

**SEARS ROEBUCK ACCEPTANCE CORP**

**EXTERNAL REVIEW**

**WRITTEN MATERIALS IN SUPPORT OF THE “NO” POSITION**

Submitted by Linklaters LLP as Advocate for the “No” Position

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## **TABLE OF CONTENTS**

<b>I.</b>	<b>INTRODUCTION .....</b>	<b>1</b>
<b>II.</b>	<b>DEFINITIONS AND PRELIMINARY STATEMENTS.....</b>	<b>1</b>
<b>III.</b>	<b>SUMMARY OF THE “NO” POSITION.....</b>	<b>2</b>
<b>IV.</b>	<b>RELEVANT FACTUAL BACKGROUND .....</b>	<b>3</b>
<b>V.</b>	<b>NEW YORK LAW REQUIRES CONSIDERATION OF PLAIN MEANING IN LIGHT OF PROPER CONTEXT AND COMMERCIAL REASONABLENESS .....</b>	<b>3</b>
<b>VI.</b>	<b>“NO” POSITION’S STATEMENT OF THE CLAIM .....</b>	<b>5</b>
<b>VII.</b>	<b>APPLICATION .....</b>	<b>16</b>
<b>VIII.</b>	<b>IMPLICATIONS .....</b>	<b>18</b>
<b>IX.</b>	<b>CONCLUSION .....</b>	<b>20</b>
	<b>EXHIBIT 1: THE REVIEWABLE QUESTION.....</b>	<b>i</b>
	<b>EXHIBIT 2: EXTRACT FROM DERIVATIVES LAW AND PRACTICE .....</b>	<b>ii</b>
	<b>EXHIBIT 3: LOAN MARKET ASSOCIATION GUIDE .....</b>	<b>iii</b>
	<b>EXHIBIT 4: S&amp;P GLOBAL MARKET INTELLIGENCE PUBICATION .....</b>	<b>iv</b>

## **WRITTEN MATERIALS IN SUPPORT OF THE “NO” POSITION**

### **I. INTRODUCTION**

1. At a November 19, 2018 meeting of the Credit Derivatives Determinations Committee for the Americas (the “**DC**”), the DC considered whether certain Loans (the “**Sears Loans**”) made to Sears Roebuck Acceptance Corp (“**Sears**”) are Deliverable Obligations of Sears under the 2014 ISDA Credit Derivatives Definitions (the “**Definitions**”). A DC statement dated November 7, 2018 (the “**Meeting Statement**”) summarizes the DC’s discussions. A majority of the DC voted that the Sears Loans did not satisfy the Consent Required Loan Deliverable Obligation Characteristic, but because a supermajority was not reached, the matter has been submitted for External Review. The Reviewable Question (which asks whether the Consent Required Loan Deliverable Obligation Characteristic is satisfied in relation to the Sears Loans) is set out in **Exhibit 1**.

### **II. DEFINITIONS AND PRELIMINARY STATEMENTS**

2. Under Section 3.14(b)(ii) of the Definitions, a Loan will satisfy the Consent Required Loan Deliverable Obligation Characteristic if it:

is capable of being assigned or novated with the consent of the Reference Entity or the guarantor, if any, of such loan (or the consent of the relevant borrower if the Reference Entity is guaranteeing such loan) or any agent.
3. These are the Written Materials in support of the position that the answer to the Reviewable Question is “No.”
4. Capitalized terms used but not defined in this document have meanings specified in the Definitions or the 2018 ISDA Credit Derivatives Determinations Committees Rules.

### III. SUMMARY OF THE “NO” POSITION

5. The “No” Position submits that, when its plain meaning is properly construed in light of its commercial purpose, the Consent Required Loan provision requires a Loan to be capable of being assigned or novated *generally*, and except for the consent requirement, without material restriction.
6. Other provisions of the Definitions further demonstrate that this is the plain meaning and correct interpretation. Such other provisions contemplate that it is sufficient for an Obligation to be capable of transfer without these restrictions. An equivalent permissible limitation cannot properly be read into the Consent Required Loan.
7. The commercial purpose of the Consent Required Loan provision also demonstrates that this is the correct interpretation. Whereas a Seller under a credit default swap (“CDS”) takes the risk that it may be unable to transfer any Loan it receives in the settlement of a CDS without obtaining the requisite consents, it does not take the risk of having to satisfy any further restrictions or more onerous conditions.
8. This is not to say that a Loan has to be capable of being assigned or novated (if such consents are obtained) to *every* possible third party. There may be cases in which an assignment or novation would be impossible. However, as long as a Loan is not materially prevented from being assigned or novated generally, the Loan should satisfy the Consent Required Loan test. For these reasons, and those that follow, the Eligible Assignee provision precludes the Sears Loans from satisfying the Consent Required Loan test.

## IV. RELEVANT FACTUAL BACKGROUND

### A. **Terms of the Sears Loans**

9. The contractual provisions on assignment of the Sears Loans by the Lenders are set out in the Fifth Amendment to the Second Lien Credit Agreement dated as of July 5, 2018 (the “**Fifth Amendment**”).

10. Section 9.07 of the Fifth Amendment states that:

[e]ach Lender may, upon notice to the Borrowers and the Agent and with the consent, not to be unreasonably withheld or delayed, of the Agent, and, unless an Event of Default has occurred and is continuing, the Borrowers (which consent shall be deemed given by the Borrowers if the Borrowers have not responded to a request for such consent within ten (10) Business Days), assign to one or more Persons all or a portion of its rights and obligations under this Agreement (including all or a portion of the Loans and other amounts owing to it and any Note or Notes held by it); provided, however, that...(v) *each such assignment (other than an assignment of Alternative Tranche Line of Credit Loans) shall be to an Eligible Assignee.*

11. The definition of “Eligible Assignee” contains restrictions on the persons to whom the Lenders may assign the Sears Loans and establishes that an Eligible Assignee must be:

(a) a commercial bank or any other Person engaged in the business of making asset based or commercial loans, or any fund or other Person (other than a natural Person) that invests in loans and which bank, Person or fund, together with its Affiliates, has a combined capital and surplus in excess of \$300,000,000 and which bank, Person or fund is approved by the Agent....

## V. NEW YORK LAW REQUIRES CONSIDERATION OF PLAIN MEANING IN LIGHT OF PROPER CONTEXT AND COMMERCIAL REASONABLENESS

12. It is common ground that New York law applies to the Reviewable Question.

13. Under New York law, “[t]he fundamental precept of contract interpretation is that agreements are construed in accord with the parties’ intent, ‘as expressed in the unequivocal language they have employed.’” *Levion v. Société Générale*, 822 F. Supp. 2d 390, 397 (S.D.N.Y. 2011), *aff’d*, 503 F. App’x 62 (2d Cir. 2012) (citation omitted). When a dispute arises as to the meaning of a contractual provision, the court must

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endeavor to determine the intent of the parties at the time the contract was made. *Marin v. Constitution Realty, LLC*, 71 N.E.3d 530 (N.Y. 2017) (citation omitted).<sup>1</sup>

14. Courts must “consider the entirety of the agreement in the context of the parties’ relationship and circumstances.” *In re Matter of Riconda*, 90 N.Y.2d 733, 738, 688 N.E.2d 248, 252 (N.Y. 1997). As the New York Court of Appeals has explained, this approach “allows the courts to reach a more reliable resolution of true intent, in the absence of a definitive direction by the parties.” *Id.* When interpreting a contract, “[t]he entire contract must be reviewed and ‘[p]articular words should be considered, not as if isolated from the context, but in the light of the obligation as a whole and the intention of the parties as manifested thereby.’” *Riverside S. Planning Corp. v. CRP/Extell Riverside, L.P.*, 13 N.Y.3d 398, 404, 920 N.E.2d 359 (N.Y. 2009) (citation omitted). Courts should not determine the meaning of a contract by “merely culling distinct provisions out of an entire agreement.” *Riconda*, 90 N.Y.2d at 738 (citations omitted).
15. Under New York law: “[A] contract must be interpreted in accordance with the intent of the parties as revealed by the language and structure of the contract.” *Frontline Commc’ns Int’l, Inc. v. Sprint Commc’ns*, 178 F. Supp. 2d 432, 436 (S.D.N.Y. 2001). A contract’s title or headings may be considered to provide context and inform the meaning of the sections they label. *Harris Trust and Sav. Bank v. John Hancock Mut. Life Ins. Co.*, 970 F.2d 1138, 1146-1147 (2d Cir. 1992) (looking to the structure of the contract and specifically the titles of each article in the contract to interpret contract).<sup>2</sup>
16. Where a written agreement is clear and unambiguous on its face, the court will determine the intent of the parties from within the four corners of the contract, based on

<sup>1</sup> See also *Maser Consulting, P.A. v. Viola Park Realty, LLC*, 936 N.Y.S.2d 693 (App. Div. 2012).

<sup>2</sup> See also *Small Business Bodyguard Inc. v. House of Moxie, Inc.*, No. 14-cv-170, 2015 WL 1290897, at \*7 (S.D.N.Y. Mar. 20, 2015) (paragraph headings “give[ ] a great deal of ‘context’ to the words that follow”); *Orchard Hill Master Fund Ltd. v. SBA Communications Corp.*, No. 14-CV-9962, 2015 WL 5841232, at \*8 n.6 (S.D.N.Y. Oct 1, 2015) (looking to a section’s title to “shed[ ] light on the meaning of [the] section”).

the plain meaning of the relevant contractual provisions, without looking to extrinsic evidence to create ambiguities. *Vivir of LI, Inc. v. Ehrenkranz*, 7 N.Y.S.3d 411, 413 (App. Div. 2015) (citing *S. Rd. Assocs., LLC v. IBM Corp.*, 826 N.E.2d 806, 808-09 (N.Y. 2005)). If a contract is unambiguous, a court determines its meaning as a matter of law and extrinsic evidence is inadmissible in interpreting the contract. *Alexander & Alexander Servs., Inc. v. These Certain Underwriters at Lloyd's, London, England*, 136 F.3d 82, 86 (2d Cir. 1998) (citations omitted).

17. Under New York law, “[it is a] well settled principle that a contract should not be interpreted to produce an absurd result, one that is commercially unreasonable, or one that is contrary to the intent of the parties.” *UMB Bank, Nat’l Ass’n v. Airplanes Ltd.*, 260 F. Supp. 3d 384, 394 (S.D.N.Y. 2017).<sup>3</sup> An interpretation is unreasonable if it produces an absurd result, namely one that no reasonable party would have accepted when entering into the contract. *Jade Realty LLC v. Citigroup Commercial Mortg. Tr. 2005-EMG*, 980 N.E.2d 945, 947-48 (N.Y. 2012).<sup>4</sup>

## **VI. “NO” POSITION’S STATEMENT OF THE CLAIM**

### **A. Deliverable Obligation Characteristics Fundamental Aspects of Seller’s Risk**

18. The Deliverable Obligation Characteristics are important features of a credit derivative transaction because, together with the Deliverable Obligation Category, they set out the criteria that must be satisfied for an Obligation of the Reference Entity to constitute a Deliverable Obligation under Section 3.2(a) of the Definitions.<sup>5</sup> The likelihood of a

<sup>3</sup> *Id.* (quoting *Cole v. Macklowe*, 99 A.D.3d 595, 596, 953 N.Y.S.2d 21 (1st Dep’t 2012) *aff’d*, 125 A.D.3d 44, 999 N.Y.S.2d 403 (2014) (rejecting an interpretation of a partnership agreement that “represents a windfall to the defendants that is absurd, not commercially reasonable and contrary to the express terms of the agreement and thus the intent of the parties.”). *See, e.g., In re Lipper Holdings, LLC*, 1 A.D.3d 170, 171 (1st Dep’t 2003); *Samba Enters., LLC v. iMesh, Inc.*, No. 06 Civ. 7660, 2009 WL 705537, at \*5 (S.D.N.Y. Mar. 19, 2009); *see also Page Mill Asset Mgmt. v. Credit Suisse First Boston Corp.*, No. 98 CIV. 6907 MBM, 2000 WL 335557, at \*6 (S.D.N.Y. Mar. 30, 2000)).

<sup>4</sup> *See also Nat’l Union Fire Ins. Co. of Pittsburgh, PA v. Monarch Payroll, Inc.*, No. 15-CV-3642, 2016 WL 634083, at \*10 (S.D.N.Y. Feb. 17, 2016), appeal withdrawn (Sept. 1, 2016) (“It would be absurd and commercially unreasonable to enter into a contract that gives Monarch a \$2,390,000 windfall in exchange for unenforceable placeholder letters.”).

<sup>5</sup> Though not material here, an Obligation may also qualify as a Deliverable Obligation under Section 3.2(b)–(d) of the Definitions.

holder of the Obligation receiving full payment and the liquidity of the Obligation in the secondary market (and, hence, its secondary market value) may depend on whether these criteria are satisfied. They are therefore fundamental aspects of the risk to which the Seller is exposed under a CDS.

19. Another feature of a credit derivative transaction is that the Seller may be hedging its exposure under one transaction by acting as the Buyer under another CDS. If Physical Settlement applies, the Buyer will typically wish to deliver to the Seller under the second transaction the Obligation it receives in the settlement of the first transaction.
20. Where the Obligation is a Loan and such delivery cannot take place because the requisite consents have not been obtained by the Physical Settlement Date, provided that an appropriate election has been made in the Confirmation,<sup>6</sup> the transaction will be settled by the payment of a cash sum (determined by reference to the market value of the Loan). If no such election has been made and the problem continues for five Business Days, a Bearer Bond that is Transferable or Not or an Assignable Loan may be delivered instead.
21. Reliance on these provisions is unattractive because, in the former case, the market value of the Loan may be adversely affected by the transfer restrictions and, the latter, the Buyer under the second transaction will need to source an alternative Obligation at short notice. If it cannot do so, the settlement will be postponed and, if settlement has still not occurred by the 60<sup>th</sup> Business Day after the Physical Settlement Date and the Confirmation specifies that “60 Business Day Cap on Settlement” applies, the transaction will terminate and the protection will be lost. The more extensive the restrictions on transfer, therefore, the greater the risk of the Buyer under the second transaction being exposed to these issues.

<sup>6</sup> i.e. Partial Cash Settlement of Consent Required Loans is applicable: Section 9.2 of the Definitions.



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22. More fundamentally, where the Consent Required Loan Deliverable Obligation Characteristic has been specified, this is a risk that the Parties have agreed to take under a CDS. However, because the Sears Loans constrain the range of potential transferees and excludes the Seller under the second transaction, the Loan may not be transferred to that Seller, even with the requisite consents. Accordingly, the alternative settlement provisions mentioned above may not be engaged at all. If the Loan has been specified in the Buyer's NOPS, the Buyer under the second transaction will then be unable to settle the second transaction and will lose the protection.
23. The Buyer under the second transaction can avoid this problem by specifying in its NOPS an Obligation that is not subject to the same constraints. However, this would create a mismatch with the first transaction. In other words, if the additional constraints on the assignment or novation of the relevant Loan are such that the Loan can be used to settle the first transaction but not the second (as where the Buyer, in its capacity as Seller under the first transaction, is a permitted transferee but the Seller under the second transaction is not), the "Yes" construction of the Consent Required Loan provision may cause an improper basis risk to arise in the market.
24. Indeed, even if the alternative settlement provisions are applied, there would still be a basis risk if the first transaction could be settled but not the second. The Buyer under the second transaction would be unable to use the Loan it received under the first transaction to settle the second and (unless it manages to sell the Loan in the secondary market) would have a continuing exposure to the Reference Entity. This risk is significantly greater than the risk that consent to transfer the Loan under the first transaction might be obtained but not under the second transaction because, in many cases, any available consent will not depend on the identity of the proposed transferee.

## **B. Context Demonstrates the Meaning of Consent Required Loan**

### **(1) Comparison with Assignable Loan Deliverable Obligation Characteristic**

25. Before discussing the Consent Required Loan provision, it is instructive to compare it to the Assignable Loan Deliverable Obligation Characteristic, which also addresses the Loan's transferability. Where both Deliverable Obligation Characteristics are specified (as is often the case) only one of them needs to be satisfied in relation to a Loan.<sup>7</sup>
26. "Assignable Loan" means:
- a Loan that is capable of being assigned or novated to, at a minimum, commercial banks or financial institutions (irrespective of their jurisdiction or organization) that are not then a lender or a member of the relevant lending syndicate, without the consent of the Reference Entity or the guarantor, if any, of such Loan (or the consent of the applicable borrower if the Reference Entity is guaranteeing such Loan) or any agent.<sup>8</sup>
27. In contrast to the Consent Required Loan provision, the Assignable Loan provision specifies the range of persons to which a Loan must be capable of being assigned or novated. Two features of the definition are of note.
28. The first is that the specified range is very broad, namely "commercial banks" and "financial institutions" from all jurisdictions, regardless of whether they are members of the relevant syndicate. These are the types of entity that are likely to be interested in acquiring a Loan in the secondary market or under a credit derivative transaction and suggests that the holder should have the flexibility to deal with a wide range of potential transferees.
29. Secondly, it is plainly not the case that a Loan must be capable of being assigned or novated to every possible commercial bank or financial institution. There may be particular reasons why a particular bank or financial institution is unable to acquire a

<sup>7</sup> Section 3.15(c) of the Definitions.

<sup>8</sup> Section 3.14(b)(i) of the Definitions.

Loan. For example, it may not have the corporate capacity to do so, so that a purported transfer to it would be invalid. It cannot be intended that this would prevent the Loan from satisfying the Assignable Loan Deliverable Obligations Characteristic or that, in order to determine the matter, the DC must conduct an exhaustive review to ascertain whether there is any commercial bank or financial institution to which the Loan cannot be transferred.

30. In other words, the question is whether the relevant Loan is capable of being assigned to commercial banks and financial institutions *generally*, not necessarily to every single entity within those categories.

## **(2) Comparison with the Transferable Deliverable Obligation Characteristic**

31. It is also illuminating to consider the Transferable Deliverable Obligation Characteristic. This sets out the criteria regarding transferability that an Obligation which is not a Loan must satisfy to constitute a Deliverable Obligation.
32. “Transferable” means:
  - an obligation that is transferable to institutional investors without any contractual, statutory or regulatory restriction, provided that none of the following shall be considered contractual, statutory or regulatory restrictions:
    - (A) contractual, statutory or regulatory restrictions that provide for eligibility for resale pursuant to Rule 144A or Regulation S promulgated under the United States Securities Act of 1933, as amended (and any contractual, statutory or regulatory restrictions promulgated under the laws of any jurisdiction having a similar effect in relation to the eligibility for resale of an obligation);
    - (B) restrictions on permitted investments such as statutory or regulatory investment restrictions on insurance companies and pension funds; or
    - (C) restrictions in respect of blocked periods on or around payment dates or voting periods.<sup>9</sup>

<sup>9</sup> Section 3.14(b)(iv) of the Definitions.

