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# Banking & Finance 2022

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**USA: Law & Practice**
**and**
**USA: Trends & Developments**

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# USA

## Law and Practice

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# 1. Loan Market Panorama

## 1.1 Impact of the Regulatory Environment and Economic Cycles

In connection with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in the aftermath of the global financial crisis, US federal regulators issued *Interagency Guidance on Leveraged Lending* (the "Guidance") in 2013 to address concerns about heightened leverage levels in the US loan market.

The Guidance mandated that regulated lenders – whether providing the loan itself or merely arranging it with an expectation of distributing to other non-regulated lenders – avoid loans exceeding specified leveraged levels and consider a borrower's ability to deleverage its capital structure during the term of the loan as a fundamental component of their credit analysis. As a result, less heavily regulated non-bank lenders and foreign institutions capitalised on this opportunity to increase market share in the leveraged finance market. The rapid growth of these non-bank or "direct" lenders materially increased competition in the US loan market, permitting borrowers to seek and obtain ever-more aggressive terms, including higher leverage multiples.

Following the onset of the COVID-19 pandemic in spring 2020 and the resulting uncertainty about its impact on borrowers, lenders became cautious about accepting the more aggressive pre-pandemic terms. This dampening effect on the market, however, was not long-lasting. Starting in late summer 2020, market observers noted a resumption of the years-long trend toward weakened covenant packages and other lender protections. Both regulated and non-bank lenders were increasingly eager to provide financing to borrowers, with few deviations from pre-pandemic norms.

More recently, the increasing inflationary environment, combined with rising interest rates and the economic uncertainty resulting from the Russian invasion of Ukraine in spring 2022, introduced uncertainty into the syndicated loan market. As a result, there has been a material reduction in loan volume throughout autumn 2022, especially in the case of acquisition-related financings.

## 1.2 Impact of the COVID-19 Pandemic

For many borrowers, the COVID-19 pandemic had implications on all aspects of their businesses, including their ability to make representations and comply with covenants under their loan facilities. Although some of these implications are long-lasting, most pandemic-related provisions began to fall away in the second half of 2021.

### Increased Focus on Liquidity

One of the early impacts of the COVID-19 pandemic in the US loan market was a dramatic increase in borrowings under revolving facilities. By mid-2020, reportedly more than 700 borrowers had collectively drawn down in excess of USD300 billion under revolving facilities.

Many borrowers, especially investment grade borrowers, also sought to shore up their balance sheets and potential liquidity needs through new loan facilities. These often took the form of delayed-draw term loans, in order to most efficiently manage their borrowing costs and financial covenant ratio compliance.

### Proactively Addressing Potential Issues

The COVID-19 pandemic resulted in increased debt loads and lower EBITDA, which was severely impaired for many borrowers, with for-

ward-looking visibility inherently unclear. This led to compliance challenges arising under their loan agreements, which many borrowers sought to actively address by pre-emptively seeking covenant and other forms of relief from lenders. These included permitting pandemic-specific EBITDA add-backs and providing financial maintenance covenant "holidays" or level resets.

Although lenders were generally amenable to providing some relief, they in turn sought concessions from borrowers, including:

- increased pricing and other fees;
- minimum liquidity covenants;
- "anti-cash hoarding" provisions;
- limitations on further debt incurrence; and
- increased reporting during the waiver period.

Many of the specific adjustments or accommodations in response to COVID-19 have now fallen away.

**Looking Forward**

On the heels of historically high levels in 2021, activity in the leveraged finance market has shown increased volatility in 2022. Following a period of heavy demand, with financial institutions and non-bank direct lenders providing increasingly large committed financings on aggressive terms, recent macro-economic conditions have resulted in troubled syndications.

This has resulted in an increasing focus (either directly or through "market flex") on lender-protective provisions, which include significant additional pricing and structure flex rights. Additional provisions are aimed at limiting future liability management transactions that could erode lender protections, including those designed to protect lenders from:

- subordination of existing lenders' liens; and
- various forms of "leakage" (eg, release of guarantees and transfer of material intellectual property to unrestricted subsidiaries).

## 1.3 The High-Yield Market

Companies increasingly look to both the syndicated loan and high-yield bond markets to meet their financing needs, often maintaining flexibility between the various forms and sizes of different instruments until and even during syndication. Ultimately a mix is reached that offers the most favourable terms consistent with their capital needs.

Covenant terms and protections in the high-yield bond market have continued their long-term convergence with those of the leveraged loan market, as highlighted by:

- the proliferation of "covenant-lite" term loans, which represented approximately 91% of all leveraged loan issuances as of June 2022; and
- the increasing prevalence of secured high-yield bond issuances, which represented approximately 37% of overall volume in 2021 (following a record year in 2020 that saw high-yield issuances exceed institutional loan volume for the first time since 2009).

In late 2021, high-yield market volumes began to show the effect of multiple economic headwinds, including (first the expectation and then the reality of) rising US and global interest rates, elevated inflation and further variants of the COVID-19 virus. This increased throughout the first half of 2022, along with economic uncertainty resulting from the invasion of Ukraine.

In LBO transactions, where buyers/borrowers seek financing in both the loan and high-

yield bond markets, sponsors have increasingly pushed for substantially identical terms and flexibility across loans and bonds. These trends have continued in 2022, with market participants increasingly focusing on structure flex provisions that allow arranging lenders to unilaterally reallocate a portion of contemplated loan financings into high-yield bond issuances (and vice versa) in order to better respond to investor preferences.

Certain differences remain between leveraged loan and high-yield bond terms. Loans continue to provide weaker "call" protection in connection with voluntary prepayments, whether measured by the scope of the triggering events or the amount and duration of the premium. Additionally, in capital structures with both leveraged loans and bonds, lenders typically continue to drive the guarantee and collateral structure and control enforcement proceedings.

Many loans, but very few bonds, continue to restrict investments in non-guarantor subsidiaries. Additionally, many loans contain "most favoured nation" (MFN) protections that require an interest rate reset upon the issuance of certain higher-yielding debt. In recent years, MFN protections for syndicated loans have significantly diminished and are often triggered only if such higher-yielding debt:

- is in the form of broadly syndicated term B loans secured on a pari passu basis with the existing loans;
- is denominated in like currency;
- is not incurred to finance permitted acquisitions or similar investments;
- is incurred within a specified period after the closing date (eg, six or 12 months); and/or
- matures earlier than a fixed period (eg, 12 months) following the maturity date of the existing term loans.

In contrast, direct or private credit loans generally hold the line on these exclusions and apply the MFN with limited carve-outs to all pari passu debt – whether in the form of loans or notes – incurred under any basket and for any purpose.

Finally, there are still a few respects in which loans contain more permissive terms than bonds, such as:

- the lack of a fixed-charge coverage governor on the usage of the "available amount" builder basket for restricted payments;
- allowing such amounts to build for positive cumulative consolidated net income in a given period without a corresponding deduction for negative amounts in other periods; and
- permitting the incurrence of debt by "stacking" based on priority (eg, by first incurring junior lien debt in reliance on a secured leverage ratio and then incurring first lien debt in reliance on a first lien leverage ratio), rather than the bond standard secured leverage governor applying to all such secured debt, regardless of priority (at least in the case of unsecured bonds).

## 1.4 Alternative Credit Providers

With private debt funds raising more than USD150 billion during the past four years, alternative credit providers have become an increasingly important presence in US loan markets.

This reflects the continued dramatic growth in direct lending – that is, loans made without a bank or other arranger acting as intermediary and the expectation of a broad syndication. Although these asset managers historically operated largely in the middle market and focused on smaller corporate borrowers, direct lenders have come to be viewed as "go-to" financing

sources for all manner of top-tier transactions by providing:

- "anchor" orders in syndicated facilities;
- "bought" second lien (or otherwise difficult to syndicate) tranches; and/or
- one-stop financing solutions to large corporate borrowers and private equity sponsors.

