UNC SCHOOL OF LAW

NORTH CAROLINA BANKING INSTITUTE

Volume 14 | Issue 1 Article 2

2010

Necessity is the Mother of Innovation during the Credit Crisis

David Line Batty

NECESSITY IS THE MOTHER OF INNOVATION DURING THE CREDIT CRISIS

DAVID LINE BATTY*

I. INTRODUCTION

The credit crisis, which began during summer 2007, took a seemingly impossible turn for the worse during September 2008. In rapid succession, Lehman Brothers collapsed into bankruptcy, AIG became a wholly-owned subsidiary of the Federal Reserve, and Wachovia was forced to merge with Wells Fargo to avoid a fate similar to Lehman Brothers. These events, together with a deepening global recession, paralyzed the syndicated loan market for new debt issuances and threw the secondary market for existing syndicated loans into free fall. This severe market dislocation tested several presumptions in syndicated loan credit agreements and forced both borrowers and lenders to structure novel solutions to problems that were virtually inconceivable when the applicable contract terms were drafted. For example, because various Lehman Brothers' entities and affiliates were lenders in numerous syndicated loan agreements at the time of the Lehman Brothers' bankruptcy, that bankruptcy triggered "defaulting lender" provisions[1] in a significant percentage of outstanding syndicated loan agreements. Prior to fall 2008 defaulting lender provisions were rarely applied. Similarly, the widespread lack of liquidity that characterized this period caused previously predictable pricing mechanisms to yield unpredictable results. Furthermore, the collapse of the secondary market for syndicated loans led numerous borrowers to attempt repurchasing their own

* Mr. Batty is a Partner at Winston & Strawn LLP in Charlotte, North Carolina.

1. In a syndicated credit agreement, a lender that fails to fulfill its contractual obligation to make loans is a "defaulting lender." Defaulting lender provisions are the express contractual remedies available to the other parties to a syndicated loan agreement for dealing with a defaulting lender. Defaulting lender provisions do not supersede other claims for damages that are available under general contract law for breach of contract.

debt at a discount from lenders needing liquidity. Finally, as many lenders were unable or unwilling to make new loans for most of 2009, borrowers facing impending maturities sought to extend existing deals with their current lenders. Although some lenders were willing to agree to such extensions, other lenders were not and maintained their loans' existing maturity date.

Part II of this Article is a general overview of basic syndicated lending concepts for those unfamiliar with the syndicated loan market.[2] Part III analyzes the shortcomings of previously common defaulting lender protections in an illiquid loan market.[3] Part IV discusses efforts to cope with an unprecedented inversion of the historic relationship between the London Interbank Offered Rate (LIBOR) and the prime rate allowing savvy borrowers to borrow at rates below some Lenders' cost of funds.[4] Part V addresses the evolution of the loan market's response to below par debt buy-back transactions.[5] Finally, Part VI of this article provides an overview of the use of "amend and extend" transactions to manage the illiquidity that characterized the syndicated loan market for most of 2009.[6]

II. OVERVIEW OF SYNDICATED LENDING CONCEPTS

Syndicated loans are large commercial loans provided to corporate borrowers by a group, or syndicate, of lenders. The syndicate of lenders, or bank group, is arranged by one of the lenders in the syndicate. The arranger of the syndicated loan typically holds a larger percentage of the overall loan than any of the other individual lenders and acts as the administrative agent for the bank group with respect to the syndicated loan. Despite the use of the term "agent," the administrative agent does not act as a fiduciary agent for the other lenders. Rather, the administrative agent's role is to facilitate the operation of the loan transaction by acting as the primary administrative point of contact

2. *See infra* Part II, pp. 2-4.
3. *See infra* Part III, pp. 4-12.
4. *See infra* Part IV, pp. 12-13.
5. *See infra* Part V, pp. 14-24.
6. *See infra* Part VI, pp. 24-27.

for both the borrower and the lenders with respect to the syndicated credit agreement. The borrower makes all payments to the administrative agent who then distributes to each lender its ratable share of such payment based on such lender's participation percentage in the syndicated loan. Similarly, the borrower delivers borrowing requests only to the administrative agent. The administrative agent is responsible for notifying each of the lenders of the borrowing request. In response, each lender then funds its share of the requested loan to the administrative agent. Once the lenders have funded their loans, the administrative agent makes the full amount of the requested loan available to the borrower. Syndicated loans are popular among both borrowers and lenders for a number of reasons. First, syndicated loans allow borrowers to obtain loans larger than those available from a single lender. Also, borrowers prefer the ease of dealing with a single administrative agent, rather than a number of individual lenders through separate loan agreements. Lenders benefit by spreading loan commitments and obligations among multiple syndicated loans to different borrowers. This allows lenders to manage default risks by diversifying their loan portfolios.[7]

In addition to standard loan arrangements such as revolving credit lines and term loans, syndicated loans frequently include other credit products, such as letters of credit and swing line loans. A letter of credit is document issued by a bank or other financial institution to a named beneficiary at the request of the borrower to guarantee a payment obligation of the borrower. Letters of credit are frequently used to facilitate foreign trade or to act as security for material future payment obligations such as a multi-year lease. The named beneficiary of the letter of credit is guaranteed payment by the issuing bank in the event that the borrower defaults on the underlying payment obligation secured by the letter of credit. Because the purpose of a letter of credit is to assure prompt payment to the beneficiary, it is not practical for a syndicate of lenders to jointly issue letters of credit. Instead, one

---

7. *See generally* STANDARD & POOR'S, A GUIDE TO THE LOAN MARKET (Sept. 2009), *available at* https://www.lcdcomps.com/d/pdf/LoanMarketguide.pdf (providing a detailed discussion of syndicated loans).

lender, typically the administrative agent, will provide a single letter of credit for the full amount requested by the borrower. Once the letter of credit is funded, the borrower is required to repay promptly the issuing lender for the full amount funded by the issuing lender on account of the letter of credit. If the borrower does not repay the issuing lender, each of the other lenders party to the syndicated credit agreement have an obligation to reimburse the issuing lender for that amount. That reimbursement amount takes the form of a mandatory syndicated loan under the syndicated loan agreement with the proceeds applied to repay the issuing lender for the amount funded under its letter of credit.

