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Client**Alert**

Financial Markets Developments

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Proposed Leveraged Finance Guidelines

Reacting to what they view as the deterioration in prudent underwriting and lending practices characterizing the rebound in new leveraged financing following the 2006 – 2008 financial crisis, including a growing absence of lender protection provisions such as maintenance covenants in the governing documents, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Commission (collectively, the "Agencies") issued on March 26, 2012 proposed guidance (the "Proposed Guidelines") to be applicable to substantially all financial firms supervised and/or regulated by any of the Agencies (the "financial institutions") establishing stringent requirements (including in respect of establishing meaningful management information systems ("MIS")) governing leveraged financings.

The general provisions of, and the motivations for the issuance of, the Proposed Guidelines have been the subject of many industry reports and client alerts/letters and will not be repeated in this Client Alert other than to emphasize that the Proposed Guidelines, if adopted in their current form, may have a negative impact on the leveraged finance market (or the terms now available therein) by, inter alia, (i) limiting financial institution participation in certain proposed transactions as a result of the leverage levels and/or amortization not satisfying the Proposed Guidelines' requirements, (ii) as a consequence of the emphasis in the Proposed Guidelines and the accompanying press release (the "Press Release") on the need for more stringent financial performance covenant protection, potentially discouraging financial institutions from participating in "covenant-lite" credit agreements in their current form and perhaps in other commonly utilized leveraged finance instruments/agreements that do not typically contain financial maintenance covenants (see full discussion below) and (iii) significantly increasing the cost (including relating to the use of management and board member time) to financial institutions (and particularly those that act as Underwriters (as defined below)), given the extensive reporting and other MIS requirements and management involvement standards, all of which should be of concern to financial institutions generally, deal sponsors and acquisition-focused corporations.

This Client Alert will focus on certain issues and questions raised and not answered by the Proposed Guidelines that need some clarification by the Agencies to ensure compliance by financial institutions with the guidance in its final form while still allowing them to remain active and competitive in leveraged finance (which is recognized by the Proposed Guidelines as "an important type of finance for the economy"). A greater degree of certitude as to whether or not a financing constitutes leveraged finance and/or is permitted leveraged finance than has been available in the past appears appropriate given the

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increased requirements imposed by the Proposed Guidelines on financial institutions in respect of leveraged finance. While the Agencies have emphasized receiving comments on the Proposed Guidelines relating to the reporting and other MIS aspects thereof, clarifications of some of the issues/questions raised herein are important to make the Proposed Guidelines work, and such clarifications appear to be an appropriate subject of comments, distinct from any comments that may be desired to be made relating to the advisability of including various provisions of the Proposed Guidelines.

I. Leveraged Finance

In that the Proposed Guidelines establish stringent requirements to be met by financial institutions desiring to participate in leveraged finance, the Agencies have attempted to broadly describe what financings actually constitute the "leveraged finance" to which the Proposed Guidelines apply, with such finance described by reference to types of activities financed and/or the financial status of the borrower. The Proposed Guidelines describe (and essentially define) leveraged finance to include "some combination of" (i) financings the proceeds of which are used for "buyouts, acquisitions or capital distributions" (howsoever named or defined and with the reference to "acquisitions" presumably a reference to M&A type acquisitions and not the acquisition through purchase or construction of an asset or series of assets (e.g., aircraft) even if financed based on the general credit of the borrower), (ii) financings for a borrower with, after giving effect to the financing and use of the proceeds thereof, a Total Debt/EBITDA ratio and/or Senior Debt/EBITDA ratio exceeding 4X and 3X, respectively (the "Specified Benchmark Ratios") "or such other levels appropriate to the industry or sector" (i.e., presumably higher ratios), (iii) financings for a borrower that is recognized in the debt market as a highly leveraged firm based principally on its total debt/net worth ratio and (iv) financings for a transaction where the borrower's post-transaction standard financial ratios, when measured by the standard financial ratios for other firms in the same industry/sector, significantly exceed industry norms "or historical levels" (the foregoing sentence, the "Definition").

While it might be concluded that the Definition represents nothing more than a listing of types of leveraged financings that is included in the Proposed Guidelines to assist a financial institution in developing policies that establish criteria to define for itself what constitutes leveraged finance, the inclusion of the Definition can be interpreted as an effort by the Agencies to identify transactions that must be included in any such criteria. In such case, an analysis of certain of the language of the Definition becomes important. The use of the language "some combination of" could lead to a conclusion that at least two of the four clauses of the Definition needs to be present for a financing to be classified as leveraged finance for purposes of the Proposed Guidelines ("Classification") although this is not entirely clear; if only one of the four clauses of the Definition needs to be satisfied in order to justify Classification, the Proposed Guidelines would apply to a broad range of transactions not customarily considered to be leveraged finance. Reading the "a combination of" language to necessitate the applicability of at least two clauses of the Definition before Classification would occur appears to be appropriate, but such interpretation would result in financings that come solely within clause (ii) of the Definition not, in all cases, being classified as leveraged finance, which may not be the intent of the Agencies.

