

Term Loans and High Yield Bonds

Tracking the Convergence

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Typical provisions for certain syndicated term loans have undergone a transformation in the last ten years, adopting some features traditionally found in high yield bonds. Investors and arrangers should understand the implications of this unmistakable trend and take into account the related risks in their decision-making.

Over the last decade, there has been a trend towards convergence of the term loan B market and the high yield bond market with respect to both the investor base and creditors' legal rights under financing documents. This trend survived various market downturns, including the 2007 global financial crisis, and is now as strong as ever. Recently, certain term loan provisions are approaching new bond-like territory that few market participants would have expected.

Historically, bank term loans and high yield bonds have been two separate asset classes. Each asset class had different market expectations and pricing. As the two asset classes converge, term loan investors and arrangers (and their counsel) should understand the implications, consider their rights as creditors and reputation as arrangers, and translate the risk factors into their pricing and decision-making.

>> For a Practice Note discussing the basic differences between raising debt by issuing debt securities versus through a syndicated loan, search [Debt Finance: Debt Securities Versus Syndicated Loans](#) on our website.

This article examines this convergence trend, focusing on:

- The factors that led to this trend.
- Bond-like features that are appearing in term loan documents.
- The prevalence of this trend in recent deals.
- Implications for lenders.
- How this trend may develop over time, along with important considerations for both borrowers and lenders.

FACTORS LEADING TO CONVERGENCE

Ten years ago, loan documents contained numerous protections for lenders. At that time, most lead arrangers of syndicated loans held a significant amount of the loan for their own accounts. As a result, arrangers focused on loan agreement provisions that would protect their long-term interests as creditors. In particular, the arrangers analyzed a borrower's business model and tailored the various covenant exceptions to correspond to the business model and the borrower's articulated business plan.

In the current market term loans in particular are widely distributed, making consents and amendments to loan documents harder to obtain. This has prompted borrowers to seek more flexibility in deal provisions upfront.

Traditionally, the financial covenant levels in term loan agreements were set to be triggered when the borrower's results deviated from the business model. Further, exceptions to the investment, disposition, debt and lien covenants would be set at dollar limits which reflected the borrower's proposed plans for those activities. Bank lenders also wanted borrowers to prepay the loans if they had excess cash and did not permit large exceptions to the covenants. Since bank loans were not widely distributed, consents or amendments to loan documents were relatively easy to obtain, which further encouraged lenders to allow only limited exceptions to the negative covenants.

>> For more information on loan agreements generally, search [Loan Agreement: Overview](#) on our website.

In the current market, however, term loans in particular are widely distributed, making consents and amendments to loan documents harder to obtain. This has prompted borrowers to seek more flexibility in deal provisions upfront.

Further, arrangers no longer expect to hold any portion of the term loan. Their principal task is to negotiate a loan that they can sell to other investors in the market who are more like bond investors than traditional commercial bank lenders. Since arrangers are not seeking the same credit protections, they are more willing to negotiate terms that meet the needs of sponsors and borrowers and that are acceptable to investors. As sponsors and borrowers push for more flexibility, certain term loan provisions in many deals are becoming much more similar to those found in bonds.

>> For a Practice Note on the main points of negotiation for financial sponsors and lenders in commitment letters, term sheets and fee letters used in private equity acquisition financings, search [Sponsor/Lender Negotiating Issues in Acquisition Finance](#) on our website.

Many forces contributed to this convergence trend in the last decade. Often cited are:

- The waxing influence of private equity sponsors, who frequently raise capital in both the term loan B and high yield bond markets, often for the same companies.

- The increasing dominance of institutional investors in the term loan B market, who are familiar with bond covenants because they also invest in high yield debt (often through the same funds that invest in term loans).
- The switch by loan arrangers to a fee-based business model, which sowed the seeds for the arrangers' emphasis on syndication and trading over holding the loans long term.

