Chambers
Global Practice
Guides

Definitive global law guides offering
comparative analysis from top-ranked lawyers

Banking & Finance 2021

USA: Law & Practice and Trends & Developments

James A Florack, Meyer C Dworkin,
Vanessa L Jackson and Adela Troconis
Davis Polk & Wardwell LLP

practiceguides.chambers.com

USA

Law and Practice

Contributed by:
James A Florack, Meyer C Dworkin,
Vanessa L Jackson and Adela Troconis
Davis Polk & Wardwell LLP** **see p.21

CONTENTS

Contributed by: *James A Florack, Meyer C Dworkin, Vanessa L Jackson and Adela Troconis,*
Davis Polk & Wardwell LLP

1. LOAN MARKET PANORAMA

1.1 Impact of Regulatory Environment and Economic Cycles

Following the global financial crisis and in connection with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, US federal regulators issued Leveraged Lending Guidance (the Guidance) in 2013 to address concerns about heightened leverage levels in the US loan market. The Guidance mandated that regulated lenders consider a borrower's ability to deleverage 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 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.

Upon the onset of the COVID-19 pandemic, lenders became cautious about accepting the more aggressive pre-pandemic terms, as they were uncertain about the near and long-term impact on borrowers. These dampening effects on the market, however, were not long-lasting. Since late summer 2020, market observers have continued to note a resumption of the years-long trend toward weakened covenant and other lender protections, including the increasing prevalence of "covenant-lite" term loans and higher leverage levels. Both regulated lenders and lighter regulated non-bank lenders are increasingly eager to provide financing to borrowers with few deviations from pre-pandemic terms.

1.2 Impact of the COVID-19 Pandemic

For many borrowers, the COVID-19 pandemic continues to have implications on all aspects of their businesses, including their ability to make representations and comply with covenants under their loan facilities.

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 over 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 (typically with one- to three-year tenors), often in the form of delayed-draw term loans, to most efficiently manage their borrowing costs and financial covenant ratio compliance.

Proactively Addressing Potential Issues

Many borrowers also sought to actively address compliance challenges under their loan agreements arising from the increased debt loads and lower EBITDA (which has been severely impaired for many borrowers, with forward-looking visibility inherently unclear) resulting from the COVID-19 pandemic by pre-emptively seeking covenant and other forms of relief from lenders, including:

- permitting COVID-19-specific EBITDA add-backs (in the form of both actual costs and, more controversially, lost revenues);
- providing financial maintenance covenant "holidays" or level resets;
- excluding the effects of COVID-19 from the material adverse effect conditions and representations; and
- permitting payment-in-kind interest for some period.

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

- increased pricing (often limited to the covenant holiday period) and amendment/consent fees;
- minimum liquidity maintenance covenants (typically defined as the sum of unrestricted cash on the balance sheet and available commitments under revolving facilities);
- anti-"cash hoarding" provisions as a condition precedent to borrowings to encourage enhanced liquidity in the form of available revolving commitments rather than cash drawn and held on the balance sheet;
- limitations on further debt incurrence and on application of capital to junior parts of the capital structure – including restricted payments (ie, dividends, distributions and other equity payments) and restricted debt prepayments (ie, payments on junior, unsecured and/or payment subordinated debt) – and other negative covenant flexibility during the waiver periods; and
- additional reporting (eg, monthly reporting and cash flow forecasts).

Liability Management

For many borrowers, especially in the retail, entertainment, travel and energy sectors, the near-term liquidity options and covenant and other relief referred to above have been either entirely unavailable or insufficient to meet their needs during the COVID-19 pandemic. To address often dire financial circumstances, these borrowers have been required to seek more creative forms of financing, commonly liability management transactions.

Please see the **US Trends & Developments** chapter in this guide for a discussion on these recent liability management transactions.

Looking Forward

Since late summer 2020 and through the first half of 2021, leveraged finance markets have rebounded and reopened to heavy demand, with financial institutions and non-bank "direct" lenders providing increasingly large committed financings on terms as aggressive – and sometimes more aggressive – than those available immediately prior to the onset of the pandemic, though with particular focus (either directly or through "market flex") on lender protective provisions, including prohibiting the transfer of material intellectual property to unrestricted subsidiaries and/or requiring 100% lender consent to subordinate existing lenders' liens.

1.3 The High-Yield Market

Companies increasingly look to both the syndicated loan and high-yield bond markets to meet their financing needs, depending on market conditions and capital structure requirements.

