Market Trends 2018/19: M&A Financing

**A Lexis Practice Advisor® Practice Note by
Eric Goodison and Margot Wagner, Paul, Weiss, Rifkind, Wharton & Garrison LLP**

Eric Goodison
Paul, Weiss, Rifkind, Wharton & Garrison LLP

Margot Wagner
Paul, Weiss, Rifkind, Wharton & Garrison LLP

This article discusses the market trends for merger and acquisition (M&A) financing in 2018, including notable transactions, deal structure and process, deal terms, disclosure trends, industry insights, and regulatory trends, and provides a market outlook for 2019. Leveraged lending activity remained strong in 2018, despite challenging market conditions during the third and fourth quarters, with institutional volume down 13% from 2017 but still with the third highest year by volume of institutional leveraged loans ever recorded in the United States.

Unlike 2017, M&A related institutional loan volume represented the largest share (63%) of leveraged loan activity, refinancing activity fell significantly from 2017, and repricing activity plummeted from the first half of 2018 compared to the second half of 2018. Leveraged buyout (LBO) institutional loan activity increased 25% over 2017, which had spiked 38% over the previous year to the highest levels seen since 2007, before the financial crisis. Middle market lending activity fell 22% from 2017. Second lien loan issuance levels fell slightly from 2017, and high yield bond issuance volume plunged to its lowest level since 2009.

Until the middle of the third quarter of 2018, high investor demand for lower-rated and higher-yielding issuers kept overall market liquidity strong and made for a borrowers' market. During that time, the general multi-year trend of borrower-favorable terms persisted and, in some respects, as discussed below, intensified, and some issuers were even able to negotiate favorable terms during the turbulent fourth quarter. The market has absorbed much of the impact of new regulatory pressures introduced in recent years (including the federal interagency leveraged lending guidance, discussed in more detail below), while some of these regulatory pressures have continued to ease. It remains to be seen how the market will continue to react to other new developments that are sure to impact the leveraged loan market, including, among others, the implementation of the major overhaul of the U.S. tax code enacted at the end of 2017, the widely anticipated discontinuance of the London Interbank Offered Rate (LIBOR) in 2021, and the effect of the Delaware law amendments permitting divisions of LLCs.

Notable Transactions

Through the first 10 months of 2018, the year was notable for a spate of large LBO transactions, reflecting a significant uptick in M&A activity, especially in the technology, healthcare, and financial sectors. One noteworthy example was Blackstone's $17 billion acquisition of a 55% interest in Refinitiv, Thomson Reuter's financial data and technology division, which was announced in January 2018 and closed in September 2018. The LBO was one of the largest since the financial crisis and garnered attention due to its size and borrower-friendly covenants including the ability for Refinitiv to sell a business unit and pay itself dividends. The acquisition was funded by $9.25 billion in loans made in Euro and Dollars, $4.25 billion in high-yield bonds, and preferred equity. The loan financing was oversubscribed, which allowed for reduced pricing and an upsized facility with a commensurate reduced bond offering. Investors noted that after accounting for the EBITDA adjustment relating to "cost savings" expected to be realized after three years, the company's leverage would be 7.7 for the year ended December 31, 2018.

Another major transaction was KKR's acquisition of Envision Healthcare, a leading provider of physician-led services, which was announced in June and completed only four months later in October. The deal was valued at $5.57 billion plus assumed debt, totaling $9.9 billion. The debt financing package for the acquisition totaled $7.2 billion, consisting of approximately $5.05 billion in a senior secured term loan facility and $2.15 billion in unsecured notes. This transaction was also oversubscribed and as a result, final pricing was lower than the original underwritten pricing.

Deal Structure and Process

Deal Process

The typical process for leveraged financing deals can be bifurcated into two phases: the commitment stage, when the lenders' commitments to provide the financing are negotiated and documented; and the definitive documentation stage, when the governing agreements for the financing arrangement are completed. The typical approach is to execute a commitment letter at the time of signing the M&A transaction that outlines the key terms of the financing, and only then turn attention to the definitive documentation. This allows borrowers to line up funding commitments and provide assurance to the seller that sufficient funds will exist to consummate the transaction without needing to wait until all of the terms of the final agreement have been documented. The trend of limited conditionality remains, reducing the risk of the conditions to the M&A transaction being met at a time when the conditions to the financing are not met.

