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**LOAN DOCUMENTATION IN  
EUROPE: RECENT TRENDS  
AND CURRENT ISSUES**

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## INTRODUCTION

Following the financial crisis, corporate borrowers in Europe sought to diversify their sources of finance, in some cases, to reduce funding costs, in others, as a result of the limited availability of bank finance. More recently, loan products have slowly begun to re-establish their status as the preferred source of debt finance for European corporates.

The commercial and contractual terms available to corporate borrowers have evolved, both to address the implications of the new regulatory environment and in response to the competitive pressures that arise in a market which remains dominated by refinancings and “amend and extend” transactions.

This booklet draws together our collective experience of how loan market conditions are affecting the terms available to corporate borrowers in each of France, Germany, Italy, the Netherlands, Spain and the UK. It also considers how (if at all) various legislative and regulatory developments affecting the loan market are being addressed in documentation, other topical documentation issues such as the implications of LIBOR reform and recent changes to the Loan Market Association (“LMA”) recommended forms of facility agreement.

Each issue is considered from the lender’s and the borrower’s perspective. Documentation provisions are discussed by reference to the current versions of the LMA’s English law recommended forms of facility agreement for investment grade borrowers (the “**Investment Grade Agreements**”). Comments on the provisions of the Investment Grade Agreements are in general of equal relevance to the LMA’s French, German and Spanish law versions of the Investment Grade Agreements.

This booklet is focused primarily on the corporate lending market, but many of the topics covered affect all types of loan documentation, and will also be of interest to participants in the leveraged and other more specialist sectors.

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## GLOSSARY

The terms specified below have the following meanings in this booklet:

<b>ACT</b>	The UK Association of Corporate Treasurers
<b>Investment Grade Agreements</b>	The LMA's English law recommended forms of facility agreement for investment grade borrowers, 16 June 2014
<b>Leveraged Agreement</b>	The LMA's recommended form of senior facility agreement for senior/mezzanine leveraged acquisition finance transactions, 16 June 2014
<b>LMA</b>	The Loan Market Association

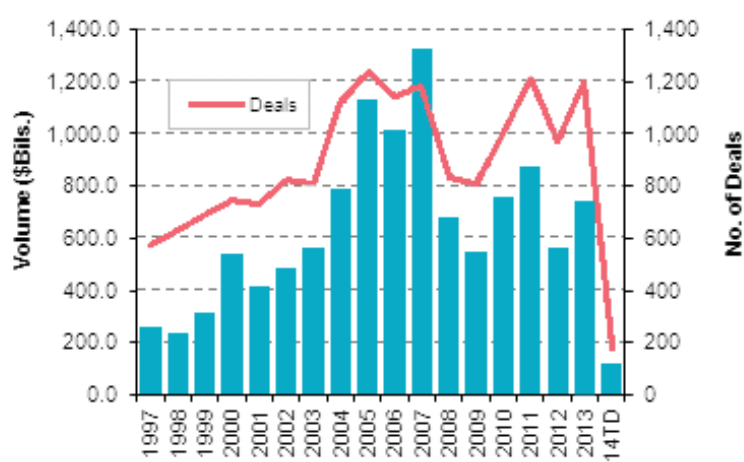
Capitalised terms not otherwise defined have the meaning given in the Investment Grade Agreements.

# 1. MARKET CONDITIONS 5 YEARS POST-CRISIS

## 1.1. Volumes and underwriting capacity

During 2013 European loan volumes increased significantly<sup>1</sup>. Loan volumes remained down on the period immediately preceding the financial crisis, but in Western Europe the loan product regained some of the ground lost to the bond market and its place as the most popular debt product for European corporates<sup>2</sup>.

### *Western Europe Annual Loan Volume<sup>3</sup>*



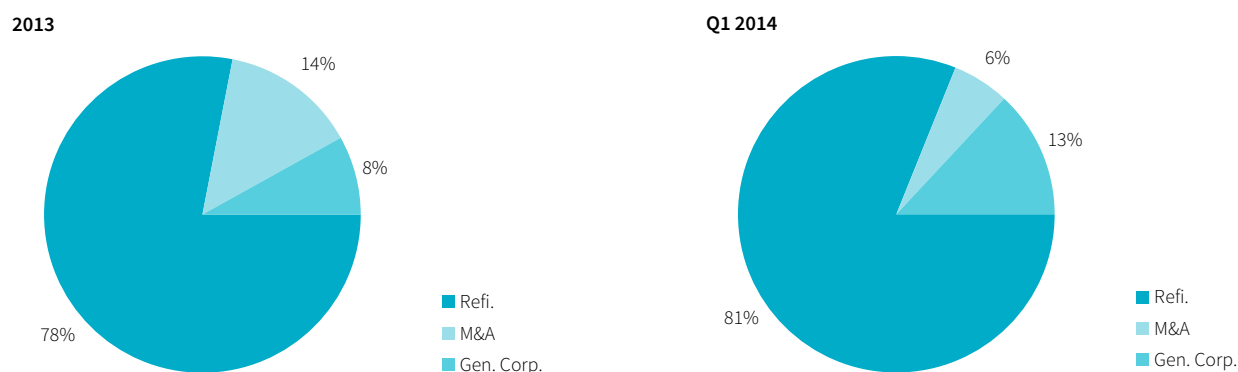
This can be attributed primarily to the European banking sector emerging from the depths of both the global financial crisis and the worst of the difficulties in the euro zone. Economic conditions across Europe have improved. European banks have been restructured and strengthened by ECB and central bank liquidity. As discussed in section 2, most of the major post-crisis regulatory reforms are now well into the implementation phase, meaning banks have a firmer grip on their future operational costs.

In light of the improving backdrop, it is perhaps surprising that the increase in lending seen in 2013 does not seem to have carried on into 2014 in most European countries (except Spain, where lending appears to have increased slightly compared to the same period last year)<sup>4</sup>. This might be due to uncertainty as to the outcome of the ongoing Asset Quality Review in the banking sector. However, the drop in lending during the first half of 2014 seems at least partly because of lack of demand, corporates having already secured their

- 1 Total loan volume in Western Europe in 2013 was \$739.84bn compared to \$560.89bn in 2012: Thomson Reuters LPC.
- 2 54% of all European corporate debt facilities in the first 9 months of 2013 were loans: Dealogic, quoted in Euroweek 22.10.13.
- 3 Thomson Reuters LPC.
- 4 Fitch Ratings Report 15 April 2014: Corporate Funding Disintermediation 2Q14.

loan finance commitments for this year. The increasingly attractive pricing on offer over the past 18 months or so led a number of borrowers to begin the process of refinancing their facilities earlier than the customary 12 months prior to maturity.

### **Western Europe Investment Grade Volume by Purpose<sup>5</sup>**



For so long as certain stronger credits continue to stimulate very strong demand from asset-light lenders, the returns on offer in the investment grade market are heavily dependent on the future ancillary business which today’s refinancings might generate from borrowers.

Will those relationship refinancing deals start shortly to bear fruit for the banks? And what will happen if there is insufficient ancillary business to justify today’s pricing?

Current indications are that the uptick in M&A activity that began in 2013 will gather further momentum. As mentioned above, the economic environment appears more stable and many larger corporates have built significant cash balances according to reports<sup>6</sup>. Although acquisition financing volumes remain relatively low, some significant underwritings have come to market recently<sup>7</sup>. The expectations of many seem to be that provided the key European economies continue to stabilise, more M&A will follow.

## **1.2. Pricing and fees**

### **Margins**

Average loan pricing has fallen in virtually all sectors of the loan market, a factor which, as mentioned above, undoubtedly enhanced loan volumes during 2013. Across Western Europe average loan pricing was 314.39bps in the first quarter of 2014, a drop of almost 40bps compared to the same period in 2013. During the first quarter of this year margins

<sup>5</sup> Thomson Reuters LPC.

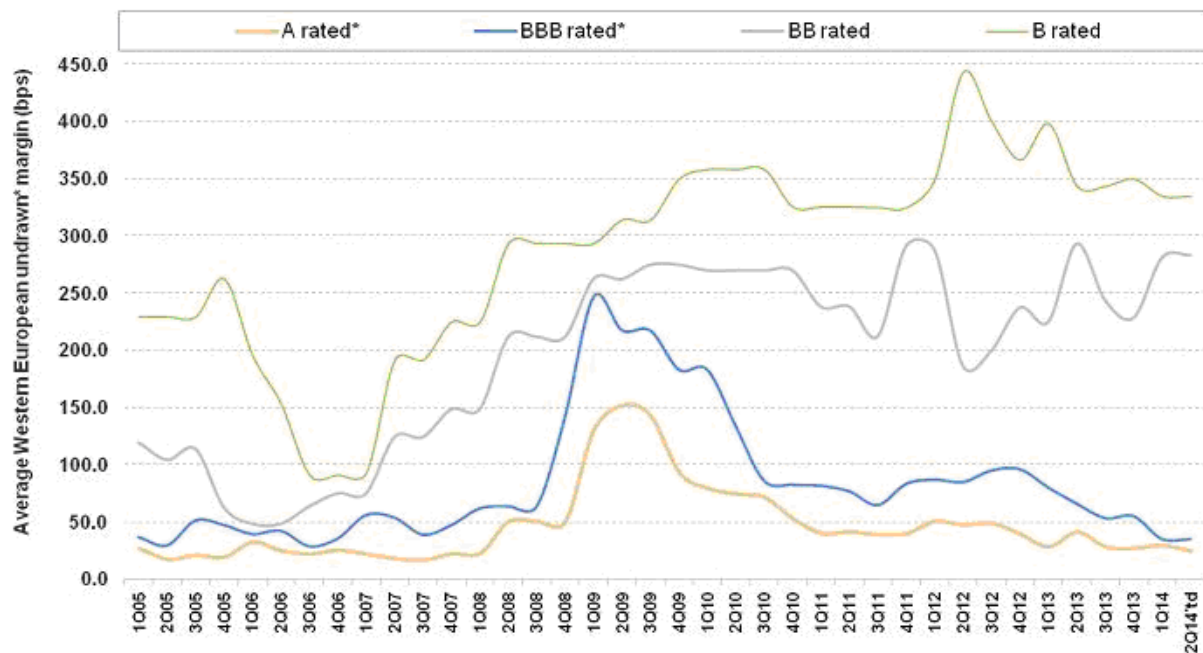
<sup>6</sup> See eg “Pressure mounts for corporate cash piles to be put to work”: Financial Times, 21.01.14.

<sup>7</sup> For example, bridge facilities extended to Verizon Communications (\$61bn), Shire (\$2.6bn), Schneider Electric (£1.5bn), Symrise (€1.25bn), Numericable (€4bn) and Bayer (\$12.2bn).

for single-A rated borrowers averaged 25bps (down from 30bps in Q1 2013). Margins for BBB-rated borrowers dropped even more significantly, from an average of 63bps to 35bps over the same period<sup>8</sup>. Average pricing for investment grade borrowers in Western Europe has fallen to its lowest level since 2008<sup>9</sup>, although there remain divergences along jurisdictional lines.

### ***Western Europe Primary High Grade and Crossover: Average Rated Quarterly***

#### ***Margins<sup>10</sup>***



The availability (and corporates' awareness) of alternative sources of funds, from the capital markets, the US and European private placement markets and (for certain borrowers), the US loan market, coupled with limited demand for M&A finance, had led to significant price competition for corporate loan financing among the banks.

Notwithstanding the overall downward trend in headline margins, banks have taken a small step towards more defensive pricing in the investment grade market. The Investment Grade Agreements contemplate fixed margins<sup>11</sup>, but variable margins linked to a ratings grid, a leverage grid (or even a combination) have become more common, even among top tier credits.

8 Thomson Reuters LPC.

9 Thomson Reuters LPC.

10 Thomson Reuters LPC.

11 Various other of the LMA's recommended forms, including the Leveraged Facilities Agreement, provide for the margin to vary by reference to leverage.



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## **Fees**

Fees have also, in general, fallen, in particular compared to 2009/10 levels, although the position is more variable in the sub-investment grade market.

For example:

- Upfront fees for investment grade syndicated loans, in our experience, are now commonly in the 20bp to 35bp range, the level quite often depending on relationships rather than credit.
- Commitment fees, which rose in some cases to 40-50% of margin in 2009/10, have now settled back to 35% of margin for most borrowers.

Utilisation fees levels have been more static but changes to their structure means that the overall fees payable if the facility is drawn are probably higher than might have been the case for corporates who last refinanced in 2009/10.

Until fairly recently, utilisation fees in the investment grade market became payable only once the facility was at least one-third drawn, stepping up to a higher rate once the facility was two-thirds drawn. “First draw” utilisation fees now apply to many corporate revolving facilities in the Dutch, English, French and German markets. A three-stage step-up still generally applies, but in many transactions borrowers are now required to pay utilisation fees as soon as the facility is drawn. This may prompt debate as to whether such fees should be restructured and incorporated into margins.

The “first draw” fee trend probably first emerged in France as a disincentive to drawing, after it became apparent that the pricing on undrawn standbys had become so low for some borrowers that they were able to arbitrage the difference between the margin and deposit rates by drawing their revolving facilities (or utilising them through ancillary lines) to a level below that at which utilisation fees became payable.

“First draw” fees for investment grade corporates, where applicable, might range from 7.5-12.5 bps, rising to 15-25bps if the facility is more than one-third drawn, and 30-45bps or even in some cases 50bps, if the facility is more than two-thirds drawn.

We have noted some evidence of variations in utilisation fees on standby facilities by jurisdiction, with German corporates enjoying slightly tighter rates than those in other jurisdictions.

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## **Fee caps in Italy**

There has been some concern in the Italian loan market as a result of the recent amendment to article 117-bis of the “Consolidated Banking Act<sup>12</sup>”, which places certain limits on the fees payable to the lenders on loans qualifying as “*apertura di credito regolata in conto corrente*”, which might arguably include revolving credit facilities. The Bank of Italy has however expressed a non-binding opinion which confirms that the limitations should apply only to retail transactions.

## **1.3. Tenors**

Tenors have gradually lengthened over the past few years, although maturities have not quite returned to those on general offer pre-crisis. As a result, in a number of countries it has become common to incorporate extension options into loan agreements.

By 2010, 5 year tenors had returned to the investment grade market and top-rated credits were often able to negotiate two one-year extension options on top of the initial five year maturity. By 2011, the “5+1+1” structure was being made available to borrowers in the BBB ratings bracket.

In those countries which have adopted the “5+1+1” structure, it has become reasonably established as a standard offering to all investment grade corporates<sup>13</sup>.

Tenors on offer to corporates further down the credit spectrum have tended towards the 3-5 year range (often “3+1+1”), although there is some evidence this year that crossover credits are also able to borrow “5+1+1”.

Any extension options are generally exercisable at the discretion of the lenders, although the lenders are to some extent incentivised by ancillary business to agree to extension requests as far as possible. In a few transactions lenders have imposed a requirement that the extension may proceed only if a minimum number of lenders wish to participate (e.g. 75%), but in most cases the borrower is free to proceed with as few or as many lenders as wish to be involved.

Lenders are also entitled to charge extension fees, usually left to be determined at the time of the extension, and/or request changes to the loan terms in exchange for granting the extension. Typical extension fees might be somewhere between 20-40bps for an investment

12 Legislative Decree no. 385/1993, as amended by articles 27 and 27-bis of the Law Decree no. 1/2012, converted into Law No. 27/ 2012 and as amended by Law Decree No. 29/2012, converted into Law No. 62/2012.

13 The exception is in Spain. Extension options are not generally used in the domestic market in Spain as lenders in the Spanish market will normally require any extension to an agreement to be formalised before a notary public.

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grade credit. It is often the case that loan terms are not amended when extension options are exercised.

Firm 7 year facilities, common before the crisis for top-rated credits, remain rare. Initially, this could be explained by market conditions and nervousness about the impact of impending regulatory change. As pricing has consistently tightened at the top end of the market, the lack of 7 year deals may also be due to lack of demand from appropriately rated borrowers.

#### **1.4. Other commercial terms**

In addition to the improved pricing currently available to many borrowers, there is evidence of a more general softening of corporate loan terms in favour of the borrower, compared to what might have been achievable 2-3 years ago.

Some borrowers are finding themselves able to improve their covenant terms and there have been a couple of instances this year of credits in the BB range refinancing without upstream guarantees and security.

A high level summary of the key commercial terms corporates might expect according to their ratings band/leverage is set out in the Schedule to this booklet. It is, however, indicative only; the terms of any loan ultimately depending on a variety of factors.

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## 2. REGULATORY IMPACT

### 2.1. Introduction

Basel III and its implementation in the EU, new regulations affecting the derivatives industry, the ever-increasing global web of sanctions and anti-corruption laws and other foreign measures with significant extra-territorial effect, such as the US Foreign Account Tax Compliance Act (“**FATCA**”) all have the potential to affect the terms and costs of corporate lending in Europe, and in some cases, the availability of loans or certain types of loan.

Many of these measures are now finalised or at least, better understood, but managing the impact of this unprecedented volume of new legislative and regulatory measures remains an ongoing challenge for the loan market and the financial sector generally.

This section considers the implications of the most important of these measures for loan documentation and how they are being addressed in current transactions.

### 2.2. Basel III, CRD IV and the loan market

#### *Basel III*

In December 2010, the Basel Committee on Banking Supervision published a revised set of bank capital requirements aimed at strengthening existing standards, and rules imposing two new liquidity standards and a new leverage ratio (proposing a 3% cap on banks’ balance sheets as a proportion of their Tier 1 capital) in two documents: “Basel III: A global regulatory framework for more resilient banks and banking systems” (revised in June 2011) and “Basel III: International framework for liquidity risk measurement, standards and monitoring” (revised in January 2013 as “Basel III: The Liquidity Coverage Ratio and Liquidity risk monitoring tools”). These rules, together with “Globally systemically important banks: assessment methodology and additional loss absorbency requirement – rules text”, published in November 2011 and containing certain supplementary rules applicable to “global systemically important banks”, have collectively become known as “**Basel III**”<sup>14</sup>.