The high-yield bond market has continued to show significant overlap on structural terms with the leveraged loan market, as highlighted by the proliferation of covenant-lite loan structures, representing approximately 84% of all loan issuances in 2020 compared to 17% in 2007, and the increasing prevalence of secured high-yield bond issuances, which in the second quarter of 2020 exceeded institutional loan volume for the first time since 2009. In leveraged buyout 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.

Certain differences remain between loan and high-yield bond terms. Loans continue to provide lesser "call" protection in connection with voluntary prepayments – in terms of the scope, amount and duration of the premium. Additionally, where leveraged loans and bonds are issued in a single capital structure, lenders typically continue to drive the guarantee and collateral structure, with the loan agent controlling enforcement proceedings. Certain loans, but not bonds, continue to restrict investments in non-guarantor subsidiaries and require interest rate spreads to reset upon the issuance of certain higher yielding loans (commonly referred to as most-favoured-nation (MFN) protection), although the loan market's emphasis on MFN protections has significantly diminished over the last few years, with MFNs often triggered only if such higher yielding loans:

- are denominated in like currency and/or are broadly syndicated;
- are not incurred to finance permitted acquisitions or similar investments;
- are incurred prior to some period of time after the closing date (eg, six or 12 months); and/or
- mature earlier than a fixed period (eg, 12 months) following the maturity date of the existing term loans.

Finally, there have been a few instances where loans contain more permissive terms than bonds, such as the lack of fixed charge coverage governors on the usage of the "available amount" builder for restricted payments or allowing such amounts to build for positive cumulative consolidated net income in a period without a corresponding deduction for negative amounts in other periods. This also arises where bonds have been revised to conform to customary loan terms, such as permitting the incurrence of debt by "stacking" based on priority (ie, by first incurring junior lien debt in reliance on a secured leverage test and then incurring first lien debt in reliance on a first lien leverage ratio) rather than a standard secured leverage governor applying to all such debt.

1.4 Alternative Credit Providers

With private debt funds raising more than USD100 billion over the past four years, alternative credit providers have become an increasingly visible presence in US loan markets, with direct lending (ie, loans made without a bank or other arranger acting as intermediary) continuing to grow dramatically. While these asset managers historically operated largely in the middle market, focusing on smaller corporate borrowers, direct lenders are increasingly viewed as "go-to" financing sources for all manner of top-tier transactions, including by providing "anchor" orders in syndicated facilities, "bought" second lien (or other 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 USD2 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 to parts of the capital structure that are not readily available in the broadly syndicated market, such as holding company (structurally junior) loans or blended 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 during which terms could be "flexed".

1.5 Banking and Finance Techniques

Banking and finance techniques continue to evolve in the face of an increased 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 amongst bank and non-bank lenders to lead financing transactions, there has been a marked increase in documentation flexibility in recent years. 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 on underwritten borrower-friendly documentation precedents to ensure that the terms of the new financing are "no worse than" their most recent financing (and on "market flex" rights to scale back the most aggressive terms solely to the extent 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).

Debt Activism

The US loan market has recently experienced unique forms of debt activism, leading to heightened awareness by market participants of terms that could lead to unintended adverse consequences. Examples include lenders to distressed borrowers being more willing to resist "accretive" liability management transactions and treating loan defaults as commercial opportunities. Most prominently, certain debt activist funds have engaged in "net short activist" strategies, 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, with the ultimate goal of asserting a default or otherwise taking 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, with the most prominent being the transition away from the London Interbank Offered Rate (LIBOR) as the benchmark rate for loans, the exponential growth in transactions involving special purpose acquisition companies (SPACs) that has resulted in changes to documentation to permit acquisitions of borrowers by SPACs, and the inclusion of erroneous payments language to address recent judicial decisions.

LIBOR Successor Rate Provisions

LIBOR is currently the benchmark rate for most US loan issuances. Criticism of the integrity of the process by which LIBOR has historically been determined – and the depth of the "observed transactions" on which it supposedly rests – led to calls for its replacement and the UK's Financial Conduct Authority (FCA) announcing that it will phase out its historical practice of compelling reference banks to submit LIBOR quotations. In response, regulators and loan market participants have begun preparing the transition away from LIBOR to a replacement benchmark rate, with broad (but not unanimous) agreement that the successor in the US dollar-based loan market will be the Secured Overnight Financing Rate (SOFR), a rate based on a deep market of overnight secured financings monitored by the Federal Reserve.

On 25 March 2021, the Alternative Reference Rates Committee of the Federal Reserve (ARRC) released final form fallback language endorsing the "hardwired" approach, which recommended a "Benchmark Replacement" waterfall of options, assuming some variation of SOFR will be the designated replacement rate. Between the fourth quarter of 2020 and the second quarter of 2021, more than half of the new and amended loans in the CS Leveraged Loan Index included hardwired fallback language.

