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Published by
Global Legal Group Ltd.
59 Tanner Street
London SE1 3PL, UK
Tel: +44 20 7367 0720
Fax: +44 20 7407 5255
Email: info@glgroup.co.uk
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Yankee Loans – What You Need to Know

Alan Rockwell

Denise Gibson

Allen & Overy LLP

Introduction

This chapter discusses what you need to know about Yankee Loans:

- What is a Yankee Loan?
- Evolution of the Yankee Loan market.
- Look back at the Yankee Loan market in 2016.
- Outlook for the Yankee Loan market in 2017.
- Summary of key structuring considerations for Yankee Loans.
- Comparison of certain key covenant provisions that differ between the US and European and Asian leveraged finance markets (and related credit documentation) which need to be taken into account for Yankee Loans.

What is a Yankee Loan?

"Yankee Loans" are term loans (typically, although not always, denominated in US dollars) that are syndicated in the US Term Loan B market to institutional investors and provided to European and Asian borrowers, based on New York law credit documentation.

Evolution of the Yankee Loan Market

Prior to 2010, European and Asian borrower groups sourced most of their financing needs through local European and Asian leveraged finance markets, based on English law LMA- or APLMA-based credit documentation, and would only seek to raise financing in the US loan markets either to match US dollar-denominated financing against the US dollar portion of their revenue streams or in certain more limited circumstances where there was insufficient liquidity in local markets to finance larger transactions.

Since the beginning of 2010, the depth and liquidity of the institutional investor base in the US Term Loan B market has proved at times to be an attractive alternative source of financing for some European and Asian borrower groups.

It first became a key source of financing liquidity to such borrowers in the early years following the 2008–2009 financial crises, when financial conditions at the time in local markets affected availability of financing for borrowers in Europe and Asia. However, even as liquidity returned to the European and Asian loan markets, the US Term Loan B market remained an attractive proposition for many non-domestic borrowers because Yankee Loans were typically seen as delivering more flexible terms often at similar or in some cases better pricing (even after factoring in currency hedging costs).

A Look Back at 2016

Total Yankee Loan issuances in the US market decreased in 2016. Full year issuance by volume (as a percentage of all leveraged loans on the US market) was down by 7% compared with the previous year. 2016 saw 68 Yankee Loans hit the loan market (including 53 Yankee Term B Loans and six Yankee Term A Loans).[1] Of those deals, 39 Yankee Loans were done on a covenant-lite basis,[2] meaning that covenant-lite Yankee Loans as a proportion of total Yankee Loan issuance brought to market was unchanged compared with the previous year, holding steady at 57%.[3] Yankee Loans also continued to be available to non-domestic borrowers in a broad number of jurisdictions (including Australia, Austria, Belgium, Canada, the Czech Republic, France, Germany, Grenada, Hong Kong, Ireland, Luxembourg, the Netherlands, New Zealand, Singapore, Switzerland and the United Kingdom).

So, why the slow-down in Yankee Loans volume in 2016?

In the first instance, it is worth considering the factors at play in the US loan market. The US loan market had a slow start to 2016, with many key players starting the year "long" on underwriting positions that had been carried over from the second half of 2015. Against this backdrop, the appetite of lenders generally to underwrite any new deals was very low, even for domestic US borrowers. Although the US loan market recovered strongly by the second half of 2016, the uptick in non-domestic borrowers looking to tap this market was not as sharp. This is likely a function of recent developments in local markets since the beginning of 2015, which accelerated strongly in 2016.

In recent times, the European loan market has developed a much greater acceptance of and appetite for covenant-lite loans. As terms in the US Term Loan B market and European covenant-lite market have converged, unless there is a pricing arbitrage to be had at the relevant time by going to the US Term Loan B market or a particular need for US Dollars, European borrower groups may be more likely to raise their capital closer to home.

For Asian borrowers, the current high levels of liquidity available from local lenders makes local pricing too hard for the international institutional markets to compete with. It seems that the arbitrage on covenant and terms flexibility offered by the international institutional markets has not been enough to overcome the pricing differential which has arisen. In addition, it has also been the case that some strong borrower groups have been able to access the improved pricing offered by local banks whilst eliciting some of the "bells and whistles" on covenant and terms flexibility that would be available from international institutional investors.

Outlook for 2017

Market views on the outlook for Yankee Loans in 2017 continue to be varied. On the one hand, the significant growth in depth and liquidity in the European Term Loan B market, the current low interest rate environment in Europe and the current high levels of liquidity in the Asian loan markets, coupled with a rising interest rate environment in the US loan markets, point to the likelihood of a further drop in overall Yankee Loan issuance volume in 2017. On the other hand, the impact of the introduction of the ECB guidance on leveraged transactions in Europe (scheduled to take effect later in 2017), the potential uncertainty that may arise during Brexit negotiations between the UK and the EU and the anticipated (or perhaps, more accurately, hoped for) change in US financial regulatory oversight following the start of the new President Trump administration in the US, all could potentially negatively impact capacity and liquidity in the European and Asian loan markets while at the same time boosting capacity and liquidity in the US loan markets.

