Feature

KEY POINTS

- Covenant lite loans have become a fixture in the European leveraged finance market, but documentation has yet to become standardised.
- There are a number of structural risks with using a covenant package which has been developed for one jurisdiction (the US) in deals which involve multi-jurisdictional European borrower groups.
- One particular area is how the existing and potential future creditors of the group are dealt with by the covenants and the intercreditor agreement.

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Dangers for the unwary: intercreditor agreements, covenant lite and additional debt

In this article, David Billington and Carlo de Vito Piscicelli consider the impact of covenant lite deals on European loan documentation. They set out steps security trustees and their counsel should take, short of requiring the appointment of additional security agents for each new tranche of debt.

INTRODUCTION

After years of ultra-low interest rates, investors in leveraged loans have become increasingly keen to secure high-yielding assets. That demand has not been matched by a steady supply of new leveraged buyout transactions, in a market dominated in recent times by refinancing and repricings. The result of this "over-liquidity" has been twofold: (1) margin erosion and (2) covenant erosion. This article explores the latter, and its impact on European deal documentation.

Financial sponsors and their advisers, aware that demand for new leveraged finance transactions exceeds supply in today's market, have taken the upper hand in negotiations, and begun to impose covenant lite structures on the European investor base. Such structures have been common in the US for some years, but have been controversial in Europe, and only began to take hold in early 2014 – the buyout financing of Ceva Sante Animale in March 2014 is usually cited as the first "pure" covenant lite loan deal to be syndicated in Europe. It was not just the hunt for yield that sparked the rise of covenant lite in Europe. The seed was planted by European issuers accessing the US debt markets directly while the European markets were still sluggish in the wake of the financial crisis. Added to that was the deepening liquidity of the European high-yield bond markets, feeding a growing community of non-bank investors who are able to buy both bonds and loans, and are comfortable with the incurrence-style covenants.

Covenant lite in Europe was initially only available for large deals, often with a significant US dollar component, where the borrower was of relatively high credit quality, with a track record in the debt markets. It has now trickled down to mid-market deals and is a fixture of the European leveraged lending scene. However, the way in which such deals are documented has not yet settled on any particular form. Historically, English law leveraged loan agreements were fairly homogeneous – broadly following the model of the Loan Markets Association (LMA), though heavily negotiated. No such model exists for covenant lite loans, and the market is gradually moving towards the American custom, whereby the documentation for the most recent similar transaction is taken as a starting point, and then customised.

With much of the drafting technology in a covenant lite deal being copied over from US law agreements, often some structural risks are overlooked. That is particularly true in the case of intercreditor agreements, which have evolved differently in Europe and the US due to the very different ways in which an insolvency of the borrower would play out.

WHAT SORT OF COVENANT LITE DEAL DO YOU HAVE?

As noted above, there is no standard form for a covenant lite loan agreement in Europe. Broadly the deals that we have seen in the market fall into one of four categories:

(1) **High-yield style**: An English law, LMA-style credit agreement with the general undertakings section removed, and a New York law governed schedule of high-yield bond-style covenants. There may be a single "springing" leverage covenant, applicable to the revolving facility only, which is only tested if that facility is drawn above a certain threshold (usually the lower of: (i) a fixed monetary amount; and (ii) an amount equal to a certain percentage of the total revolving facility commitments). This structure is typical for super-senior revolving facilities that sit alongside a high-yield bond, but is also seen in stand-alone loan transactions.

(2) **US style**: New York law credit agreement with incurrence covenants and a springing financial covenant applicable to the revolving facility. This is seen only rarely in Europe, in very large transactions marketed to global financial institutions.

(3) **Hybrid style**: English law, LMA-style credit agreement but with the covenant baskets modified to be roughly equivalent to high-yield bond style incurrence covenants, plus a springing financial covenant.

(4) **Covenant loose**: English law, LMA-style credit agreement with LMA-style undertakings and flexible grower style baskets, the possibility to incur additional incremental facilities, and one or two financial covenants.

When we refer to "covenant lite" in this article we are referring to any structure where the general covenants in the senior secured debt (in particular the financial indebtedness covenants) are incurrence based.

Each template described above comes with its own potential pitfalls. In general caution should be exercised when using covenants that track closely the pure incurrence covenant model, because those typically reflect US practice which assumes that:

(A) all of the borrower's subsidiaries will give guarantees and security;

(B) guarantees will not typically be subject to significant limitations and the collateral will comprise substantially all of the assets of the obligors; and

(C) any restructuring would be effected through a Chapter 11 process.

