Feature

KEY POINTS

- The well-established convergence of high yield bonds and syndicated loans in the US, where incurrence as opposed to maintenance covenants and more relaxed operational and capital flexibility are the norm, is now materialising in the European loan market.
- European lenders are loosening traditional underwriting conventions to compete with the US institutional loan market notwithstanding, however, that the same legal and economic conditions in the US in which "cov-lite" loans have flourished do not fully exist in Europe.
- Cross-pollination of legal concepts as a result of European sponsors accessing the US institutional loan market via so-called "Yankee loans" continues to influence loan documents on both sides of the Atlantic, but different legal customs still remain.

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Across the pond and back again: US and European leveraged finance terms

This article examines certain features and trends in syndicated leveraged loans in Europe and the US, with a focus on the recent convergence of loan documentary terms juxtaposed against the market influences in each jurisdiction.

The European and American credit markets compete with and influence each other at the same time in terms of overall loan supply as well as the commercial and legal terms of the governing loan documents. This article examines certain features and trends in syndicated leveraged loans in Europe and the US, with a focus on the recent convergence of loan documentary terms juxtaposed against the market influences in each jurisdiction.

A NEW DAWN OF LENDING IN EUROPE

Cov-lite loans and the institutional (term loan B or TLB) loan facilities in which they are typically found, have a comparatively long and established history in the US, dating back to before the most recent financial crisis. Since the economic recovery began, cov-lite loans have consistently represented a majority of all new institutional loans brought to market. At its root, the term "cov-lite" refers to a loan which has no maintenance financial covenants, the early-warning indicators of financial deterioration on which lenders have long relied to engage in advanced discussions with a distressed borrower. Institutional loan agreements in the US typically comprise a cov-lite term loan (or loans) and a revolving credit facility that contains a "springing" financial covenant. Such loans have various other hallmarks, including the broad flexibility to incur additional leverage (irrespective of the use of proceeds) and to continuously re-lever the financed business up to (or above) the leverage level of the business as of the date of the original financing. Borrowers can incur such additional debt within the confines of the existing loan facility (by way of incremental facilities) or under completely separate documentation. The ever-present "free and clear" or "freebie" baskets negotiated with respect to incremental facilities allow borrowers additional debt capacity that can be incurred without regard to the leverage level of the business.

The emergence of cov-lite loans and loans that resemble term loan B facilities in Europe is a more recent development. Such loans first appeared sparingly in or around 2007 and only re-emerged post-financial crisis environment, and were slow to gain traction. Prior to this period, loans in Europe were consistently "covenanted" with as many as four maintenance financial covenants. As the debt capital markets re-opened post-financial crisis, so too did the interest of European sponsors in US businesses or businesses with substantial US-based income. European sponsors have availed themselves of the opportunity to access the US loan markets in order to finance or re-finance their businesses. As sponsors began to push European lenders towards the more flexible structures attainable in the US, a practice of "covenant loose" loans emerged in Europe. Such facilities comprise one or two maintenance financial covenants, typically a leverage ratio covenant and interest coverage ratio covenant. Through cov-loose structures, European lenders accommodated the increasing pressures to compete with the US cov-lite model while maintaining some measure of tight underwriting standards. Ultimately, market pressures prevailed, and cov-lite loans now are increasingly accepted for larger transactions in the European market. While the volume of loans generally, and cov-lite loans in particular, are less than in the US, fully European covenanted loans have transformed into cov-lite loans at a rapid pace.

WHO CONSTITUTES A "LENDER" IS NOT NECESSARILY THE SAME IN THE US AND EUROPE

The proliferation of cov-lite and term loan B facilities in the US is as much a function of the convergence of syndicated loans and high yield bonds as it is a function of aggressive lobbying by sponsors and borrowers. Hedge funds, CLOs and other alternative lending institutions typically comprise the end consumers of such term loan B facilities. These institutions historically purchased bonds as a primary source of yield for their investors, and only relatively recently (with the leveraged buyout boom of the early 2000s) began purchasing loans in any meaningful quantity. Such institutional lenders focus on yield versus balance sheet preservation, and as such, are not concerned with engaging in discussions with borrowers at the first possible signs of stress or confirming a steady deleveraging profile. Consequently, high yield bonds, and more recently, loans marketed to such institutions, de-emphasise maintenance tests or cash sweeps.

The size of the institutional loan market in the US has historically been, and continues to be, enormous compare to that in Europe. As an example, from January through to August 2015 arrangers raised over $73bn for new CLO issuances in the US, versus just over $10bn in Europe over the same period. Such data shows that banks continue to be the main consumers of loans in Europe (although

the European non-bank investor base has continued to increase). The difference between the makeup of lenders in Europe and the US explains certain divergent trends in US versus European loan documentation and also serves as a cautionary note for the wholesale importation of concepts across markets.