Regardless of where this shakes out in terms of volumes for 2017, one thing remains clear. Yankee Loans are on the "menu" to stay. In part this is because it makes sense for non-domestic borrowers to consider this option when deciding on the right capital structure. Depending on underlying market "technical" conditions at the relevant time, a Yankee Loan may well be the product that delivers the best fit for the underlying business plan. However, there is also a sense that certain US headquartered global asset managers simply have a preference for conformity across their portfolio and so, in the absence of any clear reason to deviate, they may default to a US Term Loan B solution.

Summary of Key Structuring Considerations

When looking at "Yankee Loan" transactions, it is important to understand the key drivers for properly structuring a deal involving senior secured debt. The likely insolvency regime that would apply in an enforcement scenario as a result of the location of the borrower(s) and guarantors of any senior secured debt is of paramount importance and requires the consideration of some important issues which may not be relevant in domestic US transactions.

Why the applicable restructuring regime matters

The primary focus of senior secured lenders in any leveraged finance transaction is the ability to recover their investment in a default or restructuring scenario. The optimal capital structure in any transaction is one which minimises enforcement risk by ensuring that senior secured lenders have the ability to control the restructuring process, and this is achieved differently in the US and in Europe and Asia.

United States Chapter 11

In the US, a typical restructuring in a leveraged finance transaction is usually accomplished through a Chapter 11 case under the US Bankruptcy Code, where the position of senior secured lenders as secured creditors is protected by well-established rights and processes. Chapter 11 allows senior secured lenders to cram down "out of the money" junior secured or unsecured creditors and release their debt claims, guarantee claims and collateral pursuant to a Bankruptcy Court-approved plan of reorganisation.

A Chapter 11 restructuring is a uniform, typically group-wide, court-led process where the aim is to obtain the greatest return by delivering the restructured business out of bankruptcy as a going concern. Bankruptcy petitions filed under Chapter 11 invoke an automatic stay prohibiting any creditor (importantly this includes trade creditors) from taking enforcement action which in terms of its practical effect has global application, because any person violating the automatic stay may be held in contempt of court by the applicable US Bankruptcy Court. The automatic stay protects the reorganisation process by preventing any creditor from taking enforcement action that could lead to a diminution in the value of the business. It is important to note that a Chapter 11 case binds all creditors of the given debtor (or group of debtors). Senior secured lenders retain control through this process as a result of their status as senior secured creditors holding senior secured claims on all (or substantially all) of the assets of a US borrower group.

Europe and Asia – Out-of-court process

By contrast, in Europe and Asia, it is more usual for a restructuring in a leveraged finance transaction to be accomplished through an out-of-court process; this is typically achieved through enforcement of share pledge security to effect a transfer of equity interests of the top holding company of the borrower group and a sale of the business as a going concern, although in some situations restructurings can be achieved through a consensual out-of-court restructuring process without enforcing transaction security.

The reason for this is that placing a company into local insolvency proceedings in many European and Asian jurisdictions is often viewed very negatively as the option of last resort. Suppliers and customers typically view it as a precursor to the corporate collapse of the business and often there is no Chapter 11 equivalent restructuring process available in the applicable European or Asian jurisdiction(s). The result is that entering into local insolvency proceedings can very often be value-destructive (in particular because of the lack of an automatic stay that binds trade creditors and, in some cases, because of a lack of clear procedures for cramming down junior creditors).

In order for senior secured lenders to retain control of a restructuring process in Europe or (less commonly) Asia, they traditionally rely on contractual tools contained in an intercreditor agreement (principally enforcement standstills and release provisions). The enforcement standstill and release provisions in an intercreditor agreement are designed to enable a borrower group to be sold at the direction of the senior secured lenders as a going concern.

An enforcement standstill operates to limit or prohibit junior creditors from taking any enforcement action including taking any steps to accelerate their debt claim or to enforce (or instruct the security agent to enforce) the transaction security. An enforcement standstill is designed to prevent junior creditors from obtaining leverage through threatening to force a borrower group into a value-destroying local insolvency proceeding and to allow the senior secured lenders time to implement a controlled disposal of the borrower group through enforcement of transaction security.

Release provisions apply upon a "distressed" disposal of the borrower group, i.e. a disposal following an acceleration event or when transaction security has otherwise become enforceable. The release provisions in an intercreditor agreement will operate to allow senior secured lenders to sell a borrower group free of the claims of the junior creditors that are party to the intercreditor agreement. Such release provisions provide that the borrowing and guarantee liabilities of, and the collateral granted by, the borrower group entity being sold (together with the borrowing and guarantee liabilities of, and the collateral granted by, any of its subsidiaries) will be released upon a distressed disposal.

