved by all affected lenders.

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 cap the amount that sponsors and affiliates (that are not *bona fide* debt funds) may hold (usually at 25% to 30% of the facility) and also restrict the right of such sponsors or affiliates in voting the loans repurchased.

Similarly, in European loan agreements, "Debt Purchase Transaction" provisions have been included in LMA recommended form documentation since late 2008. Traditional European loan agreements and the newer high yield bond-style loan agreements both tend to adopt the LMA form of debt purchase transaction mechanics. 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 more common alternative that permits such debt buybacks, provided certain conditions are met (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). Large cap and midmarket sponsors can generally expect their loan agreement to permit debt purchase transactions.

In the case of European loan agreements, under which the borrower is permitted 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 at the same time 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). Some sponsors and borrowers also have the flexibility to enter into a debt purchase transaction pursuant to a "bilateral process" where, following the completion of a solicitation process, a purchaser can purchase participations directly from lenders.

Traditional European loan agreements and high yield bond-style loan agreements both provide for the disenfranchisement of the sponsor (or its affiliate) in respect the purchased portion of the loan (i.e., so it cannot exercise votes attaching to the acquired loans and commitments and cannot receive information prepared for the lenders or participate in lender conference calls or meetings).

Mandatory Prepayments and Change of Control

Most credit agreements require U.S. borrowers prepay term loans with the net proceeds of certain material asset sales and/or casualty events and with the net proceeds of non-permitted debt. A loan agreement documenting a TLB facility will also include an excess cash flow sweep, and the percentage of excess cash flow that is required to be used to prepay the term loans will decrease as leverage decreases. Often, the asset sale prepayment provisions only apply to non-ordinary course assets sales incurred in reliance on the unlimited basket, include generous reinvestment rights, and/or include a threshold amount under which the borrower need not use the proceeds to prepay. Increasingly, U.S. loan agreements include step-downs permitting borrowers to apply increasingly lower percentages of the net proceeds of asset sales and/or casualty events to prepay loans as leverage declines (similar to the excess cash flow sweep), and most 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 often seen in European loan agreements. 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 or her fiduciary duty by failing to approve a dissident slate where such failure causes a change of control event of default under an existing loan 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 loan agreement containing a change of control provision restricting the ability of existing directors to approve a dissident slate.[25] As a result, the inclusion of any proxy put is disappearing in the U.S. market and the "dead hand" proxy put is almost never included.

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 over the past few years, 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.[26]

Financial Covenants

Historically, U.S. leveraged loan agreements contained at least two financial maintenance covenants: a leverage test (total, first lien or secured, depending on the type of facility) and an interest coverage or fixed charge coverage test, each of which would be tested at the end of each quarter. Now, an interest coverage or fixed charge coverage financial maintenance covenant is unlikely to be seen, except in an agreement governing a TLA facility, and, increasingly, even TLA facility agreements only contain a leverage test.

In the U.S., "covenant-lite" loan agreements continue to dominate the leveraged loan market. As described above, 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% has historically been fairly typical, but increasingly this can be as high as 40%). Covenant-lite loan agreements typically contain financial ratio incurrence tests – used as a condition to incurring debt, making investments, restricted payments or restricted debt 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; they merely act as governors that reduce flexibility by limiting basket use for so long as the *pro forma* incurrence test cannot be met.

European loan agreements historically included a full suite of maintenance financial covenants. With the influx of institutional investors and increased liquidity generally affording sponsors and borrowers increased bargaining power, "covenant-lite" deal structures are essentially the norm. European deal activity in the first three-quarters of 2021 revealed that all European leveraged loans but one were "covenant-lite" (*versus* 93% in 2019), meaning that the loan agreement contained a single leverage ratio covenant for the benefit of revolving facility lenders only (tested on a springing basis) or contained no maintenance financial covenant at all.[27] In European "covenant-lite" loan agreements, springing covenants are typically tested only when the revolving facility is 40% drawn (excluding non-cash utilisations, ancillaries, letters of credit and closing date revolving utilisations). Some more aggressive deals exclude any revolving facility drawings made in connection with acquisitions or investments, or any closing date utilisations, from the calculation of the test trigger.

