Feature

KEY POINTS

- Relatively free lender transferability has classically been a key feature of the leveraged loan product.
- That has facilitated the development of a liquid secondary market, participation by institutional investors and CLOs and the use by lenders of a range of asset management techniques.
- Recent documentary developments on transactions have imposed greater restrictions on lender transferability that risk reducing liquidity of the asset class and impairing lenders' ability to manage their lending positions.
- This is difficult to reconcile with both the importance of lender transferability in the context of covenant-lite transactions and increasing focus on efficient capital management by regulated institutions.
- Is lender transferability becoming less important to investors or are these developments simply a consequence of the current demand/supply imbalance in the market?

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The new breed of transfer restrictions in leveraged lending transactions: a new paradigm or just a sign of the times?

European leveraged lending practitioners will need no telling that documentary terms have been something of a one-way moveable feast for a number of years. Be it a function merely of investor demand for assets exceeding available opportunities or of an influx of a new breed of investor, a new normal of lower pricing, higher leverage and weaker covenant protection has become established across almost all levels of the market. The latest area of leveraged lending documentation to go through a process of revisionism is the extent of a lender's right to transfer its participation in a loan facility to another institution.

TRADITIONAL TRANSFER RIGHTS AND THEIR PLACE IN THE MARKET

There has always been an inherent tension between a lender's desire for maximum flexibility in how it may choose to manage its financial asset and a borrower's (or its financial sponsor's) desire to control the identity of those institutions having debt claims against it. The agreed position on lender transferability is always a compromise between these two competing positions.

In leveraged lending the traditional position has generally been one of relatively free lender transferability with:

- transfers permitted to a wide range of other institutions which are either named on an "approved list" or which are funds managed by the same asset manager (often referred to as "related funds"), without borrower consent;
- in other cases, transfers permitted with borrower consent (but subject to the qualification that such consent is not to be unreasonably withheld or delayed and is deemed to be given after a specified period of time);
- transfers to any institution permitted at any time on an event of default without borrower consent; and
- no restrictions on "synthetic" transfers, such as sub-participations and the use of credit default swaps under which the economic benefit of a lender's position is passed to the "transferee" without creating a direct relationship between the transferee and the borrower.

This position was seen to reflect not only the inherently riskier nature of a leveraged loan for a commercial bank but also went hand-in-glove with the evolution of the modern leveraged loan product from a relationship lending product held by banks to maturity to a class of financial asset capable of being traded among a wide range of institutional investors in a relatively liquid market.

As the leveraged market has developed towards so called "covenant lite" transactions, the combination of a liquid secondary market and relatively free transferability may also be seen as an explanation of, and mitigant for, the loss of maintenance financial covenants: the argument being that, by analogy with the high-yield bond market, the rationale for those covenants and the early default and "seat at the table" that they can provide on breach is reduced when secondary market liquidity is such that a lender can simply expect to be able to trade out of a deal as soon as the borrower group's performance does not meet its expectations or internal modelling.

KEY CHARACTERISTICS OF TRADITIONAL TRANSFER RIGHTS

Whilst being well short of the full free transferability longed for by secondary market practitioners, the traditional transfer rights outlined above encapsulate three elements which have generally been perceived as important for enabling institutions to manage their balance sheet and for the functioning of a liquid secondary market and, as a consequence, vital to ensure a thriving primary market for leveraged loans. These three elements are explored below.

Easily ascertainable permitted transferees and timelines

Free transferability to any institution specified on the approved list not only allows

for a wide range of potential transferees but, crucially, allows for a high degree of certainty for lenders, transferees and the facility agent that the potential transfer is "permitted" without the need for costly and time consuming advice, deliberation and judgment calls. As a general rule, the greater the uncertainty as to whether a trading counterparty is a permitted transferee the greater the delay and transaction costs associated with the trade and the higher the chance that those delays and transaction costs will cause the trade to fail or render it uneconomic.

Free transferability between related funds ensures that CLO and other fund managers can move loan assets easily between their funds, allowing for efficient portfolio management and increasing the appeal of the leveraged loan asset class to this increasingly important investor base.

If a potential transferee is not either on the approved list or a related fund of the existing lender and borrower consent is, therefore required, the deemed consent provisions limit any period of uncertainty as to whether borrower consent will, or will not, be given and promotes a swifter settlement of the relevant trade.

Free transferability on a distressed credit

Free transferability on an event of default increases a lender's options by opening up a range of potential buyers which may not be named on the approved list and transfers to which would otherwise have required borrower consent.

This can be particularly important as lenders may wish to trade out of a distressed credit in order to mitigate potential losses and the market for distressed credits is likely to have a different constituency to that envisaged by the approved list. Lenders which have taken out loan credit default swaps may also need the flexibility to transfer the loan to the credit default swap provider in order to avail themselves of the credit protection offered by those products.