The increase in the number of private debt funds focused on direct lending - and the significant dry powder of these funds – has led to record direct-lending deal sizes, with certain recent deals exceeding USD5 billion.

Competing directly with traditional bank arrangers, direct lenders have provided borrowers with greater flexibility when seeking commitments for complex financing structures. In particular, direct lenders are often willing to provide financing at higher leverage multiples, especially for:

- borrowers lacking access to traditional bank lending or high-yield debt markets; and
- parts of the capital structure that are not readily available in the broadly syndicated market, such as preferred equity, holding company (structurally junior) loans or unitranche facilities.

In addition, direct lenders can offer greater execution speed and certainty of terms, as their intent to hold the loans through maturity obviates the need for a marketing process that may be challenging in the current economic conditions and during which the pricing and other terms of the financing may be "flexed". This factor was highlighted in summer 2022, when even more borrowers sought to explore and tap private credit financings in response to dislocation in the syndicated loan market.

## 1.5 Banking and Finance Techniques

Banking and finance techniques continue to evolve in the face of an increasing number of potential financing sources for loans and new strategies employed by debt activist funds.

### Increased Flexibility from Additional Financing Sources

As a result of intense competition among bank and non-bank lenders to lead financing transactions, there has been a marked increase in documentation flexibility during recent years – albeit with a recent pullback in the past several months. Private equity sponsors have been key drivers of this increased flexibility, as repeat players in the syndicated and direct loan markets, by pushing for more aggressive terms in each subsequent transaction.

Increasingly, borrowers require lenders to rely upon underwritten borrower-friendly documentation precedents to ensure that the terms of the new financing are "no worse than" their most recent financing (often with "market flex" rights to scale back the most aggressive terms, if necessary to facilitate a successful syndication). Correspondingly, to ensure their competitiveness, bank lenders have become increasingly selective on the terms they push back on (even via market flex rights).

### Debt Activism

The US loan market has experienced unique forms of debt activism during the past few years. In a number of prominent cases, certain debt activist funds have engaged in "net short activist" strategies, thereby amassing large short positions against a borrower through credit default swaps and other derivatives (or other short positions), while simultaneously holding a smaller long position in the borrower's loans or bonds. The ultimate goal is to assert a default

or otherwise take an adverse position on their (smaller) long position in order to benefit their (larger) short position. These strategies create anomalous economic incentives for holders of a borrower's debt and, consequently, adverse outcomes for borrowers and other creditors.

### 1.6 Legal, Tax, Regulatory or Other Developments

The US loan market has seen several recent legal, regulatory, tax and other developments that will shape the terms of loan financings in the near future. The most prominent has been the transition in the benchmark rate for loans from the LIBOR to the Secured Overnight Financing Rate (SOFR). In addition, the recent market volatility has resulted in increased focus on loss mitigation tools to optimise outcomes in challenging market conditions for syndicated loans and high-yield bond offerings.

#### LIBOR Cessation and Transition to SOFR

Prior to 2022, LIBOR was the near universal benchmark rate for US loan issuances. Criticisms aimed at the integrity of the process by which LIBOR had historically been determined – and the depth of the "observed transactions" on which it supposedly rested – led to calls for its replacement. As a result, the UK's Financial Conduct Authority (FCA) announced that it will phase out its historical practice of compelling reference banks to submit LIBOR quotations.

In response, regulators and loan market participants have started transitioning away from LIBOR to a replacement benchmark rate. There has been broad (and nearly unanimous) agreement that the successor in the USD-based loan market is SOFR, a rate based on a deep market of overnight secured financings monitored by the Federal Reserve.

The FCA-regulated administrator of LIBOR, ICE Benchmark Administration Limited (IBA), announced in November 2020 that it would end one-week and two-month USD LIBOR settings on 31 December 2021, followed by the remaining USD LIBOR settings on 30 June 2023. The Federal Reserve, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) issued statements encouraging banks to transition away from USD LIBOR no later than 31 December 2021.

Since 1 January 2022, nearly all new loans were issued with SOFR as the benchmark rate. In addition, due to a combination of refinancing activity and incremental loans in the first quarter of 2022 and early opt-in elections by other borrowers, many existing loans also transitioned from LIBOR to SOFR.

The primary negotiated point between lenders and borrowers in the transition to SOFR has been the use and amount of credit spread adjustments (CSAs), which were intended to minimise the value transfer when transitioning from LIBOR to SOFR. Based on the historical median across a five-year look-back period, the US Alternative Reference Rates Committee (ARRC) recommended the use of CSAs as part of their recommended fallback language.

However, both for existing loans retaining a LIBOR-based benchmark and new loans issued with a SOFR benchmark, market practice has varied as to whether to include a CSA and, if included, whether to use:

- a "flat" CSA (eg, 10 basis points) for all tenors; or
- a CSA "curve" (whether at ARRC-recommended levels or other negotiated amounts) that varies with tenor.

**Challenges in Term Loan Syndications and High-Yield Bond Offerings**

Following record-high levels of activity in the loan and high-yield markets in 2020 and 2021, increased volatility and uncertainty has been experienced since spring 2022. Delayed or failed loan syndications have become more frequent during this time. Arrangers of syndicated term loans and bookrunners in high yield-bonds have increasingly turned their focus to loss mitigation tools to optimise outcomes in these challenging market conditions as a result.

### 1.7 Developments in Environmental, Social and Governance (ESG) or Sustainability Lending

In the US loan market, participants have shown increasing interest in linking loan pricing to the borrower's progress in meeting pre-determined ESG or sustainability goals. As more borrowers create sustainability plans that include ESG-related goals (such as reducing greenhouse gas emissions, increasing energy efficiency, achieving certain ESG ratings, and/or increasing board and workplace diversity), they seek to obtain reduced loan interest rates/fees from their lenders. Likewise, many lenders are increasingly participating in ESG financings, having committed to taking steps to increase their focus on ESG and sustainability.

Borrowers typically work with an administrative agent or a dedicated sustainability structuring agent to develop specific ESG metrics to be tracked throughout the life of the loan. These metrics often become more stringent during the tenor of the loan, in order to demonstrate the borrower's ongoing commitment to the agreed goals. If the borrower meets the targets during a particular year, a specified interest rate/fee reduction applies; however, if the borrower misses the specified targets, there is a corresponding increase in interest rate/fees.

Typically, borrowers submit annual compliance certificates to lenders regarding the agreed targets, which are often audited by a third party and/or made publicly available. On the basis of this certification, the negotiated adjustments are made to the interest rate/fees under the loan agreement.

## 2. Authorisation

### 2.1 Authorisation to Provide Financing to a Company

The USA operates a "dual-banking system", under which banks can apply for a state bank or a federal charter from the OCC. Banks chartered by state banking authorities are primarily subject to the regulations of that state authority, in addition to the Federal Reserve or the FDIC. Nationally chartered banks are subject to regulation by the OCC and are required to become members of the Federal Reserve System. Federal law also requires national and state banks to obtain deposit insurance from the FDIC.

Alternative credit providers or direct lenders may be subject to regulation under the Investment Company Act as an "investment company", yet are often exempt from many of its requirements and subject primarily to SEC regulation.

## 3. Structuring and Documentation Considerations

### 3.1 Restrictions on Foreign Lenders Granting Loans

Foreign banking organisations are:

- subject to the International Banking Act and the Foreign Bank Supervision Enhancement Act; and
- regulated by the Federal Reserve, whose approval is necessary to establish foreign banking institutions in the US.

Furthermore, foreign banking institutions must seek approval from the OCC or state banking supervisor to establish US branches and agencies. Licensed foreign bank branches may provide a full range of banking services, including making loans.

In 2019, the Federal Reserve finalised new regulatory requirements for US subsidiaries of foreign banks. These provided relaxed capital and stress-testing requirements, while also imposing stricter liquidity requirements.