In October 2020, the Internal Revenue Service (IRS) published Revenue Procedure 2020-44, providing, in part, that a modification to a LIBOR-referencing contract incorporating the ARRC-recommended fallback language for syndicated loans will not be treated as a taxable exchange.

In November 2020, ICE Benchmark Administration Limited (IBA – the FCA-regulated administrator of LIBOR) announced it would consult on ending one-week and two-month USD LIBOR settings on 31 December 2021, and on ending the remaining USD LIBOR settings on 30 June 2023, while at the same time, 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 as soon as practicable, but no later than 31 December 2021. On 5 March 2021, IBA and the FCA issued statements regarding the final date for publication of LIBOR. ARRC confirmed that, in its opinion, a "Benchmark Transition Event" has occurred under ARRC-recommended fallback language as a result of these statements.

SPAC Transactions

The exponential growth of SPAC offerings and resulting "de-SPACing" acquisitions has resulted in changes to documentation to permit – or in some cases merely clarify that – acquisitions of the borrower by a SPAC, essentially treating the acquisition as if it were a permitted IPO (that would not constitute a change of control and, therefore, not result in an event of default under the loan facility). Additionally, the threshold for the post-IPO change of control prong (ie, the maximum permitted percentage ownership of a third party) has increasingly become 50.1% (rather than the more traditional 35%).

Erroneous Payments

In 2020, a court concluded that lenders were entitled to refuse to return a payment mistakenly made by the agent out of its own funds, rather than those of the borrower, on the basis that such payment discharged an existing debt and the recipients had no notice of the mistake. Although this decision is currently on appeal, agent banks have successfully sought to adjust documentation to ensure that any such future erroneous payments may be contractually clawed back, by expressly requiring prompt return of those funds determined by the agent to have been erroneously distributed.

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

In the US loan market, participants have shown increasing interest in loans linking pricing provisions to the borrower's progress in meeting pre-determined environmental, social and governance (ESG) or sustainability goals. As more borrowers create sustainability plans including ESG-related goals (such as reducing greenhouse gas emissions, increasing energy efficiency, building affordable housing and increasing board and workplace diversity), these borrowers seek to obtain reduced loan interest rates and fees from their lenders. Likewise, many lenders are committed to taking steps to increase their focus on ESG and sustainability, and are increasingly participating in ESG financings.

Borrowers typically work with an administrative agent or a dedicated sustainability structuring agent to develop specific ESG metrics that will be tracked over the life of the loan. These metrics often become more stringent each year of the loan to demonstrate the borrower's ongoing commitment to such goal. If the borrower meets the targets during a particular year, a specified interest rate and/or fee reduction will apply; however, if the borrower misses the targets, there is a corresponding increase in interest and fees. Typically, borrowers submit annual certificates to lenders regarding the compliance with the agreed targets, which are often audited by a third party and/or made publicly available. On the basis of this certificate, adjustments are made to the interest rate and/or fees under the loan agreement.

2. AUTHORISATION

2.1 Authorisation to Provide Financing to a Company

The US operates under a "dual-banking system", in which banks can apply for a state bank charter 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, while 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", often operating under an exemption from many of its requirements, and are subject primarily to the regulations of the Securities and Exchange Commission (SEC).

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 are 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, providing relaxed capital and stress testing requirements, while also imposing stricter liquidity requirements.

3.2 Restrictions on Foreign Lenders Granting Security

Under US law, there are generally no restrictions on nor impediments to US entities granting security interests to, or providing guarantees in favour of, foreign lenders that differ from those applicable to domestic lenders.

3.3 Restrictions and Controls on Foreign Currency Exchange

The US 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 US loan agreements include restrictive 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 in violation of the margin lending rules under Regulations T, U and X, which limit loans 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, thereby limiting the amount of collateral value the lender may assign to such securities or instruments (currently 50%).

3.5 Agent and Trust Concepts

In US syndicated loan financings, an administrative agent is typically appointed to act on behalf of the lending syndicate to administer the loan. In secured transactions, a collateral agent will typically be 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 debtholders, with trust or intercreditor arrangements setting out the relative rights of the various creditor groups.

