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Market Trends 2019/20: M&A Financing

A Lexis Practice Advisor® Article by
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This article discusses the market trends for merger and acquisition (M&A) financing in 2019, including notable transactions, deal structure and process, deal terms, disclosure trends, industry insights, and regulatory trends, as well as the impact of the coronavirus 19 (COVID19) on the leveraged loan market in the first quarter of 2020, and provides a market outlook for 2020. Breaking the recent trends seen in the leveraged lending markets, leveraged lending (consisting of Leveraged buyout (LBO) and other M&A transactions) activity dropped steeply in 2019, with institutional volume down 39% from 2018, the largest year over year percentage decline since 2009. The decline in LBO-related loan issuance was not as large as the decline in M&A activity.

Despite this decline, as in 2018, M&A related institutional loan volume represented the largest share (54%) of leveraged loan activity. Institutional refinancing activity fell approximately 16% from 2018, while the volume of repricings effected via amendment declined approximately 79% from 2018 levels. LBO institutional loan activity declined approximately 26% from 2018 levels, which had seen the highest levels since 2007, before the financial crisis. Middle market lending activity fell approximately 44% from 2018, second lien loan issuance levels plunged approximately 75% from 2018, and high-yield bond issuance volume increased approximately 27% in 2019 over 2018, offsetting the contraction in leveraged loans. Repricing volume during the fourth quarter of 2019 surged to $46.5 billion, its highest level in six quarters.

The composition of investors changed from 2018 with banks and securities firms accounting for approximately 16% of market supply, a high since 2011. At the same time, institutional investors consisting of CLOs and loan funds market share decreased to approximately 84%, representing the lowest level since 2011 and a 7% decline from 2018.

The perceived quality of borrowers changed in 2019, with the volume of single B institutional credits declining 37% in 2019, and the volume of single B pro rata credits falling 24%. At the same time, the volume of double B institutional credits rose 1%, and the double B pro rata volume remained close to unchanged. In the loan market as a whole, including institutional and pro rata credits, the portion of loans issued by borrowers rated BB-, BB, or BB+ expanded and reached approximately 32% of the total U.S. leveraged loan market, increasing from 24% in 2018 and 26% in 2017. The share of borrowers rated B+ or lower still represented 49% of the U.S. leveraged loan market in 2019 and compares to approximately 60% in 2018 and 2017. The differential of spreads on institutional loans that cleared the market and were made to double B and single B issuers in 2019 peaked in November 2019 at

233 bps. Investors' interest in debt issued by companies with lower ratings was diminished while demand for debt issued by better rated companies caused their loans to be oversubscribed and allowed those borrowers to obtain more favorable loan terms. Many lower rated borrowers needed to pay higher fees and increased interest rates and accept more lender friendly terms. In addition, the lower supply and higher quality of leveraged loans brought to market in 2019 resulted in a reduction in demand for lower rated issuers' debt. Late in the fourth quarter of 2019, the ratio of downward to upward price flexes surged with many of these changes accompanied by a narrowing of OIDs, however some large deals did flex pricing upward.

Regulatory pressures have continued to ease. However, some transactions, in particular foreign transactions, face greater regulatory scrutiny. It remains to be seen how the market will continue to react to other new developments that are sure to impact the leveraged loan market, including, among others, the widely anticipated discontinuance of the London Interbank Offered Rate (LIBOR) in 2021 and the implementation of Brexit following the UK's formal withdrawal from the EU in January 2020. Additionally, the U.S. economy experienced uncertainty and turbulence in 2019 and the financial markets continue to experience volatility as a result of the COVID-19 pandemic and other concerns such as tariffs and trade wars, geopolitical events and the prospective U.S. 2020 presidential election results.

For more information on these developments and other market trends, see Market Trends. For an overview of practical guidance on COVID-19 covering various practice areas, including capital markets, see Coronavirus (COVID-19) Resource Kit. For previous market trends for M&A financing, see Market Trends 2018/19: M&A Financing.

Notable Transactions

Although M&A activity was down in 2019, the year was notable for some significant LBO transactions, including the acquisition of Genesee & Wyoming by Brookfield Asset Management and GIC ($8.4 billion), the acquisition of Johnson Control's Power Solutions business by Brookfield Business Partners L.P. ($13.2 billion), the acquisition of WellCare Health Plans by Centene Corporation ($17 billion) and the take private of Ultimate Software by Hellman & Friedman ($11 billion).

One noteworthy deal was Brookfield's acquisition of Power Solutions, the production and distribution of automotive batteries business of Johnson Controls, for approximately $13.2 billion. At the time the loan came to market in March 2019, there were no loans in the market of its size and none with all of its borrower favorable terms. The transaction closed in April 2019 with $7.71 billion of loans, denominated in dollars and euros and $3.74 billion notes (secured and unsecured), denominated in dollars and euros. The loan agreement has the ability to add significant amounts of debt and to finance dividend payments. EBITDA add-backs include the effects of increased pricing in customer contracts and contract renegotiation. Some have described the documentation terms as even more borrower favorable than the terms for the Refinitiv and Akzo Nobel deals that were completed in 2018 which at that time were deemed to contain highly borrower favorable terms. The loan financing was oversubscribed, which allowed for reduced pricing and the removal of certain collateral from the security package.

Another major transaction was Brookfield's and GIC's take private acquisition of Genesee & Wyoming, a short line rail operator, in a deal valued at approximately $8.4 billion, representing a 40% premium to existing stockholders. The deal was announced in July 2019 and completed in December 2019. The debt financing totaled $3.15 billion, consisting of a $600 million senior secured revolver and a $2.55 billion of senior secured cov-lite term loan facility. Equity commitments totaled approximately $5.5 billion. Pricing on the term loan was flexed downward from LIBOR + 250-275 to LIBOR + 200, with the LIBOR floor of 0% and 99.5 OID remaining the same.

