LATHAM & WATKINS

Client Alert
Commentary

Latham & Watkins Financial Institutions Practice

September 30, 2015 | Number 1878

New Opportunities in Cross-Border Special Situations Lending

Recent changes in cross-border leveraged loan documentation requirements open up new possibilities for both borrowers and lenders.

Cross-border leveraged loan documentation has become increasingly permissive with respect to third party debt, in some respects similar to high yield bonds, thus offering some previously unconsidered opportunities for specialist debt funds and special situations lenders. In a continued low-yield environment, careful consideration of these market developments, and the knowledge of how to utilize exceptions to covenants and other provisions in the leveraged loan and bond documentation, can open up possibilities for these lenders to offer a wider range of structured debt products to borrowers needing liquidity. This *Client Alert* revisits some of the key issues in special situations lending and identifies those areas where recent developments in leveraged loan and bond documentation create opportunities for special situations lenders.

Cross-Border Special Situations Lending – Developing Opportunities

The continuing evolution of leveraged loan and bond documentation creates two issues that specialist debt funds and other lenders should consider in connection with special situations lending opportunities. First, more recent leveraged loan and bond documentation often includes considerable flexibility in negative covenants that significantly increases the potential for special situations lenders to provide meaningful third-party financing in ways which avoid the need for consent from the existing lenders in the capital structure. Second, broadly syndicated leveraged loan and bond documentation includes “market” standard provisions that special situations lenders may wish to revisit in their own documentation.

Credit and Structuring issues

From a credit and structuring perspective, special situations lenders will want the best possible recourse within the constraints of existing documentation and applicable laws (*i.e.*, those relating to the provision of guarantees and security and relating to bankruptcy), and then price that risk accordingly. Optimizing recourse involves determining which companies can be borrowers and guarantors, and whether security is available and, if so, whether it is shared and how it ranks.

Debt and Guarantee Claims

Structural seniority can play a very important role in special situations lending. A typical acquisition financing may rely on upstream guarantees for its credit support from operating companies. Those upstream guarantees may be limited in value in many jurisdictions due to local corporate benefit rules, whereas a third party that lends directly to an operating company will have a direct claim which would not be so limited. Therefore, a special situations lender may be able to maximize the value of its claims by

Latham & Watkins operates worldwide as a limited liability partnership organized under the laws of the State of Delaware (USA) with affiliated limited liability partnerships conducting the practice in the United Kingdom, France, Italy and Singapore and as affiliated partnerships conducting the practice in Hong Kong and Japan. The Law Office of Salman M. Al-Sudairi is Latham & Watkins associated office in the Kingdom of Saudi Arabia. Under New York’s Code of Professional Responsibility, portions of this communication contain attorney advertising. Prior results do not guarantee a similar outcome. Results depend upon a variety of factors unique to each representation. Please direct all inquiries regarding our conduct under New York’s Disciplinary Rules to Latham & Watkins LLP, 885 Third Avenue, New York, NY 10022-4834, Phone: +1.212.906.1200. © Copyright 2015 Latham & Watkins. All Rights Reserved.

lending directly to one of the principal operating asset owning vehicles. Alternatively, a special situations lender that is providing an acquisition financing may want to contractually limit the ability of future lenders to lend directly to the asset owning vehicles, even though such flexibility might have been permitted in more broadly syndicated debt documentation.

Security

The extent of unencumbered and available security in borrower groups can vary significantly. Guarantor coverage tests and "agreed security principles" in loan documentation mean that security over particular types of assets, which is impracticable and/or expensive to secure, such as equipment and real estate, may have been omitted as part of the main deal financing and so may be available as security for a new loan. As a rule of thumb, this omission creates potential opportunities for special situations lenders working within the constraints of existing documentation to create security over assets not subject to the main deal security package. Furthermore, European guarantor coverage tests can range between 70-90% of EBITDA and gross assets, which may leave some value in group companies outside the guarantee and security net (although individual material companies contributing more than 5% of such amounts are likely to have been required to have been part of the existing guarantee and security package). In many cases, the shares of subsidiaries which are not "material" will not be subject to existing deal security. There may even be flexibility to reorganize a group so that there is a standalone subgroup available against which specific financing can be raised. Alternatively, a special situations lender may want to obtain security over types of assets that are often excluded in broadly syndicated debt financings. Such lenders may also want to contractually limit the ability of future lenders to obtain security over non-collateral or to lend to non-guarantor subsidiaries, even though such flexibility might have been permitted in more broadly syndicated debt documentation.

