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

by Practical Law Finance

Status: **Published on 22 Jul 2021** | Jurisdiction: **United States**

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A review of trends in large cap and middle market lending in the first half of 2021.

Following a rollercoaster 2020, the US leveraged loan market started 2021 strong as fears concerning the COVID-19 pandemic abated amid the launch of the vaccine rollout. Spurred by low interest rates, repricings and refinancings drove loan issuance in the beginning of the year, with new money deals picking up in the second quarter. Special purpose acquisition company (SPAC) and sustainability-linked loan activity surged and direct lending remained a strong part of the market. Loan agreement negotiations continued to include discussions regarding LIBOR replacement and EBITDA addbacks. Attention was also given to addressing technical matters, such as the consequences of erroneous payments by administrative agents to syndicate banks and event of default cure provisions, among others.

Market Trends and Developments

Last March, at the start of the COVID-19 lockdowns, the most pressing issue for many borrowers was the preservation of liquidity. As a result, borrowers drew down their revolvers to bolster their cash reserves and new loan issuances plummeted. The second quarter of 2020 was especially hit hard. The loan market began to stabilize in the latter half of 2020, however, and as economic growth accelerated alongside the steady rollout of vaccines, there was a surge in activity in the loan market across many sectors. A strong start to 2021 and a strongly rebounding economy has given market participants cause for optimism that this increased activity will continue through the end of 2021 and beyond.

Total US syndicated lending climbed to a healthy $710 billion in the first quarter of 2021, up 13% year-over-year. Levels jumped even higher in the second quarter, reaching $764 billion, more than double the $375.88 billion recorded in the second quarter of 2020.

Leveraged loan issuance increased to $655.8 billion in the first half of 2021, an increase of 63% from the same period last year. First quarter levels posted roughly $357.8 billion and although issuance dropped in the second quarter to $298 billion, this represented a 122% jump compared to the $134 billion posted in the second quarter of 2020.

Investment grade loan issuance reached $329 billion in the second quarter of 2021, an increase of 82% compared to the $180.5 billion posted during the same period last year. Second-quarter investment-grade M&A lending levels remained steady at $42 billion while investment-grade refinancings totaled $258 billion.

US collateralized loan obligation (CLO) activity was strong in the first half of 2021; new-issue volume reached $42.4 billion in the second quarter, up 10% from the first quarter, while CLO repricing activity totaled $134 billion in the first half of this year. According to data from JPMorgan, global CLO issuance is likely to exceed $1 trillion. The uptick in CLOs represents a change from last year when the pandemic led to a dramatic fall in issuance. Market watchers anticipate investors may flock to CLOs if newly-emerged concerns about inflationary pressures in the economy persist.

Covenant-lite loan issuance remains a strong part of the leveraged loan market. According to Debtwire Par, cov-lite deals accounted for 84% of institutional loan issuance in 2020. Market observers anticipate that borrowers with healthy balance sheets, especially those which successfully weathered the pandemic, will continue to negotiate flexible covenant packages in their loan documents for the foreseeable future.

Repricing and refinancing transactions comprised roughly 74% of leveraged loan issuance in the first quarter of 2021, according to the Fitch US Leveraged Finance Market Insight Report. Refinancings totaled approximately

$184.7 billion in the first quarter and $79 billion in the second quarter. According to Debtwire, repricings surged to $122.8 billion in the first quarter. Repricing activity will likely remain elevated if the current low-interest rate environment holds and there is a shortage of new deals in the market. According to market participants, many borrowers are eager to reprice their loans and many issuers in deals where call protection still applies plan to do so as soon as the call protection expires.

New money loan issuance picked up in the second quarter of 2021 and topped $78.2 billion, contributing to a first half total of $155.5 billion, an uptick of 74% compared to the period through June 2020. M&A-related leveraged lending totaled $160.1 billion in the first half of the year ($93.8 billion for non-leveraged buyout (LBO) M&A transactions and $66.3 billion for LBO deals), an increase of 54% and 59% from the period through June 2020. According to market watchers, the leveraged loan market has recently experienced a push toward larger M&A financings. Sponsored leveraged loan activity posted $358.5 billion in the first half of the year ($292.2 billion for non-LBO transactions and $66.3 billion for LBO deals), an increase of 124% and 58% from the period through June 2020.

Market observers anticipate SPACs are also likely to push M&A activity higher in 2021 and beyond. SPACs comprised roughly 17% of the M&A market in the first quarter of 2021, totaling approximately $232 billion. Although SPAC issuance clocked in at $13 billion in the second quarter, a decrease of 87% according to data from Barclays, pending SPAC IPOS still make up a robust $71 billion of the current pipeline.