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33. The same points can be made in relation to this provision as have been made in relation to the Assignable Loan Deliverable Obligation Characteristic.
34. First, the range of persons to which the Obligation must be capable of transfer is broad, namely “institutional investors.” Again, it can be inferred that the intention is that a holder of the Obligation that wishes to dispose of it should have the flexibility to deal with a wide range of potential transferees.
35. Secondly, the phrase “transferable to institutional investors” cannot sensibly be intended to mean that the Obligation must be capable of being transferred to every possible institutional investor. Consistent with the Assignable Loan provision and specified exclusions, the question is whether the Obligation is transferable to institutional investors generally.

### **(3) Meaning of the phrase “capable of” in the Consent Required Loan provision**

36. In contrast to the Assignable Loan provision, a Loan will satisfy the Consent Required Loan test even if it is capable of being assigned or novated only with the consent of the Reference Entity (or any agent). Even so, it is common ground that, if any consents other than those contemplated by the test are required, the test will not be satisfied.
37. Whereas the Assignable Loan and the Transferable Deliverable Obligation Characteristics specify the range of persons to which the relevant Obligation must be capable of being transferred, the Consent Required Loan provision contains no such specifications. The issue that therefore arises is what is meant by the phrase “capable of being assigned or novated?” In other words, *to whom* must the Loan be capable of being assigned or novated if the requisite consents are obtained?

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38. The Second Interpretation referred to in the Meeting Statement concluded that it is sufficient if a single person can be found to which the relevant Loan is capable of transfer:

where a Loan is capable of being assigned to *another person* with the consents contemplated by the definition of Consent Required Loan, such Loan should satisfy the Consent Required Loan definition. (emphasis added).

39. The Meeting Statement explains that:

it was ... argued that the Second Interpretation is a plain English reading of the definition of Consent Required Loan and such members of the Committee were not comfortable reading extra concepts into the definition of Consent Required Loan as, they argued, would be required under the First Interpretation.

40. This approach is, however, contrary to the plain meaning of the Consent Required Loan provision, and inconsistent with its context and commercial purpose.
41. The plain meaning of the phrase “capable of being assigned or novated” is that the relevant Loan is *generally* capable of being assigned or novated. The fact that a single person can be found to which the Loan may be assigned or novated does not mean that the test is satisfied any more than it would *fail* to be satisfied if an entity could be found that is unable to receive a Loan that otherwise would be freely assignable. This reflects the fact that the plain meaning of a phrase is the meaning that it would reasonably take when conveying to a third party, not an artificially narrow or wide meaning.
42. When the context and the commercial purpose are considered, it becomes even more clear that the Second Interpretation involves an improper, and indeed absurd, reading of the definition, which cannot have been intended. If it were correct, it would mean that, no matter how narrow the range of persons to which the Loan may be transferred, if the requisite consents were obtained, provided there exists only a single possible transferee, the test would be satisfied. This would be of little value to a CDS Seller facing the risks discussed in paragraphs 18 to 24 above.

43. On the other hand, the opposite extreme is also inconsistent with the plain meaning and commercial context of the Consent Required Loan provision. The fact that a single person can be found to which the Loan is *not* capable of being transferred, even if the specified consents have been obtained, should not cause the Loan to fail the Consent Required Loan test. This is consistent with the Assignable Loan and the Transferable tests, which would both still be satisfied in similar circumstances.

**C. Plain Meaning of the Consent Required Loan Provision: No Additional Permitted Restrictions**

44. The Consent Required Loan provision, which involves asking whether the relevant Loan “is capable of being assigned or novated with the consent of the Reference Entity ... or any agent,” plainly allows only a *single* express restriction on the ability to assign the relevant Loan, namely the consent restriction. No other restrictions are permitted.
45. In contrast, the Assignable Loan provision expressly states that it is sufficient for the Loan to be capable of being assigned or novated to commercial banks or financial institutions. Similarly, the Transferable provision states that it is sufficient for the relevant Obligation to be transferable to institutional investors. This shows that, where the drafter wanted to specify the categories of person to which an Obligation must be capable of transfer – and yet for it to still satisfy the relevant Deliverable Obligation Characteristic, he provided for this expressly.
46. Further examples of this drafting approach can be found in the definitions of “Fully Transferable Obligation”<sup>10</sup> and “Conditionally Transferable Obligation”<sup>11</sup> (which are used in the definition of Mod R and Mod Mod R, which impose limitations on the

<sup>10</sup> Section 3.31(b) of the Definitions.

<sup>11</sup> Section 3.32(b) of the Definitions.

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maturity of the Deliverable Obligations that may be used for settlement purposes in certain Restructurings).

47. “Fully Transferable Obligation” is defined as:

a Deliverable Obligation that is either Transferable, in the case of Bonds, or capable of being assigned or novated *to all Eligible Transferees* without the consent of any person being required, in the case of any Deliverable Obligation other than Bonds, in each case, as of both the NOPS Effective Date and the Delivery Date. (emphasis added).

48. “Conditionally Transferable Obligation” means:

a Deliverable Obligation that is either Transferable, in the case of Bonds, or capable of being assigned or novated *to all Modified Eligible Transferees* without the consent of any person being required, in the case of any Deliverable Obligation other than Bonds, in each case, as of both the NOPS Effective Date and the Delivery Date, provided, however, that a Deliverable Obligation other than Bonds will be a Conditionally Transferable Obligation notwithstanding that consent of the Reference Entity or the guarantor, if any, of a Deliverable Obligation other than Bonds (or the consent of the relevant obligor if the Reference Entity is guaranteeing such Deliverable Obligation) or any agent is required for such novation, assignment or transfer so long as the terms of such Deliverable Obligation provide that such consent may not be unreasonably withheld or delayed.

49. Each of these provisions specify the range of persons to which the Obligation must be transferable, or capable of being assigned or novated, for the test to be satisfied. This shows that, where the drafter wanted to specify that range, he made express provision.

50. Because the definition of Consent Required Loan does not contain the limitations that appear in the Assignable Loan, Transferable, Fully Transferable Obligation and Conditionally Transferable Obligation provisions, New York law precludes the External Reviewers from inserting these restrictions into the Definition. *See, e.g., CQ v. PQ*, 54 Misc. 3d 1223(A), 54 N.Y.S.3d 609 (N.Y. Sup. Ct. 2017):

the written contract between the parties speaks for itself. The written contract does not make financing a condition for its enforcement. Had the parties intended to make financing a condition, they could have done so. Rather, the contract is clear and complete and the court must enforce it according to its terms.

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51. Furthermore, the title of the relevant definition, “Consent Loan Requirement,” does not include any additional restrictions—only consent. Looking to the plain meaning of the title for context further demonstrates that consent is the sole express restriction on assigning or novating the Loan. *See Sigmon for Hindin v. Goldman Sachs Mortg. Co.*, No. 1:12-CV-3367, 2018 WL 1517189, at \*5 (S.D.N.Y. Mar. 26, 2018) (finding untenable plaintiff’s expansive reading that section 3.1 provided for “additional or independent transfers” or the “right to receive distributions thereof” because the section 3 heading—“Acknowledgements and Assurances”—reasonably only “concern[ed] the protections and assurances to Defendants regarding the transfer” and “that the transfer was complete.”).
- D. The absence of additional permissible limitations is not absurd, commercially unreasonable or contrary to the reasonable expectations of the Parties**
52. A requirement that there must be no material conditions, other than the contemplated consent requirements, on the ability of a holder of a Loan to assign or novate the Loan to a third party cannot be said to be absurd, commercially unreasonable or contrary to the reasonable expectations of the Parties.
53. As explained in paragraphs 18 to 24 above, one of the risks faced by a Seller under a CDS, where Physical Settlement applies, is the possibility of having to take delivery of a Loan that may be difficult to dispose. Indeed, many CDS Sellers will not wish to hold such a Loan to maturity, especially as the Reference Entity may be distressed and facing an ongoing weakening of its credit position.
54. If the Seller has a matching position under another CDS, the obvious way of achieving this is by delivering it under that transaction. If any constraints on the transfer of the Loan that go beyond the need to obtain the requisite consents prevent this, as explained in paragraphs 19 to 24 above, an improper hedging mismatch will arise.



55. If the Seller does not have a matching CDS, it will generally need to dispose of the Loan in the secondary market. If there are any material constraints on the identity of persons to which the Loan may be transferred, this may make it difficult or impossible to find a purchaser and/or affect the price that can be achieved.
56. Where Auction Settlement applies, any constraints on the identity of the persons to which the Loan may be transferred may have an adverse effect on the price achieved in the Auction. This may be because: (a) the price at which an institution is willing to bid in the Auction is affected by the existence of such restrictions; or (b) any institutions that fall outside the restrictions are unlikely to be willing to bid in the Auction.

### **E. The “No” Position Reflects the Legal Consensus**

57. There are no reported cases in which the meaning of the Consent Required Loan provision has been considered. However, the arguments advanced by the “No” Position are consistent with the views expressed in *Derivatives Law and Practice* (S. Firth, Sweet & Maxwell, London, loose-leaf), which is the leading textbook on English derivatives law. Paragraph 16.174 (which is set out in full in **Exhibit 2**) states:

It is probably ... the case that, if any additional conditions must be met, such as a restriction on the types of person to which the Loan may be transferred, the Deliverable Obligation Characteristic will not be satisfied, at least if the restriction extends to persons to which a participant in the secondary loan market might reasonably wish to sell the Loan. In other words, the Seller agrees to take the risk that the Loan it receives will not be transferable if it does not obtain any necessary consents, but probably not the risk of having to satisfy further, potentially more onerous, conditions as well.

58. The text of this paragraph has appeared, in broadly the same form, since 2003 (when the book was first published).<sup>12</sup> No commentary has been found which casts doubt on the interpretation or expresses a different view. This suggests that the author’s opinion

<sup>12</sup> The Consent Required Loan provision appeared in both the 1999 ISDA Credit Derivatives Definitions and the 2003 ISDA Credit Derivatives Definitions.

has not attracted controversy. Although it considers the position under English law, the Definitions are intended for both English and New York law contracts and their interpretation under both legal systems is likely to be extremely similar, if not identical.

59. Furthermore, Allen & Overy LLP stated to the DC in writing that, in its view, the Sears Loans do not satisfy the Consent Required Loan Deliverable Obligation Characteristic.<sup>13</sup> This was on the ground that “by limiting the universe of potential assignees to “Eligible Assignees,” consent of the borrower and any requisite agents is not the sole condition to assignment of the loan.” The fact that unqualified advice to this effect was given by a firm with considerable experience in this area suggests that it reflects the view of market practitioners.
60. Neither the views expressed in *Derivatives Law and Practice* nor the Allen & Overy memorandum are binding on the DC or the External Reviewers. However, they underline the fact that the interpretation suggested by the “No” Position cannot be said to be absurd, commercially unreasonable or contrary to the reasonable expectations of the Parties.

## **VII. APPLICATION**

61. The Sears Loans do contain restrictions on the ability of a holder of the Loans to assign or novate them that go beyond the need to obtain the consents specified in the Consent Required Loan provision. Specifically, any transferee that is not an existing Lender, an Affiliate of an existing Lender, an Approved Fund or a Permitted Holder (as defined in the Sears Loans) must:

<sup>13</sup> This memorandum is referenced throughout the Meeting Statement. For instance, the Meeting Statement explains that “members of the Committee who supported the First Interpretation were of the view that the First Interpretation . . . is consistent with the legal advice received by the Committee in connection with the interpretation of the Consent Required Loan definition . . .” Meeting Statement, at 3. At the very least, this is factual evidence that the market banking practice is entirely consistent with the “No” Position set forth herein. We have no objection to the External Reviewers’ examination of this memorandum.

## Linklaters

- (a) be a commercial bank or any other Person engaged in the business of making asset based or commercial loans, or any fund or other Person (other than a natural Person) that invests in loans; and
  - (b) together with its Affiliates, have a combined capital and surplus in excess of \$300,000,000.
- 62. These are material restrictions on the ability of a holder of the Sears Loans to assign or novate such Loans, which go beyond the need to obtain the consents contemplated by the Consent Required Loan provision. The tests would exclude many counterparties to credit derivative counterparties and a number of entities that might otherwise wish to acquire the Sears Loans in the secondary market.
- 63. This can be seen from the description of the secondary loan market contained in the Loan Market Association (“LMA”) publication, “*Guide to Secondary Market Loan Transactions*” set out in **Exhibit 3**. This states (on page 7):

Today’s secondary loan market is utilised by a diverse and vast number of participants, including investment banks, commercial banks, hedge funds, pension funds, private equity funds and specialist loan brokers, each looking to transact in par, near par and/or distressed debt.
- 64. The Loan Syndications & Trading Association has also included on its website a S&P Global Market Intelligence publication “*A Syndicated Loan Primer*” (set out in **Exhibit 4**). This lists the types of entity that participate in the loan market, including “banks,” “finance companies,” “institutional investors,” “CLOs,” “loan mutual funds,” “daily-access funds,” “continuously offered, closed-end funds” and “exchange-traded, closed-end funds.” It also notes the “explosive growth of nonbank investors groups” since 2000.
- 65. A capitalisation requirement of \$300 million is highly material and would exclude many of these market participants.

66. The significance of such a requirement can also be seen by comparing it to the test that applies under U.S. federal securities laws, which treat \$100 million in securities as a material threshold for the sale of securities to U.S. institutional investors.<sup>14</sup>
67. Similarly, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“**FIRREA**”) imposes significant capital requirements on savings institutions.<sup>15</sup> These also underscore the materiality – and inflexibility – of the \$300 million capital requirement. Indeed, the FIRREA capital requirements take into account banks’ total assets, which can vary widely. The \$300 million requirement, however, *always* applies, no matter the institution’s total assets, creditworthiness, or any other factor relevant to whether the institution is capable of taking an assignment or novation. Accordingly, the test in the Consent Required Loan provision is not satisfied.

## **VIII. IMPLICATIONS**

68. The Meeting Statement states that:

certain members of the Committee who support the Second Interpretation ... view the primary purpose of the Consent Required Loan definition as to enable U.S. loans (which are often only transferable with the prior consent of the agent or borrower and would therefore be excluded under the Assignable Loan Deliverable Obligation Characteristic) to be considered for deliverability in settlement of CDS contracts. It was also noted by such members that certain restrictions on transferability (such as agent consent) are often included in U.S. loans to mitigate against the risk that a loan may be recharacterized or interpreted as a “security” under U.S. securities laws, and therefore Consent Required Loan was specifically added to account for this from a CDS deliverability perspective...

It was noted that it is relatively common in the U.S. loan market for loans to contain restrictions on the entities to which a loan can be assigned. Concern was expressed by certain members who supported the Second

<sup>14</sup> Specifically, the exemption set out under Rule 144A (of the Dodd–Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C § 5301, *et seq.*) permits the resale of securities to qualified institutional buyers (“**QIBs**”), who are considered accredited investors of significant size and sophistication. These QIBs must own and invest a minimum of \$100 million in securities to satisfy the threshold test and qualify as a QIB. This same \$100 million materials threshold is used to determine major U.S. institutional investors for the purposes of Rule 15a-6. Rule 15a-6 under the Securities Exchange Act of 1934 provides conditional exemptions from U.S. registration for foreign broker-dealers doing business with qualified U.S. institutional investors.

<sup>15</sup> These capital requirements include: (1) tangible capital equal to at least 1.5% of total assets; (2) core capital equal to at least 3% of total assets; and (3) risk-based capital more than 8% of total assets. Furthermore, to prevent insured depository institutions from engaging in an unsafe or unsound practice or condition, the Federal Deposit Insurance Corporation (“**FDIC**”) imposes material, minimum leverage capital requirements as percentage ratios of capital to total assets. *See* FDIC Act, 12 C.F.R. §§ 324.1–324.4.

Interpretation that the First Interpretation may have the effect of limiting CDS market participants' ability to deliver a number of U.S. loans, essentially turning the CDS market in the United States into a "Bond only" market.

Those members felt that this may be particularly pertinent given that, according to certain members of the Committee, the United States loan market has expanded significantly in recent years."

69. This is not correct. It is also common in the European market for Loans to contain restrictions on the persons to which they can be transferred. Indeed, the standard LMA documentation provides that the consent of the borrower is required for an assignment or novation "to another bank or financial institution or to a trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets" (unless it is to another lender, or an affiliate of it, or occurs at a time when an Event of Default is continuing).
70. The Consent Required Loan provision is, therefore, not designed merely for U.S. loans but is relevant to the entire market. Although, under the LMA documentation, the requirement for consent falls away while an Event of Default subsists, a Credit Event will not necessarily be accompanied by an Event of Default.
71. Provisions along the lines set out in the Sears Loans are sometimes found, particularly in revolving credit facilities (the creditworthiness of the lenders being particularly important in such cases, given that they have a continuing obligation to lend). However, they are not standard market practice.<sup>16</sup>
72. As the market includes Loans that are generally transferable (if the requisite consents are obtained) and Loans which are subject to additional restrictions, the fact that the Consent Required Loan provision is drafted in general terms provides further support

<sup>16</sup> Pursuant to DC Rule 4.6, we have prepared statements on market practice to this effect that can be submitted for the External Reviewers' consideration. Such statements include only market-related "information" that "was available to the Convened DC on or prior to the binding vote." To the extent the External Reviewers find that such statements "identify new information that is relevant to the resolution of a Reviewable Question," we hereby have "clearly identified" such information "to the External Reviewers." DC Rule 4.6.

for the view that only Loans in the former category are covered. Indeed, it completely undermines the argument that the mere existence of the Consent Required Loan provision shows that the restrictions in the Sears Loans are intended to satisfy the test.

73. The suggestion in the Meeting Statement that the interpretation proposed by the “No” Position “may have the effect of limiting CDS market participants’ ability to deliver a number of U.S. loans” is correct. This is not surprising, given that the Consent Required Loan provision is included to separate those Loans which should be treated as Deliverable Obligations from those which should not. If the provision were interpreted so as to place no limits on market participants’ ability to deliver Loans, it would be redundant. However, it is not true to say that this would “essentially [turn] the CDS market in the United States into a “Bond only” market.” Many Loans originated in the United States would still satisfy the Consent Required Loan test under the interpretation proposed by the “No” Position.
74. In any event, the role of the DC, and the External Reviewers, is not to decide whether, as a commercial matter, Loans containing particular provisions *ought* to be deliverable. The question is what the Parties’ intent was, as a matter of the interpretation of the Definitions. This is plainly correct as a matter of law but it is also important for reasons of predictability and fairness and, hence, the integrity of the credit derivatives market. If market practitioners consider that, as a commercial matter, the Consent Required Loan test should be wider, the appropriate way forward is for the standard documentation to be amended.

## **IX. CONCLUSION**

75. For the foregoing reasons, it is respectfully submitted that the External Reviewers adopt the “No” Position.

**LINKLATERS LLP**

**EXHIBIT 1**  
**THE REVIEWABLE QUESTION**

Do the following obligations satisfy the Consent Required Loan Deliverable Obligation Characteristic for purposes of the Auction to be held with respect to SRAC?

FIGI BBG00DX35360 2LL: PIK Term Loan – The Term Loan, as defined in the Fifth Amendment to the Second Lien Credit Agreement dated as of July 5, 2018.

FIGI BBG00DX35360 2L: Line of Credit Loans (\$525.0m) – The Line of Credit Loans, as defined in the Fifth Amendment to the Second Lien Credit Agreement dated as of July 5, 2018.

