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Transferability

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Transferability – An attempt to take the heat out of the transfer market

Immediately in the aftermath of the 2008/2009 financial crisis, the provisions governing transfers of interests in loans were more or less settled, with an established standard that a lender did not need the consent of a borrower to transfer its interest in a loan if that transfer was:

- to a lender or to an affiliate or related fund of a lender;
- to an entity set out on an agreed list; or
- made while an event of default was continuing.

Consent to a transfer could also not be unreasonably withheld and was deemed to be given within a short period of time (usually five business days).

However, more recently, market conditions have meant that demand has consistently outstripped supply; and the transferability of loans is firmly back on the agenda. With the ever-increasing liquidity in the TLB market, and an ever-growing universe of types of entities (beyond CLOs and encompassing other non-bank entities) involved in purchasing leveraged debt, sponsors and borrowers are seeking to take and retain greater control over the composition of the lender group.

This article takes a look at the current trends that we are seeing in the European leveraged market.

Approved lenders

It is commonplace to have an agreed list of entities to which a lender can transfer its interests without the borrower's consent (commonly referred to as an approved list or white list), and which the borrower may update throughout the life of the loan, for example, by removing up to five names a year. Additional restrictions are beginning to be placed on the approved list concept and loan documents increasingly include:

- restrictions, whether or not there is an event of default continuing, on a new lender (together with its affiliates) becoming a lender or sub-participant in respect of more than a certain amount (commonly 10%) of the total commitments, in order to prevent a single entity from acquiring a blocking stake;
- no overall cap on the number of names that may be removed from the approved list over the life of the loan by the borrower, and no requirement to agree or attempt to agree replacement names;
- blanket carve-outs to any entity on the approved list that is a distressed debt fund, loan to own investor or industry competitor (see further below); and
- requirements for transferring lenders to notify a borrower prior to any transfer being effective, even if the transferee is on an approved list.

In each case, a breach of the relevant transfer requirement disenfranchises the applicable commitment from voting and/or the transfer is deemed to be void.

Disqualified lenders

In contrast to the approved list concept, there has also been an attempt to introduce a disqualified lender concept (commonly referred to as a blacklist) which operates in the opposite manner to the approved list, i.e., by naming select institutions to which the loan may not be transferred. Although at face value this may seem to be an improved position for a lender, the removal of the approved list concept means transferability under a loan document is limited to transfers to an affiliate or related fund of a lender, transfers when a specified event of default is occurring (and the blacklist then further carves back these positions) or transfers following borrower consent.

This is an agreed standard in the US, where there is usually no approved list. On certain transactions in Europe now, with primarily US borrowers/sponsors borrowing in the European market, borrowers have sought to remove the approved list and instead include a disqualified lender list that applies notwithstanding whether or not an event of default is continuing. While this standard may be more palatable for lenders in the context of a super-senior RCF, which is generally less liquid, it may be less desirable to TLB investors.

Distressed debt funds

The comfort a lender, invested in a declining credit, can take from being permitted to make transfers while an Event of Default is continuing will generally be undermined by the fact that such lender probably cannot transfer to distressed debt funds or loan-to-own investors – an example of this type of provision is to limit transfers to any person whose principal business is an investment strategy which involves acquiring loans with the intention of (or view to) owning the equity or gaining control of a business.

In attempts to limit any potential overreaching of these definitions, lenders have attempted to exclude affiliates of a loan-to-own investor provided that they are regulated to carry on the business of banking and are controlled and managed independently with proper confidentiality barriers between themselves and their affiliates. A further concern is whether this restriction applies during a period when the borrower is in default. While this restriction tends to be disapplied during a continuing material event of default, strong sponsors and borrowers are often able to apply this restriction whether or not any event of default is continuing.

The definition also needs to be looked at on a case-by-case basis depending on the likely investors for any particular loan. For example, does it capture a fund that either pursues multiple investment strategies (of which loan-to-own is not the principal or dominant strategy) or funds managed by an investment manager or adviser which also manages or advises other funds pursuing a loan-to-own strategy? It is even possible to find extreme examples of the definition, proscribing any transfer to an institution whose business includes acquiring debt at less than par (a universe which includes most market participants).

Industry competitors

Lenders generally cannot transfer their interest in a loan to an industry competitor of the borrower without the borrower's consent. There is not yet a standardised definition of "industry competitor", meaning that in some loan agreements (and this is becoming more commonplace), it can be drafted very expansively to include affiliates of industry competitors, including controlling shareholders, and any private equity sponsor. From a lender's perspective, similar exceptions to those granted under distressed debt fund definitions should be considered (e.g., any bank or financial institution whose principal business or a material activity is investing in debt). Most prohibitions will continue whilst any event of default is continuing.

Events of Default

The borrower's risk of debt being sold to distressed debt funds or competitors must also be weighed sensibly against the fact that those entities are perhaps being the only interested parties while the borrower is in default. Historically, transfer restrictions have fallen away upon an event of default. However, it is becoming increasingly common for limitations on transfers to:

- stay in place, in the case of transfers to distressed debt funds and/or competitors; or

- only fall away upon specified material events of default, usually limited to a payment event of default in respect of principal or interest, a financial covenant event of default (if any financial covenant is applicable to the term debt) or an insolvency event of default.

Acting reasonably and deemed consent

The requirement that a borrower must act reasonably on any consent request for a transfer, and that the borrower's consent be deemed given after the expiry of a specified period of time, has been eroded. Often, on top-tier sponsor transactions, neither requirement is included, or deemed consent will be after a longer period of time (e.g. ten business days).

Sub-participation

Sub-participations have long been a method favoured by lenders under which they could (to a degree) avoid the transfer restrictions imposed on them by a borrower. The position has begun to change more recently as borrowers become increasingly sensitive to this circumvention, as it became clear that sub-participants could use their position to influence how a lender of record would use its voting rights or at a minimum hold some sway over its actions or involve some form of consultation right in decision making. Borrowers are now regularly requiring any sub-participation that transfers a lender of record's voting rights to be only at the consent of the borrower, while certain borrowers are now even requiring transfers of non-voting sub-participations to be subject to the same consent requirements as an outright transfer. In addition, there is an influx of requirements being imposed on sub-participations, such as:

- prior to entering into any sub-participation, full details of the agreement, including all rights to be granted to the sub-participant, are to be provided to the borrower;
- the relationship between the lender and proposed sub-participant must be one of contractual debtor and creditor; and
- the lender of record must maintain a register of each sub-participant's name, address and principal interest in the loan or other obligations under the loan, which it will share with the borrower upon reasonable request.

Conclusion

While the market conditions support sponsor and borrower friendly terms, it is understandable that one aspect of a transaction a borrower will want to control is over the composition of its syndicate. From a lender's perspective, the tighter control over transfers needs to be considered in conjunction with the general dilution of lender rights. Over the lives of cov-lite TLB loans, although early warning signs that a business is in financial difficulty will be evident in the financials that are delivered under the terms of the loan, there are unlikely to be any trigger events that would oblige a company to return to the negotiating table. Instead, a payment default is the most likely event that will trigger an acceleration right for the lenders. Lenders should, therefore, be mindful of the inability to transfer at this stage to precisely those institutions that would purchase such loans.

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