Loans, Loan Agreements and The Loan Market

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Presentation Overview

- Loan Basics
  - Investment grade
  - Leveraged loans
  - Loan market participants
- Introduction to the Loan Market
  - Loan syndications, trading, and investing
  - Growth of US corporate lending
  - Secondary loan market emerges
- Credit Agreement Provisions
  - Conditions Precedent, Representations, Covenants, and Defaults
  - Participations
  - Erroneous Payment Provision
- ESG

Loan Basics

A Company Can Borrow Money In Different Ways

- How does a company borrow money?
  - Issue senior or subordinated debt securities in the public markets (eg, bonds may be issued under an indenture)
  - Private placement transactions
  - Issuance of commercial paper
  - Borrow under a credit agreement

Loans Can Be Classified as IG or Leveraged

Investment Grade

- Higher rated companies (above BBB-)
  - Lower risk profile
  - Typically, larger companies that investors are more familiar with
- Lower spread (less expensive)
- Less restrictive terms and covenants
- Examples of Investment Grade Borrowers:

EXXON Mobil

Leveraged

- Lower rated companies (below BBB-)
  - Higher risk profile
  - Typically, smaller companies that investors may not be as familiar with
- Higher spread (more expensive)
- Often secured by collateral
- More restrictive terms and covenants
- Examples of Leveraged Borrowers:

American Airlines

A Syndicate Is A Group Of Lenders Who Together Make A Loan To A Borrower

- "**Lead arranger**" is the firm that leads the structuring and syndication of a loan, i.e., the lead arranger drives the deal; sets the terms; interfaces with the client and investors; prepares, negotiates, and closes documents; and manages the syndication process.

- The borrower pays the arranger a fee to find investor dollars for it, and this fee increases with the complexity and riskiness of the loan. (The fee letter is kept confidential.)

An Arranger May Underwrite a Loan or Agree to Syndicate on a Best Efforts Basis

- There are **three types of syndications**:
  - **Underwritten deal** – the arranger guarantees the entire commitment so if they cannot fully subscribe the loan they make up the difference. Offering to underwrite a deal can be a competitive tool to win mandates and typically provides more lucrative fees.
  - **Best efforts deal** – here the arranger underwrites less than the entire amount of the loan. If the loan is undersubscribed, the deal may not close or terms/structure may need to be adjusted.
  - **Club deal** – a smaller loan that is premarketed to a small group of lenders.

With Large Loans Involving Multiple Lenders, There Is An Administrative Agent

- The administrative agent administers the loan; it is the agent of the lenders and not the agent of the borrower (other than the with regards to maintaining the register of lenders). Thus, the borrower cannot instruct the agent to take or refrain from taking any particular action. In practice, however, the agent often has the business relationship with the borrower.

- Agent is not a trustee or fiduciary for the lenders; its job is purely ministerial.

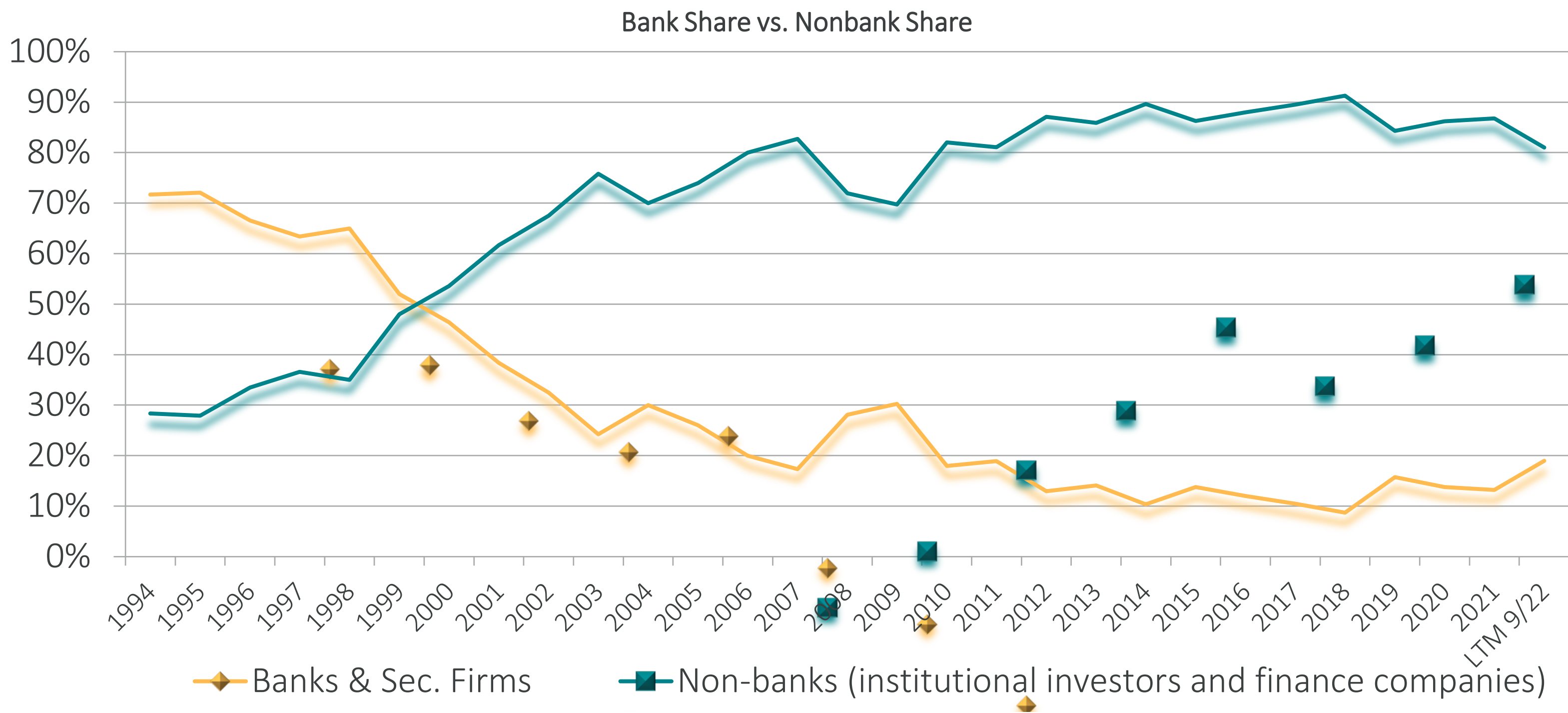
- The agent's role is to interface between the borrower and the lenders and amongst the lenders themselves. The Agent executes the "back office functions":
  - Receives financial reports from the borrower and makes them available to the lenders
  - Receives and disburses funds (e.g., payment of principal, interest, and fees) between the borrower and the lenders
  - Takes and delivers notices