A swing line loan is a short-term loan made directly by one lender, typically the administrative agent, to the borrower on shorter notice than is required for a syndicated loan from all of the lenders. Swing line loans are also available in smaller amounts than syndicated loans. If the borrower does not repay the swing line loan within the required time frame, the swing line loan will automatically convert into a syndicated loan. As is the case with letters of credit, the other lenders will simply reimburse the swing line lender for their respective ratable shares of the outstanding swing line loan. Credit products such as letters of credit and swing line loans are referred to as "fronting facilities" because one lender advances, or "fronts," the full amount of the requested loan and is later reimbursed by the other lenders party to the syndicated credit agreement.

III. DEFAULTING LENDER ISSUES

The credit crisis had a material and adverse impact on the financial health of many financial institutions. As their financial strength eroded, weakened financial institutions sought to conserve capital and made increasingly fewer loans. This lack of liquidity caused the credit crisis and the recession the credit crisis had triggered to worsen and weak financial institutions came under even greater stress. This increased stress led to a higher risk of outright collapse and risk that a distressed lender would be unable to meet its obligation to fund loans under the syndicated

loan agreements to which it was a party. In response, the syndicated loan market began to focus more and more on the effectiveness of defaulting lender provisions in syndicated loan agreements. In particular, the typical remedy of the borrower choosing to replace a defaulting lender at par is ineffective because of the lack of liquidity which characterizes the current syndicate loan market.[8]

Most current syndicated credit agreements include provisions to address a lender's failure to fund its *pro rata* share of an advance, reimbursement or participation under a syndicated credit agreement. For example, the Model Credit Agreement Provisions (Model Provisions) for syndicated credit agreements published by the Loan Syndications and Trading Association (LSTA) expressly give a borrower the right to require any defaulting lender "to assign and delegate, without recourse, in accordance with and subject to the [applicable assignment terms and conditions], all of its interests, rights and obligations under this Agreement and the related Loan Documents . . . to an assignee" at par.[9] Notably, the Model Provisions do not formally define "defaulting lender." Furthermore, except as described above, the Model Provisions do not address defaulting lender issues. Unlike the Model Provisions, most syndicated credit agreements formally define "defaulting lender." Such definitions frequently include any lender deemed insolvent or who is in receivership. As evidenced by the Model Provisions, defaulting lender terms were typically drafted under the assumption that lenders would rarely qualify as a defaulting lender, and in such cases a defaulting lender could be readily replaced by an assignment at par.

The differences between the obligations of a defaulting lender with an outstanding revolving credit commitment or other unfunded commitment, such as a delayed draw term loan commitment, and a defaulting lender holding a fully funded term loan has revealed other weaknesses with typical defaulting lender provisions. As discussed in more detail below, a defaulting lender

8. This problem was particularly acute during much of 2008 and 2009 when the trading levels of most syndicated loans in the secondary market was well below par.

9. *See* MODEL CREDIT AGREEMENT PROVISIONS: YIELD PROTECTION § 3(b) (2005).

with an unfunded commitment presents credit risks to the borrower, the administrative agent, and the other lenders. A defaulting lender holding a fully funded term loan, however, presents no credit risk to the borrower. With respect to the administrative agent and lenders, the only credit risk presented by a defaulting lender that has fully funded its term loan obligations relate to the indemnification obligations of the lenders benefiting the Administrative Agent (which typically only arise if the borrower has breached its indemnification obligations) and obligations to share amounts recovered by such defaulting lender on account of the exercise of set-off rights or otherwise in excess of its pro rata share of such recoveries.[10]

A. Credit Risks Resulting From a Defaulting Lender

Defaulting lenders' unfunded revolving credit commitments directly and adversely affect the borrower's liquidity because the borrower is not able to borrow those funds from the defaulting lender. To manage this liquidity problem a borrower may increase borrowing requests by the amount necessary to cover any expected shortfall attributable to a defaulting lender. This approach's success is limited by the overall size of the revolving credit commitment. Once the performing lenders have fully funded their respective commitments, the borrower will be unable to replace the defaulting lender's missing funds by increasing the amount of loans from the performing lenders.

Although the lenders' obligations under a syndicated credit agreement are several and not joint, the existence of a defaulting lender nevertheless creates credit risk for the other members of the bank group. For example, to the extent that a borrower increases its borrowing requests as described above, the amount of outstanding loans from the performing lenders will be higher than would have been the case if there had not been a defaulting lender. According to the Model Provisions, the administrative agent under a syndicated credit agreement has the right, but not the obligation,

10. For a more complete discussion of the obligation of lenders to share payments, see *infra* Part (V)(A).

to pre-fund all or any portion of loans requested by the borrower on behalf of the other lenders.[11] In the current market, most administrative agents have ceased all pre-funding loans on behalf of the other lenders as a matter of policy. This eliminates credit risk to the administrative agent associated with pre-funding the portion of a loan that should have been funded by a defaulting lender. To the extent the lender responsible for issuing letters of credit is not fully repaid by the borrower for letter of credit drawings, such issuing lender has credit exposure to the other lenders that are obligated to reimburse the issuing lender for such funded letter of credit with the proceeds of a syndicated loan. The issuing lender cannot, however, rely on a defaulting lender to fund its portion of the reimbursement. Although this credit risk was not treated consistently in the credit agreements signed prior to the Lehman Brothers' bankruptcy, issuing lenders typically have the discretion to refuse to issue a letter of credit if one of the lenders party to the syndicated loan agreement is a defaulting lender. This discretion does not protect issuing lenders form the credit risk associated with letters of credit outstanding at the time a lender becomes a defaulting lender.