3.6 Loan Transfer Mechanisms

In the US loan market, lender interests under credit facilities are transferred between market participants through either assignments or participations. An assignment is the sale of all or part of a lender's rights and obligations under a loan agreement to another lender, upon which the assignee replaces the assigning lender under the loan agreement with respect to the portion of commitments or loans assigned. As the "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 swing line subfacilities, the letter of credit issuers and the swing line bank. 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 (often limited to the borrower)). Usually, no borrower consent is required in connection with assignments to another lender or affiliate or "approved fund" of such lender. Typically, absent 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 only to assignments in respect of the term facility (and 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 limited voting on "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.

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, including because such institution is likely to engage in "net short" or other activist strategies. These provisions are the focus of continuing negotiation, with borrowers seeking flexibility to designate additional entities throughout the life of the financing, and lenders seeking to minimise such flexibility to maintain liquidity in the loan.

3.7 Debt Buy-Back

Debt buy-backs by borrowers and their affiliates (including private equity sponsors) are generally permitted in the US syndicated loan market, subject to customary requirements. 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 corresponding revolving facility.

Alternatively, private equity sponsors and their affiliates (other than borrowers and their subsidiaries) are typically permitted to make "open-market" purchases on a non-pro rata basis. Once held by a borrower affiliate, loans are generally subject to restrictions on voting, participating in lender calls and meetings and receiving information provided solely to lenders. Additionally, loans held by private equity sponsors and their affiliates are subject to a cap of the aggregate principal amount of the applicable tranche of term loans – typically 25%. 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 the loans voting in favour of amendments requiring the consent of a majority of lenders.

3.8 Public Acquisition Finance

While the US does not have any 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 limited and standardised sets of 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 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 (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 "inside dates" – ie, a certain date before which the financing is not required to close).

Given these dynamics, it is customary for buyers/borrowers and arrangers to execute commitment letters, including detailed term sheets, upon signing the acquisition agreement, thereby providing buyers with committed financing subject to customary "limited conditionality". The buyer and the arrangers will then negotiate the definitive documentation for the financing prior to the closing of the acquisition, during which time (other than in the case of a financing provided by "direct" lenders with the intent to hold the loan) arrangers – with the assistance of the buyer and target – seek to syndicate loan commitments to the broader market.

4. TAX

4.1 Withholding Tax

Generally, there is 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 – OID), that 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.

However, there are several important exceptions to withholding on interest, as a result of which the expectation is usually that lenders to a US obligor should be able to avoid withholding on interest so that a gross-up should not apply, without a change in law. Those exceptions include treaty exemptions, the portfolio interest exemption and an exemption from withholding if the interest is paid to a non-US lender that is engaged in a trade or business within the US (such as a non-US bank operating through a US branch).

To qualify for an exemption to withholding, non-US lenders will generally be required to provide a US tax form to the borrower or agent – typically 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 a debt instrument are generally not subject to US withholding tax (except to the extent 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 US 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, but the 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 US 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, excluding CFCs from the guarantee requirements and limiting pledges of first-tier subsidiary CFC equity interests to less than 65%.

Separately, non-US lenders should closely monitor their activities within the US to determine whether such activities give rise to a US trade or business or a permanent establishment within the US, in which case 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 (i) the rate permitted by the state in which the bank is located or (ii) 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 are permitted to 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 from New York's both 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 assets generally addressing overly burdensome and expensive perfection requirements or consequences. Common exclusions are owned real property with a value below an agreed amount, licences prohibited to be pledged by law or contract (but 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 like 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 and perfection 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 and perfect a security interest in assets not governed by the UCC (real property and certain kinds of intellectual property, for example), 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 bankruptcy proceedings. Article 9 of the UCC provides the following four methods of perfecting security interests in domestic personal property:

- filing a financing statement (known as a 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 only apply to personal property that is subject to the requirements of Article 9 of the UCC (with certain exceptions for asset types such as commercial tort claims, which must be described with more specificity), as 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 no general limitations or restrictions applicable to 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. This is often addressed by loan market participants 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 generally prohibited from guaranteeing or granting a security interest in its assets for a financing utilised to acquire its shares. However, these guarantees and security interests are subject to review for fraudulent conveyance and may be subject to regulatory schemes, making such 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 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 consent 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 at the sole cost of the borrower upon termination and payment in full of the obligations under the loan agreement. Additionally, agents are generally pre-authorised to acknowledge or confirm the release of security interests in specific 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. For example, 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), though lenders often seek protection relating to this issue by specifying that the guarantor is only released from its guarantee to the extent 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 intellectual property and other assets from guarantors to non-guarantor entities, automatically releasing the lenders' security interest in such assets in the process.

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 generally 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. For example, with respect to investment property, securities accounts and certificated securities, perfection via "control" or possession generally has priority over perfection by "filing" UCC-1 financing statements.

