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Direct Lending Transactions

Overview of the Middle Market/Direct Lending Landscape

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Middle market lending totaled $139 billion in 2016, down from $142 billion in 2015.

Middle market volume is comprised of $105 billion of large middle market issuance (down 3% YoY) and $34 billion in traditional MM volume (flat YoY).

*Traditional MM: Deal Size <=$100M, Large MM: Deal Size >$100M to $500M, For all: Borrower Sales <$500M

Source: Thomson Reuters LPC
## WHAT IS THE MIDDLE MARKET?

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Lower M/M</th>
<th>Traditional M/M</th>
<th>Large M/M</th>
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<tbody>
<tr>
<td><strong>Deal Size</strong></td>
<td>&lt;= $100 million</td>
<td>&lt;= $150 million</td>
<td>&gt; $150 million</td>
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<tr>
<td><strong>EBITDA</strong></td>
<td>&lt;= $25 million</td>
<td>&lt;= $50 million but &gt; $25 million</td>
<td>&gt; $50 million</td>
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<tr>
<td><strong>Distribution</strong></td>
<td>Direct and/or Club</td>
<td>ProRata Club and Some Institutional</td>
<td>Institutional</td>
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<tr>
<td><strong>Arrangers &amp; Investors</strong></td>
<td>U.S. Banks</td>
<td>U.S. Banks &amp; Foreign Banks</td>
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<td>Finance Companies</td>
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<td>Loan Funds</td>
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<td></td>
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<td>Hedge/High Yield Funds</td>
</tr>
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</table>
Middle Market New Money Volume

Billions

$- $10 $20 $30 $40

Syndicated MM
Private/Direct MM

1Q14 3Q14 1Q15 3Q15 1Q16 3Q16

Source: Thomson Reuters LPC
INFLOWS FROM BDCs AND CLOs INTO THE MIDDLE MARKET SPACE

Source: Thomson Reuters LPC
PRIMARY MARKET INSTITUTIONAL LOAN YIELDS

Average yield

Large Corporate Market
Middle Market

Source: Thomson Reuters LPC
Survey: The role of direct lenders will...

- **Grow**: no one else can do tougher credits (60% of respondents)
- **Not change**: growth will be focused on middle market issuers (40% of respondents)
- **Diminish**: regulatory environment will ease under new administration (0% of respondents)

Source: Thomson Reuters LPC
Evolution of the product

- Middle Market Lending has always been around. Almost every balance sheet lending bank and arranger investment bank has a “middle market” team focused on smaller corporates and mid-tier Sponsors.

- Direct Lenders are different from your traditional middle market balance sheet banks and middle market desks at arranger institutions. They may play in same space, but they are not the same.

- Direct Lenders, like balance sheet banks, are focused on a return to actual lending as opposed to distribution.

- Direct Lenders have evolved from simple club deals serving family offices and middle market sponsors to leading deals for top tier sponsors.

- Direct Lenders are unregulated non-banks
  - Leveraged Lending Guidelines do not apply, so direct lenders are able to go deeper into the capital structure.
Middle Market/Direct Lending Products

- Partially syndicated middle market deals - marketed to direct lenders, but also have a (limited) syndication strategy for the balance

- Types of Direct Lending Deals
  - Bought Deal
  - Club Deal
  - Partially Syndicated Deal with Significant Hold

- Unitranche Deals vs 1L/2L
EMERGENCE OF THE DIRECT LENDER

Will we look back on 2016 as a watershed?

- **Senior Lending:** Antares, Ares, Golub and Guggenheim are the three most active direct lenders in the senior lending space.

- **Junior Capital:** Highbridge, PSP, CPPIB, GS MBD, KKR Financial, Elliott and others showed a willingness to provide committed junior capital in late 2015 and early 2016 when the markets were over-tax ed.

- **Opportunities Taken:** When credit markets were closed in Q1 2016, these players showed that they could and would play, and wrote large tickets on economically competitive terms - and offered certainty of execution and pricing.