Basel III maintains the same general approach to capital regulation as its predecessor, Basel II, but imposes more onerous and thus more costly capital requirements. It introduces new liquidity standards, in the form of a liquidity coverage ratio (“**LCR**”) requiring banks to hold a stock of highly liquid assets sufficient to survive short-term liquidity stress and will impose a net stable funding ratio (“**NSFR**”) requiring banks to maintain sufficient sources of stable

14 Further guidance has been published in the form of questions and answers on aspects of Basel III.

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funding over a longer period. Another new requirement is the leverage ratio, which was not a feature of the Basel II regime.

### ***Implementation in the EU***

Basel III does not have the force of law. Although the target date for initial implementation was 1 January 2013, the measures remain in the process of being implemented around the world<sup>15</sup>.

In the EU, the first elements of Basel III came into force a year later than initially planned, on 1 January 2014, via a fourth Capital Requirements Directive<sup>16</sup> and a Capital Requirements Regulation<sup>17</sup>, (together, “**CRD IV**”). The new Capital Requirements Regulation (the “**CRR**”) is directly applicable in each EU member state. The revised Directive requires implementation on a country by country basis to bind local banks.

The finalisation of CRD IV and the related implementing measures taken by national regulators have provided banks with significant clarity as to the shape of Basel III in the EU. However, as envisaged by Basel III, the various components of CRD IV will only come into effect gradually, over a phased timetable extending to 1 January 2019.

Banks in the EU therefore may be “CRD IV” compliant, but may not yet be compliant with certain elements of CRD IV which are not yet in force, or which are still to be fully developed. There remain elements of uncertainty in relation to the detail of some components of CRD IV, for example, the LCR as discussed further below.

### ***Impact on the loan market***

Basel III represents a very significant regulatory change for the banking industry which may increase materially the regulatory costs of originating and participating in loan assets.

The immediate impact of Basel III on loan documentation is that it gives rise to the potential for increased costs claims. Whether banks should be entitled to pass the costs of implementing and complying with Basel III onto borrowers in this manner has been debated since the Basel III papers were first published.

The other important implication of the Basel III measures for loan documentation and transactions arises out of the application of the LCR to particular types of facility.

15 Progress reports are published regularly on the Basel III section of the Bank for International Settlements website: [www.bis.org](http://www.bis.org).

16 Directive 2013/36/EU.

17 Regulation 575/2013.

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## 2.3. Basel III, CRD IV and increased costs claims

*In summary:*

- *The LMA increased cost clause leaves the recoverability of Basel III/CRD IV costs for the parties to negotiate.*
- *At present lenders are generally seeking expressly to reserve their right to recover increased costs arising out of Basel III/CRD IV (although it is not uncommon for this position to be relaxed for stronger credits).*
- *Where it is agreed that Basel III/CRD IV costs are in principle recoverable as increased costs, borrowers may seek to redress the balance slightly by negotiating provisions such as time limits on claims. Provisions of this type are being agreed with increasing frequency in the Dutch, English, French and German markets.*

### **The increased costs clause**

The increased costs clause is a feature of virtually all loan agreements. It is included in all of the LMA's recommended forms of facility agreement, including the Investment Grade Agreements. In summary, it entitles the lenders to claim from the borrower any increased costs which are attributable to that lender's participation in the relevant facility and result from a change in law or regulation after the date the facility is entered into. The provision aims to protect lenders against unforeseen costs that arise after funds have been committed.

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### **Increased costs**

*"...the Company shall, within three Business Days of a demand by the Agent, pay for the account of a Finance Party the amount of any Increased Costs incurred by that Finance Party or any of its Affiliates as a result of (i) the introduction of or any change in (or in the interpretation, administration or application of) any law or regulation or (ii) compliance with any law or regulation made after the date of this Agreement."*

*"Increased Costs" means:*

- (i) a reduction in the rate of return from the Facility or on a Finance Party's (or its Affiliate's) overall capital;*
- (ii) an additional or increased cost; or*
- (iii) a reduction of any amount due and payable under any Finance Document,*

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*which is incurred or suffered by a Finance Party or any of its Affiliates to the extent that it is attributable to that Finance Party having entered into its Commitment or funding or performing its obligations under any Finance Document.”*

Extract: Clause 14.1 LMA English law Multicurrency Term and Revolving Facility Agreement

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The LMA increased costs clause does not express a view on whether Basel III costs should be included or excluded from the borrower’s indemnity obligation. It refers to Basel III only in a footnote, reminding the parties that they may wish to address it specifically.

***How are increased costs claims arising out of Basel III being addressed contractually?***

Most lenders have sought to reserve their rights to make claims in respect of Basel III costs from the borrower since the prospect of Basel III was first announced.

Initially this did not require any changes to an LMA-style clause, the assumption being that Basel III costs were potentially recoverable, to the extent falling within the concept of “Increased Costs” as defined in that clause. Some lenders, however, preferred to amend the clause to provide expressly that costs relating to Basel III should fall within the scope of the increased costs clause<sup>18</sup>.

This approach has changed more recently. An LMA style increased costs clause, as already mentioned, captures only costs arising out of a change in law that occurs after the date of the agreement. Now CRD IV is in force, where it is agreed that lenders should be entitled to claim Basel III costs, lenders may consider it prudent to amend the increased costs clause to clarify that Basel III related costs fall within the scope of the clause whether or not such costs arise out of a change in law.

Although not yet the norm in all countries, a Basel III “carve-in” along these lines has become quite common in the Dutch, English, French, Italian and German markets.

***Is this a reasonable position for lenders to take?***

Borrowers may argue that a Basel III “carve-in” is inappropriate. The purpose of the increased costs clause is to provide lenders with a means of recouping costs that are not foreseen when the loan is entered into. Certain detailed aspects of Basel III remain work in progress, but most banks in the EU should by now be able to quantify their increased costs, especially when it comes to minimum capital requirements. Borrowers should be entitled to assume that Basel III costs have been factored into the pricing of the facility (as was the case when Basel II was implemented).

18 This point arose most often where the clause incorporated an exclusion for Basel II costs; as elements of Basel III might be viewed as an amendment to Basel II.

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The potential flaw in that argument is that in the investment grade market, and possibly even in some parts of the sub-investment grade market, loans are not priced on a cost-plus basis. This is not a new phenomenon, but market conditions over the past 18 months have emphasised the mismatch between the pricing of certain types of loan facility and their cost to the banks, further than perhaps ever before. Banks' operational costs are rising, and the supply/demand imbalance is such that they are not able to price their loan assets to support those costs; in fact pricing, in general, is falling.

Lenders may feel that reserving their rights to make increased costs claims is the only way they can protect themselves against the paradox of the current market.

Some borrowers may accept this, valuing the margins currently on offer above a more favourable contractual arrangement on increased costs. They may also feel that their lending relationships are such that the risk of claims being made in practice is unlikely, and do not pursue the point on that basis.

Others, however, feel strongly that this is not consistent with the concept of relationship lending and choose to pursue an exclusion of Basel III costs from the scope of the clause entirely. Stronger borrowers with a close bank group or who borrow bilaterally are sometimes able to achieve an exclusion. In the sub-investment grade sector of the market, where facilities may need to be more broadly syndicated, banks may be less willing to agree concessions that operate in favour of the borrower.

### ***Redressing the balance***

In the face of general resistance from lenders to the concept of excluding Basel III costs, the focus for borrowers shifts to ways to mitigate the likelihood of claims, for example:

- **Time limits:** Lenders may claim under the increased costs indemnity only costs within the scope of the indemnity which arise or are incurred within a specified period (perhaps three or six months) before the claim is made. This is a particularly important provision; if lenders are able to claim such costs at any time during the life of the facility regardless of when incurred, the usefulness of the borrower's right to remove and/or replace such lenders may be severely curtailed.
- **"Non-discriminatory" claims only:** Lenders should be entitled to claim Basel III costs under the increased costs clause only to the extent they do so on a "non-discriminatory" basis. Claims should be permitted only to the extent that the lender in question is also seeking to claim such costs from other similar borrowers where entitled to do so.
- **Compliance not implementation costs:** The costs that can be claimed from the borrower should be limited to the relevant lender's costs of complying with Basel III in relation to the facility in question (thus excluding implementation costs, the borrower's argument being that banks should be in a position to price and take into account those costs at this stage).



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- **Lender to provide details of calculation:** Any lender making a claim must specify the basis of the claim in reasonable detail. This is not an adjustment designed specifically to address Basel III, but borrowers may take particular comfort from it in this context given the components of Basel III. It remains to be seen, for example, whether lenders would, in practice, be able to calculate in a sufficiently transparent manner the increased capital costs attributable to a particular facility (perhaps the main reason, along with reputational concerns, why increased costs claims generally are extremely rare).

In all markets except Spain (where the increased costs clause is still rarely negotiated), each of these concessions has gained some traction, although some lenders are resistant to the “non-discriminatory claims only” language referred to above. The methods highlighted are also not the only means of limiting the potential for claims; other possibilities include, for example, limiting recoverable costs to those arising out of Basel III which were not reasonably foreseeable on the date of the agreement.

In summary, what is achievable is variable. The negotiated position often depends on relationships and bargaining strength rather than the policies of individual lenders.

This is a controversy that should settle as the new regime is properly finalised. Our current expectation is that discussions about Basel III in the context of the increased costs clause will continue for some time yet, at least until either there is a significant pricing adjustment in the loan market or, perhaps more likely, CRD IV has been fully fleshed out at EU and national level.

## 2.4. The LCR and the loan market

*In summary:*

- *The LCR has the potential to make loan facilities more expensive for banks to provide, in particular, liquidity facilities and facilities extended to customers classed as financial customers.*
- *The CRR makes provision for the implementation of the Basel III LCR in the EU. The LCR requirements are expected to take effect on a phased basis during 2015.*
- *The extent of the impact of the LCR on EU-regulated banks remains uncertain, for example:*
  - *the relevant provisions of the CRR have not been amended to reflect the relaxation in assumed drawdown rates implemented by the Basel Committee in January 2013;*
  - *it is not entirely clear which types of facility will attract the more onerous requirements of the LCR.*
- *The LMA circulated a note to its members in 2011 outlining a number of contractual options that lenders might wish to explore to facilitate compliance with the LCR. The challenges some of these suggestions present in practice has meant that to our knowledge, changes to loan documentation to address the LCR specifically have been very limited to date.*

### **The Basel III LCR**

The LCR component of Basel III envisages that banks will be required to hold high quality liquid assets in a quantity sufficient to meet their anticipated net cash outflows over a 30 day stressed period. Net cash outflows for this purpose include the assumed drawdown (at the applicable drawdown rates) of any lending commitments which are available for drawing during the relevant 30 day period.

The table below summarises the drawdown rates which it is assumed will be applied when the LCR is implemented. It illustrates the significantly different impact the LCR will have on the costs of different types of facility:

Facility	Rate
Committed credit facilities to retail and small business customers	5%
Committed credit facilities to non-financial corporates, sovereigns and central banks, public sector entities and multilateral development banks	10%

Facility	Rate
Committed liquidity facilities to non-financial corporates, sovereigns and central banks, public sector entities and multilateral development banks	30%
Committed credit and liquidity facilities to banks subject to prudential supervision	40%
Committed credit facilities to other financial institutions	40%
Committed liquidity facilities to other financial institutions	100%

It should be noted that the reporting obligations contemplated in the CRR currently reflect the assumed drawdown rates specified in the Basel Committee’s initial proposals, which were relaxed in January 2013. The rates in the table above reflect the latest position under Basel III rather than the CRR on the assumption that the rates applicable for the purposes of the CRR will be amended to align with the Basel III proposals in due course.

Whether or not that happens, the key point for banks and borrowers is that the drawdown rate applicable to facilities which are considered more likely to be drawn in a stressed market – namely, liquidity facilities such as swinglines and facilities extended to financial institution customers – is much higher than that applied to other types of facilities. Accordingly, it is important that banks and borrowers are able to identify which types of facility will fall into these categories.

The criteria to be applied, however, remain somewhat unclear.

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## Liquidity facilities

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A liquidity facility is defined in the Basel III papers as:

*“...any committed, undrawn back-up facility that would be utilised to refinance the debt obligations of a customer in situations where such a customer is unable to rollover that debt in financial markets (e.g. pursuant to a commercial paper programme, secured financing transactions, obligations to redeem units, etc). For the purpose of this standard, the amount of the commitment to be treated as a liquidity facility is the amount of the currently outstanding debt issued by the customer (or proportionate share, if a syndicated facility) maturing within a 30 day period that is backstopped by the facility. The portion of a liquidity facility that is backing debt that does not mature within the 30-day window is excluded from the scope of the definition of a facility. Any additional capacity of the facility (i.e. the remaining commitment) would be treated as a committed credit facility with its associated drawdown rate as specified in paragraph 131. General working capital facilities for corporate entities (e.g. revolving credit facilities in place for general corporate or working capital purposes) will not be classified as liquidity facilities, but as credit facilities.”*

(Paragraph 128 of “Basel III: the Liquidity Coverage Ratio and Liquidity Risk monitoring tools”, Bank for International Settlements, January 2013)

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Unlike Basel III, the CRR does not contain a definition of “liquidity facility” as such. Instead, it excludes from the category of facilities that qualify for the 10% assumed drawdown rate, facilities which are provided “for the purpose of replacing funding of the client in situations where he is unable to obtain its funding requirements in the financial markets”<sup>19</sup>. The CRR does not reference the final sentence of the Basel Committee definition, quoted above, which clarifies the classification of working capital and general corporate purpose facilities. Although this would not seem to be the intention, without further clarification it is possible that liquidity facilities could be interpreted by some as extending beyond commercial paper backstop facilities to encompass certain types of working capital facility.

The potential impact of the LCR on the pricing of backstop facilities is the element that corporates are likely to be most concerned about. If the LCR gives rise to a significant price differential between backstop and other types of corporate credit facilities, sources of finance which need to be backstopped, for example, commercial paper programmes, may become less attractive.

<sup>19</sup> Article 424(3) CRR.

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### ***“Financial institutions” and “financial customers”***

The Basel III papers do not define the terms “financial institution” or “financial corporate”, save to provide that the term “financial institution” includes banks, securities firms and insurance companies.

The CRR uses different terminology and makes a distinction between “financial customers” and other customers.

The definition of a “financial customer” in the CRR is quite broad<sup>20</sup>. It includes entities such as credit institutions, investment firms and insurance undertakings, plus “mixed-activity holding companies” i.e. parent undertakings not carrying on business in the financial services sector whose subsidiaries include at least one credit institution or investment firm. It also includes any entity that performs one or more of the activities listed in Annex I to the revised Directive as their main business. Annex 1 contains a list of financial activities which are subject to mutual recognition where carried out by authorised entities within the EU. These activities include, for example, deposit-taking, finance leasing, lending, customer and proprietary trading activities and the provision of payment services.

In other words, they include activities that a treasury company might perform for members of its corporate group, potentially giving rise to further uncertainty for corporates.

### ***Impact on documentation***

In 2011, the LMA published a note to members, not making recommendations, but outlining some of the contractual means that lenders might explore with a view to facilitating their reporting obligations and minimising the application of the more onerous elements of the LCR.

All of these options, if workable, could assist banks in managing their LCR. To our knowledge, few have yet been adopted in practice. The fact that limited changes are being made to facility agreements specifically to address the LCR, may be simply because it remains premature to do so. However, the lack of uptake may be an acknowledgement of the practical shortcomings of these proposals (many of which are noted in the LMA paper).

20 See Article 411.

Proposal:	In practice:
<ul style="list-style-type: none"> <li>• <b>Tighter restrictions on the use of loan proceeds:</b> Where a single agreement documents more than one type of facility, specifying in the purpose clause which facility or part of a facility is available for backstop purposes. Conversely, where a facility is not intended to be used for backstop purposes, including an express restriction to that effect.</li> </ul>	<ul style="list-style-type: none"> <li>• Many facilities incorporating swinglines based on LMA terms already distinguish between the purpose of the revolving facility and the swingline amount and so require no alteration in this regard. In a few instances, restrictions have been placed on rights to refinance swingline loans with revolving facility drawings in an effort to mitigate the risk of the entirety of the revolving facility being classified as a liquidity facility.</li> <li>• We have seen some purpose clauses amended to clarify that a facility intended for general corporate purposes shall not be used for backstop purposes.</li> </ul>
<ul style="list-style-type: none"> <li>• <b>Reporting of backstop requirements:</b> Borrowers could be required to monitor and report to lenders their backstop requirements from time to time. The aim would be to minimise the LCR costs associated with the relevant facility by enabling lenders to re-classify it (or perhaps even part of it) as a “credit” facility (which attracts the lower assumed drawdown rate under the LCR) during a testing period in which it is not required for backstop purposes.</li> </ul>	<ul style="list-style-type: none"> <li>• Requiring borrowers to keep lenders informed on an ongoing basis with regard to planned or maturing commercial paper issues or drawings under other relevant financing arrangements within the next 30 days is an onerous proposition. In relation to commercial paper backstop facilities, the nature and frequency of the relevant borrower’s/issuer’s discussions with rating agencies regarding backstop requirements would most likely need to be taken into account.</li> <li>• We have not seen any provisions along these lines in practice.</li> </ul>

Proposal:	In practice:
<ul style="list-style-type: none"> <li>• <b>Partial prepayment/cancellation in the event of an increased costs claim:</b> Under current LMA terms, an increased costs claim entitles the borrower to cancel, prepay or replace the whole participation of the relevant lender. Should an increased costs claim arising out of the LCR affect only part of a loan facility (e.g. swingline commitments comprised in a broader revolving credit facility available for general corporate purposes), the borrower could be given the right to cancel, prepay or replace the claimant lender's participation in that part of the facility which is the subject of the claim.</li> </ul>	<ul style="list-style-type: none"> <li>• We have not seen any such provisions in practice, possibly because they are considered unnecessary.</li> <li>• Any increased costs relating to the LCR which are the subject of an indemnity claim might be thought likely to be suffered by most, if not all, of the syndicate in any event.</li> </ul>
<ul style="list-style-type: none"> <li>• <b>Restrictions on the accession of financial customers/change of business:</b> Restrictions could be placed on the accession of "financial customers" as borrowers. Borrowers could also be required to undertake that no member of the group will do anything to cause an existing borrower to be classified as a financial customer for the purposes of the LCR<sup>21</sup>.</li> </ul>	<ul style="list-style-type: none"> <li>• Many facility agreements contain an undertaking to the effect that the borrower group shall not implement any substantial change in its business. This might be considered adequate to address the possibility of a borrower changing its status from non-financial to financial customer during the life of the facility. Borrowers might be expected to resist any further suggestion that they should, in effect, be responsible for assessing the treatment of the lenders' exposure to them for regulatory purposes. The possibility of excluding treasury companies as borrowers has, however, been raised in a few transactions.</li> </ul>

### ***How are these issues likely to be resolved?***

It seems unlikely that banks will be able to pursue further the contractual mechanisms highlighted above until the LCR requirements become clearer and internal compliance systems are in place.

