

A Practitioner's Guide to EUROPEAN LEVERAGED FINANCE

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Chapter 8

Recent Trends in Senior Loan Negotiation

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8.1 Introduction

At the time of writing, the “credit crunch” which commenced in the summer of 2007¹ has already had a profound impact on global economies and financial markets, including the leveraged finance community of banks, financial institutions, private equity sponsors and other investors and their respective advisers. This period will undoubtedly be remembered for the many events of historical proportions that occurred in 2008 – the bankruptcy of Lehman Brothers, emergency takeovers of venerable institutions such as Bear Stearns, Merrill Lynch and HBOS, the worldwide governmental “rescue” of many financial institutions, insurance companies and mortgage lenders etc. However, the effect of this macro event is notable also in that it potentially marks a turning point, or at least a new phase, in the balance of power between lenders and borrowers in the leveraged finance market.

In general terms, at least until the onset of the credit crunch, the deep pool of liquidity of both debt and equity had rendered the marketplace acutely competitive over recent years. This resulted in increasingly sponsor/borrower friendly commercial and legal terms being obtained (most noticeably at the higher end of the market) as

¹ This chapter regularly uses the term “credit crunch” to refer to the crisis in the global financial markets which started in August 2007 (and, at the time of writing, was continuing). The crisis resulted in turmoil in the global financial markets, a huge liquidity shortage and drop-off in deal flow (for example, the first six months of 2008 was the weakest first half-year in five years (source: Standard & Poor’s LCD Q2 2008 LBO review)).

deal-makers conceived a succession of innovative ways in which to alter the dynamics between lenders and their clients. The participants and products in this market became increasingly sophisticated, evolving over time based on past experiences (good and bad). It remains to be seen how the credit crunch will impact the market in the longer term. However, there is a palpable sense of a shift in bargaining power back towards the lenders as the excess liquidity has evaporated and world economies are faltering.

This chapter focuses on a variety of the structural and loan documentation issues which have constituted key battlegrounds for lenders and sponsors and/or have been the subject of significant market-driven changes over recent years.² Specifically, the chapter looks at changes to senior debt structures, security arrangements, financial covenants, mandatory prepayment events, restrictions on junior payments, the material adverse effect definition, voting provisions and transfer/assignment clauses. A discussion of all of the dark arts behind the underlying provisions in each of these areas warrants very detailed analysis in its own right. However, the following will give the reader an insight into certain of the more material issues that have been debated late into the night on countless transactions over recent years.

8.2 Structure and flex

This section is a review of the changes seen in the market with respect to leverage in deals and structure for debt packages.

8.2.1 Higher purchase prices and more debt

Global private equity fund-raising has been the subject of an incredible boom, increasing from approximately \$75 billion in 2003 to \$324 billion in 2007, a phenomenon that was also mirrored in Europe

² This chapter does not intend to analyse issues arising at the commitment paper stage of acquisition financings (e.g., duration and conditionality of commitments; the use of interim loan agreements or fundable term sheets, etc.) or process-related matters (e.g., determining the scope of an acquiror's due diligence; the use of sponsor standard form documentation, etc.). Despite being of considerable interest in a review of the changing relationship between sponsors and lenders over recent years, these topics are beyond the scope of this chapter.

which saw a rise from \$23 billion to \$66 billion over the same period.³ This “golden age” of private equity also saw individual funds raise unprecedented levels of capital (e.g., among many other success stories, in 2007 Apax Partners reported that its pan-European Fund VII had raised over €11 billion; in 2006 Permira closed its fourth European buyout fund raising €11.1 billion, with Kohlberg Kravis Roberts & Co. raising \$17.6 billion in the same year).

In parallel with this private equity avalanche, a revolution was occurring in the financial markets, with heightened lender confidence fuelled by consistently low default rates, coinciding with decreasing interest rates and the entry into the market of a flood of new institutional investors. For example, Standard & Poor’s reported that in 2000 there were only eight active loan investment vehicles in the European leveraged finance market, but by March 2007 this had risen to 275.

So, at least until the beginning of the credit crunch, year-on-year there was increasingly fierce competition for buyout targets as private equity firms looked to invest the funds raised whilst at the same time taking advantage of the deep liquidity in the debt markets to increase leverage. Consequently, it is no surprise that there was a huge leap in company valuation multiples from on average 7.1× EBITDA⁴ in 2003 to 9.3× EBITDA in the first quarter of 2007.⁵ This increase was funded through debt such that in European private equity deals average total leverage rocketed from 4.5× EBITDA in 2003 through 6.1× EBITDA in the first quarter of 2007⁶ to a peak of 7× EBITDA in September 2007 (on a rolling three-month basis).⁷

8.2.2 The changing nature of the debt package, including the rise and fall and rise again of amortising tranches

Aside from changes in the sheer size of leveraged finance transactions, the constituent parts of the debt package itself altered significantly during this period as sponsors took advantage of market

³ Source: Thomson Financial.

⁴ Earnings before interest, tax, depreciation and amortisation.

⁵ Source: Standard & Poor’s LCD Q1 2007 LBO review.

⁶ Source: Standard & Poor’s LCD Q1 2007 LBO review.