It is worth noting that because the release provisions give senior secured lenders the right to wipe-out the debt claim of a junior creditor, there has been an evolution of so called "value preservation

protections" which would now be included in a typical intercreditor agreement to given the junior creditors some degree of comfort that the senior secured lenders have obtained a fair price for the borrower group. This "value preservation protection" attempts to emulate the comfort that junior creditors have in a Chapter 11, court-supervised process which ensures oversight on the actions on senior secured creditors during any restructuring of a borrower group.

This intercreditor practice on enforcement standstills and release provisions has developed because, unlike the US Chapter 11 framework, there is no equivalent single insolvency regime that may be implemented across European or Asian jurisdictions. While the EC Regulation on Insolvency Proceedings provides a set of laws that promote the orderly administration of a European debtor with assets and operations in multiple EU jurisdictions, such laws do not include a concept of a "group" insolvency filing (and there is no equivalent law in Asia) and most European and Asian insolvency regimes (with limited exceptions) do not provide for an automatic stay on enforcement applicable to all creditors.

The important distinction to note is that while a Chapter 11 proceeding binds all of a borrower group's creditors, the provisions of the intercreditor agreement will only be binding on the creditors that are a party to (or otherwise bound by) it. Typically, the universe of creditors who are subject to an intercreditor agreement would be limited to the group's primary creditors who share common collateral and/or common guarantees together with intercompany lenders and shareholder lenders. Trade and other non-finance creditors are never party to an intercreditor agreement and this is an accepted market position. However given the debt incurrence flexibility in covenant-lite structures, there is a growing focus on the extent to which other types of third party creditors should be subject to similar enforcement standstill and release provisions outlined above. For example, for transactions which allow the incurrence material "unlimited" incremental debt, incremental equivalent debt, "incurred" acquisition debt or "ratio" debt subject to compliance with a financial ratio to be raised on a senior secured basis, a junior secured basis or an unsecured basis (whether or not the collateral is part of a common pool of security), if the relevant creditors are not subject to appropriate intercreditor arrangements it is easy to imagine how a structure intended to deliver control of a restructuring process to the senior secured creditors class can quickly unravel.

Europe and Asia – *an alternative – the English court-based Scheme of Arrangement*

As an alternative to an out-of-court process (but still not a formal insolvency procedure), creditors in Europe and Asia who document their transactions under English law may be able to take advantage of a scheme of arrangement – a statutory procedure under the U.K. Companies Act, which allows a company to enter into compromises and arrangements with its creditors which is then sanctioned by an English court.

Notwithstanding that a European or Asian centric transaction may have no substantive nexus to England, the scheme of arrangement option may still be available, as the English courts have determined that a sufficient connection will exist to enable an English court to sanction a scheme of arrangement so long as the primary finance document contains an English choice of law and exclusive jurisdiction clause.

The key principle of a scheme of arrangement is to allow an arrangement or compromise in respect of debt claims of a (solvent or insolvent) company to be made, and to be binding on all creditors, if the scheme is agreed by a majority in number and 75% by value of all creditors (or each class of creditors) including secured creditors – effectively allowing a 'cram-down' of minority creditors. The statute is not prescriptive and so the types of arrangements that can be made are flexible.

US: The US Term Loan B market is a mature and sophisticated market. Where a loan to a borrower group which is predominantly domestic in terms of its business and assets is to be syndicated in the US loan market, the credit documentation is universally New York law-governed and structured on the expectation that any restructuring would be effected in the US through Chapter 11 proceedings.

Europe and Asia: Deals syndicated in the European or Asian loan markets were traditionally those where the business or assets of the group were mainly in Europe or Asia, respectively, and such deals adopted a traditional European or Asian approach to structuring – the credit documentation was typically English law-governed (based on the LMA or APLMA form of senior facilities agreement and LMA leveraged intercreditor agreement), and drafted on the expectation that any restructuring would be effected through an out-of-court restructuring relying on contractual tools set out an intercreditor agreement (as described above).

So what happens to documentation when a predominately European or Asian business wants to tap the US Loan market?

Yankee Loans: Given that the US Term Loan B market is so well established, US Term Loan B institutional investors are very familiar with the US loan market-style credit documentation and therefore, most Yankee Loan deals syndicated in the US loan markets have been done using New York law credit documentation. Whilst it is not unprecedented for a foreign issuer to tap the US loan market using LMA-style English law credit documentation, this approach has been very much the exception rather than the rule.

When adopting US loan market-style credit documentation for borrower groups which are predominately non-US, it is important to consider whether the terms of such documentation (which presume a US bankruptcy process) are appropriate. Whilst it is entirely possible that a European or Asian borrower group may be able to elect to reorganise itself pursuant to a US bankruptcy proceeding (which would require only a minimum nexus with the US), this has not, for the most part, been the approach taken where a borrower group has substantial operating assets and businesses located outside the US. Against this backdrop, a US-style approach to automatic acceleration of loans, whilst an important structural feature in a domestic deal (due to the automatic stay applicable upon a US bankruptcy filing), may not result in the right outcome in the context of a non-US borrower group. Such a provision could tip that non-US borrower group into a local insolvency process which may be value-destructive and which may derail the manner in which a senior secured creditor is trying to organise a restructuring process.