Subordination

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

Arrangements for lien subordination typically provide that, among others, junior creditors are subject to a "standstill" period prior to exercising enforcement rights or remedies with respect to the collateral, payments 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.

Structural subordination arises where obligations incurred or guaranteed solely by a company are effectively junior to obligations incurred or guaranteed by a subsidiary of the company, 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 and before creditors of the parent company – such subsidiary's equity holder – are repaid. Where the parent company 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.

Under Section 510 of the Bankruptcy Code, subordination agreements are enforceable in a bankruptcy proceeding to the same extent they would be enforceable under applicable non-bankruptcy law.

6. ENFORCEMENT

6.1 Enforcement of Collateral by Secured Lenders

In general, loan documentation provides for customary sets 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 of the UCC, 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, in connection with a public sale, providing sufficient advance notification to the debtor and certain other creditors.

6.2 Foreign Law and Jurisdiction

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

New York's conflict of laws rules uphold foreign forum selection clauses, so long as the chosen jurisdiction has a reasonable relationship to the transaction – ie, 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, a significant amount of diversity exists within the US in connection with the procedure and substance relating 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 above provides only a general guideline to the relevant landscape, and does not contemplate all possible matters that are relevant to a particular financing (or even to financings generally), which 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 debt structure, the flexibility in the covenants in its outstanding debt instruments, the threshold lender consent needed 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, which, combined with an exchange offer or similar refinancing transaction, may be used to coercively initiate liability management transactions that push holdout lenders into a reorganised structure. This has been seen most commonly in the high-yield bond market with the utilisation of exit consents, in which the company offers bondholders the opportunity to exchange existing bonds for new bonds 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 bondholders agree to amend the existing notes to adversely affect the existing terms by way of "covenant-stripping". This creates an incentive for the bondholders to exchange their notes so as not to be left holding the existing bonds now devoid of meaningful covenant protections. A few 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, and in response lenders and borrowers have negotiated up front 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 can be beneficial to negotiate a restructuring support agreement prior to filing, in which the company and creditors agree to a pre-negotiated plan of reorganisation that will be presented to the bankruptcy court. This sort of "pre-packaged" bankruptcy plan is intended to shorten and simplify the bankruptcy proceeding and reduce 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, among others. 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 commonly 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, while unencumbered value is distributed to unsecured creditors 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.

While "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, 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 leveraged buyouts, where courts may deem the "transfer" to a lender of the collateral of the target or the incurrence of the target's obligation to repay the debt incurred 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 superpriority claims senior to all other unsecured claims. Such DIP financing may be approved over 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 manifold 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). Both domestic and foreign participants have confidence that, in the US, arrangements clearly documented in definitive contracts will be upheld by courts in a consistent manner without undue delay.

The US senate recently approved a USD1.2 trillion Infrastructure Bill, highlighting a broad consensus at all governmental levels for the need to update and upgrade the US system of ports, airports, roads, tunnels, rail networks and bridges.

8.2 Overview of Public-Private Partnership Transactions

The public-private partnership (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 to 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. For example, energy projects may require approval, 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 US 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 Organizations (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, among other matters.

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 US also need to be aware of the jurisdiction of the Committee on Foreign Investment in the US (CFIUS), which is authorised to review transactions involving foreign investment in the US 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 upcoming Chambers Project Finance 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, an interested reader is advised to consult the upcoming Chambers Project Finance 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 US 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 (EHS) Laws

Projects in the US 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 relating 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.

Davis Polk & Wardwell LLP delivers customised, innovative counsel to private equity sponsors, borrowers, banks and other lenders across a broad spectrum of corporate finance transactions, including leveraged and investment-grade acquisition financings, middle market and direct lending financings, project and infrastructure financings, energy financings and restructurings, and debtor-in-possession and exit financings. The finance practice includes 14 partners in New York and London, each with extensive experience in representing financial institutions and corporations in bespoke and ground-breaking financing transactions. With locations in New York, Europe, Asia and Latin America, the practice is well equipped to handle the most complex domestic and international transactions.

AUTHORS

James A Florack is a partner in Davis Polk's corporate department and is co-head of the firm's finance group. He advises clients on transactions including leveraged and investment-grade lending, structured finance, high-yield debt offerings and other capital markets transactions. He has a particular focus on acquisition financings, whether led by financial sponsors or otherwise. He represents leading US and international banks and corporations in transactions in both US and international cross-border markets.