Most loan underwriters and arrangers now organize the bankers responsible for the high yield debt and bank loan products in the same group and have the same personnel manage the issuance of both products. A few law firms are also staffing their attorneys to handle both high yield debt and bank loan deals.

>> For more information on types of loans and debt securities generally, search [Lending: Overview](#) and [Debt Securities: Overview](#) on our website.

BOND-LIKE FEATURES IN TERM LOAN AGREEMENTS

The last seven years marked a new era in documentation for deal provisions relating to risk monitoring and risk allocation between borrowers and lenders for term loan facilities. A number of bond-like features have appeared in term loan agreements, including:

- The concept of "restricted subsidiaries," which limits the application of covenants and events of default to the borrower and only certain designated subsidiaries.
- "Builder" baskets, which provide borrowers with more flexibility to allocate their excess cash flow.
- The absence of financial maintenance covenants, known as covenant-lite loans.
- In deals with a bond indenture, "all-in" conforming covenants and no requirements to use proceeds from a sale of assets to first prepay the senior term loan.
- In a few recent deals:
 - events of default that are identical to those in the bond indenture;
 - no annual excess cash flow sweep; and
 - affirmative covenants that are similar to the bond indenture.

RESTRICTED AND UNRESTRICTED SUBSIDIARIES

One of the first bond-like features that began appearing in term loan agreements was limiting the application of covenants and events of default to the borrower and its “restricted subsidiaries,” which has been a feature in bond indentures for years.

>> For a Practice Note explaining the role of the subsidiaries of a US issuer in the context of high yield indenture covenants, search [High Yield Indenture: The Role of the Subsidiaries](#) on our website.

Restricted subsidiaries are those not designated as unrestricted subsidiaries by the borrower. Unrestricted subsidiaries are not subject to the restrictions set out in the term loan agreement, although investments in those subsidiaries by the restricted subsidiaries and the borrower are usually limited. In return, EBITDA (earnings before the deduction of interest, taxes, depreciation and amortization) of the borrower attributable to its unrestricted subsidiaries is excluded from the financial ratio tests, including for purposes of calculating certain permissible covenant baskets, such as those for the debt covenant. The end result is more flexibility for the borrower to manage covenant compliance according to its own business plans.

For example, a borrower may wish to use its unrestricted subsidiaries to invest in a different business line with different sources of financing. The disadvantage for the lenders is less control over the borrower and all of its subsidiaries. Because the unrestricted subsidiaries usually are not covered by any of the representations and warranties, covenants or events of default, the lenders have limited ability to monitor the unrestricted subsidiaries after the loan closes.

From a credit risk standpoint, ten years ago a traditional commercial bank lender would find it undesirable for management to divert resources to a new business line that did not readily complement the existing business or designate certain important subsidiaries as unrestricted subsidiaries and then overload them with debt (especially if those actions were not contemplated in the approved business plan of the borrower). Importantly, because unrestricted subsidiaries are not required to become guarantors or collateral grantors in respect of the bank financing, lenders would also receive a lesser security and guaranty package than they would have received prior to the inclusion of unrestricted subsidiaries in term loan documents.

“BUILDER” BASKETS

In bond indentures, a builder basket is essentially a percentage (usually 50%) of cumulative consolidated net income of the borrower and its restricted subsidiaries since the closing of the financing, plus new equity infusions and return on investments. As long as there is no default, an issuer under a bond indenture can usually use this basket to:

- Make investments.
- Prepay subordinated debt.

- Pay dividends.
- Repurchase stock.

Additionally, the issuer must meet the leverage ratio or fixed charge coverage ratio required to incur additional debt payments the bond indenture.

In term loan agreements, the basket for dividend payments and stock repurchases is also frequently linked to a percentage of cumulative consolidated net income. However, historically the baskets for investments and prepayment of subordinated debt were often separately formulated based on the specific business plans of the borrower. Borrowers began to argue that, from a credit standpoint, investments and prepayments of subordinated debt are actually more benign than dividend payments and stock repurchases because the cash remained in the “system” or was used to pay down debt. Therefore, borrowers reasoned that lenders should not care if those baskets were more flexible. This would allow borrowers maximum flexibility to allocate their excess cash flow. Soon after, the builder basket construct became common in term loan agreements.