Introduction To The Loan Market

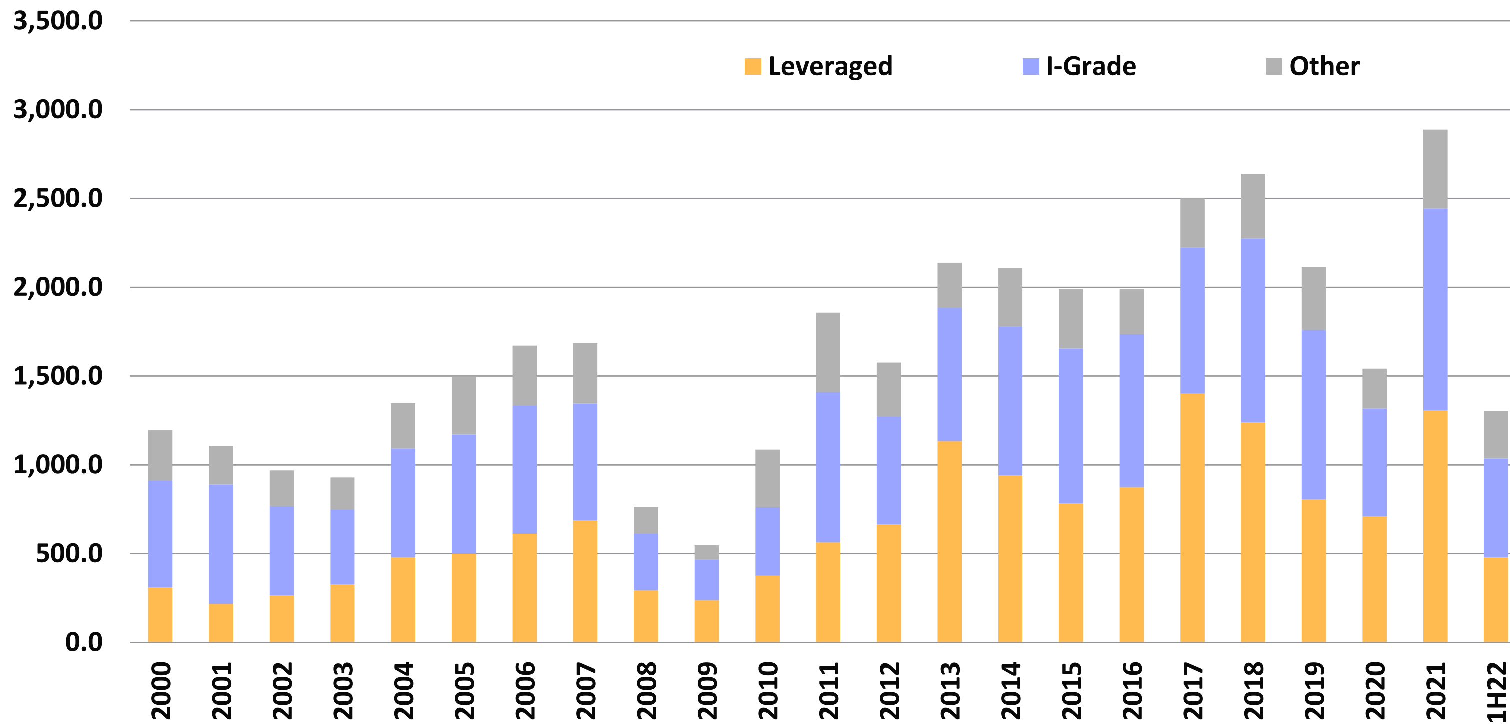
Art of Corporate Loan Syndications, Trading And Investing Has Changed Dramatically Over the Years

