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September 11, 2018

TRANSFER RESTRICTIONS - A DELICATE BALANCE?

To Our Clients and Friends:

Following the global financial crisis, the restrictions on a lender's ability to transfer its voting participations in the European leveraged acquisition finance space (assuming an English-law governed facility agreement) became reasonably standard, albeit they were slightly more favourable towards the lender than the borrower.

In summary, it became customary for a lender to be able to freely transfer its voting participations if the transfer: (i) was made to an existing lender or to an affiliate or related fund of the lender; (ii) was made to an entity specified on a "white list" pre-approved by the lender and the borrower; or (iii) was made whilst an event of default was continuing. Further, typically a borrower could not "unreasonably withhold" consent to a lender's request to transfer, and often a borrower's consent was "deemed" to be given (typically, within five business days) should consent not be forthcoming. Whilst negotiated around the edges, this general position became accepted by both borrowers and lenders.

The balance as between the interests of the lender and the borrower made sense in the context of the post-financial crisis when lenders had a greater bargaining position generally at the negotiation table and therefore were able to better control debt terms, including transferability. Then, with the increase in cov-lite loans and the corresponding dilution in certain lender protections, the ability to transfer with relative ease was an important tool in a lender's armoury and a price borrowers had to pay for the flexibility afforded by the documentation more generally.

The transformation of transfers

Fast forward to today's market and borrowers have re-gained control on documentation terms, including influencing transferability provisions. Borrowers now have much greater control over the identity of their lenders and the make-up of their syndicate more generally. We consider a number of recent trends in the market below.

1. *The white list (and now also, the black list)*

As set out above, the white list concept allows a lender to transfer its interest in a loan to any entity that is named on the pre-approved, negotiated "white list" without requiring borrower consent. Borrowers could often amend a white list by removing (or perhaps adding) an agreed number of names (typically up to five on an annual basis). Recently, however, we have seen borrowers placing additional restrictions on the white list concept.

By way of example, borrowers have: (i) argued that there should be no overall cap on the number of entity names that can be removed from a white list over the life of the loan; (ii) resisted agreeing or attempting to agree to replacement lenders to a white list; (iii) pushed for blanket carve-outs of certain entities already specified on a white list, such as vulture funds, industry competitors and/or loan-to-own investors (see further below); and/or (iv) requested to be notified prior to a transfer being effective, even if the proposed transferee is an entity on the pre-approved white list. In addition (although not directly linked to the white list), borrowers have also negotiated restrictions on the size of permitted transfers to new lenders / affiliates of existing lenders – in some examples, restricting transfers of interests which amount to ten per cent. or more of the total commitments – so as to try and mitigate a single entity acquiring a blocking stake (although this does not prohibit a number of related funds acquiring multiple stakes, all of which in essence are controlled by the same institution).

Borrowers have also attempted to introduce the US-concept of a "black list" – traditionally only seen in the US-market. Unlike a white list, entities named on a black list are "disqualified" entities to whom a lender is unable to transfer its loan participation. Black lists typically prohibit transfers to difficult or predatory entities, such as vulture funds, industry competitors and other non-traditional lenders, and therefore are conceptually different to the European white list.

2. *Major Events of Default*

Transfer restrictions typically fell away upon an event of default, such that borrower consent (as set out above) to a transfer was no longer required. The basic rationale was that lenders should not be reliant on borrower consent to a transfer when the borrower itself has either incorrectly undertaken or failed to undertake an action pursuant to the terms of the loan agreement (often an indication of a distressed borrower). However, borrowers across the market have successfully negotiated the position whereby the restrictions on a lender's right to transfer remain in place unless one of the following "major" events of default have occurred: (i) non-payment of the principal loan amount and/or interest; (ii) insolvency; or (iii) breach of a financial covenant. In other words, notwithstanding the occurrence of an event of default (provided not a "major" event of default), the borrower still has a degree of control over transferability. Of course, where the event of default arises from breach of a financial covenant, the limited nature of the financial covenant testing in a cov-lite loan means that this event of default and the lender's freedom to transfer will likely arise even later.

3. *Reasonableness and deemed consent*

Borrowers have been pushing back on the need to act "reasonably" in withholding consent to any transfer request from a lender, and have also been extending the time period within which consent is deemed to have been given. Certain top-tier sponsors have removed the concept of deemed consent completely; in other instances the time period has been increased from the previously widely accepted five business days to either ten or fifteen business days. It is worth noting, however, that lenders continue to push for the concept of deemed consent and this has been successfully flexed back in during syndication in a number of deals during 2018.

4. *Industry competitors, loan-to-own investors and vulture funds*

In the last few years, particularly following the increasing role and prevalence of sponsor debt funds, borrowers have looked to regulate the business activities of potential transferees by placing blanket restrictions on transfers to certain types of entities unless the borrower, parent and/or the sponsor provides the required consent.