Dividend recap issuance surged to roughly $20 billion in the first quarter of 2021, a high not seen since 2016, according to data from S&P Global. Market watchers have observed investors turning to dividend payments as the economy rebounds and interest rates remain low. Private equity firms may face mounting political pressure to curb dividend re-capitalization issuance in the future. Some legislators, such as Massachusetts Senator Elizabeth Warren, have voiced concerns with the increasing number of firms funding dividends with debt proceeds and may support more regulatory oversight, though currently dividend recap activity remains undimmed.

Second lien loan issuance totaled $11.65 billion in the second quarter of 2021, marking the highest quarterly volume since the third quarter of 2018 and the highest first half of a year since 2014.

Middle market lending rebounded in the second quarter of 2021, posting $46.2 billion ($40.6 billion in large middle market deals and $5.6 billion in the traditional middle market). Issuance reached $76 billion through June 2021, an increase of 56% year-over-year.

Loan Terms

In addition to the usual commercial points of negotiation between borrowers and lenders, particular issues of note in the leveraged loan market during the first half of 2021 included:

Erroneous Payment Provisions

In response to the US District Court of the Southern District of NY's decision in the Revlon case (2021 WL 606167), many arrangers have started incorporating protective language in their credit agreements to address the consequences of accidental payments made by administrative agents to syndicate members.

The issue arose when the administrative agent under Revlon's credit agreement mistakenly wired to the bank group the full amount of all outstanding principal and accrued interest, instead of just sending each lender their interim interest payments. The agent was only expected to send approximately $8 million in interest payments but instead remitted more than $900 million to the bank group. Several lenders agreed to send back the principal they had mistakenly received (accounting for roughly $400 million), but the holders of the other $500 million refused. The District Court held that these lenders could keep the money they had received, citing the "discharge for value" defense, it ruled that because the lenders believed they were entitled to receive the funds and had no knowledge or notice that the payments were sent by mistake, they should not be required to return the money. The decision is currently on appeal.

The Loan Syndications and Trading Association (LSTA) published a Market Advisory and draft model form of an erroneous payment provision on March 19, 2021 (updated June 16, 2021). Under this form of provision, the administrative agent can demand repayment of any funds sent by mistake and lenders have a contractual obligation to return the amounts mistakenly paid. There are variations in provisions seen in the market. Some provisions include a claw-back cut-off date, after which the administrative agent is no longer able to demand the return of any payments erroneously sent. Although market data from Covenant Review suggests most credit agreements do not include a claw-back cut-off date, this may emerge as a point of negotiation between loan parties moving forward (for an example of a credit agreement amendment that includes an erroneous payment provision, see Eagle Materials Inc. sixth amendment to credit agreement and see also What's Market, Frontier Communications Holdings, LLC credit agreement summary for an example of a credit agreement that includes a claw-back cut-off date in the erroneous payment (revolving credit facility) provision).

Covenant Compliance

During the pandemic, many borrowers and lenders agreed to temporarily suspend the borrower's compliance with its financial covenants or make them less onerous. As a quid pro quo for financial covenant concessions, many parties added anti-hoarding provisions and minimum liquidity requirements to their credit documents, as well as tightening other negative covenants (see Article, COVID-19: Trends in Financial Covenant Relief Amendments). Market watchers have observed an unwinding of these types of concessions for many borrowers as the economy has bounced back and many borrowers are able to meet their original financial covenant tests.

EBITDA Addbacks

Borrowers and sponsors continue to seek extended forward-looking periods during which they can make pro forma EBITDA addbacks for anticipated cost savings and other synergies. In some cases, borrowers have been able to successfully negotiate longer-than-normal periods into their credit agreements (for an example of a credit agreement with a 36-month look-forward period, see What's Market, Leslie's Poolmart, Inc. credit agreement summary).

Some borrowers, whose businesses were negatively impacted by the pandemic, negotiated addbacks for one-time, extraordinary expenses related to COVID-19, while in other deals expenses related to the pandemic were specifically excluded though covenant levels in many cases were reset to accommodate borrowers' depressed EBITDA numbers. Some credit agreements have also permitted addbacks for lost earnings due to COVID-19 though this remains rare (for an example, see What's Market, CPI CG Inc. credit agreement summary and see also What's Market, Atlas Intermediate Holdings LLC credit agreement summary for an example where losses directly related to the pandemic are permitted, but not lost revenue or profits).

Market participants have also observed adjustments for costs that are "reasonably foreseeable" for a specific period of time. Examples can include costs and expenses related to pandemic planning, relocation assistance, equipment for remote employees, and cleaning supplies and protective gear. Market watchers have also seen COVID-19 addbacks included in compliance certificates, even if these addbacks have not been incorporated in the EBITDA definition.

