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Published by
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59 Tanner Street
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Global Trends in Leveraged Lending

Joshua W. Thompson

Shearman & Sterling LLP

Caroline Leeds Ruby

Global trends in leveraged lending in 2013 have largely been driven by substantial liquidity in US dollar markets, together with cautious investor optimism in the face of regulatory and political black clouds on the horizon. In the face of continued Eurozone uncertainty, US fiscal policy ineffectiveness, US debt default posturing, and frothy asset markets with relatively anemic growth in maturing economies, the leveraged finance market has nonetheless remained relatively stable and a backbone to global economic stability in 2013. We discuss below specific trends in leveraged lending from 2013.

1. Market Ended Strongly

Although the market faltered at times in the early part of 2013 and the yield curve moved dramatically as a result of concerns that the US Federal Reserve would rapidly taper monetary stimulus, the global leveraged markets recovered and finished on a positive note at the end of 2013; we note, in particular, that this was despite the European market being adversely impacted by the Cyprus restructuring and the US market being adversely impacted by the temporary US federal government shut down. US primary issuance was USD $828 billion of leveraged loans, and issuance in the global market exceeded USD $1 trillion. The 2013 leveraged finance market on both sides of the Atlantic proved to be surprisingly robust, driven by an increased appetite for leveraged products by investors hungry for yield while interest rates remain low. M&A deal flow remained thin and, combined with an excess of credit supply over demand, borrower-friendly terms, higher total leverage and a reduction in pricing ensued. Dealogic reported that global average pricing decreased to 346bps in 2013. Frothiness in pricing was also matched by frothiness in deal structures; e.g., 2013 saw significant issuance of PIK notes (including PIK toggle notes) and strong continued growth in second-lien financing to over USD $30 billion; this data supports, in part, a general trend that investors have been willing to ease up on credit terms in the hunt for yield.

The majority of transactions in 2013 were in the form of opportunistic refinancings and repricings, although dividend recaps were also robust. Borrowers were keen to access the markets while interest rates remained low. New money deals were relatively modest in 2013, reflecting, in part, a subdued M&A market and significant cash "on the sidelines" at large corporates. Less than 35% of 2013 leveraged loan volume represented new loan assets. As a result of the large refinancing trend, the maturity profile of institutional leveraged debt has been pushed out to 2017, and portfolio churn has forced asset managers to work hard to maintain their leveraged loan assets under management. Soft call protection to compensate for early refinancing as part of a repricing transaction remained necessary in 2013; e.g., a borrower needs to pay a premium of 101% or 102% if its first-lien loans are refinanced with loans with a lower effective yield (based on margin and OID) within a specified period after initial funding (ranging from six months to two years). The depth and breadth of liquidity in the US leveraged loan market, together with lower US pricing, provided cross-border financing opportunities to both European and Asian borrowers that were unavailable in their home markets. A significant trend in 2013 was that European and Asian borrowers robustly accessed the US credit markets to borrow term loan B facilities and to enter the high yield market. The Asia Pacific leveraged market remained relatively small with about 18% of the volume of high yield issuance in the US (compared with Europe, which has about 60% of the volume in the US), but is showing signs of growth.

2. The Reshaping of Liquidity and CLO Issuance

Liquidity from the traditional bank market shrunk in 2013 as banks were affected by increased regulation. However, those banks that had repaired their balance sheets re-emerged in 2013 as underwriters of larger facilities and facilitated other liquidity solutions that have strengthened the leveraged loan market. For example, CLO issuances increased dramatically in 2013: USD $818 billion of CLOs priced in 2013 compared with USD $54.3 billion in 2012, and the CLO market shows continued strength in 2014. The resurgence of this form of securitisation reflects the continued normalisation of the global credit markets in 2013 and a stabilisation of the money supply.

