THE LOAN SYNDICATIONS AND TRADING ASSOCIATION®

Week in Review

May 15, 2015

DEFLATING THE LEVERAGED LOAN MYTH

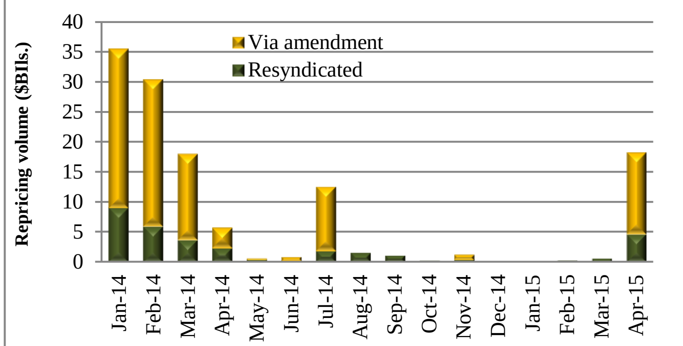
On Thursday, LSTA GC Elliot Ganz and EVP Research Meredith Coffey joined UVA's Professor David Smith and Sidley Austin's Jennifer Hagle at the annual Sidley-LSTA Chicago Conference, this year focusing on "Future Shock" and the loan market. The panel reviewed the usual suspects: State of the market today, how leveraged lending guidance could reshape the market, and how proposed bankruptcy reform could upend the value proposition in secured loans by haircutting their recoveries. But the session offered something new for our space: *Academic research and empirical evidence that leveraged loans aren't all bad*. In fact – collective gasp – they may actually be good for companies.

This research seldom grabs the headlines the way, say, "Risky Loans Surge" does. But this research is out there – and has been for decades. In 1986, Professor Michael Jensen theorized that debt could act as a disciplining device for management by forcing managers to hit benchmarks to service debt. In 1989, Professor Jensen even had kind words for LBOs, noting that they can create "optimal governance" structures for corporations via the disciplining effects of debt, concentrated ownership and the involvement of sophisticated investors. Finally, in 1992, Professors Phillipe Aghion and Patrick Bolton argued that debtholders – with their limited upside and substantial downside – are incentivized to be better monitors than managers/owners when firm performance is declining.

The economic theory was followed by empirical research. In 1987, Professor Christopher James observed that stock prices *rose* when borrowing firms announced new bank loans. In contrast, stock prices *fell* when companies announced new bond issuances. The research suggested that equity markets interpreted bank debt as a "double good": The debt disciplines the company, but the bank lenders add additional value by utilizing contracts with tight covenants and by keeping close ties with the borrower, both of which help the lender monitor the borrower. And bank loans just might be good for innovation as well. In 1996, Professor Joel Houston and Professor James observed that companies with high growth opportunities rely more on bank debt than public bonds. Why? These companies are riskier, but still need to grow. Perhaps lenders are willing to finance this growth – but only within the flexible (but safer) constraints of a loan contract and bank relationship.

Drilling down into loans themselves, Professor Greg Nini, Professor Smith, and Professor Amir Sufi in 2009 found that investment-related loan covenants (capex restrictions in this case) hinder bad investments and improve company performance. Also in 2009, Professor Michael Roberts and Sufi observed that loan agreements that are frequently renegotiated proactively manage the borrower-lender relationship. And in 2012, Professors Nini, Smith and Sufi demonstrated that financial maintenance covenant violations lead to more conservative firm behavior and improved company performance. Nini, Smith, and Sufi argue that this turnaround in performance arises because lenders step in following a covenant violation and require the borrower to pull back the reins on money-

LSTA CHART OF THE WEEK: As Demand Outstrips Supply, US Repricings Return with a Vengeance



Source: S&P Capital IQ/LCD

LSTA HIGHLIGHT: We hope to see you Tuesday at Leveraged Finance Fights Melanoma!