The hallmarks of limited conditionality in a commitment letter include (1) a closed list of conditions limited to those that are specifically enumerated in the commitment letter (and no others), (2) using the same definition of material adverse effect and governing law as the M&A transaction, (3) limiting the representations that need to be true in order to close to (x) the same business representations as those under the M&A transaction and (y) a fixed set of legal representations related to the borrower (and generally within its control), and (4) the ability to perfect some collateral on a post- closing basis. In the period between signing and closing, syndication of the commitments may occur, and the definitive documentation will be negotiated. Execution of the definitive documentation and funding typically occur simultaneously with closing of the M&A transaction. However, the commitment phase is extremely important as it sets the key terms of the financing (including pricing), ability to incur more debt, and, as discussed above, conditions to closing. For additional information, see Term Sheets.

Timeline

Deal timelines vary from a few weeks to several months. The timeline will be driven primarily by the M&A process, where factors such as required regulatory approvals or shareholder consents can have significant impacts. However, in some deals with no regulatory or other approvals needed, the principal gating item will be time to syndicate or complete the financing. It is important to make sure the timing of the closing conditions in the M&A transaction and the financing work together. Otherwise, given that financing conditions (also known as financing outs) in M&A agreements are often unacceptable to sellers, the borrower could be put at risk of being required to close the acquisition before the lenders are required to fund their commitments.

Acquisition agreements for debt-financed acquisitions frequently contain the concept of a marketing period to allow for the marketing of the debt financing before the buyer will be obligated to close the acquisition. The marketing period generally commences once the seller has delivered certain required financial information to the buyer. The required information is often defined as the financial information that is necessary to consummate a debt offering of the type being used by the buyer, primarily consisting of financial statements and, in the case of bond financings, additional information necessary to satisfy securities law requirements for registered public offerings or private placements of debt securities.

Often, in transactions with long expected windows between signing and closing due to regulatory concerns, the parties will agree that the marketing period will not commence until the closing conditions in the acquisition agreement (other than those that are to be satisfied only at closing, such as delivery of customary deliverables) have otherwise been satisfied. This gives the buyer and its financing sources the option to hold off on marketing the debt financing until the acquisition otherwise appears reasonably certain to close. This marketing period will differ from the one built into the debt commitment letter itself, which typically commences only after the financing sources have received the bank book and/or offering memorandum containing (but not limited to) the required information provided by the seller. As a result, a few additional days may be built into the marketing period under the acquisition agreement to account for the completion of the marketing materials after the buyer has received the required information from the seller.

The commencement of the acquisition agreement marketing period may also have a built-in delay to allow for the expiration of a go-shop period or the mailing of a proxy statement if shareholder approval is required for the acquisition. Depending on the time of year when the acquisition agreement is signed, there may also be blackout dates for seasonal periods when marketing debt is difficult (such as Labor Day, Thanksgiving, and Christmas).

In acquisitions involving bond financing, the marketing period will typically run only at times when the required information provided by the seller is compliant with securities laws, in a form capable of being covered by a comfort letter, and not stale under applicable securities laws and Securities and Exchange Commission (SEC) rules. Many deals also include triggers for suspending the marketing period due to accounting-relating events, including the restatement of the financial information, the withdrawal of the audit opinion with respect to the financial information, a delay in SEC reporting, or the receipt of material SEC comments on a disclosure document. These triggers may simply toll the marketing period during their continuation, or they may restart the marketing period from the beginning. For additional information on bond financings, see Municipal Bond Purchasing Agreement Drafting and Municipal Bond Pricing and Closing.

Deal Structure

Leveraged financing transactions take on various permutations involving some combination of revolving credit facilities (either cash-flow-based or asset-based), first and second lien term loan structures, and high yield bond financing. The borrower's credit profile and nature of its business, together with the market environment, will impact the capital structure put in place in any given deal.

Term loans combined with revolving asset-based loans (ABLs) have become a common deal structure. Because ABL revolvers limit borrowing capacity to a specified percentage of designated assets in the lenders' collateral package, pricing is usually cheaper than cash-flow revolvers (where maximum borrowing capacity remains fixed instead of fluctuating). ABL revolvers, unlike cash flow revolvers, tend to be documented under a separate credit agreement when used in combination with a term loan. The covenants across the two agreements will often mirror each other, with the notable exceptions that (1) many times the ABL will have a financial maintenance covenant (which may be springing depending on usage) while the term loan facility may not and (2) the ABL may allow the borrower to pay unlimited dividends, or make investments or incur debt subject to satisfying a payment condition test (generally sufficient liquidity and perhaps meeting a fixed charge ratio) after giving effect to the action.