Deal Structure and Process

Deal Process

The typical process for leveraged financing deals can be bifurcated into two phases: the commitment stage, when the lenders' commitments to provide the financing are negotiated and documented; and the definitive documentation stage, when the governing agreements for the financing arrangement are completed. The typical approach is to execute a commitment letter at the time of signing the M&A transaction that outlines the key terms of the financing, and only then turn attention to the definitive documentation. This allows borrowers to line up funding commitments and provide assurance to the seller that sufficient funds will exist to consummate the transaction without needing to wait until all of the terms of the final agreement have been documented. The trend of limited conditionality remains, reducing the risk of the conditions to the M&A transaction being met at a time when the conditions to the financing are not met.

The hallmarks of limited conditionality in a commitment letter include (1) a closed list of conditions limited to those that are specifically enumerated in the commitment letter (and no others), (2) using the same definition of material adverse effect and governing law as the M&A transaction, (3) limiting the representations that need to be true in order to close to (x) the same business representations as those under the M&A transaction and (y) a fixed set of legal representations related to the borrower (and generally within its control), and (4) the ability to perfect some collateral on a post-closing basis. In the period between signing and closing, syndication of the commitments may occur, and the definitive documentation will be negotiated. Execution of the definitive documentation and funding typically occur simultaneously with closing of the M&A transaction. However, the commitment phase is extremely important as it sets the key terms of the financing (including pricing), ability to incur more debt, and, as discussed above, conditions to closing. For additional information, see Term Sheets.

Timeline

Deal timelines vary from a few weeks to several months. The timeline will be driven primarily by the M&A process, where factors such as required regulatory approvals or shareholder consents can have significant impacts. Recently, some acquisitions, including deals involving financial institutions, pharmaceuticals, technology companies, and transactions by foreign entities, have been subject to increased regulatory review. Regulatory approval and uncertainty, including antitrust, national security, and geopolitical matters, have introduced a more unpredictable timetable to finance acquisitions and in some cases, approval has been denied or caused companies to abandon transactions. For example, after the Federal Communications Commission and the Department of Justice finally approved the T-Mobile and Sprint $26.5 billion merger, a coalition of state attorney generals filed a lawsuit in the Southern District of New York arguing that the merger should be blocked for anticompetitive reasons. The Court approved the merger in February 2020. Edgewell Personal Care, the owner of Schick shaving products, terminated its $1.37 billion acquisition of Harry's, a direct-to-consumer shaving company, after the FTC sued to block the transaction. In deals requiring regulatory approval or shareholder consents, the length of the commitment period must be extended which requires lenders to hold their commitments for longer periods and for some lenders to maintain capital on their balance sheet for the entire period. To mitigate this risk, investors often impose ticking fees that begin on a certain date after signing the commitments if the loans have not been drawn and those fees may increase after further delays. In some cases, even the interest rates can increase after these periods.

However, in some deals with no regulatory or other approvals needed, the principal gating item will be time to syndicate or complete the financing. It is important to make sure the timing of the closing conditions in the M&A transaction and the financing work together. Otherwise, given that financing conditions (also known as financing outs) in M&A agreements are often unacceptable to sellers, the borrower could be put at risk of being required to close the acquisition before the lenders are required to fund their commitments.

Acquisition agreements for debt-financed acquisitions frequently contain the concept of a marketing period to allow for the marketing of the debt financing before the buyer will be obligated to close the acquisition. The marketing period generally commences once the seller has delivered certain required financial information to the buyer. The required information is often defined as the financial information that is necessary to consummate a debt offering of the type being used by the buyer, primarily consisting of financial statements and, in the case of bond financings, additional information necessary to satisfy securities law requirements for registered public offerings or private placements of debt securities.

Often, in transactions with long expected windows between signing and closing due to regulatory concerns, the parties will agree that the marketing period will not commence until the closing conditions in the acquisition agreement (other than those that are to be satisfied only at closing, such as delivery of customary deliverables) have otherwise been satisfied. This gives the buyer and its financing sources the option to hold off on marketing the debt financing until the acquisition otherwise appears reasonably certain to close. This marketing period will differ from the one built into the debt commitment letter itself, which typically commences only after the financing sources have received the bank book and/or offering memorandum containing (but not limited to) the required information provided by the seller. As a result, a few additional days may be built into the marketing period under the acquisition agreement to account for the completion of the marketing materials after the buyer has received the required information from the seller.

The commencement of the acquisition agreement marketing period may also have a built-in delay to allow for the expiration of a go-shop period or the mailing of a proxy statement if shareholder approval is required for the acquisition. Depending on the time of year when the acquisition agreement is signed, there may also be blackout dates for seasonal periods when marketing debt is difficult (such as Labor Day, Thanksgiving, and Christmas).

In acquisitions involving bond financing, the marketing period will typically run only at times when the required information provided by the seller is compliant with securities laws, in a form capable of being covered by a comfort letter, and not stale under applicable securities laws and Securities and Exchange Commission (SEC) rules. Many deals also include triggers for suspending the marketing period due to accounting-relating events, including the restatement of the financial information, the withdrawal of the audit opinion with respect to the financial information, a delay in SEC reporting, or the receipt of material SEC comments on a disclosure document. These triggers may simply toll the marketing period during their continuation, or they may restart the marketing period from the beginning.

