The Continued Migration of US Covenant-Lite Structures into the European Leveraged Loan Market

Jane Summers

James Chesterman

Daniel Seale

Sam Hamilton

Latham & Watkins LLP

At the start of 2016, global sponsors and their advisers are continuing to apply their experiences from financing transactions in the US leveraged loan and global bond markets to the European leveraged loan market. Healthy investor appetite over the last several years means attractive terms can be selected from the US loan market, which has been more sponsor-friendly for longer than the European market, owing primarily to the depth of its investor base. The continued adoption of US covenant-lite terms into European loans itself generates a source of European "cov-lite" precedents, thus in turn strengthening the precedential case for cov-lite, in the absence of a market correction. Loan markets are currently somewhat volatile, however, so further erosion of covenant terms may be unlikely for as long as this volatility continues. This convergence brings a number of new documentation issues to consider.

Covenant-Lite Loans

The US model of covenant-lite is increasingly being adopted in Europe. In a covenant-lite loan, either there is no financial maintenance covenant or there is a single financial covenant solely for the benefit of the lenders under the revolving credit facility with no financial maintenance covenant for the term lenders. Moreover, the covenant benefiting the revolving lenders typically is a "springing" covenant, i.e., tested when the revolver is drawn and such usage exceeds a certain percentage of the revolving credit commitments, often 25–35%, with the applicable levels set with significant EBITDA "cushion" or "headroom" of around 30% or more and no or very few step downs. It is worth noting that associated provisions customary in US covenant-lite structures have not necessarily been adopted wholesale in Europe. For example, the US-style equity cure, with amounts being added to EBITBA and no requirement for debt pay-down, is still resisted by some lenders in Europe (although perhaps increasingly less successfully). The European market generally permits over-cures, whereas the US market does not.

Documentary Flux

The characteristics of European covenant-lite loans other than with respect to financial covenants themselves have to date been less uniform. This was in part due to a 'battle of the forms' in relation to documenting European covenant-lite loans. The first covenant-lite loans to emerge in the Europe market in the post-credit crunch cycle appeared in 2013, and which were documented under New York law, were used to acquire European assets and were either partly or wholly syndicated in Europe. The next generation were governed by LMA-based credit agreements, stripped of most financial covenants and otherwise modified in certain respects to reflect 'looser' US practice on terms. The third generation, in the market in 2015 and set to become the norm, are hybrid LMA-based loan agreements that in addition to the absence of financial covenants for the term loan adopt more wholesale changes based on US market practice, primarily in that they introduce leverage- or coverage-based incurrence style ratio baskets rather than traditional loan market baskets fixed at a capped amount. A number of the other features of current covenant-lite European leveraged loans are considered below.

Increased Debt Baskets

Limitations on borrowings are developing US-style characteristics, so rather than a traditional debt basket with a fixed capped amount, we now see permitted debt limited solely by a net leverage or secured leverage test with a separate fixed capped ("freebie") basket alongside. This debt can be raised through an incremental "accordion" feature and sometimes separate "sidecar" financings. This style of covenant leads to far greater flexibility for a borrower to raise additional debt as *pari passu* secured, unsecured or subordinated loans or bonds. In some financings, reclassification is permitted so that the "freebie" basket can be used if the ratio basket is unavailable, and then subsequently moved into the ratio basket once the ratio is met, thus freeing up the "freebie" basket.

Builder Baskets

Another trend from the US covenant-lite loan market (which is also a feature of the high-yield bond market) that is being adopted in European loan deals is a "restricted payments builder basket", where the borrower is given "credit" as certain items "build up" to create dividend capacity, starting with the borrower's retained portion of excess cashflow ("ECF"), IPO and other equity proceeds, and unswept asset sale proceeds, usually subject to a net leverage ratio governor as a condition to usage. There is a trend towards an even more aggressive variant based more closely on the high-yield bond formulation, which credits a percentage of consolidated net income ("CNI") (usually 50%) rather than retained excess cashflow, with the disadvantage for lenders in that CNI is not reduced by the deductions used to calculate ECF and because the build-up may begin for years prior to the onset of the ECF sweep.

US-style Events of Default

US-style events of default continue to be resisted by European loan syndicates, but we have seen isolated loan financings that

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include defaults more akin to the US loan approach, e.g., removal of material adverse change default; no audit qualification default or even the high-yield bond approach (more limited defaults with longer remedy periods).

Other Provisions

There are a few other provisions we are seeing migrate from the US covenant-lite (or high yield) market to Europe, such as:

- Permitted acquisitions controlled by a leverage test rather than by imposing absolute limits – and otherwise fewer controls on acquisitions.
- Permitted disposals similarly trending towards a high yield formulation that does not impose a cap and has varying requirements for reinvestment/prepayment and cash consideration.
- Change of control mandatory prepayment being adjusted to allow individual lenders to waive repayment (becoming effectively a put right).
- Increased use of general "baskets" (as distinct from and in addition to ratio-based incurrence tests) with a soft dollar cap that increases as total assets or EBITDA grows.
- Provisions that state that if FX rates result in a basket being exceeded, this will not, in and of itself, constitute a breach of the debt covenant (or other limitation).

Economic Adjustments

Economic adjustments such as a 101% soft call for six months, a EURIBOR floor, and nominal (0.25%) quarterly amortisation are also being introduced to make loans more familiar to US loan market participants.

Structural Consequences – the Intercreditor Agreement Revisited

Adopting products from other jurisdictions brings with it the risk of unintended consequences. US terms and market practice have developed over decades against a background of the US bankruptcy rules and US principles of commercial law. The wholesale adoption of US terms without adjustment to fit Europe's multiple jurisdictions can lead to a number of unintended consequences.