B. Remedial Provisions to Address Defaulting Lenders

Although a borrower has the right to replace a defaulting lender, the ongoing lack of liquidity in the syndicated loan market makes it virtually impossible to locate a replacement lender willing to pay anything close to par to purchase a loan and commitment from a defaulting lender. Further, to replace a defaulting lender, the borrower must typically replace all of a defaulting lender's obligations (revolving credit commitments *and* funded term loans). Therefore, the borrower must obtain new loan commitments for all of the defaulting lender's obligations (revolving credit commitments *and* funded term loans) even if the borrower only wants to replace the defaulting lender's revolving credit commitment and leave the funded term loan obligations of the

11. *See* MODEL CREDIT AGREEMENT PROVISIONS: ADMIN. AGENT'S CLAWBACK § a (2005).

defaulting lender outstanding. In addition to the borrower's replacement right, a defaulting lender will lose certain economic rights, such as the right to receive payment of commitment fees on unfunded commitments. Finally, a defaulting lender is typically stripped of virtually all voting rights. This is usually accomplished either by excluding defaulting lenders from the calculation of "required lenders" or by eliminating of a defaulting lender's voting rights, except with respect to increases in the amount of or extensions of the term of such lender's commitment. With the exception of certain critical amendments (such as changes to scheduled payment dates, reduction in the outstanding amount of loans and reductions to fees and interest, and increases in loan commitment for example) that need to be approved by all affected lenders, most amendments to syndicated loan agreements need to be approved only by lenders holding a minimum percentage of outstanding credit obligations (loans and unfunded commitments). This minimum percentage may be as low as a simple majority or as high as 66⅔% or more. This Article refers to the requisite percentage of lenders needed to approve an amendment (other than the critical issues described in the preceding sentence) as "required lenders."

C. Defaulting Administrative Agent

When the defaulting lender is the administrative agent, additional issues arise including:

- Funding issues—Are loans funded by the lenders but held by the administrative agent prior to disbursement to the borrower the bankrupt debtor's property (i.e., the administrative agent's)?
- Payment issues—Do loan payments from the borrower, held by the administrative agent prior to distribution to the lenders, constitute property of the bankrupt debtor's (i.e., the administrative agent's) estate?

- Ongoing loan administration issues—Will the administrative agent be able to carry out its administrative obligations under the credit agreement (including consenting to assignments by other lenders) without the bankruptcy court's approval?

These issues are especially important to consider if the default lender has filed for bankruptcy. In the bankruptcy case of *In re Lehman Commercial Paper Inc.*,[12] some of these issues were addressed. The bankruptcy court found "that the funds in the Agency Account are not property of the Debtor's estate, except to the extent of the Debtor's proportional share of such funds as lender."[13]

The uncertainty of having a defaulting lender who is an administrative agent creates significant pressure to replace such an administrative agent. The Model Provisions permit an administrative agent to resign for any reason upon notice to the borrower and required lenders.[14] In the case of *In re Lehman Commercial Paper Inc.,* the bankruptcy court authorized Lehman Commercial Paper to exercise its business judgment to determine which agency relationships, if any, to terminate.[15] The Model Provisions do not provide for a forced removal of the administrative agent by the borrower or the required lenders. While such a right could be added to a credit agreement by amendment, the automatic stay may prevent such an amendment if the administrative agent is in bankruptcy.

D. Assignments and Participations

A loan participation is where a third party, or participant, purchases an interest in the selling lender's share of a syndicated

12. In re Lehman Commercial Paper Inc., No. 08-13900 (JMP) (Bankr. S.D.N.Y. Oct. 6, 2008) [hereinafter October 6th Order].

13. *Id.* (order authorizing debtor to continue to utilize its agency bank account, terminate agency relationships, and elevate loan participation).

14. *See* MODEL CREDIT AGREEMENT PROVISIONS: AGENCY §6 (2005)

15. October 6th Order, *supra* note 12.

loan. The participation interest is evidenced by a separate contract, or participation agreement, between the participant and the selling lender. The participant does not become a party to the underlying loan agreement and the selling lender continues to be the full owner of the applicable loan for all purposes under the syndicated loan agreement. A participation is different from an assignment where the assignee becomes a party to the applicable loan agreement and has direct contractual privity with the other parties to the loan agreement. Because a participant is only entitled to receive payments from the selling lender under the participation agreement, the participant has no direct claim against the borrower for payments. A defaulting lender may have sold participations to third parties pursuant to the terms of the credit agreement. Any such participations should be identified as quickly as possible to determine how best to handle them going forward. In the case of *In re Lehman Commercial Paper Inc.,* the bankruptcy court forced the conversion of all outstanding participations to assignments.[16] Whether such conversions should be executed, however, should be evaluated on a case-by-case basis. A defaulting lender also may be party to pending assignment transactions, or loan trades, that have not yet closed and required payment by the assignee to the assignor. To resolve open loan trades pending at the time of the Lehman Brothers' bankruptcy, the bankruptcy court heard arguments from both Lehman and the assignment counterparties before determining which assignments would be rejected, which trades would be completed, and which trades would be closed on amended terms.

E. Bankruptcy Issues

If a defaulting lender has filed for bankruptcy, it will benefit from the automatic stay under the Bankruptcy Code. Some remedies may be prohibited by the automatic stay even if those remedies were included in the original credit agreement. Although there are no "bright line" tests for determining if actions taken against a defaulting lender violate the automatic stay, any

16. *Id.*

action or amendment which has a negative impact on the economic right of the defaulting lender may invoke the stay. Therefore, bankruptcy counsel should be consulted prior to taking any actions against, or proposing any amendments that could affect the defaulting lender's existing contract rights.