DISTRICT COURT DEFLATES SEC'D CREDITORS

As reported by Law360, in a decision of great importance to the loan market, Judge Briccetti of the United States District Court for the Southern District of New York, affirmed the bankruptcy court's controversial ruling on the issue of cramdown replacement notes in *In re MPM Silicones LLC* ("Momentive").

In Momentive, the debtor "crammed down" a plan of reorganization against the objections of the 1st lien note holders by providing them with long-term below market rate replacement notes. Chapter 11 provides, in essence, that a plan may be confirmed over a secured creditor's objection only if it maintains the creditor's security interest until the creditor has received the full value of its secured claim or provides equivalent treatment. One way to satisfy the full value requirement is to provide the creditor with a stream of payments totaling the amount of its secured claim, with a present value equal to the value of the creditor's security interest. (One could think of this as a forced refinancing.) In calculating the present value for those purposes, courts need to choose an interest rate. In *Till*, a plurality of the Supreme Court held that in chapter 13, courts should start with the prime rate and add a modest premium (1 to 3%) to compensate the lender for the risk of default. The Court rejected the notion that one should look to the prevailing rate for similar loans to subprime consumers. *However, the Court noted in a footnote that the analysis might be different in a chapter 11 case, where there is a market for loans to debtors.*

Since *Till*, lower courts have disagreed on whether and how its reasoning applies in chapter 11 cases. Some courts have held that in a chapter 11 case it is appropriate first to see if there is a market rate for such a loan – e.g., for exit financing – and apply the *Till* formula approach *only* if a market rate cannot be determined. In this case, Judge Drain rejected that approach – notwithstanding that the debtors had *actually obtained* exit financing with a higher

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wasting endeavors. Do check out the nifty charts on slide 11 of presentation that shows the not-so-dead-cat-bounce of stock prices of companies that violate their financial covenants. (Helpful hint: The "0" on the X axis indicates the time of covenant violation.)

But wait, you say. These arguments are predicated on leveraged loans having maintenance covenants. What happens when 60% of institutional loans are covenant lite? Well, almost all these institutional loans come alongside a revolver that does have at least one maintenance covenant. (To be fair, these days the revolvers might offer a springing covenant.) To the extent that the maintenance covenants in the revolver still act as a check on borrower behavior, the Nini, Smith, Sufi insights should still be relevant. Prof. Smith observes that what is probably most important is that the borrower be subjected to maintenance covenants from one lending source; it is less important *who* is doing the monitoring through that covenant.

CLE-AR INFO: INTERCREDITORS & RADIOSHACK

On Tuesday, the LSTA hosted Latham & Watkins's Jane Summers and James Chesterman for a CLE seminar on "Cross Border Leveraged Lending: Difference in European Structures and Intercreditor Agreements". Noting the continued trend of European borrowers looking to the U.S. loan markets, the speakers warned that hybrid US/European restructurings can lead to unexpected commercial outcomes, which should be addressed in the interceditor agreement. The US intercreditor agreement assumes the restructuring tools offered under Chapter 11 of the Bankruptcy Code, *e.g.*, the automatic stay. Because there is no one European insolvency regime (and many European regimes do not generally provide for the same tools), many Chapter 11-type provisions need to be contractually provided for in European intercreditor agreements. Also US investors may expect a company to be comfortable filing for Chapter 11, but the culture in Europe, and the difficulty of the in-court bankruptcy process, steers companies and their creditors toward out of court restructurings. The speakers recommended including European-style "release provisions" and limiting the leverage of junior creditors when using a US intercreditor agreement in European deals. Otherwise US lenders may be surprised by the leverage of junior creditors against European loan parties when using an unmodified US intercreditor agreement, because, absent a contractual mechanism, they will not have the ability to sell assets free and clear of debt and security claims. Latham's memo further discusses these issues.