Investors' appetite for yield through leveraged exposure to the loan asset class coupled with managers' desire to build assets under management in advance of the effective date for the risk retention rules (e.g., rules that may effectively require managers to retain 5% of the securities issued by the CLO) drove a significant demand for CLO investments among managers and junior noteholders. The limiting factor currently seems to be a scarcity of AAA investors despite spreads in the AAA tranches of about 145-150 basis points over LIBOR. This scarcity was, in part, driven by a combination of regulatory uncertainty and the effects of Basel III. For example, the Volcker Rule prohibits banking entities from acquiring or retaining any "ownership interest" in covered funds. Since an actively managed CLO with a bond basket would be a covered fund, and since the rights of senior noteholders to remove a CLO manager prior to an event of default could be viewed as a prohibited ownership interest, it is likely that some banks are passing on CLO investments while the uncertainty persists. The Volcker Rule exempts loan-only CLOs from the covered fund definition, and it is likely that banks will show increased willingness to invest in the senior tranche of such CLOs. The Basel III treatment for securitisations is also still in flux, and although the most recent proposals decrease the capital requirement for certain securitisation exposures compared to earlier proposals, the capital requirement for other securitisation exposures has been increased. The European risk-retention rules have a similar effect. Failure to satisfy the risk-retention requirements imposes higher capital charges on financial institutions investing in such non-conforming securitisations. Until recently, it seemed possible for certain third parties to retain the required risk, while newer guidance seems to retreat from that position and reintroduces uncertainty among European AAA investors, again with what is likely to be a dampening effect on demand among affected financial institutions.

Basel III also introduced a new requirement: the Net Stable Funding Ratio. This is a metric designed to mitigate funding risk and which, among other things, would require 5% of undrawn portions of committed credit facilities to be matched by stable funding (where regulatory capital and deposits are regarded as the most stable type of funding). In addition, this ratio, intended as a constraint against excess leverage and the gaming of risk-based capital requirements, does not involve a recognition of the risk exposure – reducing effects of any credit mitigation techniques (e.g., through guarantees, CDS, collateral or netting of loans and deposits). This is widely regarded as resulting in higher capital requirements for banks, which in turn has a dampening effect on loan asset growth.

Alternative finance entities continued to emerge in 2013 as liquidity providers and active market participants (e.g., insurance companies, pensions, wealth funds, private equity funds, hedge funds and credit funds). These non-bank entities were generally able to provide more flexible credit structures (e.g., unitranche financings) and take advantage of regulatory overhang in 2013. The emergence of business development companies (BDCs), being investment funds which lend to the middle-market in exchange for robust returns at relatively low leverage levels, also presented a compelling alternative for investors in 2013. Many of these alternative providers are not subject to the constraints of Basel III and are deemed to operate in the shadows of the traditional banking sector; as such, they represent stiff competition for the regulated banks and traditional structured finance market. This is but another example of investors' appetite for high yield and corresponding tolerance for higher risk.

3. European and Asian Borrowers Accessing the US Loan Financing Markets

There was continued appetite among European and Asian borrowers to raise dollar-denominated term loan B leveraged facilities in 2013, as such TLB loans were available with lower pricing than equivalent debt products in domestic European currencies and often were "cov-lite", meaning no financial maintenance covenants applied. Cash-rich US investors facing a limited supply of deals warmed to foreign borrowers in 2013. Nearly 30% more European companies raised dollar loans in the US institutional market last year than in 2012, the clear trend being that the TLB market is showing signs of becoming a global, rather than regional, market. The structural currency risk presented by these cross-border deals where a borrower does not have sufficient US dollar cash flows for a natural hedge raises complexities that may burden this market in the coming years.

4. Cov-lite Loans

A significant proportion of sponsor TLB loans issued in the US markets are cov-lite, and 2013 saw lower-rated corporate borrowers seeking cov-lite terms. Cov-lite deals traditionally exclude quarterly-tested financial maintenance covenants, but many still retain incurrence-based financial covenants (i.e., compliance with a fixed-charge coverage test or leverage test measured at the time debt is incurred, investments made or dividends issued). In addition, some revolving credit facilities only contain a springing financial covenant that is tested only while the RCF is drawn upon or the outstanding borrowings thereunder exceed certain predetermined thresholds. Financial maintenance covenants in the TLB market still remain relatively common where the TLB is structurally subordinated to an amortising term loan A or where the structure is all senior with no subordinated debt.

