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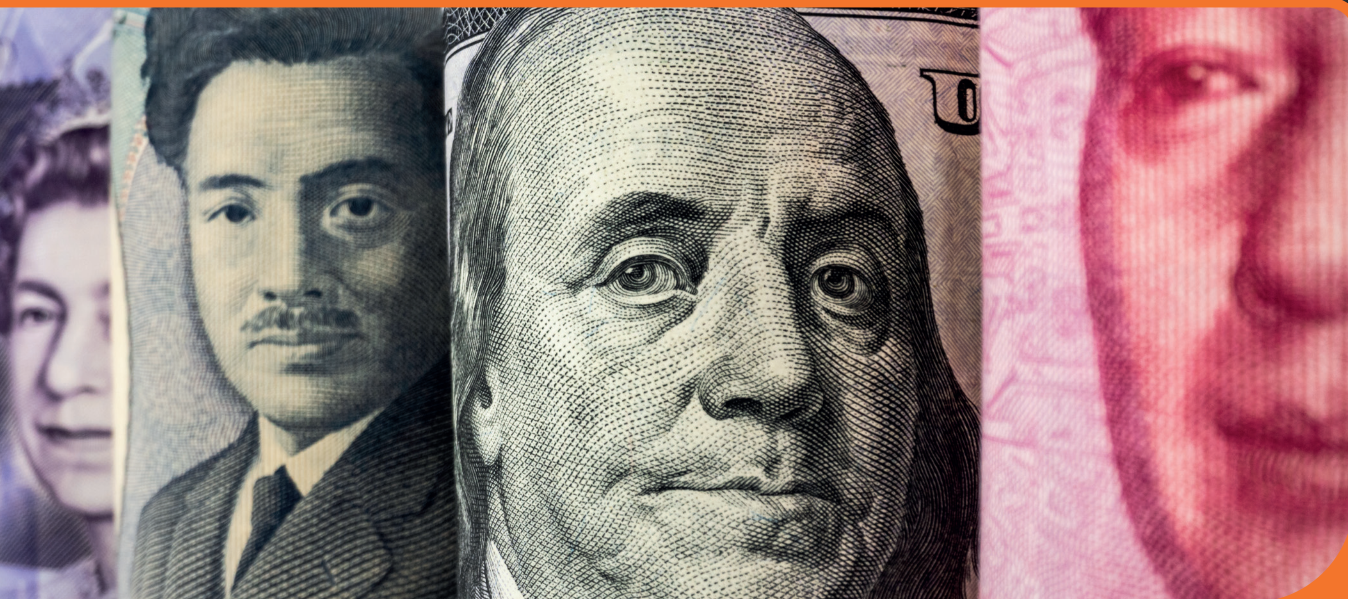

Practical cross-border insights into lending and secured finance

Lending & Secured Finance 2022

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Morgan, Lewis & Bockius LLP

LSTA
LMA Loan Market Association
APLMA Asia Pacific Loan Market Association
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Recent Developments in U.S. Term Loan B

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1 Introduction

After a robust end to 2020, the U.S. term loan B (***TLB***) market continued at a record-breaking pace during 2021. In spite of concerns over high inflation, the Federal Reserve kept interest rates low, which further boosted deal making in the U.S. With interest rates remaining near historic lows, the exceptionally high inflation did not thwart the markets in 2021. While the volume of new debt issuances did not reach the heights of 2017, the dollar value more than doubled from the already busy year of 2020. Leveraged buyout issuances in the U.S. were at the second-highest level ever, while the volume of credit facilities getting refinanced was at its fourth-highest level ever.

According to various market reports, leveraged loans funding M&A deals in 2021 amounted to over 20% higher than the previous record year in 2018. Average *pro forma* adjusted debt multiples of M&A deals increased, and there was a significant increase in deals with initial total debt multiples of 7.00x or higher. Even companies with speculative ratings issued an unparalleled $1 trillion across the loan and bond markets in the U.S. Assets held at exchange traded funds and mutual funds that invest in leveraged loans increased at the second-highest pace on record in 2021 for the same reasons as the leveraged loan and bond issuances: the expectations of interest rate hikes and very low default activity.

The high M&A activity resulted in solid returns for lenders in 2021, especially for speculative credit. Covenants in general permitted more flexibility for borrowers, especially in terms of reallocating basket capacity under one covenant to another. This chapter examines some of those developments.

2 Market Fundamentals

2.1 Attitudes

Investment banks in today's TLB market operate an originate-to-distribute model, arranging the financing package before distributing all or a significant portion of TLBs to investors (although investment banks will usually retain part of the revolving or other liquidity facilities, which are still the domain of traditional banks). The ultimate TLB holders are more likely to be non-bank lenders, i.e., institutional investors such as hedge funds and issuers of collateralized loan obligations (***CLO***s).

Institutional investors take a different approach to their participation in a loan syndicate when compared to traditional banks, viewing loans as liquid, tradable and impersonal investments, rather than part of a broader banking relationship with the relevant borrower. Institutional investors buy and sell loans opportunistically instead of holding them to maturity, meaning that such investors are less reliant on the protections that a more traditional term loan covenant package affords. An institutional investor's overall portfolio will include high yield bonds as well as loans and, accordingly, institutional investors have gotten comfortable with incurrence-based covenants (and a lack of financial maintenance covenants) for both bonds and leveraged loans in their portfolio. Sponsors and borrowers, knowing that investors will continue to tolerate weaker covenant packages and so-called covenant lite structures as long as the debt is sufficiently liquid, have been able to use this shift in composition of the lender base, in addition to the strong demand for the TLB product, to their advantage in order to push for greater flexibility in terms. The increase in secondary market activity, absence of a close relationship between a borrower and its lenders and increasing syndicate sizes mean that covenant flexibility becomes even more important for a borrower, since amendments to loan documentation cannot be obtained with larger and more impersonal syndicates as quickly, easily or cheaply as they could with small syndicates, made up of relationship banks.