Vanessa L Jackson is a partner in Davis Polk's corporate department, practising in the finance group. Her practice focuses on the representation of financial institutions and corporate borrowers in a broad range of corporate finance transactions, including leveraged and investment-grade acquisition financings, asset-based credit facilities, debt restructurings, spin-offs, working capital financings, debtor-in-possession financings, exit financings, and other secured and unsecured financings.

Meyer C Dworkin is a partner in Davis Polk's corporate department, practising in the finance group. He advises lenders and borrowers on a variety of finance transactions, including acquisition and other leveraged and investment-grade financings, asset-based financings, debtor-in-possession and other distressed financings, and structured credit financings. He regularly represents hedge funds, private equity funds and corporations in negotiating prime brokerage, derivatives and repurchase agreements, as well as other trading and financing documentation and complex structured financial products.

Adela Troconis is an associate in Davis Polk's corporate department, practising in the finance group. She advises financial institutions and corporate clients on a variety of finance transactions, including acquisition financings, project financings, particularly in Latin America, and debtor-in-possession financings and bankruptcy exit financings.

Davis Polk & Wardwell LLP

450 Lexington Avenue
New York
NY 10017
USA

Tel: +1 212 450 4000
Fax: +1 212 701 5800
Email: james.florack@davispolk.com
Web: www.davispolk.com

Trends and Developments

Contributed by:
James A Florack, Meyer C Dworkin,
Vanessa L Jackson and Adela Troconis
Davis Polk & Wardwell LLP** **see p.27

Recent Liability Management Transactions

For many borrowers, the COVID-19 pandemic has had and continues to have wide-ranging implications for their financial results and, as a result, their loan facilities. As the effects of the pandemic began to manifest in March and April 2020, borrowers considered several approaches to address their liquidity needs, ranging from the straightforward, including drawing under-committed revolving lines, to the more complex, including liability management transactions that afforded the borrower increased liquidity and/or covenant relief, while benefiting certain creditors at the expense of others.

After a relatively brief slowdown, market demand returned and even increased from pre-pandemic levels through late summer 2020 and into 2021. With the return of demand came the return of the trend toward borrower-friendly terms that had marked the years immediately preceding the pandemic. Still, while lenders have shown increasing flexibility on a multitude of key terms, they have brought to their negotiations a heightened focus and discipline on documentation terms that protect against the sort of coercive and aggressive liability management exercises that became relatively common during the height of the pandemic.

While liability management transactions come in many forms, the two basic structures upon which nearly all permutations are based are uptiering transactions and drop-down financings.

Uptiering transactions

In an uptiering transaction, the borrower offers potential lenders a claim against the existing guarantor and collateral package that is contractually senior to the claims of existing creditors, most typically through collateral/lien priority, but in the form of waterfall payment priority, in certain cases. An uptiering transaction will typically be offered to all or, more controversially, only certain existing lenders who provide all or a portion of the new financing and are, in most cases, permitted to exchange all or a portion of their existing loans into the contractually senior debt. These exchanges are usually structured at a discount to the par value of the existing loans and, to facilitate the transaction, the participating lenders will often effect the necessary amendments to the existing credit facility through an “exit” consent. The benefits of such a transaction for the borrower are additional liquidity in the form of the new financing, reduced overall debt burden arising from the deleveraging exchange and, in many cases, additional covenant flexibility.

Drop-down financings

In a drop-down financing, rather than re-tranching the existing guarantees and collateral package, the borrower identifies assets that may be readily separable from its business – often material intellectual property or a separate line of business – and transfers such assets to an unrestricted subsidiary (an entity that is part of the borrower’s corporate structure but is outside of the credit group and not required to make the representations or comply with the covenants under the credit facility) or, in certain cases, a non-guarantor restricted subsidiary (an entity that is part of the credit group but does not pledge its assets as collateral under the credit facility or otherwise guarantee the obligations thereunder) (in either case, "NewCo"). Upon the transfer to NewCo, the liens of existing creditors on the transferred assets are automatically released and the newly unencumbered assets are available to secure the new indebtedness of NewCo.

Similar to uptiering transactions, drop-down financings often include a roll-up feature permitting the lenders providing the new financing to exchange their existing debt of the borrower (again, at a discount) for the new structurally senior debt of NewCo. Depending on the structure of the financing, the quantum of indebtedness that may be incurred by NewCo may be limited by the existing credit facility covenants (in the case of excluded restricted subsidiaries) or unlimited (in the case of unrestricted subsidiaries). In either case, the claims of the new creditors against NewCo and the transferred assets are structurally senior to the claims of the existing lenders on such assets and, in limited cases, may also have a pari passu or junior claim against the borrower (and existing credit parties) and their assets.

