Joint Report from the Chairs

Dear Members:

Please email either of us if you have any ideas for either of the Committees or wish to participate in any project, subcommittee or leadership role. The Committees have a number of projects underway. Our subcommittees and task forces are very active and always welcome input. Please do not hesitate to volunteer!

We hope you enjoy this issue, and invite you to get involved in your committee(s).

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Featured Articles

USING ARTICLE 9 SALES TO ENHANCE RECOVERIES

By Ira L. Herman and Matthew E. Kaslow

In Ronnoco Coffee, LLC v. Westfield Bros., Inc., 939 F.3d 914 (8th Cir. 2019), the Eighth Circuit reaffirmed the principle that a purchaser of substantially all of a debtor’s assets at a properly conducted Article 9 sale should not have successor liability, absent extraordinary circumstances. The case illustrates how using Article 9 to sell collateral, if done properly, will protect the transaction parties and thereby provide a secured lender with a cost-effective alternative to a sale process under Section 363 in a bankruptcy case under chapter 7 or chapter 11.
Background

Through October 2014, Great Western Bank extended secured loans in excess of $5 million to U.S. Roasterie, Inc. (“USR”), a coffee bean roasting company based in Iowa. USR’s principal coffee bean supplier was Westfeldt Brothers, Inc., a Louisiana-based company. By August 2012, USR had accumulated approximately $3 million in unsecured debt to Westfeldt. Despite USR’s financial difficulties, Westfeldt continued to sell coffee on unsecured credit to USR.

When Great Western’s loans to USR matured in October 2014, Great Western made a demand for repayment in full. On February 9, 2015, at a private sale conducted by Great Western under Article 9, substantially all of USR’s assets were sold to Ronnoco Coffee, LLC for a purchase price of $2,098,670.80. After the sale, approximately $3,150,000.00 of USR’s secured debt to Great Western and $2,690,000.00 of USR’s unsecured debt to Westfeldt remained unpaid. It was undisputed that the sale was a commercially reasonable transaction.

Subsequently, Ronnoco filed an action in the Eastern District of Missouri for declaratory judgment that it was not liable to Westfeldt for USR’s debt and did not assume USR’s obligation to perform alleged future coffee supply contracts. While the sale agreement provided that Ronnoco did not assume USR’s liabilities or obligations, USR was not immediately dissolved after the sale and Ronnoco had continued coffee roasting operations at USR’s Iowa location, retained most USR employees, employed USR’s former president for approximately ten months, and employed its former CFO for approximately six months. Westfeldt filed counterclaims against Ronnoco for, inter alia, successor liability. The Eastern District of Missouri District Court granted summary judgment in favor of Ronnoco and Westfeldt appealed. The Eighth Circuit affirmed.

Rationale

The general rule is that a purchase of substantially all of the assets of a company in a properly conducted Article 9 sale does not create successor liability. Westfeldt argued that both the mere continuation and fraud exceptions to the general rule applied in this case to create successor liability.

The Eighth Circuit stated that the test to impose successor liability under the mere continuation exception is “whether there is a continuation of the corporate entity of the transferor -- not whether there is a continuation of the transferor’s business operation.” Thus, the mere continuation exception would apply where, e.g., “the owners of a failing business, to avoid successor liability, inserted relatives as sham owners and directors of a new company that continued the asset seller's business.” However, the Eighth Circuit found that the sale in Ronnoco was an “arm’s-length transaction” without continuity of ownership or management. The Eighth Circuit observed that retaining certain employees and management for “short periods” was “common after such acquisitions,” and the retention of such individuals under the facts of the case did not support a finding of successor liability. Additionally, the Eighth Circuit’s research revealed that no Iowa court had previously applied the exception where “the buying and selling corporations had different owners.” Thus, the court declined to apply the mere continuation exception.

Next, the Eighth Circuit agreed with the District Court that there was no evidence to support Westfeldt’s arguments for successor liability under the fraud exception. Westfeldt argued that USR tried to remove its assets from the reach of its creditors by planning with Great Western and Ronnoco to “intentionally stop servicing its debt so Great Western could foreclose.”

