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## Key issues in leveraged lending

Whilst Europe still doesn't have a market that is as deep as the US, nor documentation that is as sponsor-friendly, there are new trends afoot that no practitioner can afford to ignore, writes **James Chesterman**.

**T**he leveraged finance market in Europe has been continuing to develop in sophistication and depth over recent years. With the advent of sponsors operating globally, many law firms in the market having strong US and UK practices and the geographical investor base deepening and crossing the Atlantic on a regular basis in both directions, we are seeing more US loan products and documentation provisions than ever before.

#### COVENANT LITE AND LOOSE: PROTECTION IS DECLINING

Whereas pre-financial crisis a certain number of covenant lite, bond-style loans closed, over the last twelve months this has become more pronounced, although not yet a flood and very credit-specific. There are a few trends here which we think are worth identifying:

- A significant reduction in the number of financial covenants: the trend continues towards a single financial maintenance covenant (a leverage ratio), with significant headroom, which is just a “springing” covenant (i.e. tested when drawn or drawn over a certain percentage of the facility) for the benefit of the revolving credit facility only (with no term loan maintenance covenant); covenant “loose”, with just one or two financial covenants, is also becoming more common as well. We have not yet seen a European loan financing with no maintenance covenant but it may come.
- Certain negative covenants are developing US-style characteristics, so rather than a traditional permitted basket with a set amount, we now see permitted debt based on a leverage or secured leverage test with a separate general debt basket (which could



Chesterman: Phones4U not indicative of a trend

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be the greater of a capped amount and a percentage of EBITBA/Total Assets). This style of covenant leads to far greater flexibility in documents for pari secured loans and bonds. Other trends from the high yield market that are being adopted include a “restricted payments builder basket”, where certain items “build up” to create dividend capacity such as a percentage of excess cashflow, IPO and disposal proceeds, plus new equity, subject to a leverage ratio being complied with (as compared with the US loan form which has developed further to adopt a high yield formulation which includes a percentage of consolidated net income rather than excess cashflow).

- High yield style events of default have generally been resisted by loan syndicates but there are deals which have included defaults more consistent with bond defaults (e.g. no material adverse change; no audit qualification default etc.). These deals also have significant remedy/grace periods in the bankruptcy defaults, an approach which makes sense in a US deal where Chapter 11 would apply, and significantly less sense with European borrowers and guarantors and European insolvency rules and processes (due to the latter not always automatically triggering a moratorium on claims).

#### STRUCTURAL ISSUES IN US LED DOCUMENTS: VARIABLE PROTECTIONS

The greatest contrast between US and European documentation comes in the form of the intercreditor agreement. In the US, many of the restructuring tools are provided by Chapter 11, with an enforcement moratorium,

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## “ULTRA-LOW INTEREST RATES AND THE DEPTH OF THE INVESTOR BASE LOOKING FOR YIELD WILL LIMIT THE SCOPE OF RESTRUCTURINGS”.

valuation principles, the ability to sell free and clear in bankruptcy and debtor-in-possession financing all applicable by operation of law. In the absence of statutory provisions, it has fallen on the European intercreditor agreement to provide for, and develop, many of these principles.

At heart is the continuing concern that insolvency processes in Europe still, potentially, destroy value. This is not to say that all such processes do, and significant steps have been taken in many jurisdictions to introduce more restructuring-friendly and rescue-driven laws, often based on Chapter 11. But it remains the case that in Europe there is a far greater sensitivity to the leverage which creditors may have in times of financial difficulty to force an insolvency filing by virtue of putting pressure on boards of directors concerned about directors' liability issues under local laws. A significant feature of the restructuring market in Europe for many years has been the use of related techniques, which junior creditors, particularly distressed buyers, adopt to get a seat at the table.

Why this gets interesting and relevant with US structures is that the second lien product in the US has structural elements which are different to European mezzanine. US second lien has lien subordination, but no contractual subordination, which means that security interests are ranked, but claims against other assets not forming part of the security package are not. When you import these structures to Europe, and layer on top of that the use by sponsors of “agreed security principles”, which means that security is often not granted over assets that are too expensive or administratively burdensome to secure (real estate being a good example), you often find that the first and second lien under a pure US structure will in fact rank *pari passu* against those assets of European guarantors not subject to transaction security. This is a pretty good position for US second lien but what makes this even more beneficial is that the typical US first and second

lien structures have a standstill on security enforcement but not on debt claim enforcement allowing junior creditors in a US style intercreditor structure to use significant leverage to get a seat at the table. Their “downside” may just be a bankruptcy where they rank *pari* with the first lien on some classes of operating assets and/or real estate. Some US second lien deals for European groups therefore adjust the subordination so recoveries from European borrowers and guarantors are subordinated both as to security and debt claims.

Another area where there has been a lot of European focus over the years has been in the “release provisions”, which provide that in the case of distressed sales on enforcement the underlying claims and security in the companies sold are released. In some deals from the last decade, these provisions were not included which meant again that junior creditors could exercise leverage by forcing a vote on the release of their claims on an enforcement. These “release provisions” do not typically extend to claims (as opposed to security) in a domestic US first and second lien intercreditor agreement, again providing second lien leverage on European deals with European guarantors.