⁷ Source: Standard & Poor’s LCD Q2 2008 LBO review.

conditions to reduce their overall cost of funds. Deals that a few years previously would have been structured with senior and mezzanine facilities, or senior, mezzanine and payment-in-kind (“PIK”) facilities, were now capable of being funded by way of all senior debt structures or senior and second lien financings (with the second lien incorporated as a tranche of the senior facilities rather than being a stand-alone facility). However, with the advent of the credit crunch, structures started to revert to those more reminiscent of prior years, not least due to the collapse of the second lien market. For example, in the second quarter of 2008 senior/mezzanine deals accounted for 68 per cent of the European market (up from just 14 per cent in the second quarter of 2007) and deals with second lien as the only additional debt below the senior facilities accounted for just 3 per cent of transactions in the market (down from 27 per cent a year previously).⁸

In addition, the context of this ever-changing environment, senior debt packages themselves have been varied, reflecting the identity of investing lenders. As explained in Chapter 2, the traditional senior acquisition term loan structure has three tranches (as described in Table 8.1) with different investors being attracted to amortising or non-amortising tranches.

Before the influx of institutional investors into the leveraged loan market described above, the A tranche was likely to have constituted approximately 50 per cent of the aggregate senior acquisition term loan structure, with the remaining 50 per cent being split equally between tranches B and C. However, the pre-credit crunch increase in liquidity amongst collateralised loan obligations (“CLOs”)/collateralised debt obligations (“CDOs”), hedge funds and other institutional

Table 8.1 *Traditional senior acquisition term loan structure*

<i>Facility</i>	<i>Tenor</i>	<i>Amortising</i>	<i>Typical investor</i>
A	7 years	Yes	“Traditional” banks
B	8 years	No	Institutional investors
C	9 years	No	Institutional investors

⁸ Source: Standard & Poor's LCD Q2 2008 LBO review.

lenders resulted in sponsors being able to take advantage of financing packages incorporating only B/C loan tranches such that the borrower group just had to service its interest payments with no amortising debt payments to make over the life of the facilities. This development was also welcomed by arrangers as these “new” lenders required little or no fees in order to participate in a transaction, with the result that the arrangers’ profit margin increased. In contrast, however, at times when these investors are much less active (such as during the credit crunch) and/or if lenders are looking to impose more operational discipline on the borrower group by using amortising debt to ensure a reduction in leverage over the life of a financing package, structures return to the more traditional approach outlined above.

8.2.3 Adding further leverage into the structure

So far this chapter has been concerned with that part of the debt package which is to be used for the acquisition of the target group, but sponsors have also examined strategies over the last few years to increase the (initially) unfunded commitments of the lenders. In the prior stages of the development of the leveraged finance market, the only unfunded commitments would in all likelihood have been a small revolving credit facility for working capital purposes and potentially a capital expenditure/acquisition facility (although this might have required further equity investment at the time of drawing so as to ensure that leverage levels were maintained) (*see further Chapter 2*). However, in times of increased liquidity, not only did the magnitude of exposure under these unfunded facilities start to increase (with equity requirements often dropped), but sponsors requested, and frequently obtained in loan documentation, further “incremental facilities” or “accordions”.

Incremental facilities are initially uncommitted but are pre-approved by the syndicate as capable of being incurred over the life of the transaction at the election of the borrower as a newly created tranche of the senior debt (provided of course that it finds one or more lenders willing to provide the new commitments on the pre-agreed terms). The borrower’s entitlement to utilise these facilities is typically subject to certain limited conditions, the most significant being a hard cap and/or a cap through a leverage covenant (i.e., the borrower can only obtain new further commitments if, as a result, its leverage ratio on a

pro-forma basis is not more than “X” times EBITDA). Upon satisfaction of these conditions, no further lender consent is required in order to introduce this further leverage into the existing structure, whereas without the “pre-approving” of this concept into the documentation the consent of all lenders is likely to be required under standard syndicate voting arrangements (see 8.8 below). If the principle is conceded, the key areas for negotiation are therefore the conditions to use of funds, in particular (and most obviously) the cap and the manner in which it is calculated.

8.2.4 Selling the debt – the need for market flex provisions

A further consequence of this ever-evolving marketplace has been the impact it has had on market flex provisions. A market flex clause is a provision (that is usually heavily negotiated) included in the commitment papers for a transaction. It allows the arrangers and underwriters of the debt financing package to make certain amendments to the originally agreed terms in order to sell loan commitments to incoming lenders as part of syndication of the facilities and thereby bring the underwriters’ hold levels down to desired amounts (i.e., a successful syndication).

In earlier phases of the leveraged finance market, arrangers could perhaps legitimately argue that the requirements to make transactions appealing to investors were not necessarily identical across all deals. Therefore, whilst precedent was important and often the starting point when structuring and pricing a new deal, the arrangers still required the ability to amend the terms, structure and/or pricing of the debt financing to the extent required to attract the necessary number of commitments.

This argument became less tenable over time, or at least when lender interest was intense for almost any transaction. As a result, when liquidity was high, market flex provisions were occasionally eliminated or, if not eliminated, they were invariably restricted to a pricing flex (i.e., no right to change the structure or other terms agreed in the commitment papers and/or long-form financing documentation) with a negotiated cap on possible pricing increases (either by reference to individual tranches or on a weighted-average basis across all tranches).