The Eighth Circuit rejected this argument because Ronnoco purchased USR’s assets from Great Western, not from USR, and Great Western’s secured debt was not fully repaid by virtue of the sale. Indeed, “Great Western, acting in its own financial interest, made the decision to sell,” which “simply confirmed the legitimacy of an asset purchase by
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What’s Market: 2019 Year-End Trends in Large Cap and Middle Market Loan Terms
by Ikhhls Rashid, Maria Barclay and Tim Fanning, Practical Law Finance

The loan market declined overall in 2019 but, compared to the last five years, 2019 was still a strong year, overall. The leveraged lending market and the investment grade loan market experienced vastly different years. Leveraged lending had a rollercoaster year starting strong, stalling around the middle of the year and recovering in the fourth quarter. Investment grade lending, on the other hand, remained consistent throughout the year, with issuances dipping slightly but still notching up the second highest annual volume on record.

The tale of two loan markets is caused by several macroeconomic factors influencing the market throughout 2019 including:

- High corporate valuations.
- The fallout from geopolitical uncertainty surrounding Brexit.
- Ongoing trade tensions.
- Signs of China’s slowing growth.
- Concerns over slowing global growth and the possibility of a recession that many have long anticipated.

Despite favorable market conditions, strong technicals, and widely available capital from both traditional and emerging lending sources, confidence in the loan market dropped and potential investors stepped away from transactions.

Against this backdrop, syndicated lending reached $2.4 trillion in 2019, a 18% decrease compared to 2018. Syndicated mergers and acquisitions lending volume dropped by 28%, falling from $648 billion in 2018 to $465 billion in 2019, the lowest annual total in five years. Similarly, at $1.45 trillion in 2019, refinancings fell by 19% from $1.79 trillion in 2018.

According to Gold Sheets Daily, A Refinitiv LPC Publication, dated January 7, 2020: "Both leveraged corporates and private equity-backed credits struggled amid higher market valuations and increased lender scrutiny of credit quality as uncertainty gave rise to greater risk aversion among investors."

Leveraged lending decreased for the second consecutive year. 2019 issuances reached $808 billion, a 35% fall from 2018 levels and the lowest volume in four years. Refinancing levels in leveraged lending dropped by 40% to $453 billion in 2019. Institutional new-money issuances fell to $239 billion, a 30% decline from 2018. Institutional refinancing activity also declined with volume falling by 59% to $167 billion. 2019 saw less corporate M&A activity than in the prior year. Overall, M&A volume decreased to $253 billion in 2019, a

a purchaser that did not assume the former owner's liabilities.” Regardless, Westfeldt failed to show that it was prejudiced by the sale because “there [was] no evidence that, absent the alleged fraud by Ronnoco, USR would have been able to pay off its entire debt to Great Western and then make payment to Westfeldt.”

Accordingly, the Eighth Circuit affirmed the entry of summary judgment in favor of Ronnoco on Westfeldt’s successor liability claims for lack of evidence of mere continuation or fraud.

**Conclusion**

The holding in Ronnoco is significant, but not because it represents a change in or extension of successor liability law to unique facts. Quite the opposite; the factual and legal issues in the case could best be described as rather pedestrian. Rather, Ronnoco is important because it highlights how secured lenders can use a private Article 9 sale to maximize their recovery after a borrower's default. When properly conducted at arm's-length, such sales are advantageous to secured lenders as they can progress on an accelerated timeline, unburdened by the procedures and expenses attendant to Section 363 sales in bankruptcy, whether under chapter 7 or chapter 11, while still protecting purchasers and allowing them to potentially acquire assets free of many of a debtor’s liabilities.

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33% decrease, fueled by a 20% drop in leveraged buyout (LBO) volume, which reached $124 billion, and a 44% decline in non-LBO M&A volume, which reached $129 billion.

Leveraged sponsored issuances fell to $364 billion in 2019, a 41% decrease from 2018 levels. Driving this decrease was a 48% drop in non-LBO lending to sponsors which totaled only $255 billion in 2019. Market participants observed that leveraged sponsored issuances, in particular, were stymied by higher corporate valuations and increased lender scrutiny of credit quality.