- **Scale and Scope:** Top Tier/Large Cap Sponsors have taken notice:
  - Bain (Antares led Navicore)
  - KKR (Golub led Mills Fleet)
  - Thoma Bravo (Qlik and other deals)
  - Vista (Golub and Antares have led several deals for Vista, including recent SunGard carve-out)
  - Warburg (NeoGov and Hygenia led by Antares)
  - Providence (Golub led OEC)
Qlik Technologies received a $1.075 billion unitranche credit backing a buyout of the company by Thoma Bravo. Ares Capital Corp. is leading the financing, which is the largest-ever unitranche deal by a business development company. Ares Capital is administrative agent, joint lead arranger, and joint bookrunner. Golub Capital, TSSP (TPG’s dedicated credit and special situations platform), and Varagon Capital Partners are also joint lead arrangers.

[Note that QLIK soon will be eclipsed by the refinancing of the existing debt of the Affinion Group with committed unitranche financing from Highland, comprised of a 5-year $1.34 billion term loan facility and a $110 million revolver.]
When syndicated markets were all but closed, Golub led the first lien, with Oaktree and GS, with $535 million first lien facilities, PSP led the $180 million second lien, with Wells providing a $100 million ABL.
PRIMER ON BDCs

BDCs

Business development companies ("BDCs") are special investment vehicles designed to facilitate capital formation for small and middle-market companies:

- Must invest at least 70 percent of its assets in "eligible portfolio companies."

- An eligible portfolio company encompasses all private U.S. companies, as well as U.S. public companies with an equity market capitalization of up to $250 million.

- A BDC has discretion to invest in any other investments with the remaining 30 percent of its portfolio.

- BDCs are exempt from the Volcker Rules, and are not banks so not subject to leverage lending guidelines either.
Differences For Committed Deals

1. Limited or no syndication
   - Committed club deals often do not require preparation of CIM or other marketing materials
   - Syndication often limited to a targeted strategy of pre-identified lenders

2. Less emphasis on Marketing Period
   - Speed of execution
   - Club deals

3. Limited or no flex/“Successful Syndication”

4. Limited Ratings
   - No ratings process – cost saving for Sponsor
   - Smaller deals rely almost exclusively on shadow ratings
   - Larger deals (>300mm) will often include some form of syndication

5. Terms are what the lenders will have to live with – stronger focus on underwriting at commitment stage, no flex to rely on
WHY ARE SPONSORS USING DIRECT LENDERS

The Value Proposition

1. Certainty of pricing: limited or no pricing flex. Compared to risk of pricing at the caps.
   - Less competitive vs indicative pricing
   - Very competitive vs fully flexed pricing
   - Certainty on closing upfront fees leads to certainty of proceeds
2. No Flex on Terms: customary to have no flex on terms
3. Conscious Shift to Limited Conditionality: Direct Lenders decided to get competitive with Arrangers
The Value Proposition (Cont’d)

4. More Leverage: Leveraged Lending Guidelines often do not apply

5. Willingness to speak for the most difficult piece of capital structure: willing to take down the 2nd lien, often on a bought basis

6. Unitranche deal gives sponsor call protection flexibility: call protection rarely as onerous as a 2nd Lien/bond deal

7. Disintermediation of Banks: often means lower all-in costs (potentially)
DIRECT LENDER EXPECTATIONS

Direct Lenders Do Get Certain Terms:

1. Financial Covenant (Senior Lenders): Still a strong reluctance to forego the financial covenant or adopt more bond-like covenant packages/basket structures

2. Higher Indicative Pricing: Certainty comes at a price

3. Stronger Underwriting: Direct Lenders do expect, and often get, better terms.

4. No Market Check: Arrangers still can sell syndicated paper at the best possible market clearing price if the market is there. Direct Lenders will not attempt to do so. The price is agreed at signing. There is no upside for the sponsor if the market improves during interim period.
With more sophisticated Sponsors and with the need to be competitive with other Arrangers in auction situations, Middle Market Lenders/Direct Lenders have had to agree to terms that do converge with large cap transactions:

- Run rate EBITDA cost savings adjustments
- Bleeding edge revenue side adjustments
- Incurrence based covenants
- Reclassification rights (In some deals)
- Underwritten Doc Precedent from large cap deals

But they still continue to exhibit their Middle Market DNA:

- DQ List fall-aways in default
- 4Q/Monthly financials
- Quarterly lender calls and/or MD&A
- DACAs and Collateral
- Views re: earnouts
Some Middle Market Lenders/Direct Lenders will adopt covie lite structures but many will fight to retain some form of financial covenant:

- Even in deals of significant EBITDA sizing, they will pursue a financial maintenance covenant.
  - e.g., KKR agreed to a single Total Leverage Ratio covenant in Mills Fleet Farm ($1bn total deal size, $550mm First Lien), with several step downs in the “base case”
- Number of step downs is heavily negotiated
- Cushion set at levels that gives the sponsor comfort that the covenant has only minimal teeth in most cases
- Unlike flex-triggered financial maintenance covenants, there are no surprises – step-downs are what they are.
Financial Definitions

Lack of flex means terms are often heavily even more heavily-negotiated at commitment stage than for broadly syndicated deals:

- Usually more conservative than large cap – credit driven analysis of each EBITDA adjustment not uncommon
- Caps are common for EBITDA adjustments, not just limited to cost savings adjustments (e.g., addback for unusual and non-recurring charges)
- Real realization periods are fought for but run rate adjustments are sometimes agreed to
- Netting is carefully considered, often capped or subject to control requirements or limited to cash of the borrower and its domestic restricted subsidiaries held in U.S. domestic accounts
- Flip side: willing to lean in for appropriate credits and consider bespoke revenue adjustments in competitive context
Financial Reporting

While generally there has been a shift towards convergence with large cap terms, some middle market lenders/direct lenders are still focused on:

- **4Q Financials (not just 3Q + 1 annual) –**
  - Designed to mitigate issues around length of time to deliver audited financials
  - Related to covenant testing as well

- **Monthly financials**

- **Quarterly/annual calls**
MIDDLE MARKET/DIRECT LENDER TERMS

Negative Covenants Generally

While generally there has been a shift towards convergence with large cap terms, some middle market/direct lenders are still focused on:

- Unlimited RPs/Investments/RDP Baskets – focus on significant deleveraging before these baskets are available.
- Builder Baskets – focus on leverage tests for usage and real deleveraging
- Reclassification right – real concerns re: limiting availability of this flexibility
- Additional Covenants/Fall Away – Provide for additional restrictive terms if direct lender’s funds hold > x% after syndication
- Earn Outs – heavily negotiated
Attitude Towards Acquisitions

While generally there has been a shift towards convergence with large cap terms, some middle market lenders/direct lenders are still focused on:

- **Limited Conditionality Transaction Testing** – Only became acceptable to these lenders in late 2015 when they found themselves competing with large cap terms

- **Some true middle market lenders will look to a $ cap on acquisitions (in sub $150mm deals), but that position is being eroded to convergence with large cap terms**

- **Earn Outs** – heavily negotiated (as discussed previously)
Incremental Facilities

While generally there has been a shift towards convergence with large cap terms, middle market lenders and some direct lenders are still focused on:

- No new RCF tranches, RC increases only
- ROFOs – Want to be able to fund ratable share (control club)
- True middle market deals may require pro forma fin covenant compliance for use of “free/clear” prong of incremental facility and also require limits on use of proceeds (no RPs, only accretive investments etc.)
Economic Terms

- OID/Upfront Fees – Includes RC

- Rates – typically, no pricing stepdowns unless pressured by competitive situation, LIBOR floor applies to RC as well as term loan, same pricing on RC, drag along for RC in flex (if any flex exists)

- Call Protection – call protection often meaningful for unitranche deals. 102/101 not uncommon for unitranche but usually not as onerous as true hard call that’s typical in the second lien market

- Default Rate – debate may exist whether it should apply to all obligations vs. on overdue amounts, triggered on any EOD or specified EOD not just payment/BK (and maybe also financial covenant default), and whether it’s automatic or on only on demand
Voting

While generally there has been a shift towards convergence with large cap terms, some middle market/direct lenders are still focused on:

- Club style voting (at least two to three lenders holding more than 50%, can’t have one or two holders dictating outcome)
- Stricter limits on sponsor-affiliated voting, or not permitted at all
- Vestigial concerns about junior creditors with crossover holdings voting in senior deal
Assignments

Direct lenders are still focused on:

- Disqualified Lender List falling away on specified default
- Competitors who can be DQ’d more limited, clearer definition of vertical market
MIDDLE MARKET/DIRECT LENDER TERMS

Second Lien/Junior Capital

A Second Lien/Junior Capital deal clubbed up with direct lenders is distinctly different from an arranger-led deal:

- Often will have a real financial maintenance covenant, set at a cushion to the first lien level
- Can press for real improvements in terms
- Battleground is on cross payment default/acceleration, cushions, whether cushions should apply to ratios, anti-layering, debt caps, ability to offer a competing DIP, and voting issues
Intercreditors/AALs

- Where both 1L and 2L are direct lender clubs, the ICA negotiation is often particularly contentious.
- Club 2nds have a voice and often will negotiate terms up front. Their focus will be on:
  - Shorter/better rights on on standstill from 2L
  - Strict limits on layering, caps on first lien and tighter caps on first-lien DIP capacity
  - One-sided limits on increases to first lien pricing (sponsors will resist)
  - Multiple purchase rights, exercisable on broader range of defaults
  - Some will try to blind side the first with requests for broad unsecured lender rights (1L will always resist).
Intercreditors/AALs

- e.g., in recent large cap deals where the 2nd lien was privately placed at signing, the seconds pre-negotiated specific ICA rights.
- Agreements among lenders in unitranche deals often negotiated at the fund level and do not require deal team input.
## YE 2016 Middle Market Arranger League Table

### US Middle Market Bookrunner League Tables (Deals under US$500m)

<table>
<thead>
<tr>
<th>Firm</th>
<th>Rank</th>
<th>Deal Count</th>
<th>Deal Value ($USM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wells Fargo &amp; Company</td>
<td>1</td>
<td>593</td>
<td>49,647</td>
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<tr>
<td>Bank of America Merrill Lynch</td>
<td>2</td>
<td>603</td>
<td>47,845</td>
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<td>JP Morgan</td>
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<td>510</td>
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<td>U.S. Bancorp</td>
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<td>331</td>
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<td>PNC Financial Services Group</td>
<td>5</td>
<td>262</td>
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<tr>
<td>SunTrust Banks</td>
<td>6</td>
<td>240</td>
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<tr>
<td>Citi</td>
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<tr>
<td>KeyBanc Capital Markets Inc.</td>
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<tr>
<td>Citizens Financial Group</td>
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<tr>
<td>BMO Capital Markets</td>
<td>10</td>
<td>194</td>
<td>9,794</td>
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*Source: Thomson Reuters YE 2016 League Tables, Ranked by Deal Value*
## MIDDLE MARKET/DIRECT LENDING PLAYERS

### YE 2016 Direct Lender

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<tr>
<th>Direct Lender</th>
<th>#of Deals</th>
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<td>Antares Holdings (GE Antares Capital)</td>
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<tr>
<td>Madison Capital</td>
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<tr>
<td>Golub Capital</td>
<td>33</td>
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<tr>
<td>NewStar Financial</td>
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<td>NXT Capital</td>
<td>31</td>
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<tr>
<td>Ares Capital</td>
<td>28</td>
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<td>Monroe Capital</td>
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<tr>
<td>MidCap Financial</td>
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<td>Alcentra Capital</td>
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<td>Babson Capital Management</td>
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<td>Audax Capital</td>
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<tr>
<td>Crescent Capital Group</td>
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<td>Hercules Capital</td>
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<td>Varagon Capital</td>
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<td>Main Street Capital</td>
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<td>Maranon Capital</td>
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Sources: Prequin, Pitchbook, Dealogic, CapitalIQ  
Deals announced or completed through December 31, 2016

### Private Debt Dry Powder, 2005 - 2017

As of January 2017, nearly 1,400 active private debt fund managers collectively hold $193bn in dry powder. Untapped capital committed to private debt funds continues to accrue for North America-focused funds, with dry powder held by funds focused on the region increasing by nearly $13bn since December 2015 to reach $132bn. In contrast, dry powder held by Europe-focused funds dropped by just over $6bn over the same period to $54bn.
# LATHAM’S MARKET POSITION

## Middle Market YE 2016 Legal Advisor League Tables

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<th>Rank</th>
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<tbody>
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<td>Latham &amp; Watkins LLP</td>
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<tr>
<td>Moore &amp; Van Allen PLLC</td>
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<td>109</td>
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<td>Jones Day</td>
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<tr>
<td>Cooper, McGuire Woods, LLP (VA)</td>
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<td>Sidley Austin LLP</td>
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<td>Cahill Gordon &amp; Reindel</td>
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<td>Simpson Thacher &amp; Bartlett</td>
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<td>Kirkland &amp; Ellis</td>
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<td>Weil Gotshal &amp; Manges</td>
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<td>58</td>
<td>10,068</td>
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<tr>
<td>Ropes &amp; Gray</td>
<td>10</td>
<td>52</td>
<td>8,987</td>
</tr>
</tbody>
</table>