- In the past, banks made loans to their corporate borrowers and kept those loans on their books.
- Over time, investors were drawn to loans because of their attractive features. Unlike bonds, loans are senior secured debt obligations.
- Today, loans are held by banks, but they are also sold to other banks, mutual funds, insurance companies, pension funds, hedge funds, etc.
- Consequently, the US loan market has experienced remarkable growth.

Primary Market for Highly Leveraged Loans Was Dominated by Banks…



In 2021, US Syndicated Lending Hit a Record $2.9T



Source: Refinitiv LPC

US Secondary Loan Market Has Grown Significantly in Last 15 Years

Samsonite

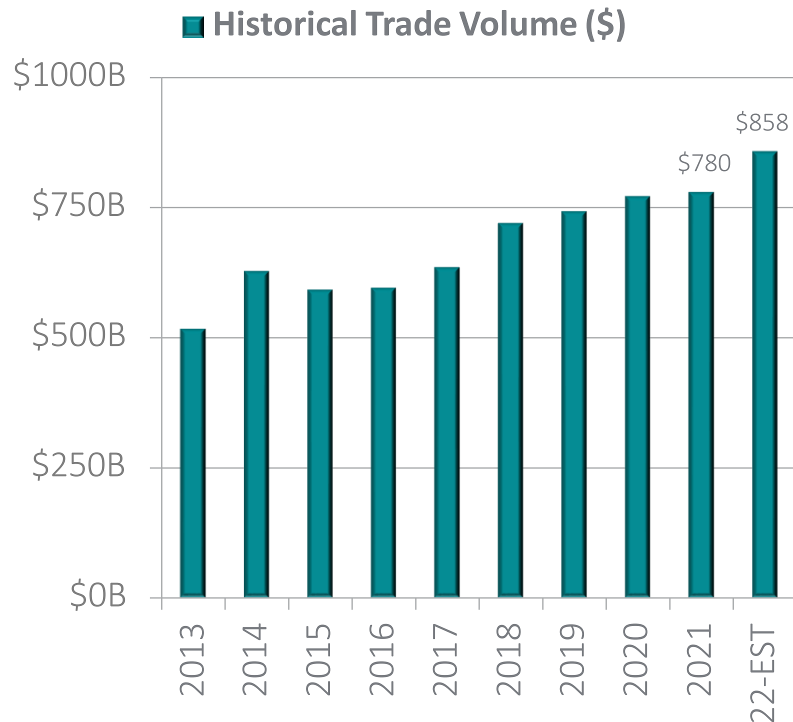
weightwatchers

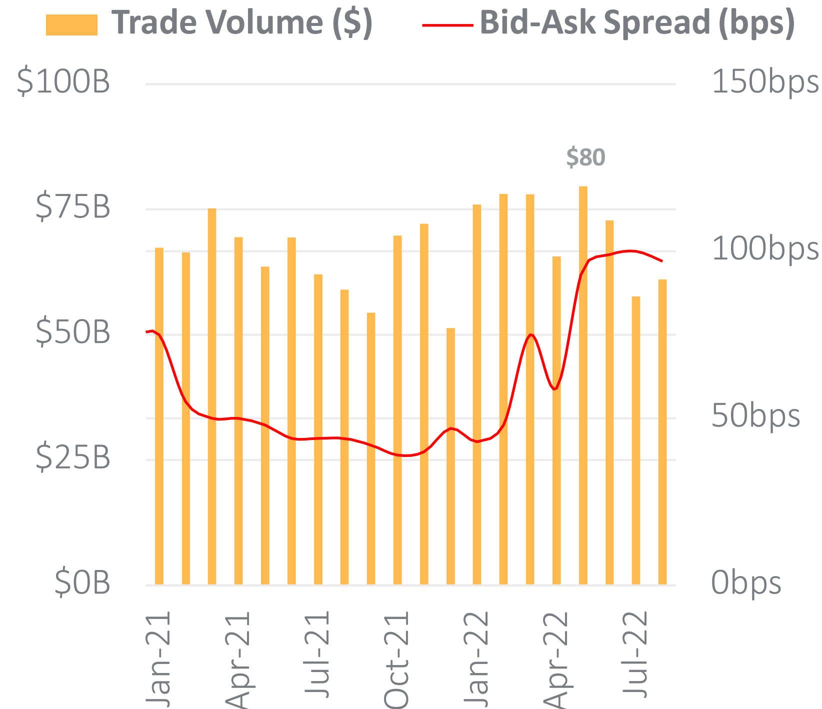
STAPLES

SEAWORLD PARKS & ENTERTAINMENT

Note: The logos on this page are trademarks and service marks belonging to the respective companies shown above