From the perspective of existing lenders, the most challenging feature of liability management transactions is that non-participating lenders (who may not even be offered an opportunity to participate) may find themselves contractually or structurally subordinated to other creditors, in direct contradiction to key operating assumptions in the senior secured loan market, including general priority of position in the capital structure and equal treatment across lenders in a single facility. In contrast, from the perspective of borrowers, liability management transactions afford flexibility to manage their capital structure, since obtaining covenant relief and other amendments or incremental liquidity under the existing facility in times of distress may not be economically feasible. To increase the likelihood that financings of this type will be available in these circumstances, borrowers seek the ability in their loan documentation to offer priming liens and/or senior claims to creditors who are willing to provide additional liquidity and, where necessary, covenant flexibility. Liability management transactions thus offer critical optionality to distressed borrowers, and borrowers will often argue that lenders will also see a benefit in the long run, as it provides the additional runway necessary to stabilise the underlying business and avoid a value-destructive bankruptcy filing.

Reconciling these competing interests and negotiating a set of contractual provisions that clearly delineate a compromise position is challenging. However, provisions have been introduced into a large number of recent transactions (either directly or through "market flex") limiting the borrower's ability to subordinate existing obligations or modify "pro rata" sharing provisions, with a simple majority vote. Lenders also continue to be focused on potential "drop-down" liability management transactions and, again, increasingly seek protection from these, either directly or through "market flex".

The contractual provisions in loan documentation implicated by liability management transactions, and subject to the most detailed negotiation, include the following.

- The investments covenant is implicated in drop-down financings when the borrower's assets are transferred to – "invested" in – an unrestricted subsidiary or non-guarantor restricted subsidiary and used as collateral for the new structurally senior debt. Accordingly, lenders have been focused on ensuring that certain "trapdoor" provisions that allow non-loan party restricted subsidiaries to invest proceeds received from loan parties without restriction (including in unrestricted subsidiaries) are removed from documentation. Lenders have also focused more generally on aggregate investment capacity, and ensuring there is a cap (or, increasingly, "market flex" to add a cap) on investments by loan parties in non-loan parties. More tailored provisions in response to certain high-profile transactions have also developed, which seek to prohibit the movement of key assets, often material intellectual property, outside the loan party and/or restricted party group, either through investments, dispositions or the designation of unrestricted subsidiaries. To the extent they have the effect of limiting borrowers' flexibility to operate their business, particularly borrowers with a global footprint, these restrictions tend to be strongly resisted by borrowers.

- Unrestricted subsidiaries are subsidiaries of the borrower that are not subject to the representations, covenants, events of default and other limitations included in loan documentation. As these entities provide borrowers with significant operating flexibility, loan documentation generally restricts the borrower's ability to invest in such entities, subject to the agreed baskets referred to above. Although lenders have continued to view unrestricted subsidiaries with scepticism, there has been relatively little movement on the mechanics for designating unrestricted subsidiaries. Typically, such designation is subject solely to an event of default "blocker" and, increasingly rarely, a ratio test (though designation will typically be a deemed investment subject to available investment capacity). Focus has instead been on the amount and type of assets that can be contributed to, or owned by, an unrestricted subsidiary, as noted above.
- Pro rata sharing and subordination of all or substantially all collateral – since the onset of the pandemic there have been a number of so-called "uptiering transactions" that resulted in new lenders having a claim against the existing credit parties that was contractually senior to the claims of existing lenders. Many lenders were surprised that this result could be achieved with only a majority lender vote under typical credit agreement provisions. In response, lenders have increasingly requested protections (either directly, or increasingly through "market flex") that would prevent such subordination without an "all-affected" lender vote. Even where agreed, there are several borrower-friendly variations in the market, including:
  - (a) excluding DIP facilities or the use of cash collateral in a bankruptcy proceeding of the borrower;
  - (b) limiting application to "debt for borrowed money";
  - (c) excluding indebtedness "otherwise permitted" by the credit agreement; and
  - (d) excluding subordination to senior indebtedness to the extent the subordinated lenders were given an opportunity to participate in that senior indebtedness.
- As noted above, one of the keys to many liability management transactions (both uptiering and drop-down transactions) is the ability to roll-up or exchange existing loans of participating lenders into more senior loans on a non-pro rata basis without offering the opportunity to all lenders. The most typical and effective mechanism for achieving this exchange is an "open market purchase" by the borrower of the loans subject to the "roll-up". "Open market" purchases, in most credit agreements, contain no requirement to make a pro rata offer to all lenders of the applicable class, and have been interpreted broadly by many borrowers to permit privately negotiated buy-backs at any price agreed to by the borrower and selling lenders, with few restrictions. Lenders in several liability management-related cases have taken issue with this interpretation, arguing that open market purchases should occur solely through brokered transactions and should be con-

summated solely based on a quoted market price, although most credit agreements do not require either expressly. There has been some effort by lenders to expressly require that all buy-backs be offered pro rata to the applicable existing class (and make changing that requirement a "sacred right"). However, that approach has only been used in limited cases. In contrast, a fair number of borrowers have successfully included language that specifically permits "privately negotiated exchanges" as part of the "open market purchase" exception to pro rata treatment.