*Source: Thomson Reuters YE 2016 League Tables, Ranked by Deal Value*
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# Latham Leveraged Finance Team

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<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Contact Information</th>
</tr>
</thead>
<tbody>
<tr>
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</tr>
<tr>
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<td>Banking Partner, San Francisco, Silicon Valley</td>
<td>T +1.415.395.8870  E <a href="mailto:haim.zaltzman@lw.com">haim.zaltzman@lw.com</a></td>
</tr>
</tbody>
</table>
Andrew A. Fayé is a partner in the Los Angeles office of Latham & Watkins and is a member of the Finance Department and the Banking Practice. Mr. Fayé has also worked in Latham & Watkins' London office.

Profile
Mr. Fayé specializes in lender side leveraged finance, acquisition finance, asset-base lending and complex cross-border secured transactions. In his national practice, Mr. Fayé represents a wide range of commercial, investment banks and non-traditional lenders, centered in New York and California. He has acted as arranger’s counsel on numerous middle-market and large cap syndicated credits for non-investment grade companies.

Experience
Mr. Fayé has acted as lead attorney on over 20 completed transactions for GE Capital and GE Antares over the last three years, as well as numerous middle-market and large cap financings for Bank of America Merrill Lynch, Macquarie Capital, Credit Suisse and Deutsche Bank, among others.

Career highlights include representing UBS in its senior secured financing of Sony Corp, Mubadala Development Company, the estate of Michael Jackson and other investors’ multi-billion dollar acquisition of EMI Music Publishing.

Mr. Fayé has practiced in both the United States and London, and in both the High Yield and Banking groups at Latham & Watkins, allowing him to oversee numerous complex first, second, third and split-lien transactions and numerous cross-border financings.

Mr. Fayé regularly presents training seminars both to clients and at bar association events regarding upper-middle market and large cap topics and trends, and has served as head of the Latham & Watkins Finance Department in Los Angeles.

Recognition Highlights
Recognized as a Recommended Lawyer in The Legal 500 US 2015 and 2016 rankings (Tier 1) and described as a "superb counsellor in every sense."

Recognized as a leading banking and finance lawyer in Chambers USA 2016. Sources describe Mr. Fayé as "phenomenal" and a lawyer who is “very thoughtful and can work through problems.”

Education
JD, Georgetown University Law Center, 1996
BA, University of California, Los Angeles, 1992

Bar Qualifications
California
Jane Summers is a partner in the New York office of Latham & Watkins and is a member of the firm’s Finance Department and Banking Practice. Ms. Summers is also a member of the firm’s Ethics Committee and Finance Committee, and Co-chair of the firm’s women’s initiatives in New York.

Profile
Ms. Summers focuses primarily on the representation of major financial institutions in:
- Leveraged finance transactions
- Acquisition financings
- International financings
- Exit financings
- Asset-based facilities
- Senior secured lending transactions
- Strategic purchases of distressed debt

Ms. Summers also advises loan market participants on strategic initiatives designed to address structural issues in the syndicated lending and loan trading markets, speaks frequently on market trends and serves as an expert witness and consultant involving questions critical to market practices.

Experience
Ms. Summers served as Executive Vice President and General Counsel of the Loan Syndications & Trading Association (LSTA), the industry organization for the corporate loan market.

While at the LSTA, Ms. Summers was responsible for developing and managing the organization’s legal, documentation and regulatory strategies for key industry issues that establish standard market practices and procedures. Ms. Summers was appointed the LSTA’s first general counsel in 2000.

Ms. Summers spent the first decade of her career in the leveraged finance group at another major law firm, following which she served as Deputy General Counsel for Barclays in the Americas.

Ms. Summers is a member of the American Bar Association Business Law Section’s Syndications and Lender Relations Subcommittee, the New York State Bar Association, the Association of the Bar of the City of New York and its Committee on Women in the Profession.

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JD, University of Pennsylvania Law School, 1984, cum laude
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