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What's Market: 2021 Mid-Year Trends in Large Cap and Middle Market Loans

by Practical Law Finance

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Experts' View: Rajani Gupta and Judah Frogel, Allen & Overy LLP

Rajani and Judah discuss auto-cure provisions, LIBOR, and COVID-related trends.

It's been over a year since the world changed due to the COVID-19 pandemic. How have borrowers and lenders continued to adapt their business practices and loan documents to address the pandemic? Which trends do you predict, if any, will remain a focus in the second half of the year?

At the outset of the pandemic, COVID-related addbacks to EBITDA and MAE carveouts for pandemic-related events, especially in directly affected industries, such as travel and leisure, were two key changes making their way into documentation. In addition, for affected credits with financial covenants, there was a wave of waivers and amendments. However, despite the overall sense of uncertainty surrounding the long-term impact of economic shutdowns and social distancing, as activity rebounded near the end of Q4 2020 and into 2021, loan documentation terms remained largely unchanged. COVID-related addbacks have since faded away and stronger credits and sponsors continue to enjoy more favorable terms as demand for the institutional loan product remains steady and default rates low. Market participants should expect continued focus on flexibility of restrictive covenants and EBITDA addbacks, but it appears no lasting remnants of the pandemic have made their way permanently into documentation.

How have lenders and borrowers responded to the uncertainty about the replacement rate for LIBOR?

With LIBOR cessation fast approaching, there is still uncertainty around which rate will ultimately replace USD LIBOR in the broader loan markets, and whether that rate will be a forward looking term rate or a daily rate. The markets have been aware of and preparing for LIBOR's cessation for some time now with robust fallbacks incorporated into the vast majority of loan facilities over the past three years (beginning with the streamlined amendment approach from 2018-2020 and then the hardwired approach gaining some momentum, then retracting a bit, over the past 18 months). While some borrowers and lenders have been hedging in recent months around the prospect of certain forward looking credit sensitive rates taking hold, the ARRC's recent announcements regarding the selection of CME Group as the administrator for Term SOFR and the likely recommendation of Term SOFR in the not-too-distant future are welcome developments that may lead to renewed commitment in the market to the ARRC's hardwired fallbacks with Term SOFR as the first step in the replacement rate waterfall.

Market watchers have observed introduction of an "auto-cure" provision in several credit documents. What is an "auto-cure" and what impact could this feature have on the leveraged loan market? What other negotiated points related to defaults and events of default have you seen in your practice?

"Auto-cure" provisions have been somewhat of a staple in European LMA style loan documentation

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for quite some time and have started to make their way into the US leveraged loan market over the last few years. Auto-cure provisions can take many forms, but in substance an auto-cure provision operates to retroactively cure a default once the facts and circumstances that gave rise to the default no longer exist. Put differently, if facts change, or the borrower affirmatively takes steps to remedy a default, the borrower will be back in the same position as if the default never occurred, and lenders can no longer terminate their commitments or exercise remedies based upon that now-remedied default. In certain circumstances, this notion may not be particularly concerning. For example, if a default occurred due to a short delay in the delivery of financial statements by the borrower, an auto-cure provision can be a useful tool to remedy the default once the delivery is made, without the expense and uncertainty of a lender waiver process. However, for breaches due to material misrepresentation or negative covenant non-compliance, auto-cure provisions can be a bit more troubling to lenders, as it may be difficult to ascertain what truly constitutes remedial facts and circumstances. Further, when it comes to financial maintenance covenants, which are aimed at measuring financial performance on a fiscal period-by-period basis, auto-cure provisions might provide that compliance in subsequent periods remedies non-compliance for past periods. This approach somewhat undermines the purpose of financial maintenance covenants to provide an ongoing barometer of company performance and can allow for systemic cash flow problems to go unchecked for longer and for lenders to lose their earlier proverbial "seat at the table." Parties have long negotiated cure and grace periods for payment delays, misrepresentations, and certain covenant defaults and that trend continues these days with some borrowers pushing for grace periods on late principal payments and expanding grace periods to cover more categories of defaults instead of only non-compliance with certain affirmative covenants. These types of grace and cure provisions allow for a more tailored approach and may be more appropriate for certain credits. That being said, auto-cure provisions are becoming more widely accepted in the top-tier market and if history is any indicator with terms once considered aggressive gaining market acceptance starting with top-tier deals, these provisions are likely to become more commonplace across the loan market more broadly.

An additional expansion in the negotiation of default provisions relates to the so-called "Windstream provisions." Some versions of these provisions operate to place a two-year statute of limitations around lender action for enforcement. This feature is more troubling for lenders, who historically had no time limit around their exercise of remedies, with most loan documents expressly stating that failure or delay in remedial action will not operate as a waiver of lenders' rights to exercise remedies in the future. While this feature continues to be resisted by lenders with greater frequency than auto-cure provisions, it is certainly becoming more prevalent in the top-tier market.

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