Autocure Provisions

Breaches of loan agreement financial covenants are generally not curable unless the loan agreement includes an equity cure right. The purpose of an equity cure provision is to enable a borrower's parent or sponsor to directly inject cash into the borrower that is used to improve the measure of the borrower's performance for purposes of its financial covenant ratios so as to rectify any financial covenant default (see Practice Note, What's Market: Equity Cure Rights).

In an auto-cure provision, borrowers can take action to remedy a default or event of default which is then deemed cured. The borrower can take this action at any time after the initial breach unless the lenders have voted to exercise remedies. The effect of an autocure provision means that borrowers, and more importantly sponsors, are not limited by the applicable cure period for the default and have more time to consider and take into account the lenders' next steps before committing to fund a covenant cure.

Auto-cure provisions, which have been found in several large unitranche documents, have raised concerns among lenders. According to market participants, the right to cure at any time places almost all the power in a sponsor's hands; sponsors are no longer required to put up any cash, can extend the default date indefinitely, and can choose to exit the negotiation table at any time.

For more information on auto-cure provisions, see Box, Experts' View: Rajani Gupta and Judah Frogel.

Incremental Facilities

Borrowers continued to successfully negotiate permissive incremental loan facilities and weaken the scope of the most favored nations (MFN) provisions. Under MFNs, if the interest rate margin on an incremental loan is higher than that on the initial loan by more than a threshold amount, the interest rate margin on the initial loan is increased so that it is not more than a specified number of basis points less than the rate on the incremental loan. Although the MFN threshold amount has typically been set at 50 basis points (bps), practitioners have observed borrowers and sponsors increasingly negotiating higher threshold levels (for an example of a credit agreement with a 75 bps MFN, see What's Market, Petco Health and Wellness Company, Inc. summary and for an example of a credit agreement with a 100 bps MFN, see What's Market, Leslie's Poolmart, Inc. amended and restated credit agreement summary).

Parties also continue to negotiate MFN sunsets into their credit agreements, so that the MFN ceases to apply after a certain period after closing (for examples of credit agreements with MFN sunsets, see What's Market, PPD, Inc. credit agreement summary (six months), What's Market, WW International, Inc. credit agreement summary (12 months), and What's Market, Torrid LLC credit agreement summary (18 months)). It is also common for MFN protection to exclude certain categories of incremental debt, so that the debt can be incurred without triggering MFN protection for the initial loan, such as incremental loans:

- With a final maturity date later than the maturity date of the initial term loans under the credit facility (see What's Market, WW International, Inc. credit agreement summary (final maturity date more than two years after the initial term loan maturity date)).
- Incurred in connection with a permitted acquisition or investment (see What's Market, Franchise Group, Inc. first lien credit agreement summary) or incurred up to a ratio-based amount (see What's Market, Petco Health and Wellness Company, Inc. first lien credit agreement summary).
- Consisting of a bridge financing provided the bridge financing converts into long-term debt (see What's Market, Resideo Funding Inc. amended and restated credit agreement summary).

For more information on incremental facilities, see Practice Note, What's Market: Incremental Facilities.

Call Protection

Call protection, which requires a borrower to pay a prepayment premium or penalty if it prepays all (or a portion) of the loans, continues to be a common negotiated feature. In soft call provisions, lenders typically define repricing and refinancing transactions as those for which the primary purpose is lowering interest, with exceptions for certain transactions, including change of control, initial public offerings, and other transformative transactions. The change of control exception allows a sponsor to sell the borrower and repay the loans to recoup its investment without having to pay a prepayment premium. Transformative transactions are typically large-scale acquisitions, dispositions, and investments (for an example of a credit agreement with a call protection exception for transformative transactions, see What's Market, Paya Holdings III, LLC credit agreement summary). More recently, borrowers and their sponsors have requested a carve-out from call protection in connection with any material acquisition or disposition, as well as dividend recapitalizations (for an example of a credit agreement with a call protection exception for dividend recapitalizations, see What's Market, Signify Health, LLC credit agreement summary). See also Box, Experts' View: Kelly A. Lazaroff and Robert J Lewis.

Regulatory Developments

The change in the political landscape with the Biden administration may have significant ramifications for the leveraged lending market. While the Trump administration loosened many of the financial regulatory rules that were put in place in the aftermath of the global 2008-2009 financial crisis, President Biden may take a more stringent approach to financial regulation. The Biden administration's priorities also differ from that of its predecessor and its policies and their implementation may impact business activity and the direction of the leveraged lending market as the agenda takes shape.

In 2017, the Government Accountability Office effectively eliminated the Leveraged Lending Guidance (LLG) for technical legislative reasons under the Congressional Review Act. However, with the Democrats now in control, there may be renewed interest in mandating certain minimum underwriting standards. Secretary of the Treasury Janet Yellen, as well as Chairwoman of the House Committee of Financial Services Maxine Waters both previously backed the LLG.