While 2019 investment grade loan volume fell by 8% to $952 billion, this level is the second highest total on record. Investment grade loan volume includes $714 billion of refinancings and $193 billion of M&A lending.

Surprisingly, even with the diminished role played by the Leveraged Lending Guidance (LLG) and favorable market conditions, total leverage levels on LBO deals remained relatively stable when compared to 2018. It is reported that 74% of 2019 LBOs had leverage above 6 times EBITDA, while in 2018, 73% of LBOs were levered at this level. LBOs levered 7 times or higher slightly decreased from 41% in 2018 to 37% in 2019.

In 2019 second lien loan volume reached $23.4 billion, a 37% decrease from the previous year.

Consistent with anecdotal evidence from market participants that observed seeing more distressed and troubled credits, there has been $24.2 billion of defaulted loan deal volume from 44 issuers. The institutional leveraged term-loan default rate stayed the same from 2018 to 2019 at 1.8%, as reported by Fitch Ratings.

As direct lenders continued to dominate the middle market and other market conditions persisted, traditional middle market lending fell 12%. Syndicated middle market loan volume declined by 21%. However, the number of middle market LBO deals increased to 128 in 2019 from 112 in 2018.

Given the state of the loan market and market sentiment in loan agreement negotiations, this article examines significant issues and trends in the loan market, including:

- Cryptocurrencies and blockchain technology.
- A surge in direct lending.
- The growth of green financing.
- LIBOR’s replacement by the Secured Overnight Financing Rate (SOFR).
- Issues in the negotiation of commitment papers and loan terms.
- Specific issues in loan agreement negotiations, including:
  - encouraging borrowers to delever and tightening leverage using asset sale and excess cash flow sweeps;
  - EBITDA adjustments;
  - incremental loan facilities;
  - negative covenant flexibility, including the evolution of basket reclassifications, basket stacking and basket sharing;
  - restrictions on assignments and on certain activist loan investors; and
  - tax reform and the treatment of foreign subsidiaries.

For a complete copy of this article published on the Practical Law website on February 28, 2019, which also includes links to recent examples of loan agreements and Expert Views from four leading practitioners, see Practice Note, What’s Market: 2019 Year-End Trends in Large Cap and Middle Market Loan Terms, Practical Law, at http://us.practicallaw.tr.com/w-024-1026.

Cryptocurrencies and Blockchain Technology

Over the past few years ownership of Bitcoin and other cryptocurrencies have become more widespread, raising questions for lenders regarding how to deal with borrowers issuing, holding, and trading cryptocurrencies. Addressing these issues requires an understanding of blockchain technology, a decentralized database designed as a key component of the Bitcoin cryptocurrency. Market participants are starting to analyze the Bitcoin and blockchain issues impacting credit agreements. Specifically, lenders are struggling with credit analysis of companies that own or issue digital tokens and with the treatment of digital tokens in loan documentation. For more information, see Article, Expert Q&A on Blockchain and Bitcoin Issues Impacting Credit Agreements, Practical Law, at http://us.practicallaw.tr.com/w-022-1904.

Surge in Direct Lending

The dominance of direct lending continued in 2019 with its market share of the middle market space growing significantly. Originating in the middle market, direct lending is now expanding into the lower end of the large cap market.
Last year direct lenders continued to dominate the second lien loan market. Although the use of flex by arrangers may overstate the true picture (as not all looser terms clear the market), as in prior years direct lenders appear to be more conservative than arrangers regarding leverage and other terms and conditions. Some practitioners also report that in certain sponsor-backed deals, the sponsor debt fund buys a percentage of the commitments after the commitment papers are signed, which lessens the burden on the direct lenders holding the debt and helps the sponsor make a good return on capital. In a club deal, if a sponsor affiliate buys a percentage of the commitment, this gives confidence to potential lenders that some percentage of the debt is already sold.

Growth of Green Financing

According to Refinitiv LPC, about $113 billion in global green and sustainability-linked loan volume was announced in 2019 (with $45 billion closing in the first half of the year).