Borrowers with cov-lite terms effectively have a longer period of time to deal with underperforming companies without having to negotiate with syndicate lenders, but at the cost of increased credit risk to the lenders who are losing the early warning signs of deteriorating credit. Lenders also have to wait longer to reprice cov-lite loans resulting in greater credit risk exposure and the prospect of lower returns. Restructuring of a borrower of a cov-lite loan is likely to happen at a later stage of financial distress and in a more compressed time frame when fewer options may be available to preserve enterprise value. Senior bank lenders may no longer be "at the table" negotiating with the borrower ahead of other creditors. However, it is interesting to note that recovery rates for US borrowers of cov-lite loans do not seem to have been less than for loans with maintenance financial covenants. There is little data yet for Europe where bankruptcy laws are generally less creditor friendly than Chapter 11 of the US Bankruptcy Code.

Cov-lite issuance increased dramatically during 2013 and represented a majority of total issuance in the United States, and Thomson Reuters LPC reports that the total issuance was USD $381 billion versus the prior 2007 record of USD $108 billion. There have been reports that CLOs have been increasing the proportion they are permitted to invest in cov-lite loans from 30-40% to 50% and narrowing the definition of cov-lite for the purposes of their investment guidelines to allow greater investment in the asset class. The abundance of cov-lite loans was highlighted in a paradoxical statement by a senior analyst at Moody's Investors Services, who noted that if one does come across a new transaction today with a full set of maintenance covenants, this may "*suggest other problems with the credit, maybe that it is new to the market or exiting from bankruptcy*".

In the Interagency Guidance on Leveraged Lending, 78 Reg. 17766 March 22, 2013 (the "Leveraged Guidance"), US regulators expressed concerns regarding the additional risk cov-lite loans carry compared to loans with financial maintenance covenants and indicated that they would review such loans as part of the overall credit evaluation of an institution. It is possible that increased regulation or a rise in the default rate may affect cov-lites in the next couple of years. US regulatory focus on counter-cyclical monetary policy in the leveraged finance market to control asset bubbles was a notable and significant trend in 2013; it remains to be seen how this new regulatory focus will play-out and the potentially new competitive landscape that will evolve in response.

5. Amend and Extend Transactions

2013 saw borrowers elect to negotiate an amendment and extension of their facilities at lower pricing rather than incur the fees for a full refinancing. Amendment fees were often between 50 and 100bps for a European amend-and-extend ("A&E") transaction, which is much cheaper than a refinancing. CLOs nearing the end of their reinvestment period also preferred A&E transactions as they locked in yield for a longer period. In the US market, it is common for A&E transactions to only require the consent of the majority of affected lenders. Recent changes have been made to the European Loan Markets Association precedent facilities agreement to also allow for structural changes with the consent of only the majority of affected lenders and to allow non-*pro rata* debt buybacks by a modified Dutch auction.

6. Accordion Facilities

US facilities often have an accordion feature allowing the introduction of new tranches of debt by upsizing existing facilities or allowing incremental equivalent debt in the form of a new term loan tranche or an increase in an existing revolving credit commitment or the issuance of second-lien or subordinated debt, subject to certain terms and conditions. Generally such incremental loans (or, in certain instances, notes) are subject to a dollar cap and/or the satisfaction of a leverage test alongside the requirement that existing loan financial covenants be complied with unless the majority lenders agree to vary them. A new incremental tranche is almost always required to have a later maturity and a longer weighted average life to maturity than the existing or initial tranche(s). US facilities usually also include a most favoured nations (MFN) clause. If the effective total yield (including OID, margins and floors) on new *pari passu* debt exceeds that on the existing debt by an agreed amount (usually 50bps), then the margin on the existing debt increases to reduce that differential to only 50bps – thereby providing the existing lenders with interest rate protection for the excess in the effective yield differential over 50bps. Sponsors have sought, with mixed success in 2013, that the MFN interest rate protection end, or "sunset", after a period of time (usually 18 months). One of the primary reasons is that in a situation where the original loan and incremental loan have identical terms but are issued for different prices that result in different accruals of OID (or one loan having OID and the other not), there is the question as to whether the loans are fungible from a tax perspective (bearing in mind that tax non-fungibility will impair liquidity and therefore potentially increase the all-in effective cost to the borrower). In Europe, accordion facilities have often been limited to uncommitted acquisition or capital expenditure facilities but US style accordion features are appearing. It is becoming more usual for European intercreditor agreements to provide for the introduction of new *pari passu* debt and the possible release and re-grant of security where this is the only route under local law for such security to secure the new existing debt.