## EXHIBIT 2

### EXTRACT FROM DERIVATIVES LAW AND PRACTICE

#### Consent Required Loan<sup>1</sup>

By contrast, a Consent Required Loan is a Loan that is capable of being assigned or novated, but only with the consent of the borrower or guarantor (or any agent).<sup>2</sup> Inevitably, there remains a risk in such a case that consent will be obtained to transfer the Loan to the Seller but no further. It is therefore only suitable for Sellers that are willing and able, if necessary, to hold any Loan that is delivered both to maturity and throughout any subsequent restructuring process (although the entry into of a participation would be a method of achieving an economic transfer).<sup>3</sup>

The requirement for a Loan to be “capable of being assigned or novated with the consent of” the borrower, the guarantor or any agent appears to mean that any transfer of the Loan must be possible, subject to obtaining any necessary consents: it is not sufficient that it can be transferred to the Seller in this way. The opposite conclusion would render the Consent Required Deliverable Obligation Characteristic redundant because the Buyer must in any event transfer a Deliverable Obligation to the Seller when effecting Physical Settlement. The Seller’s objective in including this Deliverable Obligation Characteristic must therefore have been to ensure that it is able to transfer any delivered Loan to third parties, subject to obtaining any necessary consents.

It is probably also the case that, if any additional conditions must be met, such as a restriction on the types of person to which the Loan may be transferred, the Deliverable Obligation Characteristic will not be satisfied, at least if the restriction extends to persons to which a participant in the secondary loan market might reasonably wish to sell the Loan.<sup>4</sup> In other words, the Seller agrees to take the risk that the Loan it receives will not be transferable if it does not obtain any necessary consents, but probably not the risk of having to satisfy further, potentially more onerous, conditions as well. If the additional conditions may be waived by the borrower or guarantor (or any agent), the conclusion would probably be different, on the basis that the waiver is itself a type of consent. However, if the waiver requires the consent of the other banks in the syndicate, the consent would fall outside those contemplated by the Deliverable Obligation Characteristic. Many Loans do contain restrictions on transfer that go beyond the need to obtain the consent of the borrower, the guarantor or any agent. For example, transfers are often limited to banks and other financial institutions. These Loans probably cannot be delivered under credit derivative transactions that specify Consent Required Loan as a Deliverable Obligation Characteristic if they cannot be waived without the agreement of the other syndicate banks.

<sup>1</sup> If Consent Required Loan is specified as well as Assignable Loan or Direct Loan Participation, the loan need only satisfy one of these Deliverable Obligation Characteristics: 2014 Definitions s.3.15(c).

<sup>2</sup> 2014 Definitions s.3.14(b)(ii).

<sup>3</sup> As with Assignable Loans, the tax implications of taking delivery of a Consent Required Loan should be considered.

<sup>4</sup> Although this is not expressly stated in the 2014 Definitions, it would appear to be overly restrictive if a Loan failed the Consent Requirement because a single person could be identified to whom the Loan would not be transferable. To make commercial sense of the provision, therefore, some limit must be placed on the scope of this requirement.

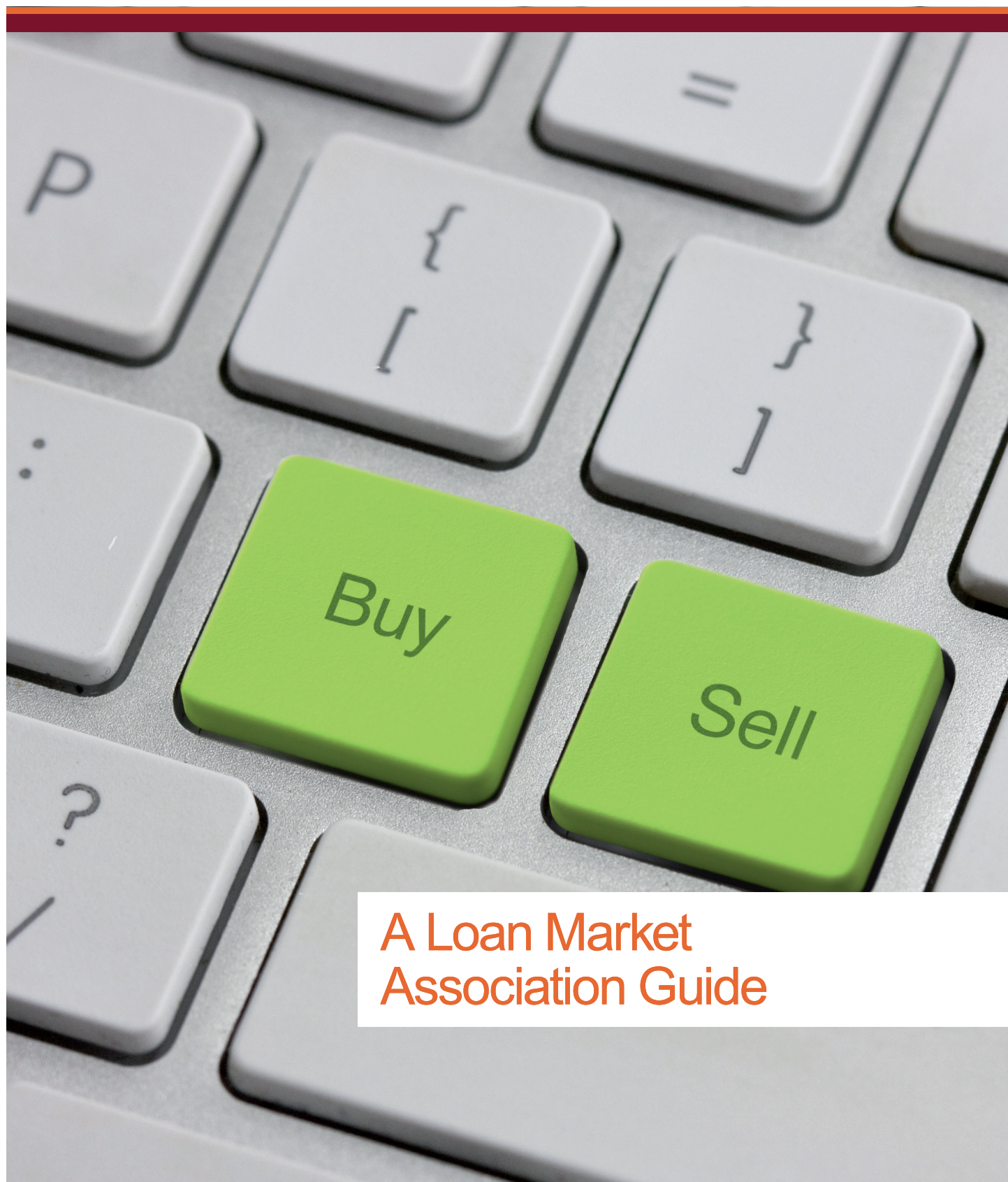


**EXHIBIT 3**

**LOAN MARKET ASSOCIATION GUIDE:  
“GUIDE TO SECONDARY LOAN MARKET TRANSACTIONS”**

# Guide to Secondary Loan Market Transactions

March 2017



**A Loan Market  
Association Guide**

## **A LOAN MARKET ASSOCIATION GUIDE**

### **A GUIDE TO SECONDARY LOAN MARKET TRANSACTIONS**

Loan Market Association

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The views and opinions expressed in this publication are the views of the authors. The Loan Market Association and the authors have made every effort to ensure the complete accuracy of the text but none of the Loan Market Association, the authors or the publishers can accept any legal responsibility or liability for any error or omission in its contents.

This "Guide to Secondary Loan Market Transactions" is not intended to be completely comprehensive. Rather, it seeks to provide an overview of the role of the secondary market in the syndicated loan market. Most importantly, this publication is not designed to provide legal or other advice on any matter whatsoever.

#### **The Loan Market Association**

The Loan Market Association (LMA) is the trade body for the Europe, Middle East and Africa (EMEA) syndicated loan market and was founded in December 1996 by banks operating in that market. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 650, covering 60+ nationalities, and consists of banks, non-bank lenders, borrowers, law firms, rating agencies and service providers. The LMA has gained substantial recognition in the market and has expanded its activities to include all aspects of the primary and secondary syndicated loan markets. It sees its overall mission as acting as the authoritative voice of the EMEA loan market vis à vis lenders, borrowers, regulators and other interested parties.

**CONTENTS**

	Page Number
INTRODUCTION	3
DEVELOPMENT OF THE SECONDARY LOAN MARKET	4
HISTORICAL DATA	6
MARKET PARTICIPANTS	7
TYPES OF DEBT	8
ANATOMY OF A TRADE	9
TRANSFER MECHANISMS	14

### INTRODUCTION

Syndicated loans started as a way of allowing lenders to lend large sums of money to a single borrower, where the sums involved went far beyond the credit appetite of a single lender. Origination and syndication of the transaction take place in the primary market; it is where lenders lend directly to borrowers, with loans syndicated before the loan is made, or shortly thereafter.

Following completion of the transaction, the loan becomes "free to trade", subject to the terms and conditions contained in the primary documentation. The secondary loan market refers to the sale and distribution of syndicated loans by lenders in the original syndicate or by subsequent purchasers of the loan.

The secondary loan market has aided the growth of the syndicated loan market by opening the market to a wide variety of types of institution, including, amongst others, insurance companies, pension funds and hedge funds, fuelling an increase of liquidity within the primary and secondary markets. The secondary loan market is also an essential tool that lenders use to manage their loan portfolios.

The purpose of this guide is to provide an introductory overview of the secondary loan market. Amongst other things, this guide shall provide a (1) target timeline for a typical secondary loan market transaction, including a brief explanation of the documentation which may be entered into by the parties; (2) description of the parties active in the secondary loan market; and (3) description of the common methods used by lenders to transfer syndicated loan participations.

### Section 1

#### DEVELOPMENT OF THE SECONDARY LOAN MARKET

The secondary loan market refers to the sale of loans that occurs after syndication of the original loan has been closed and allocated. It includes sales or trades of syndicated loans made by lenders in the original syndicate and those made by subsequent purchasers.

A lender under a syndicated loan may decide to sell all or part of its commitment in a facility for a number of reasons, including:

1. *Realising Capital*: if the loan is a long-term facility, a lender may need to sell its share of the commitment to realise capital and improve its liquidity to be able to take advantage of new lending opportunities;
2. *Risk Management*: a lender may consider that its loan portfolio is weighted with too much emphasis on a particular type of borrower, geography, industry or maturity. By selling its commitment in this loan, it may lend elsewhere, thereby taking advantage of new lending opportunities and diversifying its portfolio;
3. *Regulatory Capital Requirements*: a bank's ability to lend is subject to both internal and external requirements to retain a certain percentage of its capital as cover for its existing loan obligations.<sup>1</sup> The secondary loan market is becoming an increasingly important tool for lenders to actively manage their loan portfolios to comply with regulatory capital requirements; and
4. *Crystallise a loss*: the lender may decide to sell its commitment if the borrower runs into difficulties, thereby realising an immediate value for its commitment, rather than holding on to a commitment where there is no guarantee that the borrower will be able to repay its debt. In addition, a lender can incur substantial costs when monitoring a borrower in financial difficulty, for example, regularly reviewing the borrower's overall financial position, reviewing its options should a borrower breach a term of the facility agreement, and analysing its rights vis-à-vis other creditors. Specialists dealing in distressed debt provide a market for such loans.

That said, there are a number of reasons that a buyer will want to acquire a commitment in a facility, including:-

1. *Develop and expand relationships*: a primary lender may wish to increase its exposure to a specific borrower, thereby increasing its profile and developing its relationship with the borrower, so that it may take on the role of agent or arranger in future syndications and/or cross-sell products to the borrower. Additionally, lenders may use the secondary loan market to acquire a commitment in a facility that they were not a primary party to, to build a relationship with the borrower or other financial institutions;

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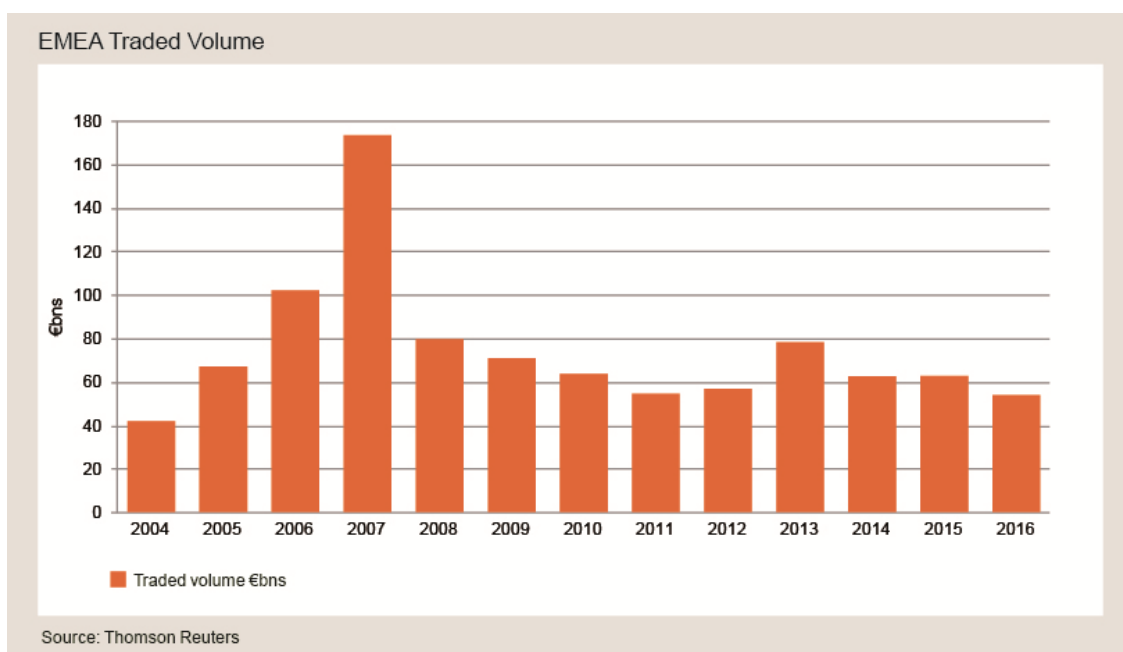
<sup>1</sup> The application of capital ratios imposed by national regulators and EC directives, specifically by way of implementation of Basel II and Basel III, requires banks to maintain capital equivalent to a certain percentage of their risk-weighted assets, so that sufficient capital is available to support the bank against losses. For further information, see the LMA Guide "Regulation and the Loan Market".

2. *To make a profit:* traders seek to use the secondary loan market to make a profit, by selling on an acquired debt at a level higher than its purchase price, usually within a short space of time; and
3. *To own part of the debtor company:* specialist investors may buy a large portion of a borrower's debt, potentially with a view to acquiring control of the company. Alternatively, the investor may look to influence the borrower's insolvency or restructuring process. The investor may be making an investment on its assessment of the probability that the company will be successfully rescued, the ultimate aim being to profit from any subsequent upside in the value of the business. The investor may also be taking a view that the breakup value or recovery via insolvency will be sufficient to make a profit on its original investment.

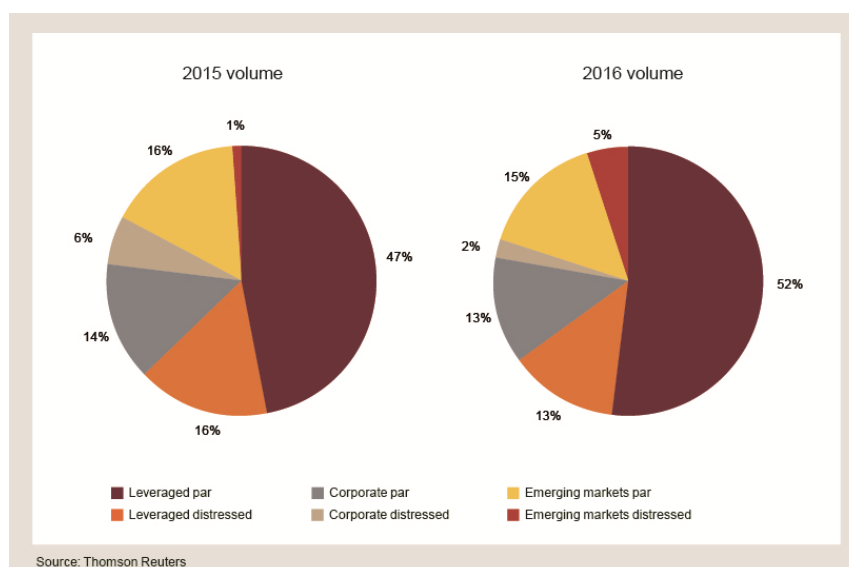
## Section 2

### HISTORICAL DATA

The secondary loan market is a private market and data with regard to depth and liquidity is limited. There is no single data source to determine the actual volume of loans traded. Data which is available is collated on a contributor basis, via third party service providers, and reflects in the main only those transactions concluded on an intermediated basis, i.e. those trades which have passed through trading desks, rather than those traded directly between seller and buyer without the involvement of one of the banks contributing to the data collation exercise. A 12-year overview of reported volumes, for the years 2004 to 2016, is given below. Given the limitations as described, the expectation would be that actual traded volumes are somewhat higher.



Over the last 12 years traded volumes as reported have been dominated by leveraged finance. A breakdown of reported EMEA volumes in 2015 and 2016 are given below.





### Section 3

#### MARKET PARTICIPANTS

Up to the mid-1990s, participation in the secondary loan market in Europe was dominated by a small number of US houses, predominantly investment banks, specialist debt traders and vulture funds, with activity focused on the distressed market. However, from the mid-1990s onwards, institutional investors and other non-bank financial institutions increasingly looked to the secondary loan market to invest their money. Today's secondary loan market is utilised by a diverse and vast number of participants, including investment banks, commercial banks, hedge funds, pension funds, private equity funds and specialist loan brokers, each looking to transact in par, near par and/or distressed debt.

In the distressed market, the diversification and growth in the number of participants follows from the diversification and growth in the number of participants in the leveraged finance market generally. In addition, government agencies, such as the Irish National Asset Management Agency (NAMA), were set up to buy non-performing debt as a result of the 2007-2009 financial crisis.

Although there are no statutory or conceptual barriers to a borrower, or its associated companies, buying back its own debt, there may be practical or commercial difficulties in its doing so. We will not explore the possibility of borrower-buy backs in this guide.

### Section 4

#### TYPES OF DEBT

##### A. PAR AND NEAR PAR DEBT

Par value or near par value loans are traded at or very near to (and in some cases above) their face value. These are loans that the market considers to be extremely likely to be repaid on time and in full. The secondary loan market in par debt is particularly useful for lenders that wish to change the focus of their lending portfolio by concentrating on, or diversifying away from, particular borrowers, countries or types of business. The purchase of debt may also be used to build a relationship with specific borrowers or particular lenders in a syndicate, especially if the buyer was unable to participate in the original syndication.