Annual Secondary Loan Trading Volume is Estimated to Rise 10% in 2022 to a Record $858B

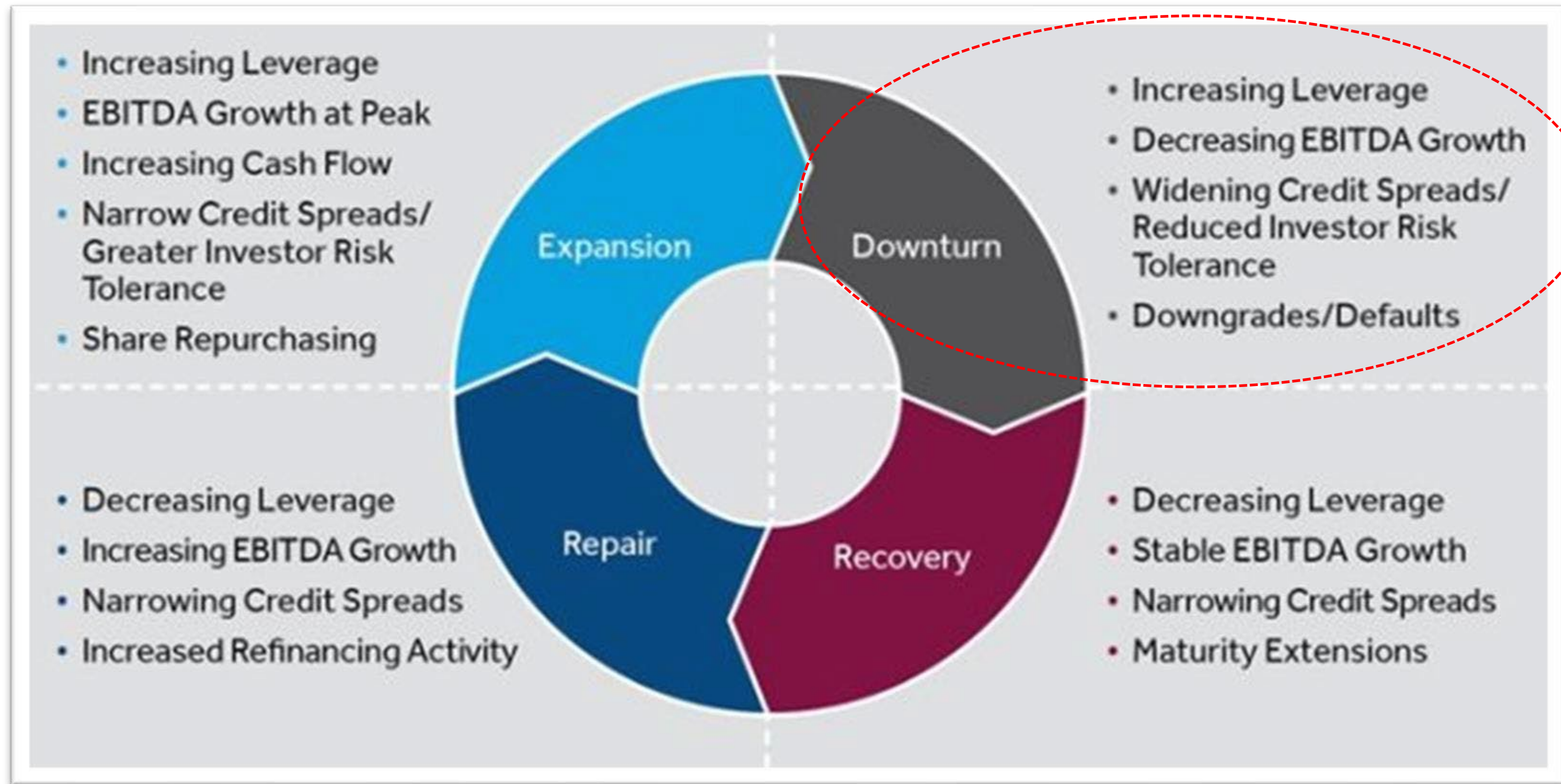




Source: LSTA Trade Data Study

LSTA

Where Are We in the Credit Cycle?
Have Borrower Fundamentals Peaked?