As noted above, in the U.S., many agreements allow the borrower to designate "unrestricted subsidiaries", subject to the customary conditions, and the debt and consolidated adjusted EBITDA of unrestricted subsidiaries are not considered for purposes of leverage covenant compliance (unless, in the case of consolidated adjusted EBITDA, it is 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 top-tier sponsor deals sometimes only test first lien debt). Lenders are understandably concerned about this approach as the covenant may not accurately reflect overall debt service burden. 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. Lenders may try to cap the amount of cash a borrower may net out to discourage both over-levering and hoarding cash, but this is increasingly uncommon. In addition, aggressive deals do 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. The trends with regard to netting illustrate the continued success of higher-quality credits in pushing for greater flexibility.

In Europe, the total net debt test is generally tested on a consolidated group basis, with the total net debt calculation usually including the debt of all subsidiaries (excluding intragroup 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 reduced the effectiveness of financial covenants by increasing the amount of add-backs included in the borrower's consolidated adjusted 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 (historically, 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. Today, borrowers generally have much more flexibility with respect to adding back items of this type (as well as business optimisation, restructuring costs and other amounts). The trend had been for add-backs becoming 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 and other broad add-backs that include all "business optimisation" expenses and references to "synergies" and "initiatives" – with no cap on the percentage of consolidated adjusted EBITDA that such add-backs account for.

In the U.S., in 2014, the Leveraged Lending Guidance and the federal regulatory agencies enforcing it (discussed further in Part D) suggested that regulators may apply heightened scrutiny to definitions of consolidated adjusted EBITDA that provide for add-backs without "reasonable support".[28] This regulatory scrutiny initially led to greater negotiation of EBITDA add-backs for projected improvements in operating results, sometimes resulting in limits on the timing for the realisation of anticipated synergies. Whilst some U.S. deals do not limit the time period during which such cost savings must be realised or are expected to be realised, 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.[29] In some cases, there also may be percentage caps on savings and synergies add-backs, typically 20%–35% of consolidated adjusted 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, lenders are increasingly aware of the pitfalls of including uncapped EBITDA add-backs in their loan documents, with most European leveraged loan deals coming to market in 2021 with a 20–25% EBITDA cap on *pro forma* adjustments for projected cost savings and synergies.[30]

Equity Cures of Financial Covenants

The majority of sponsor deals in the U.S., loan agreements that contain maintenance financial covenants (whether or not "covenant-lite") also contain the ability for the sponsor to provide an "equity cure" to remedy any non-compliance. The proceeds of such equity infusion are usually limited to the amount necessary to cure the applicable financial covenant default and, if the applicable capital contribution is made in cash or other approved equity, will be deemed added to EBITDA solely 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 in any year) and absolute number (usually no more than five times over the term of the credit facility) of equity cures. In some cases, lenders 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 required to be applied in prepayment of the facilities). Whilst historically it was restricted to the latter, European deal activity over the last few 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. 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 test 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 many European loan agreements permitting consecutive cures (following the U.S. loan market construct by allowing up to two cures in any four-quarter period) and increasing the overall cap to no more than four or five times over the term of the facility.

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 often 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 three 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 still no LMA recommended equity cure language.