##### B. DISTRESSED DEBT

Distressed debt (also known as "impaired debt" or "sub-performing debt") refers to loans that are unlikely to be repaid in full because the borrower is either in a form of insolvency process or in severe financial distress. Distressed debt typically trades at a significant discount to face value. A buyer will take a view on the likelihood that either a portion of the debt will be repaid as part of the insolvency settlement or that the borrower will recover and the loan will eventually be repaid in full.

In some cases, the buyer will buy enough debt to secure influence in the borrower's insolvency or restructuring process, perhaps ultimately assuming control of the borrower. In the latter case, the buyer will make its investment decision based also on its ability to rescue an insolvent or distressed company.

### Section 5

#### ANATOMY OF AN LMA TRADE

##### A. STAGES OF AN LMA TRADE

Assuming that a trade commences when either a prospective Seller decides to sell an asset or a potential Buyer decides that it wishes to acquire a particular loan asset, a trade breaks down into a number of relatively well-defined stages.

##### I. Identify the counterparty

Parties must be aware of any restrictions contained in the underlying credit documentation regarding the type of entity to whom loans can be transferred (by novation) or assigned. There is generally less of an issue where the 'sale' is to be by way of participation, although occasionally credit documentation does impose restrictions on participations as well as transfers and assignments. In addition, parties should be aware that there may be restrictions regarding the minimum amount a lender can transfer and the minimum amount a lender must hold.

##### II. Confidentiality<sup>2</sup>

Once potential counterparties have been identified the question of confidentiality arises, as the prospective buyer will wish to undertake due diligence on the loan asset it is acquiring. In most instances, the underlying credit documentation will impose a duty on all parties to maintain the confidentiality of the terms of the transactions and the credit documentation, explicitly setting out the instances in which confidential information may be disclosed. However, where English law applies and credit documentation is silent on the subject of disclosure, borrower consent must be obtained before any disclosure of information relating to the borrower, the group or the financing received, including copies of the credit documentation, can take place. Note that this need to obtain consent where the credit documentation is silent on the subject of disclosure applies irrespective of whether a confidentiality agreement is entered into between the prospective seller and buyer.

##### III. Due diligence

A prospective buyer is expected to have carried out all necessary due diligence prior to the trade date and any relevant "know your customer" checks. Due diligence by a prospective buyer cannot, of course, start until the required confidentiality agreement has been entered into. Once entered into, the seller can provide the buyer with the necessary information, including copies of the credit documentation and financial information.

Having acquired the relevant information, the buyer will then seek credit approval to purchase the asset.

##### IV. The Trade

Once credit approval is obtained, the seller and the buyer should be in a position to carry out a trade. This will normally be done over the phone. Unless the parties explicitly stated that the trade is

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<sup>2</sup> See the "LMA Transparency Guidelines" for further information on confidentiality issues market participants should consider when looking to trade in the secondary loan market.

subject to contract, there should be a binding contract at the time of the oral trade (the **Trade Date**).<sup>3</sup>

The key terms usually agreed orally at the time of the trade include:-

- the price paid – is it at par, a premium (i.e. above face value) or a discount;
- the facility and specific tranche – a borrower could have a number of multi-tranche facilities in the market at any one time. Parties will therefore want to ensure that they are both looking to trade the same tranche of the same facility;
- amount – whether the buyer is purchasing the whole of the seller's commitment, or just a portion of it. This could impact how any voting rights are apportioned;
- the form of purchase – whether the trade is to settle via legal transfer only, via legal transfer with a fall-back option to funded participation or directly via funded participation;
- the target settlement date - being the date on which the trade is physically settled, the default target date being as soon as reasonably practicable;
- the treatment of interest payments and fees – the treatment of any unusual fees, such as repayment premiums, should be expressly agreed as a trade specific term; and
- trade specific representations and warranties.

### V. The Confirmation

The trade confirmation (the **Confirmation**) is designed to record the terms of the trade as agreed orally. It is envisaged that at the time of the oral trade, the seller and buyer will agree all those matters which are required to be decided in order to complete the Confirmation, including which of the parties is to prepare it. The party charged with that responsibility is referred to as the **Responsible Party**. The Confirmation is to be completed by the Responsible Party and sent to the other party, usually within two business days of the Trade Date. The other party is required either to sign and return the Confirmation to the Responsible Party or to raise any disagreement with any of the terms of such Confirmation, usually by no later than the end of the second business day after delivery of the Confirmation. It should be noted that the Confirmation is intended solely to evidence the terms that were agreed at the time of the trade; it is not intended to be subject to negotiation in its own right.

### VI. Third party consents

Consents of third parties, most commonly the borrower, may be required. However, since restrictions on the ability to transfer debt affect the marketability of the debt, facility agreements

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<sup>3</sup> In *Bear Stearns Bank plc v Forum Global Equity Ltd* [2007] EWHC 1577 (Comms), the High Court held that parties to a distressed debt trade concluded a contract during a telephone conversation, when the price for the trade was agreed but the settlement date was not; transactional documentation was to be prepared by the parties' respective lawyers following the call. The case is significant because it endorses distressed debt market practice and gives certainty to oral trades.

will often include a requirement that the borrower does not unreasonably withhold consent. In some cases, facility agreements provide for "deemed consent" to operate in specified instances, for example, a transfer of debt to an institution within a designated class could be effected without borrower consent.

Where consent is required, the seller should apply (via the Facility Agent) for any such consent on, or as soon as practicable after, the Trade Date. The refusal of any necessary consent will not lead to the transaction being terminated without any liability of either party. Instead the seller and buyer will be required to settle the proposed transaction by a funded participation or by some mutually acceptable alternative means which provides the seller and buyer with the economic equivalent of the agreed-upon trade; this is founded on the principle that a "trade is a trade".

### **VII. Transaction documentation**

The parties choose who is to prepare the documentation required to complete the transaction, with parties looking to execute the transaction documentation as soon as reasonably practicable after the Trade Date. Documentation will include transfer certificates, usually in the form scheduled to the underlying facility agreement, and pricing letters, which detail the various fund transfers required, including payments to the agent and between the buyer and seller.

### **VIII. Settlement date**

If the facility is documented using an LMA facility agreement and the transfer is by way of novation, the trade is legally completed on the later of the date specified in the transfer certificate and the date the transfer certificate is signed by the Agent (the **Settlement Date**). In all other cases, the trade is legally completed on the settlement date agreed by the parties. The asset is transferred to the buyer and, unless the trade is to be completed by way of risk participation, the settlement amount is required to be paid. Depending on the circumstances and the nature of the asset, the settlement amount may be required to be paid by the buyer to the seller or by the seller to the buyer or, in some cases, two way payments may be required. The settlement amount is adjusted to take account of any delayed settlement compensation, being a mechanism used to put the parties in the economic position they would have been in had the trade settled within the timetable recommended by the LMA (10 Business Days after the Trade Date for par and 20 Business Days after the Trade Date for distressed). The settlement amount will also be adjusted for any principal repayments received from the borrower by the seller between Trade Date and Settlement Date.

### **IX. Post-settlement date**

Any notices which need to be given, or other matters which need to be carried out, should be done as soon as possible after the Settlement Date. This may, for example, include giving notice to the borrower that the assignment is complete and/or registration of the buyer as a secured party in overseas jurisdictions.

### **X. Secured Debt**

Most secured loans traded in the secondary loan market will be syndicated loans that are part of

multilateral financing structures, which will often include a security trust arrangement.<sup>4</sup> In a syndicated loan, which is documented under English law, a security trustee is typically appointed to hold security on trust for all the lenders from time to time. The incoming lenders take the benefit of the security on completion of the trade without any need for any amendments to the security documents or additional registration, as the security itself remains untouched.

The use of a security trust arrangement avoids the need for the security to be assigned or for new security to be taken when a loan is transferred. New security would trigger a new registration requirement and, in the event of insolvency, this fresh security would be particularly susceptible to challenge during any hardening periods.

In most cases, once a transfer occurs in accordance with the provisions of the facility agreement, the incoming lender becomes a **Finance Party** and as such, a beneficiary of the security. However, in some cases, the incoming lender may also be required to accede to a security trust deed and/or intercreditor agreement to ensure that they also agree to be bound by the terms of those documents. The form of the accession is usually contained in a schedule to the security trust deed and/or intercreditor agreement.

Note that where there are non-English Obligors and/or there is security which is not governed by English law, the security trust arrangement may not be recognised in the relevant jurisdictions. This can be problematic for transfers of the loan and related security.

### B. TIME-LINE

Set out below is a target time-line for a straightforward secondary loan market trade, showing the points at or by which the parties should aim to enter into the various documents to a trade.

T – x	KYC requirements satisfied  Buyer and Seller exchange Confidentiality Letters (if necessary)  Buyer commences due diligence on Credit Documentation (if required)
T	Trade Date – oral agreement of the trade (or, as the case may be, written agreement of the trade (e.g. by email))
T + 1	Seller sends: <ul style="list-style-type: none"><li>• Request to Agent for Borrower consent</li><li>• Credit Documentation to Buyer (unless sent before Trade Date)</li></ul>

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<sup>4</sup> A security trust is a trust that is used to hold security over an obligor's assets that are secured in favour of a trustee (the security trustee) for the benefit of the obligor's lenders as beneficiaries. Note that in some jurisdictions a trust structure is not appropriate or legally possible, it is therefore important to take local legal advice before implementing such a structure.

## GUIDE TO SECONDARY LOAN MARKET TRANSACTIONS

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T + 2	Responsible Party sends Confirmation to Other Party Agent sends consent request to Borrower
T + 4	Other Party returns Confirmation to Responsible Party
T + 5	Responsible Party sends Transaction Documentation to Other Party
T + 7	Borrower's approval of trade
T + 7 (Par Trade) T + 15 (Distressed Trade)	Both parties sign Transaction Documentation – deliver to the Agent
T + as soon as reasonably practicable	Settlement Date
T + 10 (Par Trade) T + 20 (Distressed Trade)	If applicable, delayed settlement compensation starts to accrue
T + 60 (Par Trade only)	Buy-in/Sell-out applies if one party fails to perform its Settlement Delivery Obligations

### Section 6

#### TRANSFER MECHANISMS

English law provides several legal techniques to transfer a loan to a third party. The most common forms of transfer to enable a lender to sell its loan commitment are:

- I. novation (the most common legal mechanic using transfer certificates scheduled to facility agreements);
- II. legal assignment;
- III. equitable assignment; and
- IV. sub-participation.

Methods (I) and (II) result in the lender disposing of its loan commitment, with the new lender assuming a direct contractual relationship with the borrower, whilst methods (III) and (IV) result in the lender retaining a contractual relationship with the borrower. Each of these methods is examined in more detail below.

##### A. Novation

Novation is the only way in which a lender can effectively 'transfer' all its rights and obligations under the facility agreement. The process of transfer by novation effectively cancels the existing lender's obligations and rights under the loan, while the new lender assumes identical new rights and obligations in its place.

The contractual relationship between the transferring lender and the parties to the facility agreement ceases and the new lender enters into a direct relationship with the borrower, the agent and the other lenders. At the time the new lender becomes a party to the facility agreement the loan could be fully drawn, particularly if it is a term loan facility. However, particularly in the case of a revolving credit facility, the new lender could be assuming obligations to advance monies to the borrower.

All of the parties to the original syndicated facility agreement, including the borrower, need to consent to the novation. The documentation required to effect a novation of a participation in a syndicated loan depends on the provisions in the facility agreement. However most facility agreements (including the LMA recommended form) contain comprehensive novation provisions in which all parties (including the borrower) agree that, provided the other conditions to any transfer by novation set out in the facility agreement are complied with, they consent to the novation. Most transfers by novation are effected by the execution of a transfer certificate.<sup>5</sup> The form of Transfer Certificate is usually attached as a schedule to the facility agreement. The agent, the new lender and

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<sup>5</sup> In *Habibsons Bank Ltd v Standard Chartered Bank (Hong Kong) Ltd* [2010] EWCA Civ 1335, the Court of Appeal confirmed that parties may give their consent to novation in advance, provided that the scope and the terms of the new contract are sufficiently clear and specific. The decision is not binding (it was an interlocutory appeal) but it provides comfort that the standard practice of obtaining consent in advance in many lending transactions is effective.



the existing lender are the only parties usually required to execute the transfer certificate.

### **B. Legal Assignment**

An assignment involves the transfer of rights, but not obligations, under a contract. In the context of the syndicated loan, a legal assignment will transfer all of the existing lender's rights under the facility agreement (including the right to sue the borrower and the right to discharge the assigned debt) to the new lender. The obligation of the existing lender to provide funds to the borrower cannot be transferred by legal assignment and thus remains with the existing lender. Similarly, the obligations of the existing lender to the other finance parties cannot be assigned. The new lender therefore usually provides an indemnity to the assignor and the other finance parties that it will assume those obligations as if named as a lender under the facility agreement.

In order to be a legal assignment, s.136 of the Law of Property Act 1925 provides that the assignment must be:

- absolute (i.e. an unconditional transfer);
- a transfer of the whole of the debt outstanding to the existing lender, and not just part of the debt;
- in writing and signed by the existing lender; and
- notified in writing to the borrower and any other obligor under the facility agreement.

If any element of this requirement is missing, the assignment is likely to be equitable rather than legal (see Section 5.C below).

### **C. Equitable Assignment**

As mentioned above, an equitable assignment is created when one or more of the provisions of section 136 of the Law of Property Act 1925 is not met, provided the intention to assign is present between the parties. This means that the new lender will obtain a beneficial interest in the debt.

In contrast to a legal assignment, the new lender, as the equitable assignee, must join the existing lender, as assignor, in any action on the debt. The most significant difference between a legal and equitable assignment arises if the borrower is not notified of the assignment. In this instance, the new lender will be subject to all equities (for example, mutual rights of set-off) which arise between the existing lender and the borrower, even after the loan has been assigned.

### **D. Sub-participation**

A sub-participation is essentially a contractual agreement between the lender and the participant to make funding arrangements. It is an entirely separate contract from the underlying facility agreement and does not involve the transfer to the buyer of a legal or beneficial interest in the debt. The participant will, therefore, not have any directly enforceable rights against the borrower. Borrower consent is not usually required and so this method can be confidential.

A sub-participation may take one of two forms:-

### I. Funded participation

Under a funded participation the existing lender (the **grantor**) and the participant enter into a contract providing that, in return for the participant paying the grantor an amount equal to all or part of the principal amount loaned by the grantor to the borrower, the grantor will pay the participant an amount equal to all or the relevant share of principal and interest received by the grantor from the borrower in respect of that amount.

In a funded participation, the participant agrees that its deposit will be serviced (in terms of payment of interest) and repaid only when the borrower services and repays the loan from the grantor. The funded participation agreement must ensure that the grantor is put in funds in time to meet the borrower's demands for drawdown. Therefore, the participant takes a double credit risk, that of the borrower failing to pay and of the grantor failing to pay.

### II. Risk participation

Under a risk participation, the risk participant will not immediately place any money with the grantor, but will agree, for a fee, to put the grantor in funds in certain circumstances (typically on any payment default by the borrower). The grantor therefore exchanges the credit risk of the borrower for that of the participant. Risk participation is therefore akin to a guarantee for the loan, and may be provided by a new lender as an interim measure before it takes full transfer of a loan.

There is no direct contract between the participant and the borrower, but the participant usually obtains rights of subrogation. Therefore if the participant has to pay the grantor as a result of the borrower's default, the participant gains the right to step into the grantor's shoes and pursue all remedies of the grantor against the borrower.



## Guide to Secondary Loan Market Transactions

### A Loan Market Association Guide

The secondary loan market has aided the growth of the syndicated loan market by opening the market to a wide variety of types of institution, fuelling an increase of liquidity within the primary and secondary markets. The secondary loan market is also an essential tool that lenders use to manage their loan portfolios.

The aim of this paper is to provide an overview of the role of the secondary market in the syndicated loan market, identifying, amongst other things, participants active in the secondary loan market, the types of debt available, a typical anatomy of a trade and the different transfer mechanisms.

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**EXHIBIT 4**

**S&P GLOBAL MARKET INTELLIGENCE PUBLICATION:  
“A SYNDICATED LOAN PRIMER”**

# A Syndicated Loan Primer

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# *Contents*

Loan Purposes .....	4
Types of Syndications .....	5
The Syndication Process .....	5
Public Versus Private .....	7
Credit Risk: An Overview .....	8
Syndicating a Loan by Facility .....	10
Pricing a Loan in the Primary Market .....	10
Types of Syndicated Loan Facilities .....	11
Lender Titles .....	14
Secondary Sales .....	14
Participations .....	15
Loan Derivatives .....	15
Pricing Terms .....	16
Loan Math—The Art of Spread Calculation .....	21
Default and Restructuring .....	21
Dodd Frank & the Leveraged Loan Market .....	23
Bits and Pieces .....	23

# *A Syndicated Loan Primer*

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A syndicated loan is a commercial loan provided by a group of lenders and structured, arranged, and administered by one or several commercial or investment banks known as arrangers.

Starting with the large leveraged buyout (LBO) loans of the mid-1980s, the syndicated loan market has become the dominant way for issuers to tap banks and other institutional capital providers for loans. The reason is simple: Syndicated loans are less expensive and more efficient to administer than traditional bilateral, or individual, credit lines.

Arrangers serve the time-honored investment-banking role of raising investor dollars for an issuer in need of capital. The issuer pays the arranger a fee for this service, and, naturally, this fee increases with the complexity and riskiness of the loan. As a result, the most profitable loans are those to leveraged borrowers—issuers whose credit ratings are speculative grade and who are paying spreads (premiums above LIBOR or another base rate) sufficient to attract the interest of nonbank term loan investors, typically LIBOR+200 or higher, though this threshold moves up and down depending on market conditions.

By contrast, large, high-quality companies pay little or no fee for a plain-vanilla loan, typically an unsecured revolving credit instrument that is used to provide support for short-term commercial paper borrowings or for working capital. In many cases, moreover, these borrowers will effectively syndicate a loan themselves, using the arranger simply to craft documents and administer the process. For leveraged issuers, the story is a very different one for the arranger, and, by “different,” we mean more lucrative. A new leveraged loan can carry an arranger fee of 1-5% of the total loan commitment, generally speaking, depending on (1) the complexity of the transaction, (2) the strength of market conditions, and

(3) whether the loan is underwritten. Merger and acquisition (M&A) and recapitalization loans will likely carry high fees, as will exit financings and restructuring deals. Seasoned leveraged issuers, by contrast, pay lower fees for refinancings and add-on transactions. Because investment-grade loans are infrequently drawn down and, therefore, offer drastically lower yields, the ancillary business is as important a factor as the credit product in arranging such deals, especially because many acquisition-related financings for investment-grade companies are large in relation to the pool of potential investors, which would consist solely of banks.

The “retail” market for a syndicated loan consists of banks and, in the case of leveraged transactions, finance companies and institutional investors such as mutual funds, structured finance vehicles, and hedge funds. Before formally launching a loan to these retail accounts, arrangers will often read the market by informally polling select investors to gauge their appetite for the credit. Based on these discussions, the arranger will launch the credit at a spread and fee it believes will clear the market. Until 1998, this would have been it. Once the pricing was set, it was set, except in the most extreme cases. If the loan were undersubscribed, the arrangers could very well be left above their desired hold level. After the Russian debt crisis roiled the market in 1998, however, arrangers adopted market-flex language, which allows them to change the pricing of the loan based on investor demand—in some cases within a predetermined range—as well as shift amounts between various tranches of a loan, as a standard feature of loan commitment letters. Market-flex language, in a single stroke, pushed the loan syndication process, at least in the leveraged arena, across the Rubicon, to a full-fledged capital markets exercise.