7. Structural Adjustments

Structural adjustment provisions are now often included in both US and European credit agreements. Introduction of a new tranche or increase or extension of an existing facility or an extension of a payment date or reduction in pricing requires only the consent of the affected lenders and the majority lenders (typically 50.1% of lenders in the US and 66 2/3% of lenders by commitment in Europe). These provisions have been used to allow borrowers to reprice or amend and extend without unanimous lender consent.

English law schemes of an arrangement have been used successfully by both English and non-English borrowers to cram down dissenting senior lenders to achieve a restructuring of facilities (such as the Icopal deal).

As A&E transactions have become easier to do, forward start facilities have become less common. Forward start facilities are facilities previously seen in the European market, which are negotiated 12 to 24 months before existing facilities mature, and become available upon the maturity date of existing facilities. These facilities remove refinancing risk for the borrower but are more expensive than A&E transactions.

8. Dividend Recapitalisations

Dividend recapitalisations remained an important part of the story in 2013, continuing a strong trend from 2012. Return of capital through dividends, *in lieu* of full exits, has remained attractive to asset owners where exits are not optimal and the cost of debt remains relatively modest on a WACC basis. Repeat "drive-by" dividend recapitalisation deals have been received by the market with mixed success, but have remained, while the market remains highly liquid, reasonable and plausible deals to bring to market for stronger stable credits. Certain credits that were on the cusp of exits in 2012 were converted to dividend recap deals in late 2012 and early 2013 due to weakening sell-side conditions, but were able to exit completely in 2013 as sell-side stories improved; a heart-warming story of dividends followed by very attractive P/E exits for these sponsors. For those sponsors that have pushed the envelope on leverage and fixed charge coverage ratios, dividend recap deals have, occasionally, led down the less pleasant path of negative ratings actions, increased negative scrutiny by investors and a scepticism when the credit returns to market for refinancing; this was particularly the case for credits where the equity investors had already received a complete cash return of equity.

9. Downward Pricing Trends and Reverse Flex

Strong credits took advantage of market conditions in 2013 to push the envelope on pricing through so-called "reverse flex" during syndication. In March 2013, approximately four times as many deals saw pricing move down versus deals that were forced to increase pricing. In response to strong investor demand, issuers continue to push down pricing during syndication, tightening spreads and accelerating commitment deadlines. However, explicit "reverse flex" provisions in commitment papers were rare in 2013 and reserved only for the most creditworthy and sought-after borrowers in bespoke circumstances.

10. Convergence of Bank and Bond Terms

There continues to be a convergence between high yield bonds and the TLB market, particularly as the same investors continue to invest in both products. Bond style features are now often seen in US facilities, and some are appearing in European and Asian term facilities, particularly where a borrower already has US facilities. These include:

(a) the ability to designate subsidiaries as "Unrestricted Subsidiaries" (which are ring fenced but to which many of the covenants and events of default do not apply);

(b) the inclusion of builder baskets, being a percentage (usually 50%) of cumulative consolidated net income (or retained excess cash flow) plus new equity injected plus returns on investments, which can be used (in the absence of a default and subject to compliance with a leverage ratio test) to make investments, pay dividends, return capital or prepay junior debt; and

(c) being subject to some negative covenants mirroring those of high yield bonds; e.g.: debt may be permitted to be incurred subject to satisfaction of a *pro forma* leverage test (rather than a cap); liens to secure debt may be permitted subject to satisfaction of a tighter *pro forma* senior secured leverage test or if such liens are silent junior liens, and, in each case, subject to an agreed intercreditor agreement; and asset sales may be permitted for fair market value where 75% of the consideration is in cash and where proceeds are reinvested or used to prepay the term facilities.