During this period strong sponsors also typically considered a number of further ways to limit the ability of arrangers to exercise these flex rights, for example:

- (a) limiting the time period following closing of the acquisition during which any flex provisions can be implemented;
- (b) requiring a period of prior consultation with them before changes can be implemented, during which time arrangers need to prove by reference to market feedback why the pricing increase is justified;
- (c) requiring that the arrangers pre-agree that they will offer a minimum percentage of their underwriting/arrangement fees to potential participants before they are able to request the exercise of their flex rights; and
- (d) specifying that any changes can only be made if they are (objectively) necessary (not just advisable) in order to ensure that the arrangers achieve their agreed hold levels (which would be negotiated to as high a level as possible).

Sponsors also requested “reverse flex” provisions whereby the arrangers agree to use best or reasonable endeavours to reduce the transaction pricing if it was still possible after such reduction to have a successfully syndicated deal. A good indicator of a changing market is that in the first quarter of 2007, 50 per cent of institutional tranches were reverse-flexed. This percentage reduced to 28 per cent in the second quarter of 2007, 2 per cent in the third quarter of 2007 (with a corresponding huge increase in the number of deals which were flexed up based on broader market flex clauses) and 0 per cent during the first six months of 2008.⁹

8.3 Security

In the structures described above, what security have the lenders had the benefit of and how has this changed?

⁹ Source: Standard & Poor’s LCD Q2 2008 LBO review.

8.3.1 Legal and practical considerations and the use of "agreed security principles"

At a time when borrower groups in the London acquisition finance market had operations based exclusively (or almost exclusively) in the UK, taking security was easy. Lenders would request, and borrowers would generally be amenable to provide, full fixed and floating charge debentures from all (or material) group companies. Aside from the need for target group companies to complete a financial assistance "whitewash" procedure, this was a relatively time- and cost-efficient process.

However, as the market expanded with sponsors targeting companies located (or with major subsidiaries incorporated) across continental Europe and the rest of the world, this approach became increasingly problematic given the difficulties of taking equivalent security in other countries. Accordingly, sponsors argued that when structuring guarantee and security packages in non-UK transactions it was necessary to reflect the different legal requirements across relevant jurisdictions which prevented or otherwise limited the borrower's ability to deliver to the lender's full guarantees and security for reasons such as lack of corporate benefit; financial assistance laws; thin capitalisation issues; excessive costs, etc.

The ground rules for this would be recorded in "agreed security principles" and a sample set of these principles is now contained in the standard form leveraged loan documentation of the Loan Market Association ("LMA").¹⁰ Their general considerations are set out in Table 8.2. (The LMA principles also include sections relating to the obligations to be secured, some general principles for negotiation and provisions relating to the undertakings and representations/warranties to be included in the security documents.)

These basic principles are often further extended and supplemented by the sponsors in a number of ways, including to specify:

¹⁰ The Loan Market Association was formed in 1996 and is Europe's trade association for the syndicated loan markets.

Table 8.2 *Extract from LMA agreed security principles*

In determining what Security will be provided in support of the Facilities (and any related hedging arrangements in respect of interest rate liabilities [and/or any exchange rate [or other] risks]) the following matters will be taken into account. Security shall not be created or perfected to the extent that it would:

- (a) result in any breach of corporate benefit, financial assistance, fraudulent preference or thin capitalisation laws or regulations (or analogous restrictions) of any applicable jurisdiction;
- (b) result in a significant risk to the officers of the relevant grantor of Security of contravention of their fiduciary duties and/or of civil or criminal liability; or
- (c) result in costs that, in the opinion of the Agent, are disproportionate to the benefit obtained by the beneficiaries of that Security.

For the avoidance of doubt, in these Agreed Security Principles, “cost” includes, but is not limited to, income tax cost, registration taxes payable on the creation or enforcement or for the continuance of any Security, stamp duties, out-of-pocket expenses, and other fees and expenses directly incurred by the relevant grantor of Security or any of its direct or indirect owners, subsidiaries or Affiliates.

- (a) which assets the lenders cannot take security over;
- (b) the (limited) circumstances when they can exercise their rights in respect of any guarantees and security (i.e., post acceleration of the debt facilities only);
- (c) how the borrower group can use assets pending enforcement; and
- (d) the limited scope of representations, undertakings and other terms of the security documents.

More specifically, commonly requested further terms have often included:

- (a) Agreement that guarantees/security will not be required from joint ventures and other non-wholly owned subsidiaries and that security does not need to be granted over assets subject to existing third-party arrangements which prevent the charging of those assets.
- (b) Agreement that perfection of security will not be required if it would have a material adverse effect on the ability of the relevant charging company to conduct its business in the ordinary

- course or if it requires action to be taken outside of the jurisdiction of incorporation of the charging company.
- (c) Agreement that costs of taking guarantees and security (including any notarial, registration and similar expenses) above an agreed cap will be for the account of the arrangers.
 - (d) The principle that the terms of the security documents will not be unduly burdensome on the charging company and that any further representations or undertakings will only be included if required to confirm any registration or perfection of the security unless otherwise necessary as a matter of local law.
 - (e) That where notice is required to be given to a third party in order to perfect or protect security (e.g., with respect to security over bank accounts, insurance policies and the acquisition documents), the relevant charging company will have discharged any obligations to obtain an acknowledgment of any such notice by using reasonable endeavours for an agreed period (typically around 20 business days).
 - (f) That where security is being taken over trade receivables, notice to each trade counterparty is not required to be given until acceleration of the debt facilities and that where lists of such receivables are requested to be provided, they will only be made available to the extent required to ensure perfected security under applicable local law.