THE MOTIVATION BEHIND TRANSFER PROVISIONS IS NOT ALWAYS BLACK OR WHITE

The different loan investor base in the US versus Europe can help explain the different market conventions that have developed around loan transferability in each jurisdiction. In the US, institutional loans typically restrict assignments or transfers to "Disqualified Lenders" which consist of two categories of lenders: competitors of the borrower (in the case of corporate credits) or of the target (in the case of acquisition finance) and disqualified financial institutions. The latter group refers to those institutions which have been identified by the borrower or sponsor as ineligible to be lenders. In syndication, the list of disqualified institutions is disclosed to the arrangers. While there are no parameters as to what institutions can appear on a restricted list, the most common names include opportunistic or "loan-to-own" funds. Absent a unique experience of a particular sponsor or borrower, it is unusual to see a bank's name on such a list.

In European transactions it is customary to see a "White List", which is a list of institutions to whom existing lenders can transfer loans without obtaining the consent of the borrower. Unlike in the US where loans are routinely syndicated to alternative lending institutions and sponsors/borrowers focus on disqualifying unwelcomed investors, in Europe the majority of lenders are still banks and the concern is more on free alienability. Such a phenomenon is just one example of the historical economic climate driving loan documentary terms. Some Yankee loans have introduced the concept of a White List into New York documentation, and likewise, recent cov-lite loans in Europe modelled on US-style term loan B facilities have introduced the concept of a disqualified lender list. It will be interesting to see how much convergence there is on transferability as the cross-pollination of markets increases.

DIFFERENT INSOLVENCY REGIMES MUST BE CONSIDERED WHEN STRUCTURING TLB-LIKE LOANS

Sponsors and borrowers often jockey for European cov-lite facilities that are modelled slavishly on US-style term loan B facilities. Importing US-style provisions without appreciating the different legal regimes and markets in which such provisions were designed, however, carries various risks for lenders.

The different insolvency regimes in the US versus Europe greatly influence documentation principles in such jurisdictions. Chapter 11 of the United States Bankruptcy Code is designed to allow for the rehabilitation of entities seeking protection. Out of court enforcements are less common in the US than in Europe, and consequently, intercreditor agreements are less comprehensive in the US than in Europe. US intercreditor agreements typically only include lien subordination and aim to allow the most senior class of creditors to direct the outcome of a bankruptcy.

Europe insolvency is much more complicated. Aside from the fact that each European jurisdiction has its own insolvency regime, European insolvency processes are generally viewed as value destructive, with the result being that out-of-court enforcements are more common. Further, debtors and senior creditors do not enjoy the benefit of an automatic stay that would prevent litigious conduct from junior creditors. As a result, intercreditor agreements feature prominently in European finance transactions, seeking to preserve senior lenders' recovery prospects and force junior lenders to standstill. Lenders may exercise enforcement remedies by foreclosing on a share pledge over one of the top holding companies in a borrower group, and selling the applicable business as a going concern. For this reason, European intercreditor agreements ensure that a "self-help" enforcement process will be workable and that all creditors of the business agree that their claims can be extinguished in the event of a distressed sale of the business.

Inserting customary US term loan B provisions into European loan documents may frustrate lenders' enforcement efforts in a default scenario. Consequently, lenders must exercise caution when importing such provisions into a European facility or any loan agreement whereby the credit is a business with a meaningful presence in Europe. As one notable example, term loan B facilities typically allow for concepts of excluded or unrestricted subsidiaries, which are entities that reside outside of the ring-fenced group of restricted subsidiaries. Such unrestricted subsidiaries are not subject to any of the covenants or other provisions of the loan documentation and, correspondingly, their net income is not factored into any of the financial covenants of the restricted group. While there may be limitations on the ability to designate unrestricted subsidiaries, such subsidiaries can grow in size without being restricted by the terms of the loan documentation. In the US, unrestricted subsidiaries do not typically present a problem in a bankruptcy proceeding with respect to enforcement because a bankruptcy court may reconcile all creditors' claims in connection with a sale or plan of reorganisation. Outside of a bankruptcy, however, the creditors of unrestricted subsidiaries may frustrate the extrajudicial efforts of lenders to maximise the value of the entire group through a foreclosure. In Europe this risk is heightened because a lender's principal (and often only) means of enforcement is through an out-of-court sale of the borrower group.

