CLEARY GOTTLIEB

Latest Developments In European Leveraged Finance
Evolution of the Transferability Clause

Early 2000s

Lenders' freedom to transfer their participations in large leveraged loans has been gradually eroded by developments introduced through the last few credit cycles.

By the time of the pre-crisis peak in 2007/2008, the provisions governing freedom to transfer had settled on the following:

— Transfers had to be to *"another bank or financial institution or to a trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets"*.

— Borrower consent to any transfer was required (which could not be unreasonably withheld and was deemed given if not expressly refused within a short period), except:

  • if there was an Event of Default continuing; or

  • for transfers to affiliates or related funds or other lenders.

— Permitted transferees of revolving facilities often had to comply with minimum ratings criteria.

— Restrictions on sub-participations were not universal, and in many cases only applied where voting rights passed to the sub-participant.

— Requirements to disclose the identity of sub-participants were rare.

Post-crisis developments

Following the financial crisis, borrowers focused again on transferability as their bank lenders came under pressure to dispose of non-core assets and the range of potential buyers of leveraged debt expanded through the proliferation of non-bank investors. The deep liquidity in the secondary market and hunt for yield that has characterized the last few years has armed borrowers with the negotiating power to push for ever more stringent restrictions on the lenders' ability to sell out and walk away.

Borrower consent rights (subject to reasonableness and a now typical 5 business day response deadline) as noted above remain the anchor around which negotiations take place. However, the inherent uncertainty of applying a reasonableness test to any given situation has led to the increasing use of express transfer restrictions not subject to such test. Broadly, those restrictions can be put into two categories.

1. Restrictions on acceptable transferees:

WHITE LISTS:

The use of pre-agreed lists of specific entities to whom transfers do not require borrower consent are now prevalent. Further, it is now commonplace to have a separate clause which legislates for how and when such white list can be altered – specifying whether the borrower can remove names from the white list and, if so, the circumstances and frequency of alterations. Typically, names can be removed if the relevant entities have merged with or been taken over by entities not on the list, or if they have become 'loan-to-own' investors (see below). But in some deals borrowers may remove names without rationale, subject to a fixed cap of typically between 3 and 5 names per financial year.

VULTURE FUNDS:

Even where loan transfers are subject to borrower consent, many deals now also contain an absolute prohibition on transfers to generically defined 'loan-to-own investors' or 'vulture funds'. These entities are often defined along the lines of:

"any person or entity which engages in investment strategies the primary purpose of which is to purchase loans or other debt securities with a view to owning the equity or gaining control of a business"

In the absence of a clear fact pattern, this may be difficult to prove given it has a strong subjective element. Like art, a vulture fund is difficult for a borrower to describe, but they will know it when they see it. For obvious reasons, the borrower would expect this prohibition on transfers to continue even if there is an event of default which is "continuing".

COMPETITORS:

Although we haven't seen this happen often in practice, many borrowers harbor a concern that an industrial competitor will purchase a participation in the loan, and use that position to extract private information or, if the borrower is in distress, to exert leverage by withholding consent to waiver or amendment requests. A typical definition would look like this:

"any person or entity (or any of its affiliates) which is a trade competitor of a member of the Group and any controlling shareholder of a trade competitor of a member of the Group"

A private equity sponsor may also harbor a similar concern vis-à-vis its rival sponsors and will want a similar restriction to apply.

Again, a well-advised sponsor/borrower will want the prohibitions above to continue even if there is an event of default. Again the language has not been tested in court, although we believe this concept is more likely to be susceptible to convincing factual proof than the vulture fund concept.

LENDER CONCENTRATION:

An as yet early stage innovation in the market which may be worth exploring is a right of the borrower to withhold consent if the transfer would result in a single lender (and its affiliates) holding a "blocking stake", i.e. a percentage of the loan commitments which could result in that lender effectively having a veto in an amendment request or scheme of arrangement. This could be particularly useful where the transferee seeks to slip through the "vulture-fund" or "competitor" tests above. If set at an appropriate level by reference to the relevant voting majority, it would limit the disruptive potential of such transferee particularly in a restructuring situation.

Further reading: ***A Practitioner's Guide to Syndicated Lending, 2nd Edition (2017)***

2. Restrictions on the circumstances where borrower consent is not required:

The idea that the lenders should have total freedom to transfer their participations once a borrower has also defaulted has been eroded. In many deals we now see only 'serious' defaults triggering a dis-application of the borrower consent right. Those would usually be:

— failure to pay interest or principal;

— breach of financial covenants (if there are any) or failure to provide a compliance certificate; and

— insolvency and insolvency proceedings.

Usually sub-participations, even where voting rights do not pass to the sub-participant, are subject to the same regime as outright transfers.

Other Notes

A further development, which is now well-settled in the market, is the legislation for the consequences of breach of the transfer restriction. The rule at common law in England is that any assignment of a contract in breach of an anti-assignment provision is void with respect to the obligor. That position is now effectively set out in the document – transferees who have acquired their participations in breach of the assignment restrictions are disenfranchised from voting. In contrast, for deals governed by New York law, the UCC will override contractual restrictions on assignment and such assignment is valid as between the assignor and assignee, but the assignee will have no direct rights of enforcement against the borrower – it becomes a sub-participant in practice.

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DEAL CHECK LIST

1. Borrower consent to transfers required? ☐
2. Borrower consent right disapplied for only:
   - transfers to affiliates or related funds; ☐
   - other lenders; and/or ☐
   - when an Event of Default or 'Material Event of Default' is continuing. ☐
3. Transfers to entities on white list permitted? ☐
4. Modification of white list provision? ☐
5. Transfers to vulture funds prohibited? ☐
6. Transfers to competitors (borrower and sponsor) prohibited? ☐
7. Lender concentration limitation applied? ☐
8. If unfunded commitments:
   - ratings or other creditworthiness criteria; and/or ☐
   - provision requiring transferor to fund if transferee does not. ☐
9. Disenfranchisement of prohibited transferees? ☐

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