During any period when the ability to close transactions in the leveraged loan market is more difficult (e.g., during the credit crunch), it is of course harder for lenders to accept these exclusions to the scope of their security package given the additional scrutiny being given to collateral coverage.

8.3.2 The use of guarantor coverage tests

As a further part of the cost/benefit analysis undertaken with respect to the granting of guarantees and security by borrower groups, coverage tests were introduced so as to ensure that non-material companies were not obliged to become guarantors and provide security, whilst at the same time ensuring that the lenders had appropriate collateral protection. Such a test would specify that the borrower group only had to ensure that the guarantors/security providers account for not less than an agreed percentage of the group's total assets, turnover and EBITDA.

The key issues that have been debated with respect to this concept are as follows:

- (a) At what level is the threshold set? Lenders might start at 95 per cent but the stronger sponsors would be looking for 80 per cent or lower.
- (b) What are the components of the test? As noted above, lenders would argue for EBITDA, assets and turnover components, sponsors for just EBITDA.
- (c) Does the coverage test apply before or after application of the agreed security principles described above? For example, if the coverage test is set at 90 per cent and a subsidiary generating 10 per cent of the group's EBITDA is legally prevented from giving a guarantee/security for the financing, does the test now require 90 per cent coverage in respect of the remainder of the group even though this means a "true" coverage test of 81 per cent?
- (d) Which entities count towards satisfying the threshold? It could be assumed that just the actual guarantors/security providers count, but sponsors have argued that entities whose shares have been pledged should also be included, notwithstanding that their assets are not secured and no direct guarantees have been given and therefore the lenders would not rank in priority to trade and other creditors of the relevant entity.

These are all issues where there is typically merit on both sides of the argument and therefore need to be negotiated on a deal-by-deal basis based on factors specific to the parties and deal in question and the market environment at the time of the transaction.

8.4 Financial covenants

A key difference with the incurrence style covenants of high yield debt (explained in Chapter 5): what do senior lenders test and what is there to negotiate?

8.4.1 Purpose

Unlike high yield debt instruments which contain only "incurrence" covenants (i.e., where generally a group company must take an action

to cause a default and which are only tested when the particular action is being taken), typically in leveraged loan agreements there will be “maintenance” covenants which require the borrower group to maintain a certain level of financial health in order to avoid a default.

Financial covenants were designed to (hopefully) assist the lenders in monitoring the financial performance of a borrower group during the lifetime of the financing, providing them with a meaningful test of this performance and a realistic early warning signal that a borrower might be in trouble. If the covenant is breached when tested (typically quarterly), the lender group then has the ability to call a default and exercise its rights and remedies.

8.4.2 The different approaches

Table 8.3 summarises in general terms the various options that have been taken by lenders with respect to financial covenants in leveraged finance transactions. Whilst the use of “full” covenants has generally been the accepted approach, covenant “lite” and covenant “loose” were both adopted in a number of deals at the height of the pre-credit crunch environment (albeit less frequently in Europe than in the market in the US). Their attraction for sponsors is obvious, though they should be viewed as the product of a very liquid and competitive market.

Further details on these covenants can be found in Chapter 2.

Table 8.3 *Financial covenant package options*

Full covenants	Leverage (debt to EBITDA), interest cover (EBITDA to interest), cash-flow cover (cash flow to debt service) and capital expenditure
Covenant “lite”	Leveraged loans with high yield style incurrence covenants only (i.e., no financial covenants)
Covenant “loose”	Leveraged loans with high yield style incurrence covenants plus one or two financial covenants from the full covenant package described above
Full covenants but with fall-away/suspension	As per full covenants but certain covenants drop away or are suspended following a listing and/or on reaching an agreed leverage level

8.4.3 Providing headroom

As explained in Chapter 2, the levels for the financial covenants are set by building a certain amount of headroom into the performance ratios specified in the business plan for the group which has been agreed between the sponsor and the arrangers. One of the main areas for debate is therefore how much this headroom is and, at the height of the market, a strong sponsor would be looking for at least 30 per cent, whereas in a tighter/weaker market, the arrangers will probably require closer to 20 per cent. This headroom of course needs to be based on a suitable underlying business plan (i.e., one that does not underestimate expected performance thereby providing a further inbuilt headroom before the “official” headroom is agreed) and diligence work is required by the arrangers to ensure that this is the case.

Finally, it is of course important for the lenders to be satisfied that the definitions used in the loan documentation accord with the methodology used in the preparation of the business plan. Otherwise, once again, the agreed headroom can be distorted easily.