In a financing with both a cash flow revolver and a term loan, the financial covenant may only be for the benefit of the revolving lenders. This is because term loans, but not revolvers, routinely lack financial maintenance covenants in broadly syndicated loans and larger middle market deals (but less so in small middle market deals) under the trend of covenant lite (as further discussed below).

In order to prevent the term loan lenders from indirectly benefiting from the revolver's financial covenants, the term loan agreement will often contain a cross-acceleration, instead of a more typical cross-default, to the revolver. This requires the revolving lenders to actually accelerate their loans before an event of default under the ABL gives rise to an event of default under the term loan agreement.

In deals involving bond financing, there will typically be a bridge loan commitment (generally provided by the financial institutions that expect to underwrite the bond deal) to serve as a backstop in case the bond issuance fails to occur. In recent years, the trend has been for the banks to have the right to force the borrower to issue debt securities immediately at, but generally not before, closing, in lieu of funding bridge loans. This has the practical effect of further reducing the likelihood that the bridge loans will actually be funded.

Deal Terms

On balance, deal terms remain generally borrower-friendly, but there are a few areas where the balance at times has swung back in favor of lenders. The following are some of the key trends in deal terms in 2018:

- **Covenant lite.** Covenant lite deals continued to feature prominently in the broadly syndicated and larger middle markets (BSL). In 2018, the overall market share of covenant lite loans reached 85%, the highest volume on record. In these deals, financial maintenance covenants (such as maximum leverage ratios and minimum interest coverage ratios) are absent from the term loan facility or, less frequently, from the revolving credit facility. In addition, covenant lite loans typically have looser restrictions on the borrower, and include incurrence-based ratio tests (which historically have been associated with high yield bond indentures) rather than fixed baskets. This allows the borrower to take otherwise restricted actions, such as incurring additional debt, paying dividends and other distributions, or making additional investments, if the specified incurrence test is satisfied. For additional information on covenants in debt financings, see High-Yield vs. Investment-Grade Covenants.

- **Call protection.** Soft call protection, where prepayment premiums are applicable only to repricing transactions, have become standard in the BSL market. This contrasts with hard call protection (still seen in some smaller middle market deals) required to be paid in connection with voluntary prepayments made for any reason. The soft call period during which premiums apply commonly runs for the first six to twelve months after closing. In some transactions, the soft call provisions apply to any prepayment or amendment having the effect of reducing the borrower's pricing. However, borrowers have been successfully expanding the categories of exclusions from soft call protection. Many recent deals (including some smaller middle market deals with hard calls) now carve out repricings that occur in the context of change of control transactions or transformative acquisitions from the requirement to pay call premiums.
- **Incremental facilities.** It has become an established feature of the market for credit agreements to contain uncommitted incremental facilities (accordions) allowing the borrower to upsize the existing credit facilities or incur debt under new tranches to be established under the credit agreement. Incremental facilities commonly have most favored nation (MFN) provisions enabling the existing lenders to benefit from increased pricing if the new loans have a higher all-in yield. Typically, the pricing on the existing loans would be increased to a level that is an agreed spread less than the higher pricing on the incremental loans. Historically, the agreed spread was 0.50% but recently more and more borrowers have had success in pushing the yield differential to higher levels (such as 0.75%). Many times, the MFN applies only to incremental term loans, but it may apply to incremental revolving facilities as well. In addition, there may be a sunset provision limiting the MFN's applicability to incremental facilities incurred within a specified period after closing (such as six months). It has become common for borrowers to have exceptions to MFN protection such as, excluding a designated portion of the total incremental debt capacity, and excluding incremental debt incurred in connection with permitted acquisitions or permitted investments or maturing after the existing debt by a period to be agreed such as a year or sometimes longer.

  Incremental facilities are commonly permitted up to a dollar-based cap plus an unlimited additional amount subject to compliance with a specified leverage ratio test plus an amount equal to certain voluntary prepayments and permanent reductions in commitments. Increasingly, the dollar-based cap in the BSL market will now also have a separate prong (sometimes referred to as a grower component) allowing additional incremental loans based on a specified percentage (often 100%) of the borrower's earnings before interest, taxes, depreciation, and amortization (EBITDA) with other agreed upon adjustments or total assets.