Secretary Yellen has also voiced support for pulling non-bank financial institutions under a stricter regulatory umbrella. Alternative lenders hold an advantage in the loan market, as they do not face the same regulatory constraints as banks. Secretary Yellen recently stated that "We need to change the structure of the Financial Stability Oversight Council (FSOC) and build up its powers to be able to deal more effectively with all the problems that exist in the shadow banking sector. I think the structure is inherently flawed. I think the agencies need a definite financial stability mandate."

Market watchers are also keeping an eye on the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). In 2018, Congress passed the Economic Growth, Regulatory Relief and Consumer Protection Act, which rolled-back several oversight measures placed on banks under Dodd-Frank. Secretary

Yellen has praised Dodd-Frank, stating that increased regulations bolster the financial system, thereby setting the stage for a shift towards greater regulation in the future.

A key item on the Biden administration's agenda centers on climate change. According to market watchers, green banking and some regulation of the leveraged loan market may help push environmental initiatives forward. Pricing incentives and other favorable terms for borrowers incorporating environmental, social, and governance (ESG) measures into their loan documents are potential avenues to drive this change (see Sustainability Financing). The Biden administration's goal of net-zero emission targets may also play an indirect role on lenders' decisions concerning ESG metrics, according to market watchers. President Biden also earmarked $27 billion for a "Clean Energy & Sustainability Accelerator", also known as a green bank, in his American Jobs Plan, which supports and finances clean energy projects. For more information on significant Biden administration actions and initiatives on climate, energy, and environmental issues in 2021, see Practice Note, Biden Administration Energy and Climate Change Policies and Regulations: 2021 Tracker.

Interest Rates

The economic impact of the pandemic led the US Federal Reserve (Fed) to issue a series of interest rate cuts in 2020 in an effort to bolster the economy and steady the markets. In early March 2020, the Fed moved benchmark rates down by 50bps to a target range of 1.00% to 1.25% and then two weeks later slashed rates another full percentage point to bring them to near zero, where they have stayed since.

As was widely expected, the Fed decided to hold benchmark rates near zero at their June 2021 meeting. Despite an improving economic outlook, Fed Chairman Jerome Powell has indicated the need to adopt a cautious approach to tightening monetary policy to prevent a reversal in the country's economic fortunes. However, the Fed has indicated that interest rate rises may be expected in 2023.

In its deliberations regarding interest rates, the Fed must also keep a close watch on inflation, which Chairman Powell stated "... could turn out to be higher and more persistent than we expect." According to the Fed, inflation may reach 3.4% in 2021, a higher projection than the 2.4% predicted earlier this year.

Loan Defaults

Total leveraged loan default volume stood at $4.6 billion as of June 22, 2021, according to Fitch Ratings, significantly lower than the $37.1 billion recorded at the same time last year. Government aid, coupled with the vaccine rollout and re-opening of the economy, pushed levels down from the highs seen at the height of the pandemic. According to data from S&P Ratings, 20 rated US businesses defaulted as of April 22, 2021, considerably less than the 40 defaults reached in the same period last year. Fitch Ratings forecasts that the technology, healthcare and pharmaceuticals, and service and miscellaneous sectors (the three largest sectors of the institutional loan market) are likely to end the year with defaults rates at 1% or less. According to Fitch, the energy default rate is likely to reach 5% by year-end. The default rate for other sectors, especially areas hit hard during the pandemic, may be higher. According to Fitch Ratings, as of June 21, the projected default rate for the leisure and entertainment sector stood at 14%, while the retail sector was forecast to close at 7%. Market watchers are optimistic these industries will rebound as long as demand for travel and leisure activities continues to grow.

In June, Fitch Ratings decreased its overall 2021 default forecast to 1.5%, down from the 2.4% projected in May and 3.3% predicted in April. The current forecast is the lowest since 2011 (0.6%) and dramatically less than the 5% to 6% projected at the same time last year. According to Fitch, favorable conditions in the market may push this number even lower.

LIBOR Transition

On March 5, 2021, the ICE Benchmark Administration (IBA) announced publication of a feedback statement on its December 2020 consultation on IBA's intention to cease publication of all tenors of LIBOR settings (see Legal Update, ICE Benchmark Administration (IBA) Issues Feedback Statement on Intention to Cease Publication of LIBOR Settings). On the same date, in a related statement, the FCA announced that panel bank submissions for all LIBOR settings will cease (after which representative LIBOR rates will no longer be available) on the following dates:

- Immediately after December 31, 2021, in the case of all euro, sterling, Swiss franc, and Japanese yen settings, and the one-week and two-month US dollar settings.
- Immediately after June 30, 2023, in the case of the remaining US dollar settings.