8.4.4 Mulligans: what are they?

Most social golfers will at one point in their golfing lives have no doubt had recourse to a mulligan – that is, the opportunity to retake their first shot of the round. This concept of a “second chance to get things right” found its way into the financial covenant provisions of certain European leveraged finance transactions and allowed the financial covenants to be breached without being treated as a default unless the same covenant was breached a second time. The mulligan had added impact when considered alongside significant equity cure rights (see 8.4.5 below) as the potential second breach could always be cured with an injection of new equity or subordinated shareholder debt. This is perhaps the most infamous example of the pro-borrower market of 2006 and 2007 and is unlikely to be seen in the market in the near future.

In recent years sponsors have also often requested a “soft” mulligan (or “deemed cure”) provision. This provides that a prior breach of a financial covenant is deemed to be cured as soon as the borrower group is back in compliance with that covenant provided that the

lenders have not taken enforcement action in the meantime with respect to the prior breach. Accordingly, it provides clarification to all parties regarding when a financial covenant default is continuing for the purposes of the rights of the lenders to accelerate the debt and exercise their remedies. This provision is typically less contentious and more easily accepted by lenders when compared to the “hard” mulligan described above, although care is still required to ensure that the lenders’ rights with respect to the breach are properly protected and that they can take action before the deemed cure occurs and can continue pre-existing action after it has happened.

8.4.5 Equity cure provisions

A further feature of the developing market has been the introduction of equity cure provisions. A sponsor would argue that it was possible that a financial covenant could be breached for one financial quarter only as a result of a temporary or one-off event or minor downturn in performance and that, notwithstanding this lack of long-term materiality, the lenders would nevertheless be entitled to exercise all of their remedies under the finance documents. Accordingly, the concept of an equity cure was developed whereby sponsors are allowed to “cure” a financial covenant breach by the injection of further equity (or deeply subordinated shareholder debt). These provisions of course give rise to numerous issues to consider for borrowers and lenders alike:

- (a) How should the new cash injection be used / treated? Should the borrower be required to reduce the senior debt through a prepayment (more advantageous for the lenders) or should the group be allowed to retain the cash and count it as an increase to cash flow or EBITDA as required to cure the breach? (An addition to EBITDA in particular is a significantly better result for the sponsors given the impact that this has across all of the covenants and the “multiplier” effect of an addition to EBITDA in comparison to a repayment of debt.)
- (b) How often can the cure provisions be used? Whilst in theory lenders should be agreeable to all additional equity contributions, it is obvious that they do not want a sponsor “drip-feeding” equity into a business which is under-performing just to prevent a breach of the financial covenants and disenfranchise

the lenders in respect of remedies which would otherwise be available. Typically, therefore, these provisions have a cap on overall usage plus an inability to use the cure more than once in any 12-month period.

- (c) How much can the cure amount be? Some lenders maintain that the cure amount should never be more than that needed to cure the covenant breach on the basis that an over-injection of equity would help to cure a potential covenant breach in the following three quarters (on the basis that a cure amount is treated as cash flow and EBITDA for all testing periods in the rolling 12-month period following the receipt of that cure amount). A further argument is that an overall cap on the amount of any cure is required so that very significant breaches cannot be cured.
- (d) How quickly must the cure amount be provided? The lenders clearly want to know if the sponsor is intending to cure a default or not and therefore a period of not more than approximately 20 business days following the delivery of the compliance certificate evidencing the underlying breach is typically agreed.
- (e) Can the cure amount be counted in the calculation of the leverage ratio for other purposes in the loan documentation (e.g., the margin ratchet, excess cash flow mandatory prepayment obligations and so on)? From a lenders' perspective, the desire would be, of course, to limit the impact of any cure payments to the calculation of the financial covenants.

8.5 Mandatory prepayment provisions

What rights do senior lenders have to require early prepayment of the loans?

8.5.1 Taking excess cash flow

The concept of the excess cash flow mandatory prepayment requirement was explained in Chapter 2. However, as the leveraged market has evolved, so these requirements can in certain circumstances be seen to have ceased to fulfil their intended objectives, with sponsor-friendly negotiated positions rendering such requirements largely

ineffectual in ensuring a degree of amortisation. The key issues that are the subject of such negotiation include:

- (a) Definitions: the definition of “excess cash flow” and related definitions became more and more complicated in certain deals, with an increasing number of deductions from cash flow included in the calculation (many of which were not necessarily justified) such that the resulting number bore little resemblance to true “excess cash”.
- (b) The percentage for prepayment: historically, the lenders took 100 per cent, or a minimum 75 per cent, of excess cash flow in prepayment. At the height of the bull market, this percentage was often as little as 50 per cent, decreasing quickly to 25 per cent and then to zero when certain leverage ratios were obtained, with increased flexibility to distribute the excess cash that has not been required to be used in mandatory prepayment out of the credit group by way of a dividend or repayment of shareholder debt to the sponsor.
- (c) Size of basket and manner of calculation: it became typical to include a basket of cash which is never swept. This was originally intended as a *de minimis* number but was increased over time. In addition, in certain transactions this basket exception was deducted after having calculated the notional amount required for prepayment, thus the true basket amount became even higher (see Table 8.4 for a worked example).
- (d) Fall away / suspension: certain transactions have benefited from a provision which results in the excess cash flow prepayment obligation being disapplied following the occurrence of certain trigger events – typically either the leverage ratio reaching an agreed level or upon an initial public offering.