Credit Agreement Provisions

More Complex Credit Agreements Give Borrowers More Certainty & Flexibility

- Credit Agreements look different depending on the borrower and its business, including its size.

- In its simplest form, a credit agreement provides for a loan; in more complex agreements, it may include letters of credit, deposit facilities, and other ways to make credit available to a borrower.

- A 150-page credit agreement takes time to negotiate and draft, and the borrower must live with it for the term of the loan, but it also gives the borrower:
  - Committed funds
  - Business stability
  - Long-term debt that comes with an agreed repayment schedule

The Basic Form of Every Credit Agreement Is The Same

- Although credit agreements can be very complex, the basic form is the same:
  - Borrow money
  - Repay money with interest
  - Make representations
  - Agree to covenants
  - Include events of default for breaching a term of the agreement

- A short promissory note can also achieve the same result:
  - Borrower must repay
  - Lender can enforce that obligation

Term Loans Are Used to Fund Longer Term Capital Needs of a Borrower

- Term loans are made under a credit agreement and may be used by a company to finance an acquisition, refinance other debt, or provide funds for capital improvements.

- Once term loans are borrowed and repaid, they cannot be re-borrowed (but note that term loans - Delayed Draw Term Loans - can be made in multiple drawdowns over a period of time). (If a revolver is like a credit card, then a term loan can be analogized to a 30-year mortgage on a home.)

Revolving Credit Loans “Revolve” Within Commitments of the Lenders

- In a revolving credit facility (a/k/a “a revolver”), the aggregate amount of the loans may increase or decrease during the commitment period, i.e., a borrower may borrow money, repay, and re-borrow loans during the term of the lenders’ commitments. (A revolver is like a credit card.)

- Typically, revolving credit loans are used by borrowers that need working capital facilities, e.g., seasonal businesses like retailers

Credit Agreement Provisions

- Conditions precedent
- Representations
- Covenants
- Defaults
- Transfer provisions which are important for the secondary market, e.g. participations
- ….. But the document is always evolving! For example, the erroneous payment provision is now being added…

Conditions Precedent

Conditions Precedent are Like a Closing List and Can be Simple or Complex

- Conditions precedent generally must be met before lenders are required to lend. They specify:
  - What documents a borrower must deliver to the lenders or administrative agent
  - What actions the borrower must take
  - What other circumstances must exist for the loan to be made
- Although CPs are crafted for each deal, there are some which appear in nearly every credit agreement:
  - Execution of documents and corporate matters
  - Opinions
  - Material adverse change (MAC)

Representations and Warranties

Representations Serve Several Different Purposes

- Representations are **affirmations by the borrower** of certain facts that the lenders want to know are true. They are included in a credit agreement as a way to **confirm the assumptions** upon which the lenders based their decision to make the loan. If lenders learn that a representation is not true, they do not need to lend.

- A breach of a representation is a default under the credit agreement and lenders can accelerate the loan.

- Representations may also affirm the lenders' good faith (eg, if a regulator questions the care the lenders took to comply with applicable law, lenders can point to a representation given by borrower.) .

Certain Representations Address the Legal Status of the Borrower

- Borrowers will all typically give the following representations:
  - Organization, existence, power, and qualification to do business
  - Due authorization
  - Due execution
  - Enforceability
  - No conflict
  - Government approvals
  - Compliance with law; licenses
  - USA PATRIOT Act; FCPA; sanctions …

Even Investment Grade Borrowers Make Financial Condition Representations

- Financial condition representations address the financial and other business attributes of the borrower and cover financial statements, taxes, etc., and are considered “boilerplate”.
  - Financial statements
  - Material Adverse Change (MAC)
  - Litigation
  - Projection
  - Taxes
  - Pension plans and solvency
  - Material Agreements

Certain Representations Disclose Facts About The Borrower's Business/Property

- These are not boilerplate representations, and whether they are included is negotiated by the parties, e.g.:
  - Authorized capitalization
  - Complete list of subsidiaries/real property interests
  - Existing debt and liens
  - Good title to all real and personal property material to its business
  - Labor matters
  - Intellectual property
  - Environmental matters

Covenants

There Are Three Categories of Covenants: Affirmative, Negative, and Financial

- Affirmative covenants stipulate what borrowers must do:
  - They generally cover ministerial matters, e.g., delivery of reporting info, providing notices, compliance with laws, payment of taxes, etc.

- Negative covenants describe what borrowers are prohibited from doing.
  - These regulate how much additional debt the borrower can incur and on what terms, what investments may be made, when dividends can be paid.