Despite the brief period at the start of the COVID-19 pandemic in 2020 when lenders were able to tighten up the covenants, 2021 continued the previous trend of loosening covenant protections. Less protective covenants were coupled with higher interest rates as discussed further in this chapter.

2.2 Legal and regulatory developments

2.2.1 U.S. LIBOR replacement and SOFR

Since the Alternative Reference Rate Committee's (***ARRC***) initial selection of the Secured Overnight Financing Rate (***SOFR***) as the preferred alternative to U.S. dollar (***USD***) LIBOR, ARRC advised regulated banks to stop any new issuances on USD LIBOR by no later than December 31, 2021. On March 5, 2021, the Financial Conduct Authority and the ICE Benchmark Administration published announcements stating that publication of the one-week and two-month USD LIBOR settings would cease immediately after December 31, 2021, and that publication of the overnight and 12-month USD LIBOR settings as well as the one-month, three-month and six-month USD LIBOR settings will cease on June 30, 2023.

Thus, with all tenors of USD LIBOR ending on June 30, 2023, the Loan Syndication and Trading Association (***LSTA***) and ARRC continued encouraging market participants to switch away from LIBOR by using a "hardwired approach" (the ***Hardwired Approach***) in their loan agreements throughout the year of 2021. Under the Hardwired Approach, LIBOR is automatically replaced with a specified successor rate upon the occurrence of a defined trigger event subject to a waterfall (***Waterfall***). While there are four different types of SOFR that may be used in loan agreements, the ARRC formally recommended Term

SOFR as the first option under the Waterfall followed by Daily Simple SOFR and finally, by a type of an amendment approach. It was reported that by August 2021, over 90% of new loan issuances included the Hardwired Approach.

Although there have been loan agreements since late 2020 that have adopted the Hardwired Approach to allow a future flip forward to Term SOFR, the first broadly syndicated institutional term loan that had Term SOFR pricing was not marketed until mid-September 2021. Perhaps surprisingly, however, less than 10% of deals launched in 2021 used SOFR as the basis for pricing. This was likely due to widespread market uncertainty over pricing Term SOFR loans (and whether any adjustments are applicable during a transition period while most loans trading are based on LIBOR), and also on operational challenges at agent banks that manage trading. In 2022, given the ARRC's requirement to stop using LIBOR for new loans, the transition will be quick and abrupt.

2.2.2 LSTA loan documentation

A growing trend in recent years has been the move toward standardized loan documentation in the U.S. market. The LSTA continues to publish standardized loan documents and is increasingly taking on a more active role in the primary market. Within the last seven years, the LSTA has released several versions of its primary documents, including an expanded publication of its Model Credit Agreement Provisions, a model credit agreement for revolving loan facilities and term loans, and in 2021, four different documents with respect to SOFR, the LSTA form of Term SOFR Credit Agreement, the LSTA form of Daily Compounded SOFR in Arrears Credit Agreement, the LSTA form of Multicurrency Loan Credit Agreement and the LSTA form of Daily Simple SOFR and Daily Compounded SOFR Credit Agreement.

This trend toward standardized documentation in the U.S. mirrors the use of Loan Market Association documentation in parts of Europe, and we fully expect it to continue in the years to come. At present, the U.S. market has not adopted these models wholesale but has instead adopted select LSTA provisions relating to regulatory matters and secondary market trading. The form of documentation used in the market continues to be based primarily on the documentation used in a precedent transaction between the investment bank arranging the loans and the borrower or sponsor.

2.2.3 Erroneous payments

In August 2020, a group of TLB lenders sued Revlon Inc. over a restructuring transaction, with Citibank as the administrative agent. When the lawsuit was still ongoing, instead of wiring the intended interest payment on the loans, Citibank mistakenly transferred $900 million, i.e., the full outstanding balances under the Revlon credit agreement, to the lenders. This amount included $500 million in excess of what it had intended to transfer. Citibank was able to recover about $350 million of the funds but there were a group of lenders who declined to refund the money. They argued that they were entitled to keep the funds due to an obscure legal doctrine called "discharge for value."

While the district court ruled in the lenders' favor and the ruling is in appeal, in response, administrative agents began requiring so-called "erroneous payments" language in the credit agreements that addresses this issue and is designed to prevent a similar result from taking place. Although 2020 had seen its share of credit agreements that already included some form of this language, it became more standard in 2021 and the LSTA published a version of this language, which became widely adopted.

2.2.4 ESG loans

ESG loans are loans used in sustainable investing where environmental, social and governance (***ESG***) considerations are important when making decisions to extend credit to a company. Some ESG loans contain a margin ratchet linked to environmental, social, and governance considerations, which is often also referred to as a "sustainability linked" margin ratchet.

In 2021, the market for loans with ESG features emerged differently in the U.S. and in Europe. In Europe, ESG loans had become the hottest trend already in late 2020 and over two thirds of the loans issued in the fourth quarter of 2021 included an ESG feature. In the U.S., on the other hand, only a few credit agreements included any ESG-related provisions by the end 2021, although the topic itself had been widely discussed in the U.S. leveraged finance market. One reason why "sustainability linked" ratchets have so far been more common in Europe than in the U.S. may be that margin ratchets have in general been more popular in Europe. That does not, however, fully explain why by the end of 2021, no U.S. domiciled company had issued any cross-border loans with ESG features or why the number of such ESG loans within the U.S. market has been so low to date. Another reason may be that, unlike in the U.S., the number of ESG funds increased significantly in Europe in 2021 and this increase also affected the number of ESG loan issuances. It remains to be seen whether talk about ESG loans translates to actual transactions in the U.S. during the course of 2022.