Table 8.4 *Calculations of excess cash flow*

<i>Basket is deducted first:</i>	<i>Basket is deducted last:</i>
Excess cash flow is €20,000,000 Basket of €5,000,000 is deducted = €15,000,000 Lenders sweep 50 per cent of this Prepayment obligation of €7,500,000	Excess cash flow is €20,000,000 50 per cent of this = €10,000,000 Lenders sweep this <i>less</i> basket of €5,000,000 Prepayment obligation of €5,000,000

8.5.2 Other

Chapter 2 also describes the other typical mandatory prepayment events – a change of control, listing, receipt of proceeds from certain asset disposals, receipt of proceeds from certain insurance claims and receipt of proceeds from claims under the acquisition documents and acquisition-related due diligence reports. Against this background, this chapter just mentions some of the more contentious issues for consideration by the parties in this context:

- (a) Change of control: what level of ownership should trigger a change of control, in particular post-listing? The lenders are likely to want voting and economic control to be maintained by the sponsor over the group at all times, whereas a strong sponsor will argue for voting control before a listing and thereafter control of a lower percentage of the votes, for example 30 per cent provided that they are still the largest shareholder. In addition, can other sponsors be “pre-approved” into the change of control such that the financing becomes a “portable” deal (or a “transferable recapitalisation”), surviving a change in sponsor? This concept has typically not been received enthusiastically in the market and remains extremely unusual.
- (b) IPO: does this trigger full prepayment (i.e., as per the occurrence of a change of control) – the position adopted in the LMA leveraged loan documentation – or should only a set percentage of the net proceeds (decreasing with reduced leverage) be required to be used in prepayment (the typical sponsor request)?
- (c) Disposal proceeds, acquisition proceeds and insurance proceeds: what disposals/events trigger a prepayment obligation? How long is any reinvestment period? (A strong sponsor will be looking for 12 or more months from receipt of proceeds before being required to repay debt.) What size is any basket exception? What deductions can be made from the proceeds to calculate “net proceeds” required for prepayment?

8.6 Restrictions on junior payments

This section describes how the ability to get cash out of the credit group to the sponsor (or to repay junior debt) has changed.

8.6.1 The “traditional” approach

It is a basic principle of leveraged lending that no payments can be made to the shareholders of the borrower group until the debt is repaid in full. Further, in capital structures with multiple layers of financing, it is also generally accepted that no repayment of junior debt can be made until all of the more senior monies are repaid in full.

8.6.2 Fall-away/suspension of the “traditional” approach

However, as the leveraged finance market developed, sponsors sought to look for exceptions to this including to allow flexibility to receive cash benefits themselves by virtue of permitted payments. A list of permitted payments typically requested is set out in Table 8.5 (although it is not exhaustive).

With respect to repayment of junior debt, it is not surprising that borrowers would prefer to have the flexibility to repay the more expensive debt first. Accordingly, many transactions in the pre-credit crunch period would allow second lien and mezzanine facilities to be repaid once leverage reached an agreed level even if the senior facilities were still outstanding. Further exceptions to this also include repayment of junior lenders in the event of an illegality event or as a result of a borrower exercising its rights to repay a lender claiming increased costs or tax gross-up or under a “yank-the-bank” provision (*see* 8.8.5 below).

Table 8.5 Requested permitted payments

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|---|
| <ul style="list-style-type: none">(a) Payments to the sponsor if leverage is below an agreed level or with proceeds from a listing which are not required to be used in mandatory prepayment;(b) Payments to holding companies above the credit group for reasonably and properly incurred administrative costs, directors' fees, tax, professional fees and regulatory costs;(c) Payment of a monitoring or advisory fee to the sponsor not in excess of an agreed annual amount (increasing in each year in line with the Retail Price Index);(d) Payments to the sponsor or an adviser to the sponsor for corporate finance, M&A and transaction advice actually provided to the group on bona fide arm's-length commercial terms; and(e) Payments to fund the purchase of any management equity and/or to make other compensation payments to departing management. |
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8.7 Material adverse effect

This section examines one of the key definitions in a leveraged loan agreement.

8.7.1 The importance of the definition

The concept of “material adverse effect” is typically used in two types of circumstances in a European leveraged loan agreement:

- (a) It is used as a qualification to a number of the representations, covenants and events of default contained in the loan agreement where this level of materiality is deemed to be appropriate to a specific situation (e.g., a covenant would provide that each member of the group must do “X” unless failure to do so does not, or could not reasonably be expected to, have a material adverse effect).
- (b) Unlike in the US market, almost all European leveraged loan agreements will contain a generic event of default which is triggered if any event or circumstance occurs which has, or is reasonably likely to have, a material adverse effect.

Accordingly, it is of paramount importance for both borrowers and lenders that the definition is acceptable.

8.7.2 Changes over time and implications

Table 8.6 shows the definition of material adverse effect currently contained in the standard leveraged loan documentation of the LMA.

There are a number of elements to this definition that a strong sponsor (or indeed any sponsor in a bull market) would be keen to negotiate and which, as a result, are often excluded or amended in agreed documentation:

- (a) The test being subjective in the reasonable opinion of the majority lenders rather than objective.
- (b) The reference to the “prospects” of the group being adversely effected, creating a forward-looking and uncertain element to the test.

