

# Debt governed by two laws – the best of both worlds

by Tom Siebens\*, Milbank

ONE OF THE MORE SIGNIFICANT TRENDS DURING THE PAST YEAR IN THE EUROPEAN CROSS-BORDER LOAN MARKETS HAS BEEN THE GROWING USE OF A TECHNIQUE THAT IS FUNDAMENTAL TO THE HIGH YIELD DEBT CAPITAL MARKETS – COVENANT PACKAGES BASED SOLELY ON INCURRENCE COVENANTS. A CHALLENGE IN THE PROCESS HAS ARISEN FROM THE FACT THAT MOST LARGE CROSS-BORDER CREDIT FACILITIES IN THE EUROPEAN MARKET ARE GOVERNED BY ENGLISH LAW, WHEREAS THE HIGH YIELD MARKET, DUE TO ITS ORIGINS IN THE US, HAS LONG BEEN DOMINATED BY NEW YORK LAW.

A solution to this dilemma has been to use high yield covenants in credit facilities governed by English law while specifying, in a split governing law clause, that those covenants are to be construed in accordance with New York law. This article discusses the rationale behind the approach and the jurisprudence that supports the use of split law clauses.

## What works best in subordinated capital structures

The introduction of US style high yield debt to the European markets in the late nineties brought the benefits of incurrence covenant packages to European companies. As is now commonly known, under such a package, the restrictions on an issuer's ability to take certain actions such as incurring debt, granting security, paying dividends and other distributions to shareholders, making capital expenditures and investments, disposing of assets, engaging in mergers and acquisitions and entering into transactions with affiliates, are flexible while still maintaining the

credit by tightening flexibility in times of poor business performance. Under incurrence covenants, deterioration of the borrower's business performance, by itself, does not trigger a default. A breach of such covenants occurs only if the issuer affirmatively takes an action that is not permitted.



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In contrast, traditional European senior and subordinated bank facilities are based on maintenance covenants, including, in particular, financial ratio covenants. These require the borrower to maintain a certain level of financial health, as measured by its compliance with periodic financial ratio tests. As a result, failure, or potential failure, to satisfy financial ratios due simply to business deterioration and not to affirmative actions by the borrower, can lead to a default. An array of other maintenance covenants in the typical bank facility that relate to, for example, prudential practices and reporting increase the chances that lender waivers or consents will be required during the life of the facility.

The flexibility of incurrence covenants makes them particularly adaptable to the subordinated levels of a borrower's capital structure, which is one reason why, over a number of years, these covenants have been making their way into the subordinated debt markets in Europe as an alternative to the traditional and more rigid bank covenant packages. Accordingly, they are today the basis for European high yield, payment-in-kind, or PIK, facilities and other subordinated financings, as well as, more recently, even the most senior tranches of capital structures.

From the outset of the European high yield market, investors have recognised that the most advanced learning and experience with incurrence covenants is in the US market, and that incurrence covenants governed by New York law benefit from interpretive precedent developed over the long history of the US high yield market. Although some high yield bonds have been issued using New York style incurrence covenants but governed by English law, the US market has not accepted this approach. The European market also has rejected this approach in all but the smallest, and more locally placed, offerings. Any significant high yield bond, and any high yield bond that involves a significant US offering, is today done under New York law.

Similarly, in the European loan markets an effort has been made to adapt English law credit facilities, based on the forms of the Loan Markets Association, to an incurrence covenant approach by simply eliminating financial ratio tests. This approach has proven to be less beneficial to

borrowers and lacks the flexibility for the borrower to act, without lender consent, under key provisions such as those governing the incurrence of debt, payment of dividends, making of loans and investments, engaging in acquisitions and capital expenditures, designation of unrestricted subsidiaries and the repurchase of debt. In many cases, this approach retains maintenance-type covenants that impact the borrower if its business performance deteriorates. This 'modified LMA' approach also generally does not reflect other provisions that are typical in high yield instruments, such as those that provide issuers with the ability to require the release security and guarantees or the right to invest the proceeds of asset disposals in their business rather than repaying senior debt. Given its divergence from US practice, this approach is not well-suited for transactions syndicated in the US market.

