Private Equity Law Report
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November 16, 2021

FINANCING FACILITIES

Preparing for LIBOR Transition: Remediation Terms Managers Should Incorporate Into Their Existing Subscription Facilities (Part Two of Two)

By Helen Kim, *Private Equity Law Report*

The end of the London Interbank Offered Rate (LIBOR) is nigh. On January 1, 2022, existing multicurrency credit facilities and all new credit facilities will no longer use LIBOR – a staple of the financing world for years – as a benchmark interest rate. PE sponsors entering into new subscription credit facilities will be seeing a non-LIBOR benchmark rate – for U.S. Dollar (USD), most likely the Secured Overnight Financing Rate (SOFR) – in their loan agreements. Existing subscription credit facilities that use USD LIBOR, however, have until June 30, 2023, to amend and restate those loan agreements.

This second article in a two-part series addresses important aspects of LIBOR remediation in the subscription line space that managers should monitor, including the amount of the spread adjustment and the timing of the actual transition. The first article explored what PE sponsors should know about the LIBOR transition and how the PE industry is reacting to the coming end of LIBOR.

See our two-part series on trends in the use of subscription credit facilities: "Advantages for PE Investors and Sponsors Have Led to Adoption by Some Private Funds" (Jan. 24, 2019); and "Structuring Considerations Negotiated With Lenders and Important LPA and Side Letter Provisions" (Feb. 7, 2019).

Negotiating Amendments

Approach to Amendments

Lenders have approached PE sponsor borrowers differently about LIBOR remediation for subscription credit facilities depending on deal size, number of currencies and how many banks are involved, observed Cadwalader partner Michael C. Mascia.

Multicurrency facilities have been a priority for banks, due to their complexity and the need to remediate before LIBOR ceases to be quoted at the end of 2021 for U.K. pound sterling, Swiss francs, Japanese yen and E.U. euros. In July 2021, many banks began to identify subscription loan agreements that allowed sponsors to draw loans in foreign currencies, explained Haynes and Boone partner Holly Loftis. "In many cases, the borrower never intended to actually borrow in any of those foreign currencies. In those circumstances, many parties agreed to eliminate the option to draw on any foreign currencies to avoid building in mechanics or benchmarks for non-USD LIBOR quoted currencies."

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In addition, an existing USD-only facility that does not mature for two years technically does not need to be remediated before the end of the year because USD LIBOR will continue to be quoted through June 30, 2023.

Amendment Process

The Alternative Reference Rates Committee (ARRC) proposed two approaches for handling LIBOR transition – the amendment approach and the hardwired approach, with the latter currently dominating the market. Many times, however, lenders simply reach out to their counterparties and consensually agree to amend the facilities without following the technicalities of either ARRC approach, observed Cadwalader partner Jeffrey Nagle.

The LIBOR transition is typically revised in documents when a borrower reaches out to amend its subscription facility for an unrelated reason. In that situation, the lender will often address the LIBOR changes with the requested amendment, Mascia stated. "There's definitely an effort to tie LIBOR remediation with other amendments to create efficiency," he noted. Sometimes, however, the addition of the LIBOR remediation language can catch a borrower off guard. "For the CFO of a smaller PE fund who is expecting a two-page amendment, those additional 10 or 13 pages can be an unpleasant surprise," explained Foley Hoag partner Thomas Draper.

As December 31, 2021, draws near, more banks are reaching out with only LIBOR-focused amendment language instead of tying it to another amendment, noted Latham & Watkins partner Benjamin Berman.

See "SEC Division of Examinations' 2021 Priorities Track and Advance 2020 Priorities" (Apr. 27, 2021).

Associated Legal Costs

Estimates from a lender-side counsel and a borrower-side counsel of legal fees arising from amending legacy facilities with ARRC fallback language were remarkably close – $15,000 to $20,000 total (borrower and lender combined). A multicurrency syndicated loan, however, could reach six figures in legal fees for LIBOR remediation, one expert warned.

To decrease costs, some banks with an overwhelming volume of bilateral agreements have engaged third-party service providers to perform automated reviews of those agreements and provide simple amendments, but anything more complicated requires outside counsel, Loftis advised.

See "How Fund Managers Can Control Legal Costs and Negotiate Outside Counsel Fees (Part One of Three)" (Mar. 10, 2020).

Time to Remediate Existing LIBOR Loans

In terms of time, one lender's counsel estimated that fallback language amendments could be completed in a week or two, assuming minimal borrower comments. Although the market has widely accepted language recommended by the ARRC for remediating LIBOR-based loans, that language has changed over time.

In addition, each bank has its own version of ARRC language that reflects its internal policies and systems. "Earlier in the process, banks tended to drop in ARRC language without a lot of modification," said Latham & Watkins attorney Donald Cooley. "Now that we are closing in on the end of the year, each bank's internal LIBOR team has come up with its own ARRC-adjacent language," he noted. "Most of the versions and iterations line up

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with ARRC language, but not all," Berman agreed. "Trying to keep up with the changes from each bank, each time, consumes time, however."