Given the limitations under many local insolvency regimes, European and Asian restructurings have tended to occur outside of any local insolvency process, either pursuant to an out-of-court transaction security enforcement process (relying on a contractual intercreditor arrangement) or pursuant to an English law scheme of arrangement. Given the limited circumstances in which an English law scheme of arrangement is likely to be available in the context of a Yankee Loan documented under New York law credit documentation, it is very important when structuring Yankee Loans to implement a more European/Asian-style approach to the intercreditor arrangements (as described above).

So how did the European market respond to the rise in Yankee Loans?

European Covenant-Lite: In 2016 there was a significant uptick in the volume of covenant-lite loans in Europe as a percentage of overall leveraged loan issuance. As this market began to evolve, there was a sense that, in addition to the approach to financial covenants, the market was also converging with the US Term Loan B market in relation to covenant and terms flexibility (in particular,

the approach in documentation in relation to matters such as debt incurrence, restricted payments and acquisitions).

However, throughout 2016, the evolution of European covenant-lite documentation became less predictable because of the adoption of a "pick and mix" approach by strong borrower groups: some deals featured wholesale adoption of a high yield bond covenant package (without any material modification to reflect a secured bank loan); others imported provisions substantially equivalent to those in US Term Loan B credit documentation; and in many cases, deals featured a combination of these two approaches **plus** a sprinkling of terms which are not commonplace in either a high yield bond covenant package or a US Term Loan B package but which had been seen to clear the market during syndication in another European loan market deals.

The covenant and terms flexibility and competitive pricing now available in the European covenant-lite market and the Asian local markets has undoubtedly dulled the enthusiasm of some non-US borrower groups to look at the option of a Yankee Loan, since they may now be able to access the same or better terms in their home market.

What's next: As US, European and Asian loan markets continue to evolve and mature, it can be expected that credit documentation in each market will continue to be impacted. The globalisation of the leveraged finance market and the dominance of global assets managers suggest that, as terms become customary in one region, there will be an expectation that equivalent terms should be available in other regions. Lenders will need to consider carefully whether it is appropriate in all cases to import terms "across the pond" in either direction.

With that being said, there are differences between the US and European loan markets that mean that for at least some deals, loan terms and structures may never fully converge. The key reasons for this are (1) banks remain an important source of liquidity in several European jurisdictions (especially where the underlying credit needs significant local currency which is not be readily available in the institutional market) and banks generally have not been willing to buy significant amounts of covenant-lite debt on a take and hold basis, and (2) as outlined above, the restructuring regime underlying the documentation is fundamentally different in the European market and this needs to be addressed through certain contractual protections not customarily included in New York law credit documentation.

From an Asian perspective, whilst local loan markets continue to develop, the expectation is that it will be some time before US Term Loan B or European covenant-lite terms are viewed as acceptable (or, in fact, appropriate) for the majority of transactions in Asia. This is primarily a function of (1) the high levels of liquidity available from local banks (including domestic champions that provide very competitive pricing) meaning that international institutional investors (who require higher yield in exchange for lighter terms) are not as prevalent, and (2) the structuring issues noted above that often occur in transactions involving developing jurisdictions. A space to watch, however, is the Australian market. The first Australian dollar Term Loan B governed by Australian law was executed in September 2016. It will be interesting to see whether the institutional investor market in Australia will demonstrate sufficient growth to support more substantial (by size and number) covenant-lite transactions.

Why the location of the borrower(s) and guarantors matters

Jurisdiction of Borrower – some issues to consider

In US secured loan transactions, the most common US state of organisation of the borrower is Delaware, but the borrower could be organised in any state in the US without giving rise to material concerns to senior secured lenders. In Europe or Asia, however, there are a number of considerations which are of material importance to senior secured lenders when evaluating in which European or Asian jurisdiction a borrower should be organised and the credit support that can be provided by guarantors.

Lender licensing rules: Many European and Asian jurisdictions impose regulatory licensing requirements for lenders providing loans to borrowers organised in that particular jurisdiction.

Withholding tax on interest payments: Withholding tax may be payable in respect of payments made by borrowers organised in many European or Asian jurisdictions to lenders located outside of the same jurisdiction (in particular, many "offshore" US Term Loan B investors are unable to lend directly to a borrowers located in certain European and Asian jurisdictions without triggering withholding tax or interest deductibility issues). In addition, some European jurisdictions may impose limits on the number of creditors of a particular nature that a borrower organised in that jurisdiction may have without triggering additional withholding tax obligations.

Foreign Debt restrictions: In certain jurisdictions in Asia, there are restrictions on foreign debt (i.e. debt that is either provided by a non-resident lender and/or debt that is not denominated in the borrower's local currency) being borrowed by local borrowers.