Initially, arrangers invoked flex language to make loans more attractive to investors by hiking the spread or lowering the price. This was logical after the volatility introduced by the Russian debt debacle. Over time, however, market-flex became a tool either to increase or decrease pricing of a loan, based on investor demand.

Because of market-flex, a loan syndication today functions as a “book-building” exercise, in bond-market parlance. A loan is originally launched to market at a target spread or, as was increasingly common by the late 2000s, with a range of spreads referred to as price talk (i.e., a target spread of, say, LIBOR+250 to LIBOR+275). Investors then will

make commitments that in many cases are tiered by the spread. For example, an account may put in for \$25 million at LIBOR+275 or \$15 million at LIBOR+250. At the end of the process, the arranger will total up the commitments and then make a call on where to price, or “print,” the paper. Following the example above, if the paper is oversubscribed at LIBOR+250, the arranger may slice the spread further. Conversely, if it is undersubscribed even at LIBOR+275, then the arranger may be forced to raise the spread to bring more money to the table.

## Loan Purposes

For the most part, issuers use leveraged loan proceeds for four purposes: (1) supporting a merger- or acquisition-related transaction; (2) backing a recapitalization of a company’s balance sheet; (3) refinancing debt; and (4) funding general corporate purposes or project finance.

## Mergers and acquisitions

M&A is the lifeblood of leveraged finance. There are the three primary types of acquisition loans:

**1) Leveraged buyouts (LBOs).** Most LBOs are backed by a private equity firm, which funds the transaction with a significant amount of debt in the form of leveraged loans, mezzanine finance, high-yield bonds, and/or seller notes. Debt as a share of total sources of funding for the LBO can range from 50% to upwards of 75%. The nature of the transaction will determine how highly it is leveraged.

Issuers with large, stable cash flows usually are able to support higher leverage. Similarly, issuers in defensive, less-cyclical sectors are given more latitude than those in cyclical industry segments. Finally, the reputation of the private equity backer (sponsor) also plays a role, as does market liquidity (the amount of institutional investor cash available). Stronger markets usually allow for higher leverage; in weaker markets lenders want to keep leverage in check. There are three main types of LBO deals:

- **Public-to-private (P2P)**—also called go-private deals—in which the private equity firm purchases a publicly traded company via a tender offer. In some P2P deals, a stub portion of the equity continues to trade on an exchange. In others, the company is bought outright.

- **Sponsor-to-sponsor (S2S)** deals, where one private equity firm sells a portfolio property to another.
- **Noncore acquisitions**, in which a corporate issuer sells a division to a private equity firm.

**2) Platform acquisitions.** Transactions in which private-equity-backed issuers buy a business that they judge will be accretive by either creating cost savings and/or generating expansion synergies.

**3) Strategic acquisitions.** These are similar to platform acquisitions but are executed by an issuer that is not owned by a private equity firm.

## Recapitalizations

A leveraged loan backing a recapitalization results in changes in the composition of an entity’s balance sheet mix between debt and equity either by (1) issuing debt to pay a dividend or repurchase stock, or (2) selling new equity, in some cases to repay debt.

Some common examples:

**Dividend.** Dividend financing is straightforward. A company takes on debt and uses proceeds to pay a dividend to shareholders. Activity here tends to track market conditions.

Bull markets inspire more dividend deals as issuers tap excess liquidity to pay out equity holders. In weaker markets activity slows as lenders tighten the reins, and usually look skeptically at transactions that weaken an issuer’s balance sheet.

**Stock repurchase.** In this form of recap deal a company uses debt proceeds to repurchase stock. The effect on the balance sheet is the same as a dividend, with the mix shifting toward debt.

**Equity infusion.** These transactions typically are seen in distressed situations. In some cases, the private equity owners agree to make an equity infusion in the company, in exchange for a new debt package. In others, a new investor steps in to provide fresh capital. Either way, the deal strengthens the company’s balance sheet.

**IPO (reverse LBO).** An issuer lists—or, in the case of a P2P LBO, relists—on an exchange. As part of such a deleveraging the company might revamp its loans or bonds at more favorable terms.



## Refinancing

Simply put, this entails a new loan or bond issue to refinance existing debt.

## General corporate purposes and build-outs

These deals support working capital, general operations, and other business-as-usual purposes. Build-out financing supports a particular project, such as a utility plant, a land development deal, a casino or an energy pipeline.

## Types of Syndications

There are three types of syndications: an underwritten deal, a “best-efforts” syndication, and a “club deal.”

### Underwritten deal

An underwritten deal is one for which the arrangers guarantee the entire commitment, and then syndicate the loan. If the arrangers cannot fully subscribe the loan, they are forced to absorb the difference, which they may later try to sell to investors. This is achievable, in most cases, if market conditions, or the credit’s fundamentals, improve. If not, the arranger may be forced to sell at a discount and, potentially, even take a loss on the paper (known as “selling through fees”). Or the arranger may just be left above its desired hold level of the credit. So, why do arrangers underwrite loans? First, offering an underwritten loan can be a competitive tool to win mandates. Second, underwritten loans usually require more lucrative fees because the agent is on the hook if potential lenders balk. Of course, with flex-language now common, underwriting a deal does not carry the same risk it once did when the pricing was set in stone prior to syndication.

### Best-efforts syndication

A “best-efforts” syndication is one for which the arranger group commits to underwrite less than the entire amount of the loan, leaving the credit to the vicissitudes of the market. If the loan is undersubscribed, the credit may not close—or may need major surgery to clear the market. Traditionally, best-efforts syndications were used for risky borrowers or for complex transactions.

### Club deal

A “club deal” is a smaller loan (usually \$25 million to \$100 million, but as high as \$150 million) that is pre-

marketed to a group of relationship lenders. The arranger is generally a first among equals, and each lender gets a full cut, or nearly a full cut, of the fees.

## The Syndication Process

### The information memo or “bank book”

Before awarding a mandate, an issuer might solicit bids from arrangers. The banks will outline their syndication strategy and qualifications, as well as their view on the way the loan will price in market. Once the mandate is awarded, the syndication process starts. The arranger will prepare an information memo (IM) describing the terms of the transactions. The IM typically will include an executive summary, investment considerations, a list of terms and conditions, an industry overview, and a financial model. Because loans are not securities, this will be a confidential offering made only to qualified banks and accredited investors.

If the issuer is speculative grade and seeking capital from nonbank investors, the arranger will often prepare a “public” version of the IM. This version will be stripped of all confidential material such as management financial projections so that it can be viewed by accounts that operate on the public side of the wall or that want to preserve their ability to buy bonds or stock or other public securities of the particular issuer (*see the Public Versus Private section below*). Naturally, investors that view materially nonpublic information of a company are disqualified from buying the company’s public securities for some period of time.

As the IM (or “bank book,” in traditional market lingo) is being prepared, the syndicate desk will solicit informal feedback from potential investors on their appetite for the deal and the price at which they are willing to invest. Once this intelligence has been gathered, the agent will formally market the deal to potential investors. Arrangers will distribute most IMs—along with other information related to the loan, pre- and post-closing—to investors through digital platforms. Leading vendors in this space are Intralinks, Synttrak, and Debt Domain. The IM typically contains the following sections:

The *executive summary* will include a description of the issuer, an overview of the transaction and rationale, sources and uses, and key statistics on the financials.

**Investment considerations** will be, basically, management's sales "pitch" for the deal.

The **list of terms and conditions** will be a preliminary term sheet describing the pricing, structure, collateral, covenants, and other terms of the credit (covenants are usually negotiated in detail after the arranger receives investor feedback).

The **industry overview** will be a description of the company's industry and competitive position relative to its industry peers.

The **financial model** will be a detailed model of the issuer's historical, pro forma, and projected financials including management's high, low, and base case for the issuer.

Most new acquisition-related loans kick off at a bank meeting at which potential lenders hear management and the sponsor group (if there is one) describe what the terms of the loan are and what transaction it backs. Understandably, bank meetings are more often than not conducted via a Webex or conference call, although some issuers still prefer old-fashioned, in-person gatherings.

Whatever the format, management uses the bank meeting to provide its vision for the transaction and, most importantly, to tell why and how the lenders will be repaid on or ahead of schedule. In addition, investors will be briefed regarding the multiple exit strategies, including second ways out via asset sales. (If it is a small deal or a refinancing instead of a formal meeting, there may be a series of calls or one-on-one meetings with potential investors.)

Once the loan is closed, the final terms are then documented in detailed credit and security agreements. Subsequently, liens are perfected and collateral is attached.

Loans, by their nature, are flexible documents that can be revised and amended from time to time. These amendments require different levels of approval (*see Voting Rights section below*). Amendments can range from something as simple as a covenant waiver to something as complex as a change in the collateral package or allowing the issuer to stretch out its payments or make an acquisition.

## The loan investor market

There are three primary-investor constituencies: banks, finance companies, and institutional investors.

**Banks**, in this case, can be either commercial banks, savings and loan institutions, or securities firms that usually provide investment-grade loans. These are typically large revolving credits that back commercial paper or are used for general corporate purposes or, in some cases, acquisitions. For leveraged loans, banks typically provide unfunded revolving credits, LOCs, and—although they are becoming less common—amortizing term loans, under a syndicated loan agreement.

**Finance companies** have consistently represented less than 10% of the leveraged loan market, and tend to play in smaller deals—\$25 million to \$200 million. These investors often seek asset-based loans that carry wide spreads and that often feature time-intensive collateral monitoring.

**Institutional investors** in the loan market are principally structured vehicles known as collateralized loan obligations (CLO) and loan participation mutual funds (known as "prime funds" because they were originally pitched to investors as a money-market-like fund that would approximate the prime rate). In addition, hedge funds, high-yield bond funds, pension funds, insurance companies, and other proprietary investors do participate opportunistically in loans focusing usually on wide-margin (or "high-octane") paper.

**CLOs** are special-purpose vehicles set up to hold and manage pools of leveraged loans. The special-purpose vehicle is financed with several tranches of debt (typically a 'AAA' rated tranche, a 'AA' tranche, a 'BBB' tranche, and a mezzanine tranche) that have rights to the collateral and payment stream in descending order. In addition, there is an equity tranche, but the equity tranche is usually not rated. CLOs are created as arbitrage vehicles that generate equity returns through leverage, by issuing debt 10 to 11 times their equity contribution. There are also market-value CLOs that are less leveraged—typically 3 to 5 times—and allow managers more flexibility than more tightly structured arbitrage deals. CLOs are usually rated by two of the three major ratings agencies and impose a series of covenant tests on

collateral managers, including minimum rating, industry diversification, and maximum default basket.

**Loan mutual funds** are how retail investors can access the loan market. They are mutual funds that invest in leveraged loans. These funds—originally known as prime funds because they offered investors the chance to earn the prime interest rate that banks charge on commercial loans—were first introduced in the late 1980s. Today there are three main categories of funds:

**Daily-access funds** are traditional open-end mutual fund products into which investors can buy or redeem shares each day at the fund's net asset value (NAV).

**Continuously offered, closed-end funds** were the first loan mutual fund products. Investors can buy into these funds each day at the fund's NAV. Redemptions, however, are made via monthly or quarterly tenders rather than each day like the open-end funds described above. To make sure they can meet redemptions, many of these funds, as well as daily access funds, set up lines of credit to cover withdrawals above and beyond cash reserves.

**Exchange-traded, closed-end funds** are funds that trade on a stock exchange. Typically, the funds are capitalized by an initial public offering. Thereafter, investors can buy and sell shares, but may not redeem them. The manager can also expand the fund via rights offerings. Usually, they are only able to do so when the fund is trading at a premium to NAV, however—a provision that is typical of closed-end funds regardless of the asset class.

In March 2011, Invesco introduced the first index-based exchange traded fund, PowerShares Senior Loan Portfolio (BKLN), which is based on the S&P/LSTA Loan 100 Index.

## **Public Versus Private**

In the old days, a bright red line separated public and private information in the loan market. Loans were strictly on the private side of the wall and any information transmitted between the issuer and the lender group remained confidential.

In the late 1980s, that line began to blur as a result of two market innovations. The first was more active secondary trading that sprung up to support (1) the

entry of nonbank investors in the market, such as insurance companies and loan mutual funds, and (2) to help banks sell rapidly expanding portfolios of distressed and highly leveraged loans that they no longer wanted to hold. This meant that parties that were insiders on loans might now exchange confidential information with traders and potential investors who were not (or not yet) a party to the loan. The second innovation that weakened the public-private divide was trade journalism that focuses on the loan market.

Despite these two factors, the public versus private line was well understood and rarely controversial for at least a decade. This changed in the early 2000s as a result of:

- The proliferation of loan ratings, which, by their nature, provide public exposure for loan deals;
- The explosive growth of nonbank investors groups, which included a growing number of institutions that operated on the public side of the wall, including a growing number of mutual funds, hedge funds, and even CLO boutiques;
- The growth of the credit default swaps market, in which insiders like banks often sold or bought protection from institutions that were not privy to inside information; and
- A more aggressive effort by the press to report on the loan market.

Some background is in order. The vast majority of loans are unambiguously private financing arrangements between issuers and their lenders. Even for issuers with public equity or debt that file with the SEC, the credit agreement only becomes public when it is filed, often months after closing, as an exhibit to an annual report (10-K), a quarterly report (10-Q), a current report (8-K), or some other document (proxy statement, securities registration, etc.).

Beyond the credit agreement, there is a raft of ongoing correspondence between issuers and lenders that is made under confidentiality agreements, including quarterly or monthly financial disclosures, covenant compliance information, amendment and waiver requests, and financial projections, as well as plans for acquisitions or dispositions. Much of this information may be material to the financial health of the issuer and may be out of the public domain until the issuer

formally puts out a press release or files an 8-K or some other document with the SEC.

In recent years, this information has leaked into the public domain either via off-line conversations or the press. It has also come to light through mark-to-market pricing services, which from time to time report significant movement in a loan price without any corresponding news. This is usually an indication that the banks have received negative or positive information that is not yet public.

In recent years, there was growing concern among issuers, lenders, and regulators that this migration of once-private information into public hands might breach confidentiality agreements between lenders and issuers and, more importantly, could lead to illegal trading. How has the market contended with these issues?

**Traders.** To insulate themselves from violating regulations, some dealers and buy-side firms have set up their trading desks on the public side of the wall. Consequently, traders, salespeople, and analysts do not receive private information even if somewhere else in the institution the private data are available. This is the same technique that investment banks have used from time immemorial to separate their private investment banking activities from their public trading and sales activities.

**Underwriters.** As mentioned above, in most primary syndications, arrangers will prepare a public version of information memoranda that is scrubbed of private information like projections. These IMs will be distributed to accounts that are on the public side of the wall. As well, underwriters will ask public accounts to attend a public version of the bank meeting and distribute to these accounts only scrubbed financial information.

**Buy-side accounts.** On the buy-side there are firms that operate on either side of the public-private divide. Accounts that operate on the private side receive all confidential materials and agree to not trade in public securities of the issuers in question. These groups are often part of wider investment complexes that do have public funds and portfolios but, via Chinese walls, are sealed from these parts of the firms. There are also accounts that are public. These firms take only public IMs and public materials and, therefore, retain the option to trade in the public securities markets even when an issuer for which they own a loan is involved. This can be tricky to pull off in practice because in the

case of an amendment the lender could be called on to approve or decline in the absence of any real information. To contend with this issue, the account could either designate one person who is on the private side of the wall to sign off on amendments or empower its trustee or the loan arranger to do so. But it's a complex proposition.

**Vendors.** Vendors of loan data, news, and prices also face many challenges in managing the flow of public and private information. In general, the vendors operate under the freedom of the press provision of the U.S. Constitution's First Amendment and report on information in a way that anyone can simultaneously receive it—for a price of course. Therefore, the information is essentially made public in a way that doesn't deliberately disadvantage any party, whether it's a news story discussing the progress of an amendment or an acquisition, or a price change reported by a mark-to-market service. This, of course, doesn't deal with the underlying issue that someone who is a party to confidential information is making it available via the press or prices to a broader audience.

Another way in which participants deal with the public versus private issue is to ask counterparties to sign "big-boy" letters. These letters typically ask public-side institutions to acknowledge that there may be information they are not privy to and they are agreeing to make the trade in any case. They are, effectively, big boys and will accept the risks.

## ***Credit Risk: An Overview***

Pricing a loan requires arrangers to evaluate the risk inherent in a loan and to gauge investor appetite for that risk. The principal credit risk factors that banks and institutional investors contend with in buying loans are default risk and loss-given-default risk. Among the primary ways that accounts judge these risks are ratings, collateral coverage, seniority, credit statistics, industry sector trends, management strength, and sponsor. All of these, together, tell a story about the deal. Brief descriptions of the major risk factors follow.

### **Default risk**

Default risk is simply the likelihood of a borrower's being unable to pay interest or principal on time. It is based on the issuer's financial condition, industry

segment, and conditions in that industry and economic variables and intangibles, such as company management. Default risk will, in most cases, be most visibly expressed by a public rating from Standard & Poor's Ratings Services or another ratings agency. These ratings range from 'AAA' for the most creditworthy loans to 'CCC' for the least. The market is divided, roughly, into two segments: investment grade (loans to issuers rated 'BBB-' or higher) and leveraged (borrowers rated 'BB+' or lower). Default risk, of course, varies widely within each of these broad segments. Since the mid-1990s, public loan ratings have become a de facto requirement for issuers that wish to do business with a wide group of institutional investors. Unlike banks, which typically have large credit departments and adhere to internal rating scales, fund managers rely on agency ratings to bracket risk and explain the overall risk of their portfolios to their own investors. As of mid-2011, then, roughly 80% of leveraged-loan volume carried a loan rating, up from 45% in 1998 and virtually none before 1995.

## Seniority

Where an instrument ranks in priority of payment is referred to as seniority. Based on this ranking, an issuer will direct payments with the senior-most creditors paid first and the most junior equityholders last. In a typical structure, senior secured and unsecured creditors will be first in right of payment—although in bankruptcy, secured instruments typically move to the front of the line—followed by subordinate bondholders, junior bondholders, preferred shareholders, and common shareholders. Leveraged loans are typically senior secured instruments and rank highest in the capital structure.

## Loss-given-default risk

Loss-given-default risk measures the severity of loss the lender is likely to incur in the event of default. Investors assess this risk based on the collateral (if any) backing the loan and the amount of other debt and equity subordinated to the loan. Lenders will also look to covenants to provide a way of coming back to the table early—that is, before other creditors—and renegotiating the terms of a loan if the issuer fails to meet financial targets. Investment-grade loans are, in most cases, senior unsecured instruments with loosely drawn covenants that apply only at incurrence, that is, only if an issuer makes an acquisition or issues debt. As a result, loss given default may be no different from risk incurred by other senior unsecured creditors. Leveraged loans, by contrast, are usually senior secured instruments that, except for covenant-lite loans

(see below), have maintenance covenants that are measured at the end of each quarter whether or not the issuer is in compliance with pre-set financial tests. Loan holders, therefore, almost always are first in line among pre-petition creditors and, in many cases, are able to renegotiate with the issuer before the loan becomes severely impaired. It is no surprise, then, that loan investors historically fare much better than other creditors on a loss-given-default basis.