>> For more information on negative covenants, search [Loan Agreement: Negative Covenants](#) on our website.

Initially, in term loan agreements this basket was built using a percentage of excess cash flow that is not required to prepay the term loans, rather than 50% of consolidated net income. More recently, borrowers with outstanding bonds have argued that it is easier to comply with the covenants in their various debt instruments if the baskets are calculated similarly under both the term loan agreement and the bond indenture. In certain instances, banks have agreed. However, there is also one important caveat. At least when this feature was first adopted, to use the builder basket, a borrower of a term loan that also issued high yield bonds would often be required under the term loan agreement to meet a stricter or different financial ratio test than the one specified in the bond indenture.

Several high-profile deals during the early- to mid-2000s showed this trend in its initial phase, including Dex Media, PanAmSat and SunGard.

Dex Media Deals

In the 2002 Dex Media (East) credit agreement, the portion of the excess cash flow that was not required for prepayments of the term loans could be used for dividend payments and stock repurchases when, among other things, the pro forma leverage ratio was lower than 4.75x. But the same amount could not be used for investments or prepayments of subordinated debt.

In the 2003 Dex Media (West) credit agreement, the same basket could be used for dividend payments, stock repurchases and prepayments of subordinated debt (but still not



for investments) when, among other things, the pro forma leverage ratio was lower than 5x.

In both Dex Media deals, the bond indentures required the issuer to meet a 6x leverage ratio test to use the basket for dividend payments, stock repurchases, investments and prepayments of subordinated debt. Neither deal had the concept of restricted subsidiaries.

PanAmSat and SunGard Deals

Both the 2004 PanAmSat credit agreement and the 2005 SunGard credit agreement had the concept of restricted subsidiaries and a builder basket that could be used for dividend payments, stock repurchases, investments and prepayments of subordinated debt. Specifically:

- In the PanAmSat deal, both the senior notes indenture and the credit agreement required the issuer or the borrower to meet a 5.5x leverage ratio test to use the builder basket. However, under the credit agreement the borrower was not required to meet this leverage ratio test to use the builder basket for investments.
- In the SunGard deal, the credit agreement required the borrower to meet a 6.25x leverage ratio test and the senior notes indenture required the issuer to meet a 2x fixed charge coverage ratio test to use the builder basket.

>> For more information on financial covenants, search [Loan Agreement: Financial Covenants and High Yield Indenture: What are Financial Covenants and Ratios?](#) on our website.

COVENANT-LITE LOANS

Bond indentures do not contain financial maintenance covenants, which are usually found in traditional term loan agreements. However, some term loan agreements do not have financial maintenance covenants, such as the October 2005 financings for the leveraged buyout (LBO) of Neiman Marcus by TPG and Warburg. These types of loans are often referred to as covenant-lite loans.

Covenant-lite loans emerged because some borrowers complained about the costs of complying with financial maintenance covenants. Borrowers also argued that seasonality or unexpected events may only affect compliance for a short period of time, yet they must pay the same steep price for a technical default as if there was a real credit crisis.

Although covenant-lite loans are beneficial to borrowers, lenders lose the early warning signs of deteriorating credit. Lenders also have to wait until cross-defaults or other covenant defaults are triggered before they can exercise remedies. This means that the senior bank lenders are no longer “at the table” negotiating with the borrower ahead of other creditors. This result is highly undesirable for lenders during a restructuring of the borrower.