F. Response to Shortcomings in Defaulting Lender Provisions

In response to the inadequacy of the typical remedy of simply replacing a defaulting lender revealed by the lack of liquidity in the secondary syndicated loan market, various administrative agents have developed additional remedial provisions to address defaulting lender situations. First, standard credit documentation has been clarified to strip defaulting lenders of the right to receive any payment with respect to unfunded commitments. Quite simply, if a defaulting lender is unable or unwilling to honor its commitment to fund future advances, it will not be paid for the commitment. Second, most current credit agreements effectively subordinate the defaulting lender's right to receive payments to the other lenders' rights to receive such payments. This is accomplished by allocating principal and interest payments to the obligations owed to non-defaulting lenders prior to the defaulting lenders. Finally, the standard terms for fronted facilities such as letter of credit and swing line facilities[17] now require full cash collateral from the borrower for all fronted amounts whenever there is a defaulting lender. Furthermore, fronted facilities are now only offered at the discretion of the fronting lender even if there are no defaulting lenders in the syndicate.

In addition to the changes to standard credit documentation described above, other remedial provisions have been incorporated into recent deals. For example, certain transactions give the borrower the right to unilaterally terminate the commitment of a defaulting lender without other lenders' consent. Similarly, in certain circumstances the lenders

17. *See supra* Part II (providing an overview of letter of credit and swing line facilities).

constituting the required lenders have demanded the right to force a defaulting administrative agent to resign, however, the right to force the resignation of an administrative agent is rarely granted. Such rights are also typically limited to asset-based lending transactions where the administrative agent has numerous obligations with respect to day-to-day management of the loans and collateral.

IV. PRICING ISSUES IN THE SYNDICATED LOAN MARKET

Syndicated loan agreements typically provide the borrower with two interest rate options—a base rate of interest (the Base Rate) which is linked to the administrative agent's prime rate or an interest rate linked to LIBOR, the rate at which banks are willing to lend to each other in the London Interbank market. In either case, a pricing margin is added to the underlying reference rate. This pricing margin preserves the lender's return once the cost of funds is deducted from the overall interest rate. Historically, the prime rate has been higher than LIBOR. Because of the stable relationship between prime rate and LIBOR, the pricing margin for Base Rate loans in most syndicated credit agreements has generally been between one percent and 1.50% (this difference is the LIBOR-Base Rate Spread) less than the applicable margin for LIBOR Loans. The LIBOR-Base Rate Spread was used to achieve relative pricing parity between Base Rate loans and LIBOR loans so that the Borrower had no meaningful incentive to select one rate of interest over the other. One of the effects of the financial crisis was an inversion of the historic relationship between the prime rate and LIBOR during fall 2008.[18] Although temporary, this rate inversion meant that in many instances the interest rate paid by a borrower for a Base Rate loan was lower than the interest rate paid by the borrower for a LIBOR Loans.

18. *See generally* Malcolm G. Henderson, *Turmoil in Credit Markets Causes Inversion of Key Bank Lending Rates*, FOLEY HOAG, LLP, Oct. 14, 2008, http://www.foleyhoag.com/newscenter/publications/alerts/business/business_alert-101408.aspx?ref=1 (describing the inversion of the prime rate and LIBOR during fall 2008).

This subjected banks to unexpected and unacceptable negative returns once the cost of funds was taken into account.

To resolve the problems caused by potential future rate inversions, administrative agents have revised the standard Base Rate definition. Historically, the Base Rate was defined as equal to the greater of (1) the administrative agent's publicly announced prime rate and (2) the sum of 0.50%[19] plus the federal funds rate.[20] Following the period of rate inversion during fall 2008, the Base Rate definition has been revised to include a third prong so that the Base Rate is equal to the greatest of (1) the administrative agent's publicly announced prime rate, (2) the sum of 0.50% plus the federal funds rate, and (3) a rate equal to the sum of (a) LIBOR for an interest period of one month *plus* (b) the LIBOR-Base Rate Spread. The addition of the LIBOR-based third prong to the Base Rate definition ensures that regardless of the actual relationship of the prime rate to LIBOR, the interest rate for Base Rate loans cannot drop below the interest rate for LIBOR-based loans.[21]

---

19. Although a fifty (50) basis point spread is typical for Base Rate determined by reference to the federal funds, this spread is subject to negotiation and may be as high as one hundred and fifty (150) basis points.

20. The federal funds rate is a daily rate per annum equal to the weighted average of the rates on overnight Federal funds transactions with members of the Federal Reserve System arranged by federal funds brokers on such day (or, if such day is not a business day, for the immediately preceding business day), as published by the Federal Reserve Bank of New York on the business day next succeeding such day, provided that if such rate is not so published for any day which is a business day, the average of the quotation for such day on such transactions received by the administrative agent from three Federal Funds brokers of recognized standing selected by the administrative agent. Similar to LIBOR, the federal funds rate is measurement of the cost of funds to a bank for short term borrowings.

21. This solution to the rate inversion issue creates several new complications when calculating the interest rate for Base Rate loans. For example, because LIBOR is now an element in calculating the Base Rate, the standard LIBOR illegality and unavailability provisions set forth in the Model Provisions must be modified to address situations when LIBOR would otherwise be used to calculate the interest rate applicable for Base Rate loans.

V. DEBT BUY-BACKS OF TERM LOANS

Historically, senior secured loans have been a stable asset class, with prices of term loans[22] in the secondary market trading within a narrow band near par.[23] Despite this historic stability, the unprecedented disruption of the credit markets caused significant negative effects for the senior secured loan market. Secondary market prices decreased to a discount from par of twenty to thirty percent, or more during 2008.[24] Such depressed conditions continued well into 2009. Borrowers and their affiliates viewed the crisis as an opportunity to repurchase debt at a significant discount. Because the purchase price will be less than par, however, not all lenders may be willing to sell their loans at the price offered.