Sustainable finance or green financings are on the rise as more borrowers and lenders, seeing environmental awareness and responsibility play a greater role in the corporate world, recognize the potential benefits of this type of financing for their businesses. Green financing products represent the finance industry’s efforts to facilitate financing of environmentally responsible business opportunities and to help address the challenges of climate change. For lenders and investors, this financial product produces investment returns while also generating positive social impact. For borrowers, green financing is a way to improve their environmental impact, as well as enhance their reputation for their commitment to the environment. For more information on green financing, including green loans and sustainability-linked loans, see Practice Notes, Understanding Green and Sustainability-Linked Loans at http://us.practicallaw.tr.com/w-023-1549 and What’s Market: Green Loans and Sustainability-Linked Loans at http://us.practicallaw.tr.com/w-020-8513.

Replacing LIBOR with SOFR

During 2019, market participants continued to anticipate and prepare for LIBOR’s likely replacement with SOFR. These efforts are certain to continue in 2020 as the market prepares for 2021 when panel banks are no longer required to support LIBOR and LIBOR may become incapable of being determined.

Fallback Language

To facilitate the transition from LIBOR to alternative reference rates, in April 2019, the Alternative Reference Rate Committee (ARRC), recommended syndicated loan agreements begin including fallback language, “contractual provisions that specify the trigger events for a transition to a replacement rate, and the spread adjustment to align the replacement rate with” LIBOR. Two approaches to fallback language have developed:

- An “amendment approach” under which, following a trigger event, the borrower and administrative agent enter into an amendment to replace LIBOR by selecting a successor rate and spread adjustment.
- A “hardwired” approach under which fallback language is included in the credit agreement, which results in the loan automatically converting to a successor rate after a trigger event occurs. The successor rate in this instance is either:
  - forward-looking term SOFR plus a spread adjustment;
  - if the forward-looking rate does not exist, a compounded average of daily SOFRs plus a spread adjustment; or
  - if neither exist, the hardwired approach reverts to the amendment approach.

Though the LSTA recommends the hardwired approach, the market almost universally follows the amendment approach. Practical Law Finance analyzed 155 publicly filed credit agreement filed between May 1, 2018 and April 30, 2019. Of the 155 credit agreements, 151 deals included LIBOR fallback language and all 151 deals (100%) followed the amendment approach. For more information on LIBOR and to view the analysis, see Article, Current Trends in LIBOR Successor Rate Provisions, Practical Law, at http://us.practicallaw.tr.com/w-020-0846 and Practice Note, What’s Market: LIBOR Interest Rate Provisions, Practical Law, at http://us.practicallaw.tr.com/8-385-8146.

Practitioners observed as the year progressed that LIBOR fallback provisions began giving more discretion to the agent to take the steps necessary to implement LIBOR’s replacement. Banks hope that when the market settles, they have discretion to implement the replacement rate. To ensure this flexibility, in some deals:

- The LIBOR successor rate language specifically states that prevailing market conventions are to be considered when setting the new rate.
- The agent is given the sole authority to set the new rate.
- The LIBOR fallback provision allows the agent to apply the replacement benchmark in a manner consistent with market practice or in a manner otherwise reasonably determined by the agent.
The agent has the right in consultation with the borrower to make certain conforming changes to the loan agreement that the agent reasonably believes must reflect the adoption and implementation of the benchmark replacement and to permit the agent to administer the benchmark replacement consistent with market practice.

By the end of 2019, the LIBOR fallback provisions began to refer to SOFR in a few deals.

**Transition to SOFR**

Practitioners have expressed concern that replacing LIBOR with SOFR may be operationally challenging for lenders. There are an enormous number of loan facilities that need to be amended to effect the transition. Throughout the year, the LSTA continued to warn of the potential consequences of a significant number of leveraged loans in 2021 suddenly switching to base rate if amendments effecting the rate change are not in place in time. Some practitioners believe that a regulatory solution is needed to ensure a smooth transition from LIBOR to SOFR.

Attempting to shift the focus to SOFR, during 2019, the LSTA encouraged lenders to implement the hardwired approach referencing SOFR. In 2019, one deal, Royal Dutch Shell plc (Shell) entered into a $10 billion sustainability-linked financing with loan pricing based on SOFR, though use of SOFR is delayed until one year after the closing date at the earliest. The facility currently uses LIBOR, but LIBOR interest is to be replaced with SOFR once the loan market is more prepared for SOFR as an underlying rate.