The following related Standard Clauses can be found on practicallaw.com

>> **Simply search the title OR resource number**

[Loan Agreement: Negative Covenants or 7-383-5792](#)

[Loan Agreement: Financial Covenants or 2-383-3168](#)

[Loan Agreement: Prepayment and Commitment Reduction Provisions or 2-384-1535](#)

[High Yield Indenture: Financial Covenants or 4-422-4909](#)

[High Yield Indenture: Limitation on Indebtedness Covenant or 2-386-4188](#)

[High Yield Indenture: Limitation on Liens Covenant or 2-422-4420](#)

[High Yield Indenture: Limitation on Restricted Payments Covenant or 1-422-4411](#)

In the years leading up to the financial crisis, covenant-lite loans were found in a number of deals and were widely covered by the press. Interestingly, covenant-lite loans were only selectively adopted in the term loan market. Lenders pushed back in several deals, even before the market downturn. This is perhaps the only bond-like feature adopted by term loans that has been frequently scrutinized by market participants. However, in deals with financial covenants, it is now common to set the covenant levels at a 30% cushion to the business model, making the financial covenants less meaningful than many might realize.

>> For more information on covenant-lite loans, search [Covenant-lite Loans: Overview](#) and [What's Market: Covenant-lite Loans](#) on our website.

“ALL-IN” CONFORMING COVENANTS AND PREPAYMENT PROVISIONS

Another less discussed but significant feature in the Neiman Marcus LBO was that the negative covenants in the term loan credit agreement were virtually identical to those in the bond indenture. This included covenants that only apply upon the “incurrence” or making of debt, liens, investments, prepayments of subordinated debt and payment of dividends and repurchases of equity.

Traditional term loan financial maintenance covenants apply at all times. In contrast, incurrence-based covenants, which are typical in bond indentures, allow the borrower to avoid monitoring compliance with its covenants until it is actively pursuing a transaction that would have a negative effect on its financial position. Incurrence-based covenants are increasingly being used in term loan agreements, particularly covenant-lite loans.

Additionally, in the Neiman Marcus LBO, the proceeds from a sale of assets by the borrower’s restricted group were not required to be used to first prepay the senior bank financing. Instead, the borrower could use the proceeds to ratably prepay all senior debt, including unsecured high yield notes. However, if the assets being sold are those on which the term loan has a first priority lien compared to the asset-based revolver, the borrower may only prepay other debt if it is secured by a permitted lien on the collateral that secures the term loan.

In short, these trends reflect the changing notion that senior bank financings should generally have tighter covenants than other instruments and should be the first to get paid with asset sale proceeds or even collateral proceeds.

EVENTS OF DEFAULT, EXCESS CASH FLOW SWEEP AND AFFIRMATIVE COVENANTS

Although it appeared that the convergence trend would be limited to the inclusion of bond-like negative covenants (together with their related definitions) in term loan agreements, the boundary shifted after the cooling effects of the financial crisis had faded.

In the March 2011 term loan agreement for Calpine Corporation, both the negative covenants and the events of default are identical to those in the super priority notes indenture. This means that:

- A breach of a representation and warranty is not an event of default.
- The grace period for a default in payment of interest is 30 days (instead of the usual three business days).
- The grace period for a covenant default is 60 days (instead of the usual no grace period for all negative covenants and a few critical affirmative covenants and 30 days for other covenants).
- There is a cross acceleration and cross payment default instead of the usual cross default provision.

Other borrowers with the same or substantially the same negative covenants and events of default in their term loan agreements and bond indentures include NXP, Level 3 Communications and AES. Further, the term loan agreements in these deals do not have any financial maintenance covenants.

>> For more information on events of default, search [Loan Agreement: Events of Default](#) on our website.

Additionally, none of the term loan agreements in these deals have the usual annual excess cash flow sweep and, like a high yield bond indenture, two of these deals had term loan agreements that do not include lenders’ visitation rights.

The affirmative covenants in the Calpine term loan agreement and the super priority notes indenture are also virtually identical:

- The reporting covenants were reduced to the delivery of the borrower's annual Form 10-K and quarterly Form 10-Q reports, publicly filed current reports and notices of defaults.
- The only other affirmative covenants are to:
 - maintain corporate existence, essential franchises and insurance policies; and
 - pledge after-acquired collateral and provide guaranties for additional guarantors.