Deal Structure

Leveraged financing transactions take on various permutations involving some combination of revolving credit facilities (either cash-flow-based or asset-based), first and second lien term loan structures, and high-yield bond financing. The borrower's credit profile and nature of its business, together with the market environment, will impact the capital structure put in place in any given deal.

Term loans combined with revolving asset-based loans (ABLs) have become a common deal structure. Because ABL revolvers limit borrowing capacity to a specified percentage of designated assets in the lenders' collateral package, pricing is usually cheaper than cash-flow revolvers (where maximum borrowing capacity remains fixed instead of fluctuating). ABL revolvers, unlike cash-flow revolvers, tend to be documented under a separate credit agreement when used in combination with a term loan. The covenants across the two agreements will often mirror each other, with the notable exceptions that (1) many times the ABL will have a financial maintenance covenant (which may be springing depending on usage) while the term loan facility may not and (2) the ABL may allow the borrower to pay unlimited dividends, or make investments or incur debt subject to satisfying a payment condition test (generally sufficient liquidity and perhaps meeting a fixed charge ratio) after giving effect to the action.

In a financing with both a cash-flow revolver and a term loan, the financial covenant may only be for the benefit of the revolving lenders. This is because term loans, but not revolvers, routinely lack financial maintenance covenants in broadly syndicated loans and larger middle market deals (but less so in small middle market deals) under the trend of covenant lite (as further discussed below).

In order to prevent the term loan lenders from indirectly benefiting from the revolver's financial covenants, the term loan agreement will often contain a cross-acceleration, instead of a more typical cross-default, to the revolver. This requires the revolving lenders to actually accelerate their loans before an event of default under the ABL gives rise to an event of default under the term loan agreement.

In deals involving bond financing, there will typically be a bridge loan commitment (generally provided by the financial institutions that expect to underwrite the bond deal) to serve as a backstop in case the bond issuance fails to occur. In recent years, the trend has been for the banks to have the right to force the borrower to issue debt securities immediately at, but generally not before, closing, in lieu of funding bridge loans. This has the practical effect of further reducing the likelihood that the bridge loans will actually be funded.

Deal Terms

On balance, deal terms remain generally borrower-friendly, but there are a few areas where the balance at times has swung back in favor of lenders. The following are some of the key trends in deal terms in 2019:

- **Covenant lite.** Covenant lite deals continued to feature prominently in the broadly syndicated and larger middle markets (BSL). In 2019, the overall market share of covenant lite institutional loans was 90%, the highest volume on record. In these deals, financial maintenance covenants (such as maximum leverage ratios and minimum interest coverage ratios) are absent from the term loan facility or, less frequently, from the revolving credit facility. In addition, covenant lite loans typically have looser restrictions on the borrower, and include incurrence-based ratio tests (which historically have been associated with high-yield bond indentures) rather than fixed baskets. This allows the borrower to take otherwise restricted actions, such as incurring additional debt, paying dividends and other distributions, or making additional investments, if the specified incurrence test is satisfied. For additional information on covenants in debt financings, see Corporate Debt Securities in U.S. Capital Markets, Market Trends 2019/20: Investment Grade Debt Offerings, Top 10 Practice Tips: High Yield Debt Offerings, and High Yield vs. Investment Grade Covenants Chart.
- **Call protection.** Soft call protection, where prepayment premiums are applicable only to repricing transactions, have become standard in the BSL market. This contrasts with hard call protection (still seen in some smaller middle market deals) required to be paid in connection

with voluntary prepayments made for any reason. The soft call period during which premiums apply commonly runs for the first 6 to 12 months after closing. In some transactions, the soft call provisions apply to any prepayment or amendment having the effect of reducing the borrower's pricing. However, borrowers have been successfully expanding the categories of exclusions from soft call protection. Many recent deals (including some smaller middle market deals with hard calls) now carve-out repricings that occur in the context of change of control transactions or transformative acquisitions from the requirement to pay call premiums.

- **Incremental facilities.** It has become an established feature of the market for credit agreements to contain uncommitted incremental facilities (accordions) allowing the borrower to upsize the existing credit facilities or incur debt under new tranches to be established under the credit agreement. Incremental facilities commonly have most favored nation (MFN) provisions enabling the existing lenders to benefit from increased pricing if the new loans have a higher all-in yield. Typically, the pricing on the existing loans would be increased to a level that is an agreed spread less than the higher pricing on the incremental loans. Historically, the agreed spread was 0.50% but recently more and more borrowers have had success in pushing the yield differential to higher levels (such as 0.75%). Many times, the MFN applies only to incremental term loans, but it may apply to incremental revolving facilities as well. In addition, there may be a sunset provision limiting the MFN's applicability to incremental facilities incurred within a specified period after closing (such as six months). It has become common for borrowers to have exceptions to MFN protection such as, excluding a designated portion of the total incremental debt capacity, and excluding incremental debt incurred in connection with permitted acquisitions or permitted investments or maturing after the existing debt by a period to be agreed such as a year or sometimes longer.

  Incremental facilities are commonly permitted up to a dollar-based cap (the free and clear basket) plus an unlimited additional amount subject to compliance with a specified leverage ratio test plus an amount equal to certain voluntary prepayments and permanent reductions in commitments. Increasingly, the dollar-based cap in the BSL market will now also have a separate prong (sometimes referred to as a grower component) allowing additional incremental loans based on a specified percentage (often 100%) of the borrower's earnings before interest, taxes, depreciation, and amortization (EBITDA) with other agreed-upon adjustments or total assets.

  It is also becoming more common in the BSL market to see credit agreements that permit the borrower to use incremental loan capacity to incur additional debt under separate facilities outside the credit agreement in lieu of incurring incremental loans under the credit agreement, though it may be required to take the form of bonds if secured on a pari passu basis.