3 Economic Terms

3.1 Pricing

In terms of leverage loan market activity, 2021 was a very good year, especially for riskier, lower-rated assets. The index measuring the performance of the largest facilities in the leveraged loan market increased from 3.12% in 2020 from the prior year to 5.20% in 2021; with the market value component of total return that measures the change in secondary prices increasing 1.02% in 2021 compared to a loss of 1.77% in 2020. Loan assets grew in volume by more than 10% thanks to the record M&A activity seen in 2021.

The Federal Reserve held the Federal Funds Rate near zero throughout 2021 despite higher consumer spending and rising inflation. Therefore, funding costs remained low in 2021, with the average yield to maturity of new-issue leveraged buyout loans dropping below 5.00% for the first time ever. The average yield to maturity on all outstanding leveraged loans was 4.20% at the end of 2021, which is significantly lower than the 4.70% at the end of 2020 and 6.13% at the end of 2019. It is also worth mentioning that the average yield to maturity hit its all-time low in October 2021 at 4.16%, and did not climb more than 4 basis points in the three months from October to December 2021.

Since investors turned to lower-rated assets in 2021 in search for a higher yield, CCC-rated loans posted their best performance since 2016, a 12.45% annual return. CCC-rated loans also performed better than that of BB-rated and B-rated loans for most of 2021.

3.2 Optional prepayments

Unlike bonds, investors still generally accept that a TLB is repayable without penalty or premium. Investors continue to demand that some limited pricing protection be included in TLB facilities from the outset. The typical protection is a 1.00% prepayment premium that applies both to refinancings and amendments that effectively reduce the interest rate or the all-in-yield applicable to TLB under the credit agreement (known as "soft call" protection).

While soft call protection as a concept remained, in 2021 borrowers continued to press for broader exceptions to the requirement to pay a prepayment premium. Soft call protection

provisions typically included a "sunset" of six months. Soft call protection was often limited to refinancings with U.S. dollar denominated, floating-rate and broadly syndicated TLB facilities. While prepayments made in connection with material or transformative acquisitions, a change of control or an initial public offering remained common carveouts from the soft call protection in 2021, prepayments made in connection with dividend recapitalizations and transactions resulting in an increase in the principal TLB amount emerged as "new" carveouts. Prepayments made when the "primary purpose" of the transaction is not repricing also remained as another expansive and commonly seen carveout in 2021.

3.3. Mandatory repayments

3.3.1 Asset Sale Sweep

The asset sale sweep requires the borrower to use proceeds from certain asset sales to repay term loans outstanding under the credit agreement (***Asset Sale Sweep***). For the Asset Sale Sweep and the asset sale covenants, which in leveraged loan agreements are coupled together, 2021 was a year of weakening lender protections. Over half of the leveraged loans in the fourth quarter of 2021 included Asset Sale Sweep leverage-based step-downs and several loan agreements had minimum thresholds for the Asset Sale Sweep to apply with the option to have the unused portion of such minimum thresholds carried over the subsequent years. Some credit agreements reduced the scope of the Asset Sale Sweep by defining asset sales that are subject to the sweep very narrowly. The asset sale covenant, on the other hand, continued to impose a condition that consideration received consists of at least 75% cash but the number and type of carveouts from this covenant increased further in 2021. One common exception to the asset sale covenant was to permit the sale of non-collateral assets without restrictions (including not subjecting proceeds to the Asset Sale Sweep).

Furthermore, in 2021, several loan agreements permitted borrowers to use the Asset Sale Sweep proceeds to make restricted payments or pay down junior debt, provided that the borrower had sufficient capacity under the applicable covenants (the ***Asset Sweep RP Option***). These features under the Asset Sweep RP Option meant that a lot of the cash that would have traditionally gone to paying down debt or reinvesting into the business could now be provided to shareholders or junior debt holders. The most aggressive borrowers were able to have the Asset Sale Sweep fall away if there is any restricted payment capacity under the credit agreement at the time the borrower receives the proceeds. This trend is expected to continue in 2022.

3.3.2 Excess cash flow sweep

Excess cash flow (***ECF***) is usually based on EBITDA and represents the cash flow generated from the borrower's operations less tax payments and other cash expenses, interest and principal debt repayments and capital expenditures. The borrower is typically required to use a portion of each year's ECF to prepay the term loans (***ECF Sweep***). Any retained ECF is often used as the basis for the builder basket (see section 4.7 below).

In recent years, similar to the Asset Sale Sweep, the ECF Sweep has become less of a focus for lenders, with an increasing number of deals not requiring an ECF Sweep. Almost all the deals that have included an obligation to make mandatory prepayments set the prepayment amount at 50% of ECF, with leverage-based step-downs to 25% and 0%. Furthermore, credit agreements usually include numerous reductions that reduce the ECF payment amount. A notable shift in market practice has occurred in terms of how such reductions get calculated: are they reductions or are they credits? The historical way has been to reduce ECF on a dollar-for-dollar basis with respect to any voluntary prepayments, capital expenditures or other payments made. However, in recent years, the growing trend has been to move from ECF deducts to ECF credits. Under the "dollar-for-dollar credit system," instead of deducting such payments when calculating ECF, such amount would be credited on a dollar-for-dollar basis to the ECF Sweep. This is a more borrower-friendly formulation. The dollar-for-dollar credits, combined with increasingly higher minimum threshold, tend to result in the ECF Sweep only rarely being triggered. The dollar-for-dollar credits to ECF Sweep instead of the dollar-for-dollar deducts from the definition of ECF also affect the builder basket as discussed in section 4.7 below.