### 3.2 Restrictions on Foreign Lenders Granting Security

Under US law, restrictions on US entities granting security interests to, or providing guarantees in favour of, foreign lenders generally do not differ from those that apply to domestic lenders.

### 3.3 Restrictions and Controls on Foreign Currency Exchange

The USA does not currently impose any foreign currency exchange controls affecting the US loan market, unless a party is in a country that is subject to sanctions enforced by the Office of Foreign Assets Control (OFAC) of the US Department of the Treasury. OFAC administers and enforces economic and trade sanctions based on US foreign policy and national security goals.

### 3.4 Restrictions on the Borrower's Use of Proceeds

Most loan agreements in the USA include negative covenants limiting the borrower's use of loan proceeds to specified purposes. US loan documentation also prohibits borrowers from using loan proceeds in violation of US and applicable foreign anti-corruption and anti-money laundering regulations (principally the Foreign Corrupt Practices Act and sanctions enforced by OFAC).

In addition, US law restricts the use of loan proceeds that are in violation of the margin-lending rules under Regulations T, U and X, which limit financings used to acquire or maintain certain types of publicly traded securities and other "margin" instruments if the loans are also secured by such securities or instruments. Therefore, the amount of collateral value the lenders may assign to such securities or instruments is limited (currently up to 50%) as a result.

### 3.5 Agent and Trust Concepts

In US syndicated loan financings, an administrative agent is appointed to act on behalf of the lending syndicate to administer the loan. In secured transactions, a collateral agent is appointed to administer collateral-related matters. Where financings involve debt securities or multiple lending groups sharing the same collateral, security interests are sometimes granted to collateral trustees or other "intercreditor" agents to act on behalf of all creditors, with the trust or intercreditor arrangements setting out the relative rights of the various creditor groups.

### 3.6 Loan Transfer Mechanisms

In the US loan market, lenders may transfer their interest under credit facilities to other market participants through assignments or participations. An assignment is the sale of all or part of a lender's rights and obligations under a loan agreement, upon which the assignee replaces the assigning lender under the loan agreement with respect to the portion of commitments or loans assigned. As the new "lender of record",

the assignee benefits from all rights and remedies available to lenders thereunder.

Assignments under US loan agreements typically require the consent of the borrower, the administrative agent and – in the case of revolving facilities including letter of credit and/or swingline subfacilities – the letter of credit issuers and the swingline banks. Loan agreements often provide for limitations on borrowers' consent rights during the continuation of any event of default – or, increasingly, during the continuation of a payment or bankruptcy event of default.

Usually, borrower consent is not required in connection with assignments to another lender (or an affiliate or "approved fund" of such lender). Typically, in the absence of any objection within a specified period of time (usually five to 15 business days), the borrower is deemed to have consented to such assignment. It is not uncommon for such deemed consent to apply solely to assignments in respect of term loans (but not revolving facilities).

In contrast, participations involve a transfer of only a subset of the lender's rights, primarily the right to receive payments on the loan and the right to direct voting on a limited set of "sacred rights" viewed as essential to protecting the transferred rights. The transferee becomes a "participant" in the loan, but does not become a lender under the loan documentation and has no contractual privity with the borrower. Participations rarely require notice to or consent from the borrower or any other party. However, some borrowers have sought to impose limitations on these participation rights, including consent and notice requirements.

Increasingly, loan agreements restrict assignments and participations to "disqualified institutions", which generally include the borrower's competitors and certain financial institutions that the borrower deems undesirable. (This includes institutions that are perceived as likely to engage in "net short" or other activist strategies.) These provisions are the focus of continuing negotiation. Borrowers seek flexibility to designate additional entities throughout the life of the financing, whereas lenders seek to minimise such flexibility in order to maximize liquidity in the loan.

## 3.7 Debt Buy-Back

Borrowers and their affiliates (including private equity sponsors) are able to purchase loans in the US syndicated loan market, subject to customary requirements and restrictions. Borrowers and their subsidiaries are generally permitted to buy back loans pursuant to "Dutch" auctions made available to all lenders on a pro rata basis or on a non-pro rata basis on the open market. Loan agreements typically require that, in connection with such buy-backs, the purchased loans are cancelled and such buy-backs are not financed with loans under any revolving facility.

In addition, private equity sponsors and their affiliates (other than borrowers and their subsidiaries) are typically allowed to make "open-market" purchases of loans from their portfolio companies on a non-pro rata basis. Once held by a borrower affiliate, these loans are normally subject to restrictions on:

- voting;
- participating in lender calls and meetings; and
- receiving information provided solely to lenders.

Loans held by private equity sponsors and their affiliates are also subject to a cap of the aggregate principal amount of the applicable tranche of term loans – typically 25–30%. Bona fide

debt fund affiliates of private equity sponsors that invest in loans and similar indebtedness in the ordinary course are usually excluded from these restrictions, but are still restricted from constituting 50% or more of votes in favour of amendments requiring the consent of the majority of lenders.

### 3.8 Public Acquisition Finance

Although the USA does not have specific rules or regulations mandating "certain funds" requirements with respect to financing acquisitions of public companies, financing commitments with respect to both public and private company acquisitions are generally subject to a limited and standardised set of "SunGard" conditions. The narrowing of conditions precedent in typical acquisition financings has been driven largely by the increased focus on deal certainty in M&A transactions. The most important of these conditions are:

- accuracy of certain "specified representations" relating to the enforceability and legality of the financing itself;
- accuracy of certain material seller or target representations made in the acquisition agreement, the breach of which would permit the buyer to terminate the acquisition;
- absence of a material adverse change with respect to the target (on terms identical to the corresponding condition to the acquisition); and
- conditions relating to the timing required by arrangers to properly syndicate the loans in advance of acquisition closing (either in the form of marketing periods or an "inside date").

Given these dynamics, it is customary for buyers/borrowers and arrangers to execute commitment letters, including detailed term sheets, upon signing the acquisition agreement. This provides buyers with committed financing, subject to this customary "limited conditionality". The borrower and the arrangers will then negotiate the definitive documentation for the financing prior to the closing of the acquisition, during which time arrangers of syndicated financings – with the assistance of the buyer and target – will seek to syndicate loan commitments to the broader market.

## 4. Tax

### 4.1 Withholding Tax

There is usually a 30% US withholding tax on the gross amount of interest paid to non-US lenders. If a loan is issued at a discount in excess of a de minimis amount (original issue discount, or OID), this discount is treated as interest income when paid, subject to the 30% withholding tax. Certain fees may also be treated as OID for this purpose.

There are several important exceptions to withholding on interest, however. In the absence of a change in law, the expectation is that lenders to a US obligor should be able to avoid withholding on interest so that no gross-up should apply. Those exceptions to withholding on interest include:

- treaty exemptions;
- the portfolio interest exemption; and
- where the interest is paid to a non-US lender engaged in a trade or business within the USA (such as a non-US bank operating through a US branch).

To qualify for an exemption from withholding, non-US lenders are required to submit a US tax form to the borrower or agent – usually IRS Form W-8BEN-E (for treaty benefits or the portfolio

interest exemption) or IRS Form W-8ECI (if the interest is effectively connected with the non-US lender's US trade or business).

Principal payments and proceeds from a sale or other disposition of debt instruments are not subject to US withholding tax (except to the extent that such payments are treated as a payment of interest or OID). However, fee income that is not treated as OID may be subject to 30% withholding unless a treaty applies or the recipient is engaged in a US trade or business. The portfolio interest exemption may not apply because the fee may not be treated as interest for US tax purposes.

Finally, in 2010, the USA enacted the Foreign Account Tax Compliance Act (FATCA), which imposes a 30% US withholding tax on non-US banks and financial institutions (including hedge funds) that fail to comply with certain due diligence, reporting and withholding requirements. FATCA withholding tax applies to payments of US-source interest and fees, without any exemptions for portfolio interest or treaty benefits.