Hardwired Fallbacks

US federal agencies have encouraged lenders to cease entering into new contracts that use LIBOR as a reference rate as soon as practicable, but by no later than December 31, 2021. New contracts entered into before December 31, 2021 should either use a reference rate other than LIBOR or have robust fallback language that includes a clearly defined alternative reference rate that would apply after LIBOR's discontinuation. Market participants should now be actively engaged in transitioning away from LIBOR to a successor rate (see Checklist, Loan Agreement LIBOR Fallback Checklist).

Under the hardwired approach, fallback language is included in the credit agreement that provides that the loan automatically converts to the specified successor rate after a trigger event occurs. This differs from the amendment approach, under which, following a trigger event, the borrower and the administrative agent facilitate a streamlined amendment to replace LIBOR by selecting a successor rate and a spread adjustment. The Alternative Reference Rates Committee (ARRC) has published recommended fallback language for various cash products including syndicated and bilateral loans. In an increasing number of loan deals the parties are incorporating hardwired fallback language into their loan documents in preparation for a successful transition to a replacement rate. A month-to-month breakdown of the percentage of deals that followed the amendment approach or incorporated hardwired fallbacks (based on an analysis of 229 publicly-filed deals) is as follows:

	Amendment	Hardwired
January 2021	24%	76%
February 2021	15%	85%
March 2021	13%	87%
April 2021	10%	90%
May 2021	10%	87%
June 2021	4%	94%

For more information, see Practice Note, What's Market: Hardwired LIBOR Fallbacks. For a guide that provides helpful resources and credit agreement LIBOR fallback language, see Toolkit, Loan Agreement LIBOR Fallback Language Toolkit.

SOFR and Credit Sensitive Rates

The ARRC has previously identified SOFR as its preferred LIBOR-alternative reference rate and there are currently several SOFR rates under consideration to replace LIBOR (including term SOFR and daily simple SOFR). Market chatter has indicated SOFR-based loans may actually be on the horizon in the near future. According to a report from Refinitiv, Ford Motor Co. recently hinted it may tie its loan to SOFR when it refinances its existing credit facility in the fall. It may not be the only one. According to the LSTA, the second half of 2021 may show an uptick in non-LIBOR loans because of the ARRC's recommendation that market participants cease issuing LIBOR-based loans by the end of June 2021.

Interest is also growing in credit-sensitive rates (CSRs) as alternatives to SOFR as possible replacements for LIBOR. Examples include the American Interbank Offered Rate (known as Ameribor) and Bloomberg Short-Term Bank Yield Index rate (BSBY). In response to member requests, the LSTA published sample language on April 8, 2021 for a rider that can be incorporated into hardwired fallback language so that loans may transition to a CSR (see Legal Update, LSTA Publishes Market Advisory Regarding Credit Sensitive Rate Option for LIBOR Fallback Language).

Chairman Powell voiced his support last year for Ameribor as another alternative rate to LIBOR for certain banks, citing its appeal to smaller and mid-size regional and community banks that fund themselves through the American Financial Exchange. Some banks have already indicated their preference for Ameribor. According to a report from the American Banker, Zions Bancorp, an $81.5 billion-asset bank, announced its intent to use Ameribor in most loan contracts starting this summer. Larger banks are also testing non-SOFR benchmarks (see Legal Update, Credit Sensitive Rates Appear in Loan Market). For an example of a credit agreement referencing BSBY, see What's Market, Duluth Holdings Inc. credit agreement summary.

Legislation

On March 24, 2021, the New York legislature passed a bill that provides a framework for the upcoming transition away from LIBOR for all contracts, securities, and instruments governed under New York law that use LIBOR as a benchmark and that do not otherwise include fallback provisions (see Legal Update, New York State Legislature Passes Bill Designed to Provide Smooth Transition Away from LIBOR). On April 6, 2021, Governor Cuomo signed this bill into law. The law is expected to have limited impact on the syndicated loan market.

In February 2021, Chairman Powell also hinted that the Fed is open to federal LIBOR legislation to ensure a smooth transition for legacy contracts to a replacement rate, stating that "...federal legislation creating a path for a backup would be the best solution, we think." Chairman Powell's testimony represents a shift from a statement he made last year, when he told lawmakers "in terms of the need for federal legislation, we have not reached a point where we think it's going to be necessary."

For more information on issues and considerations related to benchmark interest rate reform, see Practice Note, What's Market: LIBOR Interest Rate Provisions.

Sustainable Financing

Sustainability-linked loans (SLLs) continued to gain traction in 2021 as an increasing number of US companies looked for ways to incorporate more environmentally-friendly, sustainability, and good governance metrics and targets into their loan documents. For example, in March 2021 BlackRock Inc. amended its credit facility to, among other things, tie the margin on its loans to increasing its diversity efforts and meeting certain sustainability goals (see Legal Update, Growth and Increasing Diversity of the US Sustainability-Linked Loan Market). In a further example, in April 2021, General Mills added an ESG metric to its credit agreement to become the first borrower in the consumer packaged goods industry to execute an SLL-linked facility (for additional examples of sustainable financing credit agreements, see summaries for HP Inc. and Lam Research Corporation). As the SLL market matures, more different types of borrowers may enter into these facilities and more changes in the terms of these documents may emerge (see Legal Update, Market Developments for Green Loans and Sustainability-Linked Loans).