## Split law clauses as the solution

As a result, professionals in the European market have sought a way to combine the best of both worlds – English law loan agreements familiar to the traditional European lender market, with New York law covenants well-developed over time in the traditional high yield market. Key to this innovation has been the use of split governing law clauses under which a credit agreement governed by English law specifies that incurrence covenants and related provisions in relation to the borrower's operations are to be construed in accordance with New York law.

Although this approach may be novel in English law credit facility agreements, applying different laws to different aspects of a transaction is not a new concept. In legal terminology, *depeçage* is the word used to refer to the principle that the rules of one legal system can apply to regulate certain issues arising from a transaction while those of another system regulate other aspects. The concept is involved in many financings. Even where only one law governs the contract regulating a debt facility, *depeçage* is relevant because other laws may govern certain aspects of the arrangements needed to give legal effect to the commercial terms of the facility, notably the legal capacity of the parties, the law governing security interests over collateral in different

jurisdictions and limitations on guarantees by subsidiaries of loans made to affiliated companies.

Consistent with the principle that, even where one law is stated to govern an agreement not all issues arising out of that relationship will be governed by the same law, *depeçage* also encompasses the concept that different laws may apply to different parts of the same agreement.

English courts recognise split law provisions in contractual agreements by virtue of the Rome Convention of 1980, which was incorporated into English law by the Contracts (Applicable Law) Act 1990 (although in this respect that Act did not change the previous common law position). Article 1(1) of the Rome Convention applies to “contractual obligations in any situation involving a choice between the laws of different countries.” Article 3(1) of the Rome

Convention contemplates the application of different laws to different parts of a contract: “By their choice the parties can select the law applicable to the whole or a part only of the contract.” The article applies even if contracting parties are not from a jurisdiction that is a signatory to the Convention or if the laws of such a jurisdiction are being applied, as can be the case in a credit facility with an English-New York split-law provision.

In order to ensure that a split law clause works properly under English law, three requirements must be met. First, the contract must remain logically consistent. Put another way, each law specified must relate to elements of the contract that can be governed by a different law without giving rise to contradictions – a provision in a contract (or indeed the whole contract) cannot be expressed to be governed by English law and at the same time subject to the principles

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of some other law. Second, the law governing the general obligation created under a contract cannot be split. For example, a single body of law must govern questions such as the validity of the contract, the ability of an innocent party to terminate due to the other party's breach and the discharge of contractual obligations by frustration of contract. Third, the choice of law under a split governing law provision must be consistent with English choice-of-law principles. For example, the choice of a law other than English law will be without effect if it is contrary to English public policy or is made in order to evade an English statute.

Similarly, New York courts have long recognised, in case law, the concept of *depechage*, including in situations where parties have specifically agreed that different laws should govern different aspects of a contract, provided that certain conditions are satisfied. First, the provisions to which separate laws apply must be separate and distinct, which is similar to the English concept that two laws cannot govern the same provisions of a contract given the contradictory interpretations of the provision that could result. Second, the contract must expressly state what law governs which provisions. Third, the choice of law must comply with New York choice of law principles.

In short, the English and New York cases involving governing law clauses that split the law applicable to an agreement support the view that an English law-New York law split between a credit agreement generally and its incurrence covenants specifically can be implemented if documented correctly. A credit agreement can be clear in specifying that a separate law governs the incurrence covenants. Whether an action has occurred in breach of such a covenant is logically a question discrete from other terms of the credit agreement (for example, interest payment clauses, indemnities, events of default and

remedies for default), thereby minimising the risk of a contradictory application of both English and New York law to a particular covenant.

## Conclusion

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One of the greatest benefits of incurrence covenants under New York law is their foundation in a well-established body of legal and market practice, given the long history of such provisions in the US high yield market. Over the past 10 years, European high yield market practice has evolved based on these covenant packages. The history of the product has created a large investor base inside and outside the US that understands the covenants and related provisions. These characteristics of the market, as well as the flexibility of high yield covenants themselves, are the drivers behind the attempts by bankers and borrowers to adapt English law credit documentation in a way that preserves what is familiar to the cross-border lending markets while adding incurrence covenants to reflect the know-how of the US high yield product. Split governing law clauses can be employed to ensure that borrowers and lenders enjoy the best of both worlds.

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