FATCA was scheduled to apply to payments of gross proceeds from a sale or other disposition of debt instruments of US obligors beginning on 1 January 2019. However, the Internal Revenue Service (IRS) and US Department of the Treasury issued proposed regulations in 2018 (the preamble to which specifies that taxpayers are permitted to rely on the proposed regulations pending finalisation), stating that no withholding will apply on payments of gross proceeds.

Many countries have entered into agreements with the USA to implement FATCA, which may result in modified requirements that apply to financial institutions organised in such countries.

## 4.2 Other Taxes, Duties, Charges or Tax Considerations

Under Section 956 of the Internal Revenue Code, if a foreign subsidiary of a US borrower that is a controlled foreign corporation (CFC) guarantees the debt of a US-related party (or if certain other types of credit support are provided, such as a pledge of the CFC's assets or a pledge of more than two-thirds of the CFC's voting stock), the CFC's US shareholders could be subject to immediate US tax on a deemed dividend from the CFC.

Following regulatory changes published by the US Treasury and the IRS in 2019, US borrowers may obtain credit support from CFCs without incurring additional tax liability if certain conditions are met. However, despite these regulatory changes, the majority of loan documents today continue to maintain customary Section 956 carve-outs. This excludes CFCs from the guarantee requirements and limits pledges of first-tier subsidiary CFC equity interests to less than 65%.

Separately, non-US lenders should closely monitor their activities within the USA to determine whether such activities give rise to a US trade or business or a permanent establishment within the USA. If so, they could be subject to US taxation on a net-income basis.

## 4.3 Usury Laws

National and state-chartered banking institutions are subject to usury laws prohibiting lenders from charging excessively high rates of interest on loans, which are largely enforced at the state level. Nationally chartered banks may not charge interest exceeding the greater of:

- the rate permitted by the state in which the bank is located; or

- 1% above the discount rate on 90-day commercial paper in effect in the bank's Federal Reserve district.

If the state where the bank is located does not prohibit usurious interest, banks may not charge interest exceeding the greater of 7% or 1% above the discount rate on 90-day commercial paper in effect in the bank's Federal Reserve district. In general, state-chartered banks may charge the same interest rate as national banks, and federal law will pre-empt any state usury law that prohibits state-chartered banks from applying the same interest rate as a nationally chartered bank.

Under New York law, with certain exceptions, charging interest in excess of 16% constitutes civil usury, and charging interest in excess of 25% constitutes criminal usury. However, loans in excess of USD250,000 are exempt from the civil statute, but remain subject to the criminal statute. Loans in excess of USD2.5 million, which include nearly all broadly syndicated loans in the US, are exempt both from New York's civil and criminal statutes.

## 5. Guarantees and Security

### 5.1 Assets and Forms of Security

**Determining the Collateral Package**

Pledges of (substantially) "all assets" of real and personal property of borrowers and their subsidiaries are common, with negotiated exclusions of specific asset categories generally addressing burdensome and expensive perfection requirements or consequences. Common exclusions are:

- owned real property with a value below an agreed threshold;
- licences prohibited to be pledged by law or contract (although the proceeds thereof are generally included);
- assets requiring third-party consent to be pledged;
- assets with de minimis value;
- assets subject to burdensome perfection regimes such as certificates of title (including motor vehicles); and
- "intent-to-use" applications for the registration of a trade mark.

**Creating an Enforceable Security Interest**

The creation of security interests for most categories of personal property are governed by the Uniform Commercial Code (UCC), which has been adopted with some differences in most states. In order to create enforceable security interests with respect to personal property under Article 9 of the UCC:

- the lender must provide value to the grantor of the security interest;
- the grantor must have rights in the collateral or the power to transfer rights in the collateral to the lender; and
- either the grantor must execute a security agreement providing a description of the collateral or, in the case of certain types of collateral, the collateral must be in the possession or control of the lender.

To create a security interest in assets not governed by the UCC (eg, real property and certain kinds of intellectual property), the parties will typically create separate collateral documents or mortgages pursuant to applicable legal requirements in the jurisdiction governing the property.

**Perfection Requirements**

Lenders must perfect such security interest to enforce it against other creditors and in bank-

ruptcy proceedings. Article 9 of the UCC provides the following four methods of perfecting security interests in domestic personal property:

- filing a financing statement (UCC-1) in the appropriate jurisdiction, which includes a description of the collateral;
- possession, in the case of certain tangible assets;
- establishing control, which may be effected by entering into control agreements in the case of deposit accounts, letter of credit rights, investment accounts and electronic chattel paper; and
- automatic perfection, in the case of certain other personal property.

### 5.2 Floating Charges or Other Universal or Similar Security Interests

Article 9 of the UCC permits the granting of a floating lien in the form of an "all assets" pledge, which includes all personal property owned or later acquired by the grantor, subject to negotiated exclusions. Importantly, these floating liens apply only to personal property that is subject to the requirements of Article 9 (with certain exceptions for asset types such as commercial tort claims, which must be described with more specificity). Other assets – such as real property and federally registered copyrights – cannot be subject to floating liens.

### 5.3 Downstream, Upstream and Cross-Stream Guarantees

In the US, there are broadly no limitations or restrictions on the provision of downstream, upstream or cross-stream guarantees, other than the requirements applicable to guarantees generally. Because of the nature of cross- and upstream guarantees, lenders are conscious of limitation or invalidation risks on grounds of fraudulent conveyance, which requires that the entity providing the upstream or cross-stream guarantee either receives adequate consideration or is solvent after giving effect to such guarantee. Loan market participants often address this by including "savings clauses" or other limitations on the amount of the guarantee obligation to ensure continued enforceability.

Furthermore, to increase the likelihood of enforcement, guaranty agreements usually require that the guarantees be "absolute and unconditional" (to avoid common law defences) and not contingent upon commencing or exhausting remedies against the primary obligor or any collateral.

### 5.4 Restrictions on Target

In the US, a target company is not usually prohibited from guaranteeing or granting a security interest in its assets for a financing used to acquire its shares. However, these guarantees and security interests are subject to review for fraudulent conveyance and, in certain cases, may be subject to regulatory schemes that make such a guarantee impracticable even if legal. Subject to such limitations, lenders will typically require guarantees and security interests to be provided by the target company – along with delivery of any certificated securities of the target company – as a condition to the closing of the acquisition financing.

### 5.5 Other Restrictions

Anti-assignment provisions in commercial contracts pose difficult issues for lenders in secured financings. A statutory override of anti-assignment provisions in contracts is generally available under the UCC but, if the restricted collateral is critical to the collateral package, lenders are likely to require such third party to consent to the pledge as a condition to the loan.

## 5.6 Release of Typical Forms of Security

In the US, loan documentation typically authorises administrative agents or collateral agents to acknowledge or confirm the release of the lenders' security interest in the collateral upon termination and payment in full of the obligations under the loan agreement. Additionally, agents are pre-authorised to acknowledge or confirm the release of security interests in assets that are disposed of – or guarantees of entities that are no longer subject to the guarantee requirements – in transactions permitted under the loan documentation.

Lenders are increasingly focused on the unintended consequences of such provisions. Borrowers may rely upon exclusions from the guarantee requirements to release a guarantor that is no longer wholly owned by the borrower (even if wholly owned by its affiliates). Lenders have increasingly sought protection from this concern by specifying that the guarantor is released from its guarantee only in certain circumstances (eg, it becomes non-wholly owned in a bona fide transaction involving a third party without the intent of releasing the guarantee as part of the transaction).

Furthermore, borrowers have previously relied upon "trap-doors" in investment covenants to move valuable IP and other assets from guarantors to non-guarantor entities, thereby automatically releasing the lenders' security interest in such assets in the process. Lenders have, similarly, sought to limit or even completely eliminate this flexibility.