Further, some borrowers push back on the proposed language, asking for minor modifications. "It makes perfect sense for borrowers to try to improve their positions, but those changes need more internal approvals at the bank than a commercial point would," Mascia explained. "The commercial point doesn't have to align with a new software system. If, for example, a borrower wants to be able to borrow in euros under the new rate on a same day basis, the bank needs to determine if its new software can do that," he posited. "Consequently, the time to process comments can take longer."

See "ILPA Subscription Credit Facilities Guidance: Reiterating the Need for Increased Disclosures on the Use of Facilities and LP Obligations (Part One of Two)" (Aug. 25, 2020).

Key Negotiating Terms

ARRC's hardwired approach specifies a set of trigger events, a successor rate (determined by a waterfall selection), a spread adjustment and a mechanism for handling conforming changes. The replacement of USD LIBOR occurs in June 2023 unless one of the parties triggers an early opt-in election. Although ARRC's hardwired approach itself is generally accepted, borrowers have pushed for some control over early opt-ins, the amount of the spread adjustment and conforming changes.

Consent Over Spread Adjustment

Most banks are using spread adjustment numbers approved by ARRC to bring the forward-looking SOFR term rates closer to LIBOR. The current low-interest-rate environment, however, means that "if the transition were to happen today, most borrowers would see an increase in their all-in interest rate," explained Ropes & Gray partner Steven R. Rutkovsky.

Although interest rates should theoretically even out over time, borrowers have pushed back by insisting on having consent rights over the timing of the transition as well as, in some cases, the amount of the spread adjustment to be added to SOFR at the time of the transition, Rutkovsky elaborated. Regulated banks are reluctant to negotiate that point, but alternative lenders (*e.g.*, private credit funds) have been willing to give borrowers approval rights over the amount of the spread adjustment, he added.

Emergence of Negotiated Spread Adjustment

The market is also beginning to provide its own solutions to the spread-adjustment issue. "We are starting to see loans that include a negotiated credit spread adjustment, which deviates from the ARRC-recommended spread adjustment," Rutkovsky said. "Upon transition from LIBOR to SOFR, the new benchmark rate would be SOFR plus a negotiated spread adjustment that is generally lower than the ARRC-recommended spread." The Loan Syndications & Trading Association (LSTA) has advised its members to be prepared to implement negotiated spread adjustments that deviate from the ARRC-recommended spread.

"Borrowers should be having conversations with their lenders about the timing of the transition and the appropriate spread adjustment, given that the ARRC-recommended spread adjustment is significantly higher than the current delta," Rutkovsky advised.

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Early Opt-In and Consent Rights Over Timing

ARRC's hardwired approach for bilateral loans states that if at least five publicly available, currently outstanding USD syndicated or bilateral credit facilities contain a SOFR-based benchmark, then the lender may provide notice to the borrower of its election to opt into SOFR early. If the borrower does not object by the deadline, the early opt-in takes effect on the next business day.

As ARRC-recommended fallback language contains a joint election, borrower consent has been part of most LIBOR remediation. "The borrower and the agent would jointly elect to the change the benchmark, to the extent it is happening early," Loftis said.

Due to each lender having its own approach to LIBOR remediation, however, borrower counsel still must review the language to ensure that borrower consent over timing is preserved. Some lower middle market and regional banks have deviated from the ARRC-recommended fallback language by retaining the unilateral authority to determine when to transition from LIBOR to SOFR, Rutkovsky observed.

See "Advice for Allocating Legal Tasks Between In-House Attorneys, Outside Counsel, Consultants and Other Vendors" (Mar. 24, 2020).

Conforming Changes

The ARRC fallback language provides administrative agents the ability to execute conforming changes, without borrower consent, to syndicated loans to implement and administer the successor rate. Although conforming changes are intended to be merely administrative, borrowers "want to ensure they get a right to say what those changes are, not just let the agent decide what they are," Draper explained. "They also want to make sure the agent doesn't strike the 'reasonably' qualifier."

In the subscription line space, a number of large sponsors were given nonbinding consultation rights for conforming changes to loan documents, but not consent rights, Loftis said. "Practically speaking, banks could not give consent rights because they have thousands of loans, and seeking consent for conforming changes would have greatly slowed down the process," she elaborated. Consultation rights require the lender to show the conforming changes to the borrower and likely discuss them, but they do not require the lender to accept any borrower comments.

Alternatively, the LSTA has released "super-hard-wired" language that does not require lenders to make as many conforming changes, Loftis said. The LSTA provisions create defined terms for risk-free rate loans and related concepts and weave them in throughout the agreement, she said. "Notwithstanding those provisions, however, PE sponsors are still asking for consent or consultation rights on conforming changes because the agent continues to have the right to further revise the agreement unilaterally for those types of changes."

See "Outdated Technology and Poor Transparency Severely Compromise PE Firms' Ability to Manage Outside Counsel Expenses" (Feb. 9, 2021).

Generally Non-Contentious Negotiations

Most LIBOR negotiations between borrowers and lenders in the subscription facility

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agreement area have not been particularly contentious, experts agreed. That is likely because most market participants have closely followed ARRC-recommended fallback language. Sponsors – and their counsel – understand that the disappearance of LIBOR is a big change for lenders and that lenders did not have a choice in the matter, Berman said.