## Credit statistics

Credit statistics are used by investors to help calibrate both default and loss-given-default risk. These statistics include a broad array of financial data, including credit ratios measuring leverage (debt to capitalization and debt to EBITDA) and coverage (EBITDA to interest, EBITDA to debt service, operating cash flow to fixed charges). Of course, the ratios investors use to judge credit risk vary by industry. In addition to looking at trailing and pro forma ratios, investors look at management's projections and the assumptions behind these projections to see if the issuer's game plan will allow it to service its debt. There are ratios that are most geared to assessing default risk. These include leverage and coverage. Then there are ratios that are suited for evaluating loss-given-default risk. These include collateral coverage, or the value of the collateral underlying the loan relative to the size of the loan. They also include the ratio of the senior secured loan to junior debt in the capital structure. Logically, the likely severity of loss-given-default for a loan increases with the size of the loan as it does when the loan constitutes a greater percentage of the overall debt structure. After all, if an issuer defaults on \$100 million of debt, of which \$10 million is in the form of senior secured loans, the loans are more likely to be fully covered in bankruptcy than if the loan totals \$90 million.

## Industry sector

Industry is a factor, because sectors, naturally, go in and out of favor. For that reason, having a loan in a desirable sector, like telecom in the late 1990s or healthcare in the early 2000s, can really help a syndication along. Also, loans to issuers in defensive sectors (like consumer products) can be more appealing in a time of economic uncertainty, whereas cyclical borrowers (like chemicals or autos) can be more appealing during an economic upswing.

## Sponsorship

Sponsorship is a factor, too. Needless to say, many leveraged companies are owned by one or more pri-

vate equity firms. These entities, such as Kohlberg Kravis & Roberts or Carlyle Group, invest in companies that have leveraged capital structures. To the extent that the sponsor group has a strong following among loan investors, a loan will be easier to syndicate and, therefore, can be priced lower. In contrast, if the sponsor group does not have a loyal set of relationship lenders, the deal may need to be priced higher to clear the market. Among banks, investment factors may include whether or not the bank is party to the sponsor's equity fund. Among institutional investors, weight is given to an individual deal sponsor's track record in fixing its own impaired deals by stepping up with additional equity or replacing a management team that is failing.

### *Syndicating a Loan by Facility*

Most loans are structured and syndicated to accommodate the two primary syndicated lender constituencies: banks (domestic and foreign) and institutional investors (primarily structured finance vehicles, mutual funds, and insurance companies). As such, leveraged loans consist of:

***Pro rata debt*** includes revolving credit and amortizing term loans (TLAs) which are packaged together and, usually, syndicated to banks. In some loans, however, institutional investors take pieces of the TLa and, less often, the revolving credit, as a way to secure a larger institutional term loan allocation. Why are these tranches called "pro rata?" Because arrangers historically syndicated revolving credit and TLAs on a pro rata basis to banks and finance companies.

***Institutional debt*** includes term loans structured specifically for institutional investors, although there are also some banks that buy institutional term loans. These tranches include first- and second-lien loans, as well as prefunded letters of credit. Traditionally, institutional tranches were referred to as TLbs because they were bullet payments and lined up behind TLAs.

Finance companies also play in the leveraged loan market, and buy both pro rata and institutional tranches. With institutional investors playing an ever-larger role, however, by the late 2000s, many executions were structured as simply revolving credit/institutional term loans, with the TLa falling by the wayside.

### *Pricing a Loan in the Primary Market*

Pricing loans for the institutional market is a straightforward exercise based on simple risk/return consideration and market technicals. Pricing a loan for the bank market, however, is more complex. Indeed, banks often invest in loans for more than just spread income. Rather, banks are driven by the overall profitability of the issuer relationship, including noncredit revenue sources.

#### **Pricing loans for bank investors**

Since the early 1990s, almost all large commercial banks have adopted portfolio-management techniques that measure the returns of loans and other credit products relative to risk. By doing so, banks have learned that loans are rarely compelling investments on a stand-alone basis. Therefore, banks are reluctant to allocate capital to issuers unless the total relationship generates attractive returns—whether those returns are measured by risk-adjusted return on capital, by return on economic capital, or by some other metric.

If a bank is going to put a loan on its balance sheet, then it takes a hard look not only at the loan's yield, but also at other sources of revenue from the relationship, including noncredit businesses—like cash-management services and pension-fund management—and economics from other capital markets activities, like bonds, equities, or M&A advisory work.

This process has had a breathtaking result on the leveraged loan market—to the point that it is an anachronism to continue to call it a "bank" loan market. Of course, there are certain issuers that can generate a bit more bank appetite; as of mid-2011, these include issuers with a European or even a Midwestern U.S. angle. Naturally, issuers with European operations are able to better tap banks in their home markets (banks still provide the lion's share of loans in Europe), and, for Midwestern issuers, the heartland remains one of the few U.S. regions with a deep bench of local banks.

What this means is that the spread offered to pro rata investors is important, but so, too, in most cases, is the amount of other, fee-driven business a bank can capture by taking a piece of a loan. For this reason, issuers



are careful to award pieces of bond- and equity-underwriting engagements and other fee-generating business to banks that are part of its loan syndicate.

## Pricing loans for institutional players

For institutional investors, the investment decision process is far more straightforward, because, as mentioned above, they are focused not on a basket of returns, but only on loan-specific revenue.

In pricing loans to institutional investors, it's a matter of the spread of the loan relative to credit quality and market-based factors. This second category can be divided into liquidity and market technicals (i.e., supply/demand).

**Liquidity** is the tricky part, but, as in all markets, all else being equal, more liquid instruments command thinner spreads than less liquid ones. In the old days—before institutional investors were the dominant investors and banks were less focused on portfolio management—the size of a loan didn't much matter. Loans sat on the books of banks and stayed there. But now that institutional investors and banks put a premium on the ability to package loans and sell them, liquidity has become important. As a result, smaller executions—generally those of \$200 million or less—tend to be priced at a premium to the larger loans. Of course, once a loan gets large enough to demand extremely broad distribution, the issuer usually must pay a size premium. The thresholds range widely. During the go-go mid-2000s, it was upwards of \$10 billion. During more parsimonious late-2000s \$1 billion was considered a stretch.

**Market technicals, or supply relative to demand**, is a matter of simple economics. If there are a lot of dollars chasing little product, then, naturally, issuers will be able to command lower spreads. If, however, the opposite is true, then spreads will need to increase for loans to clear the market.

## Mark-To-Market's Effect

Beginning in 2000, the SEC directed bank loan mutual fund managers to use available price data (bid/ask levels reported by dealer desks and compiled by mark-to-market services) rather than fair value (estimates based on whether the loan is likely to repay lenders in whole or part), to determine the value of broadly syndicated loan portfolios. In broad terms, this policy has made the market more transparent, improved price discovery and, in doing so, made the

market far more efficient and dynamic than it was in the past.

## Types of Syndicated Loan Facilities

There are four main types of syndicated loan facilities:

- A revolving credit line (within which are options for swingline loans, multicurrency-borrowing, competitive-bid options, term-out, and evergreen extensions)
- A term loan
- A letter of credit (LOC)
- An acquisition or equipment line (a delayed-draw term loan)

A **revolving credit line** allows borrowers to draw down, repay, and reborrow. The facility acts much like a corporate credit card, except that borrowers are charged an annual commitment fee on unused amounts (the facility fee). Revolvers to speculative-grade issuers are sometimes tied to borrowing-base lending formulas. This limits borrowings to a certain percentage of specified collateral, most often receivables and inventory (see "Asset-based lending" section below for a full discussion of this topic). Revolving credits often run for 364 days. These revolving credits—called, not surprisingly, 364-day facilities—are generally limited to the investment-grade market. The reason for what seems like an odd term is that regulatory capital guidelines mandate that, after one year of extending credit under a revolving facility, banks must then increase their capital reserves to take into account the unused amounts. Therefore, banks can offer issuers 364-day facilities at a lower unused fee than a multi-year revolving credit. There are a number of options that can be offered within a revolving credit line:

A **swingline** is a small, overnight borrowing line, typically provided by the agent.

A **multicurrency line** allows the borrower to borrow in one or more alternative currencies (in most agreements this option is capped).

A **competitive-bid option** (CBO) allows borrowers to solicit the best bids from its syndicate group. The agent will conduct what amounts to an auction to raise

funds for the borrower, and the best bids are accepted. CBOs typically are available only to large, investment-grade borrowers.

A **term-out** will allow the borrower to convert borrowings into a term loan at a given conversion date. This, again, is usually a feature of investment-grade loans. Under the option, borrowers may take what is outstanding under the facility and pay it off according to a predetermined repayment schedule. Often the spreads ratchet up if the term-out option is exercised.

An **evergreen** is an option for the borrower—with consent of the syndicate group—to extend the facility each year for an additional year. For instance, at the end of each year, a three-year facility would be reset to three years if the lenders and borrower agree. If the evergreen is not exercised, the agreement would simply run to term.

A **term loan** is simply an installment loan, such as a loan one would use to buy a car. The borrower may draw on the loan during a short commitment period (during which lenders usually share a ticking fee, akin to a commitment fee on a revolver) and repays it based on either a scheduled series of repayments or a one-time lump-sum payment at maturity (bullet payment). There are two principal types of term loans:

An **amortizing term loan** (A-term loan or TLa) is a term loan with a progressive repayment schedule that typically runs six years or less. These loans are normally syndicated to banks along with revolving credits as part of a larger syndication.

An **institutional term loan** (B-term, C-term, or D-term loan) is a term loan facility carved out for nonbank accounts. These loans came into broad usage during the mid-1990s as the institutional loan investor base grew. This institutional category also includes second-lien loans and covenant-lite loans, which are described below.

**LOCs** are guarantees provided by the bank group to pay off debt or obligations if the borrower cannot.

**Acquisition/equipment lines (delayed-draw term loans)** are credits that may be drawn down for a given period to purchase specified assets or equipment or to make acquisitions. The issuer pays a fee during the commitment period (a ticking fee). The lines are then repaid over a specified period (the term-out period). Repaid amounts may not be reborrowed.

**Bridge loans** are loans that are intended to provide short-term financing to provide a “bridge” to an asset sale, bond offering, stock offering, divestiture, etc. Generally, bridge loans are provided by arrangers as part of an overall financing package. Typically, the issuer will agree to increasing interest rates if the loan is not repaid as expected. For example, a loan could start at a spread of L+250 and ratchet up 50 basis points (bps) every six months the loan remains outstanding past one year.

An **equity bridge loan** is a bridge loan provided by arrangers that is expected to be repaid by a secondary equity commitment to a leveraged buyout. This product is used when a private equity firm wants to close on a deal that requires, say, \$1 billion of equity of which it ultimately wants to hold half. The arrangers bridge the additional \$500 million, which would be then repaid when other sponsors come into the deal to take the \$500 million of additional equity. Needless to say, this is a hot-market product.

## Second-Lien Loans

Although they are really just another type of syndicated loan facility, second-lien loans are sufficiently complex to warrant a separate section in this primer. After a brief flirtation with second-lien loans in the mid-1990s, these facilities fell out of favor after the 1998 Russian debt crisis caused investors to adopt a more cautious tone. But after default rates fell precipitously in 2003, arrangers rolled out second-lien facilities to help finance issuers struggling with liquidity problems. By 2007, the market had accepted second-lien loans to finance a wide array of transactions, including acquisitions and recapitalizations. Arrangers tap nontraditional accounts—hedge funds, distress investors, and high-yield accounts—as well as traditional CLO and prime fund accounts to finance second-lien loans.

As their name implies, the claims on collateral of second-lien loans are junior to those of first-lien loans. Second-lien loans also typically have less restrictive covenant packages, in which maintenance covenant levels are set wide of the first-lien loans. For these reasons, second-lien loans are priced at a premium to first-lien loans. This premium typically starts at 200 bps when the collateral coverage goes far beyond the claims of both the first- and second-lien loans, to more than 1,000 bps for less generous collateral.

There are, lawyers explain, two main ways in which the collateral of second-lien loans can be document-



ed. Either the second-lien loan can be part of a single security agreement with first-lien loans, or they can be part of an altogether separate agreement. In the case of a single agreement, the agreement would apportion the collateral, with value going first, obviously, to the first-lien claims and next to the second-lien claims. Alternatively, there can be two entirely separate agreements. Here's a brief summary.

In a single security agreement, the second-lien lenders are in the same creditor class as the first-lien lenders from the standpoint of a bankruptcy, according to lawyers who specialize in these loans. As a result, for adequate protection to be paid the collateral must cover both the claims of the first- and second-lien lenders. If it does not, the judge may choose to not pay adequate protection or to divide it pro rata among the first- and second-lien creditors.

In addition, the second-lien lenders may have a vote as secured lenders equal to those of the first-lien lenders. One downside for second-lien lenders is that these facilities are often smaller than the first-lien loans and, therefore, when a vote comes up, first-lien lenders can outvote second-lien lenders to promote their own interests.

In the case of two discrete security agreements, divided by a standstill agreement, the first- and second-lien lenders are likely to be divided into two creditor classes. As a result, second-lien lenders do not have a voice in the first-lien creditor committees.

As well, first-lien lenders can receive adequate protection payments even if collateral covers their claims, but does not cover the claims of the second-lien lenders. This may not be the case if the loans are documented together and the first- and second-lien lenders are deemed a unified class by the bankruptcy court.

For more information, we suggest Latham & Watkins' terrific overview and analysis of second-lien loans, which was published on April 15, 2004 in the firm's *CreditAlert* publication.

## Covenant-Lite Loans

Like second-lien loans, covenant-lite loans are a particular kind of syndicated loan facility. At the most basic level, covenant-lite loans are loans that have bond-like financial incurrence covenants rather than traditional maintenance covenants that are normally part and parcel of a loan agreement. What's the difference?

Incurrence covenants generally require that if an issuer takes an action (paying a dividend, making an acquisition, issuing more debt), it would need to still be in compliance. So, for instance, an issuer that has an incurrence test that limits its debt to 5x cash flow would only be able to take on more debt if, on a pro forma basis, it was still within this constraint. If not, then it would have breached the covenant and be in technical default on the loan. If, on the other hand, an issuer found itself above this 5x threshold simply because its earnings had deteriorated, it would not violate the covenant.

Maintenance covenants are far more restrictive. This is because they require an issuer to meet certain financial tests every quarter whether or not it takes an action. So, in the case above, had the 5x leverage maximum been a maintenance rather than incurrence test, the issuer would need to pass it each quarter and would be in violation if either its earnings eroded or its debt level increased. For lenders, clearly, maintenance tests are preferable because it allows them to take action earlier if an issuer experiences financial distress. What's more, the lenders may be able to wrest some concessions from an issuer that is in violation of covenants (a fee, incremental spread, or additional collateral) in exchange for a waiver. Conversely, issuers prefer incurrence covenants precisely because they are less stringent.

## Free-and-Clear Incremental Tranches

These are carve-outs in covenant-lite loans that allow borrowers to issue debt without triggering incurrence financial tests. For instance, a leverage test may say that an issuer cannot take on new debt if, on a pro forma basis, total debt to EBITDA would be 4x or more – but the test only kicks in once the issuer incurs more than, say, \$100 million of new debt. That effectively gives the borrower the ability to issue up to \$100 million of new debt at a market clearing rate whether or not leverage exceeds 4x. Lenders, in most cases, have most-favored-nations (MFN) protection that resets the yield of the existing loan to the rate of the new loan to make sure it remains on market. In rare cases, however, this protection is limited to a certain period of time by what is known as an MFN sunset. In other cases, the rate adjustment is capped to say, 50 bps. Free-and-clear tranches are an innovation that grew out of the proliferation of covenant-lite loans since 2013. Lenders expect the use of these provisions to ebb and flow with the strength of market conditions.

## *Lender Titles*

In the formative days of the syndicated loan market (the late 1980s), there was usually one agent that syndicated each loan. “Lead manager” and “manager” titles were doled out in exchange for large commitments. As league tables gained influence as a marketing tool, “co-agent” titles were often used in attracting large commitments or in cases where these institutions truly had a role in underwriting and syndicating the loan.

During the 1990s, the use of league tables and, consequently, title inflation exploded. Indeed, the co-agent title has become largely ceremonial today, routinely awarded for what amounts to no more than large retail commitments. In most syndications, there is one lead arranger. This institution is considered to be on the “left” (a reference to its position in an old-time tombstone ad). There are also likely to be other banks in the arranger group, which may also have a hand in underwriting and syndicating a credit. These institutions are said to be on the “right.”

The different titles used by significant participants in the syndication process are administrative agent, syndication agent, documentation agent, agent, co-agent or managing agent, and lead arranger or book runner:

The **administrative agent** is the bank that handles all interest and principal payments and monitors the loan.

The **syndication agent** is the bank that handles, in purest form, the syndication of the loan. Often, however, the syndication agent has a less specific role.

The **documentation agent** is the bank that handles the documents and chooses the law firm.

The **agent** title is used to indicate the lead bank when there is no other conclusive title available, as is often the case for smaller loans.

The **co-agent** or **managing agent** is largely a meaningless title used mostly as an award for large commitments.

The **lead arranger** or **bookrunner** title is a league table designation used to indicate the “top dog” in a syndication.

## *Secondary Sales*

Secondary sales occur after the loan is closed and allocated, when investors are free to trade the paper. Loan sales are structured as either assignments or participations, with investors usually trading through dealer desks at the large underwriting banks. Dealer-to-dealer trading is almost always conducted through a “street” broker.

### **Assignments**

In an assignment, the assignee becomes a direct signatory to the loan and receives interest and principal payments directly from the administrative agent.

Assignments typically require the consent of the borrower and agent, although consent may be withheld only if a reasonable objection is made. In many loan agreements, the issuer loses its right to consent in the event of default.

The loan document usually sets a minimum assignment amount, usually \$5 million, for pro rata commitments. In the late 1990s, however, administrative agents started to break out specific assignment minimums for institutional tranches. In most cases, institutional assignment minimums were reduced to \$1 million in an effort to boost liquidity. There were also some cases where assignment fees were reduced or even eliminated for institutional assignments, but these lower assignment fees remained rare into 2012, and the vast majority was set at the traditional \$3,500.

One market convention that became firmly established in the late 1990s was assignment-fee waivers by arrangers for trades crossed through its secondary trading desk. This was a way to encourage investors to trade with the arranger rather than with another dealer. This provided a significant incentive to trade with the arranger—or a deterrent to not trade away, depending on your perspective—because a \$3,500 fee amounts to between 7 bps to 35 bps of a \$1 million to \$5 million trade.

### **Primary assignments**

This term is something of an oxymoron. It applies to primary commitments made by offshore accounts (principally CLOs and hedge funds). These vehicles, for a variety of tax reasons, suffer tax consequences from buying loans in the primary. The agent will therefore hold the loan on its books for some short

period after the loan closes and then sell it to these investors via an assignment. These are called primary assignments and are effectively primary purchases.