Additionally, recent regulatory and accounting initiatives have served to increase the importance of free transferability of distressed loan assets for regulated institutions:

- the European Commission's recently adopted legislative proposals on tackling non-performing loans[1] make clear that encouraging European banks to address non-performing loans on their balance sheet will be a key regulatory initiative: the freedom to transfer such loans is likely to become increasingly important in this context; and
- the impact of IFRS9 (establishing, among other things, a forward looking expected loss model for financial assets) will require earlier provisioning against loan assets and could increase the capital expense associated with holding distressed loan assets.

No restriction on synthetic transfers

This is important for three main reasons:

- in the secondary market, sub-participations are the primary fall-back means of settlement if, for any reason, the agreed trade cannot complete as a full transfer (such as when a borrower consent cannot be obtained). The widespread availability of sub-participation as a fall-back has allowed the market to operate on the basis of very limited conditionality (often referred to as a "trade is a trade") with participants having a high degree of certainty that an agreed trade will at least be settled synthetically, encouraging liquidity and promoting the rise of the leveraged loan as an easily tradeable asset class;
- in the contexts of institutions' balance sheet management and CLO establishment, sub-participations are frequently used to structure securitisations of loan assets which cannot be easily transferred; and
- as capital reforms increase the cost to regulated institutions of holding loan assets, the use of credit insurance and other risk mitigation techniques is becoming a key requirement for those institutions from a capital management perspective.

THE NEW BREED OF TRANSFER RESTRICTIONS AND THEIR POTENTIAL IMPACT

Recent developments in leveraged lending documentation have started to erode each of the three key characteristics of traditional transfer rights. The cumulative effect of this erosion risks lessening secondary market liquidity and reducing the extent to which lenders are able to manage their lending positions. The key developments are explored below.

Restrictions on activities of transferees

Sponsors are increasingly able to negotiate additional transfer restrictions framed by reference to business activities of the proposed transferee which are perceived to conflict with the interests of the borrower group. The most common of these restrictions are provisions which prohibit transfers to any of:

- a competitor of the borrower group;
- a private equity sponsor;
- a supplier or sub-contractor of the borrower group; and
- a distressed debt investor,

without borrower consent, regardless of whether the proposed transferee is on the approved list or is a related fund of the existing lender. Frequently there are no deemed borrower consent provisions in these circumstances.

Whilst these restrictions are understandable from a sponsor perspective, they are often and unsurprisingly, expressed in wide terms and it can therefore be difficult in any individual case for lenders to assess the extent to which the proposed transferee may or may not fall into one of the categories to which transfers are prohibited.

By way of example:

- "Competitors" are frequently defined to include any entity that holds a controlling interest in any affiliate of a person whose primary business is similar to the borrower group's activities. In practice this can mean that the restriction has a wide breadth and that it is hard to assess whether

the restriction applies, especially if the proposed transferee is part of a large conglomerate. Even if there is a carve-out, as is often the case, for the financing arms of large groups there is often a requirement for sufficient information barriers and operational independence to be in place – often difficult to determine definitively in practice.

- Distressed debt investors are notoriously difficult to define with any certainty and definitions often end up being framed by reference to the material purpose with which an entity invests in loan assets or the extent to which an entity invests in loan assets trading at a discount to par value. In practice this can be difficult to assess and potentially captures a large range of potential investors (particularly if all loan assets are trading at such a discount in times of market dislocation).
- "Suppliers" and "sub-contractors" are frequently undefined and, taken to an extreme, might cover all manner of unexpected entities: is the group's insurer a "supplier" of services? Does that mean that transfers to its debt financing arm are restricted?

The greater the extent of the uncertainty the greater the chances of the trade being delayed, subject to disproportionate transaction costs or, in the worst case, simply abandoned as being too difficult. The difficulties created can also potentially hamper efficient portfolio management and asset allocation across a fund manager's range of CLOs.

If, erring on the side of caution, borrower consent is sought, the lack of any deemed consent provisions mean that there is no ascertainable timeline, no incentive for the borrower to prioritise the request and the trade can be left in limbo for an indefinite period.

Restrictions on transferability of distressed credits

Transferability on distress has always been a difficult issue as, in the context of an individual transaction, it is close to being a zero-sum game. Sponsors recognise that where one of their portfolio companies becomes a distressed credit the constituency of its lending syndicate becomes increasingly significant to that company's survival, and to their chances of retaining their equity investment in that company, and wish to restrict transferability, whereas lenders have pushed for free transferability in such circumstances for the reasons outlined above. The pendulum has swung firmly in favour of sponsors in two ways.