21 Alternatively, the borrower could undertake to compensate the lender for its additional LCR costs should it become a "financial institution" (although that suggestion is perhaps even less attractive to borrowers).

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The LMA and others have been lobbying the authorities to provide greater clarity on the more uncertain aspects of the LCR in the near future, as the LCR is due to come into force in the EU, following an initial observation period, during January 2015, building up to full implementation on 1 January 2018<sup>22</sup>.

Without further guidance on the topics discussed in this section, there may be wide disparities from bank to bank in how the requirements of the LCR are interpreted. At the time of writing, what further guidance is likely to be forthcoming and if so, when, remains unclear.

## 2.5. Sanctions and anti-corruption laws

In summary:

- Financial sanctions typically involve the freezing of funds and economic resources owned, held or controlled by sanctioned persons and prohibitions on the making of funds and economic resources available to or for the benefit of a sanctioned person.
- Financial sanctions are unpredictable. Their scope can change on short notice, being dependent on political views. Applicable derogations and exemptions vary and are difficult to anticipate.
- Governments around the world have implemented an array of anti-corruption laws in recent years, for example, the Bribery Act 2010 in the UK. Like sanctions, such provisions are international in nature and different countries may take differing approaches.
- The importance of compliance in these areas from a legal, credit and reputational perspective has led many lenders to seek from borrowers wide-ranging representations and undertakings in facility documentation which address sanctions and anti-corruption laws specifically.
- Borrowers often have concerns about their ability to monitor and comply with provisions proposed by lenders. The question of whether an event of default is the appropriate consequence of the breach of representations and undertakings on this topic also remains open.
- Sanctions and anti-corruption provisions are the subject of negotiation in most current transactions.

<sup>22</sup> Article 460(2) CRR.



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### ***The lenders' perspective***

Historically, requests from lenders for specific representations and/or undertakings from borrowers in relation to anti-corruption and sanctions legislation were generally made only in relation to groups whose business profile presented particular risks. Over the past 2-3 years, such requests have become more common in all types of debt financing transactions.

The impetus is the increasing range of anti-corruption and sanctions legislation put in place by authorities across the world, the significant extra-territorial reach of certain aspects of the regime of some countries and the various examples in recent years of severe penalties being imposed on non-compliant financial institutions by US and other regulators for breach of these provisions.

Sanctions and anti-corruption laws have a direct impact on loan transactions. For example, EU sanctions typically prohibit EU nationals, EU companies and non-EU companies who do business in the EU from (i) dealing with funds or economic resources belonging to, owned, held or controlled by a sanctioned person and (ii) directly or indirectly making funds or economic resources available to, or for the benefit of, a sanctioned person, in each case with knowledge of or reasonable cause to suspect that result.

It is not uncommon for national sanctions to operate in this manner. Where sanctions are framed in a similar or more pervasive way (the most expansive of which tending to be US sanctions), borrowers within the EU who borrow from banks subject to those overseas sanctions regimes can find themselves similarly affected. Most internationally active banks are subject to, or regard themselves as being at risk of being pursued in relation to, US sanctions.

Most financial institutions have reviewed and put in place much more robust internal policies to ensure compliance with anti-corruption and sanctions laws. The internal policies of many banks (in particular, in our experience, US banks and government-owned banks) require specific contractual provisions relating to sanctions and/or anti-corruption laws to be included in every loan they enter into. If such provisions are not included, or a derogation from their terms is requested, there is usually an internal clearance process that must be followed.

### ***Are existing “compliance with laws” representations and undertakings not sufficient?***

Corporate borrowers may be resistant to additional and often onerous provisions in their facility documentation (or indeed their bond documentation) to address sanctions and anti-corruption laws. Borrowers may argue that lenders already have the means to monitor the group's compliance with sanctions and anti-corruption laws.

Under the terms of most loan agreements (including the LMA's recommended forms), each obligor represents, often on a repeating basis, that the entry into and performance of its obligations under the loan agreement does not conflict with any applicable law and

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undertakes that it will comply with all applicable laws on an ongoing basis. These provisions quite often extend beyond the obligors, requiring the parent to represent and undertake to procure compliance with applicable laws by all members of the group. Should an obligor become aware of a potential breach of these representations and undertakings, it is usually obliged to notify the lenders.

To the extent lenders need to satisfy themselves further (the borrower may say), they should submit questions to the borrower as part of their pre-contract due diligence enquiries and the KYC process. Additional contractual protection which could trigger an event of default for the borrower is unnecessary.

This argument is sometimes accepted (see “Market Practice” below), but in many cases, lenders do not consider these general representations and undertakings to be adequate in the context of sanctions and anti-corruption laws:

- The customary “compliance with laws” undertaking usually requires compliance to the extent failure to comply with laws would materially impair the relevant obligor’s ability to perform its obligations under the agreement or would have a “Material Adverse Effect”. This is to avoid triggering an event of default as a result of a technical or immaterial breach. Sanctions and anti-corruption laws do not typically provide any threshold for breach. Any breach of sanctions and/or anti-corruption legislation is potentially sufficiently serious (lenders may argue) to warrant there being consequences under the facility.
- More generally, lenders often feel that placing specific obligations on the borrower group serves to emphasise the importance of this topic. This gives lenders comfort that it is the subject of proper focus and may assist in defending the lenders’ position in the event of a breach. Thus it is appropriate and necessary to address these issues separately and specifically.

For these reasons, the focus of more recent discussions on anti-corruption and sanctions has, in many cases, been on the extent to which the borrower is able to accommodate lenders’ requests (which can differ from bank to bank), rather than whether the provisions should be included at all.

### ***What is the scope of any additional protection typically sought by lenders?***

Sanctions and anti-corruption provisions typically proposed by lenders tend to address most or all of the following areas:

- **Policies and procedures:** the group has policies and procedures designed to promote and maintain compliance with applicable sanctions and anti-corruption laws.

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- **Compliance:** the group is in compliance with applicable sanctions and anti-corruption laws (without any qualification by reference to materiality) and will continue to be compliant during the life of the facilities.
  - **Use of proceeds:** the proceeds of the facilities will not be used in breach of any relevant laws. For example, lenders may request an undertaking that the funds they advance will not be used to fund any transaction in breach of applicable sanctions or in any other manner that might result in a violation of any sanctions provisions by any obligor, any finance party (lender) or any other person.
  - **Repayment:** any funds used to repay or pay other amounts due under the facility do not originate from a sanctioned person or entity and (in some cases) are not otherwise derived from transactions that violate sanctions.
  - **Management/control:** no director, officer, employee, agent or representative of the group is an individual or entity that is subject to sanctions and no member of the group is owned or controlled by an individual or entity subject to sanctions.
  - **Location of business/income:** no obligor/member of the group is located, organised or resident in a country or territory that is subject to country-wide sanctions (a more common feature of the US sanctions regime). Sometimes this takes the form of a limit on the proportion of the group's business that can be located in a sanctioned country or earned from investments in sanctioned countries or transactions with sanctioned persons.

### ***The borrower's perspective***

Borrowers may not object to providing lenders with some form of assurance on most of the topics listed above. However, the manner in which such provisions are presented, their consequences and the detail of their scope is likely to be negotiated.

A key point is that provisions relating to sanctions and anti-corruption laws proposed by lenders are not typically limited by jurisdiction. In the same way as the general illegality provisions and the "compliance with laws" representation and undertaking, such provisions will usually encompass all such laws, wherever they originate.

A borrower may be comfortable to confirm, for example, that it does not carry on a particular type of business in or with a particular jurisdiction. The borrower may be nervous to undertake to a lender, that it does not carry on any business of a kind which is restricted or prohibited by an unfamiliar overseas legal regime as it does not have knowledge of all of the relevant laws.

Sanctions and anti-corruption provisions may stem primarily from concerns arising out of overseas regimes to which lenders are subject (whether they cover sanctions, anti-corruption

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laws or both) but with which the borrower's business otherwise has no connection. The need to investigate the extent of such provisions also potentially necessitates the involvement of additional legal counsel to explain what the borrower is representing or undertaking to comply with. There have been instances of the borrower being asked to ensure that the lenders comply with all laws applicable to them in the course of making the loan. Is it reasonable to expect the borrower to know which laws are applicable to all of the lenders in an international (and changing) syndicate?

Borrowers may also feel unable to give the representations and undertakings requested by lenders relating to the use of proceeds/repayment of the loan and management/control, if they are drafted so broadly as to be impossible to police.

For example, borrowers may be able to undertake to maintain adequate policies and procedures to facilitate compliance with sanctions and anti-corruption laws. However, an undertaking that no director, officer, employee, agent or representative of the group is an individual or entity that is subject to sanctions and that no member of the group is owned or controlled by an individual or entity subject to sanctions may be more challenging. A publicly listed borrower would not be able to monitor day to day changes in its share register and verify whether shares have been purchased by a person on a UN, US, EU or government sanctions list. If, as in many jurisdictions, its shares are bearer shares, the borrower may not be able to monitor its shareholder base or control the identity of its shareholders at all.

Borrowers may also struggle with the possibility that the legal obligations of an individual lender (rather than the borrower) might trigger an event of default under the loan, and potentially cross-default other obligations.

This is a particular concern in relation to sanctions provisions, as these are perhaps more likely than anti-corruption laws to impact the borrower as a result of its association with the lenders rather than due to its own operations. In the European loan market each lender is also invariably entitled to require the borrower to prepay and cancel its commitment should it become illegal for it (or its affiliates) to participate in the facility. Borrowers may argue that lenders should exit the transaction in reliance on these illegality provisions where their participation becomes illegal because of a breach of sanctions, rather than by accelerating the loan based on an event of default.

### ***Limitations on representations and undertakings***

In practice, the ever-changing and overlapping scope of international sanctions legislation means that banks' sanctions policies are not designed specifically to overlay any particular regime, but rather to address the most likely indicators of breach in a general fashion. Accordingly, save in the context of legal impediments (see further below), limiting contractual provisions by reference to applicable laws may not be considered an appropriate and acceptable compromise by lenders.

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A more workable means of limiting sanctions and anti-corruption provisions can be to qualify the relevant provisions by reference to the borrower's awareness or intentions. For example, the penalties for breach of EU sanctions typically, although not always<sup>23</sup>, apply only where the provisions are knowingly or intentionally breached or where the person concerned had reasonable cause to know of the breach.

Whatever is agreed, the borrower group will need to ensure that it has internal procedures in place to ensure that directors and management communicate any potential issues of which they become aware to the team which manages the group's debt facilities.

In any event, where there is a significant gap between the protection lenders are looking for and what the borrower feels able to offer, it can assist negotiations if lenders are prepared to provide the borrower with background information regarding the drivers of its sanctions policy, including examples, to enable the borrower to understand what the lenders are seeking to achieve.

### ***Consequences of breach***

Lenders may consider that the illegality provisions alone will not protect them sufficiently should sanctions affect the transaction, as the illegality machinery is dependent on the lender becoming aware of the existence of the illegality. In addition, some lenders' sanctions policies are framed to address reputational, in addition to pure legal risk. This means that lenders may desire the means to exit the transaction as a result of the borrower's dealings with a sanctions target in circumstances where the illegality provisions do not apply.

The existence of illegality provisions, therefore, may not of itself persuade lenders to do away with representation and undertakings. However, lenders sometimes have sympathy with the borrower's desire to avoid an event of default should those representations and undertakings be breached.

In some transactions lenders have agreed that rather than being incorporated into the facility documentation, assurances regarding sanctions provisions can be set out in a bilateral side letter between the lender and the borrower. The borrower will be liable to the lender for breach of the terms of the side letter, but the arrangement is set up such that breach will not trigger a drawstop or event of default. To achieve this, particular care must be taken to ensure that the letter is not a "Finance Document" for the purposes of the facility, and that the events of default in the facility agreement do not otherwise capture the terms of the side letter (for example, the misrepresentation event of default).

23 For example, the French statutory instruments which specify the penalties for breach of EU sanctions apply regardless of whether the person in breach had reasonable cause to suspect the breach. However, in practice, there is considered a strong likelihood that the relevant person's intent or knowledge of the breach would be taken into account by the French authorities in deciding whether to impose penalties for non-compliance.

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Side letters may also be used in situations where only one or two lenders in the syndicate are concerned about sanctions. The side letter enables comfort to be given to those affected lenders, without drawing the issue into the general documentation discussions. Whether it is appropriate to provide some but not all lenders with equivalent assurances requires consideration on a case by case basis. It may not be an attractive route in the context of a club deal with relationship banks.

There is also the possibility that specific provision could be made in the facility agreement that breach of any sanctions representations or undertakings should not be an event of default, but instead (for example) trigger a specific mandatory prepayment event.

### ***An additional technical difficulty – legal impediments***

Many requests for provisions relating to compliance with sanctions legislation originate from lenders which are subject to the jurisdiction of US sanctions legislation. Sanctions imposed by the US Treasury Department's Office of Foreign Assets Control ("**OFAC**") often have broad extra-territorial effect and breach can result in fines which run to millions of dollars. Enforcement is widespread and often difficult to challenge, so the policies of lenders whose operations are subject to the OFAC regime (which includes most banks which are internationally active) may be particularly cautious.

Applicable EU law, however, may in certain cases prevent EU companies from providing those lenders with unqualified comfort that they are in compliance with US requirements.

EC Council Regulation 2271/96, as amended (the "**Blocking Statute**"), applies to EU residents and EU-incorporated legal entities (such as companies and partnerships), in each case when they engage in international trade and/or the movement of capital and related commercial activities between the Community and other countries ("**EU persons**").

The Blocking Statute prohibits compliance by EU persons with any requirement of any US legislation identified in an Annex to the Blocking Statute as potentially prejudicial to EU interests. The Annex is amended from time to time and currently includes certain US sanctions against Cuba, Iran and Libya.

The Blocking Statute is directly applicable in all EU member states, but each member state is required to make provision in national law for the penalties for breach, so there may be some disparity in terms of the consequences of breach, depending on the nationality of the relevant EU person.

Although instances of the Blocking Statute and related national legislation being enforced are extremely limited, there can be nervousness among EU corporates about giving contractual assurances which contemplate action that potentially conflicts with the terms of the Blocking Statute. Many argue that any representations or undertakings given by EU-incorporated borrowers regarding compliance with the OFAC sanctions regime should be limited to the extent the borrower is legally able to comply with such provisions

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The lenders' perspective on which of the two conflicting legal regimes to comply with can vary.

Generally speaking, most internationally active banks feel it necessary to favour compliance with the OFAC regime. Some European lenders may not agree. For example, German banks regularly limit their contractual protection to sanctions imposed by the EU or Germany, to avoid the risk of enforcing sanctions in breach of the Blocking Statute which, under German law, would constitute an offence.

If lenders within a syndicate take differing views on this issue, one solution we have seen is the inclusion of broader contractual provisions relating to OFAC compliance in the facility agreement to satisfy those lenders which require that protection, together with provision for additional terms to carve out from the benefit of those provisions, those lenders which wish to avoid falling foul of the Blocking Statute. However, such carve-outs are difficult. Having lenders with differing rights under the same agreement is for various reasons, less than ideal.

### **Market practice**

*When considering how to address sanctions and anti-corruption laws in loan transactions, the range of options includes:*

- **Due diligence:** *Treating compliance as a due diligence issue which does not need to touch the contractual documentation.*
- **Limit general scope of contractual provisions:** *Limiting the sanctions and anti-corruption representations and undertakings to those areas which are not addressed by the general representations and undertakings, usually, the maintenance of adequate policies and procedures and the use of the proceeds of the facility.*
- **Address transaction specific limitations:** *A full suite of sanctions and anti-corruption representations and undertakings, narrowed where possible to address the borrower's specific concerns (possibly by reference to awareness) and any legal impediments.*
- **Side letter:** *Addressing lenders' requirements in a side letter outside the facility documentation (which may also be suitable where only one or two lenders in the group are concerned about the issue).*
- **Providing for consequences of breach:** *Where specific representations and undertakings are included, providing for prepayment and/or cancellation rather than an event of default if breached.*

The varying approaches of lenders to sanctions and anti-corruption provisions means that although borrowers should anticipate that lenders will raise this issue in most new transactions, any lender proposal should be explored in negotiations if there are aspects with which the borrower is not comfortable.

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Whether lenders are happy to proceed without specific contractual protection may depend on practice in the domestic market. For example, lenders' due diligence (through the KYC process) is the normal means for addressing these issues in all types of loan transaction in Spain.

More generally, strong credits may be able to resist specific contractual provisions in all jurisdictions. There remain a number of examples of investment grade loan documentation which does not include any provisions along these lines, notwithstanding the policies of the participating banks. The banks' requirements are instead met as part of the due diligence process, or sometimes, by the provision of a side letter along the lines described above.

Some banks take a less rigid approach than others, so what is agreed with individual borrowers tends to depend on the composition of the lending syndicate as well as the borrower's bargaining position more generally. It can therefore be helpful to borrowers if the views of the lead banks are explored as early as possible, ideally at the appointment stage.