Table 8.6 *LMA definition of material adverse effect*

<p>“Material Adverse Effect” means [in the reasonable opinion of the majority lenders] a material adverse effect on:</p> <ul style="list-style-type: none">(a) [the business, operations, property, condition (financial or otherwise) or prospects of the Group taken as a whole; or(b) [the ability of an Obligor to perform [its obligations under the Finance Documents]/[its payment obligations under the Finance Documents and/or its obligations under Clause 26.2 (<i>Financial condition</i>) of this Agreement]]/[the ability of the Obligors (taken as a whole) to perform [their obligations under the Finance Documents]/[their payment obligations under the Finance Documents and/or their obligations under Clause 26.2 (<i>Financial condition</i>) of this Agreement]]; or(c) the validity or enforceability of, or the effectiveness or ranking of any Security granted or purporting to be granted pursuant to any of, the Finance Documents or the rights or remedies of any Finance Party under any of the Finance Documents.]

- (c) Paragraphs (a) and (b) of the test being listed as alternatives rather than being cumulative criteria (i.e., the test should only be triggered if there is a material adverse effect on the business of the group such that it is reasonably likely to be unable to perform its payment obligations. In tighter markets, this is likely to be the most controversial (and often rejected) request).
- (d) All of the options in paragraph (b) of the test being too wide and that a material adverse effect should only relate to an impact on the ability to meet payment obligations.
- (e) Paragraph (c) of the test containing neither an element of materiality nor a carve-out for “legal reservations” (i.e., any general principles which are set out as qualifications as to matters of law in the deal legal opinions), a concept which is typically found as a qualification to representations relating to enforceability.

Finally, it is worth noting in the context of any references in this definition to compliance with financial covenant obligations, that the impact of liberal equity cure provisions and mulligans (as explained above) make this limb of a material adverse effect test that much harder to breach.

8.8 Voting and related provisions

This section covers amendments and waivers: what to look for.

8.8.1 The “traditional” and LMA approach

The traditional approach to voting in syndicated loan agreements, as reflected in the current LMA standard leveraged loan documentation, is that, subject to certain exceptions which require the approval of all lenders, amendments and waivers can be agreed upon by the borrower and the majority lenders (typically being two-thirds by commitments of the syndicate in European transactions). Table 8.7 below summarises the customary all-lender decisions in typical loan documentation.

Table 8.7 Typical all-lender decisions

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| <ul style="list-style-type: none">(a) Changes to the definition of “majority lenders”.(b) An extension to the date of payment of any amount under the finance documents.(c) A reduction in the margin or a reduction in the amount of any payment of principal, interest, fees or commission payable.(d) A change in currency of payment of any amount under the finance documents.(e) An increase in or an extension of any commitment or the total commitments.(f) A change to the borrowers or guarantors other than as contemplated by the loan agreement.(g) Any provision which expressly requires the consent of all the lenders.(h) The clauses dealing with the several nature of the finance parties’ rights and obligations, with the transfer mechanics and with amendments/ waivers.(i) The nature or scope of any guarantees, the secured property or the manner in which the proceeds of enforcement of the transaction security are distributed.(j) The release of any guarantees or of any transaction security unless permitted under the loan agreement or any other finance document or relating to a sale or disposal of an asset which is the subject of the transaction security where such sale or disposal is expressly permitted under the loan agreement or any other finance document.(k) Any amendment to the order of priority or subordination under the intercreditor agreement. |
|--|

However, this “traditional” approach does have some obvious limitations, and a lender holding only a very minor stake in the capital structure has a veto over these all-lender matters notwithstanding the possibility of overwhelming support from the rest of the syndicate. This has led to a number of refinements to this approach over time which are regularly used by sponsors and are described in more detail in the following paragraphs.

8.8.2 Introduction of a super-majority concept for security releases

One of the first ways in which sponsors looked to introduce a greater degree of flexibility to voting arrangements was through the use of a super-majority of lenders concept, constituted by lenders holding 95 per cent of loan commitments of the syndicate and more recently reduced to as low as 85 per cent. The most common decision placed in the hands of this super-majority is the release of security or guarantees.

8.8.3 Structural adjustments

The “traditional” approach to voting has been further (and most significantly) altered pursuant to the adoption of a permitted “structural adjustments” concept. This typically encompasses the various matters set out in Table 8.8.

Table 8.8 Structural adjustments

- | |
|---|
| <ul style="list-style-type: none">(a) The provision of any additional tranche or facility under the finance documents in any currency or currencies (whether ranking senior to, <i>pari passu</i> with or junior to the existing facilities).(b) Any increase in or addition of any commitment, any extension of a commitment's availability, the redenomination of a commitment into another currency and any extension of the date for or redenomination of, or a reduction of, any amount owing under the finance documents.(c) Any changes to the finance documents (including changes to, the taking of or the release coupled with the retaking of security and consequential changes to or additional intercreditor arrangements) that are consequential on, incidental to or required to implement or reflect any of the foregoing. |
|---|

Each of these are matters which under the “traditional” model would require all-lender approval. However, documentation incorporating a “structural adjustments” concept would provide that these amendments be permitted with the consent only of the majority lenders and each lender participating in the relevant additional tranche or facility or changing its commitments or any amount owed to it.