None of those assumptions are likely to be true for European deals.

WHAT ADDITIONAL DEBT COULD BE INCURRED?

One important area in which covenant lite loans offer more flexibility to a borrower is in the limitations on incurring additional debt, including secured debt. Instead of a traditional debt basket with a capped amount, covenant lite terms often limit the amount of additional debt that may be incurred only by reference to a leverage or interest coverage test, with additional, often sizable, "freebie" baskets that can be used even if the leverage or interest coverage test is not met. Furthermore, the terms of these loans often provide that the borrower can freely incur external debt so long as its purpose is to refinance all or a portion of a then existing debt instrument (including the senior secured loans themselves).

This additional "ratio debt" as well as the "refinancing debt" can usually be incurred either by way of an incremental or refinancing facility under the same documentary architecture as the original loan, or through separate documentation that meets certain criteria (so-called "sidecar" structures). In either case the additional facility will be entitled to share the security package with the original lenders on either a *pari passu* or junior basis, depending on the pro-forma financial metrics of the borrower.

In addition to this secured indebtedness, the covenants may permit sizable baskets for unsecured indebtedness, which could be incurred in different forms (for example, finance leases or bilateral working capital facilities). Such hefty baskets are common in US financings because, as noted above, typically all of the companies in the borrower's group will guarantee the bank debt, and the lenders can be comfortable with how unsecured debt would be treated in a Chapter 11 process if things go wrong.

A (BRIEF) HISTORY OF EUROPEAN INTERCREDITOR AGREEMENTS

European intercreditor agreements were developed in a market where the tranching and amount of the debt elements of the borrower's capital structure were all identified at the outset (eg a senior secured credit facility coupled with a secured mezzanine facility or an unsecured high-yield bond), with very little ability for the borrower to tinker with it during the life of the agreement by way of refinancing, upsizing or inserting additional layers of secured or unsecured financing. The key risk with using an unmodified English style intercreditor agreement for a covenant lite deal is that a large part of that intercreditor will legislate for how creditors must behave in a default situation, and those provisions determine how (and indeed, whether) any future restructuring could be implemented. These provisions evolved in Europe with the purpose of ensuring that a restructuring or security enforcement could be implemented before any insolvency process is started. Unlike Chapter 11 in the US, most insolvency processes in Europe are still value destructive, and once commenced they often precipitate a full-blown collapse of the borrower as a going concern, as its counterparties cease to trade with it or extend credit. Moreover, unlike the US Federal bankruptcy law, there is no single framework for resolving businesses with subsidiaries organised in multiple European jurisdictions, as bankruptcy laws vary significantly across member states. European intercreditor agreements therefore rely on:

- robust standstill clauses, preventing creditors from taking any enforcement action (broadly defined to include payment demands as well as enforcement of security interests) against the borrower's group until the "instructing group" of creditors has had time to formulate a plan;
- enforcement sale provisions allowing the security trustee to enforce the share pledge at (ideally) the topmost company in the group and sell the entire business as a going concern to a third party or a sub-group of supportive creditors. In order to complete that process the security agent will need the ability to release all of the material debt in the group, and detailed provisions have been developed in order to facilitate that.

WHAT ARE THE RISKS?

With a covenant package that permits the incurrence of significant secured and unsecured debt, thought needs to be given to the following at the outset of the transaction:

Which companies in the borrower's group should be permitted to use the additional debt baskets?

This matters more in European deals, because typically only some of the borrower's subsidiaries will guarantee the senior secured debt. Many European jurisdictions impose restrictions on the granting of upstream and cross-stream guarantees and security, and typically borrowers will be subject to a coverage covenant that only requires subsidiaries which account for a certain percentage of consolidated EBITDA (earnings before interest, tax, depreciation and amortisation) and/or assets to become guarantors.

Even where a guarantee is actually granted, local law considerations often require its amount to be limited, to the effect that it is not unusual for an upstream guarantee to have no meaningful value to the creditors.