4 Restrictive Covenants

4.1 General

In 2021, the format and structure of the covenants in TLBs, for the most part, remained consistent. TLB facilities have until now generally resisted incorporating high yield covenants wholesale, although this approach has been taken in some circumstances (usually where the TLB sits alongside high yield bonds in the capital structure). While the use of high yield covenants in a TLB is still very much an outlier, the substance of TLB covenants continued to become more akin to high yield bond incurrence covenants, where many corporate actions are permitted subject to the meeting of certain ratios on the date of such action. For example, most TLB facilities keep payments to shareholders (also known as "restricted payments"), investments and prepayments of subordinated debt as separate covenants but have builder baskets and general baskets that are shared across the three covenants. This bond-like flexibility allows borrowers increasingly to enter into strategic transactions and incur or refinance debt without seeking the consent of their lender syndicate and without incurring the associated consent fees otherwise required to be paid. TLB facilities typically still include more stringent parameters around the terms of secured debt than unsecured debt, including tighter limitations on the borrowing entity, final maturity, weighted average life, prepayments and, sometimes, more restrictive terms (for example, requiring a "most favored nations" (***MFN***) provision in the case of the inclusion of a financial covenant in any *pari passu* term debt as further discussed in section 4.4.3).

In 2021, covenants related to debt incurrence, investments and restricted payments were the most heavily negotiated. The borrower's ability to incur incremental debt, make investments and make restricted payments right after closing increased, as well as the borrower's ability to incur debt with any unused investment or restricted payment capacity (as further discussed in section 4.11). Leverage governors became looser, "no worse than" tests became more common (see section 4.5) and the springing tests for the financial covenants applicable to revolving loans became even less restrictive than before (see section 4.2).

We have described the main covenant developments in 2021 in greater detail below.

4.2 Financial covenants

The prevailing trend over recent years toward "covenant-lite" institutional loans continued in 2021. "Covenant-lite" loans are a variation on the syndicated loan facility, which, at the most basic level, are loans that have bond-like financial incurrence covenants instead of the more traditional maintenance covenants.

Most TLB facilities have been "covenant lite" for decades, i.e., merely had incurrence-based financial covenants. Incurrence covenants are generally only triggered if the borrower takes certain action (e.g., paying a dividend, making an acquisition or incurring more debt).

If a financial maintenance covenant is included under an agreement, it is a springing financial covenant for the benefit of a cash flow revolving loan. Springing covenants are typically tested only when the relevant revolving lending facility is drawn above a certain threshold (***Trigger Threshold***). Inclusion of letter of credit exposure in calculating the Trigger Threshold has been a hot button issue with respect to "springing" financial covenants for a few years now and some loans continued excluding not only undrawn letters of credit from leverage calculations but all revolving borrowings, as well.

Springing financial covenants further loosened in 2021 and were mostly tied to a first lien leverage ratio instead of the secured leverage ratio or the total leverage ratio. Trigger levels increased compared to the previous year and were up from an average 7.25x first lien leverage ratio to 7.41x according to market reports.

Another significant feature of the springing financial covenants in 2021 that provided the borrower with more flexibility was the difference between the first lien leverage at closing and the actual covenant trigger level, so-called "Headroom." According to market reports, this average Headroom had been at 2.89x in 2020 but soared to an average of 3.11x in 2021 with, again, the fourth quarter seeing the highest Headroom at 3.30x. The Trigger Thresholds also increased a bit from 2020, from an average of 33.6% to 34.8%, with the most common trigger level for large and mid-market sponsor deals being 35%. Despite the slight uptick in the average Trigger Threshold, the 35% is consistent with the market practice from prior years.

With respect to incurrence covenants, the share of loans where the ratio governor was set at or above the borrower's closing date ratio, meaning that the borrower would not have to pay down debt at all in order to take that specific action, held steady for restricted payments and even tightened up a bit for investments, making this area one of the few where lenders were able to maintain or even improve their existing level of protections.

4.3 Day-One Capacity (debt, restricted payments and restricted debt payments)

Under most loan documents, borrowers are able to access rights to incur additional debt, make restricted payments and make restricted debt payments immediately after closing. This is called Day-One Capacity. Day-One Capacity was an area of investor attention in 2021. Investors continued focusing particularly on the amount of first lien debt that could be incurred immediately and whether that debt could be structurally senior to a TLB facility as a result of, for instance, being incurred by a subsidiary that was not a guarantor of the borrower's facility.

The level of Day-One Capacity available to borrowers increased significantly in 2021. According to market reports, the Day-One Capacity under the general debt basket, for example, soared from around 2.00x turns of EBITDA in the fourth quarter of 2020 to almost 3.00x turns of EBITDA in the fourth quarter of 2021. This is a significant increase from pre-COVID-19 levels, with mid-2020 onward seeing Day-One Capacity for general debt incurrence at around 1.50x turns of EBITDA.

4.4 Incremental debt

4.4.1 General

Additional debt incurred under a particular credit agreement is typically referred to as an incremental facility. For years, TLB credit agreements have included a right to add one or more new tranches of TLB (or increase the size of an existing tranche) on a *pari passu* basis within the framework of the original credit agreement. This ability is usually subject to both (i) a restriction on the aggregate amount of new debt that can be issued, and (ii) the protection of an MFN provision, further discussed below in section 4.4.3.