- **Basket reclassification.** Another feature that has migrated from the high-yield bond market to the BSL market is the ability for a borrower to reclassify usage under a dollar-capped negative covenant basket into usage under an unlimited ratio-based basket. This feature is becoming increasingly common, especially among large cap deals but even in some larger middle market transactions. It allows a borrower that may have used up its dollar-based baskets to reload these baskets (i.e., provide for additional capacity) by shifting the usage to incurrence-based baskets when its financial performance improves enough to satisfy the relevant ratio tests. For additional information on high-yield bond provisions, see Market Trends 2018/19: High Yield Debt Offerings and Top 10 Practice Tips: High Yield Debt Offerings.

- **Collateral leakage and designation of unrestricted subsidiaries.** Collateral leakage is becoming an increasing concern to lenders since they rely on the assets owned by the loan parties at the time they make their credit decision and the restrictions in the documentation to prevent deterioration in the assets available to repay the loans. Several negative covenants, when working in concert, provide flexibility for loan parties to move assets to entities outside of the credit group. As a result of one instance of a borrower using its covenant flexibility to move material IP to an unrestricted subsidiary, some deals now limit the ability to transfer IP or other key assets.

- **Negative covenants and grower baskets.** Although lenders have been focused on collateral leakage, borrowers still typically negotiate favorable terms to make investments in non-guarantor restricted subsidiaries. These agreements may resemble high-yield bond indentures where the borrower is permitted to make unlimited investments in such entities. If the agreement permits restricted subsidiaries to make unlimited investments in non-guarantor restricted subsidiaries, direct assets may leave the collateral package and be replaced with an equity pledge. The debt, lien, and restricted junior debt repayments covenants remain borrower-friendly and often include grower baskets based on EBITDA or another agreed-upon metric. Builder baskets typically include retained asset sale proceeds, declined mandatory prepayments, unused baskets such as restricted payments, and other negotiated components. In turn, the builder basket can be used to make additional restricted payments, restricted junior debt repayments, incur debt, and make investments.

- **EBITDA addbacks.** In 2019, borrowers and sponsors continued to seek friendly EBITDA adjustments. The issue has become one of the most negotiated points since covenant compliance and grower baskets are, and pricing may be, determined by the result. Current borrower-friendly trends to EBITDA adjustments include increased or removal of caps on pro forma cost savings synergies, permitting projected cost-savings not connected to acquisitions, synergies "of a type" shown in a sponsor's QOE report, longer look-forward periods, board expenses, severance and relocation costs, accrued dividends on preferred stock, expenses due to exercise of employee options, indemnification payments that are reimbursable by third parties, and others.
- **Unitranche loans.** Unitranche loan structures continued to be popular in 2019, especially in middle market deals. This type of financing combines what would otherwise be separate debt instruments (e.g., first lien and second lien) with separate priority classes of creditors into a single credit agreement with (from the borrower's perspective) a single class of creditors. The lenders separately enter into an agreement among themselves to create separate "first out" and "last out" tranches of debt (i.e., senior and junior priority), with payment waterfalls that effectively put the lenders into the positions of different classes having different levels of payment or lien priority. The borrower pays a single blended interest rate that the lenders divide up among themselves to account for the differing levels of credit risk they assume. Unitranche structures have been growing increasingly more complex, with multiple layers of priority (which may be split up differently across term loan and revolving credit facilities) being addressed in the agreement among lenders. The agreements among the lenders governing these relationships are generally proprietary and not shared with borrowers.

  The enforceability of agreements among lenders remains an open question. In one notable case, In re RadioShack Corp. (Case No. 15-10197 (Bankr. D. Del. 2015)), the Delaware bankruptcy court implicitly recognized the enforceability of an agreement among lenders. That case involved two separate unitranche financings—a term loan facility and an ABL—secured by crossing liens on current assets and fixed assets. The debtor sought approval of a Section 363 asset sale, in which one of the last out lenders attempted to credit bid its last out loans to purchase a portion the debtor's assets. The first out lenders objected on the basis that not all of their claims would be satisfied because no reserve was being established for their contingent indemnification claims. The parties ultimately agreed to settle the dispute, so the bankruptcy court issued no written opinion on the matter, but the transcript of the hearing indicates that the court offered guidance on the interpretation of the applicable agreement among lenders. Although this does not have the precedential value of a written opinion, it offers some level of comfort that a bankruptcy court will enforce an agreement among lenders in appropriate circumstances.
- **Additional trends.** In some recent deals, the loan agreements have included the following provisions:
  - An ECF deductible where there is no requirement to prepay loans unless ECF exceeds a minimum amount.
  - An "auto cure" on defaults or events of default where a borrower can deem the default or event of default cured if the lenders have not submitted a notice to enforce their rights by a certain period of time. In some cases, the lenders are not permitted to submit a notice of default or acceleration that is based on facts if the facts giving rise to the default or event of default were publicly known for a specified period of time.
  - Net short provisions have started to appear as a result of a ruling in early 2019 by the US District Court in the Southern District of the State of New York in a case known as the "Windstream" case. As a result of this decision, some agreements provide for the disenfranchisement of lenders who are net short in a borrower's debt, providing in some scenarios that the net short lenders are not permitted to take actions in connection with amendments or waivers, submit notices of default, or any other notices or requests. In cases that permit these actions, lenders may be required to make a representation that they are not net short or may be deemed to have made such a representation. Net short lenders may be added to a disqualified lender list.
  - Some borrowers have been able to successfully limit the lien covenant to prohibit only liens securing indebtedness and to eliminate all real estate from the collateral package.