During 2019, law firms began to prioritize LIBOR replacement and SOFR implementation. Certain law firms have established LIBOR transition committees, working groups and task forces to stay abreast of LIBOR-related issues. For more information on issues and considerations related to benchmark interest rate reform and the replacement of LIBOR with SOFR, see Article, Ring in the New: Expert Q&A on LIBOR Replacement and the Secured Overnight Financing Rate (SOFR), Practical Law, at http://us.practicallaw.tr.com/w-022-9242.

**Negotiations of Commitment Papers and Loan Terms**

In 2019, flex language continued to play a central role in the negotiation of loan terms. Most large cap commitment papers included pricing flex and non-economic covenant or term flex. Similar to prior years, arrangers continued to be prepared to go to market with aggressive indicative terms subject to flex. In the second half of the year, practitioners noted more flexing up than flexing down, as lenders pushed back on some of the more aggressive loan terms.

Continuing the trend of recent years, loan negotiations often moved forward on an aggressive timetable with widespread use of sponsor precedent in private-equity-backed deals and with lender’s counsel designated by sponsors. The time pressures associated with signing commitment papers and proceeding to documentation on an expedited basis continues to make it difficult for lender’s counsel to give detailed consideration to all of the complex loan terms and conditions.

**Loan Documentation Developments**

Throughout 2019 there was a marked disparity between the way stronger and weaker borrowers fared in loan negotiations. Deals for stronger sponsors and corporate credits were often heavily oversubscribed. In contrast, deals for weaker credits encountered more selective investors that pushed back on terms which were often tightened using flex.

Despite the different levels of scrutiny lenders gave to weaker credits and varied negotiating strength of borrowers, in 2019 loan terms remained broadly borrower friendly.

**Encouraging Borrowers to Delever**

In 2019, even with the limited relevance of the LLG, lenders remained concerned about leverage levels as a credit matter. In certain deals, lenders focus on asset sale sweeps and excess cash flow sweeps as a mechanism to encourage borrowers to delever.

**Asset Sale Sweeps**

Asset sale sweeps in the mandatory prepayment provisions are one approach that is designed to ensure the borrower delevers over time. 100% of asset sale proceeds traditionally would be used to prepay loans, subject to reinvestment right exclusions. More recently, some borrowers have successfully negotiated leverage-based step-downs (for example, an asset sale sweep provision with a 50% leverage-based step-down). However, in 2019 practitioners reported seeing less deals with step-downs with the sweep going back to 100% of asset sale proceeds in some deals.
Excess Cash Flow Sweeps

During 2019, excess cash flow (ECF) sweeps remained an important topic for borrowers, sponsors, and lenders alike. In certain deals, lenders negotiated provisions requiring borrowers to delever faster (for example, increasing the percentage of ECF applied to prepayments and removing leverage-based step-downs). In other deals, borrowers successfully negotiated looser and more borrower favorable ECF provisions (for example, decreasing the percentage of ECF applied to prepayments and permitting step-downs).

In 2019, many lenders pushed to include more robust ECF sweeps, including sweeps of 75% or 100% and ECF provisions designed to ensure that any cash generated is applied to the sweep. For more creditworthy borrowers, the ECF sweep may start at 50% and step down to 25% and 0.

Finally, strong borrowers and sponsors are able to use the retained portion of ECF to increase builder basket capacity.

EBITDA Adjustments

Adjustments to EBITDA continued to be an important area of focus for borrowers and lenders. EBITDA is central to the calculation of financial ratios and leverage-based baskets, and lenders may try to limit EBITDA adjustments (for example, by capping addbacks and limiting forward-looking periods) as a means of influencing leverage. In addition to discussions around cost savings, revenue synergies were also hotly negotiated points in large cap and sponsored deals.