4.4.2 Incremental free and clear baskets

The total amount of incremental debt that TLB borrowers are permitted to incur has also evolved. Size was typically determined by one or more of the following three components: (1) a free and clear basket that may be incurred irrespective of *pro forma* compliance with a financial ratio; (2) a ratio amount limited only by such *pro forma* compliance; and (3) an add-on amount equal to voluntary prepayments of the existing debt. While originally free and clear baskets were a fixed dollar amount, a significant number of such free and clear baskets in large and mid-market sponsor TLB loan agreements now include a grower concept that sets the size of the free and clear basket at the greater of a fixed amount and a percentage of EBITDA, providing greater flexibility to the borrower to incur debt without the limitations of *pro forma* compliance. The ratio used to determine *pro forma* compliance is a point of negotiation as well. A first lien leverage ratio (often set at first lien leverage on the closing date) is the most common, but total secured leverage is common as well, and a small number of TLBs will determine the size of the ratio amount by reference to total leverage.

In 2021, the average incremental free and clear basket escalated further from the levels it had reached the previous years. The EBITDA grower in free and clear baskets was on average more than 1.20x of the closing date Consolidated EBITDA at the end of 2021, compared with around 1.00x a year earlier. The main reason for this development was the large amount of credit agreements that in 2021 permitted the borrower to use the general debt basket to incur incremental debt under the free and clear basket.

4.4.3 MFN sunsets and carveouts

The protection of the MFN provision ensures that any newly incurred incremental debt will be issued with an all-in-yield of no more than a threshold amount (traditionally 50 basis points of Headroom, which has gradually increased to 75 or even 100 basis points as discussed below) in excess of the all-in-yield on the original TLB facility (***MFN Differential***). The MFN provision requires the margin of the original debt to be adjusted to ensure the variance is no greater than the MFN Differential, and as a result, MFN provisions provide further economic disincentive for a borrower considering incurring debt under an incremental facility at a higher price. For this reason, borrowers typically push for an MFN provision to expire (the so-called MFN sunset) after closing. The typical MFN sunset used to be around 12 months but has been reduced to six months in recent years. Furthermore, by the end of the fourth quarter, over half of the loans issued had an MFN Differential of 75 basis points or more and over a quarter had an MFN Differential of as high as 100 basis points.

In addition to the MFN sunset, the MFN provision has long been subject to specific carveouts that allow the borrower to avoid increasing the existing lenders' all-in-yield even if the set MFN Differential is exceeded. Both the number of these carveouts and the portion of credit agreements that included such carveouts further expanded in 2021. By the end of the year, more than 50% of the loans issued had a dollar-based minimum threshold that had to be met for the MFN to be triggered and carved out any incremental TLB where the proceeds would be used to finance an acquisition or other permitted investment. Some MFN carveouts even went as far as to exclude all debt from

MFN protection that was not incurred to refinance the existing debt. Finally, with an increasing number of cross-border facilities, it is becoming more common for TLB facilities to specify that the MFN will apply only to the original term loans incurred in the same currency as the new incremental facility.

Some TLB facilities also incorporate other exceptions under which the borrower may incur additional debt that is not subject to the MFN provision. These exceptions include MFN provisions that are not triggered by additional debt maturing some period later than the maturity date of the original term loan. This period used to be two years but has recently been reduced to as short as six months. Some transactions include the right for a certain amount of incremental loans to mature earlier than the existing senior secured term loans without triggering the MFN provision (***Inside Maturity Basket***). The Inside Maturity Basket has gained a lot of traction and according to market reports, in 2021 over 60% of the credit agreements included an Inside Maturity Basket. Furthermore, in most deals it was not just a fixed basket but rather a fixed basket combined with a grower amount based on the borrower's Consolidated EBITDA.

In recent years, TLB facilities have also included a right to incur additional debt within the same parameters negotiated for incremental facilities under documents other than the original credit agreement – called "incremental equivalent debt" or a "side-car facility" – that meet certain pre-agreed criteria on the theory that the economic effect is the same as an incremental facility. Lenders typically permitted borrowers to incur incremental equivalent debt under bond offerings, but some TLBs include a right to incur side-car facilities in the form of term loans. The incurrence of such loans typically does not trigger MFN protections, although there has been some push by investors for the MFN to apply to side-car facilities that are incurred in the form of *pari passu* secured term loans.

4.5 Ratio tests and "no worse than" prongs

There is no dominant approach as to which financial ratio should govern ratio-based covenant exceptions, including those for debt incurrence – first lien leverage ratio, total secured leverage ratio, total leverage ratio, interest charge coverage ratio and fixed charge coverage ratio are all used.

To facilitate using incremental facilities to finance acquisitions and provide the borrower (and an acquisition target) with more certainty around the availability of their financing to close the acquisition, most credit agreements permit testing of the conditions to incurring an incremental acquisition facility (including projected compliance with any ratios and whether a default or event of default has occurred, other than a payment or insolvency default) only at the time of signing the related acquisition agreement (compared with actually closing the acquisition). TLB facilities have not settled, however, on whether a borrower must calculate and comply with ratio thresholds while the acquisition is pending by reference to financials that assume the acquisition has not occurred, *pro forma* figures that assume closing of the acquisition, or both. It is in addition increasingly common to permit the use of incremental facilities, incremental equivalent debt and other ratio-based debt baskets for acquisitions, even if the borrower does not currently comply with the applicable incurrence ratio, so long as the ratio is the same or better after consummation of the acquisition on a *pro forma* basis – a so-called "no worse than" prong to debt incurrence. Borrowers argue for these provisions, noting that growth benefits lenders with a larger collateral pool and increased EBITDA; however, lenders are hesitant to increase the debt load of companies that cannot meet the ratios otherwise agreed for new debt based on *pro forma* projections that may not be achieved.