By way of example, borrowers have successfully negotiated absolute restrictions on transfers to competitors of the borrower and/or the borrower group – typically known as, "industry competitors", and this term is often very broadly defined. More recently, and seen particularly throughout 2017 / 2018, borrowers have also looked to restrict transfers to entities which customarily acquire distressed debt with a view to potentially converting the debt into equity and acquiring a stake in the company, i.e. "loan-to-own" investors. These restrictions capture a broad class of potential transferees. Borrowers have also sought for restrictions on transfers of loan participations to so-called "vulture funds", being distressed debt funds, private equity funds and hedge funds that are in the business of investing in poorly performing debt.

Whilst the rationale for a borrower restricting transfers to institutions of this nature are fairly well-rehearsed – i.e. as a generalisation, these institutions are traditionally regarded as enforcing their rights in a distressed scenario in a potentially more aggressive manner than traditional conventional bank lenders – borrowers also need to be wary of not overly prohibiting transfers in such a distressed scenario when it may in fact be advantageous to them to move the debt away from conventional bank lenders (see further below).

5. *Notification rights*

A further trend observed during 2018 has been the inclusion by borrowers of notification rights prior to a transfer. Such provisions require a lender to notify a borrower of all transfers, assignments and voting sub-participations (typically, between five to seven business days) ahead of such transfer, assignment or sub-participation occurring. This not only results in an (easily tripped) timing and administrative burden on the transferring lender but also, if the notification is not provided in time, it could (depending on the drafting within the loan agreement) result in the transferring lender being disenfranchised.

6. *Sub-participation*

Historically, restrictions on transfers only applied to absolute transfers and not sub-participations (whether voting or otherwise). However, borrowers have pushed for controls on transfers of voting sub-participations, and this is now very much the market norm. This is understandable from a borrower perspective as a transfer of voting rights is in many respects akin to an absolute transfer when it comes to assessing the nature of the lender syndicate for a waiver / consent or for other voting purposes. In addition, borrowers have more recently requested information on all (not just voting) sub-participation arrangements and copies of registers containing details on each sub-participant. The next likely step, in our view, will be for borrowers to strengthen this position further and request restrictions on non-voting as well as voting sub-participations.

Where does this leave us – present and future?

What was once perhaps considered a boiler-plate, "back-end-of-a-loan-agreement" provision has morphed into a heavily contested and negotiated mechanic seeking to balance the desire of the sponsor/borrower to be able to control the composition of, and its relationship with, its lending syndicate against the desire of the lenders wishing to retain maximum flexibility to transfer their interests in the underlying debt.

Whilst this tension exists in most lending relationships throughout the term of the loan, it is likely to be at its most precarious in the period leading up to and during an event of default or distressed cycle. On one hand, it is understandable why a borrower wants to continue to control the identity of its lenders during such a period – a vulnerable and sensitive point in time for any borrower. On the other hand, if a lender is only able to transfer the debt after the occurrence of a specified major event of default or is unable to transfer to distressed debt funds and/or industry competitors even after an event of default, the lender has very limited flexibility at a potentially crucial time in a credit cycle.

Unrestricted transferability following an event of default increases a lender's options by opening up a pool of potential buyers – e.g. to those entities which may not be listed on the white list or entities to whom transfers would otherwise have required borrower consent. If the more recent, borrower-friendly provisions described above are adopted more widely, a lender essentially has to wait right up until the very end of a borrower's distressed period (this is particularly so in a cov-lite loan where the incurrence nature of the financial covenant testing can result in a late invitation to the lenders to the negotiation table). By this time, the underlying asset will arguably have lost significant value, with the lenders experiencing a significant hair-cut in the par value of the debt before being able to freely trade it. This could result in the lender facing internal pressure from its credit and trading desks (such as realising value, de-risking, portfolio management and compliance with regulatory capital requirements), and an all-round "loss of interest" which could ultimately jeopardise the lender's relationship with the borrower and its opportunity to secure future mandates from that borrower / sponsor. Similarly, by prohibiting loan transfers to vulture funds, loan-to-own investors and/or industry competitors, borrowers could be penalising themselves: borrowers are ousting the very entities that are most likely going to be interested in acquiring the debt and trying to help turn around the business after an event of default, and they could instead find themselves in an acceleration / enforcement scenario.

Whilst the trend towards a dilution of a lender's rights and increased restrictions on transferability seems (at least at this point in time) to be continuing, lenders (and borrowers) should perhaps be cautious of overly restricting transferability and liquidity in the loan market. Whilst current conditions favour sponsors and borrowers, these conditions may of course change. The possibility that a lack of liquidity will return should be a concern for borrowers and lenders alike.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Global Finance practice group, or the authors:

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