The negative covenants in a European super senior RCF for a bank and bond financing are generally the same as those incurrence covenants in the applicable bond indenture together with a restriction on purchasing notes over a threshold without reducing the super senior revolving credit facility *pari passu*. European lenders generally still require customary loan style affirmative undertakings, a cross default, loan style insolvency event of default tailored for the jurisdictions concerned, a grace period for non-payment of three business days and breach of representation event of default and, for term loan financings, an excess cash flow sweep.

In the US market, traditional distinctions generally still exist for term loan events of default and affirmative covenants from that contained in the high yield bond market. However, in a small number of recent deals in the US market, there has been a gradual move towards: (i) events of default and affirmative covenants that are similar to those in the bond indenture (where a breach of a representation is not an event of default); (ii) a longer grace period for a payment default (instead of the usual three business days); (iii) a longer grace period for a covenant default (instead of no grace period); (iv) no annual excess cash flow sweep (which is strongly resisted by lenders who are looking for a clear path to deleveraging); and (v) a cross acceleration and cross payment default instead of the usual cross default provision. Even though at this stage the convergence of bond-like events of default and affirmative covenants remains relatively small (and often concentrated in certain segments of the market), it is not inconceivable that this trend may strengthen in years to come.

11. Super Senior Revolving Credit Facilities and "First Out" Facilities

"First out" RCFs have traditionally been relatively uncommon in the US market but gained popularity in 2013 in middle-market financings and restructurings. In these deals, RCF lenders seek additional protection as compensation for the low yield on these types of facilities, which are typically only drawn when the borrower comes under financial pressure. The RCF and term lenders share the same collateral on a *pari passu* basis, but the proceeds of the collateral enforcement are paid first to the RCF lenders under a waterfall usually included in the security documents or in an intercreditor agreement. The documentation will provide for class voting on changes affecting the first-out structure such as an increase in the RCF, and control on enforcement. Revolving lenders' ability to control enforcement remedies, as well as their rights in a bankruptcy, are often highly negotiated and frequently depends on their leverage in any particular deal. Super senior RCFs ("SSRCFs") continue to be popular in Europe as the European borrowers continue to access the secured senior bond market. The SSRCF has super priority with respect to recoveries from security or distressed disposals of collateral and related claim releases. However instructions of the bondholders with respect to enforcement will trump those of the SSRCF lenders for a certain period (usually six months) following an event of default if the SSRCF has not been discharged in full and in other specified circumstances such as insolvency of the debtor. The SSRCF usually only has one or two financial covenants such as an interest and/or a leverage financial covenant and has negative covenants mirroring those in the bond. Financial covenants may only be tested when the RCF is drawn or before it is drawn.

12. Portability

2013 saw a limited number of US facilities with a "pre-cap" or "portability" feature. These provisions permit a change of control to occur (and, therefore, no mandatory prepayment will be required and no event of default will occur) if the company is sold to an eligible sponsor or company with a similar business and subject to meeting certain conditions; e.g., these conditions usually define, among other things, acceptable buyers, time constraints, minimum equity contributions and *pro forma* leverage tests to be satisfied. For example, the purchaser must be over a certain size/credit rating and the transaction must occur within a maximum of 18 months and is subject to a minimum equity contribution requirement and maximum debt incurrence test. The precap deal may also include a modest step-up in interest margins following the transaction or the payment of a fee in connection with it. This structure is beneficial for private equity buyers and sellers who are able to avoid a costly refinancing. This feature is less popular with investors who are wary of losing control over those to whom they are lending. Investor reservations mean that only top companies in a strong market and in a very strong transaction usually qualify for a pre-cap. Even though some sponsors tried in 2013 to make this a permanent feature of the market, US bankers do not see pre-cap becoming a widespread market norm (in contrast to cov-lite loans); rather it will likely remain an exceptional provision to be used only in specific circumstances and subject to significant market testing prior to deal launch.