LIBOR Successor Rate Provisions

During 2021, the transition away from LIBOR in the U.S. market reached its final stages. On 5 March 2021, the Financial Conduct Authority (LIBOR's regulator) announced that the publication of the one-week and two-month USD LIBOR maturities and non-U.S. dollar LIBOR maturities will cease after 31 December 2021, with the remaining U.S. dollar-LIBOR maturities ceasing to be published after 30 June 2023.[31] The Alternative Reference Rates Committee (the "ARRC"), the body tasked with replacing U.S. dollar LIBOR, formally recommended Term SOFR on 29 July 2021.[32] The ARRC published updated recommended fall-back language for syndicated loans in March of 2021, providing that, upon a trigger event, a successor rate would be determined in accordance with a two-step waterfall (i.e., the "hard-wired" approach) that first would look to Term SOFR, with a specified adjustment, as an alternative reference rate and then to Daily Simple SOFR, with a spread adjustment in accordance with that recommended by a relevant government body for replacing the relevant tenor of LIBOR.[33] The language does not provide a refreshed "amendment" approach, as the ARRC determined enough certainty existing around using SOFR as a replacement benchmark that agreements should move away from that approach. The ARRC noted that hardwired fall-back language offers certainty as to the successor rate and spread adjustment. These events, in conjunction with the statement from the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation on 30 November 2020, encouraging banks to cease entering into new contracts that use U.S. dollar LIBOR by no later than 31 December 2021 and to include clear fall-back language in contracts entered into prior to such date, meant that by the end of 2021 the vast majority of new credit agreements included "hard-wired" LIBOR replacement provisions with Term SOFR as the primary alternative reference rate.[34]

In Europe, since the announcement in July 2017 that market participants should not rely on LIBOR being available after 2021, the LMA has played a key role in the transition to the use of risk-free reference rates in syndicated loans in each of the LIBOR currencies. In September 2020, the Working Group on Sterling Risk-Free Reference Rates (the "Working Group") published recommendations for conventions for sterling loans based on the Sterling Overnight Index Average ("SONIA"). As a response, the LMA issued recommended forms of two multicurrency term and revolving facilities agreements incorporating rate switch provisions. The "switch" mechanic was intended to assist market participants who were unable to enter into transactions based on compounded risk-free reference rates initially but anticipated being able to do so at an agreed date in the future such that they would be compliant with the Working Group's recommendations for inclusion of contractual arrangements in documentation by the end of the third quarter of 2020 for transition away from the use of LIBOR. As operational capacity to enter into loan transactions based on compounded risk-free reference rates increased and in light of the Working Group's recommendation that "all new issuance of sterling LIBOR-referencing loan products that expire after the end of 2021 should cease by the end of Q1 2021", in the first half of 2021 the LMA published a suite of facilities agreements to assist market participants who are able to enter into loan transactions which may be based on compounded risk-free reference rates from the outset.[35] Towards the end of 2021, a significant number of market participants in the European leveraged finance space were focused on amending loan documentation to replace Sterling LIBOR terms with the LMA recommended form wording (or an equivalent). Certain large banks even turned to artificial intelligence to identify and assist in the amendment of LIBOR wording[36] (though it is unlikely that amendments to European syndicated leverage finance loan agreements were completed by robots!).

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 (the "Anti-Corruption/Sanctions Laws"). Because they are fundamental to the ability of any financial institution or investor to extend credit, in the U.S. market, limited conditionality provisions (discussed in Part A) identify representations with respect to Anti-Corruption/Sanctions Laws as specified representations, though these often 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, at least in private acquisitions. 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").[37] 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/UK Bail-in Rule (discussed in detail below), and it is 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/UK Bail In Legislation

On 15 April 2021, the LMA published a revised version of its user guide pertaining to EU Bail In Legislation, including updates to its recommended form of Bail In Clause (within section 3 of the user guide).[38] 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 of EU Directive 2014/59 (also referred to as the Bank Resolution and Recovery Directive, "BRRD"). The BRRD contains broad powers for European Economic Area ("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.

Part C – Syndicate Management

Voting Thresholds

Traditionally U.S. loan agreements require only a simple majority of lenders (that is, more than 50% of lenders based on outstanding loans and unused commitments) for most amendments, except as described below. Such percentage constitutes the "Required Lenders". As discussed earlier in this chapter, the execution of "super priority uptier exchanges" in 2020 demonstrated the power of a simple majority and lenders have started to push to include protections against such "priming" transactions.