  It is also becoming more common in the BSL market to see credit agreements that permit the borrower to use incremental loan capacity to incur additional debt under separate facilities outside the credit agreement in lieu of incurring incremental loans under the credit agreement, though it may be required to take the form of bonds if secured on a pari passu basis.

- **Basket reclassification.** Another feature that has migrated from the high yield bond market to the BSL market is the ability for a borrower to reclassify usage under a dollar-capped negative covenant basket into usage under an unlimited ratio-based basket. This feature is becoming increasingly common, especially among large cap deals but even in some larger middle market transactions. It allows a borrower that may have used up its dollar-based baskets to reload these baskets (i.e., provide for additional capacity) by shifting the usage to incurrence-based baskets when its financial performance improves enough to satisfy the relevant ratio tests. For additional information on high yield bond provisions, see Market Trends 2018/19: High Yield Debt Offerings.
- **Collateral leakage and designation of unrestricted subsidiaries.** Collateral leakage is becoming an increasing concern to lenders since they rely on the assets owned by the loan parties at the time they make their credit decision and the restrictions in the documentation to prevent deterioration in the assets available to repay the loans. Several negative covenants, when working in concert, provide flexibility for loan parties to move assets to entities outside of the credit group. As a result of one instance of a borrower using its covenant flexibility to move material IP to an unrestricted subsidiary, some deals now limit the ability to transfer IP or other key assets.
- **Negative covenants and grower baskets.** Although lenders have been focused on collateral leakage, borrowers still typically negotiate favorable terms to make investments in non-guarantor restricted subsidiaries. These agreements may resemble high-yield bond indentures where the borrower is permitted to make unlimited investments in such entities. If the agreement permits restricted subsidiaries to make unlimited investments in non-guarantor restricted subsidiaries, direct assets

may leave the collateral package and be replaced with an equity pledge. The debt, lien, and restricted junior debt repayments covenants remain borrower-friendly and often include grower baskets based on EBITDA or another agreed upon metric. Builder baskets typically include retained asset sale proceeds, declined mandatory prepayments, unused baskets such as restricted payments, and other negotiated components. In turn, the builder basket can be used to make additional restricted payments, restricted junior debt repayments, incur debt, and make investments.

- **EBITDA addbacks.** In 2018, borrowers and sponsors continued to seek friendly EBITDA adjustments. The issue has become one of the most negotiated points since covenant compliance and grower baskets are, and pricing may be, determined by the result. Current borrower-friendly trends to EBITDA adjustments include: increased or removal of caps on pro forma cost savings synergies, permitting projected cost-savings not connected to acquisitions, synergies "of a type" shown in a sponsor's QOE report, longer look-forward periods, board expenses, severance and relocation costs, accrued dividends on preferred stock, expenses due to exercise of employee options, indemnification payments that are reimbursable by third parties, and others.

- **Unitranche loans.** Unitranche loan structures continued to be popular in 2018, especially in middle market deals. This type of financing combines what would otherwise be separate debt instruments (e.g., first lien and second lien) with separate priority classes of creditors into a single credit agreement with (from the borrower's perspective) a single class of creditors. The lenders separately enter into an agreement among themselves to create separate "first out" and "last out" tranches of debt (i.e., senior and junior priority), with payment waterfalls that effectively put the lenders into the positions of different classes having different levels of payment or lien priority. The borrower pays a single blended interest rate that the lenders divide up among themselves to account for the differing levels of credit risk they assume. Unitranche structures have been growing increasingly more complex, with multiple layers of priority (which may be split up differently across term loan and revolving credit facilities) being addressed in the agreement among lenders. The agreements among the lenders governing these relationships are generally proprietary and not shared with borrowers.

  The enforceability of agreements among lenders remains an open question. In one notable case, In re RadioShack Corp. (Case No. 15-10197 (Bankr. D. Del. 2015)), the Delaware bankruptcy court implicitly recognized the enforceability of an agreement among lenders. That case involved two separate unitranche financings—a term loan facility and an ABL—secured by crossing liens on current assets and fixed assets. The debtor sought approval of a section 363 asset sale, in which one of the last out lenders attempted to credit bid its last out loans to purchase a portion the debtor's assets. The first out lenders objected on the basis that not all of their claims would be satisfied because no reserve was being established for their contingent indemnification claims. The parties ultimately agreed to settle the dispute, so the bankruptcy court issued no written opinion on the matter, but the transcript of the hearing indicates that the court offered guidance on the interpretation of the applicable agreement among lenders. Although this does not have the precedential value of a written opinion, it offers some level of comfort that a bankruptcy court will enforce an agreement among lenders in appropriate circumstances.

