The Association of Corporate Treasurers

Syndicated loan facilities:

non-bank Lenders, and the influence of credit derivatives: current issues and opportunities for Borrowers

Part 1

TREASURY, RISK AND FINANCE PROFESSIONALS

ACT

Produced with assistance and sponsorship from
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London, July 2007

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Part 1

Non Bank Lenders

The climate for raising syndicated debt in the UK is currently more favourable to Borrowers, especially in the leveraged market, than at any time over the last 10 years. Factors include low interest rates, the growth in the appetite of collateralised loan obligation vehicles ("CLOs") and hedge funds, the private equity boom, the immense growth in the secondary loan markets, the hedging and arbitrage capabilities of credit derivatives, and the development of synthetic securitisation techniques. All these have combined to bring significant benefits to Borrowers, in terms of facility size, pricing and covenants. "Covenant mulligans", which allow a breach on a covenant testing date to be ignored unless repeated on the next, have been succeeded by the arrival from the US of so-called "covenant-lite" deals, without the tight financial controls that have traditionally typified syndicated lending.

These benefits however bring with them some challenges for Borrowers, and the purpose of this note is to focus on some aspects of two of these:

- the increased numbers of non-bank Lenders participating in lending syndicates (Part 1, below), and
- the influence of credit derivatives on syndicated loans (Part 2 http://www.treasurers.org/technical/resources/lma/synloanfacil-part2.pdf).

Non-bank Lenders

There has been widespread press coverage of the vast increase in non-bank Lenders in the syndicated loan market, especially in the leveraged sector. For example, Standard & Poors have reported that in March 2007, the proportion of European leveraged finance accounted for by banks dropped below 50% for the first time; ten years ago, the figure was 95% (Financial Times, 1 May 2007). The non-banking entities with the biggest appetites for syndicated debt appear to be CLOs (38% according to Standard & Poors), hedge funds and insurers.

The debate

Debate continues about the attitude Borrowers should take to non-bank Lenders. Some are negative. It is often alleged that hedge funds lack the inclination and resources to work with a Borrower in the traditional bank fashion, and that CLOs are liable to sell at the first sign of deterioration. A common concern is that the success of a rescue could be jeopardised by rapid trading for short term profit, and by the resulting difficulties for a Borrower in identifying and communicating with its Lenders.

Others however say that this is to miss the point, that without the CLOs and hedge funds, Borrowers would not have access to the liquidity and pricing opportunities that they are currently enjoying. Borrowers should not anticipate that in a downturn these non-bank Lenders would be uniformly problematic. On the contrary, it is said, these funds can be more flexible and creative than a traditional Lender, with faster approval processes than a bank. There is a great diversity in approach among the many funds in the market, so that a generalised view that they may create difficulties in a restructuring is not justifiable.

Confidentiality

Another issue is the protection of confidential information. There are concerns about the application of a duty of confidentiality to non-bank Lenders, and its scope. Further concern focuses on the ability of some non-bank Lenders to receive material non-public information.

These concerns are not in the current circumstances confined to legal theory. In the light of the very substantial increases in the participations in syndicated loans taken by non-bank institutions, the FSA is now monitoring daily price movements in the loan trading markets (FT.com, 2 July 2006). The aim is to determine whether some investors may be engaged in insider trading. According to the FT, "*Some bankers fear that hedge funds may be getting access to privileged information via these loan purchases, and then using that data to trade other instruments, such as CDS or shares*". In April 2006, the LMA published a paper reminding lenders about their obligations in relation to confidential and price-sensitive information about Borrowers, and in December 2006 joined a number of major trade organisations, including ISDA, LIBA and the LSTA, in endorsing a paper reiterating the same points.

Withholding tax

Another major concern for Borrowers in relation to non-bank Lenders is withholding tax. This is an issue which is not addressed by this note but which Borrowers should not overlook.

Balancing the issues

While many Borrowers, in both the investment grade and leveraged markets, would like some control over syndicate membership, most recognise that this issue is only one of many to be included in a balance. There will usually be many other important requirements – facility size, pricing, financial covenant headroom and so on. The view of the Arrangers will also be a determining factor: tradability is usually one of their priorities.

The purpose of this note is not therefore to express a judgment as to the role of non-bank Lenders in lending syndicates, but rather to highlight some of the methods currently available to those Borrowers wishing to control syndicate membership, and to identify some of the provisions which many Borrowers are currently deploying to manage their Lenders.

Syndicate membership

Discussion about membership of the syndicate focuses on two distinct periods: primary syndication and the secondary market.