While portability features are seen in high yield bonds issued by European investors, the portability feature has not taken off in the European or Asian loan markets. It may also present regulatory challenges.

13. Unitranche Facilities

Unitranche facilities remained popular in 2013 in both the European and US mid-market and the trend was in increasing deal size in both markets. Unitranche facilities, which combine the senior and junior tranches into one unified layer of debt under a single credit facility, are often provided by alternative lenders such as credit funds and private equity funds. They fall between senior and mezzanine debt in terms of leverage pricing and risk. While unitranche facilities are often fully "bought" deals (e.g., thereby carrying no market syndication risk for the borrower), they do present additional complexity for borrowers as a result of the intercreditor agreement among the tranches (the so-called agreement among lenders (AAL)). The borrower is not a party to an AAL so, unless otherwise regulated by other credit documents, the borrower will often not be aware of significant matters that may affect the credit (e.g., voting arrangements that may be decisive in a workout). However, with fewer lenders (and, often, a single lender) providing the debt in connection with a unitranche structure, a borrower benefits from more streamlined negotiations and much greater flexibility on terms. One material disadvantage is the uncertainty as to how courts will treat this structure in a bankruptcy scenario – unitranches have not yet been meaningfully tested in bankruptcy courts (that being said, the absence of extensive caselaw suggests that few sophisticated investors have been willing to invest the resources to test the efficacy of the structure).

Unitranche facilities can be highly bespoke. They may have a bullet repayment, cash and PIK interest, call protection and incurrence and maintenance covenants (or a mix of the two). Typical unitranche lenders cannot usually provide working capital or hedging facilities, so one or more banks usually have to provide these and they will generally rank as super senior creditors being paid out first from recoveries but with no rights to block payments on the unitranche facilities. Unlike in a super senior RCF in a bank bond structure, the senior lenders do not have separate voting rights but will vote with the junior lender. However, it is common for the unitranche structure to include certain additions to the list of matters requiring unanimous lender consent so that the senior lenders cannot be outvoted on these matters. The senior lenders may also have an independent right to enforce on the occurrence of certain events of default after an agreed period or can take over enforcement after 6-9 months.

14. Syndicate Control

Given the wider variety of possible investors, 2013 saw sponsors and significant corporate borrowers continuing to seek more control over the identity of potential lenders including imposing white lists/black lists and enhanced consent rights. This reflects a trend that certain investors have become more activist.

In the context of assignments, disqualified lender provisions continued to be heavily negotiated in 2013, and sponsors came out of the gate recently asking for a blanket prohibition against assignments to "competitors" (typically undefined and therefore very broad in application) and certain affiliates thereof. Arrangers have generally been successful in limiting the competitor concept, in many cases getting sponsors to agree that all disqualified institutions, including competitors and competitor affiliates, must be expressly identified to the arrangers prior to the execution of the commitment letter.

15. ABL Deals

In 2013, ABL facilities allowed borrowers to obtain higher leverage at a lower cost compared to cash-flow-based term debt, while also providing certainty of execution and a flexible covenant package. ABL deal flow was relatively weak in 2013 (e.g., approximately 320 deals with a value of USD 75 billion; many of which were renewals or upsizings). Asset-based lenders remained mired in a market burdened by limited deal flow and few signs of any near-term pickup.

Syndicated ABL tranches as part of leveraged deals were rare in cross-border deals in Europe and Asia as more complex structuring considerations arise; e.g., these deals often involve a sale of receivables to an SPV to ensure satisfactory recoveries on a bankruptcy under the less creditor-friendly bankruptcy laws in certain European and Asian jurisdictions. These structures remain, generally, more expensive and time consuming to implement than US ABL structures. Conversely, US ABL structures, which often involve lending to opcos with monitored strictly defined borrowing bases and cash dominion mechanisms, demonstrated very robust to total recoveries upon bankruptcy, according to a 2013 Fitch Ratings report.