## 5.7 Rules Governing the Priority of Competing Security Interests

### Priority of Conflicting Security Interests

The relative priority of security interests held by different creditors in the same assets of a borrower is determined by the UCC of the applicable jurisdiction and is subject to the following rules:

- a perfected security interest has priority over a conflicting unperfected security interest;
- conflicting perfected security interests rank in priority according to the time of filing or perfection; and
- conflicting unperfected security interests rank in priority according to the time at which the security interest attached or became effective.

In addition, the UCC allows certain categories of collateral to be perfected by multiple methods, with priority determined based on the "preferred" method, regardless of the rules set forth above. With respect to investment property, securities accounts and certificated securities, perfection via "control" or possession has priority over perfection via filing a UCC-1 financing statement.

### Subordination

Lenders and borrowers may agree to structure a financing subject to payment or lien subordination, which can be accomplished contractually, structurally or both.

Payment subordination is the ranking of specified debt obligations of a particular obligor by way of express agreement by the holders of the subordinated debt. All forms of payment subordination provide that, in bankruptcy, the specified senior debt is to be paid before the subordinated debt and holders of the subordinated debt receiving payment before the senior debt must "turn over" the payment to the senior debt holders. However, other terms – including the extent and timing of payment blocks – vary with the type of instrument and negotiation of the parties.

Arrangements for lien subordination ordinarily provide that:

- junior creditors are subject to a "standstill" period prior to exercising enforcement rights or remedies with respect to shared collateral;
- payments from the proceeds of shared collateral received by junior creditors in violation of the agreement will be held in trust and turned over to senior creditors; and
- certain specified amendments to both senior and junior priority loan documents will be subject to agreed limitations.

Under Section 510 of the Bankruptcy Code, subordination agreements – including payment and lien subordination – are enforceable in a bankruptcy proceeding of the relevant debtor to the same extent that they would be enforceable under applicable non-bankruptcy law.

Structural subordination arises where obligations incurred or guaranteed solely by a borrower are effectively junior to obligations incurred or guaranteed by a subsidiary of the borrower, to the extent of that subsidiary's assets. In such a situation, the subsidiary's creditors have the right to be repaid by such subsidiary (or out of its assets) as direct obligations of such entity in any insolvency scenario before creditors of the parent borrower – such subsidiary's equity holder – are repaid. Where the parent borrower is primarily a "holding company" for the equity interests of its operating subsidiaries, creditors of an operating subsidiary will be paid in priority to the holding company's creditors from assets of such subsidiary.

## 6. Enforcement

### 6.1 Enforcement of Collateral by Secured Lenders

In general, loan documentation provides a customary set of rights and remedies exercisable by agents, on behalf of lenders, following the occurrence and continuation of "events of default".

Article 9 of the UCC provides secured parties with several remedies following an event of default giving rise to enforcement rights, including:

- the right to collect payments directly from the obligor under accounts receivable, deposit accounts and certain other types of intangible assets;
- the right to repossess collateral, through judicial proceedings or non-judicially; and
- the right to dispose of the collateral through a public or private sale.

In order to exercise the remedies available to them under Article 9, lenders must comply with certain requirements intended to protect the borrower – primarily that the time, place and manner of any such remedy is commercially reasonable, including providing sufficient advance notification to the debtor and certain other creditors in case of a public sale.

### 6.2 Foreign Law and Jurisdiction

New York courts generally permit parties to select foreign law as the governing law of loan agreements. However, where there is no reasonable basis for the parties' choice of law or the provision is contrary to a fundamental policy, courts may decline to enforce a governing law clause if the law selected has no substantial relationship to the parties or the transaction.

New York's conflict of laws rules uphold foreign forum selection clauses, as long as the chosen jurisdiction has a reasonable relationship to the transaction – eg, a significant portion of the negotiating or performance of the underlying agreement occurs in such jurisdiction.

Additionally, in cases involving foreign states, the Foreign Sovereign Immunities Act permits a waiver of immunity either explicitly or by implication.

### 6.3 A Judgment Given by a Foreign Court

New York courts will generally recognise and enforce foreign judgments, subject to certain conditions (including due process and reciprocity). Despite the adoption of uniform laws among many states, there is still a significant amount of diversity within the USA in terms of procedure and substance when it comes to the recognition and enforcement of foreign judgments. Under federal common law, courts generally rely upon the principles of international comity set forth in Hilton v Guyot with respect to the recognition and enforcement of foreign judgments.

### 6.4 A Foreign Lender's Ability to Enforce Its Rights

The previous sections provide an outline of the relevant landscape but do not contemplate all possible matters that could apply to a particular financing (or even to financings generally). These will depend on the facts and circumstances in each case.

## 7. Bankruptcy and Insolvency

### 7.1 Company Rescue or Reorganisation Procedures Outside of Insolvency

As a company becomes distressed and at risk of insolvency, management may seek to reorganise the capital structure in an attempt to restructure the business as a viable going concern. Prior to filing a petition for relief under the Bankruptcy Code, the company may attempt this reorganisation with its creditors non-judicially and in a consensual manner.

Out-of-court restructurings can take many forms – such as maturity extensions, debt-for-debt exchanges, debt-for-equity exchange offers or covenant waivers – and are highly dependent on a company's capital structure, the flexibility in its outstanding debt instruments, the threshold lender consent required to effect changes to each piece of the structure and the creditors' willingness to agree to those changes.

A company's debt documents may provide flexibility to modify certain terms with less than 100% lender consent. Combined with an exchange offer or similar refinancing transaction, this may be used to coercively initiate liability management transactions that leave holdout lenders in a reorganised structure.

#### Exit Consents

Traditionally, this was most commonly seen in the high-yield bond market with the use of exit consents – that is, where the company offers debtholders the opportunity to exchange existing debt for new debt issued with a lower principal amount (or other company-friendly structural change) but a higher priority claim (whether through the grant of collateral or structural or payment seniority) or otherwise enhanced terms. In return, exchanging debtholders agree to amend

the existing debt to permit the new financing and often to adversely affect the existing terms by way of "covenant-stripping". This creates an incentive for all debtholders to exchange their debt so they are not left holding existing debt without meaningful covenant protections.

A number of recent transactions in the loan market have employed similar exchange (or similar repayment and reborrowing) and "exit consent" mechanics to effect the uptiering of a particular group of creditors (or "drop down" of material assets to be financed by a new group of creditors). In response, lenders and borrowers have reconsidered the scope of relevant amendments that require a 100% or "all affected lender" vote.

### 7.2 Impact of Insolvency Processes

If a bankruptcy filing is unavoidable but a distressed company has time to prepare in advance, it may seek to negotiate a restructuring support agreement in which the company and creditors agree to a pre-negotiated plan of reorganisation. The plan will then be presented to the bankruptcy court with the intention of simplifying the bankruptcy proceeding and reducing the costs and the potential for negative impact on the business.

Whether a bankruptcy is voluntary or involuntary, the filing of a petition for relief under the Bankruptcy Code will immediately result in an injunction referred to as an "automatic stay", without the need for further action by the bankruptcy court. The automatic stay prevents creditors from enforcing or perfecting pre-petition liens or guarantees, foreclosing on collateral, enforcing pre-petition judgments or terminating contracts on account of pre-petition defaults. The automatic stay is intended to preserve the going-concern value of the debtor by addressing the collective action problem of creditors taking uncoordinated unilateral enforcement action to preserve their own investment to the detriment of other creditors.

### 7.3 The Order Creditors Are Paid on Insolvency

The Bankruptcy Code requires any liquidation or reorganisation plan to be "fair and equitable" with respect to any class of creditors that does not consent to different treatment. Therefore, senior creditors must be paid in full (unless otherwise agreed) prior to any payments to junior creditors and equity holders may only receive assets or payments after all creditors are paid in full. This hierarchy is referred to as the "absolute priority" rule. The value of collateral-securing creditor claims is distributed in accordance with the relative priority of the lienholders, whereas unencumbered value is distributed to all creditors (including unsecured) in accordance with their statutory priority.