Primary syndication

During primary syndication, it is widely accepted that the Borrower's approval is required for the inclusion of a prospective Lender in the syndicate. Syndication strategy, including selection of members, is usually set out in the Mandate Letter or Term Sheet for the transaction. Typically, provision will be made for invitations to be sent to financial institutions fulfilling a set of criteria, or on a list previously agreed with the Borrower; but Borrowers need to take care to focus on this issue at an early stage, as for example the LMA form of Mandate Letter gives them only consultation rights in relation to prospective members of the initial syndicate.

On an acquisition financing, the sponsor will often insist that syndication takes place after signing, so that it takes a credit risk at signing only on the underwriters; the underwriters usually agree, recognising that the Borrower is paying substantial fees and that the process of negotiating the loan documentation may be easier with fewer parties involved.

The secondary market

Practice varies in relation to loan trading after primary syndication has closed and the loan documentation is signed. Lenders aim to minimise any restrictions on trading, as these will have a negative effect on liquidity in the secondary market, and also on the credit derivatives markets, where a loan participation may be required to be transferred to a third party (more on this in Part 2). While Borrowers (both investment grade and leveraged) are often able in the current market to insist that their consent to a transfer must first be obtained, they often have to concede that this requirement will fall away on the occurrence of an Event of Default (almost invariably in the leveraged market). Although this position represents an improvement for leveraged Borrowers, in comparison with the situation a few years ago, when it was more usual for them to have consultation rights only, it remains to be seen how market practice in relation to transfer provisions will develop.

The Lenders of record

Trading in the secondary market usually takes one of three possible legal forms: novation, commonly referred to as a transfer; assignment; and sub-participation. Following a novation, the purchaser assumes the rights and obligations of the seller, and thus enters a contractual relationship with the Borrower. An assignment transfers rights only, but gives the purchaser a claim directly against the Borrower. A sub-participation, by contrast, is a back-to-back contract between seller and purchaser, under which the purchaser has no direct relationship with the Borrower. As a result, while transferees and assignees become Lenders of record, a sub-participant does not.

Loan documentation conventionally imposes restrictions only in relation to transfers and assignments, as sub-participants do not become Lenders of record with a direct relationship with the Borrower. (The LMA documentation follows this model.) The focus of the rest of Part 1 of this note is therefore on the Lenders of record, who acquire interests through transfer or assignment. The powerful economic influence of transactions "behind the scenes", such as sub-participations, should not however be overlooked, and will be illustrated by Part 2 of this note, which will focus on the impact of credit derivatives.

There are two main tools available for Borrowers to exert control over membership of the syndicate in the secondary market:

- The class of permitted Lenders.
- The requirement for the Borrower's consent for transfers and assignments.

Permitted Lenders

Many syndicated loan facilities adopt the LMA requirement for Lenders to be a bank, financial institution or "*a trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets*". The LMA class of permitted Lenders is thus very broad, and includes for example CLOs, hedge funds and distressed debt specialists, as well as insurance companies and pension funds.

A recent decision of the Court of Appeal has made it clear that in order to qualify as a financial institution, in the context of a loan facility, an organisation need only be a "*legally recognised form or being, which carries on its business in accordance with the laws of its place of creation and whose business concerns commercial finance*". In particular, it is not necessary that an organisation's business should include "bank-like activities". The class of permitted Lenders is therefore very broad, where the LMA language is used.

In the current climate, Borrowers are able to negotiate specific exclusions from this class, especially in the leveraged market. For example, a list of institutions which are not acceptable may be settled, or industry competitors may be excluded, by name or by reference to a sector. In the leveraged market, some sponsors routinely exclude named funds from the class of permitted Lenders; there has been extensive press coverage of private equity funds blackballing certain hedge funds, as they are liable to take opposing views in a corporate collapse.

Consent to transfers

The requirement for the Borrower's consent to a transfer or assignment is standard in the UK for investment-grade Borrowers. For example, the LMA loan documentation for investment-grade Borrowers includes a requirement for the Borrower's consent to transfers, though it may not be unreasonably withheld or delayed.

There is no such requirement, however, in the LMA leveraged facility documentation, which merely requires consultation with the Borrower, though not after an Event of Default has occurred. The right to be consulted is of course much less valuable to the Borrower than a right of veto.

However, as mentioned earlier, in the current market sub-investment grade Borrowers are often able to negotiate a veto, although this falls away almost invariably after an Event of Default has occurred. The value of the veto is of course greatly reduced if it ceases to apply once an Event of Default has occurred. In those circumstances, the scope of the class of permitted Lender would clearly be important.

A reasonableness requirement is standard practice. Other qualifications that may be settled include defining some of the circumstances where it would not be unreasonable to refuse consent. Examples include where the institution has previously been in a minority of Lenders refusing consent to a request.

