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A Closer Look at Asset Sales in Leveraged Finance: reinvest, repay, repeat

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The traditional approach to the treatment of disposal proceeds in leveraged loan agreements has evolved in recent years, as borrowers seek to retain greater flexibility as to what they need to (or can) do with such proceeds, while also aligning itself with the approach taken in the high yield bond market.

Mandatory prepayments from the proceeds of disposals

Although creditors tend to be primarily focused on the amount of EBITDA a group generates - for its consequential effect on leverage as a key performance indicator and a focus on sales as a going concern for any likely enforcement scenario - the disposal of any material assets will remove value from the group and could still adversely affect performance if those assets contribute to EBITDA generation. As such, disposals have typically needed to have a neutral impact, with the proceeds either being required to be reinvested or used to repay senior debt incurred under a loan agreement.

Traditional loan agreement mandatory prepayments

Under traditional LMA-style loan agreement terms, a group is prohibited from disposing of any asset, undertaking or business, unless such disposal is on a limited list of "permitted" operations. Typically, these would be relatively limited and only include disposals such as those of trade assets in the ordinary course of business, intra-group transfers, comparable asset exchanges (provided replacements of secured assets are equally secured) or sales of redundant machinery for cash. The consideration received (less reasonable expenses and taxes) would then be required to be promptly applied to prepay the lenders and cancel commitments (each pro rata to their respective commitments). A group is therefore limited in what changes it can make to its business and operations while being required to repay debt as soon as it does receive disposal proceeds. Such obligations both lowered the borrower's incentive to make extraordinary disposals while progressively de-leveraging the group.

Over time, additional common exceptions to the requirement for prepayment (often referred to as "Excluded Disposal Proceeds") have developed in the loan market. We will discuss below the cumulative effect of these exceptions and how they have developed more recently, but traditionally these have included:

- **Individual *de minimis* thresholds:** a buffer amount of proceeds from single disposals (or related disposals) before the prepayment obligation is activated. Only the excess proceeds (above the threshold) are then applied towards prepayment.

- **Aggregate exception***:* in addition to the *de minimis* threshold, an overall basket where the requirement to prepay is only triggered once the threshold is reached for the relevant period (for the financial year or over life of the loan).
- **Right to reinvest:** a borrower can avoid its prepayment obligations if it reinvests disposal proceeds towards the business, capital expenditure or the purchase of replacement assets (which may include investments in joint ventures or acquisitions which are otherwise permitted). This holiday period however requires the borrower to do so within a certain period of time - usually within 12 months of receipt of the disposal proceeds, with an additional 6 months grace if the application of such proceeds has been formally committed to in that period - if not, the prepayment of excess proceeds will be required.
- **Other exceptions**: will often be heavily negotiated and for that reason will vary from deal to deal. Typically, these are intended to capture specific exceptions which would not otherwise fall under traditional ordinary course exceptions, deal-specific exceptions (e.g. disposals that are already committed to or are expected by the creditors) or jurisdiction specific/local law requirements. Often the general basket for "Permitted Disposals" will also be excluded from the repayment requirement.

It is worth noting that a sale of all (or substantially all) of a group's assets would still typically trigger a mandatory prepayment of all lenders in full or, in recent times, a right for lenders to get repaid – as found in the "Exit" or "Change of Control" mandatory prepayment.

Recent developments – asset sale covenants under incurrence covenants

The influence of high yield bond-style covenants has meant that mandatory prepayment provisions have evolved to meet the need for borrowers to have more flexibility in using disposal proceeds and the desire for lenders to have more stable long-term investments that would not be excessively prepaid prior to maturity. To such extent, the traditional restrictive covenants prohibiting everything but certain "permitted" operations are increasingly now being replaced in more permissive syndicated deals by the reverse concept where everything is permitted, provided that certain requirements of an "asset sale covenant" are complied with (as is customarily the case in high yield bonds).

A customary high yield style asset sale covenant will provide that, for an asset disposal to be permitted:

1. the group must receive fair market value (as determined by the board of directors of the parent of the group);
2. the consideration must be largely (usually 75%) cash or cash equivalent investments; and
3. the net proceeds must be reinvested in the business (including via capital expenditures) within a certain time or used to repay certain types of debt (mostly senior debt or pari passu debt).