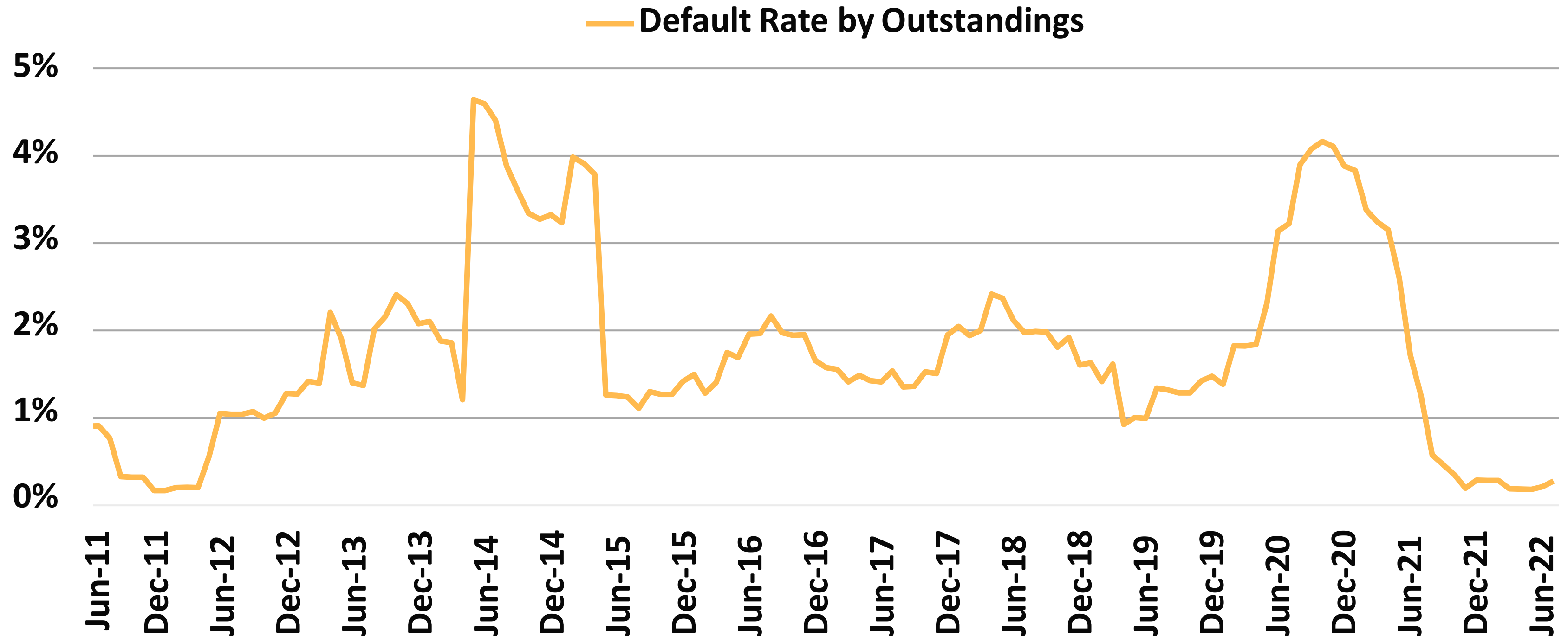
- Financial covenants require the borrower to meet certain financial performance targets.

An Incurrence Test Restricts How Much Debt a Borrower Can Incur

- As used in negative covenants, there is a distinction between an incurrence test and maintenance tests. "Cov lite" loans still have an incurrence covenant.
- An **incurrence test** is a **one-time restriction**, while a **maintenance test** is a **continual or periodic restriction**, e.g., a debt covenant that is an incurrence test might state that a company cannot borrow or issue debt if after giving effect thereto, the ratio of debt to EBITDA exceeds 5.00:1.

Events Of Defaults

Today's Default Rate Stands at Only 0.28% but is expected to increase in 2023



Lenders May Accelerate the Loans Once an Actual Event of Default Has Occurred

- An event of default such as a commencement of a bankruptcy proceeding constitutes a serious and urgent problem.
- Other events of default may relate to lesser nonpayment breaches that may be described as “technical defaults”.
- A default may take time to ripen into an **“event of default”** (only after notice is given or time has elapsed).

The Occurrence of an Event of Default Can Lead to a Real "Parade of Horribles"

- Events of default are specified events that suggest a borrower will not be able to pay lenders.

- Events of default can trigger a range of consequences:
  - Lenders can stop extending credit to the borrower
  - A lender can commence suit to recover the loan
  - Default interest may begin to accrue; late fees may be incurred
  - A borrower loses its right to consent to a loan transfer (a DQ list stands)

- An event of default could lead to a **cross-default** to other debt resulting in a daisy chain of accelerated debt obligations.

Participations

A Lender May Sell a Participation Without the Borrower's Consent

- Any lender may sell its portion of a loan and settle that loan trade as an assignment or as a participation. Where it sells as a participation, it can typically do so without the borrower's consent; however:
  - The lender's obligations under the agreement remain unchanged
  - The lender remains solely responsible to the other parties under the agreement, and
  - The borrower continues to deal directly with the lender.