Disclosure Trends

Although bank loans are not securities for purposes of U.S. federal securities laws, participants in the loan markets and their affiliates also frequently engage in securities trading and are therefore sensitive to issues involving disclosure of material nonpublic information (MNPI). Because lenders in loan syndicates would normally receive MNPI from their borrowers in the ordinary course of administering the credit facility but may also want to trade in related securities without restriction, the loan market has developed the approach of bifurcating lender syndicates in any given deal into two groups: public-side lenders and private-side lenders. Each lender in the syndicate chooses which group it wishes to join.

Public-side lenders will generally not have access to MNPI and can therefore trade in securities issued by the borrower with decreased risk of violating the securities laws. Lenders who opt to become private-side lenders will obtain MNPI from the borrower, giving them additional information to use in making credit decisions but which may preclude them from trading in the borrower's securities. The borrower and the loan arranger will typically ensure that the general bank book or confidential information memorandum prepared for the lender syndicate contains no MNPI, and then a separate supplement containing MNPI will be prepared for the private-side lenders. These disclosure packages are marketing materials that generally include a relatively high-level description of the borrower's business and management, an overview of the applicable industry, key credit highlights, and pro forma capitalization and financial information. For additional restrictions on MNPI, see Regulation FD and Insider Trading Policies.

Industry Insights

Leveraged lending activity in 2018 was broadly distributed across a range of industries. The technology sector experienced the most leveraged lending activity of any industry, capturing slightly more than 20% of all new money leveraged loan volume. After technology, the next most active industry sectors were healthcare, and services and leasing, representing slightly more than 12% and 11%, respectively, of all new money leveraged loan volume. After these three sectors, the next most active industry sectors were chemicals, oil and gas, manufacturing and machinery, real estate, building materials and entertainment, and leisure. Each of these individually represented less than 10% of new money leveraged loan volume, and collectively, together with the technology, healthcare, and services and leasing sectors, represented approximately 68% of all new money leveraged loan volume.

Legal and Regulatory Trends

Regulatory developments recently affecting the loan markets include the following:

- **Tax reform.** The passage of the Tax Cuts and Jobs Act of 2017, the most significant revision of the U.S. tax code in decades, may impact the leveraged loan markets in ways that still remain to be seen and may become more transparent in 2019 when borrowers and sponsors have had a full tax year to adjust to the new law. A number of the tax law changes have special significance to transactions involving leveraged debt financing. One is the general disallowance of deductions for net interest expense in excess of 30% of adjusted taxable income (ATI). The limitation on a borrower's ability to deduct the interest expense associated with its loan facilities obviously has the potential to make the incurrence of debt a less attractive proposition, especially if interest rates start to climb. ATI is defined in a manner that excludes deductions for depreciation and amortization for tax years beginning before 2022, so ATI approximates straight EBITDA until that year (and EBIT starting with that year). However, because credit agreement EBITDA definitions tend to have various nonuniform adjustments to EBITDA, financial modeling of leveraged transactions may become more difficult.

  Another tax law change that would have had enormous effects on the structuring of leveraged financing transactions and that was anticipated to be a part of the tax reform—the elimination of the rule under Section 956 of the Internal Revenue Code (26 U.S.C. § 956) treating foreign subsidiary credit support for the debt of its U.S. parent as a "deemed dividend"—was unexpectedly not included in the final legislation. Although some regulations regarding Section 956 were issued, market practice is still to exclude foreign subsidiaries from being guarantors.

- **Federal leveraged lending guidance.** The federal leveraged lending guidance has been in place for several years now but only started to significantly impact the loan market in the last couple of years. First issued in March of 2013 by the three U.S. federal banking regulatory agencies—the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation—the "Interagency Guidance on Leveraged Lending" is a set of guidelines released in response to concerns that deteriorating underwriting practices in the loan market contributed to the 2008 financial crisis and could pose systematic risks to the financial system. Most of the guidelines take the form of general, high-level recommendations for underwriting standards and risk management practices for lenders to use in their leveraged lending activity, but the most far-reaching market impact stems from a single statement contained in the guidance: "Generally, a leverage level . . . in excess of 6x Total Debt/EBITDA raises concerns for most industries."