Capping Adjustments

A common approach is to cap adjustments for pro forma cost savings and synergies based on a percentage of EBITDA. Over the last few years, the general trend was for borrowers to bolster EBITDA with, for example, uncapped EBITDA adjustments. Practitioners report uncapped adjustments continued in 2019, but mainly for the largest deals and the strongest sponsors. For other deals, especially weaker credits, lenders reinstated caps, generally not to exceed 10% to 25% of EBITDA, though caps of 30% and 35% of EBITDA were observed.

In addition to negotiating the size of the cap, borrowers and lenders often debate whether to apply the cap before or after giving effect to the add backs. Lenders typically favor calculating the cap before applying the EBITDA adjustments, while borrowers argue for calculating the cap after applying the EBITDA adjustments. For example, if a borrower has EBITDA of $10 million and $4 million of potential adjustments and the lender proposes a 30% cap calculated before applying the adjustments, the adjustments are limited to $3 million (30% of $10 million). However, if the cap is calculated after the adjustments are applied, the cap is $4.2 million (30% of $14 million), which means the add-back is below the cap.

Another negotiated point in the middle market and the lower end of the large cap market is whether the cap applies to certain adjustments in the aggregate or whether there are specific caps for individual adjustments. When caps apply to individual adjustments, one adjustment may have a 20% cap and a different adjustment may have a 15% cap. Negotiating caps in this way means the borrower may request higher caps for adjustments it deems important and to agree to lower caps for less important adjustments.

Other EBITDA Adjustments

New EBITDA adjustments practitioners reported seeing in 2019 include add-backs relating to:

- The SEC’s decision to change rules regarding pro forma adjustments to include management adjustments. Under the SEC changes, management adjustments are to include reasonably estimable synergies and other transaction effects that have occurred or are reasonably expected to occur.
- “Pre-opening” expenses.

Trends in Incremental Loan Provisions

Much of acquisition financing in the current climate is in the form of incremental loans that the borrower uses to consummate add-on acquisitions.

MFN Thresholds and Sunsets

During 2019 lenders continued to try to bolster most favored nations provisions (MFNs), restoring the MFN’s ability to protect lenders. By keeping the MFN threshold around the same level as last year, increasing or eliminating sunset periods and limiting carveouts, lenders had some level of success in this regard in 2019. As with other loan agreement provisions, the extent to which lenders were able to negotiate these protections depended on the creditworthiness of the borrower. For strong sponsors and borrowers, MFN coverage continued to erode, with sponsors and borrowers continuing to request an increasing number of exclusions limiting any practical application of the MFN.
Compared to 2018, MFN thresholds remained the same in 2019. It is reported that in most large cap and sponsor-backed deals, the MFN threshold is 75 basis points (bps), while in non-sponsored middle market deals the MFN continues to be 50 bps.

Reversing the trend of prior years, lenders resisted requests by borrowers for shorter sunset periods. Over the last two years, borrowers were able to negotiate six- or 12-month sunsets. Practitioners report these sunset periods are no longer widely used. MFN provisions may instead have a 12- or 24-month sunset or no sunset.

In terms of MFN carveouts, growing numbers of carveouts are subject to flex. Large cap borrowers and sponsors were more successful in obtaining these exceptions, but for other borrowers many of these carveouts were flexed out. In 2019, the carveouts most frequently included in incremental loan provisions include:

- Carveouts regarding debt incurred in an acquisition.
- Carveout for ratio incurrences.
- A specified dollar carveout.

Sidecar facilities permitted under a credit agreement were not generally subject to the MFN.

**Baskets**

For stronger credits, interaction between the fixed freebie basket and the ratio basket continues to trend toward flexibility in incrementals.

In prior years, lenders had resisted borrower demands for a reallocation of general debt basket capacity to increase incremental capacity. With concerns about leverage diminished as the significance of the LLG has fallen away, practitioners reported that in 2019 this reallocation permission reappeared in commitment papers, though often subject to flex.

**Negative Covenant Trends**

**Baskets: Reclassification, Stacking, and Sharing**

In 2019, there was continued focus in negative covenant negotiations on reclassification (moving a transaction entered into in reliance on one basket into a different basket), stacking (allowing a ratio basket to be used concurrently with a dollar basket, without counting the dollar basket usage in running the ratio) and sharing or reallocation (combining multiple baskets from different covenants to increase aggregate capacity for particular transactions).