Although the Borrower's consent for transfers is required in more facilities than was the case a few years ago, it is likely to remain a key issue for debate, given the importance of tradability in the market. Individual Borrowers will need to determine the importance to them of the identity of their Lenders in the context of all their priorities when negotiating a new facility, and settle the transfer provisions with their Arrangers when agreeing the Term Sheet.

Related to the issue of control of syndicate membership are a number of strategies for managing the syndicate which have become familiar to the market in the last few years.

Managing the syndicate

In the current market, Borrowers, especially in the leveraged sector, are often able to negotiate a range of other provisions which, taken together, can bolster their position significantly. These other tools can include:

Meaningful consultation: the consultation process can be prescribed – for example, consultation can be required to be for a minimum period to ensure that it takes place properly, and to give the Borrower time to suggest alternatives.

Syndicate size: it is common to provide for minimum hold amounts for MLAs, and substantial minimum transfer amounts.

Disenfranchising ("snooze and lose"): the increasing numbers of non-bank Lenders in syndicates, such as hedge funds, which typically are not geared up to deal with Borrower requests, have led to a widespread acceptance of "snooze and lose" provisions. In these provisions, the commitment and/or participation of a Lender is disregarded if it fails to respond within a fixed period (usually between 5 and 15 Business Days). A variation is "delay and it's ok". Borrowers should beware however that the existence of these rights may prompt a swift negative response to consent requests. However, they can be useful in conjunction with "Yank the bank" provisions (see below).

Removal of Lender ("yank the bank"): The basic version of this provision, in the LMA leveraged loan documentation, allows a Borrower to arrange for a Lender to be taken out at par by another Lender or other institution, following claims under the gross up clause, the tax indemnity, or a claim for increased costs. It also applies where a request requires unanimous consent and a majority have consented, allowing the refusing or snoozing Lender to be taken out at par. The second element of the provision is not always acceptable to syndicates, as it could effectively allow a Lender an exit route at par in difficult circumstances, when otherwise its recovery rate would be rather less. Borrowers should note also that even if the provision is included, success at the time of a dispute will depend on finding a Lender willing to buy at par. It will be important, as a practical matter, to include authorisation for the Agent to sign the transfer documents on behalf of the Lender being taken out.

Reduction in majority required for consent/waiver: Another noticeable trend in the leveraged market at the moment is for weaker Lender consent provisions. Fewer matters require unanimity. The introduction of a 90% majority requirement for certain decisions is another feature. In particular, Borrowers are increasingly settling a requirement for supermajority consent, rather than unanimity, to the release of security. In addition, an increasing number of decisions requires only 50% instead of the usual 66%. This trend is expected to continue.

No gross up: the LMA documentation reflects market practice, entitling a new Lender to grossed up payments only to the extent that the old Lender would have been entitled to them. Although conventionally regarded as a disincentive to prospective non-bank Lenders, this provision has not always succeeded in deterring hedge funds from participating.

Confidentiality undertakings: The LMA loan documentation, in line with market practice, sets out the circumstances in which Lenders may disclose confidential information. These include to a prospective transferee, assignee, sub-participant and credit derivative seller. It is also conventional for a confidentiality undertaking to be required from the recipient of the information. As the LMA documentation presents the requirement for the confidentiality undertaking as an option, Borrowers need to insist on it. They should also ask for express confidentiality undertakings to be set out in the loan agreement; these provide better protection than any implied obligation, and are now seen regularly.

Notice of Lenders' names: in cases where there is no requirement to consult the Borrower, or obtain its consent, it will be helpful to the Borrower if the Agent is obliged to notify it, on request, of the names of the Lenders and their participation size.

Possible Borrower action: summary

Borrowers with concerns about the role of non-banks in their lending syndicates will need to balance them against their other priorities, such as facility size, pricing and terms. In that context, they may wish to consider the following:

- the class of **permitted Lenders**, bearing in mind tax as well as relationship considerations; in the leveraged market, consideration might be given to excluding named organisations or funds;
- the **right to veto transfers**, which may be qualified (for example, not to be unreasonably withheld or delayed, and not applicable after the occurrence of an Event of Default). A consent right is much more valuable than a mere right to be consulted. If a consultation right is agreed, it will be helpful to prescribe the process to ensure that it is meaningful and to give the Borrower time to try to find another purchaser;
- other protective mechanisms mentioned earlier, in particular a "**snooze and lose**" provision;
- **express confidentiality undertakings** from the Lenders, as these will provide better protection than any implied obligation. Borrowers should also ensure that disclosure is permitted subject to the provision of a confidentiality undertaking from the recipient.

In the current climate, these are all topical issues for Borrowers to discuss with their Arrangers.