This concept is often supplemented by a provision which states that any amendment or waiver relating to the rights and obligations applicable to a particular loan, facility or class of lenders, and which does not materially and adversely affect the rights or interests of lenders in other loans or facilities or another class of lender, shall only require the consent of two-thirds of the participating lenders.

8.8.4 “Snooze-you-lose”

As the investor base for leveraged loans moved outside of the established banking community, certain sponsors became concerned that more recent entrants into the market were not necessarily well disposed to respond to urgent requests for amendments or waivers. In addition, certain of these investors were “public” investors and therefore did not want to receive any information regarding the borrower group which was not otherwise in the public domain, including such requests. As a result, “snooze-you-lose” clauses were introduced requiring lenders to vote on amendments or waivers within 10 or 15 business days of being notified of the relevant request otherwise their vote would not count. This is contrary to the “traditional” approach which contains no such deadline, although this does of course run the risk of receiving “no” responses as the deadline approaches if the relevant lender(s) have not been able to complete all internal approval processes required before voting positively. The LMA has recently introduced suggested optional wording for a “snooze-you-lose” clause in its recommended form of leveraged loan agreement.

8.8.5 “Yank-the-bank”

A further way in which borrowers have looked to introduce greater flexibility into voting arrangements is through “yank-the-bank”

provisions. Subject to certain conditions, these allow borrowers to force lenders to transfer their commitments, or (if negotiated) accept a prepayment, if they did not agree to the relevant requested amendment or waiver. In certain circumstances, the threat alone of using these powers might be sufficient to persuade a lender to vote in favour of the relevant decision. However, it should be noted that at times when loans in leveraged finance transactions are trading below their par value in the secondary market (e.g., during the credit crunch), the benefit of this clause has been diluted significantly given that transfers and prepayments need to be made at par.

The issues for debate with the arrangers on these clauses are typically:

- (a) Should the provision allow just a forced transfer or should the borrower also be permitted to use free cash in order to repay the relevant lender, noting that this reduces cash in the group and potentially encourages hold outs? The LMA “yank-the-bank” provision only allows forced transfer.
- (b) Can a lender only be a “non-consenting lender” on matters which require unanimous approval (as per the LMA proposal) or should the “yank-the-bank” apply to all decisions (i.e., even if a majority lender decision has been approved, can the borrower still “yank” a dissenting lender even though this is not actually required in order to ensure the approval)?
- (c) What level of consents are required from the lender group before a lender can be “yanked”? When this clause was initially used in the European market, it was not uncommon for a borrower to be required to obtain 95 per cent approval from its syndicate (and therefore that it could only “yank” up to 5 per cent) such that it only applied with respect to a very small dissenting minority of lenders. Subsequently, sponsors have in recent years been able to negotiate that any lender can be “yanked” once majority lender approval has been obtained, thereby potentially applying the clause to one-third of the syndicate.

8.9 Transfer and assignment clauses

This section is a review of the issues for negotiation in the transfer provisions.

8.9.1 *Consent versus consultation: can the borrower block transfers?*

Most lenders (and the LMA) would typically argue that a borrower should have no consent rights to transfers as this fetters the free transferability of loans, which is a key component of the syndicated lending market and essential at times of reduced liquidity including following the onset of the credit crunch. However, from the perspective of a borrower, the borrower wants to ensure that its syndicate is composed of “friendly” banks willing to listen objectively to requests for amendments or waivers. In addition, as the market developed and many sponsors established debt trading funds looking to invest in leveraged loans, a concern arose that competitors would invest in transactions in order to receive the benefit of all of the information rights given to lenders. These competing tensions need to be resolved in the debate as to whether or not a borrower has consent or consultation rights over transfers.

8.9.2 *Transfers and sub-participations*

A further question that will often arise relates to the scope of the consent or consultation rights described above. If the borrower has been successful in obtaining consent rights but this just relates to actual transfers of the position of lenders of record, any form of sub-participation or other “behind-the-scenes” transaction whereby the voting rights are passed on by these lenders will mean that the hard-fought battle over consent rights is a pyrrhic victory. Therefore, certain borrowers will argue that their consent rights should also extend to these further transactions, although this type of extended consent right is unlikely to be capable of capturing all risk allocation techniques adopted by lenders.

8.9.3 *When consent/consultation rights are suspended*

The typical circumstances in which any consent or consultation rights are suspended would be:

- (a) if the proposed transfer is to another existing lender or an affiliate of a lender;
- (b) if the transferring lender is a fund, when the proposed transfer is to a related fund of that lender; or
- (c) when an event of default is continuing.

These are not often the subject of much debate although certain sponsors have tried to limit the last of these to certain of the more “material” events of default (non-payment, financial covenant breach, insolvency, etc.).

8.10 Conclusion

This chapter has hopefully highlighted and explained a number of the key topical areas of debate among borrowers and lenders, and sponsors and arrangers, with respect to leveraged loan agreements. Clearly the chapter is neither intended to be (nor can it be) an exhaustive account nor are the issues raised necessarily applicable to all deals. However, it will serve as a useful introduction to, or reminder of, certain of the more material issues that have over recent years been considered to be worthy of much debate.