While the "no worse than" prong has been widely used for acquisition debt and for investments, some borrowers were able to broaden the concept in 2021 to other debt incurrences as well. Combined with the generous EBITDA add-backs, the "no worse than" prong provides a borrower with significant additional flexibility to incur additional debt. In 2021, ratio tests in general were also looser. While a lot of credit facilities have typically allowed junior lien and unsecured debt to being incurred subject to an interest coverage ratio or a fixed charge coverage ratio, before 2021 this threshold was mostly set at the customary high yield threshold of 2.00x. In 2021, however, the threshold was dropped to an average of 1.75x, making it easier for the borrower to incur unsecured and junior lien indebtedness. The ratio tests for incurring secured debt were also looser and several credit agreements permitted secured debt to be incurred subject to an interest coverage ratio or a fixed charge coverage ratio (versus a leverage governor). In some deals, the coverage ratio for incurring secured debt was also set at the very low 1.75x.

4.6 Dividend recapitalizations

Dividend recapitalizations, which take place when a private borrower issues new debt in order to raise money to pay a special dividend to the investors who helped fund the initial purchase of the credit group, was yet another area that broke records in 2021. The volume of divided recapitalizations more than doubled from 2020 to over $80 million in 2021 and reached its peak especially toward the end of the year. The factors driving the dividend recapitalizations in 2021 included the increase in Day-One Capacity for borrowers to make restricted payments with respect to dividend-related loans and a jump in the share of loans clearing the market with borrower-friendly covenants and terms.

4.7 Available Amount

As with the free and clear basket for incremental facilities, it is also typical for TLB loan agreements to provide flexibility to borrowers to undertake acquisitions, investments, restricted payments, junior debt prepayments and similarly restricted transactions that would otherwise require *pro forma* ratio compliance up to a total maximum amount without such ratio compliance. This maximum amount, called the "Available Amount," "Cumulative Amount," or, more colloquially, the "builder basket," has traditionally been pegged to retained ECF, resulting in the basket's size building up over time. Now, instead of retained ECF, a lot of large TLB facilities base the "Available Amount" on a percentage of consolidated net income (***CNI***) (usually 50%), which permits the borrower to build the basket faster.

Traditionally, in order for the borrower to use the Available Amount basket, no Event of Default should have occurred and a *pro forma* incurrence ratio needs to be satisfied. For bonds, the incurrence test was often two times the fixed charge coverage ratio while for loans, it tended to be a leverage test. However, the requirements to utilize the Available Amount basket have eased over time.

In addition to the performance-based component, the Available Amount will also grow based on event-based components (e.g., equity issuances, debt exchanged for equity, declined proceeds from mandatory prepayments, etc.). The "Available Amount" now typically includes a fixed starter amount, and usually for large TLBs provides that the starter amount is the greater of a fixed dollar amount and a "grower" amount equal to a percentage of borrower's EBITDA (or sometimes total assets). The starter amounts permit borrowers to effectuate investments, restricted payments and other transactions from day one (an issue of focus for investors, as noted above).

While it is not a new invention to allow the borrower to select either retained ECF or CNI as the basis for the Available Amount's builder basket, several borrowers in 2021 were able to select the greatest of 50% of CNI, retained ECF or 100% of EBITDA less an interest expense multiple as the builder basket. Usually, the borrower was asked to make the selection before the launch of syndication. The inclusion of EBITDA as a builder basket option is good from the borrower's perspective as it allows the borrower to receive the benefit of add-backs negotiated in the EBITDA definition, including all of the cost savings and projected synergy add-backs.

Historically, when CNI was used as the builder basket, 100% of the losses would be deducted from a positive cumulative CNI. In 2021, there were credit agreements that had a zero-dollar floor for the cumulative calculation of CNI, meaning that losses would be a part of the builder basket calculation but only to the extent the cumulative amount was zero. In some other formulations, the zero-dollar floor was not for the cumulative CNI calculation but for each fiscal year. This would mean that any year with negative CNI would just be excluded from the calculation.

Finally, as noted in section 3.3.2, the dollar-for-dollar credits have become more common for the ECF Sweep than the more traditional ECF deducts. If the builder basket is based on retained ECF, this means that the borrower not only gets dollar-for-dollar credit for capital expenditure and any other spending that reduces the ECF Sweep, but additionally such amounts do not reduce ECF itself, which means greater capacity for restricted payments, investments and any other negative covenants that can utilize the builder basket under the credit agreement.

4.8 Reclassification

A significant number of TLB facilities now allow the borrower to reclassify debt that was initially incurred under the fixed debt basket as debt incurred under the ratio debt basket when capacity becomes available under such ratio debt basket (a concept borrowed from high yield bonds). These "reclassification" provisions have been incorporated into the additional debt baskets as well as the incremental facility amount. In practice, reclassification permits a borrower to refresh the starter amount it can borrow without complying with the ratio tests whenever capacity under the ratio amount or another additional debt basket later becomes available. Such provisions will also now typically provide that additional debt is deemed to be incurred first under any ratio capacity before the starter basket in order to preserve the amount that may be borrowed without being subject to the ratio cap. Some TLB facilities will also permit reclassification across certain covenants, such as, for example, reclassifying a fixed dollar basket for restricted payments to be used to make a junior debt prepayment (additionally, please see section 4.10 for the ability to use basket capacity across different covenants). TLB facilities rarely specify that a borrower must give notice or justify a reclassification (as reclassification is a borrowed concept from high yield bonds, which do not require notice or explanation of reclassification).