The minor differences in the Calpine affirmative covenants, such as references to securities laws in the bond indenture and the reference to the National Flood Insurance Program in the term loan agreement, were mostly the result of differing regulatory regimes.

Reduced and diluted reporting covenants can also be found in the Level 3 Communications term loan agreement and bond indenture. Both provide no visitation rights to lenders and require the borrower to report any default within 30 days (instead of the usual "promptly" timeframe).

>> For more information on affirmative covenants, search [Loan Agreement: Affirmative Covenants](#) on our website.

PREVALENCE OF BOND-LIKE PROVISIONS IN TERM LOAN AGREEMENTS

A survey of a random sample of ten large public covenant-lite term loans, which include Axcan, Del Monte, Emergency Medical Services, HD Supply, Hertz, KAR Auction, Lyondell, Noranda Aluminum, TransDigm and USPI, shows that:

- Four contain bond-like negative covenants.
- None have bond-like events of default or affirmative covenants.
- Only one does not require annual prepayments from excess cash flows.

Among the sample, the types of negative covenant structures fall across a spectrum, ranging from identical negative covenants for both loan and bond documents to the traditional bifurcated structure, with a minority in the middle where some of the baskets are slightly tighter for the term loans. The fact that none of the deals in the sample have bond-like events of default and affirmative covenants shows that the traditional distinctions generally still exist in this area.

The handful of term loan facilities mentioned in this article that have bond-like events of default seem to be concentrated in a certain segment of the market, primarily large leveraged loans with at least \$500 million dollars in issued principal and at least a single B credit rating. Notably, in some deals there seems to be a tacit acknowledgement that there should

be some distinction, no matter how slight, between the term loan and the high yield bonds.

For example, in two of these term loan agreements, a breach of a representation and warranty was added as an event of default (one had the usual shorter grace period for an interest payment default and one had a tighter debt basket). Interestingly, in these deals where almost all of the covenants and events of default in the term loan agreement are clones of those in the bond indenture, the arranger and its counsel managed to convince the borrower that there should be some token boundary to distinguish the term loan from the high yield bonds.

IMPLICATIONS FOR LENDERS

The implications of this convergence trend for lenders are enormous. Without additional reporting covenants and visitation rights, the lenders have no edge over the bondholders in monitoring credit deterioration of the borrower. Without the critical differences in negative covenants and events of default, if the bonds are secured on a pari passu basis with the loans (which is the case in half of these precedents where the term loans have bond-like events of default), there is virtually no difference between the two asset classes in terms of default risks and remedies.

If the borrower's financial position deteriorates, a default would no longer occur under the term loan agreement first before it would occur under the bond indenture. As a result, the term loan lenders would no longer be the first major group of creditors to negotiate with the borrower. The term loan lenders therefore lose substantial leverage to steer a restructuring process to their advantage.

>> For a Practice Note examining a lender's available remedies upon an event of default under a loan agreement, search [Lender's Remedies and Enforcement Issues](#) on our website.

>> For an overview of out-of-court restructurings, search [Out-of-Court Restructurings: Overview](#) on our website.

Interest rates may also be affected. In fact, in the recent low default environment during the first quarter of 2012, the interest rate spread already narrowed between high yield bonds and term loans.

One main reason for the historical interest rate spread of bonds over loans has been the difference in recovery rates. As the legal rights related to default risks increasingly converge, in time enough data will accrue to show that the recovery rates for the two products have become increasingly indistinguishable in the case of pari passu secured bonds. However, it will take some time for market perception to catch up with the data. Once the market generally perceives that the spread of secured first priority bonds over loans is not warranted or

should be significantly narrowed, there may be far-reaching implications from these documentation trends for the overall term loan and high yield bond markets.