Foreign Exchange restrictions: In certain jurisdictions in Asia and Latin America, foreign currency exchange rules mean that there are limitations – or in some cases, prohibitions – on expatriating cash and, to add to the complexity, these rules in some cases can be vague, untested and can change frequently.

Need for a US Co-Borrower: Many institutional investors in the US leveraged loan market (CLOs in particular) have investment criteria which govern what type of loans that they may participate in. These criteria usually include the jurisdiction of the borrower of the relevant loans, with larger availability or "baskets" for US borrower loans, and smaller "baskets" for non-US borrower loans. As a result, some Yankee Loans have included US co-borrowers in an effort to ensure that a maximum number of US Term Loan B institutional investors can participate in the financing. However, in deals where the US co-borrower will actually incur all or a portion of the relevant loans, careful consideration needs to be given to limitations that may affect joint and several liability between US co-borrowers and non-US co-borrowers.

Comparing guarantees and collateral in different jurisdictions

US: The value of collateral and guarantees from borrowers and guarantors located in the US in secured loan transactions is generally not a source of material concern for senior secured lenders. The UCC provides for a relatively simple and inexpensive means of taking security over substantially all of the non-real property assets of a US entity and taking security over real estate assets is, generally, relatively straightforward and inexpensive. Furthermore, save for well understood fraudulent conveyance risks, upstream, cross-stream and downstream guarantees from US entities do not give rise to material value leakage concerns for senior secured lenders.

Europe and Asia: In contrast, there are very few European and Asian jurisdictions in which fully perfected security interests can be taken over substantially all of a company's non-real property assets with the ease or relative lack of expense afforded by the UCC and taking security over real estate assets is generally less straightforward and can often be very expensive. Furthermore, the value of upstream and cross-stream guarantees given by companies in many European and Asian jurisdictions is frequently limited as a matter of law (and in some cases, may be prohibited altogether). This can often mean that value leakage is a material concern because lenders either do not get the benefit of a guarantee for the full amount of their debt or collateral in amount equal to the full value of the assets

of the relevant guarantor. Some other factors which do not apply to US borrowers or guarantors also need to be taken into account for European and Asian borrowers and guarantors. Examples include: (1) in many jurisdictions, it is not practically possible to take security over certain types of assets, especially in favour of a syndicate of lenders which may change from time to time (if not from day to day) or be given at all in support of obligations owed to financial institutions outside the jurisdiction of incorporation of the relevant security provider; (2) in some jurisdictions, it is not possible to take both first-ranking and second-ranking security over the same asset (an issue in second lien financings); and (3) the US concept of excluding certain assets from the collateral package is not workable for certain types of "floating" security available in some European and Asian jurisdictions; instead, customary guarantee and security principles should operate in those jurisdictions to reflect local market requirements.

As a result, when structuring a Yankee Loan, careful consideration should be given to the jurisdiction of borrowers and guarantors to assess the quality and value of credit support and collateral that will be available.

In addition, to ensure that a European or Asian borrower group restructuring may be accomplished through the use of the relevant intercreditor provisions, it is important to determine an appropriate "single enforcement point" (SPE) in the group structure where a share pledge could be enforced quickly and efficiently, without interference by other creditors and stakeholders, in order to effect a sale of the whole group or business as a going concern. In this regard, the governing law of the share pledge and the jurisdiction of the relevant entity whose shares are to be sold should be considered to ensure that the distressed disposal provisions in a European or Asian intercreditor agreement may be fully taken advantage of (if needed). Particular attention should also be paid to the inclusion of provisions which ensure that a senior secured lender can require a borrower group to provide any updated financial information needed to produce or deliver any market valuation required in connection with the operation of any release provisions in an intercreditor agreement at or shortly before the time of enforcement of any SPE share pledge.

A Comparison of Key Terms

When considering what changes should be made to a typical negative covenant package for a Yankee Loan, lenders need to understand both (1) the difference in drafting styles between New York law credit documentation and European and Asian LMA and APLMA credit documentation, and (2) why the substantive terms of credit documentation in the US and European and Asian markets have traditionally differed, based on the expected outcome under different applicable restructuring regimes (see under "**Structuring Considerations**" above). Below is a summary of recent market developments in credit documentation in the different loan markets and issues to watch out for.

US Covenant-lite

In 2016, Covenant-lite deals in the US accounted for 75% of leveraged loan issuance.[4] In a covenant-lite deal, term loans do not benefit from any maintenance financial covenant. Only the revolving facility benefits from a single maintenance financial covenant, normally a leverage-based ratio (and this only applies on a "springing" basis, i.e. at the end of a fiscal quarter, on a rolling LTM-basis, if utilisation exceeds a certain trigger percentage; at the time of writing, typically ranging between 25–35%).

More importantly, the negative covenant package for "covenant-lite" facilities is either fully or partially incurrence-based in nature, similar to what would commonly be found in a high yield unsecured bond covenant package, reflecting the rapid and continuing convergence between the Term Loan B and high yield bond markets in the US.