Lawyers Have Tried to Pigeonhole Participations Into a Legal Category

- Does the participant acquire a legal or beneficial ownership interest? Is a trust relationship created? Is it a non-recourse loan from participant to seller?

- He LSTA has created Froms of Participation for the market to use, and they should ensure that sale accounting treatment is afforded to the sale of it.

- Participations have three basic elements:
  - Participation typically sold without recourse to the selling lender, i.e., the grantor.
  - A participation is a legal relationship between the selling lender and the participant.
  - Participation agreements impose a standard of care on the selling lender once the participation is acquired.

Erroneous Payment Provisions

Judge Furman’s Decision in Revlon Surprised Many in the Loan Market

- In August 2020, the agent under a Revlon credit agreement was due to pay approximately $7.8 million in interest to lenders.
- Due to a series of errors, however, the agent wired Revlon's lenders approximately $900 million (an amount coinciding with the aggregate principal and interest then outstanding).
- **Agent realized its error within 24 hours** and **promptly notified the lenders** of the mistake and requested they return the funds. Adhering to market practice, many lenders promptly returned the funds, and agent quickly recouped about $385 million. But about $500 million was not returned
- Agent sought to recover the monies paid by mistake from those “non-returning lenders.” The non-returning lenders, in turn, relied upon the common law defense of “**discharge-for-value**”.

Erroneous Payment Provision is Response by Agents to the Revlon Decision

- Judge Jesse Furman's decision in Citibank August 11, 2020 Wire Transfers (a.k.a. "Revlon) raised a number of issues for the loan market.
- Legal response: LSTA drafted a new erroneous payment provision ("EPP") for credit agreements
- Operations response: LSTA worked with agent banks who created appropriate payment notices to limit the risk of a Revlon type situation

Lenders Waive Discharge for Value Defense in the EPP

- On September 8, 2022, the US Court of Appeals for the Second Circuit vacated the decision by the District Court. The Second Circuit held that the case did not fall within the scope of the discharge-for-value defense; the defendants were not "shielded" from Citi's claims for restitution.

- **Will parties now drop the Erroneous Payment Provision from Credit Agreements?**
  - It is highly unlikely. Because and most importantly, in the EPP, the lenders waive the discharge for value defense. (Remember this was the common law defense relied on by the non-returning lenders when the agent sought to recover from them the monies paid by mistake.) EPP is likely here to stay!

ESG and the Loan Market

What is ESG?

- ESG stands for Environmental, Social, and Governance considerations
- Investors are increasingly applying these factors as part of their credit analysis process to identify risks and opportunities associated with ESG factors
- Common ESG Integration Strategies:
  - Positive screening
  - Negative screening/exclusions
  - Impact investing
- In the loan market, the focus on ESG has been largely related to risk mitigation
- Investors are interested in:
  - ESG disclosure
  - Awarding tailored mandates
  - ESG products/structures

ESG Disclosure in the Loan Market is Immature but Set to Improve

- Incomplete and incomparable ESG data is a challenge across financial markets, however, ESG ratings and reports are available on public companies
- However, many leveraged loan borrowers are loan-only and lenders only have access to the information that a borrower chooses to share with them
- Currently ESG reporting in the loan market is sporadic, uneven and superficial
- ESG disclosure is no longer a nice to have, it is a need to have

LSTA has Introduced First Steps and is Leading Industry-Wide Efforts to Harmonize ESG Data Requests

- The LSTA's ESG Due Diligence Questionnaire (DDQ) – Borrowers introduced an ESG disclosure hygiene:
  - Facilitates ESG dialogue among transaction parties
  - Can serve as a starting point for borrowers new to ESG
  - Can establish a baseline of ESG information
- Best practice is to make the completed DDQ available to all lenders and prospective lenders
- Completed DDQ should be posted to the data room on any loan transaction in the primary market
- The DDQ should also be posted to the Agent site for prospective lenders looking to buy loans in the secondary market

Contact Name:	
Role:	
Contact Email:	
Date Completed:	