What the borrower has agreed to (if anything) in its other financing documentation may also be a relevant consideration. Debt capital markets and private placement issuers are increasingly being asked to give representations (in varying forms) in relation to compliance with OFAC and other sanctions regimes and legislation. Borrowers will want to ensure that their compliance obligations are consistent across all of their sources of debt as far as possible.

### ***LMA provisions***

This lack of market consensus is reflected in the LMA recommended forms.

In September 2012, the LMA added a representation and undertaking regarding anti-corruption laws to its recommended form of facility agreement for senior/mezzanine leveraged finance transactions (the "**Leveraged Agreement**"). The LMA provisions address the group's compliance with the UK Bribery Act 2010, the US Foreign Corrupt Practices Act of 1977 and other "applicable" anti-corruption laws as well as the group's institution and maintenance of appropriate compliance policies and procedures. The undertaking also requires the group not to use the proceeds of the facilities for any purpose which would breach such legislation.

This provision is now replicated in the LMA's super senior revolving facility agreement and its recommended forms of facility agreement for pre-export finance transactions and developing markets transactions (discussed further in section 4). The Investment Grade



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Agreements, however, do not touch on this topic and none of the LMA's recommended forms currently address sanctions or anti-terrorism legislation specifically.<sup>24</sup>

Lenders and borrowers should be aware that the LSTA<sup>25</sup> recently published a note on this topic, "LSTA Guidance Regarding US Sanctions Issues<sup>26</sup>", which includes recommendations as to the sanctions provisions US lenders may wish to see in loan documentation. It is anticipated that at least pending any recommendations from the LMA, US lenders in particular may refer to this LSTA guidance in discussions with borrowers going forward.

## 2.6. FATCA

*In summary:*

- *The US FATCA legislation requires foreign financial institutions to provide detailed information to the IRS regarding US account holders or suffer a 30% withholding tax on, among other things, their US source income.*
- *FATCA withholding started to apply to payments of US source income on 1 July 2014.*
- *The conclusion of intergovernmental agreements between the US and a number of countries, including France, Germany, Italy, the Netherlands, Spain and the UK, has the effect of largely eliminating the risk of FATCA withholding for financial institutions within the scope of those agreements.*
- *As a result, lenders in jurisdictions covered by an IGA have become more comfortable with FATCA and practice for addressing the withholding and compliance risk in loan documentation has become more settled.*
- *The LMA's FATCA "Rider 3", which entitles all parties to withhold as required but imposes no gross-up or indemnity obligation on the borrower, has become the standard way of dealing with FATCA risk in loan documentation, regardless of whether the borrower group includes a US entity or has US source income.*
- *The contractual treatment of FATCA risk still requires discussion in transactions involving lenders in non-IGA jurisdictions (for example, certain Middle Eastern and Asian countries), where there remains some variation in the agreed position.*

24 Although the LMA has not published any guidance or recommendations with regard to the specific contractual provisions lenders might look for in relation to sanctions compliance, it has responded to members' questions regarding the impact under LMA facility documentation of the EU and US sanctions relating to Russia and Ukraine. On 30 June 2014 it circulated a note to members analysing the options for lenders and agents should the borrower become subject to an asset freeze under either the EU or the US regulations.

25 The Loan Syndications and Trading Association, in effect, the US equivalent of the LMA.

26 The Guidance is available from the LSTA website: [www.lsta.org](http://www.lsta.org).

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## **FATCA and the loan market**

The US made significant amendments to its tax laws in March 2010 by introducing the Foreign Account Tax Compliance Act (“**FATCA**”) as a means of addressing US tax evasion by US account holders. FATCA requires foreign financial institutions (“**FFIs**”) to provide detailed information to the US Internal Revenue Service (“**IRS**”) regarding their US account holders or face a punitive 30% withholding tax on, inter alia, their US source income.

This withholding tax started to apply to payments of US source income (the aspect of FATCA of most immediate relevance to the loan market) on 1 July 2014.

Whether the withholding obligation will apply to a payment depends on the status of the person making the payment, the status of the recipient and the source of the payment. The withholding tax regime can therefore affect FFIs as either recipients or payers of payments (and whether as principal or intermediary). To determine the extent to which FATCA might affect a syndicated loan transaction, the two key issues are (i) the FFI status of the parties and (ii) whether any payments under the Finance Documents will constitute US source income.

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### **What is an FFI?**

*“FFI” is a broad concept designed to catch any foreign entity, which is, as defined, a financial institution. There are three general types of activity that cause an entity to be regarded as an FFI: accepting deposits in the ordinary course of banking or similar business, holding financial assets for the account of others and engaging primarily in the business of investing, reinvesting or trading in securities. Insurance companies providing policies which constitute “financial assets” (such as life assurance) will also be regarded as financial institutions, as will holding companies of groups which include such an insurer. Treasury centres and certain holding companies are within the definition of FFI, but broadly only if there is an FFI (other than a treasury centre or holding company) somewhere in the group. In the context of loans, in addition to the Finance Parties being FFIs, it is possible that FFIs will exist in the borrower group.*

A payment of interest under a loan agreement will in general be US source income for an FFI if it is made by a US borrower or by an agent or guarantor on behalf of a US borrower. Where an obligor has a US trade or business, interest paid by that trade or business may also have a US source.

FATCA is an unusual and exceptionally complex piece of legislation and both lenders and borrowers were very concerned about how the withholding risk should be allocated and how compliance with the reporting requirements might be achieved when the rules were first published. The LMA’s tax gross-up and indemnity provisions were thought to provide lenders with partial protection but were not designed to address the nuances of FATCA. In any event, the potential for claims under gross-up and indemnity obligations was unlikely

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to be an acceptable outcome for the borrower, given that the risk of FATCA withholding is essentially one that can be mitigated by the recipient of any affected payments, in other words, the Finance Parties.

The US regulations include grandfathering protection for certain historic transactions. Having been amended several times, the current regulations provide that any obligations that were outstanding on 1 July 2014 (which includes loans advanced or committed to before that date) will fall outside the FATCA withholding and compliance rules for their duration.

Grandfathering is not a complete solution, even for obligations entered into before grandfathering expired. It may not cover ancillary facilities, for example, which form part of pre-existing facilities but are not committed until drawn. Further, if an existing “obligation” is materially modified on or after the grandfathering date, it may be treated as a new obligation and subsequently lose grandfathering protection. This latter point significantly reduces the value of grandfathering protection to assets such as loans which are commonly amended.

The good news is that more recently, in light of the agreements that various countries have reached with the US which have the effect of largely eliminating the withholding risk, lenders in those jurisdictions have become more comfortable with FATCA, and practice for addressing it in loan documentation has settled.

### ***Inter-governmental agreements***

Bilateral inter-governmental agreements (“**IGAs**”) between the US and other jurisdictions have eased FATCA concerns considerably for FFIs by making compliance far easier and all but eliminating the threat of withholding for FFIs in relevant jurisdictions.

The US signed the first IGA with the UK in September 2012. The effect of the UK/US IGA is that financial institutions in the UK (which includes UK branches of overseas institutions but not overseas branches of UK financial institutions) will report information on their US account holders to HMRC rather than the IRS (unless they are non-reporting UK financial institutions (such as pension funds) in which case they will not have any reporting obligations). UK financial institutions are “deemed compliant” for FATCA purposes. There will be no FATCA withholding on payments to a deemed compliant FFI; and payments made by a deemed compliant FFI are safe too unless the FFI has elected to assume primary withholding responsibility (a scenario which is expected to arise rarely in practice).

The IRS has since entered into IGAs in substantially the same form with more than 35 other jurisdictions, including France, Germany, Italy, Spain and the Netherlands. In addition, the US Treasury has announced that it will treat countries which have agreed an IGA “in substance” although not yet signed it, as though the IGA were in effect, provided that the country concerned has consented to this treatment. As at 13 June 2014, there were more

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than 40 jurisdictions listed as benefiting from this treatment<sup>27</sup>. These IGAs in substance must be signed by the end of 2014; however, as after 31 December 2014, the US will revert to treating only signed IGAs as being in effect.

IGAs are based on one of two forms. The UK/US IGA, like most others entered into to date, is based on “Model 1”. Model 1 requires reporting financial institutions to report to a national agency (in the UK, HMRC) which will pass on the relevant information to the IRS. “Model 2” IGAs, by contrast, still require direct reporting between the FFI and the IRS. Each of France, Germany, Italy, Spain and the Netherlands have entered into IGAs based on Model 1, so the key implications of FATCA under those IGAs are substantially similar to the position under the UK/US IGA, outlined above.

Although the US Treasury may not be able to conclude IGAs across every jurisdiction, the global spread is expected eventually to cover most of the major jurisdictions that participate in the international financing markets.

As a result, a lender in a country which does not have the benefit of an IGA should be able to lend via a branch in an IGA jurisdiction and thereby remove any risk of FATCA withholding.

FATCA’s withholding tax regime is also proposed eventually to extend to “foreign passthru payments” made by certain FFIs. However, this has generally been the subject of less focus as the US regulations issued in January 2013 regarding the implementation of FATCA confirm that foreign passthru payments will not apply before 1 January 2017 at the earliest and it may be some years before detailed rules on foreign passthru payments are issued (including the relevant grandfathering dates). Passthru withholding is also unlikely to affect FFIs in jurisdictions which have entered into IGAs, which, by 2017, should hopefully have been concluded with those countries who wish to do so.

### ***FATCA in loan documentation***

Lenders which do not have IGA protection or which are not compliant FFIs could include a number of provisions to mitigate FATCA withholding risk; these could, for example, require that no obligor is a US person, a non-US person owned by a US person or an FFI. Similarly, provisions could be included requiring such obligors to resign before any withholding would arise. Lenders and obligors may also want the right to replace any agent or other administrative party that is a non-compliant FFI before withholding arises.

All of these provisions may assist in limiting FATCA risk. However, it would still be necessary for the parties to agree contractually how to allocate FATCA withholding risk if FATCA withholding arises.

<sup>27</sup> Including, most recently, China.

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In the US loan market, it has been accepted for some time that the lenders should bear the risk and cost of any FATCA withholding, because only they can comply with FATCA's reporting requirements and thereby eliminate the risk.

The approach taken in the European loan market has been more varied until recently.

The key driver behind European lenders' initial reluctance to accept FATCA withholding tax risk was the possibility of conflicts with confidentiality and data protection rules. With the development of the IGA concept, that concern has faded. Until recently, the LMA had not made any changes to its recommended forms to address FATCA, although it had produced a note for members containing three sets of riders providing various options for addressing reporting requirements and the allocation of withholding risk (to the extent applicable).

### ***The LMA Riders***

The LMA's FATCA riders were first published in March 2012, and were subsequently revised a number of times as the FATCA regime developed and became better understood. The last version was published in July 2013:

- **Rider 1:** Rider 1 placed the risk of FATCA withholding on the borrower. The borrower represents to the lenders that it does not have any US source income and/or undertakes to gross-up or indemnify the lenders should any FATCA withholding arise (in which event the borrower is also entitled to prepay/cancel the relevant lender's commitments).
- **Rider 2:** Rider 2 ostensibly placed the risk of FATCA withholding on the lenders, but only to the extent that the loan attracts grandfathering protection (which as already mentioned, protects obligations that were outstanding on 1 July 2014 in respect of FATCA withholding and compliance rules). If that protection falls away (as a result of the loan being "materially modified" after the grandfathering date), FATCA risk, in effect, passes to the borrower. The drafting achieves this by giving all lenders the right to veto any amendments to the facility – including changes to the obligors – that might result in the loss of grandfathering protection. If the borrower chooses to proceed with an amendment which has been vetoed and grandfathering protection is lost as a result, the borrower is obliged to replace or prepay and cancel the participation of any affected lender should FATCA withholding obligations subsequently arise.
- **Rider 3:** This provision was added to the LMA's FATCA Riders in July 2013, once the UK/US and a number of other IGAs had been signed. Rider 3 placed FATCA risk on the lenders and was the most favourable outcome from the borrower's perspective. It entitles all parties to withhold where relevant, but makes clear that should withholding arise, the borrower is not subject to any gross-up or indemnification obligation.

The FATCA Riders also included a set of "common provisions", intended to be used regardless of which Rider is selected. These are essentially information sharing provisions, which require each party to the agreement to confirm its FATCA status to the others to

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facilitate compliance. These common provisions also provide a mechanism for replacing the agent if not FATCA-compliant or covered by an IGA.

### **Current LMA provisions**

Due to the spread of IGAs, over the last 12 months using Rider 3 plus the common provisions has become the standard way of dealing with FATCA risk in loan documentation, regardless of whether the borrower group includes a US entity or has US source income.

As a result, in June 2014, the LMA incorporated the text of Rider 3 and the common provisions (with some very minor adjustments) into each of the Investment Grade Agreements. These provisions were added to the French, German and Spanish law versions of the Investment Grade Agreements, as well as a number of the LMA's other recommended forms at the same time.

FATCA still requires discussion, however, in transactions involving lenders in non-IGA jurisdictions (for example, certain Middle Eastern and Asian countries), where there remains some variation in the agreed position. In such situations, US tax advice is likely to be required. Thus LMA Riders 1 and 2 remain available for use in the LMA's "2014 Summary Note on FATCA" published on 9 June 2014 as a precursor to the revised Investment Grade Agreements and to replace the FATCA Riders.

## **2.7. Derivatives regulation**

*In summary:*

- *EMIR and other regulatory developments affecting the derivatives market have led to more borrowers being required to collateralise their derivative exposures, whether to comply with regulatory requirements or to obtain more favourable pricing.*
- *The collateralisation of derivatives can have implications under a number of provisions in a loan agreement, in particular the negative pledge and the covenant restricting disposals.*
- *It is important that any collateralised derivatives to which members of the borrower group are party are borne in mind when negotiating loan documentation and that appropriate amendments are made to facility terms as required.*

Whether borrowers are permitted to collateralise derivatives exposures under current lending terms is a topic being considered by many borrowers in light of the European Market Infrastructure Regulation ("**EMIR**")<sup>28</sup> and other regulatory developments affecting the derivatives industry.

28 Regulation (EU) No. 648/2012.

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Even borrowers who do not need to put up collateral as part of the clearing process (or are not otherwise required to do so under EMIR risk mitigation requirements) may do so for economic reasons to get better pricing on their derivatives, which due to regulatory changes are becoming a more expensive product to provide for banks. Basel III, for example, requires banks to hold more capital against derivatives which are not centrally cleared.

The collateralisation of derivatives can have implications under a number of provisions in an LMA-style loan agreement, in particular under the restrictive covenants.

An LMA-style negative pledge clause, for example, restricts the creation of “Security”. This is a broadly defined concept (and therefore quite often negotiated by borrowers) which encompasses arrangements which have a “similar effect” to security as well as interests which would more commonly be understood as security.

If a swap is collateralised using the ISDA credit support annex title transfer arrangement, the prudent view is probably that it does constitute “Security” and the obligors’ ability to enter into such arrangements is, if not specifically addressed, restricted by the terms of an LMA negative pledge.

An exception to the LMA negative pledge makes clear that set-off and close-out netting arrangements in ordinary course hedging transactions are permitted, but that permission expressly excludes the provision of collateral by way of credit support for hedging.

Accordingly, borrowers may wish to negotiate a specific exception to their negative pledge clause to address any collateralised derivatives, or otherwise, make sure that any basket amount is sufficient to accommodate their requirements. It may also be necessary to discuss an equivalent exception to any covenant restricting disposals, given that most English law collateral is provided via a title transfer arrangement.

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## 3. OTHER DOCUMENTATION ISSUES

### 3.1. Introduction

A number of the other documentation points that are being raised on current transactions, like the regulatory issues discussed in section 2, are the product of the global financial crisis and other adverse events that have affected the financial sector since then.

The recessionary period brought to light a number of risks that were not previously catered for specifically in loan documentation and provided the opportunity for the courts to provide guidance on some of the provisions in common usage.

Many of the issues highlighted in this section have had a direct effect on the more mechanical areas of a loan agreement, which might previously have been put into the category of “boilerplate” and rarely disturbed in negotiations. New iterations of certain “boilerplate” provisions are quite often the subject of discussion in current transactions.

This is not necessarily because they are objectionable, but because they are new, and, in some cases extensive, and so need to be justified and understood.

For example, provisions aimed at dealing with the reforms that have been made to LIBOR and other benchmarks, managing defaulting lenders and euro fragmentation (each discussed below) are generally designed to address risks which have the potential to affect (or should affect) lending documentation of all types. Lenders and borrowers will wish to understand their implications and what they are trying to achieve but they are points on which their interests may in most cases be aligned.

New clauses which allocate more risk or place greater restrictions on the borrower may give rise to commercial issues and are therefore less easily presented as “boilerplate”. For example, agent banks and other administrative parties are generally looking for more extensive protection from liability. More restrictive amendment and waiver provisions are also gaining some traction in the market. Such provisions have commercial implications for the borrower which warrant consideration, even if the risks are perceived as remote. Many examples in this category stem from lenders’ experiences in particular sectors of the market, specifically, the leveraged market.

In circumstances where borrowers find it difficult to understand the justification for, or relevance of, the proposed provisions to their own situation, negotiation will be required, which may have implications in terms of the time and costs involved in settling the agreement. On the other hand, the arguments for and against addressing risks which might be viewed as very remote can be finely balanced. For most borrowers, achieving the best pricing, the right maturity profile and a limited and flexible set of covenant terms are more significant determinants of the success of a refinancing than the length of the



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boilerplate. Lenders may, however, wish to anticipate that certain terms will not be treated automatically as “standard” by all borrowers.