Disclosure Trends

Although bank loans are not securities for purposes of U.S. federal securities laws, participants in the loan markets and their affiliates also frequently engage in securities trading and are therefore sensitive to issues involving disclosure of material nonpublic information (MNPI). Because lenders in loan syndicates would normally receive MNPI from their borrowers in the ordinary course of administering the credit facility but may also want to trade in related securities without restriction, the loan market has developed the approach of bifurcating lender syndicates in any given deal into two groups: public-side lenders and private-side lenders. Each lender in the syndicate chooses which group it wishes to join.

Public-side lenders will generally not have access to MNPI and can therefore trade in securities issued by the borrower with decreased risk of violating the securities laws. Lenders who opt to become private-side lenders will obtain MNPI from the borrower, giving them additional information to use in making credit decisions but which may preclude them from trading in the borrower's securities. The borrower and the loan arranger will typically ensure that the general bank book or confidential information memorandum prepared for the lender syndicate contains no MNPI, and then a separate supplement containing MNPI will be prepared for the private-side lenders. These disclosure packages are marketing materials that generally include a relatively high-level description of the borrower's business and management, an overview of the applicable industry, key credit highlights, and pro forma capitalization and financial information.

For additional restrictions on MNPI, see Regulation FD and Insider Trading Policies.

Industry Insights

Leveraged lending activity in 2019 was broadly distributed across a range of industries. The technology sector experienced the most leveraged lending activity of any industry, capturing approximately 19% of all new money leveraged loan volume. After technology, the next most active industry sectors were services and leasing and healthcare, representing slightly more than 16% and 13%, respectively, of all new money leveraged loan volume. After these three sectors, the next most active industry sectors were oil and gas, automotive, chemicals, entertainment, and leisure and manufacturing and machinery. Each of these individually represented less than 10% of new money leveraged loan volume, and collectively, together with the technology, services and leasing and healthcare sectors, represented approximately 72% of all new money leveraged loan volume.

Legal and Regulatory Trends

Regulatory developments recently affecting the loan markets include the following:

- **Tax reform.** The passage of the Tax Cuts and Jobs Act of 2017, the most significant revision of the U.S. tax code in decades, may impact the leveraged loan markets in ways that still remain to be seen and may become more transparent in 2020 when borrowers and sponsors have had more time to evaluate the impact of the new law on their businesses. A number of the tax law changes have special significance to transactions involving leveraged debt financing. One is the general disallowance of deductions for net interest expense in excess of 30% of adjusted taxable income (ATI). The limitation on a borrower's ability to deduct the interest expense associated with its loan facilities obviously has the potential to make the incurrence of debt a less attractive proposition, especially if interest rates start to climb. ATI is defined in a manner that excludes deductions for depreciation and amortization for tax years beginning before 2022, so ATI approximates straight EBITDA until that year (and EBIT starting with that year). However, because credit agreement EBITDA definitions tend to have various nonuniform adjustments to EBITDA, financial modeling of leveraged transactions may become more difficult.

  Another tax law change that would have had enormous effects on the structuring of leveraged financing transactions and that was anticipated to be a part of the tax reform—the elimination of the rule under Section 956 of the Internal Revenue Code (26 U.S.C. § 956) treating foreign subsidiary credit support for the debt of its U.S. parent as a "deemed dividend"—was unexpectedly not included in the final legislation. Although some regulations regarding Section 956 were issued, market practice is still to exclude foreign subsidiaries from being guarantors.

- **Federal leveraged lending guidance.** First issued in March of 2013 by the three U.S. federal banking regulatory agencies—the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation, the "Interagency Guidance on Leveraged Lending" is a set of guidelines released in response to concerns that deteriorating underwriting practices in the loan market contributed to the 2008 financial crisis and could pose systematic risks to the financial system. Most of the guidelines take the form of general, high-level recommendations for underwriting standards and risk management practices for lenders to use in their leveraged lending activity, but the most far-reaching market impact stems from a single statement contained in the guidance: "Generally, a leverage level in excess of 6x Total Debt/EBITDA raises concerns for most industries."

Initially, this statement led to concerns that it could be interpreted as establishing a de facto restriction against leveraged loans having a leverage ratio in excess of 6.0x. Later statements by the regulators clarified that they do not view a 6.0x leverage ratio as a bright-line test when evaluating transaction risk, but they indicated that such loans are more likely to receive heightened scrutiny. As a result, the percentage of deals involving a leverage ratio in excess of 6.0x dropped off afterwards, and reports in the press and anecdotal evidence started to suggest that regulated banks were increasingly becoming reluctant to participate in leveraged financing transactions where the debt-to-EBITDA multiple was expected to exceed this level. In addition, as reported in market league tables that rank bank arrangers by deal volume, the banks that had traditionally acted as lead arrangers in high-profile syndicated loan transactions were steadily ceding market share to other lenders that make up the so-called shadow banking system (which includes hedge funds, the lending arms of private equity sponsors, and mezzanine funds that are not regulated by the federal banking agencies and consequently fall outside the scope of the guidance). In late November of 2016, the European Central Bank published its own draft version of similar leveraged lending guidelines to be applicable to relevant supervised financial institutions in Europe.

In the August 2017 report issued by the banking regulators in connection with their semiannual Shared National Credit (SNC) review (which are available here), the regulators noted substantial progress towards full compliance with the underwriting and risk management expectations set forth in the leveraged lending guidance. However, they also expressed concern that weaknesses in underwriting practices, cov-lite structures and liberal repayment terms continued to pose risk and were particularly critical of incremental facilities (which allow a borrower to incur new debt that shares in the existing lenders' priority of claims), especially when used in order to fund dividend payouts and other transactions that weaken a borrower's underlying credit profile. The regulators stated that including incremental facilities in credit agreements can be thought of as "effectively outsourcing a bank's risk appetite and diminishing internal underwriting controls" and warned that "usage of incremental debt facilities shortly after funding an initial debt package may result in risk rating downgrades and non-pass originations."