  Initially, this statement led to concerns that it could be interpreted as establishing a de facto restriction against leveraged loans having a leverage ratio in excess of 6.0x. Later statements by the regulators clarified that they do not view a 6.0x leverage ratio as a bright-line test when evaluating transaction risk, but they indicated that such loans are more likely to receive heightened scrutiny. As a result, the percentage of deals involving a leverage ratio in excess of 6.0x dropped off in recent years, and reports in the press and anecdotal evidence started to suggest that regulated banks were increasingly becoming reluctant to participate in leveraged financing transactions where the debt-to-EBITDA multiple was expected to exceed this level. In addition, as reported in market league tables that rank bank arrangers by deal volume, the banks that have traditionally acted as lead arrangers in high-profile syndicated loan transactions have been steadily ceding market share to other lenders that make up the so-called shadow banking system (which includes hedge funds, the lending arms of private equity sponsors, and mezzanine funds that are not regulated by the federal banking agencies and consequently fall outside the scope of the guidance). In late November of 2016, the European Central Bank published its own draft version of similar leveraged lending guidelines to be applicable to relevant supervised financial institutions in Europe.

In recent reports issued by the banking regulators in connection with their semi-annual Shared National Credit (SNC) review (which are available at https:// www.occ.treas.gov/topics/credit/commercial-credit/shared-national-credits-reports.html), the regulators noted substantial progress towards full compliance with the underwriting and risk management expectations set forth in the leveraged lending guidance. However, they also expressed concern that weaknesses in underwriting practices (including covenant-lite structures and liberal repayment terms) continue to pose risk. The SNC reports have been particularly critical of incremental facilities (which allow a borrower to incur new debt that shares in the existing lenders' priority of claims), especially when used in order to fund dividend payouts and other transactions that weaken a borrower's underlying credit profile. The regulators stated that including incremental facilities in credit agreements can be thought of as "effectively outsourcing a bank's risk appetite and diminishing internal underwriting controls" and warned that "usage of incremental debt facilities shortly after funding an initial debt package may result in risk rating downgrades and non-pass originations."

However, late in 2017, the fate of the leveraged lending guidance was thrown into doubt when the Government Accountability Office, after being prompted by a U.S. Senator (Pat Toomey), made a determination that the guidance actually constitutes a rule that should have been subjected to congressional review pursuant to the Congressional Review Act, but that review was never undertaken.

In February 2018, the Chairman of the Federal Reserve and the Comptroller of the Currency both made statements implying that banks no longer need to comply with the leveraged lending guidance. Some lawyers believe it is likely the guidance may be abandoned or perhaps be replaced by an alternative approach. These statements, indicating a softer tone by regulators, means that some lenders may be less worried about criticism from regulators over their underwriting practices. More deals in 2018 had leverage above 6x EBITDA: 73% of LBO financings had leverage over 6x and 41% of corporate LBOs for large companies had leverage over 7x, both market records.

- **Risk retention rules.** The risk retention rules for asset-backed securities promulgated pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (111 P.L. 203, 124 Stat. 1376) (the Dodd-Frank Act) initially cast a large shadow over the leveraged loan market but their effect turned out to have been short-lived.

  The risk retention rules became effective for collateralized loan obligations (CLOs) on December 24, 2016, but were invalidated insofar as they apply to open-market CLOs by a federal court decision in February of 2018 (as discussed below). The risk retention rules generally require that sponsors of securitization transactions retain 5% of the credit risk of the assets being securitized, widely referred to as retaining skin in the game. The regulatory rationale is to align the interests of the transaction sponsors with the investors in the asset-backed securities in order to avoid excessive risk-taking of the type that characterized the origination of mortgages that were packaged into securitizations in the years leading up to the financial crisis.

  Despite initial arguments from the CLO industry that the Dodd-Frank Act's risk retention mandate should not apply to CLOs due to fundamental differences in their structure and management from traditional asset-backed securitizations (such as residential mortgage backed securitizations), the federal regulators concluded that CLOs were not exempt from the risk retention requirements. The Loan Syndications and Trading Association (LSTA) filed a lawsuit in November of 2014 arguing that the federal agencies exceeded their statutory authority in making the risk retention rules applicable to CLOs. Although the federal district court ruled against the LSTA, that decision was reversed on appeal in February of 2018. The U.S. Court of Appeals for the D.C. Circuit remanded the case to the district court with instructions to vacate the risk retention rule to the extent it applies to open-market CLOs, and on April 5, 2018, the risk retention rule was vacated to such extent.