According to data obtained from Refinitiv on June 25, 2021, the global green loan and SLL volume was about $290 billion, up from about $85 billion for the same period in 2020. SLLs represented more than 90% of this volume, up from about 60% in 2020. Issuance of US loans with terms tied to sustainability targets topped $52 billion through May 21, a staggering 292% increase over the entire 12-months of 2020, according to data from Bloomberg. Market participants anticipate continued interest in SLLs in the US market, especially considering the Biden administration's focus on climate change and environmental matters.

SLLs are just one of the sustainable financing products in the market along with green loans, green bonds, social loans, and others but they are increasingly popular because of their availability to all types of companies and the diversity in the terms they offer. Unlike green financing products, SLLs do not have a use of proceeds provision which requires the loans to be used for a green or environmentally-friendly project or purpose. Rather, they are performance-based loans with terms (typically, interest rate margins) that adjust up or down depending on the borrower's ability to meet pre-determined sustainability performance targets (SPTs) as measured by pre-defined key performance indicators (KPIs). The KPIs that must be met are varied and range from environmental targets to increasing diversity in the borrower's board of directors.

The LSTA, together with the Loan Market Association (LMA) and the Asia Pacific Loan Market Association (APLMA) have published several documents relating to principles and guidance for sustainable financing. Originally published in 2019, the Sustainability-Linked Loan Principles (SLLP) and the Guidance on Sustainability-Linked Loan Principles (GSLLP) were most recently updated in May 2021 (see Legal Update, LSTA Publishes Revised Versions of the Sustainability-Linked Loan Principles and Accompanying Guidance). The 2021 updates were published in response to the dramatic increase in the volume of SLLs and are intended to promote transparency and integrity in the SLL market and tighten the language regarding the choice of KPIs and scope of SPTs. Key changes to the SLLP and the related GSLLP include:

- Providing a clear definition of the KPIs.
- Selecting creditable KPIs that are material to the borrower's "core sustainability and business strategy" and address ESG challenges in the borrower's industry.
- Establishing ambitious and appropriate SPTs with which the borrower must comply under an SLL transaction.
- Engaging an independent third party to verify the borrower's performance against each SPT for each KPI.

The updated SLLP and related GSLLP became effective for SLL transactions entered into on and after June 3, 2021.

For more information on SLLs and green financing, see Practice Notes, Understanding Green Loans and Sustainability-Linked Loans and What's Market: Green Loans and Sustainability-Linked Loans. See also Practice Note, Biden Administration Energy and Climate Change Policies and Regulations: 2021 Tracker and Box, Experts' View: Kelly A. Lazaroff and Robert J Lewis.

SPACS

Competition in the M&A space remains fierce as an increasing number of venture-backed companies turn to SPACs as a vehicle to complete acquisitions. A SPAC is an entity formed for the purpose of funding and completing a business combination. It offers an alternative to going public for a private company, while enabling it to raise capital in the public equity markets. SPACs are formed by sponsors with the experience and expertise of raising money in an IPO which is then used by the SPAC to acquire a private business. While the SPAC is a public company and the target is not, the SPAC must report the target's financial results combined with its own in consolidated reporting (for more information on SPACs, see Article, Recent De-SPAC Transactions).

SPAC IPO activity in 2021 is on course to eclipse even the record numbers observed in 2020. According to SPACresearch.com, US SPAC IPO issuance totaled 378 as of July 21, 2021 compared to 248 SPAC IPOs in the whole of 2020.

SPACS have successfully negotiated leveraged loan packages on market terms (even agreeing to covenant-lite terms although maximum leverage multiples are likely to be lower than in private equity deals). Both traditional banks and direct lenders have provided funding. According to market participants, a key trend that has emerged in leveraged loan negotiations involving private borrowers is to allow the acquisition of the borrower by a SPAC. In this case, the SPAC acquisition is treated as if it were a permitted IPO and does not constitute change of control under the loan agreement, which is commonly an event of default. An important practical advantage for a target company acquired by a SPAC is that it can refinance its debt using the SPAC's IPO proceeds, enabling it to delever and reduce its debt servicing costs and create a stronger balance sheet.

Some investors are concerned that SPACs may be part of a market bubble that may burst at any time. The House Committee on Financial Services also recently proposed legislation to regulate SPACs more stringently. The draft bill, which amends the Securities Act of 1933 and the Securities Exchange Act of 1934, looks to exclude all SPACs from safe harbor protection for forward looking statements.