## 3.2. Benchmark reform

*In summary:*

- *Adjustments are being made to Euribor and LIBOR definitions in new loan documentation to reflect recent and pending changes to the administration of those rates along the lines proposed by the LMA, although documentation which pre-dates the change is not generally being re-opened specifically to address this issue.*
- *The range of available maturities for Euribor and LIBOR has been reduced. Changes have been made to all of the LMA’s recommended forms which provide for the calculation (on a straight line basis) of interpolated rates for maturities for which a Screen Rate is not available.*
- *The Reference Bank Rate remains the standard fallback if the Euribor or LIBOR Screen Rate is unavailable but some banks are reluctant to act as Reference Banks until they are comfortable that to do so would not conflict with their regulatory obligations. The LMA has not yet made any recommendations in this regard, although a variety of provisions have featured in recent transactions, including:*
  - *obligations on agent banks to keep Reference Bank quotes confidential;*
  - *provisions limiting the Reference Banks’ liability for any rate submissions;*
  - *the interposition of an interim fallback rate based on historic Screen Rates between the Screen Rate and Reference Bank Rates; and*
  - *provision for the identity of the Reference Banks to be determined as required rather than on the date of the agreement (if no lender is willing to act).*
- *Alternatives to LIBOR have had to be identified for loans in those currencies for which LIBOR rates have been discontinued. The alternative choice is often the locally published benchmark for the relevant currency.*
- *It has become common (and reflected in the LMA’s recommended forms) for a zero floor to be imposed on Euribor and LIBOR calculations to address the possibility of rates moving into negative territory.*

### Overview

LIBOR and, for loans in euro, Euribor, as published on screen are the standard benchmarks used in the loan market, with Reference Bank Rates as a fallback if the screen rates are unavailable.

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The LMA has made a number of adjustments to the “IBOR” definitions and related provisions to address the changes that have been made to LIBOR, and the changes that are proposed to be made to Euribor, as a result of the global regulatory review of benchmarks in the financial markets prompted by the misconduct of various contributors to LIBOR and other benchmark rates.

The changes which reflect the new administration arrangements for Euribor and LIBOR, as well as the discontinuation of various maturities are described below and are generally not controversial. The topics that require more thought (and on which the LMA has not made any recommendations to date) are fallback rates; what should be used in place of the discontinued LIBOR currency rates and the availability and position of Reference Banks.

### ***Administrative changes and interpolated rates***

A key plank of the UK government’s reform package for LIBOR was to move responsibility for LIBOR away from the BBA, the UK trade association for banks, to a new and independent administrator.

In anticipation of this change, following consultation with its members and the ACT, on 11 March 2013 the LMA published a note containing a revised definition of “Screen Rate” catering for the change of administrator and also any potential change of screen rate provider/screen reference that might accompany the change of administrator.

By that time, the European Commission had launched a review of the Euribor calculation process. As a result, the LMA’s revised definition of “Screen Rate” built greater flexibility into the definitions of both Euribor and LIBOR.

To improve the reliability of LIBOR, the UK government also decided that the number of LIBOR rates should be reduced, to focus on those rates which are most heavily used. In addition to a number of currency rates (see further below), the 2 week, 4 month, 5 month, 7 month, 8 month, 9 month, 10 month, 11 month maturities were removed from the LIBOR framework. Only the 1 week, 1 month, 2 month, 3 month, 6 month and 12 month rates for each of LIBOR currencies remain.

On 1 November 2013, the number of Euribor maturities was reduced for similar reasons. The 3 week, 4 month, 5 month, 7 month, 8 month, 10 month and 11 month maturities were discontinued. Eight Euribor rates remain: 1 and 2 weeks, 1 month, 2 month, 3 month, 6 month, 9 month and 12 month.

The LMA agreements did not provide expressly for the calculation of interest rates applicable to periods for which Euribor or LIBOR is unavailable, nor the basis on which interpolated rates might be calculated, although interpolation was in practice used to address non-quoted interest periods.

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As a result, following further consultation, the LMA published a second version of its note to members on 30 April 2013, suggesting further changes to the definitions of Euribor and LIBOR. The revised definitions provide that if no Screen Rate is available for the relevant interest period, an “Interpolated Screen Rate” shall apply, a rate interpolated from available Euribor/LIBOR maturities on a straight line basis.

The revised definitions of Screen Rate and a slightly adjusted version of the interpolation provisions<sup>29</sup> were incorporated into all of the LMA’s recommended forms of facility agreement on 30 July 2013.

In mid-January 2014, it was announced that ICE Benchmark Administration (“**ICE**”), part of the Intercontinental Exchange Group (NYSE:ICE), would officially take over as the new administrator of LIBOR on 1 February 2014.

On 23 January 2014, the LMA published two more notes. The first included an updated definition of “Screen Rate”, replacing the reference to the BBA, with a reference to ICE.

This updated definition was subsequently incorporated into the LMA’s recommended forms and is being used in new LMA-based loan documentation.

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*“Screen Rate” means:*

- (a) in relation to LIBOR, the London interbank offered rate administered by ICE Benchmark Administration Limited (or any other person which takes over the administration of that rate) for the relevant currency and period displayed on pages LIBOR01 or LIBOR02 of the Reuters screen (or any replacement Reuters page which displays that rate); and*
- (b) in relation to EURIBOR, the euro interbank offered rate administered by the Banking Federation of the European Union (or any other person which takes over the administration of that rate) for the relevant period displayed on page EURIBOR 01 of the Reuters screen (or any replacement Reuters page which displays that rate),]*

*or [in each case,] on the appropriate page of such other information service which publishes that rate from time to time in place of Reuters. If such page is replaced or service ceases to be available, the Agent may specify another page or service displaying the relevant rate after consultation with the Company.”*

Extract: Clause 1.1 LMA English law Multicurrency Term and Revolving Facility Agreement

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<sup>29</sup> The definition of “Interpolated Screen Rate” was amended to include a rounding convention.

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The second note contained a summary of the legal advice received by the LMA on the impact of the transition of LIBOR to ICE on LIBOR definitions in legacy LMA documentation.

### **Legacy documentation**

The changes to the definition of “Screen Rate” described above were made because the pre-existing definition referred to the “British Bankers’ Association Interest Settlement Rate” as displayed on the appropriate page of the Reuters screen. There was some concern that this definition would not be adequate to identify new LIBOR once responsibility transferred from the BBA to ICE, potentially leading to disputes as to whether the “Screen Rate” (i.e. BBA LIBOR on screen) is available.

The likelihood of such disputes arising was thought by most to depend primarily on what, if any, changes the new administrator made to the composition and/or calculation of LIBOR. For now, ICE has confirmed that it does not intend to make any changes to the calculation of LIBOR<sup>30</sup>. The advice given to the LMA in the context of its English law primary documents and reflected in its note, confirms the generally held view that provided LIBOR remains essentially the same rate, an English court “*would interpret the reference to BBA LIBOR..as a reference to a renamed LIBOR administered by ICE*”.

We would expect that French, German or Spanish courts would reach similar conclusions in relation to the equivalent provisions of the French, German and Spanish law versions of the Investment Grade Agreements.

At present therefore, agreements on legacy LMA terms are not being amended specifically to address LIBOR transition. However, as not all loan agreements use the LMA form or track the LMA definitions precisely, whether amendment is necessary must be considered on a case by case basis.

### **Use of Reference Bank Rates**

In syndicated deals, around three Reference Banks are usually appointed by the agent in consultation with the borrower<sup>31</sup>. If the Screen Rate is unavailable, under LMA terms, the rate ultimately reverts to the average of Reference Bank quotes.

The Reference Bank fallback mechanism is intended to cater for two main scenarios:

- Euribor/LIBOR is not published on screen because it has not been calculated (due to lack of inputs); or

30 “ICE is a continuation of what was previously known as BBA LIBOR and there are no changes to how the rate is calculated or how the submissions are collected at present” ([https://www.theice.com/publicdocs/IBA\\_LIBOR\\_FAQ.pdf](https://www.theice.com/publicdocs/IBA_LIBOR_FAQ.pdf)).

31 In most cases, the Reference Banks are selected from among the syndicate, although practice does vary, for example, in Spain, the Reference Banks are usually banks who do not form part of the syndicate, with a view to avoiding any perceived conflict of interest.

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- Euribor/LIBOR has been calculated, but has not been published on screen (most likely due to a service breakdown).

It is important to borrowers that the Reference Bank Rate fallback mechanism is as robust as possible if the Screen Rate is unavailable. If the Reference Banks fail to quote (or only one Reference Bank quotes), under LMA terms, a “Market Disruption Event” occurs which triggers a requirement for the lenders and the borrower to discuss alternative rates (and the borrower may have to pay lenders’ actual funding costs pending agreement on an appropriate alternative)<sup>32</sup>.

A Market Disruption Event is therefore something the parties generally, and the borrower in particular, will wish to avoid.

The circumstances in which the Reference Bank Rate fallback will be invoked and the exposure of banks which agree to act as Reference Banks have become sensitive topics for some lenders. These aspects of the LMA agreements have come under particular scrutiny as a result.

In our view, the combination of certain recent regulatory changes to LIBOR and current LMA terms might provide Reference Banks with significant comfort that they will be called on to quote only in an extremely limited set of circumstances.

### ***Screen Rate cannot be calculated***

If LIBOR (or the required LIBOR rate) were unavailable because it had not been calculated, that might not, of itself trigger the application of Reference Bank Rates.

During the transition period immediately preceding the transfer of LIBOR to ICE, the LIBOR Interim Oversight Committee published a contingency plan which specifies what should happen if sufficient inputs for a rate are either not received, or not received on time. In summary, if less than the full set of banks provide their inputs, the rate will be calculated based on the submissions received. If inputs are received from fewer than 4 banks (or no inputs are received), a new rate will not be calculated, but the LIBOR rate for the previous day will be republished and treated as the LIBOR rate for that day.

The Euribor Code of Conduct was amended in December 2013 to similar effect in the event that quotes are provided by fewer than 12 panel banks<sup>33</sup>. It makes specific provision for the

32 This is the case pursuant to the terms of the Investment Grade Agreements and most of the other LMA recommended forms. Note, however, that the LMA’s forms of facility agreement for leveraged transactions contain a more complex market disruption mechanic which forms part of the LMA’s “Lehman” provisions. This is discussed briefly in section 3.5.

33 Although it does not refer expressly to a scenario where all banks fail to quote.

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formulation of a strategy for preserving the continuity of Euribor in that event within three fixing days.

The existence of these contingency plans potentially narrows significantly the circumstances in which Reference Banks would be called on to quote in lieu of Euribor or LIBOR. Nonetheless, the possibility of disputes as to whether contractually, a previous day's rate should be treated as the current day's rate should not be ruled out completely, in particular, if the historic rate were to prevail for a continuous period.

### **Screen rate provider service breakdown**

The unavailability of the relevant rate on the designated Screen Rate service may not automatically require Reference Bank Rates to be used either.

The LMA definitions contain a contingency that could be applied in the event of service breakdown. The definition of "Screen Rate" (quoted in full above), provides that if the specified screen page "*ceases to be available, the Agent may specify another page or service displaying the relevant rate in consultation with the Company*".

There are multiple screen rate providers. If an alternative page or service can be specified pursuant to this provision, Screen Rate Euribor/LIBOR should only be completely unavailable if all of the screen rate services break down at the same time.

### **Interpolated Screen Rates**

The interpolation language recently added to the LMA recommended forms may provide a further buffer between the unavailability of a screen rate and Reference Bank Rates.

The current LMA definition of LIBOR is as follows:

*“**LIBOR**” means, in relation to any Loan:*

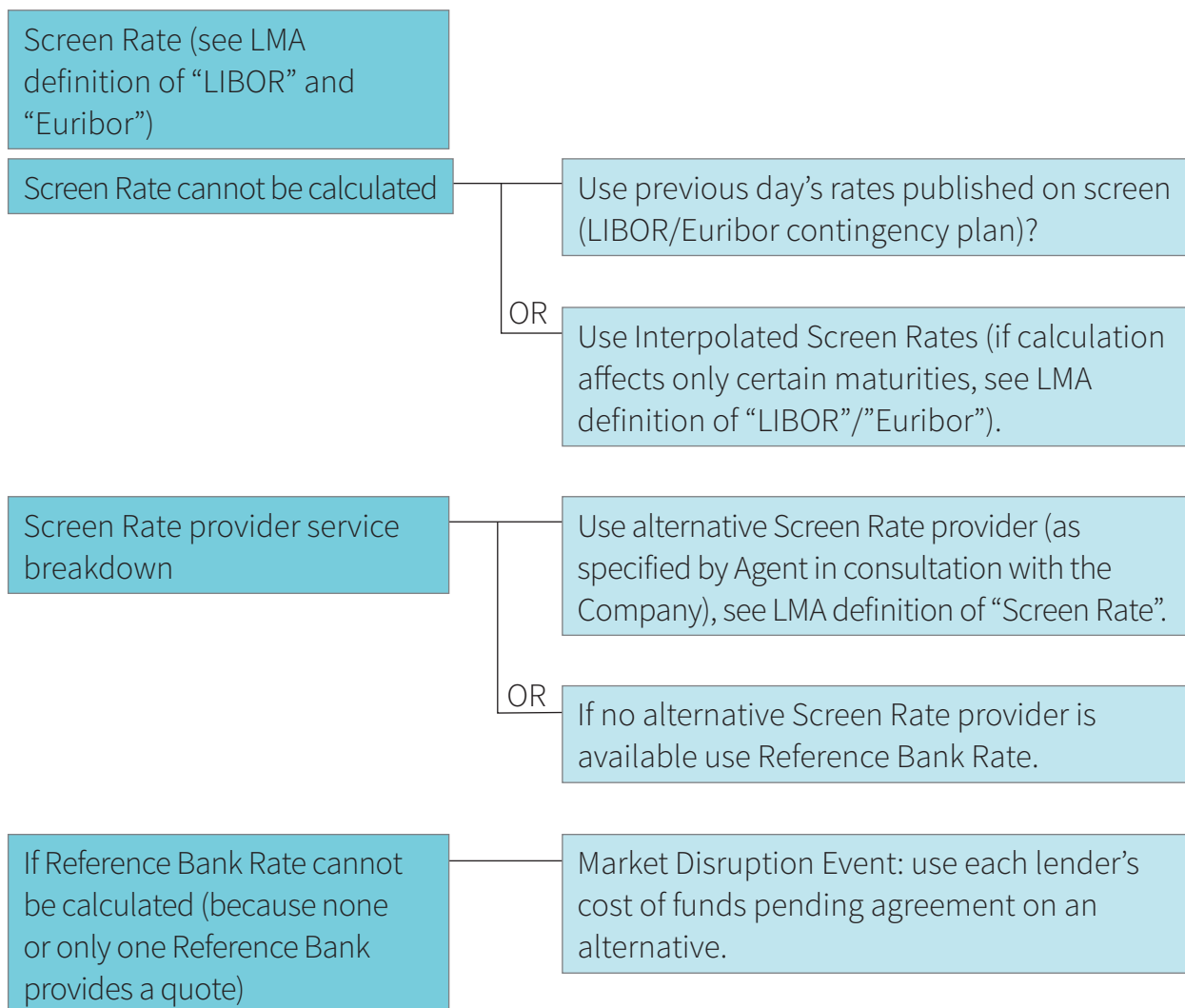
- (a) the applicable Screen Rate;*
- (b) [(if no applicable Screen Rate is available for the Interest Period of that Loan) the Interpolated Screen Rate for that Loan];] or*
- (c) if:*
  - (iii) no Screen Rate is available for the currency of that loan; or*
  - (iv) no Screen Rate is available for the Interest Period of that Loan [and it is not possible to calculate an Interpolated Screen Rate for that Loan],*

*the Reference Bank Rate.”*

“Euribor” is defined in substantially the same way.

The interpolation language in square brackets above is presumably intended primarily to cater for future reductions or alteration in the maturities for which Euribor or LIBOR is quoted (the definition of “Interpolated Screen Rate”, as mentioned above, provides for the calculation of an interpolated rate based on available maturities). However, it could also provide further protection for Reference Banks should particular maturities be unavailable due to a lack of inputs and/or service breakdown. If e.g. 3 month US\$ LIBOR were unavailable, it would be possible to calculate an interpolated rate if shorter and longer maturities are available.

### **Interest rate waterfall (current LMA terms)**



### **Reference Bank availability**

Notwithstanding the limited role of Reference Banks, a number of banks are unwilling to act as Reference Banks, especially in the London market. This has generally been attributed to the new regulatory obligations applicable to LIBOR panel banks.

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The measures put in place to restore confidence in LIBOR include a number of changes to the submissions process. LIBOR panel banks are required to base their submissions on actual trading data as far as possible.

The Reference Bank Rate in the LMA's recommended forms is crafted as a proxy for LIBOR. The definition tracks the definition of BBA LIBOR (which has been adopted by ICE LIBOR): *"the rate at which the relevant Reference Bank could borrow funds in the London interbank market...in the relevant currency and for the relevant period, were it to do so by asking for and then accepting interbank offers for deposits in reasonable market size in that currency and for that period"*.

Due to the similarities between the basis of calculation of the Reference Bank Rate and LIBOR, LIBOR panel banks in particular may be reluctant to act as Reference Banks which may be asked to quote in circumstances where LIBOR is unavailable due to lack of inputs. Under LMA terms, they are essentially being asked for the same rate.

Although, as mentioned, this concern has to date arisen largely in the London market, similar concerns may also arise in relation to Euribor. The definition of Reference Bank Rate is the same where the Reference Banks are asked to quote in place of Euribor, save that they are asked for the rate at which they could borrow funds in the European interbank market. Reference Banks therefore sometimes request that for loans in euro, the definition is amended to mirror more closely the definition of Euribor, for example *"the rate which the relevant Reference Bank assesses to be the rate at which euro interbank term deposits in euros and for the relevant period are offered for spot value (T+2) by one prime bank to another prime bank within the EMU zone"*.

As a result, the availability of Reference Banks for both LIBOR and Euribor can be a problem.

In some instances lenders are insisting, as a condition of their agreeing to act as Reference Banks, on the inclusion of provisions, in addition to the LMA provisions, which minimise further the circumstances in which Reference Bank Rates might be required.

The approach taken by some lenders provides for the use of alternative interest periods or historic screen rates (or even interpolated historic screen rates) if interpolation is not possible. Such provisions may be an effective means of further limiting the role of Reference Bank Rates and, as such, are not necessarily objectionable to borrowers. However, they add a further layer of difficulty to provisions which are already complex and so require close attention.