  Despite the application of the risk retention rules to CLOs for the entire year (and despite initial concerns that this would have a chilling effect on the availability of CLO capital), CLO issuance levels actually surged during 2018 to make it the highest year on record. Now that the risk retention requirement will no longer generally apply to CLOs, the prospects for CLO fundraising appear even brighter.

For additional information on the Dodd-Frank Act, see Dodd-Frank Wall Street Reform and Consumer Protection Act Key Provisions.

- **Division of Delaware LLCs.** In August 2018, the DE LLC Act was amended to permit the division of Delaware LLCs into two or more LLCs, with the original LLC surviving or terminating. A division can be used in connection with a sale of lines of businesses, spin-offs, asset sales, mergers, etc., without forming a new LLC (even for asset sales to multiple buyers, with equity interests in the resulting

LLCs issued to each buyer). Upon the effectiveness of a division, the original LLC's assets/liabilities can be allocated to and vested in the resulting LLCs, as specified in a required plan of division, with no need for action by other parties, perhaps allocating all assets to an LLC that is not providing any credit support. A lender's security interests in its collateral may be affected. The original LLC may survive or could be exchanged for / converted into cash, property, or interests in one or more of the resulting LLCs (or in any other business). Lenders will likely focus on the following provisions and Borrowers should expect the following changes: "Asset Sale" and/or "Disposition" definitions will include any plan of division; Restricted Payments will explicitly provide that any type of allocation of assets pursuant to a plan of division constitutes a Restricted Payment; Further Assurances will provide that any entity (especially below the Borrower) that is created after closing must join as a Guarantor/Grantor unless one of the exceptions applies; Mergers, Fundamental Changes will provide that no divisions are permitted unless the resulting entity becomes a Guarantor/Grantor; any caps on investments in, or transfers to, an Unrestricted Subsidiary or an immaterial subsidiary should be tested as if it will be/was effectuated through this type of allocation/ division; and designations of subsidiaries to Unrestricted Subsidiaries provisions will be analyzed.

- EU bail-in rule. In January of 2016, the European Union (EU) Bank Recovery and Resolution Directive (2014/59/ EU) became effective, implementing the European bail-in rules. These rules (available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0059) are intended to address a future banking crisis without resorting to the type of taxpayer-funded public bailouts of failing institutions that occurred during the financial crisis. They give European regulators broad authority to cancel or modify the liabilities of an affected financial institution in order to obviate the need for a public bailout. The rules also require affected institutions to obtain contractual recognition of the potential for this type of bail-in modification of liabilities in any contracts entered into by such institutions that are governed by the law of a jurisdiction outside the purview of the applicable European regulators, including the United States. Given that European lenders play a significant role in the U.S. loan market, EU bail-in contractual recognition provisions have become widespread in U.S. credit agreements. The market has largely coalesced around the model contractual recognition provisions published by the LSTA, so there is typically little negotiation of these provisions.

- **Know your customer issues.** The information-gathering and diligence conducted by lenders in order to comply with know your customer (KYC) requirements under the USA PATRIOT Act and other anti-terrorism, anti-money laundering, and similar rules continues to have an outsized impact on leveraged financing deals. Lenders have set up protocols to collect detailed information about borrowers and their related parties in order to ensure compliance with KYC regulations, and the KYC diligence process in any given deal now often takes on a life of its own as multiple lenders in the syndicate all conduct separate diligence with no central control repository or information-sharing among lenders (or even among the deal team and the KYC team within a single lender). This stems from the fact that each organization usually has its own internal requirements and processes for KYC matters, compounded by the fact that it is typically treated as a back-office function handled by staff members not otherwise involved in the transaction. In January of 2016, the LSTA released KYC guidelines for syndicated lending transactions, which were updated in October of 2017 (primarily to address the finalization of applicable rulemaking by the Financial Crimes Enforcement Network of the U.S. Department of the Treasury). These guidelines made some progress towards offering a consistent set of standards that lenders could uniformly apply, but uncontrolled, disruptive KYC processes continue to be an issue in leveraged financing deals.