Liability Management Transactions

During the past few years, multiple high-profile litigation cases, such as J. Crew, PetSmart, and more recently Serta Simmons Bedding, have pushed lenders to adopt measures that better protect their collateral from being used by borrowers to secure additional funding that is permitted under the breadth of their loan agreement permissions.

Drop-Down Financing

Following J. Crew, lenders turned their attention to the designation of "unrestricted subsidiaries" and the transfer to those unrestricted subsidiaries of material intellectual property assets outside of the existing collateral pool. In a drop-down financing, a company incurs new debt financing through a newly formed or designated unrestricted subsidiary or another non-guarantor subsidiary secured by assets technically outside of the existing collateral package. The borrower has taken the assets securing the new debt and either sold or transferred them to a subsidiary outside the credit group. Known as a "trap door" maneuver, the assets are now outside the reach of the existing secured creditors and can be used to obtain new financing.

As a way to prevent this movement of valuable assets outside the credit group, lenders continue to tighten their credit agreements and negotiate so-called J. Crew blockers. These blocker provisions may take many forms, such as requiring lender consent to designate an unrestricted subsidiary or restrictions on investments in or transfers of intellectual property or material assets to unrestricted subsidiaries.

For an example of a credit agreement with a J. Crew blocker, see What's Market, Petco Health and Wellness Company, Inc. first lien credit agreement summary.

Uptiering Transactions

A more recent trend involves the use of "uptiering." In a typical uptiering scenario, a subset of existing lenders delivers new "super-priority" loans to a borrower, which then receives enhanced lien priority over the existing collateral to secure their claims. Uptiering transactions commonly involve:

- Super-priority loans provided by a subset of existing lenders.
- "Rolling up" of existing debt of participating lenders into pari passu super-priority or second priority loans.
- Subordinating the existing loans of non-participating lenders to the new loans.

Practitioners expect uptiering transactions to remain a popular feature of the leveraged loan market in 2021. Negotiated points between loan parties are likely to center on numerous issues, including voting, waterfall distribution, pro rata sharing, intercreditor limitations, exit consents, subordination, and open market purchases. Some market participants have also broached the idea that lenders make subordination of claims or liens a sacred right in the loan agreement, which then requires a 100% vote of affected lenders.

For an example of an uptiering transaction, see What's Market, Owens & Minor Distribution, Inc. credit agreement.

For more information on liability management transactions, see Article, What's Market: 2020 Year-End Trends in Large Cap and Middle Market Loan Terms.

Direct Lending

In 2020, large US lenders' loan books fell for the first time in more than ten years, according to a Wall Street Journal report. According to the report, "Bank of America's loans and leases dropped by 5.7%, Citigroup's loans dropped by 3.4%, and Wells Fargo's shrank by 7.8%. Among the biggest four banks, only JPMorgan Chase had more loans at the end of the year than the start."

There is increasing competition for high quality credit and market watchers expect direct lending activity to continue to grow in the middle market. From a borrower's perspective, an appealing advantage of direct lending is that alternative lenders tailor their financing proposals more closely to the needs of an individual business and offer some of the benefits of traditional relationship lending. Unlike in the syndicated market, there is no syndication risk in direct lending leading to certainty of funds, as well as a speedier closing process, which is a significant advantage for a borrower in a competitive acquisition environment. Direct lenders may also be more willing to provide increased flexibility around leverage, amortization, EBITDA adjustments, and covenant limitations.

Market participants are also keeping watch on digital technologies, which they believe will be necessary to move the direct lending market forward post-pandemic. According to observers, the remote-work landscape and increased reliance on virtual mediums will lead many market participants to conduct business online, which will require investment in digital workflows and technologies.

Overall, practitioners predict the number of non-bank lenders entering the space, coupled with increased capital and economic growth, will continue to drive the market throughout the remainder of 2021.

Looking Forward

As the US economy continues to rebound, borrowers and lenders in new deals are expected to center much of their negotiations around the level of operational flexibility for borrowers in loan agreement covenant packages. Inflation is expected to remain a primary concern for loan investors throughout 2021, which may lead to increased investor demand for leveraged loans. Further COVID-19 waves caused by new variants may also have an impact on the loan market.

Lenders are also likely to watch the Biden administration closely for any tightening of regulations, which may impact certain sectors of the economy and have a knock-on effect on deal flow. Given the administration's emphasis on climate change, the sustainable-financing market is also likely to remain a popular segment within the leveraged loan market.

Market observers also expect borrowers and lenders to continue to prepare their loan documents for the discontinuation of LIBOR.

The market statistics cited in this article (unless otherwise stated) were provided by Refinitiv LPC, an LSEG business.

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 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.