Incurrence-based covenants typically provide permissions (for example, to incur additional debt or to undertake an acquisition of a third party) subject to compliance with a specific financial ratio which is tested at the time of the specific event, rather than a maintenance financial covenant which would require continual compliance at all times, which traditionally has been required in senior secured bank loans by testing compliance against a projected business plan or base case financial model.

European covenant-lite/covenant-loose

Traditionally, European leveraged loans were structured with a suite of four maintenance financial covenants testing leverage, interest cover, cashflow cover and capex spend.

As noted previously, in recent times there has been a significant uptick in the volume of covenant-lite deals in Europe. For the most part, the fundamentals of this product have adopted a similar approach to their US equivalent (i.e. in terms of the "springing" RCF covenant and the incurrence-based permissions).

However there have also been significant developments in the Europe loan market even for those transactions which perhaps cannot support a full "covenant-lite" approach. It is very unusual for a lender in the current European market to benefit from the full suite of financial maintenance covenants. The so-called "cov-loose" market in Europe began by cutting two of the four traditional maintenance financial covenants (leaving investors with (typically) a leverage ratio and an interest cover ratio) and has evolved such that most of today's "cov-loose" transactions would only benefit from a leverage ratio.

The other development in the European "cov-loose" market is that increasingly the financial maintenance leverage covenant will be static (or to the extent it does step-down, there is likely to be only one step before the covenant flat-lines). In the absence of the leverage covenant requiring de-levering, "cov-loose" loans in Europe will now often include similar incurrence-based permissions to those in a "covenant-lite" structure.

***Asian leveraged loan terms*:** Asian leveraged transactions are traditionally conducted out of the established hubs of Singapore and Hong Kong, which will typically cover acquisitions of assets across the region. Unlike in Europe, leveraged loans transacted in the region still often include a full set of maintenance financial covenants, with typical LMA- or APLMA-style covenant protections that are not incurrence-based in nature.

However, "strong" borrowers continue to push for more "covenant-lite"- or "covenant-loose"-style terms and can achieve these in big ticket transactions when there is liquidity and competitive enthusiasm amongst the large domestic banks and international banks. The push for these terms is predominantly coming from "strong" European and US sponsors, as well as their legal counsel.

Issues to watch out for

For the most part, for a US-only borrower group, the additional flexibility in covenant-lite transactions does not result in any material additional risk to senior secured lenders because enforcement will still occur, for the most part, through a US bankruptcy process under Chapter 11.

However, when agreeing to increased flexibility in negative covenant packages in the case of a borrower group where material credit support will be provided by non-US borrowers and/or guarantors (or where there is no US credit support at all), senior secured lenders need to consider the impact of this additional flexibility very carefully and in particular should spend some time focusing on the reason why such flexibility was traditionally not allowed in European or Asian credit documentation (which in most cases ties back to the very different way in which non-US borrowers and guarantors would be treated in a restructuring or insolvency process under local law compared to a Chapter 11 process).

In particular, the following issues are worth noting:

Debt incurrence (including incremental or accordion baskets and ratio debt baskets)

In US leveraged loan deals, there is usually no hard cap on debt incurrence, i.e. an unlimited amount of additional debt can be raised subject to compliance with one or more different incurrence financial ratio tests.

Such debt may be equal ranking secured debt incurred pursuant to the credit agreement as incremental debt, typically by the existing borrower(s) only.

It may also be incremental "equivalent" debt (relying on incremental basket capacity), "ratio" debt or, in some deals, "incurred" acquisition debt, and such debt may be either senior secured debt (which can be in the form of senior secured notes or in some cases in the form of sidecar loans) or junior secured, subordinated or unsecured debt. In each case, such debt is incurred outside of the credit agreement, and usually can be incurred by any "restricted" group member subject to a non-guarantor cap. The same "MFN" protection that applies to incremental debt usually also applies to incremental "equivalent" debt, "ratio" debt or "incurred" acquisition debt incurred in the form of so-called "sidecar loans", although certain "strong" borrowers negotiate for exceptions to one or more of these baskets and some deals in the US market have now added a further restriction that senior secured debt incurred in the form of senior notes must not be on terms that are functionally the equivalent of a Term Loan B bank loan, to avoid backdoor circumvention of MFN protection.

Debt incurrence flexibility works well in deals that only involve US borrowers and guarantors, because there is generally no material concern about being able to deal with junior secured creditors or unsecured creditors in a restructuring or bankruptcy context.

However, in deals that involve non-US borrowers and guarantors, if comparable debt incurrence flexibility is allowed, issues can arise due to the fact that guarantees provided by non-US entities may be subject to material legal limitations and/or prohibitions and because the collateral provided by non-US entities may be subject to material legal and/or practical limitations resulting in security over much less than "all assets" of the relevant non-US entity, leading to some unexpected results for senior secured lenders in a Yankee Loan deal.

