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**LMA credit documentation: recent key negotiation issues**

**Feature**

Karl Clowry

*is special counsel in the London office of Cadwalader Wickersham & Taft LLP. His practice is focused on debt finance, in particular European restructurings and refinancings of corporate entities. Email: karl.clowry@cwt-uk.com*

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*Karl Clowry considers the likely adjustments to LMA credit documentation in the current economic climate.*

**KEY POINTS**

- The Loan Market Association ('LMA') standard credit documentation continues to be an engine for convergent evolution in the European syndicated debt markets.
- European leveraged loan market documentation is now being negotiated closer to LMA forms reflecting the recent shift in bargaining power.
- Additional public policy standards may apply in civil law syndicated credit documentation.

The LMA developed documentation for use by London syndicated loan market participants to establish a consistent framework to enable the secondary loan market to develop more efficiently. The initial milestone of producing a suite of secondary (par/near par) loan trading documents in 1996 was followed by investment grade primary syndicated documentation and distressed debt trading documents in 1999. During the rapid expansion of the leveraged loan market in Western Europe a set of leveraged loan primary documents was developed in 2004. These templates have been adapted to a variety of borrowers, loan markets and jurisdictions across the European market, including a French law investment grade credit document in July 2002 and a German law investment grade credit agreement in September 2007. These forms have enabled investors and borrowers to assess loan assets using more easily comparable standards than had previously been the case.

This concerted documentary approach has not only improved fluidity in the origination and trading of loans but also assisted lenders when seeking to address vexed legal, tax, regulatory and other practice issues by focusing on the specific provisions in the documentation affected by such matters. Many loan markets that had been dominated by bilateral lending have readily accepted such syndicated documentation. This enabled lenders to use their balance sheets much more effectively and for transactions to be executed in much briefer timescales.

Hedge funds and Collateralised Loan Obligations ('CLOs') emerged as very significant debt market investors in the last five or so years and this has led to an expectation of more commoditised and standard credit documents which may be rolled into a portfolio of similar exposures. Mandated lead arrangers have consequently sought to use documentation templates in which such institutions have confidence while having to compete intensively on pricing and on the key legal terms to obtain mandates from sponsors/borrowers.

### **NEGOTIATING ENVIRONMENT 2003-2007**

LMA standard form documentation is, of course, only a suggested initial reference point for any negotiation. Consequently, its provisions have been subject to considerable adjustment to reflect the borrower/sponsor friendly macro-economic backdrop in which arrangers had to compete intensively for mandates in recent years. Many sponsors provided prospective arrangers with their own preferred forms of funding documentation and sought to resist strongly any move to render their documentation more LMA-centric. In this way sponsors could more easily make comparisons between the differing terms offered by prospective arrangers competing on one template.

Pro-borrower flexes in the structure of leveraged debt transactions were negotiated to enable more highly leveraged A, B, C & D (second lien) structures to develop, with less early years' amortisation. Borrowers had enjoyed the option of toggling to 'PIK' interest on more junior debt to maintain cashflow rather than meeting interest expense. Equity cures and the rare 'Mulligan' (second-strike) clause in relation to breaches of financial covenants, along with generous senior headroom amounts were included in many transactions up to July 2007. A number of recent leveraged transactions have involved secondary or tertiary buy-outs and so the scope to increase earnings has sometimes been optimistically based on a continuingly benign macro-economic environment and corresponding business models.

The compression of certain-funding documentation for time critical leveraged transactions has involved a move from: (i) the original status quo of lenders requiring a signed commitment letter and complete credit documents; through (ii) requiring a commitment letter and a term sheet; (iii) using a fundable interim funding agreement; and finally (iv) culminating in funding on the basis of a detailed term sheet with a sponsor.

Such front-ended negotiations on the terms of even large syndicated transactions resulted in limitations on the ability to invoke a business or market material adverse change prior to funding and to the inclusion of sponsor-favouring reverse price flexing where transactions were heavily oversubscribed by prospective lenders. This trend has in part been used by prospective private equity purchasers in order to out-compete other prospective bidders for businesses. It has also hastened the speed at which transactions can be concluded rather than conducting the majority of negotiations through several hundred pages of advanced form credit documentation.

### **PENDULUM SWINGS BACK**

As lender investors return to fund new transactions, the lower margined second lien tranche is likely to be increasingly supplanted by larger and higher margined mezzanine tranches with warrants attached for buy-outs/re-financings involving particularly ambitious business plans. The recent, and sometimes unwarranted, downward pricing of loan assets has led to a more pro-lender documentary environment. The legacy effect of 'covenant-lite' credit agreements has enabled borrowers/sponsors to delay the re-negotiation of terms even when there is a departure from business plan and prospective financial covenant breaches appear. In many cases the ability to equity cure actual breaches of financial covenants also forestalls more fundamental discussions about the structure and terms of leveraged transactions. By the time such re-negotiations commence equity value and mezzanine debt may be considerably impaired.