The most common form of debt buy-back is a repurchase by the borrower or a subsidiary that is followed by an immediate cancellation of the debt. Because a repurchase with an immediate cancellation is effectively the same as an optional prepayment, some debt buybacks were structured as optional repayments. Debt buy-backs may also take the form of a purchase or assignment of debt by a parent holding company or a non-subsidiary affiliate with debt either cancelled as a condition to the buy-back or with the debt remaining outstanding subject to subordination protections in favor of the non-affiliated lenders. As discussed more fully below in Part V, assignments to the borrower or optional repayments by the borrower tend to give rise to more problematic voting issues than assignments to a parent holding company or a non-subsidiary affiliate.

---

22. Because revolving loans can be repaid and re-borrowed, they do not generate a predictable future stream of interest income. For this reason, and because revolving loans include a future commitment to lend, most loan investment funds are prohibited by their organizational documents from purchasing or holding revolving credit loans. Therefore, the secondary loan trading market is limited to term loan obligations.

23. *See* MEREDITH COFFEY, LSTA, STATE OF THE U.S. LEVERAGED LOAN MARKET 3 (2009).

24. *See id.*

A. Are Debt Buy-Backs Permitted under Syndicated Loan Agreements?

Due in part to the historic price stability of the senior secured loan asset class, most syndicated loan agreements closed before the credit crisis began simply did not contemplate non-par debt buy-backs. Syndicated loan agreements that do not directly deal with non-par debt buy-backs must be reviewed carefully to determine which terms and conditions may be implicated by a proposed non-par debt buy-back. The key issue raised by a debt buy-back transaction is whether or not the transaction may properly be characterized as a payment by or on behalf of a borrower to the lenders participating in the buy-back transaction. Each lender participates equally and expects equal repayment. Therefore, one of syndicated loan transactions' central terms is that all lenders that must be party to a syndicated loan transaction are treated equally and ratably on a *pari passu* basis with the other similarly situated lenders party to such syndicated loan transaction. However, not every lender may be willing to take a below par repayment in connection with a debt buyback transaction. Therefore, a debt buyback will result in not every lender receiving a payment in exchange for selling their loans. To the extent that this payment is properly characterized as a repayment of outstanding loans, the requirement that payment must be made to all lenders on an equal and ratable basis will be violated.

1. Credit Agreement Provisions Applicable to Debt Buy-Back Transactions

Typically, the following credit agreement provisions restrict debt buy-back transactions and will need to be amended or modified to permit a debt buy-back transaction:

- Assignment provisions including the definition of "Eligible Assignee"[25] and limitations on assignments to affiliates of the Borrower;[26]
- Payment sharing provisions requiring that payments of loans *received by a Lender in excess of its pro rata share thereof* shall be *shared ratably with the other Lenders*;[27] and

---

25. *See* MODEL CREDIT AGREEMENT PROVISIONS: DEFINITIONS (2005):

"Eligible Assignee" means (a) a Lender, (b) an Affiliate of a Lender, (c) an Approved Fund, and (d) any other Person (other than a natural person) approved by (i) the Administrative Agent, (ii) in the case of any assignment of a [Revolving] Commitment, the Issuing Bank, and (iii) unless an [Institution to select appropriate cross-reference to default] has occurred and is continuing, the Borrower (each such approval not to be unreasonably withheld or delayed); provided that notwithstanding the foregoing, "Eligible Assignee" shall not include the Borrower or any of the Borrower's Affiliates or Subsidiaries.

26. *See* MODEL CREDIT AGREEMENT PROVISIONS, *supra* note 25, SUCCESSORS AND ASSIGNS:

(b) Assignments by Lenders. Any Lender may at any time assign to one or more assignees all or a portion of its rights and obligations under this Agreement (including all or a portion of its Commitment and the Loans at the time owing to it); provided that any such assignment shall be subject to the following conditions:

***

(v) No Assignment to Borrower. No such assignment shall be made to the Borrower or any of the Borrower's Affiliates or Subsidiaries.

***

(d) Participations. Any Lender may at any time, without the consent of, or notice to, the Borrower or the Administrative Agent, sell participations to any Person (other than a natural person or the Borrower or any of the Borrower's Affiliates or Subsidiaries)...

27. *See* MODEL CREDIT AGREEMENT PROVISIONS, *supra* note 25, SHARING OF PAYMENTS BY LENDER:

If any Lender shall, by exercising any right of setoff or counterclaim or otherwise, obtain payment in respect of any principal of or interest on any of its Loans or other obligations hereunder resulting in such Lender's receiving payment of a proportion of the aggregate amount of its Loans and accrued interest thereon or other such obligations greater than its pro rata share thereof as provided herein, then the Lender receiving such greater proportion shall (a) notify the Administrative Agent of such fact, and (b) purchase (for cash at face value)

- Payment provisions requiring that all payments of loans *by the Borrower* shall be made to the Lenders on a pro rata basis.[28]

---

participations in the Loans and such other obligations of the other Lenders, or make such other adjustments as shall be equitable, so that the benefit of all such payments shall be shared by the Lenders ratably in accordance with the aggregate amount of principal of and accrued interest on their respective Loans and other amounts owing them, provided that:
(i) if any such participations are purchased and all or any portion of the payment giving rise thereto is recovered, such participations shall be rescinded and the purchase price restored to the extent of such recovery, without interest; and

(ii) the provisions of this paragraph shall not be construed to apply to (x) any payment made by the Borrower pursuant to and in accordance with the express terms of this Agreement or (y) any payment obtained by a Lender as consideration for the assignment of or sale of a participation in any of its Loans or participations in LC Disbursements to any assignee or participant, other than to the Borrower or any Subsidiary thereof (as to which the provisions of this paragraph shall apply).