## *Participations*

As the name implies, in a participation agreement the buyer takes a participating interest in the selling lender's commitment.

The lender remains the official holder of the loan, with the participant owning the rights to the amount purchased. Consents, fees, or minimums are almost never required. The participant has the right to vote only on material changes in the loan document (rate, term, and collateral). Nonmaterial changes do not require approval of participants. A participation can be a riskier way of purchasing a loan, because, if the lender of record becomes insolvent or defaults, the participant does not have a direct claim on the loan. In this case, the participant then becomes a creditor of the lender and often must wait for claims to be sorted out to collect on its participation.

## *Loan Derivatives*

### **Loan credit default swaps**

Loan credit default swaps (LCDS) are standard derivatives that have secured loans as reference instruments. In June 2006, the International Settlement and Dealers Association issued a standard trade confirmation for LCDS contracts.

Like all credit default swaps (CDS), an LCDS is basically an insurance contract. The seller is paid a spread in exchange for agreeing to buy at par, or a pre-negotiated price, a loan if that loan defaults. LCDS enables participants to synthetically buy a loan by going short the LCDS or sell the loan by going long the LCDS. Theoretically, then, a loanholder can hedge a position either directly (by buying LCDS protection on that specific name) or indirectly (by buying protection on a comparable name or basket of names).

Moreover, unlike the cash markets, which are long-only markets for obvious reasons, the LCDS market provides a way for investors to short a loan. To do so, the investor would buy protection on a loan that it doesn't hold. If the loan subsequently defaults, the buyer of protection should be able to purchase the loan

in the secondary market at a discount and then deliver it at par to the counterparty from which it bought the LCDS contract. For instance, say an account buys five-year protection for a given loan, for which it pays 250 bps a year. Then in year 2 the loan goes into default and the market price falls to 80% of par. The buyer of the protection can then buy the loan at 80 and deliver to the counterparty at 100, a 20-point pickup. Or instead of physical delivery, some buyers of protection may prefer cash settlement in which the difference between the current market price and the delivery price is determined by polling dealers or using a third-party pricing service. Cash settlement could also be employed if there's not enough paper to physically settle all LCDS contracts on a particular loan.

### **LCDX**

Introduced in 2007, the LCDX is an index of 100 LCDS obligations that participants can trade. The index provides a straightforward way for participants to take long or short positions on a broad basket of loans, as well as hedge their exposure to the market.

Markit Group administers the LCDX, a product of CDS Index Co., a firm set up by a group of dealers. Like LCDS, the LCDX Index is an over-the-counter product.

The LCDX is reset every six months with participants able to trade each vintage of the index that is still active. The index will be set at an initial spread based on the reference instruments and trade on a price basis. According to the primer posted by Markit (<http://www.markit.com/information/affiliations/lcdx/alertParagraphs/01/document/LCDX%20Primer.pdf>) "the two events that would trigger a payout from the buyer (protection seller) of the index are bankruptcy or failure to pay a scheduled payment on any debt (after a grace period), for any of the constituents of the index."

All documentation for the index is posted at: <http://www.markit.com/information/affiliations/lcdx/alertParagraphs/01/document/LCDX%20Primer.pdf>.

### **Single-name total rate of return swaps (TRS)**

This is the oldest way for participants to purchase loans synthetically. In essence, a TRS allows an institution to buy a loan on margin. In simple terms, under a TRS program a participant buys from a counterparty, usually a dealer, the income stream created by a reference asset (in this case a syndicated

loan). The participant puts down some percentage as collateral, say 10%, and borrows the rest from the dealer. Then the participant receives the spread of the loan less the financial cost. If the reference loan defaults, the participant is obligated to buy the facility at par, or cash settle the position, based on a mark-to-market price or an auction price.

Here's how the economics of a TRS work, in simple terms. A participant buys via TRS a \$10 million position in a loan paying L+250. To affect the purchase, the participant puts \$1 million in a collateral account and pays L+50 on the balance (meaning leverage of 9:1). Thus, the participant would receive L+250 on the amount in the collateral account of \$1 million, plus 200 bps (L+250 minus the borrowing cost of L+50) on the remaining amount of \$9 million.

The resulting income is  $L+250 \times \$1 \text{ million} + 200 \text{ bps} \times \$9 \text{ million}$ . Based on the participants' collateral amount—or equity contribution—of \$1 million, the return is L+200. If LIBOR is 5%, the return is 25.5%. Of course, this is not a risk-free proposition. If the issuer defaults and the value of the loan goes to 70 cents on the dollar, the participant will lose \$3 million. And if the loan does not default but is marked down for whatever reason—market spreads widen, it is downgraded, its financial condition deteriorates—the participant stands to lose the difference between par and the current market price when the TRS expires. Or, in an extreme case, the value declines below the value in the collateral account and the participant is hit with a margin call.

### TRS Programs

In addition to the type of single-name TRS described above, another way to invest in loans is via a TRS program, in which a dealer provides financing for a portfolio of loans, rather than a single reference asset. The products are similar in that an investor would establish a collateral account equal to some percent of the overall TRS program and borrow the balance from a dealer. The program typically requires managers to adhere to diversification guidelines as well as weighted average maturity maximums as well as weighted average rating minimums.

Like with a single-name TRS, an investor makes money by the carry between the cost of the line and the spread of the assets. As well, any price appreciation bolsters the returns. Of course, if loans lose value, the investor's losses would be magnified by the leverage of the vehicle. Also, if collateral value declines below

a predetermined level, the investor could face a margin call, or in the worst-case scenario, the TRS could be unwound.

TRS programs were widely used prior to the 2008 credit contraction. Since then, they have figured far less prominently into the loan landscape as investors across the capital markets shy away from leveraged, mark-to-market product.

## Pricing Terms

### Base rates

Most loans are floating-rate instruments that are periodically reset to a spread over a base rate, typically LIBOR. In most cases, borrowers can lock in a given rate for one month to one year. Syndication pricing options include prime, as well as LIBOR, CDs, and other fixed-rate options:

The **prime rate** is a floating-rate option. Borrowed funds are priced at a spread over the reference bank's prime lending rate. The rate is reset daily, and borrowings may be repaid at any time without penalty. This is typically an overnight option, because the prime option is more costly to the borrower than LIBOR or CDs.

The **LIBOR (or Eurodollar)** option is so called because, with this option, the interest on borrowings is fixed for a period of one month to one year. The corresponding LIBOR rate is used to set pricing. Borrowings cannot be prepaid without penalty.

The **CD** option works precisely like the LIBOR option, except that the base rate is certificates of deposit, sold by a bank to institutional investors.

Other **fixed-rate options** are less common but work like the LIBOR and CD options. These include federal funds (the overnight rate charged by the Federal Reserve to member banks) and cost of funds (the bank's own funding rate).

### Spread (margin)

The borrower pays a specified spread over the base rate to borrow under loan agreements. The spread is typically expressed in basis points. Further, spreads on many loans are tied to performance grids. In this case, the spread adjusts based on one or more financial criteria. Ratings are typical in investment-grade loans.

## Financial ratios for leveraged loans

Media and communications loans are invariably tied to the borrower's debt-to-cash-flow ratio.

## LIBOR floors

As the name implies, LIBOR floors put a floor under the base rate for loans. If a loan has a 3% LIBOR floor and LIBOR falls below this level, the base rate for any resets default to 3%.

## Fees

The fees associated with syndicated loans are the upfront fee, the commitment fee, the facility fee, the administrative agent fee, the LOC fee, and the cancellation or prepayment fee.

An **upfront fee** is a fee paid by the issuer at close. It is often tiered, with the lead arranger receiving a larger amount in consideration for structuring and/or underwriting the loan. Co-underwriters will receive a lower fee, and then the general syndicate will likely have fees tied to its commitment. Most often, fees are paid on a lender's final allocation. For example, a loan has two fee tiers: 100 bps (or 1%) for \$25 million commitments and 50 bps for \$15 million commitments. A lender committing to the \$25 million tier will be paid on its final allocation rather than on initial commitment, which means that, in this example, the loan is oversubscribed and lenders committing \$25 million would be allocated \$20 million and the lenders would receive a fee of \$200,000 (or 1% of \$20 million). Sometimes upfront fees will be structured as a percentage of final allocation plus a flat fee. This happens most often for larger fee tiers, to encourage potential lenders to step up for larger commitments. The flat fee is paid regardless of the lender's final allocation. Fees are usually paid to banks, mutual funds, and other non-offshore investors at close. CLOs and other offshore vehicles are typically brought in after the loan closes as a "primary" assignment, and they simply buy the loan at a discount equal to the fee offered in the primary assignment, for tax purposes.

A **commitment fee** is a fee paid to lenders on undrawn amounts under a revolving credit or a term loan prior to draw-down. On term loans, this fee is usually referred to as a "ticking" fee.

A **facility fee**, which is paid on a facility's entire committed amount, regardless of usage, is often charged instead of a commitment fee on revolving

credits to investment-grade borrowers, because these facilities typically have CBOs that allow a borrower to solicit the best bid from its syndicate group for a given borrowing. The lenders that do not lend under the CBO are still paid for their commitment.

A **usage fee** is a fee paid when the utilization of a revolving credit is above, or more often below, a certain minimum.

A **prepayment fee** is a feature generally associated with institutional term loans. Typical prepayment fees will be set on a sliding scale; for instance, 2% in year one and 1% in year two. The fee may be applied to all repayments under a loan including from asset sales and excess cash flow (a "hard" fee) or specifically to discretionary payments made from a refinancing or out of cash on hand (a "soft" fee).

An **administrative agent fee** is the annual fee typically paid to administer the loan (including to distribute interest payments to the syndication group, to update lender lists, and to manage borrowings). For secured loans (particularly those backed by receivables and inventory), the agent often collects a collateral monitoring fee, to ensure that the promised collateral is in place.

An **LOC fee** can be any one of several types. The most common—a fee for standby or financial LOCs—guarantees that lenders will support various corporate activities. Because these LOCs are considered "borrowed funds" under capital guidelines, the fee is typically the same as the LIBOR margin. Fees for commercial LOCs (those supporting inventory or trade) are usually lower, because in these cases actual collateral is submitted).

The LOC is usually issued by a fronting bank (usually the agent) and syndicated to the lender group on a pro rata basis. The group receives the LOC fee on its respective shares, while the fronting bank receives an issuing (or fronting, or facing) fee for issuing and administering the LOC. This fee is almost always 12.5-25 bps (0.125% to 0.25%) of the LOC commitment.

## Original issue discounts (OID)

This is yet another term imported from the bond market. The OID, the discount from par at loan, is offered in the new issue market as a spread enhancement. If a loan is issued at 99 cents on the dollar to pay par, the OID is technically 100 bps, or 1 point. Col-

loquially, the OID is often expressed as the actual offer price or issue price.

### OID Versus Upfront Fees

At this point, the careful reader may be wondering just what the difference is between an OID and an upfront fee. After all, in both cases the lender effectively pays less than par for a loan.

From the perspective of the lender, actually, there is no practical difference. From an accounting perspective, an OID and a fee may be recognized, and potentially taxed, differently.

### Voting rights

Amendments or changes to a loan agreement must be approved by a certain percentage of lenders. Most loan agreements have three levels of approval: required-lender level, full vote, and supermajority.

The “**required-lenders**” level, usually just a simple majority, is used for approval of nonmaterial amendments and waivers or changes affecting one facility within a deal.

A **full vote** of all lenders, including participants, is required to approve material changes such as RATS (rate, amortization, term, and security; or collateral) rights, but, as described below, there are occasions when changes in amortization and collateral may be approved by a lower percentage of lenders (a supermajority).

A **supermajority** is typically 67-80% of lenders and is sometimes required for certain material changes such as changes in amortization in term loan repayments and release of collateral.

### Covenants

Loan agreements have a series of restrictions that dictate, to varying degrees, how borrowers can operate and carry themselves financially. For instance, one covenant may require the borrower to maintain its existing fiscal-year end. Another may prohibit it from taking on new debt.

Most agreements also have financial compliance covenants, for example, that a borrower must maintain a prescribed level of performance, which, if not maintained, gives banks the right to terminate the agreement or push the borrower into default. The size

of the covenant package increases in proportion to a borrower’s financial risk. Agreements to investment-grade companies are usually thin and simple. Agreements to leveraged borrowers are more restrictive.

The three primary types of loan covenants are affirmative, negative, and financial.

**Affirmative covenants** state what action the borrower must take to be in compliance with the loan. These covenants are usually boilerplate and require a borrower to, for example, pay the bank interest and fees, provide audited financial statements, maintain insurance, pay taxes, and so forth.

**Negative covenants** limit the borrower’s activities in some way. Negative covenants, which are highly structured and customized to a borrower’s specific condition, can limit the type and amount of acquisitions and investments, new debt issuance, liens, asset sales, and guarantees.

Many negative covenants are structured with baskets that allow issuers flexibility to take certain actions – for example, to pay dividends or make acquisitions – as long as the amounts involved remain within a set range. In many cases, the agreement will provide initial capacity, known as a Starter Basket, as well as additional capacity based on a percent of free cash flow or net income, known as a Building Basket.

**Financial covenants** enforce minimum financial performance measures against the borrower, such as that he must maintain a higher level of current assets than of current liabilities. Broadly speaking, there are two types of financial covenants: maintenance and incurrence. Under maintenance covenants, issuers must pass agreed-to tests of financial performance such as minimum levels of cash flow coverage and maximum levels of leverage. If an issuer fails to achieve these levels, lenders have the right to accelerate the loan.

In most cases, though, lenders will pass on this draconian option and instead grant a waiver in return for some combination of a fee and/or spread increase; a repayment or a structuring concession such as additional collateral or seniority. An incurrence covenant is tested only if an issuer takes an action, such as issuing debt or making an acquisition. If, on a pro forma basis, the issuer fails the test then it is not allowed to proceed without permission of the lenders.

Historically, maintenance tests were associated with leveraged loans and incurrence tests with investment-grade loans and bonds. More recently, the evolution of covenant-lite loans (*see above*) has blurred the line.

In a traditional loan agreement, as a borrower's risk increases, financial covenants become more tightly wound and extensive. In general, there are five types of financial covenants—coverage, leverage, current ratio, tangible net worth, and maximum capital expenditures:

A **coverage covenant** requires the borrower to maintain a minimum level of cash flow or earnings, relative to specified expenses, most often interest, debt service (interest and repayments), fixed charges (debt service, capital expenditures, and/or rent).

A **leverage covenant** sets a maximum level of debt, relative to either equity or cash flow, with total-debt-to-EBITDA level being the most common. In some cases, though, operating cash flow is used as the divisor. Moreover, some agreements test leverage on the basis of net debt (total less cash and equivalents) or senior debt.

A **current-ratio covenant** requires that the borrower maintain a minimum ratio of current assets (cash, marketable securities, accounts receivable, and inventories) to current liabilities (accounts payable, short-term debt of less than one year), but sometimes a “quick ratio,” in which inventories are excluded from the numerator, is substituted.

A **tangible-net-worth (TNW) covenant** requires that the borrower have a minimum level of TNW (net worth less intangible assets, such as goodwill, intellectual assets, excess value paid for acquired companies), often with a build-up provision, which increases the minimum by a percentage of net income or equity issuance.

A **maximum-capital-expenditures covenant** requires that the borrower limit capital expenditures (purchases of property, plant, and equipment) to a certain amount, which may be increased by some percentage of cash flow or equity issuance, but often allowing the borrower to carry forward unused amounts from one year to the next.

## Mandatory Prepayments

Leveraged loans usually require a borrower to prepay

with proceeds of excess cash flow, asset sales, debt issuance, or equity issuance.

**Excess cash flow** is typically defined as cash flow after all cash expenses, required dividends, debt repayments, capital expenditures, and changes in working capital. The typical percentage required is 50-75%.

**Asset sales** are defined as net proceeds of asset sales, normally excluding receivables or inventories. The typical percentage required is 100%.

**Debt issuance** is defined as net proceeds from debt issuance. The typical percentage required is 100%.

**Equity issuance** is defined as the net proceeds of equity issuance. The typical percentage required is 25-50%.

Often, repayments from excess cash flow and equity issuance are waived if the issuer meets a preset financial hurdle, most often structured as a debt/EBITDA test.

## Collateral and other protective loan provisions

In the leveraged market, collateral usually includes all the tangible and intangible assets of the borrower and, in some cases, specific assets that back a loan.

Virtually all leveraged loans and some of the shakier investment-grade credits are backed by pledges of collateral. In the asset-based market, for instance, that typically takes the form of inventories and receivables, with the maximum amount of the loan that the issuer may draw down capped by a formula based off of these assets. The common rule is that an issuer can borrow against 50% of inventory and 80% of receivables. There are loans backed by certain equipment, real estate, and other property as well.

In the leveraged market, some loans are backed by capital stock of operating units. In this structure, the assets of the issuer tend to be at the operating-company level and are unencumbered by liens, but the holding company pledges the stock of the operating companies to the lenders. This effectively gives lenders control of these subsidiaries and their assets if the company defaults. The risk to lenders in this situation, simply put, is that a bankruptcy court collapses the holding company with the operating companies and effectively



renders the stock worthless. In these cases, which happened on a few occasions to lenders to retail companies in the early 1990s, loan holders become unsecured lenders of the company and are put back on the same level with other senior unsecured creditors.

### **Subsidiary guarantees**

Although not collateral in the strict sense of the word, most leveraged loans are backed by subsidiary guarantees so that if an issuer goes into bankruptcy all of its units are on the hook to repay the loan. This is often the case, too, for unsecured investment-grade loans.

### **Negative pledge**

This is also not a literal form of collateral, but most issuers agree not to pledge any assets to new lenders to ensure that the interest of the loanholders are protected.

### **Springing liens/collateral release**

Some loans have provisions that borrowers on the cusp of investment-grade and speculative-grade must either attach collateral or release it if the issuer's rating changes.

A 'BBB' or 'BBB-' issuer may be able to convince lenders to provide unsecured financing, but lenders may demand springing liens in the event the issuer's credit quality deteriorates. Often, an issuer's rating being lowered to 'BB+' or exceeding its predetermined leverage level will trigger this provision. Likewise, lenders may demand collateral from a strong, speculative-grade issuer, but will offer to release under certain circumstances, such as if the issuer attains an investment-grade rating.

### **Change of control**

Invariably, one of the events of default in a credit agreement is a change of issuer control.

For both investment-grade and leveraged issuers, an event of default in a credit agreement will be triggered by a merger, an acquisition of the issuer, some substantial purchase of the issuer's equity by a third party, or a change in the majority of the board of directors. For sponsor-backed leveraged issuers, the sponsor's lowering its stake below a preset amount can also trip this clause.

### **Equity cures**

These provisions allow issuers to fix a covenant violation—exceeding the maximum leverage test for

instance—by making an equity contribution. These provisions are generally found in private-equity backed deals. The equity cure is a right, not an obligation. Therefore, a private equity firm will want these provisions, which, if they think it's worth it, allows them to cure a violation without going through an amendment process, through which lenders will often ask for wider spreads and/or fees in exchange for waiving the violation even with an infusion of new equity. Some agreements don't limit the number of equity cures while others cap the number to, say, one a year or two over the life of the loan. It's a negotiated point, however, so there is no rule of thumb.