>> For information on the LIBOR interest rate (also known as the Eurodollar Rate) and various market changes to that definition and related interest rate provisions, including links to recent large corporate and middle market deals, search [What's Market: Eurodollar Rate/LIBOR Interest Rate Provisions](#) on our website.

LOOKING AHEAD

BORROWERS' PERSPECTIVE

From a borrower's standpoint, more flexible terms are always desirable because they lower the cost of compliance and allow the borrower to focus on running its business. Borrowers argue that underwriters or arrangers should not care about flexible terms as long as the deal is successfully syndicated to other investors. The structural changes in the composition of investors and the increasing negotiating power of private equity sponsors vis-à-vis arrangers and investors will likely continue the push for more borrower-friendly terms in the term loan B market. It would not be surprising to see more requests from borrowers to conform the negative covenants and events of default in term loan agreements to those found in bonds, especially when investor demand in the term loan B market is strong.

Although currently it is relatively rare to have bond-like events of default, it is conceivable that within years (or even months) the picture may look very different. Another trend may be further convergence of the affirmative covenants, as seen in a small number of deals (see above *Events of Default, Excess Cash Flow Sweep and Affirmative Covenants*). It may become more common for lenders to have no visitation rights or rights to audit the borrower's financials and operations even if there is an event of default. Additionally, lenders may not be entitled to any more reports or notices than the bondholders. Other traditional affirmative covenants may also be eroded, such as the requirement for a borrower to:

- Deliver annual budgets, management letters or collateral updates, or material notices of litigation, Employee Retirement Income Security Act of 1974 (ERISA) events and other events that can have a material adverse effect.
- Comply with laws.
- Maintain insurance and books and records.

The removal of the excess cash flow sweep is likely to be resisted by lenders in the near future. This is because, similar to the covenant-lite loan concept, it is a readily quantifiable feature focused on by the principals of the lending institutions. At most, comparable to how covenant-lite loans were received, it may be adopted only selectively in certain segments of the market.

In some other less risk-critical provisions, such as those relating to mandatory prepayments triggered by asset sales, many term loan agreements have already adopted the bond-like "offer to prepay" feature. This feature allows the borrower to keep asset sale proceeds to the extent the lenders decline to accept the prepayment offer. In the last few years, the ability of the borrower and its affiliates to buy back the borrower's debt, which has always been permitted in bond indentures, has also become commonplace for term loan agreements.

>> For information on loan buybacks, search [Understanding Loan Buybacks](#) and [What's Market: Loan Buybacks](#) on our website.

Additionally, in recent years there has been a new wave of term loans (including both covenant-lite loans and term loans with financial maintenance covenants) that permit the borrower to partially refinance the term loans with new loans or bonds, which can be secured or unsecured. Borrowers and sponsors pushing for this new feature claim that since high yield debt is supposedly less restrictive, if lenders can tolerate additional bank loans in the form of incremental facilities they should have no objection to high yield debt issuances. This argument makes sense only if the high yield debt is indeed less restrictive than bank loans. However, if market demand remains strong and the convergence trend continues (eventually making this argument senseless), this feature will likely stay in the term loan market because it affords the borrower more flexibility to manage its debt capital by switching among various asset classes.

LENDERS' PERSPECTIVE

Lenders often focus less on the "purely legal" issues which are not readily quantifiable and for which they rely on their counsel, especially issues that have at least one or two recent precedents in the market. Many of the bond-like features mentioned in this article meet these characteristics and may be appropriate under the specific circumstances.

However, before agreeing to these features, lenders and arrangers may want to carefully analyze not only their immediate effects on the deal's trading prospects, but also their actual impact in a distressed situation. The inability of senior secured lenders to call a default for a breach of financial maintenance covenants or other provisions can result in more of the borrower's cash leaving the system (and being paid to other creditors) to the detriment of the senior secured lenders.

>> For information on additional market trends in loan documentation, search [What's Market: 2012 Mid-year Trends in Large Cap and Middle Market Loan Terms](#) on our website or see page 34 in this issue.