Security Avoidance Risk

Insolvency related "hardening periods" can be key considerations for loans made when companies are in financial difficulties — if security is likely to be exposed to bankruptcy avoidance risk for a certain period following execution, lenders should consider this additional risk when structuring the deal.

Security Enforcement and Bankruptcy Issues

In special situations lending, the ease with which security can be enforced may be relevant (particularly if a lender expects to become the owner of the business in the event of a default, in which case having a "single point of enforcement" and share security in a jurisdiction which is efficient in its enforcement regime such as the UK, the Netherlands or Luxembourg will be preferable). Understanding what priority and/or preferred claims, expenses and creditors can arise locally, the relevance of retention of title, applicable bankruptcy processes (including any mandatory stay regime) and more detailed legal diligence may also be necessary.

Alternatives to Loans

There may be other ways for corporates to raise new finance: selling receivables and entering into sales and leasebacks are common examples, but more structured and ingenious ways may be found to raise finance within the constraints of covenant limitations.

Traditional Lending Structures

In the past, leveraged loan documentation was highly restrictive regarding the incurrence of third-party secured and/or guaranteed debt, with relatively limited fixed "baskets" for specific types of financing (such as finance leases) and a fixed "general basket" both under the limitation on financial indebtedness and that regarding security. Companies subject to bond covenants clearly have had far more flexibility, but

bonds have often been used in structures alongside loans and so it was relatively rare in the past to have companies only restricted by bond style covenants and not tighter loan covenants.

Assuming that borrowers generally want to avoid the need for consents from existing lenders to raise new finance, they were limited in raising further finance in the past by covenant baskets and the scope of available unencumbered assets. Over the years, borrowers have been able to increase both the range and amount of baskets.

Sharing security with existing lenders on an equal ranking or super-priority basis was not usually practical under traditional lending documentation without obtaining consents from those lenders. "Junior" financings may be possible in specific instances, for example by introducing a structurally subordinated financing above the main credit group (which would be subject to an evaluation of restrictions on upstream debt service) or by executing second ranking security documentation (on the condition that there would be no need to require existing creditors to execute an intercreditor agreement, but which would often be limited by the negative pledge).

The "amendments" clause becomes critical in this situation to determine what level of consents might be needed. Such consents could include:

- All Lender – can sometimes be the case for amendments to ranking and the application of proceeds from the enforcement of security
- Super Majority – for example, if existing security needs to be released
- Majority Plus Affected Lender – relevant both for "structural adjustments" (*e.g.* amendments to key economic changes, new tranches, etc.) and also a typical US loan formulation for economic changes
- Majority – for *e.g.* amendment of negative covenants

However, as described above, often seeking consent from existing creditors in this situation is less than optimal for borrowers. Such consent can often precipitate more difficult debt restructuring discussions, and a simple consent request can in certain circumstances only be obtained laden with additional conditions and fees attached.

Recent Developments

Over the last year or so significant flexibility from both the US term loan B and the European high yield markets has penetrated the European loan market to a large extent, which has led to a broader range of specific basket exemptions (including a general basket for "ratio debt" which may be linked to either a leverage test or a fixed charge coverage test). This flexibility has been a part of the high yield bond covenant package for many years, but it is only now that loan documentation may have similar exceptions. These broader exemptions create significantly more flexibility to raise debt within the types of structures referred to above — there may be fewer assets subject to security (because guarantor coverage requirements are reduced) and much more significant sums of third-party finance may be raised without consents being required.

Importantly, this flexibility manifests itself in other ways. Accordion features (incremental facilities) are now very frequently included in credit agreements which can allow third-party creditors to lend alongside lenders under an existing credit agreement. There may also be flexibility for separate loans to be made which share in the existing guarantee and security package on a super senior, pari or subordinated basis.

- **Accordian features** These may be limited in absolute terms or by ratio tests, but have developed to allow significant financings to be raised under the framework of the main credit agreement; typically provisions relating to this new incremental tranche cannot be more onerous than the existing documentation, with a cap on any increase in pricing, consistent or later maturities required and no more onerous covenants and events of default.