If significant additional debt is incurred by a subsidiary of the borrower which is not a guarantor of the covenant lite loan or is a guarantor in name only, that debt would be structurally senior. If the creditor in relation to that debt is not required to sign up to the

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intercreditor agreement, they could end up in a very strong position if the senior secured creditors are attempting to complete an enforcement sale of the whole group, because they would not be subject to standstill, and could insist that their debt remains in place, thereby reducing the proceeds of the sale available to the senior secured creditors.

The solution is to either specify in the debt covenant that certain baskets may only be used by the issuer of the senior secured debt or at least by a guarantor of the same (which may not suit the borrower's business needs) and/or specify that if additional debt incurred under certain baskets exceeds a capped amount the relevant creditors must sign up to the intercreditor.

Stuck in the middle

One consequence of allowing future classes of creditors to share in the security granted to the providers of the covenant lite loan is that the intercreditor agreement must legislate for those classes of creditors' rights and obligations.

In the US, where these incurrence-based terms were initially developed, each class or series of creditors typically appoints its own security agent, even where the creditors share in the same collateral pool. Subject to any intercreditor arrangements, therefore, each such security agent has an independent right to enforce the security.

In contrast, in Europe, the security is usually held by a single security trustee on behalf of all secured creditors regardless of the number of debt instruments evidencing the debt or the ranking of the secured claims. Therefore, in the European context, the security trustee will, by signing the intercreditor agreement, be agreeing at the outset that it is prepared to hold the transaction security on behalf of all the potential creditors who can share the security, not just those in the structure on day 1. In a default situation, the security trustee is the entity which has the power to enforce the transaction security, and it could therefore find itself acting for a creditor base that has been completely transformed in terms of identity, amount, class composition and ranking since the original transaction.

Unlike in a US structure, where each security agent acts as a fiduciary only for the class of creditors that appointed it in the first place and is only required to take instructions from them, European security trustees are fiduciaries for all secured creditors without distinction and the documentation typically provides that they shall act in the interest of all such creditors alike.

This could put the security agent in a difficult position where the creditors have been fragmented in multiple classes with differing interests as to the timing and manner of enforcement. Short of requiring the appointment of additional security agents for each new tranche of debt, which may not be practicable under many European commercial laws, security trustees and their counsel should therefore take steps to ensure that the document very clearly sets out:

- which creditors are entitled to share the security, with a clear accession mechanic for each relevant creditor group;
- which creditors are entitled to give the security trustee enforcement instructions (ie how should the various creditor groups vote and what majority is required to trigger and direct enforcement?);
- how the security trustee is to deal with conflict of interest situations to the extent that it is required to exercise discretion because of the absence of or ambiguity in the enforcement instructions received by the applicable instructing group;
- what the "value protection" mechanisms are – typically the power to enforce security lies first with the senior creditors, but they may not be incentivised to seek enforcement proceeds greater than the value of their own debt. Consequently, in structures where there is significant junior debt, extensive provisions have developed which require any enforcement sale to meet certain criteria before the junior debt can be released, for example, the requirement that:
  - the proceeds be in cash or "substantially in cash";
  - the sale be by way of a "competitive sales process";
  - the security trustee receives a fairness opinion from an independent financial adviser;
  - all the claims of the senior creditors be released in full before any junior claim is released.

If there is no junior debt in the structure on day 1, these provisions will have to be negotiated by the borrower in the hope that they will be sufficiently attractive to junior creditors at the point in the future that it is incurred. If they are not, the borrower will find it very difficult to amend the intercreditor agreement, as typically that will require the consent of all the signatories to that document (and consent from the requisite majorities of the creditor groups they represent).

Security trustees and their counsel should also take a close interest in ensuring these provisions will work as a practical matter. If there is any ambiguity, or if the provisions could require the security trustee to exercise any discretion, there is the possibility that the security trustee could be caught up in a dispute between the creditor groups.

All parties should therefore be incentivised to ensure that the intercreditor agreement is drafted clearly. If it is not, the borrower may find itself unable to use the negotiated debt baskets, and the creditors could find any future restructuring prolonged or even prevented absent amendments to the intercreditor agreement that out-of-the-money creditors would be unlikely to agree to without financial incentives. ■

Further Reading:

- Globalisation of the European loan markets: interpretative challenges and pitfalls (2017) 3 JIBFL 143.
- Across the pond and back again: US and European leveraged finance terms (2015) 10 JIBFL 622.
- LexisNexis Loan Ranger blog: European credit documentation trends: covenant-lite or covenant empty?