Banks will not be as open to comments from borrowers because they need to be consistent, Nagle explained. "There is not a lot of room for negotiation because the remediation language has been vetted by internal LIBOR transition teams; operations; systems; risk and compliance; and many other internal teams to make sure the benchmark language works across all different products and borrowers." LIBOR remediation should be seen largely as technical changes, he added.

Borrowers overall have been receptive to lender language. "I would say that 98 percent of the LIBOR remediation provisions go uncommented on by borrowers – there are a few exceptions, but generally, I am not seeing much pushback from borrowers," Loftis said. She urged borrowers to take a big-picture view of LIBOR remediation. "It is helpful for PE sponsors to understand that banks do not necessarily want to spend their time doing this and that the mandate comes from the regulators." Regulators, including the Acting Comptroller of the Currency Michael Hsu, have stated in no uncertain terms that LIBOR origination must end by December 31.

With that understanding, borrowers have pressed mostly for consent rights or "reasonable" qualifiers if an action is in the lender's sole discretion. "We have been fairly successful at getting that kind of language," Draper said, "but we don't try to overhaul the language wholesale."

Some borrowers did offer comments, however, on the amendment version of the ARRC language and encountered strong pushback from the lenders, Berman said. "Before the hardwired approach became more prevalent, the amendment approach contained more permutations of what the rate would be, when the switch would be triggered and how the trigger was decided," he elaborated. "Now that the hardwired approach has become market standard, there is less to negotiate and correspondingly fewer comments."

For more about negotiations between lenders and sponsor borrowers, see "Umbrella Credit Facilities: Special Challenges Posed and Tips for Overcoming Them (Part Two of Two)" (Jul. 27, 2021).

Differences Between Banks and Private Lenders

Private credit funds are facing LIBOR transition on both sides, both as borrowers under their subscription facilities and as lenders. As lenders, credit funds are more flexible than regulated banks, so some of their existing loans may not be based on LIBOR. U.S.-based credit funds tend to only offer USD loans instead of multicurrency facilities, in addition to having a lower volume of loans in their portfolios compared to banks, Mascia observed. For their LIBOR-based loans, however, credit funds must make the same substantive and operational changes as their heavily regulated bank counterparts.

Organizationally, compared to banks, private credit funds may not have as many divisions that need to receive and implement the same LIBOR policies, so some have not been as assiduous in their remediation efforts as most banks, Loftis noted. The year-end deadline, however, applies to private funds as well, and

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credit funds are now working on LIBOR remediation.

For the most part, private credit funds are using ARRC language for remediating their loans to PE funds. As with banks, borrowers should compare provisions from their private lenders against the ARRC provisions carefully. As credit funds can be more flexible than banks, that flexibility can be used in favor of the borrower – *e.g.*, obtaining consent rights where banks may be more reluctant. On the flip side, a credit fund's flexibility may be used to stray further away from ARRC recommendations than a bank would.

See our two-part series on forming private credit funds: "Key Differences in Fund Lifecycle and the Use of Subscription Facilities Versus PE Funds" (May 12, 2020); and "How Material Variations in Fee Structures and Recycled Proceeds Compare to PE Funds" (May 19, 2020).

Ramifications of Missing the Deadline

If a PE sponsor does not update its fallback provisions by the end of the year and does not request any modifications to its facility, the facility will continue to operate as it has. "For 18 months after the end of this year, USD LIBOR will still exist. The rate may be less predictable as we get closer to June 2023 because it will be a much thinner market, but it is still usable," Draper assured.

Separate from amending existing LIBOR loans, when it comes to actually using the new benchmark rate, "borrowers generally do not want to wait until the last minute to switch," Berman noted. "Although there is uncertainty about being among the first to adopt SOFR, there is also uncertainty about how the LIBOR market will behave at the end of its life," he reasoned. "Once SOFR-based facilities start becoming more prevalent, I suspect many will choose to transition before the June 2023 deadline."

If there is an issue with the replacement benchmark, credit agreements also provide the option for the borrower to draw at the base rate, several experts pointed out. "It obviously is not ideal for borrowers, but the borrower still has a loan in place at the end of the day," Loftis said. "When the June 2023 deadline hits, legacy credit agreements that do not have benchmark replacement language will rely solely on the prime rate," Draper agreed. "That would likely be so high that the borrower would prepay or refinance its facility to avoid paying such a high interest rate. But, it's hard to imagine that happening."

Finally, sponsors may have heard of legislation adopted in New York and Alabama that automatically imposes a SOFR-based rate for contracts that do not contemplate permanent LIBOR cessation or use a LIBOR-based rate as a fallback. The laws also provide a safe harbor for parties that choose a SOFR-based rate recommended by ARRC. Most fund finance loans contain fallbacks to the prime rate if LIBOR is unavailable, however, and therefore are not in the scope of the legislation.

See "SEC Examination Topic Trends: Outside Business Activity Disclosure, Subscription Credit Facility Use and Cybersecurity Policies (Part One of Two)" (Mar. 19, 2019).

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