Historically, European loan agreements contained a "majority lender" threshold set at two-thirds of the relevant commitments (drawn and undrawn). Whilst a two-third majority continues to be the threshold in most European investment grade loans, an increasing number of European leveraged loan agreements (especially those that are high yield bond-style) define "majority lenders" as a simple majority, continuing a trend first observed in 2019.[39] Furthermore, in many such European loan agreements, certain votes that previously would have required unanimity may instead require only a "super majority" vote, ranging between 66⅔–80% of lenders by commitments. 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).

Historically, "unanimous" decisions in U.S. loan agreements are limited to releases of guarantors and liens (but notably, not subordination of liens or modifications to related covenants), voting provisions and *pro rata* sharing provisions, while fundamental economic matters (such as increases in pricing and extensions of maturity and, increasingly, payment and lien subordination) usually only require the consent of "affected" lenders (and are not, therefore, truly unanimous). 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, certain mandatory prepayment provisions such as "change of control" language, 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).

Net-Short Debt Activism

Over the past few years, the U.S. loan market saw documentary protections introduced in favour of borrowers against activist investors that hold net-short positions, as those investors are economically incentivised to trigger manufactured defaults (which result in a decline in credit quality) while, at the same time, maintaining 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.[40]

The genesis of anti-net-short provisions in loan documentation followed the bankruptcy of Windstream Holdings, Inc. ("Windstream"), a communications firm, in February of 2019. Prior to the filing, Aurelius Capital Management ("Aurelius") became the holder of more than 25% of Windstream's senior unsecured notes, while holding a material net-short position. Following, its acquisition of the notes, Aurelius issued a default notice, claiming that the 2015 spin-off of certain of Windstream's assets into a newly formed, publicly traded REIT violated the sale-leaseback covenant in the notes. This default notice pushed Windstream further into distress, leading to Aurelius gaining a return on its short position in excess of its loss on the notes in default. This transaction was of heightened concern to many borrowers, since Aurelius purchased Windstream's notes following the spin-off that it alleged was a default, which was publicly disclosed and, many thought, should have been taken into account by Aurelius in its decision to purchase the notes. This led to claims that Aurelius manipulated the price of the Windstream debt and drove it into bankruptcy to bolster its own short position.

As a general matter, anti-net-short provisions automatically add 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 blacklist or disqualified lender, "DQ", list. Some debt investors resist these provisions in principle, but, more commonly, investors push back on representations covering their affiliates due to logistical challenges for debt investors to determine whether they can make such representations, particularly when an investor has a debt fund affiliate. However, covering affiliates may be the most effective way for borrowers to root out activists from their lender group, and, as a result, this protection has become increasingly common.

Yank-a-Bank

Both U.S. and European loan agreements often contain provisions allowing the borrower to remove one or more institutions or other investors from the syndicate in certain circumstances. A borrower may, for example, remove, and force an assignment by, a lender that refuses to agree to an amendment or waiver requiring the consent of all lenders (or all affected lenders), if a majority of the lenders (or a majority of the affected lenders, if applicable) have consented to such amendment or waiver. Other reasons a borrower may exercise so-called "yank-a-bank" provisions are when a lender has become a "defaulting lender" or has demanded reimbursement for certain increased costs or tax payments. In such circumstances, the borrower is permitted to force the non-consenting (or otherwise impacted) lender to assign its commitment and loans to another lender or other eligible assignee without the impacted lender's consent, and some loan agreements permit the borrower to repay loans and terminate commitments of such impacted lenders on a non-*pro rata* basis.

Snooze-You-Lose

In addition to provisions governing the required votes of lenders, European leveraged loan agreements typically also contain "snooze-you-lose" provisions, which were developed just prior to the global financial crisis[41] and are designed to encourage lenders to respond promptly to requests for amendments, consents or waivers. Where a lender does not respond within a specified time frame, such lender's commitment is ignored when calculating whether the requisite vote percentage of commitments have approved the request. Such provisions are, at best, rarely found in U.S. loan agreements.