The leverage offered to those creditors without standstills has one more aspect to it: in the US, hedging providers and ancillary/banking service providers typically get the benefit of security, but no vote on enforcement and they do not have to sign the intercreditor agreement. This means those classes of creditors potentially have more leverage in a work-out if that structure is used on a deal with European borrowers or guarantors. It is notable that the European intercreditor agreement actually deals with these creditors in the opposite manner, by binding them into the intercreditor agreement, and giving them a vote on enforcement but imposing a standstill on them.

Of course, the key question here is to what extent these issues are being reflected in US syndicated and documented deals for European groups of companies. At present,

the answer is mixed. There is unquestionably more focus and attention on these issues than there was a year ago, but the approach varies, often dependent on a number of factors including the sensitivity of the underwriters and sponsor to these issues (and indeed those of their counsel as these issues are not necessarily high on the radar of US-based lawyers). Indeed, the approach varies from making no, or relatively few, amendments to US intercreditor agreements, to adopting full LMA style provisions which are generally “adapted” to a New York legal drafting style. There is no market norm, as yet, and these documents have not been tested in European restructurings to date.

There are other features of US documentation and structures which have an impact where adopted in Europe without scrutiny. For example, debt baskets in the US are agnostic about where debt is raised in a structure – structural subordination does not play a significant role in a US bankruptcy because typically the entire group would go into Chapter 11. In Europe, structural subordination can have dramatic effect on recoveries (as suffered by the first wave of European high yield in the 1990s which were structurally subordinated), as the creditors of the subsidiaries get paid out in priority to the equity recoveries of their holding companies. Even if those subsidiaries have granted upstream guarantees, those claims are usually much more limited in value to similar guarantees provided by US (or UK) based subsidiaries (often limited to e.g. “free” share capital or cash actually received from the guaranteed financing). We are seeing an increasing focus to ensure that third party debt is therefore raised in a similar borrowing holding company to the main facilities.

Significant third party debt baskets have other consequences when applied to European deals, aside from priority issues. The importance of “release provisions” in Europe is described above. Most third party debt permissions do not require the debt providers

to sign up to the intercreditor agreement unless they are sharing in the security package. So it is very possible that an unsecured debt basket can be both structurally senior and also have a strong negotiating position if the senior secured creditors are trying to sell the business on an enforcement.

#### IMPLEMENTATION: MORE TOOLS IN THE TOOLBOX

##### (a) Cashless rolls

Another feature of the US market that has come over to Europe is the cashless roll, a feature designed to maximise investor take up on new syndicated deals originally driven by the end of CLO investment periods. Where a syndicate contains a significant CLO population, it is desirable for arrangers to be able to amend deals so loans are amended or exchanged rather than refinanced with new money. What is required depends on the needs of the investors, with the simple formulation being a straight exchange of a new loan instrument for the old rather than cash funding a repayment. However, sometimes that would be considered a new investment even though no new cash has been funded and so the alternative is doing a refinancing by amending the existing loan facility. In European deals, this is effected by utilising “structural adjustment provisions” so majority consent is needed as well as affected lender consent – if this is impossible to achieve then sometimes lead banks will need to purchase and resell loan positions to front the necessary consents to be given.

##### (b) Schemes of arrangement

The burgeoning use of UK schemes of arrangement as being one of the key elements in the restructuring adviser’s toolkit has continued apace, and new developments continue to occur – the latest being the ability to render a syndicated loan scheme eligible by amending the governing law from German to English (which only needed majority consent, somewhat unusually) and then using a scheme to cram down the dissentient minority (the Apcoa case). The Loan

Market Association’s recommended position on amendments to the governing law clause is that it requires a unanimous vote so these facts may not be repeated, but it is worth mentioning to illustrate the trend, as avoiding a requirement for unanimity remains a key aim in European restructurings given their generally consensual out-of-court nature.

#### WHAT DOES THIS MEAN FOR 2015 ?

Declining covenant protection and variable structures sounds like a distressed debt investor’s ideal backdrop, but as with 2014 it is quite likely that ultra-low interest rates, likely to prevail in the Eurozone for some time, and the depth of the investor base looking for yield will limit the scope of restructurings. Until restructurings of these loans with these latest structures and terms occur, investor sensitivity to these issues will remain low. This suggests that 2015 may well be a year where deal terms continue to erode. One-off failures like Phones4U, where financial collapse was due to operational contractual issues and the structure of the financing did not affect the way the situation played out, will not affect this trend. For that company, there was a swift fall into administration as opposed to a financial restructuring allowing the issues referred to above to play out over time whilst creditors jockey for position. When one looks at the history of documentation and structural changes in the loans market, it generally takes a major high profile restructuring with many investors suffering losses to force change. We are not there: negotiation by precedent and the use of competitive grids with multiple banks competing will therefore continue unabated in 2015. ■

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