Unrestricted subsidiaries are not a common feature of European transactions but have been introduced in recent cov-lite transactions modelled on their US equivalent. When unrestricted subsidiaries are featured in a European deal, any distressed sale of a business must either address all claims against unrestricted subsidiaries or attempt to sell the business subject to such claims. Further complicating any such sale process is that unrestricted subsidiaries are not subject to the restrictions on their nature or line of business. Potential purchasers may not be attracted to a borrower group with a business being carried on by an unrestricted subsidiary that is different to the core business of the group.

Similarly, the flexibility that term loan B deals provide in terms of a borrower's capital structure presents challenges for European lenders. In the US, intercreditor arrangements are required with third party creditors only if such other creditors will share security with the syndicate. It is less common to require intercreditor agreements if such other debt

TABLE: DISTINCTIONS BETWEEN US AND EUROPEAN LOAN FACILITIES

Loan Provisions	Europe	US
Lender Voting on Amendments, Waivers, Enforcement Remedies, etc	■ 66.66% of loans or commitments. ■ "Super-majority" 80–90% consent required for certain matters, eg releases of transaction security or guarantees, or an increase in the facilities. ■ Unanimity required for "sacred" rights matters. ■ Yank the bank and snooze/lose provisions typically included.	■ Simple majority. ■ Unanimity required for matters affecting "sacred" rights, eg release of substantially all guarantees or security or change of voting mechanics. ■ Affected lenders can consent to certain other matters – eg, change in economics, maturity or *pro rata* treatment. ■ Yank the bank provisions are standard. ■ Snooze/lose provisions not typically included.
Material Adverse Change (MAE) Clauses	■ Customary to include MAE event of default clauses. ■ Not standard to include no MAE representation since covered by above.	■ Not standard to include MAE event of default clauses. ■ Standard to include no MAE representation and conditions precedent.
Acceleration	■ Requisite lenders (66.66%) must provide notice of acceleration after an event of default has occurred and is continuing.	■ Requisite lenders (simple majority) consent required; provided that acceleration is automatic upon a borrower becoming subject to a US bankruptcy.
Representations/Warranties	■ Repeated each interest period.	■ Typically only repeated on new extensions of credit.
Guarantee Limitations	■ Guarantee limitation language customarily added to address corporate benefit, financial assistance, thin capitalisation and similar rules in applicable European jurisdictions.	■ Limitation language typically included for any guarantee and/or security to be given by a non-US guarantor to support a US borrower's obligations to prevent "deemed dividend" tax code issues. ■ Savings clause typically included to limit any transfers/obligations avoided up to the amount that constitutes a constructively fraudulent transfer under applicable bankruptcy laws.
Guarantor Coverage Test	■ Yes, anywhere from 75 to 95% of EBITDA and/or assets in the aggregate.	■ Not typical; *provided* all wholly owned subsidiaries and material subsidiaries are required to be guarantors.
Swingline Facilities	■ Not typical in European facilities, except where they are used to support commercial paper issuance.	■ The agent usually provides same-day swingline loans as a subfacility of the revolving facility commitments.
Ancillary Facilities	■ Often contemplated by the loan documents which may be provided by individual lenders, the obligations of which would receive the same guarantee and security protections as the other revolver obligations.	■ Not usually included; *provided* loan documents may contemplate foreign exchange transactions, overdrafts or commodity exchange transactions, providing lenders with the same benefits of the guarantee and collateral package.
Prepayment Premiums	■ Generally not applicable to senior debt. ■ Typically included in second lien and mezzanine debt documents and may include call protection.	■ In senior loan documents, there is typically a prepayment penalty of (or flex right to add) 101 (or 1.0%) (referred to as a "soft" call) for any re-pricing or refinancing transaction which lowers the applicable margin. ■ In second lien loan documents, there is typically a phasing of 103, 102 and 101 call protections.
Revolving Credit Facility Clean-Down Clause	■ Often included (at least on a net basis taking into account available cash).	■ Not typically included.
Legal opinions	■ Typically issued by lender's counsel.	■ Typically issued by borrower's counsel.
LMA and LSTA documents	■ The LMA form loan facility is used extensively for loan agreements.	■ Lenders and sponsors utilise their own preferred precedent documentation; provided certain model LSTA provisions are typically incorporated.

Biog Box

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is unsecured unless there is intended claim subordination. In a European transaction (or a US transaction with a substantial European nexus), such a structure would serve as a potential impediment to enforcement, and would require the secured creditors to negotiate with the unsecured creditors in order to address the claims of the latter.

YOU CAN'T OVER-DRY, BUT CAN YOU OVER-CURE?