Transfers and Assignments

Generally, borrowers have the right to consent to lender assignments unless an event of default then exists, which, increasingly, if limited to the absence of a payment or bankruptcy event of default.

An exception to this, in the U.S., is that, as a general matter, lenders are able to transfer funded term loans to another lender or affiliate of a lender and, in the case of revolving commitments and loans, to another revolving lender. 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 specified period of time (typically 10 business days); however, this is becoming uncommon with respect to unfunded commitments, as borrowers have an interest in being comfortable that their working capital line of credit will be funded when needed. A similar provision is often seen in the European market. Almost all U.S. borrowers are able to negotiate a blacklist/"DQ" list of ineligible potential lenders. Even in the corporate borrower context, this is included so that competitors cannot become lenders, which would entitle them to obtain potentially sensitive and proprietary information. Sponsor-backed and more sophisticated corporate borrowers in the U.S. commonly push for expansive "DQ" lists that may include entities, such as distressed debt investors, that are often viewed as unfriendly to borrowers, and the ability to update the list post-closing (but lenders try to limit these updates to competitors and new affiliates of competitors and other disqualified lenders). Blacklists are not common in the European market, and the preference is to include a whitelist (as discussed below).

In European loan agreements (including those with high yield bond-style covenants), 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).

The European market is increasingly following the U.S. approach in relation to a borrower consent right in respect of transfers. Strong and midmarket borrowers and sponsors can expect the right to consent to lender transfers unless (a) the transferee is an affiliate or related fund of an existing lender, (b) the transferee is named on the whitelist, or (c) the transfer is made when an event of default is continuing. Sponsor-backed and more sophisticated corporate borrowers commonly push for restrictive whitelists which are agreed prior to closing and which can only be updated with borrower consent. Some sponsors and borrowers also achieve the right to unilaterally remove a capped number of names from the whitelist after closing (provided that those names do not include any day-one lenders or their affiliates and related funds). Very strong borrowers and sponsors can expect the transfers described under (c) above to be limited to non-payment events of default and insolvency events of default. Furthermore, it is now common in the midmarket for sponsors and borrowers to expect restrictions on transfers to loan-to-own and distressed investors.

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

Leveraged Lending Guidance

In the U.S., the Leveraged Lending Guidance (the "U.S. Guidance") issued in March 2013 by the Federal Reserve, the OCC and the FDIC provides, among other things, that a total leverage ratio in excess of 6.0x when compared to consolidated adjusted EBITDA will raise regulatory concern for most industries and may result in the loan being criticised.

Since 2015, non-regulated financing sources have been more active in the U.S. lending market, which is at least partially due to the U.S. Guidance. Following the issuance of an interagency statement in 2018, which clarified that supervisory guidance does not have the force and effect of law, regulated financial institutions returned to the highly leveraged lending market. In that same year, public remarks by the Federal Reserve Board Chairman and OCC Comptroller on the topic were viewed by many industry observers as indicating that the federal banking agencies were already backing away from the U.S. Guidance.[42] Further, in November 2020, U.S. federal banking agencies issued a proposed rule to codify this interagency statement and to expressly provide that supervisory guidance will not serve as the basis for examiner criticisms and formal or informal enforcement actions. That said, while codifying how the market currently views the U.S. Guidance, adoption of the rule is not a meaningful shift from the current view of enforcement authority (or lack thereof).