In these re-negotiations lenders might well seek to re-address guarantee and security packages that extend only to 80 per cent of the obligors' assets/earnings and rein-in operational flexibility provided for acquisition activity, disposals and other debt incurrence. If private equity investors accept that lower internal rates of return will apply over the next phase of the economic cycle then lower multiples of leverage and more equity

investment will be associated with leveraged debt structures. Robust sponsors may seek to use such less leveraged structures as a way of maintaining flexibility on other provisions in the documentation.

## **SPECIFIC NEGOTIATION ISSUES**

Apart from the tests and metrics to be included in financial covenants, considerable energy can be expended negotiating the add-backs and deductions to the defined financial terms. This is of particular concern to lenders where a borrower/sponsor seeks considerably more latitude than under similar transactions in the same sector. The dilution and omission of testing on: (i) cashflow to debt service; (ii) interest cover; and (iii) capital expenditure is now less evident than in recent years. However, lenders still encounter sponsors seeking to include higher levels of headroom (25-40 per cent) over the business plan than the typical flexibility (15-20 per cent) of several years ago. Where a post-acquisition restructuring is envisaged sponsors often request a prolonged non-testing phase.

The scope of representations and warranties in syndicated credit facilities is quite well established with adaptations made for particular commercial sectors or borrower types as required. Most negotiations focus on the qualification to the statements made, eg requiring actual awareness within the obligors' group, materiality qualifications or by reference to qualifications in legal opinions. Since the demise of 'cov-lite' documentation the number of applicable representations and warranties being repeated or being deemed to be repeated has increased.

Negotiation of the general undertakings usually involves considerable commercial input to ensure the various strictures are focused on the correct issues, are practicable and will be observed by the borrower. The inclusion of overly strict covenants is of little use if they are constantly breached, prove unworkable or if their breach is not easily discernible.

The transfer provisions in a credit agreement are frequently a sensitive issue for certain borrowers/sponsors who may wish to restrict transfers to competitors (expressly) or to particular investors (often impliedly by a reasonableness test). Such rights to withhold consent usually extend to sub-participations. Any such rights will cease to apply on the occurrence of an event of default or a potential event of default, or less frequently after notice of acceleration. The inclusion of a 'yank-the-bank' provision reverses the situation completely such that where a super-majority lender consent threshold (in a range from 66.67 per cent to 95 per cent) is achieved the dissentient lenders can be compelled to transfer out of the credit at par value.

## **INTERCREDITOR ISSUES**

One key, but often un-negotiated, provision in leverage finance intercreditor documentation is the term permitting the release of claims against obligors on the enforcement of security. Where such a provision enables the release of claims against both borrowers and guarantors on enforcement then 'out of the money' junior creditors may have little bargaining power to prevent an enforcement sale, provided it is undertaken for a fair market value. A provision that enables only the release of second lien/mezzanine guarantee claims on enforcement but not the primary borrowing obligations can result in out of the money subordinated lender groups having considerable hold-out value. Their consent will be required to release borrowers from their primary obligations. This may require a more involved asset based enforcement or for value to be paid to those lenders for their consent.

## **CIVIL LAW ENVIRONMENT**

Where syndicated markets developed independently of the London market, such as Paris and Frankfurt, then local law governed syndicated credit documentation was developed but very often to differing standards. This militated against making easy comparisons across loan terms and discouraged liquidity in the local markets.

When seeking to apply English governing law to contracts with obligors established in civil law jurisdictions

certain additional public policy standards may apply. Lenders seeking to enforce their rights in Germany may find that local courts seek to determine whether there is a 'good cause' to enforce such rights. Where a loan agreement is governed by the law of certain civil law based jurisdictions then a term of 'good faith' may be implied into the contract. This may result in commercially pragmatic actions by lenders being rendered void if the action is subsequently deemed not to have been exercised in good faith.

As well as implied statutory terms, civil law courts may seek evidence from the negotiations of the agreement to determine the parties' intentions. Consequently, certain lenders may seek to include a whole agreement clause to ensure certainty of interpretation.

Due to the increasingly complicated capital structures found in European borrower groups it is quite usual to have several overlays of debt, often subject to different governing laws and regulated by different intercreditor agreements. Many transactions have introduced the concept of depechage (using more than one governing law to regulate an agreement) to ensure that clauses on default interest, prepayment fees, reversals of re-distributions and application of security recoveries are governed by English law even though all other clauses in the same agreement are governed by a different law.

## **FUTURE TRENDS**

European debt markets are likely to see further continued convergent evolution of documentation using the LMA paradigm, with adaptation of clauses and its governing law for specific jurisdictions. Lender investors will expect negotiations to originate with well understood forms of principal credit documentation with more lender protective provisions, especially in M&A transactions where corporate purchasers are involved rather than private equity sponsors.