However, late in 2017, the fate of the leveraged lending guidance was thrown into doubt when the Government Accountability Office, after being prompted by a U.S. Senator (Pat Toomey), made a determination that the guidance actually constitutes a rule that should have been subjected to congressional review pursuant to the Congressional Review Act, but that review was never undertaken.

In February 2018, the Chairman of the Federal Reserve and the Comptroller of the Currency both made statements implying that banks no longer need to comply with the leveraged lending guidance. Some lawyers believe it is likely the guidance may be abandoned or perhaps be replaced by an alternative approach. Some thought that these statements, indicating a softer tone by regulators, meant that some lenders may be less worried about criticism from regulators over their underwriting practices. Average adjusted Debt/EBITDA in 2019 was 6.25x while in 2018 it was 6.08x.

In November 2018, Senator Elizabeth Warren sent a letter to banking regulators expressing her concerns regarding banks' exposures to leveraged loans and CLOs. In early 2019, the Chairman of the Federal Reserve, the Federal Deposit Insurance Corporation and the OCC jointly responded to her concerns about the overall leveraged loan market, higher leverage levels of issuers, weaker covenants and other terms including incremental debt and liberal repayment requirements. The regulators stated that the agencies continue to closely review the evolution of these risks, banks' risk management policies, including underwriting standards, and other risks in the leveraged loan market. The Chairman of the Federal Reserve stated that he did not believe that leveraged loans and CLOs pose a risk to the financial system at this time.

In contrast to the Chairman's earlier statement, the SNC Report that was released in January 2020 found that banks' credit risk exposure to leveraged loans is still high, and that many leveraged loans continue to contain terms that are too risky and that were not present in prior market downturns. According to the report, the underwriting risks "include some combination of high leverage, aggressive repayment assumptions, weakened covenants and permissive borrowing terms that allow borrowers to draw on incremental facilities and further increase debt levels." The report noted that these factors were not materially present in previous downturns.

The SNC Report also noted that the rules requiring banks to adopt risk management policies to balance the leveraged positions have never been tested in an extreme market downturn so there is no guarantee those policies are sufficient.

The SNC Report recommended that banks ensure they are capable of managing economic downturns and confirm that their risk management practices and stress testing processes are strong enough to survive "changing market conditions" and that banks make appropriate assumptions while analyzing credits and underwriting leveraged loans. The Federal Reserve Bank of New York announced in early February 2020 that large banks with significant trading volumes and operations will have their finances tested in 2020 against a scenario that includes a "heightened stress" in leveraged loans.

- **Risk retention rules.** The risk retention rules for asset-backed securities promulgated pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (111 P.L. 203, 124 Stat. 1376) (the Dodd-Frank Act) initially cast a large shadow over the leveraged loan market but their effect turned out to have been short-lived.

  The risk retention rules became effective for collateralized loan obligations (CLOs) on December 24, 2016, but were invalidated insofar as they apply to open-market CLOs by a federal court decision in February of 2018 (as discussed below). The risk retention rules generally require that sponsors of securitization transactions retain 5% of the credit risk of the assets being securitized, widely referred to as retaining skin in the game. The regulatory rationale is to align the interests of the transaction sponsors with the investors in the asset-backed securities in order to avoid excessive risk-taking of the type that characterized the origination of mortgages that were packaged into securitizations in the years leading up to the financial crisis.

  Despite initial arguments from the CLO industry that the Dodd-Frank Act's risk retention mandate should not apply to CLOs due to fundamental differences in their structure and management from traditional asset-backed securitizations (such as residential mortgage backed securitizations), the federal regulators concluded that CLOs were not exempt from the risk retention requirements. The Loan Syndications and Trading Association (LSTA) filed a lawsuit in November of 2014 arguing that the federal agencies exceeded their statutory authority in making the risk retention rules applicable to CLOs. Although the federal district court ruled against the LSTA, that decision was reversed on appeal in February of 2018. The U.S. Court of Appeals for the D.C. Circuit remanded the case to the district court with instructions to vacate the risk retention rule to the extent it applies to open-market CLOs, and on April 5, 2018, the risk retention rule was vacated to such extent.

  Senator Warren introduced a bill in July 2019 that could have negative consequences for leveraged loans and CLOs and would result in the reimposition of risk retention rules on managers of CLOs. Given the political balance of power in 2020, it is unlikely the bill will become law any time soon. However, the bill is still an indication that the leveraged loan and CLO markets are subject to continued governmental focus.

  In January 2020, five regulatory agencies approved a proposal recommending that senior AAA CLO debt liabilities that meet certain requirements should no longer be considered equity-like "ownership interests" under the Volcker Rule, and that the "loan securitization" carve-out from the definition of "covered funds" should allow a small holdings of non-loan assets, such as bonds. These changes would could benefit the CLO and loan markets. It remains to be seen whether the federal agencies will adopt the proposal as a final rule.

  Although CLO issuance levels dipped during 2019 down 8% from 2018, which was the highest year on record, because the risk retention requirement no longer generally applies to CLOs, the prospects for CLO fundraising appear bright.

  For additional information on the Dodd-Frank Act, see Dodd-Frank Wall Street Reform and Consumer Protection Act Key Provisions.