Specifically, the claims of the creditors of such incremental debt, incremental equivalent debt, ratio debt or "incurred" acquisition debt, even if junior secured or unsecured, may rank equally, or in some cases structurally senior, to the guarantee claims of the senior secured lenders who provided the main senior secured credit facilities.

This may be because incremental debt, incremental equivalent debt, ratio debt or "incurred" acquisition debt is not incurred for acquisition purposes and is therefore subject to less stringent guarantee limitations or prohibitions than the guarantee limitations or prohibitions applicable to the senior secured credit facilities incurred as acquisition debt to finance the acquisition of the applicable non-US borrowers and guarantors or it may be because the collateral provided by the applicable non-US borrowers and guarantors is not fully comprehensive, resulting in a larger pool of unsecured assets, the value of which gets shared equally between senior secured creditors, junior secured creditors and unsecured creditors with equal ranking debt claims.

Additionally, for reasons detailed in the "**Structuring Considerations**" section above, in the event of a restructuring accomplished by means of a distressed disposal and release of borrowing and guarantee claims, providers of incremental debt, incremental equivalent debt, ratio debt or "incurred" acquisition debt may not be subject to the contractual enforcement standstill or release provisions provided under a customary European-style or Asian-style intercreditor agreement.

This had led to an increasing number of European covenant-lite and "cov-loose" transactions including provisions capping the amount of additional debt (especially unsecured debt) that can be incurred without the new creditors in respect of such additional debt entering into an intercreditor agreement with the agent for the senior secured lenders. Typically, borrowers will seek to agree the terms of such intercreditor agreement at the outset of the deal in order to avoid having to negotiate or obtain consent from senior secured lenders in order to incur junior secured debt or unsecured debt in the future. To an extent, this is the continuation of a trend in the European market for transactions to include flexibility for several categories of potential future indebtedness in intercreditor agreements. The reason for doing this is to avoid senior secured lenders having a *de facto* consent right over future debt incurrence (if terms have not been agreed in advance, it is likely that obtaining such consent may be difficult in practice because of the detailed intercreditor provisions that are normally required in European loan transactions and the scope for resulting disagreement between different classes of creditors). Since 2015, an increasing number of Yankee Loans have started to follow the same approach (especially in deals that include a second lien facility).

"Grower" baskets

It is now common to include "grower" baskets in both US and European deals (including Yankee Loans) set by reference to the greater of a fixed amount and either a percentage of Consolidated Total Assets (historically more common) or a percentage of Consolidated EBITDA (now becoming much more common in both US and European deals). General "grower" baskets are still rarely seen in the Asian loan market; however increased baskets following growth as a result of permitted acquisitions are more common.

It is worth noting that, historically, a "grower" component did not apply to the "fixed" or "free and clear" components for incremental debt baskets or Available Amount baskets but "strong" borrowers have now successfully negotiated for this in many top-tier sponsor deals in both the US and Europe – while you do sometimes see flex protection to eliminate the grower component from these baskets in US deals this flex protection is very rare in European deals.

Investments and acquisitions

Consistent with high yield bond covenants, US Term Loan B deals now usually do not include a fixed cap on acquisitions and investments (although some deals retain requirement for *pro forma* compliance with a financial ratio condition). However, it is still typical to include a non-guarantor cap (or in some deals a guarantor

coverage test requirement, more similar to European or Asian deals, or a combination of the two concepts), although some recent top-tier sponsor deals involving a "build and grow" strategy have been successfully syndicated without any cap protection.

"Available Amount" (or "Builder") basket for third party investments, distributions and junior debt repayments

In US deals (including Yankee Loan deals), this basket builds with Consolidated Net Income (typically 50% CNI minus 100% losses) or a percentage of Retained Excess Cash Flow, plus certain equity contributions and returns on investments made using the Available Amount basket, and is used for (among other things) third party investments, paying distributions and repaying junior debt. Use of the basket is usually subject to a "no Event of Default" condition. Use of the basket is also usually subject to *pro forma* compliance with a leverage-based incurrence ratio condition (which often may only require minimal or no de-levering from opening leverage levels), but some deals may not include this protection for third-party investment baskets (or, in very limited cases, junior debt prepayment baskets) and other deals limit the scope of the protection solely to the "builder" component of the basket.

The European market is more disparate in its approach to Available Amount/"builder" baskets. It is not uncommon for European covenant-lite loans to limit the payment of distributions and repayment of junior debt to payments from retained excess cashflow (i.e. post sweep) and where the *pro forma* leverage is at least 2.0× inside opening leverage levels. However, in the last quarter of 2016 there was increasing convergence with the restricted payments regime in a high yield bond package or the Available Amount basket regime in a US Term Loan B package.

Available Amount/builder baskets are still rarely seen in the Asian loan market.

Additional unlimited baskets for third-party investments, distributions and junior debt repayments

In US deals (including Yankee Loan deals), it is now common for there to be uncapped ability to make third-party investments, pay distributions and to repay junior debt subject to a "no Event of Default" condition and *pro forma* compliance with an incurrence ratio condition (the level varies but would typically be set 1.5× to 2.0× inside closing date total net leverage).