### 7.4 Concept of Equitable Subordination

The Bankruptcy Code permits the court to subordinate all or a portion of a creditor's allowed claim to all or a portion of another creditor's allowed claim in order to remedy misconduct by the subordinated creditor.

Equitable subordination can only be granted if:

- the claimant engaged in inequitable conduct;
- the conduct injured other creditors or conferred an unfair advantage on the claimant; and
- it is not contrary to the principles of the Bankruptcy Code.

Although "inequitable conduct" is not defined in the Bankruptcy Code, it is typically considered to include fraud, breach of fiduciary duties and illegality. Additionally, insiders and fiduciaries are

usually held to a higher standard in determining inequitable conduct. Equitable subordination is rarely granted by the court and is considered an extraordinary remedy.

## 7.5 Risk Areas for Lenders

Lenders face several risks when borrowers, credit support providers or guarantors become insolvent.

### Use of Cash Collateral

During Chapter 11 bankruptcy proceedings, the court may permit debtors or bankruptcy trustees to use cash collateral in order to continue operating the business over a secured lender's objection only if "adequate protection" is provided to the lender to protect against the value of the lender's security interest declining. Adequate protection may be accomplished in a variety of ways, including by replacement liens or cash payments. Debtors in bankruptcy require affirmative court permission to use cash collateral pledged to a creditor and, as such, negotiations regarding use of cash collateral typically occur in the lead-up to a bankruptcy filing, thereby giving the relevant secured creditor an opportunity to negotiate protections.

### Fraudulent Conveyance

The Bankruptcy Code grants debtors or bankruptcy trustees the power to "avoid" certain prior transfers that constitute fraudulent conveyances in order to recover assets for the benefit of the estate. A fraudulent conveyance occurs where the debtor received less than reasonably equivalent value in exchange for a transfer or obligation and, either before or after the transfer the company was insolvent, had unreasonably small capital or believed it would incur debts beyond its ability to repay. This concern is generally heightened in LBOs, where courts may deem the "transfer" of the target's collateral to a lender, or the incurrence of the target's obligation to repay the debt generated to fund the transaction, voided as a transfer for which the borrower did not receive reasonably equivalent value if it did not retain the loan proceeds.

### Preference Risk

Generally, the debtor or bankruptcy trustee may recover certain "preference" payments made to unsecured or under-secured creditors within the 90-day period prior to a bankruptcy filing (or one year prior for insiders). Lenders may be able to avoid this preference risk where payments by the debtor were intended to be in exchange for new value provided to them, or were in the ordinary course of business. Lenders will seek to address preference risk in loan documentation by requiring that additional junior debt incurred by a company does not mature earlier than 91 days following the maturity of such lender's loans.

### DIP Financing

Debtors will sometimes require financing concurrently with, or shortly after, filing for bankruptcy under Chapter 11 to fund operations during the bankruptcy case. The debtor or bankruptcy trustee can seek the bankruptcy court's approval to incur debt, which may include "priming" liens senior to those securing debt outstanding prior to the bankruptcy filing as well as super-priority claims senior to all other unsecured claims. Such DIP financing may be approved despite the objection of the existing lenders if, after notice and hearing, the debtor is otherwise unable to obtain financing and the existing lenders' liens are adequately protected.

## 8. Project Finance

### 8.1 Introduction to Project Finance

A reliable and sophisticated legal framework is fundamental to a successful project financing to clearly allocate the risks – for both the commercial arrangements (such as for construction, raw material supply and product offtake) and the financial arrangements (including enforcement of the security package).

### 8.2 Overview of Public-Private Partnership Transactions

The PPP is often cited as a model for increased infrastructure improvement and other projects in the US. However, concerns remain as to whether such a model consistently attains value for money compared with other procurement methods for large-scale capital intensive infrastructure projects.

Despite the appeal, practice has not coalesced around a single paradigm for allocating risk, reward and responsibility among the private and public participants. As a result, transaction costs and challenges can be higher than anticipated, and the promise of PPP as a way to effect important public projects has been under-realised. Large programmes are often discussed at the federal level – including the USD1.2 trillion Infrastructure Bill passed by the Senate in August 2021 – with the goal of stimulating investment in infrastructure and funding new climate resilience and broadband initiatives.

### 8.3 Government Approvals, Taxes, Fees or Other Charges

The need for regulatory and governmental approval for projects, including the related financing, depends on the project's nature, and is not specific to the type of financing involved. Energy projects may require approval from – or be subject to the jurisdiction of – the Federal Energy Regulatory Commission (FERC). Sponsors and financing parties must also look to applicable state and local law requirements.

### 8.4 The Responsible Government Body

In general, US projects in the oil and gas, power and mining sectors seeking financing need to demonstrate ongoing compliance with federal, state and municipal zoning, building and construction codes, occupational health and safety regulations, and environmental requirements.

The generation, transmission and distribution of electric power in the USA is subject to extensive regulation at both the federal and state levels.

The US wholesale electricity market consists of multiple regional markets subject to federal regulation implemented by FERC and regional regulation by regional transmission organisations (non-profit corporations operating the regional transmission grid and maintaining organised markets for electricity).

Retail electricity markets are regulated at the state level. In exchange for the right to sell or distribute electricity directly to end-users in a service territory, utility businesses are subject to regulation by state-level public utility commissions, which set the framework for consumer prices, establish mandatory service standards and regulate the issuance of long-term securities by the utility.

The siting, design, construction and operation of natural gas and appurtenant facilities, the export of LNG and the transportation of natural gas are subject to extensive federal, state and local regulation. Approval from FERC, acting under the authority of the Natural Gas Act and other statutes, is required to construct, own, operate and

maintain LNG facilities, terminals and interstate pipelines. Retail delivery of natural gas is subject to local regulation.

Foreign project sponsors in the USA also need to be aware of the jurisdiction of the Committee on Foreign Investment in the United States (CFIUS), which is authorised to review transactions involving foreign investment in the USA to determine their effect on national security. The Foreign Investment Risk Review Modernization Act (FIRRMA), aimed at strengthening and modernising CFIUS, expands the scope of covered transactions to include:

- the purchase, lease or concession by or to a foreign person of real estate located in proximity to sensitive government facilities;
- "other investments" in certain US businesses that afford a foreign person access to material non-public technical information in the possession of the US business;
- any change in a foreign investor's rights resulting in foreign control of a US business or "other investment" in certain US businesses; and
- any other transaction designed to circumvent CFIUS jurisdiction.

### 8.5 The Main Issues When Structuring Deals

Please see the **Chambers Project Finance 2022 Global Practice Guide** for a discussion of the issues relevant to structuring a project finance transaction.

### 8.6 Typical Financing Sources and Structures for Project Financings

Given the complexity of this topic, interested readers are advised to consult the **Chambers Project Finance 2022 Global Practice Guide**.

### 8.7 The Acquisition and Export of Natural Resources

Issues affecting the acquisition and export of natural resources are of growing importance as the USA became a net exporter of energy during part of 2020, with the production of crude oil, natural gas and natural gas plant liquids outstripping the growth in US energy consumption. Natural resource exports may be subject to general or specific economic sanction regimes. In addition, approvals from the Department of Energy are required for the export of domestically produced LNG.

### 8.8 Environmental, Health and Safety Laws

Projects in the USA are subject to the US Clean Air Act, the US Clean Water Act and other federal, state and local laws and regulations enforced by the US Environmental Protection Agency and state and local governmental bodies. Such laws and regulations relate to the following, among other matters:

- protection of the environment and natural resources;
- generation, storage, handling, use, treatment, disposal and transportation of hazardous materials;
- emission and discharge of hazardous materials into the ground, air or water (including greenhouse gases);
- use of water;
- habitat protection, wetlands preservation and coastal zone management;
- remediation of contamination;
- waste disposal;
- endangered species, historic property, antiquities and cultural preservation; and
- noise regulation.