[The Borrower] [Each Loan Party] consents to the foregoing and agrees, to the extent it may effectively do so under applicable law, that any Lender acquiring a participation pursuant to the foregoing arrangements may exercise against [the Borrower] [each Loan Party] rights of setoff and counterclaim with respect to such participation as fully as if such Lender were a direct creditor of [the Borrower] [each Loan Party] in the amount of such participation.

28. Although the Model Provisions do not include an express requirement that all payments of loans by the Borrower shall be made to the Lenders on a pro rata basis, many credit agreements do include such a requirement. An example of such language from form documents used by my law firm is:

Each payment by the Borrower on account of the principal of or interest on the Loans or of any fee, commission or other amounts (including the Reimbursement Obligation) payable to the Lenders under this Agreement shall be made not later than 1:00 p.m. on the date specified for payment under this Agreement to the Administrative Agent at the Administrative Agent's Office for the account of the Lenders (other than as set forth below) *pro rata* in accordance with their respective Commitment Percentages (except as specified below), in Dollars, in immediately available funds and shall be made without any set off, counterclaim or deduction whatsoever.

2. Amendments and Voting Issues

As discussed in above, most syndicated loan agreements in place at the outset of the credit crisis did not contemplate non-par debt buy-backs. Therefore, any proposed debt buy-back will generally require the amendment of most or all of the Model Provisions identified above. Unfortunately, because the Model Provisions do not address voting, there is not one consistent standard of approval necessary to amend the credit agreement provisions implicated by a debt buy-back transaction. In some transactions, the relevant provisions could be amended with the consent of the required lenders. Other transactions required the consent of all lenders to amend the same provisions. This inconsistency led to market confusion and borrower frustration as market participants struggled to understand why a debt buy-back needed a simple amendment approved by the required lenders in certain deals, but all of the lenders' consent to the proposed debt buy-back in other deals. Despite the Model Provisions' lack of uniform voting mechanics, most credit agreements permit modifications to the assignment provisions (including the definition of "Eligible Assignee" and limitations on assignments to affiliates of the borrower) to be approved by the required lenders. Similarly, most credit agreements require the approval of all of the lenders to modify credit agreement provisions relating both to the (a) requirement that payments or prepayments of loans *by the borrower* shall be made *to the lenders* on a pro rata basis *and* (b) the sharing of payments by lenders.[29]

Even during the loan "bull" market preceding the credit crisis, amendments requiring one-hundred percent lender approval were difficult and costly to obtain. This is because many loan investment funds had few employees and lacked the basic administrative structure necessary to evaluate and respond to

29. Some credit agreements only require one-hundred percent approval for changes to the requirement that payments of loans by the *borrower* shall be made *to the lenders* on a pro rata basis *but not* the sharing of payments by lenders Section. Conversely, other Credit Agreements take the opposite approach. Due to the interplay of these Sections, however, there is likely not a practical difference in the outcome of the two approaches.

amendment requests. Such funds would thus not even consider an amendment unless it carried a significant fee. Following the start of the credit crisis, amendments requiring one-hundred percent approval became virtually impossible to complete at any cost because many lenders sought to use their "veto" power to negotiate for a repayment or buy-out at par. Due to the near certainly that such amendments will be rejected, most syndicated loan arrangers are unwilling to even propose amendments requiring one-hundred percent lender approval. Although amendments needing only the consent of the required lenders are not guaranteed approval, many can be successfully passed by including "sweeteners" to gain lender support for the proposed debt buy-back amendment such as:

- Amendment fees;
- Pricing increases;
- Prohibition of funding the debt buy-back with proceeds of revolving credit loans
- Detailed and even-handed auction procedures to ensure that each lender has an equal opportunity to participate in the debt buy-back, most often on a pro rata basis at the market clearing price level; and
- Limitations on the overall size and timeframe of the buy-back.

Although it took some time to develop a consensus, most syndicated loan market participants now agree that *pro rata* making and sharing of payment provisions do not apply to an assignment made to the parent holding company of a borrower (especially if the loans which are assigned to the parent holding company remain outstanding or if the debt buy-back is funded with the proceeds of a new equity contribution to the parent holding company). This is because such a structure does not require the borrower or any of its subsidiaries to take an assignment of loans from a lender nor make any payment directly to any lender as a result of the debt buy-back. As noted above, the Sharing of Payments by Lender of Model Provisions do not

require the sharing of any payment made to a lender in connection with an assignment of loans unless such assignment is made "to the Borrower or any Subsidiary thereof."[30]

B. Other Issues to Consider

Often, debt purchased by a parent holding company or a non-subsidiary affiliate was permitted to remain outstanding.[31] If the repurchased debt remains outstanding, the amendment to approve the proposed debt buy-back transaction will need to include certain additional protections for the lenders. More specifically, the repurchased debt holder's rights to participate in bank group calls and meetings and to receive information will need to be significantly restricted or eliminated in order to prevent an affiliate of the borrower from accessing confidential bank group information. Similarly, the repurchased debt holder's voting rights will need to be significantly restricted or eliminated; otherwise, an affiliate of the borrower will have the ability to influence the vote on future amendments to the credit agreement.

An example illustrates the concern with allowing the borrower's affiliates to vote on amendments.

---

30. *See* MODEL CREDIT AGREEMENT PROVISIONS, *supra* note 25 (defining sharing payments by lenders).