- **Division of Delaware LLCs.** In August 2018, the DE LLC Act was amended to permit the division of Delaware LLCs into two or more LLCs, with the original LLC surviving or terminating. A division can be used in connection with a sale of lines of businesses, spin-offs, asset sales, mergers, etc., without forming a new LLC (even for asset sales to multiple buyers, with equity interests in the resulting LLCs issued to each buyer). Upon the effectiveness of a division, the original LLC's assets/liabilities can be allocated to and vested in the resulting LLCs, as specified in a required plan of division, with no need for action by other parties, perhaps allocating all assets to an LLC that is not providing any credit support. lenders have focused on this issue and added restrictions into agreements relating to the following covenants: Asset Sales, Restricted Payments, Further Assurances, Mergers, Investments and/or Fundamental Changes.

- **EU bail-in rule.** In January of 2016, the European Union (EU) Bank Recovery and Resolution Directive (2014/59/EU) became effective, implementing the European bail-in rules. These rules (available here) are intended to address a future banking crisis without resorting to the type of taxpayer-funded public bailouts of failing institutions that occurred during the financial crisis. They give European regulators broad authority to cancel or modify the liabilities of an affected financial institution in order to obviate the need for a public bailout. The rules also require affected institutions to obtain contractual recognition of the potential for this type of bail-in modification of liabilities in any contracts entered into by such institutions that are governed by the law of a jurisdiction outside the purview of the applicable European regulators, including the United States. Given that European lenders play a significant role in the U.S. loan market, EU bail-in contractual recognition provisions have become widespread in U.S. credit agreements. The market has largely coalesced around the model contractual recognition provisions published by the LSTA, so there is typically little negotiation of these provisions. Following the formal withdrawal by the UK from the EU in January 2020, the bail-in regime entered a transition period which is expected to end on December 31, 2020. During the transition period, the existing EU bail-in regime will continue to apply to UK financial institutions. After the transition period ends, the current regime will be replaced by a new one that is expected to be substantially similar to the existing one.

- **Know your customer issues.** The information-gathering and diligence conducted by lenders in order to comply with know your customer (KYC) requirements under the USA PATRIOT Act and other anti-terrorism, anti-money laundering, and similar rules continues to have an outsized impact on leveraged financing deals. Lenders have set up protocols to collect detailed information about borrowers and their related parties in order to ensure compliance with KYC regulations, and the KYC diligence process in any given deal now often takes on a life of its own as multiple lenders in the syndicate all conduct separate diligence with no central control repository or information-sharing among lenders (or even among the deal team and the KYC team within a single lender). This stems from the fact that each organization usually has its own internal requirements and processes for KYC matters, compounded by the fact that it is typically treated as a back-office function handled by staff members not otherwise involved in the transaction. In January of 2016, the LSTA released KYC guidelines for syndicated lending transactions, which were updated in October of 2017 (primarily to address the finalization of applicable rulemaking by the Financial Crimes Enforcement Network of the U.S. Department of the Treasury). These guidelines made some progress towards offering a consistent set of standards that lenders could uniformly apply, but uncontrolled, disruptive KYC processes continue to be an issue in leveraged financing deals.

- **Discontinuance of LIBOR.** In 2019, loan parties focused even more intensely than in 2018 on the 2021 deadline when the UK Financial Conduct Authority will no longer require banks to submit quotes for LIBOR rates in sterling, though the ICE may continue to publish the dollar rate. Although loan agreements typically provide for market disruption events and the temporary unavailability of LIBOR, historically they have not addressed the complete discontinuance of LIBOR. Given the volume of U.S. financial products based on LIBOR, including syndicated loans and swaps, the impact of LIBOR's discontinuance is monumental. The Alternative Reference Rates Committee (ARRC), a committee created by the Federal Reserve Board and the New York Fed, has been instrumental in developing documentation and coordinating market feedback regarding the discontinuance of LIBOR. ARRC released recommended fallback language for syndicated loans in April 2019 and noted that fallback language should address at a minimum the following issues: trigger events, replacement rates, adjustments to the spread, and lender consents. Parties to new loan agreements are including provisions that require them to amend the agreement, as necessary, including a spread adjustment, when LIBOR is discontinued. Another approach suggested by ARRC is to "hard-wire" the agreement where a waterfall of different rates, depending on their availability, replaces LIBOR at the appropriate time. The hard-wire approach has been much less popular in the loan market. The anticipated replacement for LIBOR in the U.S. market is SOFR (secured overnight funding rate), a secured, overnight Treasuries repo rate which, unlike LIBOR, is a secured rate, and reflects actual transactions. However, since SOFR is an overnight rate it is a backward-looking rate which makes it difficult for borrowers to plan their cost of funds. LIBOR is a forward-looking rate and is published for a variety of interest periods. SWAPS are using a forward looking SOFR because the SWAP market began transitioning to SOFR earlier and a deeper market has developed. The loan market for term loans using forward-looking SOFR has not developed yet and borrowers are struggling with the inability to plan their borrowing costs as well as to hedge those costs with SWAPs that are using a different reference rate. The LSTA published a "Compound SOFR In Arrears Concept Document" providing for interest calculated on the basis of compound SOFR in arrears and a "Simple SOFR in Arrears Concept Document" providing for interest calculated on the basis of simple SOFR in arrears, in each case incorporating operational changes. Regulators and market constituents continue to urge financial institutions to include appropriate documentary provisions and institutionalize operational processes in order to accommodate the new funding possibilities; however, there may be some delay due to distractions caused by COVID19.

In March 2020, ARRC released a proposal for New York legislation intended to reduce legal uncertainty and minimize adverse economic impacts relating to the transition away from LIBOR. The proposed statute would (1) prohibit a party from refusing to perform its contractual obligations or declaring a breach of contract as a result of the discontinuance of LIBOR or the use of the legislation's recommended benchmark replacement, (2) establish that the recommended benchmark replacement is a commercially reasonable substitute for and commercially substantial equivalent to LIBOR, and (3) provide a safe harbor from litigation for the use of the recommended benchmark replacement.