Equity cures have attracted a great deal of attention in cov-lite loans. An equity cure provision allows a sponsor to inject equity in the form of cash (or often subordinated debt) into a business in order to cure a breach of a financial covenant. While a term loan B does not often contain a maintenance financial covenant, such loans are usually coupled in a loan agreement with a revolving credit facility containing a springing maintenance finance covenant. Such financial covenant, often a leverage ratio test, is only activated if at the end of a testing period (or fiscal quarter) a certain portion of the revolving credit facility has been drawn.

The US institutional loan market and the European loan market have until very recently taken different approaches to equity cures. In Europe, amounts injected by way of equity to cure a financial covenant breach have traditionally been required to prepay the applicable loans (and reduce the net debt calculation) for which the financial covenant applied. In the US, owing in large part to financial covenants applying only to revolving loans, equity cures are not required to de-lever the facility and are instead applied to increase EBITDA ("EBITDA cures"). In such a scenario, EBITDA is re-tested giving *pro forma* effect to the increased EBITDA. In contrast, in Europe, the leverage ratio must be satisfied after giving *pro forma* effect to the debt reduction resulting from application of the cure amounts.

In the US, the amount injected by way of equity cure can be no greater than the amount necessary in order to comply with the applicable financial covenant breach. In addition, such amounts are counted for no other purpose than compliance with the financial covenant. In Europe, by contrast, sponsors may infuse more money than necessary to cure a financial covenant breach ("over cure").

The ability to over-cure becomes more relevant in the context of a US style facility due to the flexibility such facilities provide for borrowers to pay dividends. US borrowers may often pay an uncapped amount of dividends so long as they comply on a *pro forma* basis with a financial ratio (such as leverage ratio). Coupled with an over-cure construct, European borrowers could mask performance metrics by round-tripping injected capital back to the sponsors as a dividend. As European sponsors push for EBITDA cures, European lenders should explicitly prohibit any unwelcomed cure implications.

PORTABILITY DEPORTED

Not all elements of the geographical convergence of loan terms in the US and Europe involve European lenders capitulating to US loan provisions. Sponsors and borrowers have also imported European loan provisions into US loan agreements. Change of control provisions are one example. Loans on both sides of the pond have consequences if there is a change of control of the financed business. In the US, a change of control typically triggers an event of default that can lead to enforcement remedies. In European loan facilities, a change of control is typically a mandatory prepayment (or put) event. The key benefit of the European approach is that there is no cross-default upon a change of control unless the borrower does not timely prepay the outstanding loans.

None of the above consequences (a default or a prepayment obligation) occurs when a loan is "portable". Under a portable loan, there is no punitive change of control if the borrower meets certain criteria (normally a *pro forma* leverage test and a one-time usage), and, consequently, the lenders will have to continue to perform under the loan facility under the control of a new sponsor/acquiror.

Portability (in bonds and loans) has been present in Europe since first introduced in the Ziggo transaction in 2010. It is mostly found in bond offerings and much more rarely in lending transactions.

Importing portability into US term loan B transactions can be dangerous. As noted, such term loans allow borrowers to pay dividends out of cash injected in the business and not otherwise applied. Moreover, leverage ratios are routinely tested net of unrestricted cash. Thus, sponsors have an opportunity to inject equity into the business to satisfy the incurrence test for portability and then, following completion, route dividend money back out to shareholders. US lenders should carefully re-examine the restricted payments baskets to prevent such payouts.

CONCLUSION

There are distinctions between many features of US and European loan facilities that are simply a function of evolution. The table opposite provides a non-exhaustive illustration of such distinctions.

Despite the legal backdrop, competition is the primary force behind the decision to accept or reject a particular loan provision. In the US, the very high demand for term loan B products has caused downward pressure on pricing and a loosening of covenants. Cov-lite loans are virtually the norm in such loans in the US. Given the way in which demand has outstripped supply in recent times, the pressure on lenders to compete does not seem likely to abate anytime soon. Furthermore, the convergence of loan markets in the US and Europe will likely continue where, but for economic forces that mandate one market or another, sponsors and corporates have increasing choice as to where to go for capital. The removal of jurisdictional boundaries between loan markets in the US and Europe presents an opportunity for lenders to compete across borders and for sponsors and corporates to extract concessions through such a broadening of an investor base. To assume, however, that a provision in one legal regime can be extracted and neatly placed into another legal regime, would be tantamount to assuming that foxglove flowers can grow wild in Central Park. ■

Further Reading:

- European credit documentation trends: covenant-lite or covenant empty? [2014] 5 JIBFL 296.
- LMA credit documentation: continuing evolution in a challenging environment [2012] 3 JIBFL 157.
- LexisNexis Loan Ranger blog: How does the LMA deal with high yield noteholders in its new suite of documents?