Similar leveraged lending regulations have been introduced in Europe. On 16 May 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.[43] 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 4.0x, 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 6.0x 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 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.[44] In July 2021, the ECB expressed concern that risk had built up in the leverage finance sector despite the COVID-19 pandemic, and stated that "in key areas such as leveraged finance ... we plan to deploy the full range of supervisory tools available to us, including minimum capital requirements commensurate with the specific risk profile of individual banks, should this become necessary".[45]

ESG and Sustainable Financing

The European syndicated loan market has continued to focus on environmental, social and corporate governance ("ESG") and sustainability related provisions in 2021. Widely syndicated loans in Europe increasingly contain a margin ratchet mechanism to adjust pricing upwards or downwards depending on (a) the satisfaction of sustainability performance targets ("SPTs"), as measured by certain bespoke sustainability key performance indicators ("KPIs"), or (b) less commonly, a borrower's ESG rating as determined by an external independent provider. Borrowers tend to prefer that the margin ratchet mechanism be linked to the achievement of SPTs, rather than a rating from an external provider, as the underlying KPIs can be tailored to the borrower's specific business and industry. Common categories of KPIs include energy efficiency, greenhouse gas emissions, sustainability, human rights, employee health and safety, business ethics and transparency. In light of this, lenders and investors have understandably been keen to ensure that KPIs are selected carefully and SPTs are relevant, sufficiently ambitious and established in good faith. In May 2021, the LMA and LSTA, in conjunction with the Asia Pacific Loan Market Association, published the Sustainability Linked Loan Principles ("SLLP") to provide market participants with voluntary recommended guidelines to capture the fundamental characteristics of sustainability linked loans. The core components of the SLLPs are selection of KPIs, calibration of SPTs, loan characteristics (such as the aforementioned margin ratchet mechanism), reporting in relation to SPTs and external verification of the borrower's performance in respect of the SPTs and KPIs. Additionally, on 28 July 2021, the LMA and the European Leveraged Finance Association announced the publication of practical guidance as to the application of the SLLPs to "ordinary" leveraged loans that seek to incorporate ESG factors or metrics. Such guidance also sets out what borrowers, finance parties and their respective advisors should consider when looking to integrate sustainability factors into their loan agreements.[46] Investors are reviewing ESG and sustainability linked provisions carefully and have been known to push back where KPIs and SPTs are not deemed sufficiently ambitious to warrant a margin reduction.[47] We expect that the European loan market will continue to develop market conventions relating to ESG and sustainable financing in the coming years.

IFRS 16

The introduction of IFRS 16 in January 2019 has continued to have an impact on the European leveraged loan market in 2021, as borrowers have sought to "backdate" applicable accounting standards when calculating their covenant capacity and headroom under their loan documents. As a result of IFRS 16 certain leases (previously categorised as operating leases) should be recognised on a borrower's balance sheet as debt, together with the underlying assets. Aggressive sponsors have sought to "have their cake and eat it", picking and choosing where to apply (or not to apply) IFRS 16 on both sides of their consolidated adjusted EBITDA calculations – effectively increasing covenant capacity and headroom across the board.

Brexit

Following the United Kingdom's withdrawal from the European Union on 31 January 2020, a transition period came into effect under the European Union (Withdrawal Agreement) Act 2020. The transition period came to an end on 31 December 2020, with the EU-UK Trade and Cooperation Agreement taking effect from 1 January 2021. As a result of the EU-UK Trade and Cooperation Agreement, EU regulations which previously had direct effect in the United Kingdom were transposed into domestic law, and UK legislation which acted to implement EU Directives was expressly preserved and given a new statutory basis. Consequently, the LMA has updated its recommended forms of English law facility documentation to supplement and replace provisions that reference EU law. Apart from these changes (which are fairly limited), it is worth noting that Brexit is now routinely designated an "Excluded Matter" pursuant to which no representation, warranty or undertaking shall be deemed breached and no event of default shall occur.[48] There has also been market-wide adoption of the LMA's "Designated Entities" provisions (reflecting the fact that lenders based in the United Kingdom have lost their passporting rights under the EU Capital Requirements legislation as a result of Brexit).[49] These provisions permit a lender based in the United Kingdom to nominate an EU-based affiliate to participate in specified utilisations in their place, without the need to transfer any part of the available commitment. It is worth highlighting, however, that most "Designated Entity" clauses do not allow the EU-based lending affiliate to automatically assume rights and obligations in relation to outstanding utilisations from the original lender. Notwithstanding Brexit, the market's long-standing preference for English law remains and the large majority of European leveraged loan agreements continue to be English law governed.