- As well as the issues of wide application and the resulting uncertainty described above, a prohibition on transfers to distressed debt investors however defined, clearly reduces a lender's opportunity to transfer out of an asset that is, or might become distressed by preventing transfer to the very investors who are likely to constitute the principal market for that asset.
- In addition, sponsors are securing transfer restrictions which restrict free transferability on default to the occurrence only of specified events of default, most commonly those triggered by a non-payment under the financing documentation or insolvency. A non-payment or insolvency event of default will generally occur only towards the very end of a distress scenario and postponing the time at which the loan asset becomes freely transferable to this point risks it losing significant value, and a lender realising a significant loss (and regulatory capital costs) before being free to trade it into the distressed market.

Restrictions on synthetic transfers

Sponsors are also succeeding in negotiating restrictions on synthetic transfers, most commonly sub-participations. These usually take the form of requiring borrower consent (with no deemed consent provisions) to the sub-participation unless certain conditions are met. Key amongst these conditions are often that:

- the arrangement does not give the sub-participant any control or right of consultation in relation to how the lender exercises any of its rights or discharges any of its obligations under the facilities agreement; and
- the facilities agreement would have permitted a full transfer to the sub-participant.

The effect of the first condition in practice is to heavily curtail the use of sub-participations. This is because many forms of sub-participation (even those which do not grant full voting rights) will require the sub-participant's consent for those significant amendments to the facility documentation that require all Lender consent. The overall effect is to create uncertainty and to limit the extent of protection that a lender is able to offer to a potential sub-participant, making a sub-participation less attractive and/or affecting pricing.

The effect of the second condition is to apply the restrictions on full transfers to sub-participations. Given that a significant utility of sub-participations has been as an alternative when a full transfer is not available because of a restriction in the facility documentation, the potential negative effect on secondary trading, an asset's liquidity and lender's balance sheet management is clear.

Occasionally the restrictions may be extended to cover other types of synthetic transfer, usually through the use of restrictions on any "sub-contract" or "economic transfer" of any of a lender's rights and obligations. Such restrictions clearly have the potential to impact upon a lender's ability to enter into risk mitigants such as credit default swaps, or total return swaps and other balance sheet management techniques such as declarations of trust and even credit insurance as well as restricting the effective structuring of a CLO or other securitisation. Another potential risk of a restriction covering such a wide range of financial products is that unrelated activity in a different part of its institution might lead to inadvertent breach by a lender.

Although a contractual restriction on synthetic transfers is unlikely to render the synthetic transfer invalid as between the

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lender and its contractual counterparty, this is clearly not a complete answer for lenders given that there would be an undeniable breach of contract and, even though actual damages may be hard to prove, it is unlikely that many financial institutions would take such state of affairs lightly. As an additional incentive, a number of sponsors seek to include provisions which disenfranchise from voting any lender which is in breach of a restriction on synthetic transfers.

TOWARDS A NEW PARADIGM?

From a sponsor's perspective, the commercial logic behind the new breed of transfer restrictions is clear. In the ideal world a borrower would prefer not to have any risk of its loan being transferred to competitors or key contract counterparties, to prevent transfers to the types of institution whose motives it fears might be nefarious, to keep control over its lending syndicate in times of difficulty and to prevent its lenders from remaining in the deal as lenders of record but off-loading the credit risk to another entity which might end up pulling the strings behind the scenes: none of this is particularly new.

What is new is that concerns around these issues are starting to outweigh the priority that underwriters and investors have classically attached to the importance of relatively free transferability, a deep and liquid secondary market, the status of the leveraged loan as a liquid asset and a lender's freedom to employ a range of asset management techniques.

Are those simply less important than once they were? Certainly the inclusion of the new breed of transfer restrictions does not seem to have noticeably dampened investor appetite for new deals (although anecdotal evidence suggests that secondary market participants are, unsurprisingly, finding them troubling). However, this notion seems perplexingly hard to square with the move of the market towards an institutional investor base accustomed to liquid markets for their assets, the reasoning behind "covenant-lite" transaction structures and the increasing importance to regulated institutions of minimising capital costs and effective management of non-performing loans.

Or is liquidity of the asset class and use of asset management techniques just as crucial as, or perhaps even more so than, it always has been? In which case perhaps the best explanation for the rise of the new breed of transfer restrictions might be that it represents a temporary phenomenon that underwriters and investors are having to swallow as a function of the demand/supply imbalance in the leveraged lending market?

Time will tell. ■

1 European Commission proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral and European Commission proposal for a Regulation of the European Parliament and of the Council on amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures.

Further Reading:

- Preying on distressed debt: limiting the scope for transfer to vulture funds (2018) 1 JIBFL 9.
- Restrictions on the transfer of rights in loan contracts (2013) 9 JIBFL 543.
- LexisNexis Loan Ranger blog: Tackling settlement delays in the LMA secondary loan market.