For purposes of clause (ii) of the Definition, Total Debt and Senior Debt are to be determined without reduction for cash on hand, and otherwise such terms and EBITDA presumably should be given "plain vanilla" definitions without additions/modifications tailored for a particular deal or transaction. However, the inclusion in such clause (ii) of the language "or such other defined levels appropriate to the industry or sector" could (unless the Agencies had theretofore expressly agreed to a proposed alternate level in a prior transaction or otherwise) create uncertainty in a situation where such language is desired to be relied upon to avoid Classification (in that presumably the Specified Benchmark Ratios will be exceeded) since there is no mechanism (e.g., some procedure for obtaining a pre-commitment sign-off by the appropriate Agency (a "Sign-Off Procedure")) to ensure that the Agencies will accept any such alternate level as appropriate for use in clause (ii). While an Underwriter might have a high degree of comfort, based on its extensive market knowledge, that the alternate levels will be accepted and thus might in various situations be willing to take the risk of Agency rejection, it may well be particularly difficult for a Limited Participant (as defined below) to make such determination, leaving such financial institution the options of (x) relying on the analysis of the Underwriters and not treating the financing as leveraged finance (but thereby risking inclusion of such financing as leveraged finance if such alternate levels are rejected by the Agencies, a determination that could result in exceeding in-house limits (as discussed below)) or (y) treating such financing as leveraged financing and as a result thereof perhaps declining to participate in the financing. Clause (iii) of the Definition creates vague and undefined parameters for including a transaction within the term leveraged finance, namely (x) how it is to be determined that a borrower is "recognized in the debt markets as a highly leveraged firm" (i.e., are there tests other than by reference to ratings by the credit agencies) and (y) whether there is some debt/net worth ratio that must not be exceeded to ensure exclusion from Classification. Again, the Proposed Guidelines provide no mechanism for any Sign-Off Procedure, leading one to surmise that many financial institutions would act conservatively and, in the absence of expressed Agency guidance to the contrary, consider all questionable transactions as meeting the clause (iii) test when deciding to participate therein. It should be noted that the inclusion of clause (iii) criteria appears to be an effort by the Agencies to indirectly include some type of net worth minimum to avoid Classification, which is consistent with the Agencies' focus on adequate capitalization throughout the Proposed Guidelines. Finally, if (x) the Proposed Guidelines are interpreted as requiring that only one of the four clauses in the Definition needs to be applicable to warrant Classification or (y) more than one such clause has to be applicable but the term "acquisitions" in clause (i) of the Definition is not limited to M&A type acquisitions as described above, the inclusion of clause (iv) of the Definition could likely have a negative impact on the use by corporations of financing for the acquisition/construction of business assets (e.g., aircraft, plants, etc.) where the post-transaction ratios are "significantly" higher (although there is no attempt in the Proposed Guidelines to quantify "significantly") than historical levels notwithstanding that none of the criteria in the other clauses of the Definition are met (and even if "acquisitions" are limited to M&A type acquisitions, this clause (iv) could result in Classification of the financing of an M&A acquisition by a highly rated corporation that will not come within any of the parameters of clause (ii) or (iii) of the Definition after the transaction and that will still retain a high credit rating from the rating agencies (even if a reduced one). Clarification as to whether this is really the Agencies' intent should be sought. It should be noted that the Proposed Guidelines are expressly not intended to limit or impact traditional well-structured asset-based financings, financings for borrowers engaged in genuine workout situations and bankruptcy code pre-packaged financings.

II. Underwriting

Many sections of the Proposed Guidelines, and particularly the sections under the headings "Underwriting Standards" and "Pipeline Management", establish standards requiring certain factors to be considered by those financial institutions originating, managing and/or underwriting the primary distribution of a leveraged financing (the "Primary Underwriters") as well as those financial institutions that actively participate in secondary distributions (the "Secondary Underwriters" and together with the Primary Underwriters, "Underwriters"), with the possibility raised that there may be some requirements as to which Secondary Underwriters will have less stringent requirements than Primary Underwriters. Such factors are quite extensive and should be reviewed by those financial institutions that anticipate being Underwriters as to feasibility from a cost and efficiency perspective.