4.9 Permitted acquisitions, investments, restricted payments and restricted debt payments

The conditions to making acquisitions, investments, restricted payments, junior debt prepayments and similarly restricted transactions continue to be borrower favorable. One typical condition to such transactions has traditionally been an absence of either (i) a continuing event of default, or, (ii) more restrictively, any event which after the giving of notice or passage of time would give rise to an event of default if not cured (i.e., a Default). It has become more common for conditions to be limited to events of default only (so a restricted transaction may be permitted while a Default is continuing), and in some cases such transactions are permitted even while an event of default has occurred or is continuing so long as the event of default does not arise as a result of a non-payment or an insolvency proceeding. Conditions for permitted acquisitions and investments may also be tested upon the signing of an acquisition agreement, mirroring the flexibility provided for incurring acquisition debt as discussed above.

The borrower generally remains subject to the overriding requirement that material wholly owned subsidiaries must become guarantors and grant security. The level of materiality before a subsidiary is subject to these requirements, and on what basis (solely by reference to EBITDA or also assets), are heavily negotiated points. Loans will often not require controlled foreign corporations (or in some cases, all foreign subsidiaries) to become guarantors. EBITDA calculations to determine the guarantor threshold may also have specific exclusions that further reduce the number of subsidiaries that must become guarantors. However, a majority of loans to sponsor-backed borrowers in 2021 permitted unlimited investments in subsidiaries that were not guarantors, and borrowers were increasingly permitted to acquire entities that were not required to become guarantors. This ability was particularly common for borrowers having significant non-U.S. operations or a non-U.S. growth strategy.

4.10 Available restricted payment capacity amount

Although seen in credit agreements since 2018, the borrower's ability to use basket capacity across different negative covenants became more common in the U.S. leveraged finance market in 2021. One of the most popular forms of such optionality was the available restricted payment capacity basket, which typically allows the borrower broad flexibility to incur additional debt with any unused investment or restricted payment capacity, whether on a first lien, junior lien or unsecured basis, inside or outside the credit facility and/or in the form of loans or bonds. 2021 also saw other similar baskets such as those reserved for paying dividends and making other distributions not only for debt incurrence but also and alternatively for investments or prepayments of junior lien debt. These baskets are usually set at a one-to-one ratio (i.e., the exact amount of unused capacity under the first basket can be incurred under the second basket).

While the available restricted payment capacity basket is not a novel invention, what emerged as a "new" feature in 2021 was the borrower's ability to sometimes utilize this basket on a ratio higher than the typical one-to-one. Some borrowers were able to negotiate the ratio to two-to-one, permitting the borrower to incur \$2 of debt for each \$1 of restricted payment and/or investment capacity.

4.11 Financial definitions

The ways in which borrowers can calculate the ratios that permit additional debt incurrence continued to be more heavily negotiated. On the cash flow side, EBITDA definitions historically permitted borrowers to add back to EBITDA prospective cost savings from synergies arising from reorganizations and acquisitions, but such savings historically needed to be expected to be realized within a period of time (traditionally 12 to 24 months) and the amount of the add-back was capped to a percentage of total EBITDA. Borrowers have pushed for more flexibility in

several ways. First, more recent definitions expand the scope of what qualifies as a reorganization transaction, include add-backs for facility consolidation and closing costs, losses, costs or cost inefficiencies related to property disruptions or shutdowns, losses associated with temporary decreases in work volume and expenses related to maintaining underutilized personnel, as well as include add-backs for expected synergies arising from any "cost savings initiative" (i.e., not in connection with a specific acquisition or an overall reorganization plan) while leaving it to borrowers to determine what initiatives qualify. Additionally, the number of credit agreements that permitted the borrower to include the *pro forma* impact of new contracts into their EBITDA calculations significantly increased from the previous year in 2021. Several TLB facilities permitted synergies "of a type" reflected in the sponsor's related quality of earnings (***QOE***) report and, in some cases, a future QOE report. Second, the period of time within which cost savings must be expected to be realized became longer in 2021. While 12 to 24 months used to be typical, it is more common nowadays to have the period capped at anywhere between 24 and 36 months. A large number of TLB facilities no longer required the cost savings to be expected to be realized within the agreed period but rather required only that the borrower have taken substantial steps toward (or, in some cases, only stated that it has committed to) completing the reorganization or acquisition that will give rise to the expected cost savings within the agreed period. Finally, there were many credit facilities that did not have any time limit for adding back cost savings.

In addition to the other borrower-friendly trends seen in the EBITDA definition in 2021, the cap on the amount of EBITDA add-backs has mostly been removed: while only 30% of the deals in the beginning of 2017 had uncapped EBITDA adjustments, the percentage of such deals had gradually increased to over 50% by the end of 2021. Furthermore, in the cases where a cap is still present (usually at around 25%), it will still generally apply to all add-backs over a four-quarter period as opposed to per individual transactions, which is a formulation sometimes seen in European deals.

On the debt side of the ratio, TLB facilities have for some time permitted borrowers to calculate debt net of unrestricted cash held by the borrower and its subsidiaries. Cash netting was traditionally capped to a maximum dollar amount, but the number of TLB facilities that permit cash netting without any cap has increased over time and now represents a majority of TLB facilities.