Where no bank in the lender group is willing to volunteer to be a Reference Bank on the date of the agreement, or lenders do not volunteer to act as Reference Banks in sufficient numbers, a practical solution seen more recently is to provide that the Reference Banks (or the remaining Reference Banks) will be appointed by the agent in consultation with the borrower as and when required.



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### ***Reference Bank liability and confidentiality***

LIBOR panel banks may be concerned about the requirement to keep their LIBOR submissions confidential. The ICE Code of Conduct for Contributing Banks<sup>34</sup> addresses this and clarifies that the Code does not prevent the disclosure of non-public LIBOR submissions to their external customers entering into transactions priced by reference to the submitted rate, if suitable confidentiality obligations are in place. Specific confidentiality and disclosure obligations designed to address this issue have started to appear in loan agreements as a result.

Some Reference Banks are also concerned about their potential liability to the borrower and the other Finance Parties in respect of their role.

The Reference Bank role is an administrative role, similar to that of the agent. As such, the borrower might accept that Reference Banks might wish to limit their liability. However, as in relation to the agent (and other administrative parties), the borrower may be reluctant for Reference Banks to be exempt from any responsibility for the rates produced.

Limiting the Reference Banks' liability by reference to gross negligence and wilful default may be an acceptable compromise and is consistent with the standard of liability generally accepted by the agent (see section 3.3 below).

### ***Discontinued LIBOR currencies***

LIBOR rates for AU\$, CAN\$, Danish Kroner, Swedish Kronor and NZ\$ have not been quoted since mid-2013.

Most parties to loans in these currencies have sought to find alternative benchmark rates rather than rely on Reference Bank Rates. The willingness of Reference Banks to provide quotes has been a particular concern. Reference Bank Rates for these currencies may be difficult to base on actual trading given they have been removed from the LIBOR framework due to the lack of an active London market.

The most obvious alternatives are the locally published benchmarks for the relevant currency. Although the UK BBA will not officially endorse alternative rates, in a feedback statement issued in December 2012, it stated that locally published benchmarks might be an appropriate starting point. The ACT also published a helpful guide to alternative rate sources in January 2013 which makes similar points<sup>35</sup>.

34 As reissued on 3 February 2014.

35 This note is available from the ACT's website, [www.treasurers.org](http://www.treasurers.org).

Currency	Local benchmark
AUS\$	BBSW (Bank Bill Swap Reference Rate)
CAN\$	CDOR (Canadian Dealer Offered Rate)
DKK	CIBOR (Copenhagen Interbank Offered Rate)
SKK	STIBOR (Stockholm Interbank Offered Rate)
NZ\$	BKBM (New Zealand Bank Bill Reference Rate)

Local benchmarks are not always a satisfactory substitution as they are generally based on rates in the domestic inter-bank market (rather than the London inter-bank market) which may not reflect the relevant lenders' cost of funds. The lack of workable alternatives (for example, a combination of LIBOR rates for a continuing currency plus swap costs has been mooted as a possibility but is quite complex to implement) means that local benchmarks, in our experience, are currently the parties' usual choice in this situation.

### ***Euribor/LIBOR zero floor***

A further development relating to benchmarks which affects the definitions used in loan agreements is how to deal with negative interest rates.

The LMA published a note containing an optional zero floor provision to be inserted into the LMA definitions of Euribor and LIBOR in late 2011. This was in response to negative CHF LIBOR during the summer of 2011, which gave rise to concerns that a negative IBOR rate could erode lenders' margins. The effect of the optional language is that if IBOR is negative, it will be deemed to be zero for the purposes of the agreement.

The zero floor has become quite widely adopted by lenders and commonly appears in first draft loan documentation. As a result, it has been added to the LMA's recommended forms.

It is not generally controversial. However, the parties should consider whether it is necessary to reflect the zero floor in any associated interest rate hedging arrangements, to preserve the protection of the swap and/or to ensure there is no adverse impact on hedge accounting treatment (if applicable) or on the exemption of the swap from central clearing requirements under EMIR.

### ***Next steps***

The global review of benchmarks and benchmark regulation remains ongoing.

An IOSCO board level task force started work in September 2012 and published its final report on 17 July 2013. The report contains an over-arching set of principles for financial benchmarks, which IOSCO members are urged to implement, with the aim of imposing

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minimum standards of governance and accountability on administrators and submitters worldwide.

The European Commission's legislative proposal for the regulation of financial benchmarks was published in September 2013 and changes to the Euribor process are in train and have similar repercussions for loan documentation as the changes that have already been made to LIBOR.

In addition, and importantly for the loan market, the Financial Stability Board is currently considering alternatives to LIBOR. Their report is expected shortly.

Whether these initiatives have any further impact on the loan market and loan documentation remains to be seen.

### 3.3. Agency provisions

*In summary:*

- *The financial crisis led to increased focus on the scope of the contractual protection afforded to agent banks in syndicated loan documentation, causing the LMA to undertake a comprehensive review of the provisions in its recommended forms.*
- *The LMA has revised the agency terms in all of its recommended forms, although there are some substantive differences in the approach taken in the Investment Grade Agreements and the LMA's other recommended forms, including the Leveraged Agreement.*
- *Most of the changes serve to clarify expressly matters which were within the scope of the original LMA agency language and are not generally controversial. The general position remains that:*
  - *the agent's role is purely administrative;*
  - *its liability for the performance of its administrative responsibilities is limited to its gross negligence and wilful default; and*
  - *its liability is excluded entirely, absent fraud, if its failure to perform results from a force majeure event.*
- *The most controversial aspect of the modified LMA agency language is the proposal in the Leveraged Agreement that the scope of the borrower's indemnity to the agent should be extended to mirror the scope of the lenders' indemnity to the agent. This may be negotiated and is not market practice in the investment grade market (and is not included in the Investment Grade Agreements).*

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### ***The agency role in a syndicated loan***

The role of an agent bank in relation to a syndicated loan is essentially administrative. As a general proposition it is appropriate for the agent to expect to be protected from liability in respect of substantive obligations which are the responsibility of the lenders (or indeed the borrower).

Borrowers (and lenders) might question why the agent should not be responsible for breach of its administrative obligations. However, that agents should take no responsibility for their actions absent gross negligence or wilful default represents long-established market practice and is the position taken in all of the LMA's recommended forms. Further, under LMA terms, the agent's liability is excluded, save to the extent of its own fraud, if the agent's performance is inhibited by a "Disruption Event", in summary, a "force majeure" disruption to payment or communications systems beyond its control. Agency fees are typically set at a level that acknowledges the agent's limited administrative function.

### ***Liability of the agent***

In ordinary circumstances, the agency function should not be onerous. It is largely limited to acting as a conduit for payments and notices. More demands are likely to be made of the agent if financial difficulties arise either within the borrower or indeed within the lender group.

During and in the aftermath of the financial crisis, agents, in particular those involved in leveraged loans, found themselves increasingly occupied with consent requests and restructurings, often involving difficult issues of interpretation with regard to appropriate majorities. This led to increased focus on the scope of their contractual protection.

The LMA undertook a comprehensive review of the agency provisions in its recommended forms. The conclusions of that review were added to the Leveraged Agreement in September 2012, and were subsequently incorporated into all of the LMA's English law recommended forms, other than the Investment Grade Agreements.

The changes were only recently incorporated into the Investment Grade Agreements in a slightly modified form following discussions between the LMA and the ACT. Corresponding changes have been incorporated into the French, German and Spanish versions of the Investment Grade Agreements<sup>36</sup>.

At first sight, this new agency language appears significantly different. However, much of the new language simply spells out more clearly matters which were probably within the scope of the previous provisions.

36 Although note the borrower's indemnity to the agent in the Spanish law LMA agreement is broader than the equivalent in the Investment Grade Agreements (which was the case prior to the most recent amendments, reflecting general practice in the Spanish market).

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For example, the new language specifies in a number of places in the agreement that the agent expects to incur no liability in relation to services provided with the authority of the lenders or in reliance on the work of advisers. To the extent the new provisions provide more specific examples of circumstances in which the agent will not be liable for judgments it is tasked with fronting on the lenders' behalf (e.g. a decision as to whether a particular amendment requires Majority Lender or unanimous consent on which it takes legal advice), they do not constitute a material departure from the general principles reflected in the terms they replace.

However, in some areas, the new LMA language constitutes a substantive narrowing of the scope of the agent's liability in relation to specific risks which (in the view of the agency community) are not proportionate to the rewards of the agency role.

For example, the agent's liability is excluded in its entirety for certain actions which involve the exercise of discretion, most notably for confirming the satisfaction of the conditions precedent. In addition, the agent's liability for loss of profit damages and other indirect or consequential losses is excluded.

Nonetheless, the revised provisions relating to the role and liability of the agent should not generally speaking be too objectionable for borrowers or lenders. Liability for the performance of the lenders' obligations under the agreement should fall on the lenders and not on the agent bank whose role is purely administrative and many of the new provisions can be viewed as an extrapolation of the commercial position that currently applies.

The more difficult aspect of the modified agency language for borrowers is the suggestion that the scope of the indemnity protection offered to the agent by the borrower should be broadened.

### ***Agent's indemnities***

The LMA provisions which limit the agent's liability are supplemented with indemnity protection. The lenders undertake to indemnify the agent in respect of any of its functions, absent gross negligence or wilful default, or in all cases absent fraud if the liability relates to a Disruption Event.

In the Investment Grade Agreements, the borrower agrees to indemnify the agent in relation only to matters which are deemed to be within the borrower's control or are accepted to be a borrower risk, for example, investigating potential Defaults and transaction, enforcement and amendment costs.

The modified agency language in the Leveraged Agreement and some of the LMA's other English law agreements extends the borrower's indemnity obligations to the agent so that their scope is identical to the lenders' indemnity to the agent. The borrower is obliged to indemnify the agent for all costs, liabilities and expenses it incurs in its capacity as such, save to the extent the agent is grossly negligent or wilfully defaults. Further, if a lender

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makes a payment to the agent pursuant to the indemnity provisions, it is generally entitled to claim reimbursement of that amount from the borrower.

The broadening of the borrower's indemnity obligation is a key commercial point arising out of the new agency provisions and has met resistance from some borrowers. It is not incorporated as a matter of course and, as explained further below (see "Investment Grade Loans"), is not reflected in the current versions of the Investment Grade Agreements.

### ***Amendments to agency terms on change of agent***

Other changes to the LMA's agency provisions relate to the circumstances in which the agent can resign.

If the agent wishes to resign, the lenders, in consultation with the borrower, have 20 days to appoint a successor agent. If they fail to do so within that period, the resigning agent may appoint a successor itself.

Under the revised provisions, where the agent becomes entitled to appoint a successor, it is permitted, to the extent it considers necessary, to agree with the incoming agent changes to the rights and obligations of the agent under the agreement "consistent with then current market practice" together with "*any reasonable amendments to the agency fee payable under this Agreement which are consistent with the successor Agent's normal fee rates...*".

This modification may appear unattractive to borrowers – essentially permitting the outgoing agent unilaterally to change the terms of the agreement, most likely not in the borrower's favour. However, some agent banks which have found themselves in difficult positions consider this an important protection. The borrower might take some comfort from the requirement on the outgoing agent to act reasonably and in accordance with market practice.

### ***Pre-funding and liability for clawback costs***

It is not uncommon in the syndicated loan market for the agent to advance funds to the borrower prior to being put in funds by the lenders. Surprisingly, the LMA recommended forms (before the new agency provisions) did not contain any specific protections for the agent in the event that it found itself out of pocket due to pre-funding.

The new agency provisions include an addition to the payment mechanics section, which provides that if the agent has agreed to advance funds to the borrower before being put in funds by the lender, the risks and cost of a lender defaulting on its obligation to reimburse the agent falls on the borrower. The borrower is obliged to pay back to the agent the sum advanced and, to the extent the defaulting lender fails to do so, reimburse the agent any resulting costs.

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Pre-funding potentially confers a benefit on the borrower, for example, a reduction in the amount of notice required to draw the facility or even just assurance that it will get its funds in time if one lender is delayed for some reason. However, an agreement by the agent to “pre-fund” is a departure from the administrative role, to a commercial “fronting” role.

From the borrower’s point of view, it seems therefore justifiable that the agent would wish to ensure it incurs no liability as a result of providing this additional service. The defaulting lender is also probably in breach of contract in that instance, meaning that the borrower may have a claim against it for its resulting losses.

However, a borrower may not want to incorporate a clause that contemplates lender default without the rights to deal with “Defaulting Lenders” set out in LMA’s “Lehman” provisions (discussed at section 3.5 below), and it is suggested that this new clause, if incorporated, should be used in conjunction with those provisions.

***Torre Asset Funding Ltd & Anor v The Royal Bank of Scotland plc [2013] EWHC 2670 (Ch)***

The efficacy of the LMA agency provisions has recently been tested before the English courts. *Torre Asset Funding Ltd & Anor v The Royal Bank of Scotland plc [2013] EWHC 2670 (Ch)* involved a number of alleged breaches of duty by an agent bank in a complex real estate financing structure.

The documentation incorporated terms describing the duties, responsibilities and liability of the agent in terms along then-current LMA lines, which the judge decided were effective to protect the agent against all of the claims made against it.

Importantly, the court refused to impose duties on the agent outside those expressly conferred on it by the terms of the document. In the view of the court, where the parties have entered into detailed commercial agreements of this type, it is not plausible to suppose that they intended some potential additional set of “vague and unspecific” duties (such as those imposed on agents under the English common law) to apply over and above those specified in the agreement itself.

The agent bank in this case had set up the funding structure and was involved in the transaction in multiple capacities including as lender, as agent, as security trustee and as equity investor. It had become aware of the commencement of certain restructuring proposals in its capacity as lender under another tranche of debt in the structure.

The claimants argued that the existence of these proposals, and the facts underlying them, triggered an event of default under the facility agreement. One of the questions before the court was whether the agent was in breach of this duty as a result of failing to pass on this information to the claimant lender.

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The terms of the relevant facility agreement (and intercreditor agreement) obliged the agent, in summary, to notify each other agent in the structure on becoming aware of any default and to pass on to the lenders any notices of default received by it.

The judge held that on the facts, an insolvency event of default had occurred (this aspect is discussed further at section 3.6 below), but that the agent was not in breach of duty. The occurrence of the insolvency event of default required a judgment to be made as to whether the restructuring proposals and subsequent events constituted the commencement by the borrower of “*negotiations with one or more of its creditors with a view to rescheduling any of its liabilities*” by reason of actual or anticipated financial difficulties.

The team responsible for the agency function had not made any such evaluation at the relevant time. This aspect of the claim therefore failed as, according to the terms of the agreements in question, the agent was under no duty to take steps to evaluate, upon becoming aware of facts which could constitute an event of default, whether an event of default had in fact occurred.

This narrow interpretation of the agent’s obligations placed significant reliance on the LMA clause that specifies the agent’s duties to be “solely mechanical and administrative in nature”. The judge also noted the modest fees charged by the relevant agent, around £15,000 per annum, for its role.

The other claims against the agent in its capacity as such were disposed of on a similar basis.

### ***Investment Grade loans***

The commentary above contains a brief summary of just a couple of aspects of the *Torre case*. The full judgment contains a comprehensive examination of various aspects of the agent’s role in relation to a syndicated loan and the proper construction of the contractual framework. As such, the case might be viewed as confirming the fitness for purpose as a matter of English law of the LMA’s agency language in its original form, contrary to the fears of those agents whose concern about the scope of the LMA provisions prompted the 2012 revisions to the agency language in the Leveraged Agreement. We would expect that French, German and Spanish courts would come to similar conclusions in relation to the equivalent provisions of the French, German and Spanish law versions of the Investment Grade Agreements.

Notwithstanding *Torre* nor that many of the more difficult decisions faced by agents generally arise in the context of sub-investment grade lending, as mentioned above, the agency language in the Investment Grade Agreements has recently been modified following discussions between the LMA and the ACT. These changes were also made to the French, German and Spanish law versions<sup>37</sup>.

37 See footnote 36 above in relation to the indemnity provisions in the LMA’s Spanish law agreement.



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The agency provisions in the Investment Grade Agreements largely reflect the language that appears in the other LMA recommended forms. However, users should note that the language is not identical in all respects, in particular the provisions addressing the key commercial point, the extent of the borrower's indemnity obligations. The indemnity obligations have not been extended to the same extent as in the Leveraged Agreement, providing some acknowledgement of the distinction between the scope of the agency role in an investment grade loan and a leveraged loan.

### 3.4. Amendments and waivers

#### ***Matters requiring all-lender consent***

The ability to restructure a broadly held leveraged loan without unanimous lender consent can be valuable from both the borrower's and the lenders' point of view. However, certain restructurings completed in recent years have led to increased focus on the scope of the LMA amendments and waivers clause and on what some lenders might perceive as weaknesses in those provisions.

As a result, in September 2012 the LMA extended the list of matters reserved to unanimous lender consent in the Leveraged Agreement. Similar changes have since been made to its other recommended forms, although some are presented as optional provisions in the Investment Grade Agreements, reflecting that they may be less relevant in that context.

These additions include:

- **Non pro rata cancellation/prepayment:** In various restructurings, non pro rata cancellation or prepayment of lenders' commitments was achieved, in accordance with the documentation terms, with Majority Lender consent. The LMA's recommended forms, including the Investment Grade Agreements, now provide that any amendment which either (i) permits a cancellation of lenders' commitments other than rateably or (ii) permits voluntary prepayments to be applied other than pro rata to the lenders' commitments, shall require unanimous lender consent.
- **Changes to the governing law and jurisdiction provisions:** Recent English case law has confirmed that the choice of English law and jurisdiction can be a factor which determines the availability of an English law scheme of arrangement to a foreign company<sup>38</sup>. The choice of English law and jurisdiction may therefore be important for transactions involving borrowers in jurisdictions outside the UK, if lenders wish to

38 For example, the governing law and jurisdiction clauses in the underlying financing documents of companies in the Apcoa group were changed from German to English law (with majority lenders' approval) prior to the scheme application. In March 2014 the court held this provided sufficient connection for the purposes of a scheme relating to nine companies based in the UK, Germany, Belgium, Denmark, Norway and Austria.