In addition, although not legally required, most banks require that projects financed by them comply with the Equator Principles.

Projects are also subject to a number of federal and state laws and regulations, including the federal Occupational Safety and Health Act and comparable state statutes protecting the health and safety of workers.

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**Davis Polk & Wardwell LLP** delivers customised, innovative counsel to lenders and borrowers on their most important and complex financing transactions. The firm has been at the forefront of developments in the finance market for the past decade. A broad, market-leading practice led by 15 partners in New York and London provides advice to financial institutions, direct lenders and companies that anticipates market trends and protects against emerging vulnerabilities. Clients count on the firm's deep legal experience and commercial understanding in transactions that include leveraged and investment-grade acquisition financing, direct lending, bridge loans, structured finance, asset-based lending, and project and infrastructure finance. Clients benefit from Davis Polk's strong culture of cross-practice collaboration. The firm works closely with its capital markets lawyers on high-yield and investment-grade debt and as a team with its restructuring lawyers on financings, including DIP and exit facilities.

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# Trends and Developments

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## Navigating Challenging Markets

Since spring 2022, the financial markets have faced increased volatility and uncertainty. These market conditions highlight the risks associated with underwriting and marketing term loan B (TLB) and high-yield bond financings.

### *Term loan B syndications*

The syndicated TLB market operates on an "arrange-to-distribute" model. In the acquisition finance context, a small group of lenders will initially commit to provide the full amount of the financing required to consummate the acquisition, subject to negotiated terms and conditions. These initial lenders (or their affiliates) will then seek to syndicate or market the financing – and therefore reduce their exposure – by selling the loan exposure to institutional investors and other players in the primary TLB market, prior to (or concurrently with) funding on those terms.

However, if this syndication process is unsuccessful on those pre-agreed terms, the initial lenders – still committed to provide the financing – may end up holding all or a portion of their initial commitment and/or selling loans to the market at a loss.

In light of recent market volatility, where delayed or failed TLB syndications have become more frequent, it is important to develop and understand loss mitigation techniques to optimise outcomes in TLB syndications during uncertain times.

### *Market flex provisions*

One of the primary loss mitigation techniques in TLB syndications is the negotiation and use of market flex. These provisions permit the lead arrangers to unilaterally modify certain terms expressly set forth in the term sheet or the underwritten documentation precedent in consultation with the borrower – albeit without requiring the borrower's consent.

A successful syndication process often requires real-time, iterative conversations between the arrangers and potential investors, so it is often difficult to predict in advance the precise mix of pricing and other terms that will result in a fully allocated financing. For this reason, arrangers typically seek greater discretion in determining the combination of flex adjustments that may be implemented in any particular transaction. Borrowers may object to giving arrangers too much latitude; however, in practice arrangers will consult closely with the borrower prior to exercising any market flex, with the aim of reaching general agreement on the package of proposed changes to ensure a successful outcome for both the arranger and borrower.

#### *Pricing flex*

The most important category of market flex is the ability to modify key economic provisions, including pricing, call premium, "most favoured nation" protection and tenor.

Pricing flex provisions are particularly important, as they allow the arrangers to increase the interest rate margins on the TLB by a negotiated

amount. (In cases of longer-dated commitments, the amount may be accompanied by time-based step-ups.) They also permit a portion of that increase to take the form of additional original issue discount (OID) or upfront fees payable to the lenders upon the closing of the financing.

*Structure flex*

A second key category of market flex is so-called structure flex, which allows arrangers to balance a mix of the ultimate forms of debt financing in response to investor appetite by reallocating a portion of a contemplated TLB into another instrument – often pari passu (or unsecured) high-yield bonds – or vice versa. Borrowers need to carefully weigh the attractiveness of adding a call-protected, fixed-rate high-yield bond into their capital structure, for example, in lieu of a floating-rate TLB with comparatively little or no call protection.

Borrowers will also want protection as to the aggregate cost of debt across the capital structure, and may seek to impose a weighted average pricing cap across the entire package and/or specific caps for each debt tranche.

*Terms flex*

The last category of market fle is "terms" flex. These provisions permit modifications to other terms set forth in the committed term sheet that receive market pushback or prove to be too aggressive in light of market conditions.

Borrowers usually negotiate for strict adherence to the terms of an agreed documentation precedent, subject only to the modifications agreed in the term sheet and the flex terms. A typical formulation is that the definitive credit agreement must be "identical to" or "not less favorable to the borrower than" the identified precedent. Therefore, arrangers cannot expect to negotiate terms in definitive documentation once the commitment letters have been signed. Instead, they must identify areas of potential market pushback while still at the pre-commitment stage and ensure they are either explicitly reserved in the term sheet or addressed via flex rights.

***Closing and post-closing flex***

Typically, acquisition financing commitments permit market flex to be exercised at closing of the acquisition if a successful syndication has not been accomplished by such date. This allows an arranger to:

- reduce its loss in selling loans to the market at closing on the "fully flexed" (ie, most lender-favourable) terms; and/or
- hold some or all of its committed loans on its balance sheet on those terms, thereby maximising the likelihood that it will be able to sell its retained position post-closing at attractive prices.

It also reduces the extent of the loss that the arranger may be forced to recognise at close, whether by recognising a particular sale or marking its position to market.

Notwithstanding this "auto-flex" right, borrowers and arrangers can and often do agree to defer and reserve the ability to exercise flex rights for a certain post-closing period. Many fee letters expressly contemplate flex surviving the closing date. However, even if this is the case, it may be advisable to make technical adjustments to reflect this agreement. Any increase in pricing that might have been reflected in the form of OID at closing, for example, will need to be paid post-funding as a direct fee to the lenders.

The arrangers will also want to facilitate implementation of post-closing flex by allowing the

administrative agent to amend the documents unilaterally to effect any flex-related changes.

***Fronting letters and sell-down letters***

In order to facilitate the funding at closing in financings involving multiple lenders, it is common for a "fronting" arranger (usually the "lead left" arranger) to fund the entire amount of the loans to the borrower on the closing date on behalf of the other initial lenders. The fronting arranger then individually assigns the loan to the institutional investors that received allocations in syndication.

*Fronting letters*

If an assignment to an investor does not settle within a pre-agreed period following the closing date, the other initial lenders are required to purchase their pro rata share of the loans fronted by the fronting arranger. This is documented in a fronting letter.

In a deal that is not fully syndicated at closing, the fronting letter takes on new significance. If there is an unallocated portion of the financing, the lead left arranger may be unwilling to front on the basis that each committing arranger should directly retain and hold its own exposure in the absence of an allocated syndicate. If the lead left arranger does agree to front in this circumstance, the fronting letter must be adjusted to reflect this.

In a fully allocated deal, the price at which the other initial lenders are required to purchase the loans from the fronting arranger is known at closing. However, in a deal that is not fully syndicated, the OID that the market will ultimately receive – and, therefore, the price at which the other initial lenders should purchase the exposure – is not known at funding. In light of this uncertainty, the arrangers will need to discuss and agree on the price at which the other initial arrangers will purchase the loans and how any losses in syndication will be shared among them.

In a financing that is not fully allocated at closing, the fronting letter should also address the possibility that all or a portion of the loans remain unallocated within a pre-agreed time period afterward. In these circumstances, an initial lender will also need the right to "put" a pro rata share of the unallocated loans to the other arrangers at the purchase price paid by the lead arranger (or its affiliate) in the initial funding. These complications militate in favour of each lender funding its committed portion of a financing that is not fully syndicated at closing, unless there is near-term visibility as to post-closing allocations and price.

*Sell-down letters*

A "sell-down" is broadly defined as any sale, assignment, participation, syndication or other transfer of loans. Sell-down letters provide that, for an agreed period post-closing, no initial lender will sell-down any loans held by it without complying with a protocol pre-agreed and set forth in the sell-down letter.