- **Discontinuance of LIBOR.** In 2018, loan parties focused more than in 2017 on the 2021 deadline when the UK Financial Conduct Authority will no longer require banks to submit quotes for LIBOR rates in sterling, though the ICE may continue to publish the dollar rate. Loan agreements typically provide for market disruption events and the temporary unavailability of LIBOR, but historically they have not addressed the complete discontinuance of LIBOR. Given the volume of U.S. financial products based on LIBOR, including syndicated loans and swaps, the impact of LIBOR's discontinuance is monumental. Parties to new loan agreements are including provisions that require them to amend the agreement, as necessary, including a spread adjustment, when LIBOR is discontinued. Another approach being used is to "hard-wire" the agreement where a waterfall of different rates, depending on their availability, replaces LIBOR at the appropriate time. The anticipated replacement for LIBOR in the U.S. market is SOFR (secured overnight funding rate), a secured, overnight Treasuries repo rate which, unlike LIBOR, is a secured rate, and reflects actual transactions. However, since SOFR is an overnight rate it is a backward-looking rate which makes it difficult for borrowers to plan their cost of funds. LIBOR is a forward-looking rate and is published for a variety of interest periods. SWAPS are using a forward looking SOFR because the SWAP market began transitioning to SOFR earlier and a deeper market has developed. The loan market for term loans using SOFR has not developed yet and borrowers are struggling with the inability to plan their borrowing costs as well as to hedge those costs with SWAPs that are using a different reference rate.

Market Outlook

The effects of the overhaul of the tax system, the still-unfolding policy agenda of the new presidential administration, the shift towards an apparent climate of deregulation in the United States, the long government shutdown, the rising interest rate environment, the volatility in the equity markets, and geopolitical relations have all combined to introduce much uncertainty in the leveraged financing markets. If market developments adversely affect liquidity, it is possible that deal terms, which have been trending towards borrower-friendliness for several years now, could start to shift back in favor of lenders. Alternatively, new sources of capital may step in to fill any vacuum, as we saw in certain pockets of the market in recent years.

The volatility of the December markets carried over into a slow first quarter in 2019 for loans as investors continued to be risk-adverse. Institutional leveraged loan volume was only slightly above institutional leveraged loan volume in the fourth quarter of 2018, and it was the second lowest since the first quarter of 2016. Early January saw some backlogged deals clear the market but then the market slowed due to a lack of M&A activity, among other reasons. In fact, the institutional leveraged loan market during the first quarter 2019 was only $3 billion higher than in the fourth quarter of 2018 and the lowest first quarter in three years. No repricings launched, and repricing and dividend transactions combined fell to their lowest level since the first quarter of 2016. High-yield issuances grew during the course of the first quarter, though still ended up $5.8 billion below the rate of 2018. Frequently, the proceeds of the high-yield bonds were used to retire term loans where previously, loans dominated the debt markets.

In any event, it is likely that the focus on deal certainty protections will continue. Borrowers seek to ensure close alignment between the conditionality of the lenders' obligation to fund their commitments, on the one hand, and the borrower's own obligation to close the acquisition under the relevant M&A agreement, on the other hand.

Lenders will seek to limit collateral leakage to maintain the credit group's ability to repay the debt. EBITDA addbacks will continue to be a point of contention.

Eric Goodison, Partner, Paul, Weiss, Rifkind, Wharton & Garrison LLP

Eric Goodison is a partner in the Corporate Department at Paul, Weiss, Rifkind, Wharton & Garrison, LLP, New York, and is a member of the Finance practice. Eric represents domestic and international clients in their borrowing, lending and other financing transactions. With more than 25 years of experience as a financing lawyer, Eric counsels clients in acquisitions, divestitures, structured financings, and work-outs and restructurings. He has significant expertise in structuring, negotiating and consummating leveraged financings across many industries for all types of borrowers, from purely domestic companies to multinational businesses with complex global organizational structures. He has particular strength in complex leveraged transactions.

A frequent writer and speaker, Eric participated in a panel about developments in deal financing techniques at the 27th Annual Corporate Law Institute at Tulane University Law School. He is ranked nationally by Chambers USA and Chambers Global as a leading lawyer in banking and finance.

Margot Wagner, Partner, Practice Management Counsel, Paul, Weiss, Rifkind, Wharton & Garrison LLP

Margot Wagner is the Practice Management Counsel in the Corporate Department at Paul, Weiss, Rifkind, Wharton & Garrison, LLP in New York, and a member of the Finance practice. She supports the finance practice with training, providing precedents, maintaining databases and general finance assistance.

Margot joined Paul Weiss as practice management counsel in 2018. Previously she was at Cravath, Swaine & Moore LLP and began her career at Simpson Thacher & Bartlett LLP. At Cravath, she generally acted as lenders' counsel on a variety of financing transactions including multi-jurisdictional facilities, leveraged finance facilities, asset-based facilities, letters of credit facilities, and working capital facilities.