16. Equity Cures

In both the US and European markets, 2013 continued to see a widespread acceptance of equity cure rights, but with continued discussions around permitted amounts, use in consecutive fiscal quarters and the application of equity cure proceeds to repay debt. An equity cure right allows an injection of capital into the borrower group to stave off or 'cure' a financial covenant default. When lenders agree to include such provisions, they generally take comfort from the fact that, in exercising them, sponsors will inject further equity or subordinated debt into the group, providing both additional funds and a show of commitment.

17. Regulatory and Political Overhang

Globally, the strong flow in the leveraged finance pipeline in 2013 occurred in an uncertain regulatory environment that cast a long shadow on both lender and issuer behaviour. In the United States, Federal Reserve actions around interest rates and QE tapering at the end of 2013 contributed to heightened volatility in the high yield bond market and periods of intermittent bond outflows. Risk retention, the yet-to-be finalised Basel III requirements, Federal Deposit Insurance Corp. assessments, the Volcker Rule and the Leveraged Guidance are among current and pending regulatory rules with which banks are now faced.

On a positive note, 2013 ended with the passage by the US House of Representatives of a bipartisan, two-year budget agreement, indicating that more shutdowns or standoffs are unlikely. This is a sign that perhaps 2014 will bring more economic visibility and certainty for corporate borrowers and investors alike, hopefully alleviating some of the near-term political uncertainty that global financial markets have had to endure.

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Joshua W. Thompson

Shearman & Sterling LLP
599 Lexington Avenue
New York, NY, 10022
USA

Tel: *+1 212 848 8703*
Fax: *+1 646 848 8703*
Email: *joshua.thompson@shearman.com*
URL: *www.shearman.com*

Joshua W. Thompson, Co-Head of the Global Finance Group and Co-Head of the Leveraged Finance Group, is resident in the New York office. He focuses his practice on complex financings, including acquisition financings and other leveraged lending (including leveraged buyouts, tender offers and other going private transactions), structured financings, second-lien financings and mezzanine investments. In addition, he has extensive experience representing debtors, creditors, management and investors in complex restructurings, work-outs, bankruptcies and acquisitions of troubled companies. As counsel for lead arrangers and private equity sponsors, he is involved in all aspects of deal structuring, negotiation and documentation. Josh is recognised as a leading practitioner for bank lending by IFLR 1000 and Legal 500, which notes that "clients are 'happy to put trust and faith' with the 'excellent' team head."
Josh also is the former general counsel of Jefferies Finance.

Caroline Leeds Ruby

Shearman & Sterling LLP
Broadgate West, 9 Appold Street
London, EC2A 2AP
United Kingdom

Tel: *+44 20 7655 5944*
Fax: *+44 20 7655 5500*
Email: *cleedsruby@shearman.com*
URL: *www.shearman.com*

Caroline Leeds Ruby, a partner of the firm, is resident in the London office. She represents banking and corporate clients and private equity and fund investors in complex cross-border financings in developed and developing markets, including acquisition financings, leveraged lendings of all types (including going private transactions, mezzanine and PIK loans), financings to funds, receivables financings, debt buy-backs, multinational restructuring transactions, work-outs, distressed purchases and defaulting loans. As counsel for lead arrangers and investors or corporate borrowers, she is involved in all aspects of deal structuring, transaction management, negotiation and documentation.
Caroline is ranked as a leading lawyer by Chambers UK 2013. "A range of impressed clients note that Caroline Leeds Ruby is 'really first-class,' 'stays cool under pressure' and has 'excellent business acumen'."

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GLG
Global Legal Group

59 Tanner Street, London SE1 3PL, United Kingdom
Tel: +44 20 7367 0720 / Fax: +44 20 7407 5255
Email: sales@glgroup.co.uk

www.iclg.co.uk