This protocol typically provides that all sell-downs be made pro rata across the initial lenders, subject to each initial lender having an opportunity to decline to participate in each such sell-down. Subsequent sell-downs will continue to be made pro rata based upon closing date loan holdings, so that the initial lenders are not incentivised to hold out on an earlier lower-priced sell-down in favour of a greater than pro rata participation in a subsequent and potentially better offer.

***Post-closing trading and loss sharing***

It is not uncommon in TLB syndications for the lead arranger to engage in market-making activ-

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ity. In a fully allocated transaction, this may take the form of the arrangers shorting the loans by allocating more than the aggregate principal amount of the loan. The arrangers will then purchase loans in the open market to cover that short position, thereby facilitating early trading in the loans.

In a deal that is not fully allocated, the lead arranger may instead seek to support secondary trading prices by going long on the loans for a period of time (either in the initial allocation or via immediate post-allocation purchases). In such a circumstance, the lead arranger may find itself taking losses if it subsequently sells the loans at a price less than the purchase price.

In this case, the lead arranger may seek to enter into a loss-sharing arrangement with the other initial lenders to ensure that any such trading losses (which are intended to benefit the unallocated loans of all initial lenders) are shared equally among the arrangers.

### *Bridge loans*

Owing to legal and regulatory restrictions and financial considerations, arrangers are typically unable or unwilling to commit in advance to purchase high-yield bonds. However, in an acquisition finance context, the issuer will need fully committed financing to ensure – and assure the seller – that sufficient funds will be available at the time of the closing of the acquisition.

One form to “bridge” this gap is a high-yield bridge loan facility under which the initial lenders commit to fund an initially short-term loan in the event that the contemplated high-yield bonds are not successfully offered prior to, or concurrently with, the closing of the acquisition. The initial lenders are de-risked of their bridge loan exposure, in whole or in part, principally through the successful offering of the high-yield bonds.

The initial lenders (or their affiliates) may also seek to de-risk by entering into agreements with investors to purchase participation interests in the bridge loans if they are ever funded. As with the TLB, funding the committed bridge loans – or taking notes issued in lieu thereof that they cannot resell – is generally a costly and undesirable outcome that initial lenders (or their affiliates) will seek to avoid.

It is also common for securities demand rights to provide that the issuer need not satisfy certain demands if they would result in adverse tax consequences. Typically, borrowers are concerned about cancellation of debt income that may arise from replacing a funded bridge loan with securities issued at a discount to par. Arrangers usually scrutinise this provision carefully to ensure that it applies solely to post-closing demands, so that they preserve their right to demand at closing. The issuer will often still retain the right not to comply with a closing date demand if it would have an adverse tax consequence. However, this will result in a demand failure, with the associated consequences.

A similar issue arises from the common requirement that a demand may only be made for a certain period of time if the bonds are being purchased by bona fide third-party purchasers. This is often, but not always, tied to the “no adverse tax consequences” requirement and can undermine one of the central objectives of the demand – that is, flexibility for the investment banks to hold the demand securities for later distribution in circumstances where there is not sufficient third-party demand. As a result, those provisions are typically drafted to apply to post-closing demands only.

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*Market flex and securities demand*

In the bridge loan context, market flex rights – if any – are usually very limited, as the goal of the bridge lenders is to reduce their exposure via a successful offering of the high-yield bond takeout. Therefore, bridge-specific market flex rights are typically limited to certain adjustments to call protection and structure flex to reallocate a portion of the bridge commitments to other parts of the proposed capital structure.

For initial bridge lenders, the focus is on the ability to force the issuer to issue debt securities – often referred to in this context as "demand" securities – to finance the acquisition (and therefore reduce the bridge loan commitment) pursuant to a securities demand. The threat of invoking their securities demand rights may be used by the arrangers to incentivise the issuer to consummate a high-yield bond offering in advance of (or concurrent with) acquisition closing, rather than funding the bridge loan and delaying the bond offering until markets improve.

In circumstances where the bonds cannot be issued, the securities demand right also serves as a loss mitigation device by allowing the initial lenders (or their broker–dealer affiliate) to hold bonds, rather than bridge loans. These may be viewed as less expensive to carry and easier to sell when conditions improve. However, in order for the initial lenders to be able to distribute the demand securities post-closing, they may need co-operation from the issuer (eg, by providing updated financial information). Therefore, it is important in such cases to include an ongoing co-operation requirement from the issuer.

*Conditions to a securities demand*

Securities demands may generally be exercised during the period beginning five business days prior to the closing date until the 12-month anniversary of the closing date. They typically provide for two or three separate exercises if less than all are requested on the initial demand. From the initial lenders' perspective, the ability to exercise the securities demand on the closing date in lieu of funding the bridge loans is critical.

This is one of the enduring changes in market practice following the 2008 financial crisis, in which many investment banks found themselves long, large, illiquid bridge facilities because the documents included a post-closing "demand holiday", during which the bridge would be funded and no demand could be exercised. These days, it is not uncommon in long-dated commitments for the initial lenders to be able to demand the issuance of securities into escrow in advance of closing, subject to certain agreed parameters.

Commitment letters often provide that, as a condition to their exercise of a securities demand, the arrangers first afford the issuer an opportunity to market bonds by participating in a customary high-yield roadshow. Although not objectionable on the face of it, arrangers should consider whether this requirement effectively provides the issuer with a veto right by simply refusing to participate in the roadshow. One way to mitigate this possibility is to provide that no roadshow is required if it would be "commercially futile".

It is also helpful to clarify that the occurrence and completion of the high-yield bond marketing period (typically a condition precedent for the funding of the bridge loans) satisfies the roadshow requirement. Therefore, it is not necessary to conduct a separate roadshow for the demand securities once the bond marketing period has run its course.

### Demand securities

The securities that the initial lenders may demand are subject to certain limits with regard to call protection, maturity, seniority and – critically – the maximum weighted average yield and minimum issue price of the demand securities (the "total cap"). Increasingly, the terms of the demand securities are:

- tied to the terms of an identified indenture precedent; and/or
- required to be "no worse" than the terms of the concurrent TLB.

However, in some respects, TLB terms have become more aggressive than typical high-yield bond terms. There are also some terms, such as leverage ratios, that do not translate cleanly from the first lien TLB to the unsecured high-yield bonds. Therefore, this requirement should be considered when negotiating commitment papers.

It is the total cap that plays the critical role in determining which party bears the risk of loss in a contemplated high-yield bond offering, however. In a scenario where a high-yield bond offering is available at acquisition closing at a yield greater than the total cap (usually in the form of an issue price that is lower than the minimum issue price permitted under the securities demand), the issuer may simply refuse to issue the high-yield bonds at the higher yield. Instead, the issuer may force the initial lenders to fund the bridge or, if a demand is made, issue demand securities that bear interest at – or have a yield equal to – the total cap.

In practice, the initial lenders may prefer to lock in their loss by compensating the issuer to issue the high-yield bonds at the clearing price (in an amount equal to the difference between the clearing price and total cap), rather than funding the bridge loan or making a securities demand.

### Demand failure events

Despite the protections included in the commitment letters, an issuer cannot actually be forced to issue the securities. This failure of the issuer to comply with a securities demand is not treated as an event of default under the bridge credit agreement nor is it a condition precedent for funding the bridge loan.

Instead, the arrangers address this possibility by disincentivising an issuer's noncooperation through consequential economic changes to the bridge loan itself. So, if the arrangers issue a valid securities demand and the issuer does not comply with the demand within the specified period, the following shall occur:

- the interest rate of the bridge loan increases to a fixed rate equal to the total cap;
- the conversion or rollover fee on the bridge (usually equal to the pre-agreed underwriting fee on the high-yield bond takeout) is immediately payable;
- the bridge loans benefit from the same call protection as the high-yield bonds; and
- the issuer's limited consent rights to assignments of the bridge loans fall away.

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