31. The most common reason for leaving the repurchased debt outstanding was to avoid the negative tax consequences of debt cancellation. More specifically, upon cancellation of outstanding debt, the borrower will recognize ordinary income in an amount equal to the discount on the face amount of the debt. Although this adverse tax treatment was mitigated by the inclusion of a short term modification to the tax code in the American Recovery and Reinvestment Act, some concerns remain. *See generally* David L. Batty & Dennis Kelly, *How the Tax Code Complicates Amending Financing*, WINSTON & STRAWN LLP CLIENT BRIEFING: HOW THE TAX CODE COMPLICATES AMENDING FINANCING, Feb. 19, 2009 (discussing these tax issues in more detail).

Hypothetical Facts

Total Syndicated Loan Facility:	$100 million
Revolving Credit Facility:	*$20 million*
Term Loan Facility:	*$80 million*
Required Lenders:	51%
Amount of Revolving Credit Loans and Term Loans held by original lenders (all funded at par):	$40 million
Amount of Term Loans held by hedge funds that purchased Loans at 55% discount to par	$40 million
Amount of Term Loans held by affiliate of The borrower pursuant to a debt buyback	$20 million

Assume that the borrower's financial performance has significantly deteriorated and it has breached its financial covenants. The borrower has requested a waiver and amendment to waive the defaults and loosen the financial covenants for a period of eighteen months. The borrower believes that the economy will significantly improve and the borrower's financial performance will recover in that time. The administrative agent projects that a liquidation of the borrower in bankruptcy would result in a recovery by the lenders of approximately fifty percent of their loans. Such a recovery would enable hedge fund lenders to realize a small profit over the purchase price paid for their loans. The original lenders would lose fifty percent of their original investment. In light of the current situation, assume that the original lenders are willing to agree to the borrower's request, but the hedge fund lenders are not. The hedge fund lenders believe that a restructuring in bankruptcy will eliminate the existing shareholders and allow the hedge fund lenders to swap their debt for full equity ownership of the borrower. The hedge fund lenders are willing to risk an outright liquidation because they will recover their full investment in a liquidation. At this point, there is a stand-off between the original lenders and the hedge fund lenders because each controls only forty percent of the vote. The original lenders cannot approve the amendment and the hedge fund lenders cannot force the administrative agent to exercise remedies because the exercise of remedies must be requested by the

required lenders. If the affiliated lender can vote, it controls the vote and will agree to vote in favor of the borrower's proposed amendment so that the amendment passes sixty percent to forty percent. Lenders are unwilling to allow the borrower's affiliates to sway votes in this manner. Had the affiliated lender been stripped of its vote, the original lenders and the hedge fund lenders would have had to work out a compromise supported by of a majority of lenders. For example, a limited forbearance period of less than the eighteen months requested by the borrower may have been palatable to all lenders.

Finally, the Lenders should consider imposing strict subordination terms on any repurchased debt held by an affiliate of the borrower to prevent the holder from exercising the right to receive payments from the borrower on a *pari passu* basis. Such subordination terms may include:

- Absolute blockage of principal payments of the repurchased term loan obligations;
- Absolute prohibition on the exercise of remedies with respect to repurchased term loan obligations;
- Express agreement by the holder of the repurchased debt, as well as the borrower, that the repurchased debt will be treated as a separate class in the event of the borrower's bankruptcy. Treatment of such debt in a separate class is necessary to ensure that such debt (1) does not participate in the same voting class as the other lenders, and (2) that such debt is not included with the other debt under the syndicated loan agreement debt when making an adequate protection determination in bankruptcy.[32]

32. A detailed analysis of the enforceability of such subordination provisions in bankruptcy is beyond the scope of this Article. However, please note that outright pre-petition limitations on, or waivers of, a creditor's voting rights under the Bankruptcy Code may not be enforceable in bankruptcy.

Note that significant changes to the terms of the repurchased debt (like the changes contemplated in this Part V(B)) will likely result in the adverse tax consequences. More specifically, such material changes may lead the Internal Revenue Service to treat the debt as cancelled and re-issued under the new terms which will force the borrower to recognize ordinary income in an amount equal to the discount to par paid to purchase the debt.[33]

In addition to the protective provisions discussed above, the lenders considering an amendment to approve a debt buy-back transaction need to evaluate several additional risk factors. First, credit rating agencies may consider a below-par debt buy-back to be tantamount to a default resulting in a downgrade of the borrower's credit rating.[34] Because many loan investment funds have minimum ratings requirements for their investments, such a ratings downgrade may cause non-compliance with such requirements. To remedy such non-compliance, the applicable fund may have to sell the loans of the downgraded borrower at below market prices. Second, financial covenants should be carefully examined to determine if any adjustments are needed as a result of the debt buy-back, including (to the extent applicable) changes in the leverage ratio, changes in interest expense coverage ratio, changes in fixed charges (including fixed charges consisting of permanent principal payments) included in the fixed charge coverage ratio, and the effect of restricted payments. These effects will vary, depending on whether the repurchased debt will be cancelled or permitted to remain outstanding. Finally, any existing mandatory prepayment provisions will need to be reviewed. In particular, excess cash flow calculations should carefully be evaluated in light of the debt repurchase and the expected use of cash.

---

33. *See also* Batty & Kelly, supra note 31.

34. *See Exchange Offers of Capital Markets Debt: New Guidance from Rating Agencies,* DLA PIPER, Apr. 27, 2009, http://www.dlapiper.com/ exchange-offers-of-capital-markets-debt-new-guidance-from-rating-agencies/.