Erroneous Payments

A relatively recent development in the U.S. market has been the inclusion of "erroneous payment" provisions. These are provisions that protect the administrative agent in the event they make incorrect or errant payments to lenders, and have arisen as response to the decision in the *In re Citibank* litigation ("Revlon"). This litigation stemmed from an erroneous payment by Citibank as administrative agent under a credit agreement for Revlon. Citibank erroneously paid a syndicate of lenders the full amount of principal and interest owed under the credit agreement, rather than just the interest, and a number of the lenders refused to return roughly $500 million of the errant payment. The resultant litigation culminated in the judge hearing the case for the U.S. District Court for the Southern District of New York ruling that the lenders were entitled to retain the errant payment under the (previously relatively obscure) doctrine of "discharge-for-value" under New York law.[50]

In response, administrative agents generally insist on including a contractual remedy for such erroneous payments in credit agreements. These provisions typically provide that lenders are required to return payments once notified by the administrative agent of the erroneous nature of such payments, and if the lender does not return such monies the provisions provide the administrative agent with various supplemental remedies – often including a right of set-off, subrogation rights, and even an assignment of such lender's interests. The provisions also typically include a waiver by the lenders of any "discharge-for-value" defence.

Conclusion

As highlighted in this chapter, 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, as well as the instances in which such terms and practice have converged or are converging. Whilst there are many broad similarities between the jurisdictions, borrowers and lenders that enter either market for the first time may be surprised by the differences, some of which may appear very subtle, but are significant. 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 greater understanding of the similarities and differences is even more critical to parties on both sides of a potential transaction.

For further information in relation to any aspect of this chapter, please contact Tracey Chenoweth in New York by email at tracey.chenoweth@skadden.com or by telephone at +1 212 735 3624, or Clive Wells in London by email at clive.wells@skadden.com or by telephone at +44 20 7519 7133.

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Acknowledgments

The authors would like to acknowledge the assistance of their colleagues Simon Cassell and Eva Lee for their invaluable assistance in the preparation of this chapter.

Tracey L. Chenoweth represents private equity firms, corporate borrowers and lenders in a variety of transactions and across numerous industries, including trading firms, hedge funds and other financial services companies, retail and manufacturing companies and gaming and other entertainment providers. Ms. Chenoweth's practice includes acquisition financings for strategic investors, leveraged buyouts, bridge loans and other secured and unsecured financings, and she has experience in the cryptocurrency space and in addressing issues raised by Regulations U and X. Ms. Chenoweth is actively involved in Skadden's training and recruiting programmes and serves on the firm's Opinion Committee, Summer Associate Committee and Women's Initiatives Committee.

Skadden, Arps, Slate, Meagher & Flom LLP
One Manhattan West
New York, NY 10001
USA

Tel: +1 212 735 3624
Email: tracey.chenoweth@skadden.com
URL: www.skadden.com

Clive J. Wells advises on a wide range of banking matters, including acquisition and leveraged finance, real estate finance, investment grade financings, asset finance, project finance and structured finance transactions. Mr. Wells also advises on restructurings, reconstructions and workouts. His clients include corporates, private equity sponsors, hedge and other funds and investment banks.
Mr. Wells sits on Skadden's UK Legal Opinion Oversight Committee and has repeatedly been selected for inclusion in *The Legal 500*, *Who's Who Legal – Banking*, *IFLR1000*, *Chambers Global: The World's Leading Lawyers for Business*, *Chambers Europe* and *Chambers UK*, which cites sources describing Mr. Wells as being "precise and [having] a strong strategic view", in addition to being "hugely experienced [with] a wealth of knowledge to his advice".

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

Tel: +44 20 7519 7133
Email: clive.wells@skadden.com
URL: www.skadden.com

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