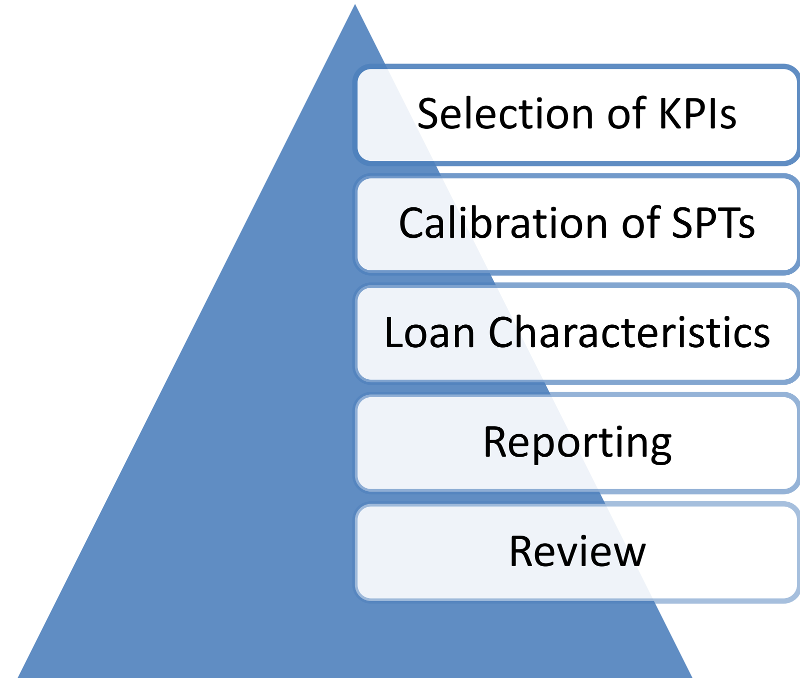
ESG Governance
1. Do you have a formal ESG policy (which may be a policy on an individual issue relevant to your company's business, e.g., workplace safety, environmental management or product safety)?
a. If the answer is "yes", please provide a copy of the policy. How is progress tracked or measured?
b. If the answer is "no", please describe any intentions or concepts with respect to ESG that your company has identified as relevant and your company's plans with respect thereto.
Please describe below:
c. What type of ESG-related reporting do you make available?
Please describe below:
2. Which individual(s) have formal oversight of ESG issues at your company? What is their title, department and reporting line, for examp business unit? What is the level of board oversight and expertise in ESG-related areas? How is performance tracked or measured?
Please describe below:
3. Are ESG factors integrated in management performance evaluation or compensation? *If "yes", please describe how below:*

Use of Proceeds Loans Have a Similar Structure and are Aligned with Their Bond Counterparts

- **Use of Proceeds** is the **key determinant**
  - **Green Loan**: Any type of loan where **100% of proceeds are used to finance/refinance** one or more "**green projects**" and aligns with the **four core components** of the Green Loan Principles (GLP).
  - **Social Loan**: Any type of loan where **100% of proceeds are used to finance/refinance** one or more "**social projects**" and aligns with **the four core components** of the Social Loan Principles (SLP).
- GLP and SLP are **closely aligned with the bond frameworks** maintained by ICMA to promote consistency across financial markets.
- Where appropriate, an **external review is recommended**.

Sustainability Linked Loans are not Tied to Use of Proceeds

- **Sustainability Linked Loan**: Any type of loan which **incentivizes the borrower's achievement** of **ambitious, predetermined sustainability performance targets (SPTs) based on material metrics (KPIs) which are core to the borrower's business**.
- The loan **use of proceeds is not a determinant.**
- Sustainability Linked Loan Principles (SLP) establish a framework which sets out **five core components.**
- **Borrowers must obtain independent and external verification of the borrower's performance** level against each SPT for each KPI **over the life of the loan.**



Bios

Bridget Marsh is Executive Vice President & General Counsel of the Loan Syndications and Trading Association (LSTA).

Prior to joining the LSTA, Bridget practiced as a corporate finance attorney at Milbank, New York, and as a lawyer in the Corporate/M&A department of Simmons & Simmons, London, and completed a judicial clerkship for The Honorable Justice Beaumont of the Federal Court of Australia. Bridget is a Fellow of the American College of Commercial Finance Lawyers, a Fellow of the American Bar Foundation, and a member of the Practical Law Finance Advisory Board.

Bridget Marsh received her Bachelor's degree *magna cum laude* from Georgetown University, a law degree with first class honors from Sydney Law School, University of Sydney, and a Masters in Political Science from the University of New South Wales. She is admitted as an attorney in New York, England & Wales, and New South Wales, Australia.

Tess Virmani is Deputy General Counsel & Executive Vice President - Public Policy of the LSTA. She is also the LSTA's Head of ESG.

Tess has a broad range of responsibilities at the LSTA. She leads the LSTA's sustainable finance and ESG initiatives which seek to foster the development of sustainable lending as well as to promote greater ESG disclosure in the loan markets. In addition, Tess engages in the LSTA's policy initiatives, including advocacy, regulatory engagement and developing industry solutions to loan market issues. Tess also focuses on maintaining and augmenting the LSTA's extensive suite of documentation, which includes templates, market standards, and market and regulatory guidance. Finally, she is involved in the development and presentation of the LSTA's robust education programs.

Prior to joining the LSTA, Tess practiced as a finance attorney at Skadden, Arps, Slate, Meagher & Flom LLP in New York. She received a B.S. in International Politics from the Walsh School of Foreign Service at Georgetown University and a J.D. from Fordham University School of Law. She is admitted as an attorney in New York. She is a Fundamentals of Sustainability Accounting Credential Holder and holds a CFA Institute Certificate in ESG Investing.