Experts' View: Kelly A. Lazaroff and Robert J. Lewis, Sidley Austin LLP

Kelly discusses the role of the administrative agent and other key loan trends while Robert examines sustainability-linked financing.

In your practice, how has the role of the administrative agent shifted in response to recent court decisions such as Revlon, Chewy and Serta? What do you expect to see in the second half of 2021?

I have not seen a change in the role of the administrative agent in response to these developments and don't expect one. Administrative agents were, are, and always will be intent on articulating their narrow non-fiduciary obligations to lender group members. That said, most administrative agents have responded to the current environment by embracing a heightened (albeit in most cases, only modestly higher) degree of scrutiny to documentation flexibility that could be used nefariously in a way that undermines the administrative agent institution's underwriting of a credit and its broader reputation in the market. Generally speaking, administrative agents are cognizant that they are not going to be able to solve for every possible work-around, but to the extent they can make improvements and reduce the risk of looking foolish, they are going to do so.

Borrowers, on the other hand, will sharpen their focus on limiting the administrative agent's discretion around entering into intercreditor agreements and amendments providing for incurrence, partial refinancing or exchanges of debt. They will look to ensure that the failure of an administrative agent to act in the face of pressure from a lender group (or competing sub-groups thereof) or fear of liability does not preclude taking advantage of hard-fought flexibility.

What key issues do you think will be the focus in loan agreement negotiations in the second half of 2021?

Based on the current torrid market pace, I would expect to see continued focus on creating flexible financial definitions and capacity for debt incurrence, investments, and restricted payments. In my experience, when people are busy they have a tendency to focus on what matters most, and these are the areas that are going to determine immediate and near term opportunity to be nimble in response to economic developments, including tax changes.

Call protection and MFN terms for incrementals will similarly be top-of-mind, with both carve-outs and sensitivity thereto expanding given the dominance of dividend recaps in the first half of 2021, add-on acquisitions, and spin-offs supplanting new platform M&A as COVID-era EBITDA slowly rolls off the books, and pent up investor demand coupled with limited opportunity to deploy dollars. On call protection, in addition to the usual carve-outs for change of control, qualifying IPO (now defined to also pick up SPAC transactions) and transformative acquisitions, financial sponsors have been successful pushing through carve-outs for any material acquisition or disposition and even dividend recapitalizations, including in second lien issuances. MFN protection has pushed towards 75 basis points, though lenders continue to push back on abbreviated sunsets and acquisition exceptions.

Administrative agents, bank group members and borrowers will all continue to muddle through LIBOR replacement and, now, Revlon provisions. The former constituencies will try to preserve consistency across documentation at the same time as they are finding their footing institutionally and borrowers will continue to be compelled to have a say, however marginal, impractical or practically inconsequential it may be.

An increasing number of US borrowers have started adding sustainability metrics into their credit agreements, for example, General Mills became the first US consumer packaged goods company to enter into a sustainability-linked loan and BlackRock, Inc. amended its credit facility to, among other things, tie the margin on its loans to increasing its diversity efforts and meeting certain sustainability goals. What factors do you believe are supporting the growth of sustainability-linked loans and what do you expect to see in this area in 2021?

In late May 2021, the LSTA, the LMA, and the APLMA jointly published updated sustainability-linked loan principles (SLLPs). This update brought the prior SLLPs in line with existing sustainability-linked bond principles. Unlike green loans which focus on the use of loan proceeds for a specific ESG (Environmental, Social and Governance) objective, sustainability-linked loans are not limited in use of proceeds but instead introduce pricing incentives (and, in the best structures, pricing penalties) based on a borrower's achievement (or failure to achieve) specific ESG targets during the life of the loan.

Several factors have accelerated market participants' interest in this loan product. The prospect of reduced pricing has drawn the acute attention of borrowers. Both relationship and institutional lenders are addressing internal mandates, and community and investor demands, for loans that have ESG-positive characteristics. Regulatory attention to portfolio management linked to the credit risks of environmental change is also increasing.

With a combined focus on transparency and meaningfulness, the updated SLLPs require ongoing, independent third-party verification of a borrower's key performance indicators (KPI). The SLLPs also strongly encourage the engagement of an independent third-party to ensure that the initial selection of the KPIs are integrated into a borrower's publicly-articulated ESG strategies, and a larger ESG framework (for example, carbon neutrality by 2050 or expanding diversity in corporate management and governance), and that the selection of the annual KPI targets are meaningful both to the individual borrower and when compared to a borrower's industry peers. However, there is growing concern that the KPI targets do not represent meaningful improvements over borrowers' past performance in the selected KPIs or improvements over the borrower's industry peer group, so-called ESG-washing. Independent, third-party participation in the development of KPIs and the annual targets, as well as monitoring and auditing ongoing performance, will introduce an important re-evaluation of this loan product to ensure that it is both transparent and meaningful.