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preserve their ability to pursue an English law scheme. Conversely, it may be important to preserve the parties' choice of another governing law and jurisdiction if lenders believe a cram-down arrangement should be possible only with unanimous lender consent (and wish to avoid that position being overruled through an English law scheme).

- **Prepayment/cancellation rights on a change of control:** Where the change of control clause confers an individual right on lenders to require prepayment (which may be the case in an investment grade deal), lenders may feel that an individual decision should not be capable of removal or amendment by Majority Lenders. They may also be concerned that being forced to waive individual rights upon a change of control by Majority Lenders could conflict with their regulatory obligations.

These additions to the list of matters requiring all-lender consent may not generally be controversial, but more extensive restrictions can be difficult for corporate borrowers to respond to. If such additional restrictions are aimed at closing off routes which certain borrowers have exploited to their advantage in the course of restructurings, the principle behind the changes (the desire to avoid back-door avoidance and abuse of the minority) may seem reasonable.

On the other hand, corporate loan documentation should not be engineered beyond what is required in the circumstances at which it is aimed. If the amendments and waivers provisions in corporate loan documentation move closer towards the provisions that are employed in the leveraged loan market, that raises the question of whether borrowers might also need the provisions customarily included in leveraged agreements to mitigate the consequences of a broad list of matters requiring all-lender consent. These include “you-snooze-you lose” clauses, which, although invoked in a handful of cases involving larger syndicates, are generally not considered appropriate or necessary outside the leveraged market.

### **3.5. Finance party default and market disruption**

#### ***The Lehman provisions***

The risk of lender default under a loan agreement is a risk factor the loan market moved swiftly to address following the collapse of Lehman Brothers.

The LMA published a set of optional clauses for dealing with “Finance Party Default and Market Disruption” in 2009. These are often colloquially referred to as the “Lehman” provisions. They contain provisions addressing the potential consequences of a Finance Party default plus alternative versions of the market disruption and cost of funds provisions.

The Lehman provisions were incorporated in full into the Leveraged Agreement shortly after publication.

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Only the “cashless rollover” provisions, which provide for cashless repayment and drawing on the rollover of a revolving facility loan, have been incorporated into the Investment Grade Agreements and the other LMA recommended forms. The remainder are still presented as optional clauses.

### ***Defaulting Lenders and Impaired Agents***

The bulk of the Lehman provisions address the consequences of a lender becoming a “Defaulting Lender”. In summary, a Defaulting Lender is a lender:

- which fails to fund, or gives notice that it will do so;
- which rescinds or repudiates a Finance Document; or
- in respect of which an “Insolvency Event” occurs.

For facilities incorporating fronted letter of credit facilities, the definition of a Defaulting Lender is extended to include a fronting bank (an “Issuing Bank” in LMA terminology) whose credit rating has deteriorated below an agreed minimum.

Once a lender becomes a Defaulting Lender, the following provisions are triggered:

- The borrower can cancel the undrawn commitments of the Defaulting Lender, which can be immediately or later assumed by a new or existing lender selected by the borrower.
- The participation of the Defaulting Lender in the revolving facility is automatically termed out and can be prepaid (an optional provision).
- The Defaulting Lender can be forced to transfer its participation in the facilities to a new lender at par.
- No commitment fee is payable to the defaulting lender (an optional provision).
- The defaulting lender is disenfranchised to the extent of its undrawn commitments and on its drawn commitments if it fails to respond in the specified time frame (“you snooze you lose”).
- The identity of a Defaulting Lender may be disclosed by the agent to the borrower.

Similar provisions allow an “Impaired Agent” to be removed by Majority Lenders, and for borrowers and lenders to make payments to each other and to communicate with each other directly, rather than through the Agent.

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Although these provisions have still not been incorporated into the Investment Grade Agreements, the “Defaulting Lender” and “Impaired Agent” provisions are widely used in many jurisdictions (such as Germany, the Netherlands and the UK) and, while not the norm, are starting to appear with more frequency in others (for example, Spain). Where used, these provisions are generally not the subject of extensive discussions. This applies also to the Defaulting Lender mechanics for swingline loans that form part of the Lehman provisions.

The Lehman provisions also include clauses which aim to protect Issuing Banks by providing a mechanism for cash collateralising the obligations of any lender with a rating below the agreed minimum requirement, or which is a “Defaulting Lender”. These provisions have not been used as extensively as other aspects of the Lehman provisions because the availability of fronted syndicated letters of credit has decreased considerably in recent years, due to a lack of institutions willing to act as Issuing Bank and to take credit risk on the syndicate members from time to time. However, where this structure is used, the Lehman mechanics provide valuable protections to the Issuing Bank(s) and are generally incorporated.

### ***Reference Banks and Market Disruption***

Other elements of the Lehman provisions are less widely used.

Alternative definitions of Euribor/LIBOR provide the option of using Reference Bank rates from the outset, rather than Euribor/LIBOR as published on screen. These have not found much favour and, in light of more recent developments in that area (see section 3.2 above), that does not seem likely to change.

Also comprised in the Lehman provisions, but not often adopted, are some alternative market disruption provisions, which are intended to reduce the likelihood of lenders charging the borrower interest at their individual cost of funds upon the occurrence of a “Market Disruption Event”. These provisions are long and complicated, which is perhaps the reason why they are not often incorporated into corporate loan agreements. However, given that they introduce an additional requirement for Reference Bank quotes into the agreement, it would seem unlikely that they will gain further traction in the current environment for the same reasons as the abandonment of Screen Rate Euribor/LIBOR.

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## 3.6. Loan documentation before the courts

*In summary:*

- *As a result of the downturn, a number of disputes with regard to the correct interpretation of loan documentation along LMA lines have come before the English courts, specifically, “no material adverse change” provisions and aspects of the insolvency events of default.*
- *Contractual construction cases are fact-sensitive and many of the English decisions are first instance decisions only. Nonetheless, the views that the courts have taken on these important aspects of loan documentation have had or may in future have an impact on documentation terms.*
- *To the extent these decisions colour future documentation discussions, they are of interest to lenders and borrowers involved in the English law loan market and to the extent influenced by trends in English law commercial terms, the European loan market more generally.*

### **Material adverse change**

Under most loan agreements, the occurrence of a material adverse change (“**MAC**”) affecting the borrower and/or its group has the potential to trigger a misrepresentation (and thus the misrepresentation event of default) and separately, if applicable, any “no MAC” event of default.

A representation from the borrower/obligors that no MAC has occurred since the last set of financial statements is customary and is included in all of the LMA recommended forms. A MAC event of default is optional in the Investment Grade Agreements, but nowadays is included in the loan agreements of all but the strongest credits.

Although parties to loan documentation often seek to define the sorts of circumstance which will give rise to a MAC, what constitutes a “material adverse change” is difficult to answer definitively. Hence two 2013 English decisions on the interpretation of LMA-style no MAC provisions generated significant interest. The first concerned a “no MAC” representation, the second, a “no MAC” event of default.

### **Grupo Hotelero – “no MAC” representations**

In *Grupo Hotelero Urvasco S.A. v Carey Value Added S.L. & Anor*<sup>39</sup>, the commercial court was called on to determine whether the financiers of a newbuild hotel in London were

39 [2013] EWHC 1039.

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justified in cutting off the developers' funding in reliance on the breach of an LMA-style representation that there had been no "material adverse change" in the financial condition of the relevant companies since the relevant date.

The judgment provides some interesting guidance on the interpretation of MAC provisions in loan documentation. The judge was of the view that the "change" in question must be more than just temporary to trigger a MAC. He went on to sum up his construction of the representation in question as follows:

*"Under such terms, the assessment of the financial condition of the borrower should normally begin with its financial information at the relevant times, and a lender seeking to demonstrate a MAC should show an adverse change over the period in question by reference to that information. However, the enquiry is not necessarily limited to the financial information if there is other compelling evidence. The adverse change will be material if it significantly affects the borrower's ability to repay the loan in question. However, a lender cannot trigger such a clause on the basis of circumstances of which it was aware at the time of the agreement. Finally, it is up to the lender to prove the breach."*

From a drafting perspective, the judge's view that the reference to a change in "financial condition", in the absence of "compelling evidence" to the contrary, should be assessed by reference to the company's accounts is notable. An example of such "compelling evidence" would be the existence of a payment default.

That is potentially quite a difficult argument as the "no MAC" representation may not be made on a date upon which financial information is delivered against which to assess the change. For example, in the investment grade market the "no MAC" representation is generally made only on the signing date by reference to the last audited accounts and is not a repeating representation.

The judge felt, however, that the "financial condition" of a company during the course of an accounting year is "usually" capable of being established from interim financial information and/or management accounts. He noted that the reference to "consolidation" in the representation (which also appears in the LMA wording) provides contextual support for that view. A significant chunk of the judgment is thus devoted to the expert evidence extrapolating the company's financial position as at the date of the alleged MAC, from the accounts published closest to the relevant time.

The case nonetheless appears to confirm that the MAC which includes "*events which have a material adverse effect on a company's business covers a broader scope than the MAC which is limited to the company's financial condition*". The judge's comments suggest that if it is intended that external factors (i.e. broader economic circumstances) should be taken into account in determining whether a MAC has occurred, express clarification in the text of the representation is prudent.

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The judge in *Hotelero* also expressed the view that the adverse change will only be material (again, absent express words to the contrary), if it significantly affects the borrower's ability to meet its payment obligations. This narrow construction could have implications for the approach which is often adopted in the context of "no MAC" events of default, of defining what is meant by a material adverse change or "Material Adverse Effect" (which generally will lead to a more broad-ranging result).

### ***Repetition of "no MAC" representations***

In leveraged loans, in contrast to investment grade loans, it is not unusual for the "no MAC" representation to be a repeating representation. One particular aspect of the *Hotelero* judgment may have influenced some recent changes made by the LMA to the Leveraged Agreement.

Although the judge decided that, on the facts of *Hotelero*, a breach of the "no MAC" representation had occurred, that was ultimately of no consequence because of a technical timing issue. At the point at which the lenders took action, the no MAC representation was not repeated.

In May 2013, following the publication of the *Hotelero* judgment, the Leveraged Agreement was altered to provide, optionally, for the "no MAC" representation to be repeated on a more frequent basis, although the LMA did not indicate whether this change was connected.

As mentioned above, in the investment grade loan market, the "no MAC" representation is not usually a repeating representation, hence this issue does not arise. We are not aware that this change is being incorporated into leveraged loan documentation generally in any event.

### ***Cukurova Finance – "no MAC" events of default***

The second English case, *Cukurova Finance Intl Limited v Alfa Telecom Turkey Ltd (BVI)* [2013] UK PC 2 concerned the correct construction of a "no MAC" event of default, similar in formulation to the equivalent provisions of the Leveraged Agreement<sup>40</sup>.

The clause referred to "*an event or circumstance which in the opinion of [the lender] has had or is reasonably likely to have a material adverse effect on the financial condition, assets or business of [the borrower]*".

The Privy Council held that for the purposes of that clause, while the event need not objectively have a material adverse effect, it was essential that the lender believed that it had such an effect (in other words, that the lender had formed that opinion), and that

40 The no MAC event of default in the LMA Leveraged Agreement applies if: "*Any event or circumstance occurs which the Majority Lenders reasonably believe has or is reasonably likely to have a Material Adverse Effect*".

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that belief was rationally and honestly held. Although the MAC left the determination to the lender's discretion, it did not follow that a court would not review the exercise of that discretion to ensure it was rational and honest.

*Cukurova* confirms that an event of default drafted in these terms in an English law agreement sets a low benchmark for lenders to satisfy; on the facts, it was sufficient that the lender was able to produce a paper trail of board minutes and witness statements showing that the determination had been properly formed by the ultimate "directing minds" of the lender. The Privy Council did not consider whether, objectively, the decision was correct or examine the underlying reasons for the determination; it was simply concerned that the lender had given the issue due consideration.

A similarly worded event of default was considered by the English commercial court in *Torre* (see section 3.3 above). In circumstances where the agent was "entirely relaxed" about the borrower's proposal to roll-up certain cash pay interest, it could not be said that the proposal constituted an event or circumstance which was reasonably likely to give rise to a MAC "in the reasonable opinion of the Agent".

Accordingly, under English law, if the parties wish an objective standard of reasonableness to apply to a "no MAC" event of default (i.e. for the lender to exercise its discretion reasonably), which most borrowers will seek to negotiate, that should be expressly specified.

### ***Insolvency event of default***

The insolvency event of default in the LMA's recommended forms is broadly drafted and often the subject of discussion. It encompasses the insolvency of any member of the group on either a cashflow basis (where it is unable to pay its debts as they fall due) or a balance sheet basis (where the value of its assets is less than the amount of its liabilities, taking into account contingent and prospective liabilities). However, due to the drafting, the event of default may be applicable in a wider range of circumstances.

In the English law Investment Grade Agreements it reads as follows:

- "(a) A member of the Group is unable or admits inability to pay its debts as they fall due, suspends making payment on any of its debts, or by reason of actual or anticipated financial difficulties, commences negotiations with one or more of its creditors with a view to rescheduling any of its indebtedness.*
- (b) The value of the assets of any member of the Group is less than its liabilities (taking into account prospective and contingent liabilities).*
- (c) A moratorium is declared in respect of any indebtedness of any member of the Group."*



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A particular difficulty with this event of default is that it is potentially capable of being triggered at a point which is earlier than the point at which a company would be considered to be insolvent as a matter of applicable law.

In some jurisdictions, where clear statutory provisions determine insolvency (for example, in Germany), general practice is therefore to limit this event of default by reference to applicable insolvency statutes. In jurisdictions where the limits of the statutory test for insolvency are the subject of some uncertainty (for example, and as highlighted below, the UK), borrowers may seek to limit this event of default in other ways.

### ***Grupo Hotelero and Torre – rescheduling***

The English commercial court has had cause to consider the second half of the first limb of the LMA’s insolvency event of default in two recent cases already mentioned.

In both *Grupo Hotelero* and *Torre* whether the borrower had “*by reason of actual or anticipated financial difficulties*”, commenced “*negotiations with one or more of its creditors with a view to rescheduling any of its indebtedness*” was disputed.

In *Grupo Hotelero*, the reference to “*rescheduling*” was held to imply a degree of formality and should thus be construed as referring to a formal deferment of debt service payments and the application of new and extended maturities to the deferred payments.

The judge made a distinction between ordinary course discussions with lenders about rescheduling and a formal agreement being put in place. “*Rescheduling*” (in his view) requires a degree of formality (a “coffee shop” discussion about more time to pay should not suffice).

The clause, however, provides that the event of default occurs when the company “*commences negotiations with one or more creditors...*” with a view to rescheduling, so does not require a formal step.

The borrower’s primary protection against the clause having an unreasonably wide ambit is that the commencement of such negotiations will only trigger the event of default if by reason of “*actual or anticipated financial difficulties*”.

It was therefore held that these “*financial difficulties*” must be of a substantial nature for the purposes of this event of default and need to be assessed against the factual matrix.

The construction was cited with approval and applied to a similarly worded insolvency event of default in *Torre*. In that case, the borrower’s difficulties (evidenced by its request to roll up cash pay interest) were held to be of a “substantial” nature given the factual matrix. The interest in question was a significant part of the debt service obligations (7-8%); therefore in the judge’s view the borrower’s inability to service that part was evidence of a financial difficulty of a substantial nature.

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### ***Eurosail – construction of balance sheet insolvency events of default***

*BNY Corporate Trustee Services Limited & Ors v Eurosail plc*<sup>41</sup> concerned the construction of the English statutory “balance sheet” insolvency test. In *Eurosail* the Supreme Court, in summary, confirmed that the statutory test for insolvency under section 123(2) of the English Insolvency Act 1986 does not necessarily require the court to take into account all of the company’s prospective and contingent liabilities. The extent to which the court looks forward will depend on the circumstances.

Although the LMA’s drafting largely tracks the language of the statutory test, the LMA language does not refer to any statute. Accordingly, the intention might seem to be to give the words their ordinary meaning.

However, as it will not be practically possible to quantify all of a company’s contingent and prospective liabilities, it will be necessary to draw the line somewhere. Thus it is possible that a court may interpret the line in accordance with the English statutory test in an English law agreement, which means that the construction in *Eurosail* is potentially relevant.

The possibility remains, however, that a court may interpret the words more broadly, meaning that this paragraph as drafted could require the group to monitor the net asset position of its members on a more stringent basis than is required for either accounting or insolvency purposes.

Accordingly, stronger borrowers often try to delete this limb of the LMA insolvency event of default on the basis that the reference in the first limb (quoted above) to the inability (or admitted inability) of a company to pay its debts as they fall due or being unable to pay its debts as otherwise adjudicated by a competent court provides adequate protection (and probably incorporates the English law balance sheet test in any event, which is potentially preferable to the LMA’s iteration).

An alternative approach sometimes taken if deletion is not achievable, is to exclude specifically from the LMA’s balance sheet limb of this event of default any members of the group which are, or might be during the term of the facilities, in breach of this provision on an accounting basis.

## **3.7. Other issues**

### ***Euro break-up***

The impact of the fragmentation of the euro on loans denominated in euro was the subject of extensive debate during late 2011 and 2012.

41 [2013] UKSC 28.

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A number of alterations were subsequently made to loan documentation (including the LMA's recommended forms) with a view to minimising any risk of re-denomination should one or more countries exit the euro. These are, in the main, technical and very minor, for example, the incorporation of a definition of "euro", the payment obligations in most corporate loan documentation being considered at the safer end of the risk spectrum for that purpose.

More wide-ranging provisions were debated in relation to certain transactions at the height of the crisis (for example, whether the exit of a particular country or countries from the euro should constitute an event of default or cause a loan denominated in euro to convert automatically into US dollars). In our experience these were adopted in a very limited number of cases. This topic has largely disappeared as a focus of discussion over the past year or so.

### ***Acceleration rights in Spanish law facility agreements***

The LMA recommended forms, including the Spanish law agreement, provide that the lenders' rights to accelerate the loan and to enforce security are exercisable by the agent (or security agent, where applicable) upon the instructions of Majority Lenders.