- It has long been the case that a subsidiary guarantor of the borrower is released from its guarantee upon ceasing to be a wholly owned subsidiary of the borrower (even if it continues to be a subsidiary). This means that a borrower may sell or distribute a minority interest in a valuable subsidiary, thereby releasing that subsidiary from its guarantee (and resulting collateral obligations). There has been a continued focus from lenders on this provision and, in some deals, this has been addressed by providing that no such release shall occur unless the sale or distribution is for a bona fide business purpose with an unaffiliated third party. In other deals, the release of the subsidiary guarantor is a deemed investment and permitted solely to the extent there is investment capacity (although that is of little value if the credit agreement permits unlimited investments in non-guarantors). In still other deals, a subsidiary guarantor is only released upon ceasing to be a restricted subsidiary.

In conclusion, while liability management transactions have been a common strategy in the high-yield bond market for years, their application to the syndicated loan market over the past 18 months has frustrated many the traditional and fundamental expectations of loan market participants. While there are potential methods for lenders to address the issues referred to above – materially tightening investment capacity in unrestricted and excluded subsidiaries, requiring a 100% lender consent to subordinate senior secured term loans, and restricting a borrower's ability to engage in certain forms of non-pro rata buy-backs – this remains a primary area of ongoing negotiation between borrowers and lenders.

Contributed by: *James A Florack, Meyer C Dworkin, Vanessa L Jackson and Adela Troconis,* ***Davis Polk & Wardwell LLP***

Davis Polk & Wardwell LLP delivers customised, innovative counsel to private equity sponsors, borrowers, banks and other lenders across a broad spectrum of corporate finance transactions, including leveraged and investment-grade acquisition financings, middle market and direct lending financings, project and infrastructure financings, energy financings and restructurings, and debtor-in-possession and exit financings. The finance practice includes 14 partners in New York and London, each with extensive experience in representing financial institutions and corporations in bespoke and ground-breaking financing transactions. With locations in New York, Europe, Asia and Latin America, the practice is well equipped to handle the most complex domestic and international transactions.

AUTHORS

James A Florack is a partner in Davis Polk's corporate department and is co-head of the firm's finance group. He advises clients on transactions including leveraged and investment-grade lending, structured finance, high-yield debt offerings and other capital markets transactions. He has a particular focus on acquisition financings, whether led by financial sponsors or otherwise. He represents leading US and international banks and corporations in transactions in both US and international cross-border markets.

Vanessa L Jackson is a partner in Davis Polk's corporate department, practising in the finance group. Her practice focuses on the representation of financial institutions and corporate borrowers in a broad range of corporate finance transactions, including leveraged and investment-grade acquisition financings, asset-based credit facilities, debt restructurings, spin-offs, working capital financings, debtor-in-possession financings, exit financings, and other secured and unsecured financings.

Meyer C Dworkin is a partner in Davis Polk's corporate department, practising in the finance group. He advises lenders and borrowers on a variety of finance transactions, including acquisition and other leveraged and investment-grade financings, asset-based financings, debtor-in-possession and other distressed financings, and structured credit financings. He regularly represents hedge funds, private equity funds and corporations in negotiating prime brokerage, derivatives and repurchase agreements, as well as other trading and financing documentation and complex structured financial products.

Adela Troconis is an associate in Davis Polk's corporate department, practising in the finance group. She advises financial institutions and corporate clients on a variety of finance transactions, including acquisition financings, project financings, particularly in Latin America, and debtor-in-possession financings and bankruptcy exit financings.

Contributed by: *James A Florack, Meyer C Dworkin, Vanessa L Jackson and Adela Troconis,*
Davis Polk & Wardwell LLP

Davis Polk & Wardwell LLP

450 Lexington Avenue
New York
NY 10017
USA

Tel: +1 212 450 4000
Fax: +1 212 701 5800
Email: james.florack@davispolk.com
Web: www.davispolk.com