The same is increasingly common for a European covenant-lite transaction although lenders may insist that there is greater degree of additional deleveraging before this basket becomes available.

This is not a feature that has been adopted in deals sold in the local Asian market.

Asset disposals

In US deals (including Yankee Loan deals), this is now commonly an unlimited basket, subject to an Event of Default blocker condition (although even this protection is excluded in some deals), and provided that 75% of consideration is cash (plus a basket for designated non-cash consideration), the sale is for fair market value and the net sale proceeds are applied and/or reinvested in accordance with mandatory prepayment asset sale sweep provisions. In some more recent top-tier sponsor deals, the percentage of net sale proceeds that must be applied in prepayment steps down from 100% to lower percentage levels (based on meeting a specified first lien net leverage or total net leverage financial ratio).

For European deals, there is not yet conformity in the approach to the asset disposals covenant. It is not uncommon to still see some form of general disposals baskets with an annual or life-of-deal cap combined with a fairly extensive list of carve-outs for certain identified assets. However increasingly, European loans (particularly where they are structured as a hybrid to incorporate certain high yield bond covenants) will adopt the US approach.

In Asian deals, one would expect to still see a fixed cap and a more tightly defined list of additional carve-outs to the disposals covenant.

Unrestricted subsidiaries

The lack of any intercompany basket protection may also be of concern in Yankee Loan deals specifically in relation to "unrestricted" subsidiaries (a concept imported originally from high yield bond deals and now routinely included in US Term Loan B deals). The ability to designate "unrestricted" subsidiaries allows a borrower group to operate a portion of its business outside of the credit support "ring-fence". The result is that such entities are not subject to any of the covenants or other provisions of the credit documentation and, correspondingly, their net income is not factored into any of the financial covenants or incurrence-condition testing of the "restricted" borrower group. This is problematic because third-party creditors who lend money to such entities could potentially disrupt an out-of-court restructuring by senior secured creditors through transaction security enforcement, by blocking a distressed disposal of the borrower group as a going concern through foreclosure or share pledge enforcement.

Conclusion

Yankee Loans look a lot like a normal US Term Loan B loans (and increasingly a lot like European covenant-lite loans). However, because of the fundamental differences between the manner in which restructuring of a US borrower group and restructuring of a European or Asian borrower group may occur in a default situation, greater care should be taken when structuring a Yankee Loan under New York law credit documentation so that it includes certain contractual protections customarily included in European and Asian credit documentation.

Endnotes

1. Source: S&P Leveraged Commentary & Data.
2. Source: S&P Leveraged Commentary & Data.
3. Source: S&P Leveraged Commentary & Data.
4. Source: Survey by Xtract Research (based on a survey of 216 US credit agreements with term loan facilities >$300 million).

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Alan Rockwell
Allen & Overy LLP
1221 Avenue of the Americas
New York, NY 10020
USA

Tel: *+1 212 610 6384*
Email: *alan.rockwell@allenovery.com*
URL: *www.allenovery.com*

Alan Rockwell is a partner in Allen & Overy's Global Banking and Finance practice, based in New York, and a senior member of the global Leveraged Finance practice. He is recognised as a leading practitioner in the Banking and Finance field by *US Legal 500 2016*. He is dual-qualified to advise on New York law and English law and has extensive experience in advising on cross-border Yankee Loan transactions syndicated in the New York, European and Asian leveraged loan markets, with a particular focus on representing and advising leading investment and commercial bank arrangers and underwriters.

His experience includes advising on secured lending and restructuring/workout transactions in over 30 jurisdictions and he has acted on Yankee Loan deals for borrowers located in France, Germany, Labuan, Luxembourg, Norway, Spain and the UK.

Alan also has experience advising lenders, borrowers and financial sponsors in a wide range of other financing transactions, including investment grade and leveraged acquisition finance, bridge finance, refinancings, repricings, maturity extensions, debt buybacks, secured lending, DIP and exit financings and restructuring/workout transactions under both New York law and English law.

Denise Gibson
Allen & Overy LLP
One Bishops Square
London E1 6AD
United Kingdom

Tel: *+44 203 088 4231*
Email: *denise.gibson@allenovery.com*
URL: *www.allenovery.com*

Denise Gibson is a partner in Allen & Overy's banking practice based in London specialising in leveraged finance. Her practice also covers other event-driven and structured finance transactions for which clients recognise her aptitude for dealing with complex structuring and execution challenges. From 2011 to 2013, Denise was an executive director in the debt underwriting group at Goldman Sachs with a responsibility for execution across leveraged loans (including US financings for European issuers) as well as high yield bonds.

Denise is recognised as a leading practitioner, having been listed as one of the "40 Under 40 Rising Stars in Legal Services" by *Financial News* in 2014. She is described by *Chambers UK 2017* as a "highly respected" presence in the market. Her experience includes advising leading financial institutions, borrowers and debt funds on a wide range of transactions.

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