A good example of this relates to European intercreditor agreements, which have over time developed to include standstills on debt claims and release provisions. At heart is the continuing concern that insolvency processes in Europe still, potentially, destroy value. Although significant steps have been taken in many jurisdictions to introduce more restructuring friendly and rescue-driven laws, it remains the case that in Europe there is a far greater sensitivity to the ability creditors may have in times of financial difficulty to force an insolvency filing by virtue of putting pressure on boards of directors through the threat of directors' liability under local laws. A significant feature of the restructuring market in Europe for many years has been the use of related techniques that creditors, particularly distressed buyers, adopt to get a seat at the table by threatening to accelerate their debt claims. Standstill provisions evolved to prevent creditors from using this type of action to disrupt a restructuring without having to resort to a bankruptcy proceeding to provide a stay and thereby obtain increased recoveries.

Another intercreditor provision of great focus over the years has been the release provision, which provides that in the case of distressed asset sales following default and acceleration, the lenders' debt and guarantee claims against, and security from, the companies sold are released. In some deals from the last decade, these protective provisions had not been included, with the result that junior creditors could gain significant negotiating leverage because their approval was needed for the release of their claims and security, without which it is not possible to maximise value in the sale of a business as a going concern.

The potentially significant debt baskets referred to above become relevant in this context. In the US, where this flexibility originated, debt baskets do not legislate as to where in the group debt can be raised – structural subordination does not often play a significant role in a US bankruptcy because typically the entire group would go into Chapter 11. In Europe, structural subordination can have a dramatic effect on recoveries (as suffered by the first wave of European high yield bonds in the 1990s, which were structurally subordinated). Even if those subsidiaries have granted upstream guarantees, the value of the claims under such guarantees are often of limited value.

Until very recently, most provisions allowing the incurrence of third party debt did not require the debt providers to sign up to the intercreditor agreement unless they were sharing in the security package. With this new flexibility it is very possible that an unsecured creditor under a debt basket can have a very strong negotiating position if the senior secured creditors are trying to sell the business in an enforcement scenario, given the lack of standstill and release provisions. We are therefore seeing a continuing trend that third party debt over a materiality threshold is required to become subject to the main intercreditor agreement. It is of note that while this is becoming a trend in loan transactions, it has yet to become a focus in European bond transactions.

What Does This Mean for the Rest of 2016?

It seems 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 continue to permit significant flexibility in covenant and documentation issues when the loan markets are open for business. Whilst volatility in 2016 has meant that further erosion of terms has not occurred, we do not see an end to the continued migration of covenant-lite in the European market at this time.

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Jane Summers

Latham & Watkins LLP
885 Third Avenue
New York, NY 10022-4834
USA

Tel: +1 212 906 1838
Email: jane.summers@lw.com
URL: www.lw.com

Jane Summers is a partner in the New York office of Latham & Watkins and is a member of the Finance Department and Banking Practice. She focuses on the representation of financial institutions in leveraged finance transactions, including acquisition, cross-border, and exit financings and other senior secured lending transactions. Ms. Summers also advises loan market participants on strategic initiatives designed to address structural issues in the syndicated lending and loan trading markets.

Ms. Summers has been active in the syndicated lending market since its infancy in the mid-1980s, having spent the first decade of her career at another global law firm, then serving as Deputy General Counsel for Barclays in the Americas, and from 2000 to 2005 acting as the LSTA's first General Counsel where she led the efforts to develop the organisation's legal, documentation and regulatory strategies for key industry issues that established standard market practices and procedures.

James Chesterman

Latham & Watkins LLP
99 Bishopsgate
London EC2M 3XF
United Kingdom

Tel: +44 20 7710 1004
Email: james.chesterman@lw.com
URL: www.lw.com

James Chesterman is a partner in the London office of Latham & Watkins and has more than 25 years' experience in finance matters across Europe, including investment grade lending, asset-based lending, leveraged and acquisition finance and workouts and restructurings. His clients include many of the world's top investment and commercial banks and he has also acted for a range of private equity funds and corporates in the negotiation of their loan facilities. More recently his client base has extended to include various non-bank lenders including credit funds and hedge funds. Mr. Chesterman is recognised as a leading lawyer in his field by *Chambers UK 2016*.

Daniel Seale

Latham & Watkins LLP
885 Third Avenue
New York, NY 10022-4834
USA

Tel: +1 212 906 1341
Email: daniel.seale@lw.com
URL: www.lw.com

Daniel Seale is a partner in the New York office of Latham & Watkins and is a Co-chair of the firm's global Banking Practice. Mr. Seale is a member of the Finance Department and the Banking, Capital Markets and Private Equity practices, and is a member of the firm's Strategic Client Committee. He is a former Vice Chair of the firm's Associates Committee and former local chair for the Finance Department in the New York office. Mr. Seale's practice focuses primarily on the representation of financial institutions, borrowers and issuers in leveraged finance transactions with a particular focus on acquisition financings. Mr. Seale has also represented buyers and sellers in both public and private mergers and acquisitions transactions. He is recognised as a leading lawyer in his field by *Chambers USA 2015*.

Sam Hamilton

Latham & Watkins LLP
99 Bishopsgate
London EC2M 3XF
United Kingdom

Tel: +44 20 7710 1124
Email: sam.hamilton@lw.com
URL: www.lw.com

Sam Hamilton is a finance partner in the London office and is Chair of the firm's Finance Department in London, which includes the practice areas of acquisition finance, banking, project finance, restructuring and structured finance. Mr. Hamilton has experience working at all levels of finance capital structures, including senior debt, mezzanine debt, unitranche debt, first/second lien financings, PIK debt, vendor loans, dividend recapitalisations, asset-backed loans, bridge facilities, high-yield bonds and restructurings. Mr. Hamilton is recognised as a leading lawyer in his field by *Chambers UK 2016*.

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