In a number of Spanish facility agreements, this position is negotiated. Lenders are seeking individual rights to accelerate, which are exercisable subject to conditions. This is the position taken in the Spanish market by most Spanish banks, in particular in relation to payment defaults.

### ***Mandatory costs***

"Mandatory Costs" are essentially regulatory costs incurred by lenders in relation to their lending function, which the lenders are entitled to pass on to the borrower.

A mechanism for the reimbursement by the borrower of lenders' Mandatory Costs used to be a customary feature of English law loans funded out of London or the euro zone.

The LMA recommended forms provided for these mandatory costs (Bank of England or European Central Bank costs, depending on whether the lender lends from London or from an office in the euro zone) to be calculated on a lender by lender basis, and others (Financial Services Authority fees<sup>42</sup>, payable by lenders who lend from a facility office in the UK), based on an average rate.

The calculation formula was maintained by the LMA in a standalone Mandatory Costs schedule for insertion into the recommended forms as required, updated annually to reflect changes in the regulatory regime. This schedule was incorporated into virtually all

42 Now, Financial Conduct Authority fees, following the replacement of the Financial Services Authority last year.

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loan agreements governed by English law. It was also used for cross-border financings in some other European jurisdictions, for example, Germany.

In January 2013, however, the LMA announced its intention to cease updating the mandatory costs schedule for use in conjunction with its recommended forms of facility agreement. The background to this decision is that operational difficulties in calculating Mandatory Costs meant that in many cases (and in particular on non-sterling loans), such costs were not being passed on to the borrower. In April 2013, all of the LMA's recommended forms were amended to make the charging of Mandatory Costs optional.

Since then, it has become common in loan documentation which previously adopted the formula approach to dispense with the concept of Mandatory Costs altogether, although some transactions continue to include an updated version of the LMA formula.

We are not aware that this change has had any impact on practice in countries such as Spain, where the concept of mandatory or “ancillary” costs is addressed in general terms rather than by reference to the LMA formula.

### ***Unilateral jurisdiction clauses***

The operation of the jurisdiction clause and the parties' choice of jurisdiction is not usually controversial but jurisdiction provisions in loan documentation have been the subject of discussion in certain transactions as a result of the 2012 decision of the French Cour de Cassation in *Ms X v Banque Privee Edmond de Rothschild, No 11-26.022*<sup>43</sup>.

In the European syndicated loan market, so-called “unilateral” jurisdiction clauses are used routinely (and included in all of the LMA recommended forms<sup>44</sup>). Such clauses provide that the borrower is permitted to bring proceedings only in the chosen jurisdiction (e.g. the courts of England) and the Finance Parties are free to bring proceedings where they please.

Provided one of the parties is domiciled in the EU, the efficacy of such clauses in conferring jurisdiction on the courts of an EU member state is governed by EC Regulation 44/2001 (“**Brussels I**”)<sup>45</sup>. In *Rothschild*, the Cour de Cassation ruled that “unilateral” jurisdiction clauses are “potestative” and therefore contrary to the object and purpose of Article 23 of Brussels I.

The reasoning does not indicate whether the Cour de Cassation based its decision on principles of French law or the interpretation of Brussels I (which as an EU Regulation forms

43 26 September 2012, judgment available only in French.

44 Except, since June 2014, the French law version of the Investment Grade Agreement, see further below.

45 Similar rules apply in the Lugano Convention – relating to the EFTA countries, except Liechtenstein and Denmark – although not mentioned further here.

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part of the law of all EU member states). Thus *Rothschild* potentially casts doubt on the validity and effectiveness of unilateral jurisdiction clauses across the EU.

It is, of course, by no means clear that other member states would adopt the same interpretation of Brussels I as the Cour de Cassation. Scholars in a number of countries have cast doubt on the compliance of the ruling with EU law. Although in some jurisdictions there are no domestic court decisions addressing this point specifically (for example, in Spain) there is recent English law, German law and Italian law authority upholding the effectiveness of such clauses.

Faced with the existence of a contrary ruling from an appellate court, other EU courts may have to refer the matter to the Court of Justice of the European Union (“**CJEU**”) to determine the correct interpretation of Article 23. Even if the CJEU overturned *Rothschild*, the proceedings would be subject to delay and uncertainty pending a final determination.

The key risk for lenders is that the borrower could, as a result of this decision, choose to test the restrictive nature of an LMA-style jurisdiction clause by bringing or contesting proceedings in courts other than those to whose jurisdiction it has submitted contractually. In transactions where the enforceability of the clause might fall to be considered by the French courts or other courts which might be thought more likely to follow *Rothschild*, lenders might consider an alternative approach to the jurisdiction clause.

In light of *Rothschild*, most French law credit agreements now adopt exclusive jurisdiction clauses applicable to lenders as well as borrowers. The French law version of the Investment Grade Agreement has recently been amended to reflect that position. As mentioned above, there has been significant criticism of the legal basis of the decision, so the circumstances in which unilateral jurisdiction clauses have been abandoned in loan documentation governed by the laws of other countries are limited.

The main alternatives to a unilateral jurisdiction clause are outlined in a note circulated by the LMA to members in January 2013 in response to *Rothschild*. The note does not make any recommendations as to the appropriate course of action, reflecting that the extent of the risk of invalidity and the appropriate solution will vary depending on the circumstances of the transaction.

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## 4. THE ADVANCE OF THE LMA

### 4.1. Primary documents

The LMA's collection of primary documentation is now widely used as a starting point for negotiations, in both the European loan market and elsewhere. In recent years, it has become ever-more extensive.

There are now 11 different English law permutations of the Investment Grade Agreements. The Investment Grade Agreement is available in single currency or multi-currency versions, incorporating term and/or revolving facilities. Separate euro or dollar swingline versions of each of the agreements which include a revolving facility are also available. A version of the multi-currency term and revolving facilities agreement incorporating an updated version of the LMA's letter of credit option is the most recent addition to the suite, published in June 2014.



German and French law versions of the Investment Grade Agreement (the multi-currency term and revolving facility) have been available for some years. More recently, the LMA added a Spanish law version. These documents largely track the terms of the Investment Grade Agreement save for changes necessitated by the governing law. The French law document is published in both English and French. The German law version is available only in English. The Spanish law version is available only in Spanish. No Italian or Dutch law version has been prepared to date.

The LMA also continues to expand its collection of recommended forms of primary document for more specialist products, including real estate, developing markets, pre-export finance and leveraged lending. The provisions of each of these are tailored to the product in question.

The most recent addition to the LMA's leveraged suite is a form of super senior revolving credit facility and related intercreditor agreement for use in leveraged transactions where any term debt requirements are financed in the bond market. The facility agreement is

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modelled on the Leveraged Agreement but is in some respects significantly different. Its most notable feature is that it contains no restrictive covenants; it assumes (in accordance with market practice) that the loan agreement will incorporate the bond covenants. To ensure that these covenants are interpreted on consistent basis across the capital structure, although the agreement is governed by English law, it makes provision for the covenants to be interpreted in accordance with New York law.

The advance of the LMA collection is expected to continue. We understand that further English law real estate and leveraged documentation is currently in progress. A suite of South African law LMA documents is anticipated in the near future, following the integration of the African Loan Market Association into the LMA in November 2013. The LMA has also become involved in products other than syndicated loans, publishing a guide to Schuldschein loans and announcing its intention to produce a form of English law loan agreement for private placements.

As the LMA's reach expands, it is important for borrowers to be aware that while all of the primary documents take the familiar LMA form, only the Investment Grade Agreements are discussed between the LMA and a separately represented borrower-side trade association (the ACT) before being revised. LMA documentation is therefore presented only as a starting point for negotiations with the expectation that each agreement will require amendment, quite significant in some cases, to reflect both the transaction structure and the commercial requirements of the parties.

The English law Investment Grade Agreements benefit from the endorsement of the ACT. As a result, on the whole the Investment Grade Agreements represent a reasonable balance between the interests of the lenders and the interests of the borrower group. Nonetheless, they contain a number of provisions which are commonly negotiated by well-advised borrowers<sup>46</sup> and should be treated as a starting point in the same way as the other LMA recommended forms.

## **4.2. Recent changes to the primary documents**

Many of the recent changes to the LMA's primary documents relate to the items discussed in the foregoing sections of this booklet. The table below summarises the key substantive changes made to the Investment Grade Agreements since the beginning of 2012.

Changes to the Leveraged Agreement can be relevant to the loan market more generally as it is used by lenders as a source of ideas for cross-over or sub-investment grade loan terms in the corporate market. The table therefore also highlights the key changes to the

<sup>46</sup> The ACT Borrowers' Guide to LMA Documentation for Investment Grade Borrowers contains a detailed commentary on the provisions of the Investment Grade Agreements from the borrower's perspective. The Guide is available from [www.slaughterandmay.com](http://www.slaughterandmay.com) or [www.treasurers.org](http://www.treasurers.org).

Leveraged Agreement over the same period which tend to, or have the potential to, spill over into corporate loan documentation.

Date	Issue	Investment Grade Agreements	Leveraged Agreement
January 2012	New forms of Investment Grade Agreement incorporating updated euro/\$ swingline option.	Yes	N/A
August 2012	Optional currency definitions and other minor alterations to currency/payment provisions prompted by euro exit concerns.	Yes (June 2014)	Yes
September 2012	Zero floor added to IBOR definitions.	Yes (June 2014)	Yes
September 2012	Status representation altered to prevent any obligor from changing its jurisdiction of incorporation after the date it accedes to the agreement.	No	Yes
September 2012	Comprehensive revisions to agency provisions including extension of borrower's indemnity obligations.	Yes (June 2014 but in slightly modified form, see section 3.3)	Yes
September 2012	New clause provides that the proceeds of any voluntary prepayment shall be applied pro rata to each lender's participation in that utilisation (and alterations to that clause require unanimous lender consent).	Yes (June 2014)	Yes
September 2012	Anti-corruption representation and undertaking added.	No	Yes
September 2012	Structural Adjustment mechanic which permits changes to certain amendments to the structure, amount or currency of the facilities with the consent of Super Majority Lenders.	N/A	Yes



Date	Issue	Investment Grade Agreements	Leveraged Agreement
September 2012	Changes to governing law and jurisdiction clauses require unanimous lender consent.	Yes (June 2014)	Yes
April 2013	Mandatory Costs provisions marked as optional provisions.	Yes	Yes
April 2013	Addition of footnote to jurisdiction clause to highlight Rothschild decision.	Yes	Yes
May 2013	Addition of option to repeat “no MAC” representations at more frequent and regular intervals e.g. weekly/monthly.	No	Yes
May 2013	Various changes to reflect the best practice recommendations in the LMA’s Guidelines on transparency and the use of information e.g. new clause specifying circumstances in which agent is obliged to provide a list of lenders to the borrower.	No	Yes
July 2013	Revised IBOR definitions.	Yes	Yes
July 2013	Changes of footnote to Increased Costs clause to highlight finalisation of CRD IV.	Yes	Yes
May 2014	Further change to “Screen Rate” definition in relation to LIBOR (change of administrator) and further change to footnote to Increased Costs clause to note CRD IV now in force.	Yes	Yes
June 2014	Update of letter of credit provisions.	Yes	In limited respects
June 2014	Incorporation of FATCA “Rider 3” and FATCA common provisions.	Yes	Yes

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The LMA forms are revised on an ongoing basis to keep pace with legal and regulatory changes and market practice. Some changes are made to all of the primary documents at the same time; sometimes amendments are made to agreements of particular types only (for example, the leveraged agreements or the real estate agreements).

This may be because the relevant provision is not thought appropriate for all types of loan agreement, but sometimes amendments are delayed for practical reasons (the desire not to burden the market with too-frequent amendments or to “store up” minor amendments rather than making them on a piecemeal basis). This approach does mean, however, that it should not be assumed that the mechanical provisions of each of the primary documents are identical.

### **4.3. Usage**

Most new syndicated loans are based on the LMA’s recommended forms in the English market. Arrangers of syndicated deals are fairly likely to encourage borrowers with pre-LMA documentation to move their terms to the LMA format when they refinance, although a number of stronger credits prefer to and continue to use their own long-established terms with their relationship banks, subject to minor technical adjustments as required.

Usage of the LMA’s recommended forms is now the norm in cross-border deals too, in particular those involving larger syndicates.

In the domestic German market, the LMA format is also widely used (for all deals in excess of approximately €200 million). The same is true in France. In Italy, notwithstanding the absence of an Italian law LMA agreement, law firms often base their templates on the English law LMA agreements, adapted to address the requirements of Italian law.

That is not the case in other European jurisdictions. For example, individual law firm templates are used rather than the LMA’s recommended form for Spanish law transactions.

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## 5. OUTLOOK

**“Italy is experiencing a new wave of refinancings through bonds (including high yield) and renewed interest in Italian borrowers by foreign lenders. New measures being enacted by the Italian Government, allowing insurance companies and securitisation vehicles to lend directly to Italian companies, are likely to boost liquidity, enabling alternative debt providers effectively to participate in loan transactions.”**

Bonelli Erede Pappalardo

**“The French debt market has been boosted in the last few months by a strong recovery in M&A and capital markets activity. It is notable that an increasing proportion of financing transactions are combining traditional bank financing with high yield or other bond financing.”**

Bredin Prat

**“Although traditional bank financing appeared to be in retreat in favour of bond financing and other sources of (institutional) financing in 2013, this trend is now in reverse. Bank liquidity is again approaching higher levels offering borrowers relatively competitive financing conditions. At the same time, increased M&A activity on the back of a slowly recovering Dutch economy may drive an increase in borrower demand for bank finance.”**

De Brauw Blackstone Westbroek

**“In 2014 the market has seen a remarkable number of “amend and extend” transactions with borrowers using the very favourable market to lock in low margins and “lite” covenants for the next 5-7 years. There is an oversupply on the lenders’ side and it is not clear when the market may return to normal.”**

Hengeler Mueller

**“Current economic and market conditions suggest a positive outlook for the loan market although the process of regulatory adjustment remains ongoing. Continuing recovery in the UK and in the euro zone, the uptick in M&A activity and more buoyant equity markets should provide a more stable platform for increases in loan volumes. The liquidity and terms currently available are welcome news for lenders and borrowers.”**

Slaughter and May

**“The Spanish market is undergoing a significant recovery in the context of M&A transactions and capital markets. Bank liquidity is also increasing, while the volume of restructurings is steadily reducing. International banks are regaining interest in financing Spanish transactions.”**

Uría Menéndez

## SCHEDULE – SUMMARY OF IMPACT OF RATINGS ON LOAN TERMS

Note: The information below should be treated as an indicative guide to how loan terms differ according to the rating of the borrower. There are exceptions and the key terms of any loan will ultimately depend on a variety of different factors.

### 1. Investment Grade

Rating	AAA to AA-	A+ to A-	BBB+ to BBB-
Purpose	Backstop/ general corporate purposes including acquisitions	Backstop/ general corporate purposes including acquisitions	General corporate purposes including acquisitions
MAC event of default	No	Unlikely	Not unusual
Negative pledge	Yes (but loose)	Yes	Yes
Limitations on transactions (e.g. disposals, subsidiary indebtedness, mergers, further indebtedness/ change of business)	No	May be some (restrictions on disposals/ subsidiary indebtedness/ mergers/change of business)  Other restrictions unlikely	Some likely (restrictions on disposals/ subsidiary indebtedness/ mergers/change of business)  May be others
Financial covenants	No	If included, very loose	Not unusual
Upstream guarantees	Unlikely	Unlikely (other than from entities participating in loan)	Possible
Security	No	No	Unlikely
Restrictions on loan transfers	Yes (subject to exceptions)	Yes (subject to exceptions)	Yes (subject to exceptions)
Maturity	5-7 years	5 (+1+1) years	3-5 (+1+1) years
Pricing basis	Relationship	Relationship	Relationship and credit risk

## 2. Cross-over and speculative grade borrowers

Rating	BB+ to BB-	B+ and below
Purpose	General corporate purposes including acquisitions	General corporate purposes including acquisitions
MAC event of default	Likely	Yes
Negative pledge	Yes	Yes
Limitations on transactions (e.g. disposals, subsidiary indebtedness, mergers, further indebtedness/ change of business)	Yes	Yes (extensive)
Financial covenants	Yes	Yes
Upstream guarantees	Yes	Yes
Security	Possibly	Yes
Restrictions on loan transfers	Possibly (subject to exceptions)	Possibly (subject to exceptions)
Maturity	3-5 years	Varies
Pricing basis	Credit risk	Credit risk

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## OUR APPROACH

### The European Best Friends Group

This booklet has been prepared by the firms comprising the European “Best Friends” group.

We are the leading independent law firms in France, Germany, Italy, the Netherlands, Portugal, Spain and the UK. Each of us enjoys an unparalleled reputation for legal excellence and client service.

We provide a cross-jurisdictional legal service that genuinely reflects what “global” means for our clients and our cross-border capability is second to none.

In addition to our capacity in Europe, our extensive and meaningful relationships with market-leading firms from around the world underpin our approach to providing our clients with the “best of the best” global service.

### How does the Best Friends approach work in practice for our clients?

Our effectiveness is demonstrated by our success in winning the largest and most complex international mandates. As a group, we ensure clarity, coherence and agility.

- Our clients work with a single united team, with one leader. Projects are partner led, but this is carefully measured to be cost-effective and fair.
- Each project is managed from the jurisdiction which best suits the client and each project can render a single account.
- Flexible working and billing practices can be tailored to the client and the job.
- There is a high level of communication and understanding between firms. We have made long-term investments to help foster connections at all levels: we have extensive experience of working and sharing knowledge together; our working practices and approaches are aligned and cultures are appreciated.

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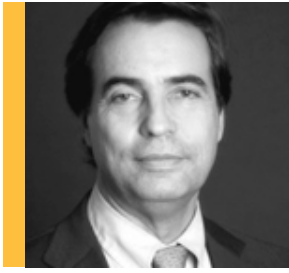
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