- **U.S. Special Resolution Regime Rules (QFC Stay Rules).** In September 2017, U.S. banking regulators adopted the QFC Stay Rules which are intended to improve the stability of U.S. global systemically important banking institutions (GSIBs) and their subsidiaries worldwide and U.S. subsidiaries of foreign GSIBs (together with GSIBs, Covered Entities) by reducing the destabilizing risks of terminations of certain agreements by restricting limitations on the terminations, liquidation and closeout of certain financial contracts (QFCs), including certain derivative contracts. The QFC Stay Rules require documents that meet certain criteria and that provide credit support, including a guarantee or grant of security interest, for a borrower's obligations under a QFC to include language that permits U.S. bank regulators to stay enforcement of QFCs and to transfer such QFCs away from an insolvent GSIB that they would under U.S. bankruptcy law. For example, if the FDIC becomes the receiver of a major bankrupt financial institution, the QFC Stay Rules permit the FDIC to transfer that institution's QFCs to another bank or transferee with the goal of maintaining market stability and preserving value. There were three deadlines for parties to comply with the QFC Stay Rules depending on whether one or more of the parties is a Covered Party. The latest deadline was January 1, 2020.
- **Other issues.** Other factors impacting the leveraged loan market and, in some cases reducing investor confidence, in 2019/2020 include the trade and tariffs war, the implementation of Brexit, the U.S. 2020 presidential election, potential geopolitical disruptions, market volatility, and the ongoing impact of COVID19 on the U.S. and world economies. Trade relations with and tariffs imposed on China resulted in significant market drops at select times during 2019 with the result that investors and issuers alike became skittish. Until December 31, 2020, unless extended, the UK is in a Brexit transition period and it remains to be seen how the U.S. markets will be affected by the transition. The upcoming Presidential election may be divisive and investors may be guided by the anticipated and the actual results. Geopolitical events such as tension in the Middle East and U.S.-Korea relations may affect the loan market and create risks that investors are unwilling to bear. Lower interest rates have resulted in investors seeking higher yields in the high-yield market.

First Quarter of 2020 and COVID19

The first quarter of 2020 saw highs and lows in the leveraged loan market, but in March 2020, the leveraged loan market and the longest economic expansion the United States had experienced collapsed as a result of the arrival and persistence of COVID19. The pandemic caused fear, far-reaching global economic consequences and extreme market turbulence. In January 2020, the volume of institutional new issue leveraged loans (excluding repricings) was approximately $65 billion, a three-year high, but it fell to $25 billion in February, and no institutional leveraged loans were issued in March, an economic event not seen since March of 2008. Similarly, repricing volume (via amendments) started strong in January at approximately $83 billion, slid to $22 billion in February and to zero in March. But, even with such a catastrophic market in March 2020, the volume of institutional loans in the first quarter of 2020 was still higher than the comparable period in 2019. Issuers looking for financing for buyouts and acquisitions were able to obtain issuer-friendly terms, and the volume of LBO and other sponsored M&A financed reached approximately $50 billion, a four-quarter high. During January and February, 71 transactions were flexed tighter and only 10 had investor friendly pricing adjustments. In March 2020, over 100 loans were downgraded, and many deals were delayed as borrowers and investors waited for market conditions to stabilize.

The credit ratings of Issuers' affected availability and terms of leveraged loans in a less pronounced manner than in 2019. Sectors that performed the worst include oil and gas, metals/minerals, cosmetics/toiletries, retail (other than drugs and food), home furnishings, leisure activities/goods, clothing/textiles, and travel including transport and lodging.

The Federal Reserve took many steps to address the financial chaos caused by COVID19. On March 3, 2020, the Federal Reserve reduced the federal funds rate by a half percentage point to 1.00%–1.25%. Less than two weeks later, on March 15, the Federal Reserve responded to market volatility by dropping the rate a full percentage point to near zero and also announced it would launch a $700 billion quantitative easing program under which it would purchase Treasury bonds and mortgage backed securities.

It remains to be seen what long-term impact COVID19 will have on the leveraged loan market. Additionally, though the federal government will support select industries such as the airlines, it is not clear which additional industries those may be and the level and length of support that will be provided. For an overview of practical guidance on COVID-19 covering various practice areas, including capital markets, see Coronavirus (COVID-19) Resource Kit.

Market Outlook

As domestic and global conditions have been volatile, borrowers will continue to carefully evaluate potential investments in terms of the quality of the investment, the availability of good pricing and the potential ability to incorporate strategic businesses into existing business models or to sell the investment. January 2020 was a busy month for the institutional lending market but the market was near collapse by the end of the first quarter of 2020.

Regardless of market conditions and domestic and global issues, in the M&A financing corner, it is likely that the focus on deal certainty protections will continue. Borrowers will seek to ensure close alignment between the conditionality of the lenders' obligation to fund their commitments, on the one hand, and the borrower's own obligation to close the acquisition under the relevant M&A agreement, on the other hand. Higher rated borrowers will continue to look for looser covenant packages.

Lenders will continue to seek to limit collateral leakage to maintain the credit group's ability to repay the debt. EBITDA addbacks will continue to be a point of negotiation.

Many constituencies in the market remain uncertain about the timing of the recovery of the leveraged loan market, and some believe it could be a long time before the market stabilizes and reopens, especially for large M&A deals. However, market participants are still hoping the market setback will be temporary and that the M&A and LBO markets will regain traction in the coming months.

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