Under a high yield bond, once a 'holiday' period of typically 12 months from the date of the disposal has expired, if the proceeds have not been applied as set out above, there is an automatic requirement to offer to prepay the bonds (at [par]) by way of an "Asset Sale/Disposition Offer", the bondholders being then free to accept such offer or not.

Leveraged loans have taken varying approaches as to how an incurrence based asset sale covenant may be translated into a loan agreement and the inclusion of an "Asset Sale/Disposition Offer" after a 12 month (or longer) holiday may often be omitted in favour of the simpler requirement to repay debt within shorter timeframes after the receipt of the proceeds, but remaining at the lenders discretion as to whether such proceeds are accepted as repayment.

Qualifications and further considerations

The cumulative effect of further qualifications, consisting of exceptions and carve-outs, (*de-minimis*) thresholds and prepayment waterfalls has meant that the traditional LMA-style loan premise, that there should a prepayment of all lenders pro rata with net proceeds, does not often apply. We have set out below some examples of these. Although each of these will not feature together on every deal and some are more common in the most permissive syndicated leveraged loans, care should be taken in assessing what impact they collectively have on the amount of disposal proceeds that are eventually applied (or offered to be applied) in repayment of outstanding loans.

- **The calculation of thresholds**: often the individual *de-minimis* threshold, other exceptions and the aggregate exception (described above) will work together, such that any disposal proceeds below the initial *de-minimis* or falling within one of the other exception baskets will not contribute to the cumulative calculation of the aggregate exception. This may include ordinary course disposals or those which are "permitted" operations/carved-out from being an "Asset Disposition" (including the general basket mentioned above). Sometimes, only disposal proceeds above the aggregate exception are then required to be applied in repayment.
- **De-minimis exceptions as to what is required to constitute "fair market value" and "cash":** often separate to the exceptions described above, a borrower may be able to "deem" certain disposal proceeds under a de-minimis threshold as not needing to be at fair market value and/or a capped amount of non-cash consideration to be taken into account when calculating whether "cash" has been received.
- **Cov-lite flexibility:** the thresholds, baskets and caps discussed here are commonly now required to be forward looking and grow in line with the business. These amounts will commonly include EBITDA "grower baskets" such that the basket size is set at the greater of a fixed cash amount and a percentage of EBITDA and/or unused amounts in respect of an exception or basket based on usage in any financial year will be capable of being carried forward and back.
- **Using Restricted Payment capacity**: there is typically an exemption from the definition of "Asset Disposition" for Restricted Payments, Permitted Investments, or, with respect to the use of proceeds, for Asset Dispositions the use of proceeds of which are to be used to pay a Restricted Payment. The latter point is to cut out a middle step, as if it would be permissible to distribute out a particular asset as a Restricted Payment, it is not commercially different to have the asset owner sell the asset and distribute up the proceeds.
- **Lenders' right to waive prepayment (and how those waived amounts are applied):** influenced by the approach in an "Asset Sale/Disposition Offer", borrowers commonly may offer lenders the right to waive a prepayment that they would otherwise be entitled to. Waived amounts must then either be offered to other lenders who have not declined prepayment pro rata to their respective commitments or the group may have the discretion as to whether they are applied in prepayment or retained and made available for any purpose otherwise permitted.
- **Prepayment ratchets:** total or senior secured leveraged-based ratchets, which determine what percentage of disposal proceeds in excess of the *de minimis* thresholds are available for repayment, down to zero if the relevant ratio test is met.
- **Types of debt being repaid:** modern cov-lite loans and high yield bonds typically now permit the incurrence of a large amount of debt with differing priorities. Such debt will commonly require some (often equivalent, if it is *pari passu* senior debt) mandatory prepayment requirements. Where debt is required to be prepaid from disposal proceeds or sometimes at the group's discretion, repayment of such other *pari passu* senior debt will be permitted on no more than a pro rata basis, or less than a pro rata basis subject to compliance with a leverage test. Certain recent examples have allowed prepayment of junior or (in exceptional cases) super senior debt to be prepaid.
- **Other uses:** although not common, disposal proceeds may be capable of being used for alternative purposes other than debt repayment, such as the payment of a dividend. In these cases, such payments will typically require compliance with a low (perhaps equivalent to investment grade) total leverage ratio.

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