- **Separate third-party debt sharing in guarantee and collateral package** This may have similar conditions to the accordion debt or may be more flexible.

Obtaining pari passu ranking security with existing financiers has become significantly easier due to accommodations made in documentation for this to occur more smoothly. Borrowers negotiate sufficient flexibility to ensure that these significant structural changes can be made with as few consents required as possible. Particularly with the advent of secured high yield deals, however, provisions have been included in high yield indentures and the intercreditor agreement that allow the security agent to agree to changes without reference to the underlying creditor groups. Loan based structures are now adopting that flexibility as well.

Because this flexibility is relatively new in the European market, negotiated positions are variable and the loan, bond and intercreditor documentation need to be studied extremely carefully to determine what is possible. Some financings may restrict which entities can borrow new money (picking up on the concerns about structural seniority referred to above). Some financings will require new third-party lenders to become party to an existing intercreditor agreement, whether the financings are guaranteed and secured on a similar basis with that financing, or, in some cases, when unsecured. In this increasingly flexible landscape, the issues the intercreditor agreement poses can vary significantly. There is an increasing trend for significant unsecured debt facilities to be required to become party to the intercreditor agreement, often for the purpose of ensuring that the pre-existing senior secured debt cannot be frustrated in its enforcement strategy by other classes of third-party debt being structurally senior to them. The following issues can be relevant in these complex and structured situations:

- What the voting group is for the enforcement of security

- What standstills (remedy bars) and payment blocks are imposed on the classes of debt, including whether the standstills are on both the enforcement of debt/guarantee claims and the enforcement of security

- How broad are the potential classes of super senior, senior and other debt (in particular, how is hedging treated)

- How the waterfall operates

- What conditions attach to the release of security on enforcement and whether the release provisions are fully effective

- What constraints are placed on further amendments of debt

One disadvantage of sharing in an existing security package may be that the covenants on offer are the same, which may not be as restrictive as a special situations lender in this position might require. For example, the special situations lender might want any remaining headroom in the debt and security covenants to be eliminated, greater information rights and other provisions more reflective of the then current position of the company rather than when the original deal was done. In a high yield bond

covenant package, for example, “control” acquisitions are largely unrestricted, and there is significant flexibility in reinvesting disposal proceeds and making restricted payments (including dividends) alongside the financial indebtedness and security related limitations, which again the special situations lender may consider gives too much flexibility. In particular, it would generally be difficult to impose significantly more onerous covenants in an accordion structure.

Conclusions

While special situations lending often involves financially distressed or near distressed situations, which are not as prevalent in the current market environment, market documentation is giving rise to more and more opportunities for specialist lenders to offer structured debt products to borrowers where, for whatever reason, the mainstream syndicated loan or bond markets are unwilling to provide funds through loan increases and bond tap issues or the company concerned does not want to utilize those markets. This lack of mainstream market availability may be related to credit issues, or it could be that terms on offer are more flexible in the private debt or credit fund market, for example: in terms of the provision of non-amortizing long term debt or relaxation of covenant protection; or where unitranche or subordinated debt might be the solution; where confidentiality is a key issue; or where US regulated institutions may be forced to limit the quantum of total debt offered in connection with a particular financing due to the US Leveraged Lending Guidelines. As the leveraged loan and high yield bond markets continue to mature and develop, in the absence of any tightening of market documentation, more and more companies will have capital structures for which these solutions may be relevant, and in these complex capital structures, mastering the applicable documentation, credit and bankruptcy issues will be key.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

James Chesterman
james.chesterman@lw.com
+44.20.7710.1004
London

Casey T. Fleck
casey.fleck@lw.com
+1.213.891.8589
Los Angeles

Greg Robins
greg.robins@lw.com
+1.213.891.8850
Los Angeles

You Might Also Be Interested In

Desktop Staleness Calendar for 2016 Offerings

FINRA’s New Research Rules

The Bankruptcy of the Securities Market Paradigm: Rethinking the Efficient Market Hypothesis

CFTC Proposes Cross-Border Application of Margin Requirements for Uncleared Swaps

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's *Client Alerts* can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit http://events.lw.com/reaction/subscriptionpage.html to subscribe to the firm's global client mailings program.