Then, on Thursday, the LSTA hosted Blank Rome's Rick Antonoff and Lawrence Flick for a webcast on "*RadioShack* - The Unitranche Structure Tested". The unitranche structure, which is increasingly favored by many borrowers and lenders, has a potential weakness: the common "first out"/"last out" structure had hitherto been untested in the bankruptcy courts. *In re RadioShack Corporation, et al.* has brought some clarity as to whether a bankruptcy court would enforce an Agreement Among Lenders (AAL) in a borrower's chapter 11 case. One threshold question was whether bankruptcy courts would hear and resolve issues between "first out" (FO) and "last out" (LO) lenders because the borrower/debtor is not a party to the agreement. Here the parties consented to the court's jurisdiction to construe and enforce the AAL. The court examined to what extent an LO lender can object to a bankruptcy sale that is supported by the FO lender. The AAL at issue provided that the FO lenders would direct the agent to consent or object to any sale or other 363 disposition, but any LO lender may raise certain objections thereto. The Last Out Participation Agreement further required that the FO lenders be "paid in full" before repayments could be made to the LO lender. The court resolved that the LO lenders were permitted to credit bid because of their rights as a secured creditor before payment …*con't*

interest rate than the rate they advocated for the first liens – because he read *Till* to bar giving lenders any "profit" in a cram-down loan. Accordingly, he imposed a below-market rate of interest.

The 1st lien bondholders will likely appeal this case to the U.S. Court of Appeals for the Second Circuit. Since the 2nd Circuit has not yet decided a case presenting the issue of how *Till* applies in chapter 11, it will raise an important question of first impression. As Schulte notes in a recent memo, "[w]e anticipate that more debtors will be pursuing cramdown plans to obtain the benefits afforded by long-term, below-market financing…" They recommend that secured creditors "re-evaluate pricing to compensate for this increased risk." Skadden agrees, warning that Momentive "may suggest a turn towards harsher treatment of secured creditors in bankruptcy." They worry that Momentive may represent "a meaningful incremental shift in the balance of power towards debtors and junior creditors." Gibson Dunn goes even further, wondering whether Momentive represents the "dawn of a new golden age for debtors" which would "fortify debtors' and junior creditors' efforts to strong-arm secured creditors … and potentially undermine [their] recoveries." The LSTA will continue to monitor Momentive as it moves through the appellate process.

OLD CALCS BENCHED, LOAN DOCS AFFECTED

Financial benchmarks have been under increased scrutiny since the financial crisis, and the Federal Funds Effective Rate (FFER) is no exception. The Federal Reserve Bank of New York recently announced proposed changes to the FFER. After reviewing the process for calculating the FFER, the New York Fed plans to enhance the rate's calculation process by transitioning from data supplied by federal funds brokers to transaction-level data collected directly from depository institutions. That data will include trades done through brokers and those negotiated directly between counterparties. The New York Fed expects to implement the calculation changes in 2016 and will make a further announcement closer to the effective date of the change. As highlighted in a Milbank memo, this change has implications for many syndicated credit agreements which typically incorporate the FFER as one of several key benchmarks against which interest rates paid by borrowers on their loans may be pegged. Typically, borrowers may choose between LIBOR or a separate base rate which is often defined as being the higher of (i) FFER plus ½ percent per annum, (ii) the prime rate, and (iii) one-month LIBOR applicable to dollars plus 1% per annum. The standard FFER definition in credit agreements - and in all the LSTA's secondary trading documents - has referred to brokered fed funds transactions. Because of the Fed's proposed changes, the LSTA plans to modify the definition of "Federal Funds Rate" in its documents by deleting the words "arranged by Federal funds brokers" and encourages its members to check their form documents to determine if a similar updating is required. For further information about this topic, please see Chapter 3 of the LSTA's Credit Agreement Guide written by the late Milbank partner, Richard Wight.

INTERCREDITORS & RADIOSHACK…(con't)

of the FO lenders' contingent indemnification. Furthermore, on objections of an LO lender to a 363 sale supported by FO lenders, the court concluded that those based on free and clear sale under §363(f) and lack of adequate protection are prohibited by the terms of the AAL, but other objections based on fairness of process or undervaluation may proceed. Paul Hastings also published a memo observing that the bankruptcy court in *RadioShack* implicitly recognized enforceability of AALs but limited coverage of FO contingent indemnification claims.