There are a number of standards that merit some special attention. While the Proposed Guidelines emphasize the importance of evaluating and understanding the intent of sponsors, the Proposed Guidelines leave examiners the option to criticize a credit as to which the Underwriters gave some positive value to the involvement of a particular sponsor when deciding to underwrite the credit unless there is some type of enforceable financial undertaking by the sponsors. The Proposed Guidelines provide that as a "general guide" base cash flow projections should show the ability over a 5 – 7 year period to amortize all senior debt or at least 50 percent of all debt. While not addressing the level of potential transactions that could not meet this test, we note that there are no standards for when this "general guide" can be modified to provide for a more negative cash flow and there is no Sign-Off Procedure relating to modification of such "general guide". Again a conservative approach would make it difficult for a financial institution to participate in any financing that negatively varies from such "general guide" in the absence of expressed Agency guidance to the contrary. One of the underwriting standards that "should be considered" focuses on the inclusion of "credit agreement covenant protections" including those relating to "financial performance (such as debt-to-cash flow, interest coverage or fixed-charge coverage)". While the inclusion of such covenants is a "factor to be considered", given the overall tenor of the Proposed Guidelines, it is prudent to assume that, in the absence of the Agencies' assent to the non-inclusion thereof in a particular situation or type of situation, the inclusion of meaningful financial covenants is expected or at a minimum strongly encouraged in most situations—a result that may well limit the availability of leveraged finance effected through "covenant-lite" credit agreements. While the underwriting standard speaks in terms of "credit agreement covenant protections", the Proposed Guidelines fail to clarify that such protections are not expected to be included in commonly utilized leveraged finance instruments such as high-yield securities (which non-inclusion would be consistent with current market practices) and leave unclear whether such covenant protections are expected to be considered for inclusion in bridge financing agreements in a manner different than current market practice. Finally, when discussing the need for protective credit agreement covenants, the Proposed Guidelines state that generally a leverage ratio, after planned asset sales, in excess of 6X raises concerns "for most industries". Since once again there is no Sign-Off Procedure for utilizing a higher maximum ratio for any specific industry or for any other reason, the conservative position would be for a financial institution to decline to participate in a leveraged finance where the leverage ratio exceeds 6X and there has been no prior approval by the Agencies of the proposed higher ratio, in order to avoid the downside impact if ultimately the examiners reject the use of such higher ratio as satisfying the Proposed Guidelines.

III. Limited Participants

Other than those provisions dealing specifically with Underwriters qua Underwriters (but presumably not any portion of such provisions establishing substantive requirements such as those relating to amortization, leverage levels and financial covenants), the Proposed Guidelines purport to apply to all financial institutions participating in a leveraged finance, even those institutions participating in relatively small amounts with the intention to hold their participation and/or to distribute a portion thereof solely to a closely related group (the "Limited Participants"). Yet for many Limited Participants, compliance generally with such provisions of the Proposed Guidelines could make participation in leveraged finance unrewarding from a cost/management utilization perspective and thus such required compliance could reduce the number of financial institutions prepared to participate in leveraged finance, creating additional room for participation by non-regulated financial firms, it being noted that the increasing participation by non-regulated financial firms in leveraged finance was cited by the Agencies in the Press Release as troubling. Certainly all financial institutions should meet the requirements listed under the heading "General Policy Expectations" as to establishing overall institutional limits for leveraged finance that are approved by its board of directors (or at least some high-level committee), with single obligor, industry and geographic sublimits, as to ensuring that the risks of leveraged finance are appropriately addressed in the institution's Allowance for Loan and Lease Loss and as to providing active management oversight (with the extent of such oversight being a subject of further discussion). However, some aspects of such requirements, such as identifying approval authorities and tracking provisions, appear more difficult to justify. Finally, the various extensive reporting and other MIS requirements are likely to result in costly and time-consuming efforts that may push some Limited Participants out of the leveraged finance market.

IV. MIS Requirements

The Proposed Guidelines clearly reflect the Agencies' desire for wide-reaching information production, while showing some awareness that the "ask" may be too broad. Each financial institution, and especially those that intend to act as Underwriters, should consider in detail the reporting and other MIS requirements of the Proposed Guidelines with the intent of arriving at requirements that provide in an efficient and cost-effective manner information that substantially meets the Agencies' desires and that establishes intelligent and feasible parameters for management/board of directors' involvement.

V. Pay-in-Kind Interest

Under Section II of the Proposed Guidelines, the Agencies note in a negative manner the inclusion of pay-in-kind interest ("PIK") provisions in junior capital instruments, notwithstanding the long history in leveraged finance transactions of such provisions and the fact that senior lenders often benefit from their inclusion. While there is no specific reference in the Proposed Guidelines relating to the use of PIK instruments, the question has to arise, given the Agencies' expressed concerns with PIK instruments, as to whether the inclusion of a PIK feature in any junior instrument included in a leveraged finance should be regarded by a financial institution as a negative when evaluating such transaction or may be treated as a non-relevant issue in making such determination.

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While many comments will be directed to (x) the reporting and other MIS requirements of the Proposed Guidelines and (y) the substantive provisions of the Proposed Guidelines that limit the participation of financial institutions in potential leveraged financings and/or increase significantly the expense and use of management time of those financial institutions (and especially Underwriters) that continue to participate in leveraged finance (with likely a concomitant increase in cost to the borrower/ sponsor), this Client Alert has attempted to bring attention to a number of areas of uncertainty in the Proposed Guidelines that should be addressed to ensure that the guidance in its final form works effectively and that financial institutions will have a higher degree of certitude as to whether a particular financing will or will not constitute leveraged finance for purposes of the final guidelines (and thus whether the many requirements thereof need to be satisfied).

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