### **Asset-based lending**

Most of the information above refers to “cash flow” loans, loans that may be secured by collateral, but are repaid by cash flow. Asset-based lending is a distinct segment of the loan market. These loans are secured by specific assets and usually governed by a borrowing formula (or a “borrowing base”). The most common type of asset-based loans are receivables and/or inventory lines. These are revolving credits that have a maximum borrowing limit, say \$100 million, but also have a cap based on the value of an issuer's pledged receivables and inventories. Usually, the receivables are pledged and the issuer may borrow against 80%, give or take. Inventories are also often pledged to secure borrowings. However, because they are obviously less liquid than receivables, lenders are less generous in their formula. Indeed, the borrowing base for inventories is typically in the 50-65% range. In addition, the borrowing base may be further divided into subcategories—for instance, 50% of work-in-process inventory and 65% of finished goods inventory.

In many receivables-based facilities, issuers are required to place receivables in a “lock box.” The bank lends against the receivable, takes possession of it, and then collects it to pay down the loan.

In addition, asset-based lending is often done based on specific equipment, real estate, car fleets, and an unlimited number of other assets.

### **Bifurcated collateral structures**

Most often this refers to cases where the issuer divides a collateral pledge between asset-based loans and funded term loans. The way this works, typically, is that asset-based loans are secured by current assets like accounts receivables and inventories, while term loans are secured by fixed assets like property, plant,



and equipment. Current assets are considered to be a superior form of collateral because they are more easily converted to cash.

## ***Loan Math—The Art of Spread Calculation***

Calculating loan yields or spreads is not straightforward. Unlike most bonds, which have long no-call periods and high-call premiums, most loans are prepayable at any time typically without prepayment fees. And, even in cases where prepayment fees apply, they are rarely more than 2% in year one and 1% in year two. Therefore, affixing a spread-to-maturity or a spread-to-worst on loans is little more than a theoretical calculation.

This is because an issuer's behavior is unpredictable. It may repay a loan early because a more compelling financial opportunity presents itself or because the issuer is acquired or because it is making an acquisition and needs a new financing. Traders and investors will often speak of loan spreads, therefore, as a spread to a theoretical call. Loans, on average, between 1997 and 2004 had a 15-month average life. So, if you buy a loan with a spread of 250 bps at a price of 101, you might assume your spread-to-expected-life as the 250 bps less the amortized 100 bps premium or  $LIBOR+170$ . Conversely, if you bought the same loan at 99, the spread-to-expected life would be  $LIBOR+330$ . Of course, if there's a LIBOR floor, the minimum would apply.

## ***Default and Restructuring***

There are two primary types of loan defaults: technical defaults and the much more serious payment defaults. Technical defaults occur when the issuer violates a provision of the loan agreement. For instance, if an issuer doesn't meet a financial covenant test or fails to provide lenders with financial information or some other violation that doesn't involve payments.

When this occurs, the lenders can accelerate the loan and force the issuer into bankruptcy. That's the most extreme measure. In most cases, the issuer and lenders can agree on an amendment that waives the violation in exchange for a fee, spread increase, and/or tighter terms.

A payment default is a more serious matter. As the name

implies, this type of default occurs when a company misses either an interest or principal payment. There is often a pre-set period of time, say 30 days, during which an issuer can cure a default (the "cure period"). After that, the lenders can choose to either provide a forbearance agreement that gives the issuer some breathing room or take appropriate action, up to and including accelerating, or calling, the loan.

If the lenders accelerate, the company will generally declare bankruptcy and restructure its debt through Chapter 11. If the company is not worth saving, however, because its primary business has cratered, then the issuer and lenders may agree to a Chapter 7 liquidation, in which the assets of the business are sold and the proceeds dispensed to the creditors.

## ***Amend-To-Extend***

This technique allows an issuer to push out part of its loan maturities through an amendment, rather than a full-out refinancing. Amend-to-extend transactions came into widespread use in 2009 as borrowers struggled to push out maturities in the face of difficult lending conditions that made refinancing prohibitively expensive.

Amend-to-extend transactions have two phases, as the name implies. The first is an amendment in which at least 50.1% of the bank group approves the issuer's ability to roll some or all existing loans into longer-dated paper. Typically, the amendment sets a range for the amount that can be tendered via the new facility, as well as the spread at which the longer-dated paper will pay interest.

The new debt is *pari passu* with the existing loan. But because it matures later and, thus, is structurally subordinated, it carries a higher rate, and, in some cases, more attractive terms. Because issuers with big debt loads are expected to tackle debt maturities over time, amid varying market conditions, in some cases, accounts insist on most-favored-nation protection. Under such protection, the spread of the loan would increase if the issuer in question prints a loan at a wider margin.

The second phase is the conversion, in which lenders can exchange existing loans for new loans. In the end, the issuer is left with two tranches: (1) the legacy paper at the initial spread and maturity, and (2) the new longer-dated facility at a wider spread.

The innovation here: amend-to-extend allows an issuer

to term-out loans without actually refinancing into a new credit (which obviously would require marking the entire loan to market, entailing higher spreads, a new OID, and stricter covenants).

## DIP Loans

Debtor-in-possession (DIP) loans are made to bankrupt entities. These loans constitute super-priority claims in the bankruptcy distribution scheme, and thus sit ahead of all prepetition claims. Many DIPs are further secured by priming liens on the debtor's collateral (*see below*).

Traditionally, prepetition lenders provided DIP loans as a way to keep a company viable during the bankruptcy process and therefore protect their claims. In the early 1990s, a broad market for third-party DIP loans emerged. These non-prepetition lenders were attracted to the market by the relative safety of most DIPs based on their super-priority status, and relatively wide margins. This was the case again in the early 2000s default cycle.

In the late 2000s default cycle, however, the landscape shifted because of more dire economic conditions. As a result, liquidity was in far shorter supply, constraining availability of traditional third-party DIPs. Likewise, with the severe economic conditions eating away at debtors' collateral, not to mention reducing enterprise values, prepetition lenders were more wary of relying solely on the super-priority status of DIPs, and were more likely to ask for priming liens to secure facilities.

The refusal of prepetition lenders to consent to such priming, combined with the expense and uncertainty involved in a priming fight in bankruptcy court, greatly reduced third-party participation in the DIP market. With liquidity in short supply, new innovations in DIP lending cropped up aimed at bringing nontraditional lenders into the market. These include:

**Junior DIPs.** These facilities are typically provided by bond holders or other unsecured debtors as part of a loan-to-own strategy. In these transactions, the providers receive much or all of the post-petition equity interest as an incentive to provide the DIP loans.

**Roll-up DIPs.** In some bankruptcies—LyondellBasell and Spectrum Brands are two 2009 examples—DIP providers were given the opportunity to roll up prepetition claims into junior DIPs that rank ahead of other prepetition secured lenders. This sweetener was particularly compelling for lenders that had bought

prepetition paper at distressed prices and were able to realize a gain by rolling it into the junior DIPs.

Junior and roll-up DIPs are suited to challenging markets during which liquidity is scarce. During more liquid times, issuers can usually secure less costly financing in the form of traditional DIPs from prepetition lenders and/or third-party lenders.

## Exit Loans

These are loans that finance an issuer's emergence from bankruptcy. Typically, the loans are pre-negotiated and are part of the company's reorganization plan.

## Sub-Par Loan Buybacks

This is another technique that grew out of the bear market that began in 2007. Performing paper fell to prices not seen before in the loan market—with many trading south of 70. This created an opportunity for issuers with the financial wherewithal and the covenant room to repurchase loans via a tender, or in the open market, at prices below par.

Sub-par buybacks have deep roots in the bond market. Loans didn't suffer the price declines before 2007 to make such tenders attractive, however. In fact, most loan documents do not provide for a buyback. Instead, issuers typically need obtain lender approval via a 50.1% amendment.

## Distressed Exchanges

This is a negotiated tender in which classholders will swap their existing paper for a new series of bonds that typically have a lower principal amount and, often, a lower yield. In exchange the bondholders might receive stepped-up treatment, going from subordinated to senior, say, or from unsecured to second-lien.

Standard & Poor's considers these programs a default and, in fact, the holders are agreeing to take a principal haircut in order to allow the company to remain solvent and improve their ultimate recovery prospects.

This technique is used frequently in the bond market but rarely for first-lien loans. One good example was from Harrah's Entertainment. In 2009, the gaming company issued \$3.6 billion of new 10% second-priority senior secured notes due 2018 for about \$5.4 billion of bonds due between 2010 and 2018.

## ***Dodd Frank & the Leveraged Loan Market***

In 2014, The Office of the Comptroller of the Currency along with the Federal Reserve and other regulatory agencies issued guidelines under which loans that fail to meet credit standards will be deemed “criticized” or “special mention” by bank regulators. Banks that either underwrite or hold such loans could face penalties as a result.

As of this writing, the primary criteria was whether an issuer is able, via normal cash flow generation, to repay either all of its senior debt or half of its total debt over seven years.

In addition to restrictions on arranging banks, CLO managers will, beginning in 2016, face risk-retention requirements under Section 941 of Dodd-Frank. Under these rules, investment managers are required to retain no less than five percent of the credit risk of assets they securitized, except for pools of qualified mortgages.

## ***Bits and Pieces***

What follows are definitions to common market jargon in the loan market:

***Staple financing.*** Staple financing is a financing agreement “stapled on” to an acquisition, typically by the M&A advisor. So, if a private equity firm is working with an investment bank to acquire a property, that bank, or a group of banks, may provide a staple financing to ensure that the firm has the wherewithal to complete the deal. Because the staple financing provides guidelines on both structure and leverage, it typically forms the basis for the eventual financing that is negotiated by the auction winner, and the staple provider will usually serve as one of the arrangers of the financing, along with the lenders that were backing the buyer.

***Break prices.*** Simply, the price at which loans or bonds are initially traded into the secondary market after they close and allocate. It is called the break price because that is where the facility breaks into the secondary market.

***Market-clearing level.*** As this phrase implies, the price or spread at which a deal clears the primary market.

***Running the books.*** Generally the loan arranger is said to be “running the books,” i.e., preparing documentation and syndicating and administering the loan.

***Disintermediation.*** Disintermediation refers to the process where banks are replaced (or disintermediated) by institutional investors. This is the process that the loan market has been undergoing for the past 20 years. Another example is the mortgage market where the primary capital providers have evolved from banks and savings and loan institutions to conduits structured by Fannie Mae, Freddie Mac, and the other mortgage securitization shops. Of course, the list of disintermediated markets is long and growing. In addition to leveraged loans and mortgages, this list also includes auto loans and credit card receivables.

***Loss-given-default.*** This is simply a measure of how much creditors lose when an issuer defaults. The loss will vary depending on creditor class and the enterprise value of the business when it defaults. All things being equal, secured creditors will lose less than unsecured creditors.

Likewise, senior creditors will lose less than subordinated creditors. Calculating loss given default is tricky business. Some practitioners express loss as a nominal percentage of principal or a percentage of principal plus accrued interest. Others use a present value calculation using an estimated discount rate, typically 15-25%, demanded by distressed investors.

***Recovery.*** Recovery is the opposite of loss-given-default—it is the amount a creditor recovers, rather than loses, in a given default.

***Printing (or “inking”) a deal.*** Refers to the price or spread at which the loan clears.

***Relative value.*** This can refer to the relative return or spread between (1) various instruments of the same issuer, comparing for instance the loan spread with that of a bond; (2) loans or bonds of issuers that are similarly rated and/or in the same sector, comparing for instance the loan spread of one ‘BB’ rated healthcare company with that of another; and (3) spreads between markets, comparing for instance the spread on offer in the loan market with that of high-yield or corporate bonds. Relative value is a way of uncovering undervalued, or overvalued, assets.

**Rich/cheap.** This is terminology imported from the bond market to the loan market. If you refer to a loan as rich, it means it is trading at a spread that is low compared with other similarly rated loans in the same sector. Conversely, referring to something as cheap means that it is trading at a spread that is high compared with its peer group. That is, you can buy it on the cheap.

**Distressed loans.** In the loan market, loans traded at less than 80 cents on the dollar are usually considered distressed. In the bond market, the common definition is a spread of 1,000 bps or more. For loans, however, calculating spreads is an elusive art (see above) and therefore a more pedestrian price measure is used.

**Default rate.** This is calculated by either number of loans or principal amount. The formula is similar. For default rate by number of loans: the number of loans that default over a given 12-month period divided by the number of loans outstanding at the beginning of that period. For default rate by principal amount: the amount of loans that default over a 12-month period divided by the total amount outstanding at the beginning of the period. Standard & Poor's defines a default for the purposes of calculating default rates as a loan that is either (1) rated 'D' by Standard & Poor's, (2) to an issuer that has filed for bankruptcy, or (3) in payment default on interest or principal.

**Leveraged loans.** Just what is a leveraged loan is a discussion of long standing. Some participants use a spread cut-off: i.e., any loan with a spread of LIBOR+125 or LIBOR+150 or higher qualifies.

Others use rating criteria: i.e., any loan rated 'BB+' or lower qualifies. But what of loans that are not rated? At Standard & Poor's LCD we have developed a more complex definition. We include a loan in the leveraged universe if it is rated 'BB+' or lower or it is not rated or rated 'BBB-' or higher but has (1) a spread of LIBOR +125 or higher and (2) is secured by a first or second lien. Under this definition, a loan rated 'BB+' that has a spread of LIBOR+75 would qualify, but a non-rated loan with the same spread would not. It is hardly a perfect definition, but one that Standard & Poor's thinks best captures the spirit of loan market participants when they talk about leveraged loans.

**Middle market.** The loan market can be roughly divided into two segments: large corporate and middle market. There are as many ways to define middle market as there are bankers. But, in the leveraged loan market, the standard has become an issuer with no

more than \$50 million of EBITDA. Based on this, Standard & Poor's uses the \$50 million threshold in its reports and statistics.

**Axe sheets.** These are lists from dealers with indicative secondary bids and offers for loans. Axes are simply price indications.

**Circled.** When a loan or bond is fully subscribed at a given price it is said to be circled. After that, the loan or bond moves to allocation and funding.

**Forward calendar.** A list of loans or bond that has been announced but not yet closed. These include both instruments that are yet to come to market and those that are actively being sold but have yet to be circled.

**BWIC.** An acronym for "bids wanted in competition." This is really just a fancy way of describing a secondary auction of loans or bonds. Typically, an account will offer up a portfolio of facilities via a dealer. The dealer will then put out a BWIC, asking potential buyers to submit for individual names or the entire portfolio. The dealer will then collate the bids and award each facility to the highest bidder.

**OWIC.** This stands for "offers wanted in competition" and is effectively a BWIC in reverse. Instead of seeking bids, a dealer is asked to buy a portfolio of paper and solicits potential sellers for the best offer.

**Cover bid.** The level that a dealer agrees to essentially underwrite a BWIC or an auction. The dealer, to win the business, may give an account a cover bid, effectively putting a floor on the auction price.

**Loan-to-own.** A strategy in which lenders—typically hedge funds or distressed investors—provide financing to distressed companies. As part of the deal, lenders receive either a potential ownership stake if the company defaults, or, in the case of a bankrupt company, an explicit equity stake as part of the deal.

**Most favored nation clauses.** Some loans will include a provision to protect lenders for some specified amount of time if the issuer subsequently places a new loan at a higher spread. Under these provisions, the spread of the existing paper ratchets up to the spread at which the new loan cleared (though in some cases the increase is capped).

**MFN sunset.** Some agreements end the MFN period after some specified period of say 12 or 18 months after which yield protection ends. □□□

# Index

---

## A

amend-to-extend · 21  
axe sheet · 24

---

## B

bank book · *See* information memo (IM)  
break prices · 23  
BWIC · 24

---

## C

calculating spreads · 20  
Carlyle Group · 10  
collateralized loan obligations (CLO) · *See* **institutional investors**  
**covenants** · 6, 9, 13, 18, 21  
    affirmative · 18  
    financial · 18  
    negative · 18  
cover bid · 24  
credit default swaps · 7, 15  
**credit risk factors** · 8  
    default · 8, 9  
    loss-given-default · 8, 9, 23  
credit statistics · 9

---

## D

Debt Domain · 5  
default  
    payment · 21  
    technical · 21  
default rate · 23  
default risk · *See* **credit risk factors**  
disintermediation · 23  
distressed · 4, 7, 22, 23, 24  
distressed exchanges · 22

---

## F

**fee** · 3, 10, 11, 12, 13, 14, 17, 18, 21  
    administrative agent · 17  
    arranger · 3  
    commitment · 12, 17  
    facility · 11, 17  
    LOC · 17  
    prepayment · 17  
    upfront · 17  
    usage · 17

---

## H

Harrah's Entertainment · 22

---

## I

**information memo (IM)** · 5  
    executive summary · 5  
    financial model · 5, 6  
    industry overview · 5, 6  
    list of terms and conditions · 5, 6  
**institutional investors** · 3, 6, 8, 9, 10, 11, 16, 23  
    collateralized loan obligations (CLO) · 6, 7, 12, 14, 17  
    prime funds · 6, 7  
Intralinks · 5

---

## K

Kohlberg Kravis & Roberts · 10

---

## L

LCDX · 15  
**lender titles** 14  
    administrative agent · 14, 17  
    agent · 5, 11, 14, 17  
    documentation agent · 14  
    lead arranger · 14, 17  
    managing agent · 14  
    syndication agent · 14

**loan** · 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19, 20, 21, 22, 23, 24  
amortizing · 10  
bridge · 12  
covenant-lite · 9, 12, 13, 18  
debtor-in-possession · 21  
junior · 22  
roll-up · 22  
institutional · 10  
investment-grade · 3, 6, 11, 12, 16, 17, 18, 19, 20  
letter-of-credit · 11  
merger and acquisition (M&A) · 3, 4  
LBO · 3, 4  
noncore · 4  
public-to-private (P2P) · 4  
sponsor-to-sponsor (S2S) · 4  
platform · 4  
strategic · 4  
recapitalization · 3  
revolving credit · 3, 10, 11, 17  
second-lien · 10, 12, 13  
syndicated · 6, 11, 16  
LyondellBasell · 22

---

## **M**

market-clearing level · 23  
market-flex language · 3  
middle market · 24  
most favored nation (MFN) · 24

---

## **O**

original issue discount (OID) · 17, 18, 21

OWIC · 24

---

## **P**

price talk · 3  
public-private divide · 7, 8

---

## **R**

**recapitalization** · 4  
dividend · 4  
equity infusion · 4  
IPO · 4  
stock repurchase · 4  
running the books · 23  
Russian debt crisis · 3, 12

---

## **S**

Spectrum Brands · 22  
spreads · 3, 6, 11, 12, 16, 20, 21, 23  
staple financing · 22  
**syndication** · 5, 8, 14  
“best-efforts” syndication · 5  
club deal · 5  
underwritten deal · 5  
Syntrak · 5

---

## **T**

TRS · 15, 16

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