C. *Market Responses to Debt Buy-Back Transactions Going Forward*

Much of the difficulty created by debt buy-back transactions during 2008 and 2009 was a result of the fact that no one ever expected syndicated loans to trade below par in the secondary market. Recent trading at a significant discount has encouraged participants in the syndicated loan market to eliminate ambiguity in credit documentation with respect to debt buy-back transactions. In Europe, the Loan Market Association (UK) has proposed model debt buy-back provisions in the model documents used by its members that permit debt buy-backs without any lender approval as long as certain basic procedures are followed to ensure that all lenders are given a fair opportunity to participate in the debt buy-back transaction. This one-size-fits-all approach may not be appropriate in all circumstances. While it is true that borrower debt buy-backs are now common in the marketplace and should be addressed in loan documents, it is also true that historically only loans of distressed borrowers have traded at a discount. Therefore, careful consideration should be given before allowing distressed borrowers to have the unfettered right to repurchase debt at a discount. The domestic loan market appears to be taking a more conservation approach. More specifically, syndicated loan arrangers in the United States are now drafting their loan documents to make it clear that only the approval of the required lenders is needed to approve a debt buy-back transaction.

VI. INNOVATIONS USED TO SOLVE THE REFINANCING CREDIT CRUNCH

The lack of liquidity in the syndicated loan market during most of 2008 and 2009 put significant pressure on borrowers facing impending maturities of pre-crisis syndicated loans. In response to the inability to refinance entire deals, borrowers and syndicated loan arrangers sought new ways to keep as much of existing credit facilities in place as possible. The solution to the liquidity problem took the form of amendments to existing agreements whereby a

subset of lenders[35] agreed to extend the existing maturity date for a set period of time (typically at least one year). These amendments are known as "amend and extend" transactions in the domestic syndicated loan market. In the European syndicated loan market this type of extension transaction is called a "forward start facility." Although conceptually similar to an "amend and extend" transaction, there are some differences between the two approaches to solving the refinancing crunch caused by a lack of liquidity. Forward start facilities are discussed in more detail in Part (VI)(B).

A. Amend and Extend Transactions

The extension of a syndicated loan's maturity date typically does not require the approval of all of the lenders under the applicable credit facility. Rather, maturity extensions need only the approval of required lenders and each lender that is willing to extend the maturity date of its *pro rata* share of the syndicated loan. However, no lender's maturity date can be extended without its consent. There are many benefits for the borrower of an "amend and extend" transaction. A maturity date extension allows the borrower to maintain a significant portion of its current liquidity without having to negotiate an entirely new loan agreement. Furthermore, the amendment fees needed to gain lender approval for such an extension are typically far less than the underwriting and upfront fees that would be paid for refinancing an existing deal with a new bank group – even if a group of willing lenders could be found.

The benefits to the lenders and syndicated loan arrangers are far less certain. The primary benefit to the lenders is economic. First, consenting lenders receive amendment fees for agreeing to the amendment. Second, interest rate margins are

35. At a minimum these transactions needed lenders holding at least a majority of the credit (outstanding loans and unfunded commitments) to agree to extend the maturity date of the existing credit facility. Frequently, credit approval for an amendment and extend transaction was conditioned on an even higher percentage of lenders agreeing to extend so that the company did not face a liquidity crisis on the existing maturity date.

typically increased to current market levels. Similarly, an "amend and extend" transaction provides the lenders an opportunity to amend terms favorable to the borrower that are no longer broadly accepted in the current syndicated loan market. Finally, such transactions allow for syndicated loan arrangers to lock in as much of the current bank group as possible in case market conditions and liquidity problems worsen. These benefits, however, were simply not enough for many lenders. Lenders who opposed "amend and extend" transactions frequently argued that increased pricing is an insufficient economic inducement to delay repayment at par on the original maturity date. Lenders seeking a prompt return of capital to shore up their own balance sheet are particularly likely to object.

B. Forward Start Facilities

The forward start facility approach is prevalent in the European credit market because extension of the maturity date typically requires approval of all of the lenders rather than only affected lenders as is the case in the domestic loan market. Similar to an "amend and extend" transaction, a forward start facility allows the borrower to maintain liquidity by obtaining current commitments from existing lenders to refinance their existing indebtedness on the existing maturity date. Forward start facilities take the form of a new credit facility whose sole purpose is to refinance the existing credit facility at maturity and the new commitments typically cannot be drawn upon until the maturity date of the existing credit facility. Frequently, large revolving credit commitments are subject to scheduled commitment reductions which function like the amortization of a term loan. These scheduled reductions reduce lenders' total credit exposure in a predictable manner as the maturity date approaches. If the existing syndicated loan transaction includes such scheduled commitment reductions, availability under the forward start facility may be phased during a transition period to replace the portion of an existing credit facility that is reduced pursuant to such scheduled commitment reductions. Because the forward start facility is used to refinance the existing credit facility, the

participating lenders avoid increased credit exposure to the borrower. The forward start facility structure avoids the need for the existing credit facility's lenders to approve the forward start facility. As is the case in an "amend and extend" transaction, lenders who participate in a forward start facility receive fees that are designed to supplement or "top up" the interest and fees under the existing credit facility. This ensures that the aggregate payment more closely reflects current market rates. The structure of the forward start facility must be reviewed closely to confirm that the borrower's obligations under the forward start facility during the period from the effective date of such credit facility through the date on which such credit facility is drawn do not conflict with the terms of the existing credit facility. For example, the payment sharing provisions of the existing credit agreement may require that any interest or fees required to be paid to the lenders that are party to both the forward start facility and the existing syndicated loan agreement be shared ratably with the other lenders that are only party to the existing credit agreement.

VII. CONCLUSION

There is no question that the credit crisis and global recession of 2008 and 2009 restricted the syndicated loan market for new debt issuances and caused a severe dislocation of the secondary syndicated loan market. This widespread market dislocation tested many customary concepts in syndicated loan credit agreements. It also forced borrowers and lenders alike to structure novel solutions to problems created by an illiquid syndicated loan market. Fortunately, participants in the syndicated loan market proved to be up to the task of adapting to a deeper and longer credit crisis than could have been imagined in the middle of 2007. Market innovations developed during this period will carry through into the nascent recovery of the broader syndicated loan market and will serve to help market participants cushion the impact of future credit disruptions.