5 Assignments and Amendments

5.1 Assignments

Some constraints on assignments of TLB remain customary. In general, a borrower's consent to assignments (not to be unreasonably withheld) is required. However, the consent requirement falls away while certain events of default (typically limited to non-payment and insolvency) are continuing. Generally, consent will also be deemed to be given if the borrower fails to respond within a specified period. The length of such period continues to be a point of negotiation, with borrowers pushing for periods longer than the LSTA-recommended position of five business days.

Assignments to disqualified institutions (i.e., competitors and other identified institutions) are also typically prohibited. A list of disqualified institutions is typically frozen at the start of primary syndication (other than as to competitors, which can be updated over the life of the TLB). Many TLB facilities now state that the list will be provided to individual lenders upon request instead of posted generally, making it more difficult for a lender to widely market a loan to secondary purchasers who do not know whether a trade will ultimately be permitted and settle. One increasing trend in recent years has been loan investors buying debt with the intention of profiting if the loan fails to perform, either through a loan-to-own strategy or through large credit default swaps that will pay off if the borrower defaults (so-called "net short" investors). In response to this strategy, 2021 continued to see an increasing number of borrowers looking to restrict transfers to such loan-to-own or net short investors as a general overriding rule and without naming specific institutions on the list of disqualified institutions (given the rapid emergence of new players in this space). These restrictions do not typically apply to regulated banks or to revolving lenders that were part of the syndicate at closing.

Finally, assignments to the borrower and its affiliates are generally permitted, although the total amount of loans that may be held by any lenders affiliated with the borrower is generally capped to an agreed percentage, typically falling around 20% to 25%, but *bona fide* debt funds of affiliates are often excluded from this cap.

5.2 Amendments

As for amendments to loan agreements, the thresholds have historically been set at a simple majority of lenders. The so-called sacred rights (including economic rights and release of substantially all guarantees and security) require the consent of all lenders. These thresholds now typically permit partial refinancings of TLB and incurrence of additional debt with consent only from "each affected lender," so that lenders who do not agree to participate in the change do not have any blocking right. In practice, some amendments (e.g., the release of all or substantially all guarantees and/or collateral) will still require unanimous consent. Agents are typically permitted, however, to agree to consequential amendments (such as those to security documentation) that implement permitted additional or replacement debt already permitted under the relevant loan agreement without any further lender consent.

Some loan agreements in 2021 more overtly disadvantaged certain lender groups over another, including lenders within the same class of loans. A loan agreement typically permits majority lenders to amend application of proceeds waterfalls to incorporate super-priority facilities within such loan agreement or enter into a subordination agreement with respect to indebtedness outside of such loan agreement. Borrowers, together with majority lenders, have structured amendments to loan agreements that provide lenders participating in such new money priming facilities more favorable treatment with respect to their existing indebtedness as compared to the existing indebtedness of the lenders not participating in such new money facilities. Further, borrowers frequently do not afford minority lenders an opportunity to participate in such priming facilities, and, consequently, such lenders are denied the more advantageous treatment for their existing indebtedness. Open market purchase provisions commonly found in TLB facilities provide borrowers with further flexibility to effectuate such deals without *pro rata* treatment among similarly situated lenders. Moreover, "covenant stripping," previously a tactic typically limited to the high yield market, was imposed on non-participating minority lenders to either coerce them into participating in the transaction or limit their future remedies in certain transactions.

5.3 Serta protections and priming debt

When Serta in June 2016 announced a proposed transaction to borrow an additional $200 million of super-priority first-out debt, an exchange of about $1.3 billion in existing loans for

$875 million of "second-out" term loans, and capacity to incur "third-out" term loans for an unspecified amount, few knew how much there would be a focus on the so-called "Anti-Serta provisions" by lenders throughout the rest of 2020. Anti-Serta provisions were designed to avoid lenders ending up in a situation as they did with Serta whereby a majority group of lenders amended the credit agreement to provide for priming debt and subordinated the lien of the existing minority lenders to that debt. Although, even before Serta, many credit agreements provided protection against releasing the lenders' lien on collateral, few protected against subordinating that lien. We note that the presence of crossover lenders, i.e., lenders that are stakeholders in more than one portion of the capital structure, and the unpredictability of finding oneself as a participating lender (as opposed to a minority non-participating or coerced lender) complicates incentives to provide meaningful protections to minority lender groups upon the origination of TLBs.

Although loan agreements also saw such Anti-Serta provisions in 2021, they started losing momentum especially in the large sponsor market. When over half of the credit agreements entered into during the second quarter of 2021 still included Anti-Serta provisions according to market reports, only less than 40% included such provisions during the third quarter of 2021. This trend was consistent with the general trend of ever-loosening covenants and lender protections.

6 Conclusion

In 2021, despite the continuing COVID-19 pandemic, low interest rates and active government spending helped fuel unprecedented M&A activity and thereby record-breaking volumes of leveraged loan, high yield bond and CLO issuances. Investors were willing to trade off covenant restrictions for a higher yield, allowing borrowers to refinance their existing debt facilities on more favorable terms. The fundamental credit conditions closed the year 2021 on an optimistic note with the rolling 12-month loan default rate below 1.00%, which is the lowest it has been in recent history. The default rate is not expected to significantly rise in 2022. Furthermore, the combination of a low default rate and rising interest rates is good for the leveraged finance market. It is expected to accelerate lending since banks will benefit from the increasing interest rates with the portion of defaulting loans envisaged to be small. The floating interest rate on which the TLB market is based will provide a hedge for lenders in the likely case that the Federal Reserve raises interest rates. All signs point to continued momentum for the U.S. TLB market in 2022.

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