Loan agreements historically only contained a debt covenant with a debt basket, an investment covenant with an investment basket, and a restricted payment covenant with a restricted payment basket (all were treated separately) and each covenant had exceptions and baskets that stood alone.

However, over the last several years, borrowers have successfully negotiated permissions to reclassify transactions and combine baskets in a way that maximizes covenant flexibility. In the case of reclassification, if the borrower has already used capacity under the original basket, the reclassification “reloads” the original basket. Below are some examples of basket reclassification, stacking and sharing, and related trends.

<table>
<thead>
<tr>
<th>Reclassification, Stacking &amp; Sharing</th>
<th>Description</th>
<th>Negotiation Trends</th>
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<tbody>
<tr>
<td>Reclassification between ratio-based basket and fixed dollar-based (freebie) basket (applies to incremental baskets, debt baskets, investments baskets and restricted payments (RP) baskets).</td>
<td>For baskets within the same covenant or permission, the borrower is permitted to reclassify a transaction consummated using dollar-based capacity to a ratio-based basket if the borrower satisfies a specified financial test, such as a leverage ratio condition, which then frees up the dollar basket for future transactions.</td>
<td>Routinely permitted for debt and lien baskets, but more closely scrutinized for other categories, particularly RP. Sponsors want automatic reclassifications. Lenders wish to be notified of a reclassification but have increasingly accepted automatic reclassification.</td>
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<td>Topic</td>
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<tr>
<td>Stacking generally.</td>
<td>Borrower permitted to enter into a transaction using a ratio-based basket concurrently with a dollar-based basket but can ignore the dollar-based basket usage in running the ratio test.</td>
<td>This is typically permitted for debt and lien permissions without controversy. It is less well accepted for RP. Sponsors often try to expand this by arguing that the dollar-based basket usage should be ignored forever in the calculation of ratios, but this is typically resisted by lenders.</td>
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<td>Stacking between general debt basket and ratio-based RP basket.</td>
<td>Borrower permitted to incur debt using general debt capacity to pay dividends under the ratio-based RP baskets without counting the debt when calculating the ratio.</td>
<td>This is an extension of stacking generally but is strongly resisted by lenders, usually successfully. Lenders want stacking to be limited to stacking within a single covenant, rather than between different covenants.</td>
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<tr>
<td>Reallocation between general debt basket and incremental freebie basket.</td>
<td>Borrower permitted to reallocate general debt capacity to incremental freebie capacity.</td>
<td>Increasingly accepted in commitment papers, but frequently subject to flex.</td>
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<tr>
<td>Sharing between investments general basket, RP general basket and junior debt basket.</td>
<td>In certain deals, borrower permitted to share general basket capacity under the RP, investment and junior debt prepayment covenants.</td>
<td>If permitted, this sharing is typically only allowed to run upstream; the borrower is permitted to use the RP basket to make investments because the borrower making investments keeps the funds within the credit structure; generally, lenders are not willing to allow the borrower to use its investment basket to make RPs because that permits money to flow outside of the credit structure.</td>
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<td>Reallocating RP capacity to debt capacity.</td>
<td>Borrower permitted to reallocate RP capacity to general debt basket, either in the form of:</td>
<td>Permission is heavily negotiated and granted mainly to aggressive sponsors and large corporate credits.</td>
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<td>• Using the “cumulative credit” or “available amount” builder basket to incur debt (sometimes secured debt).</td>
<td>Borrowers may seek to justify this reallocation by arguing the borrower already indirectly has the ability to do this. If the borrower uses the RP basket to make RP to its parent, these sums can then be contributed back to the borrower which can then incur contribution debt (and contribution debt capacity is often twice the amount of the equity contributed).</td>
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<td>• Broader permission to use RP capacity generally (that is, general RP basket, unlimited RP basket, post-IPO RP basket) to incur debt (sometimes secured debt).</td>
<td>Lenders argue that this roundtripping is only possible if the borrower has the cash to make the RP in the first place. However, because the borrower is seeking to incur debt in reliance on the RP capacity precisely because it does not have the cash (and so was unable in fact to use the RP capacity), many lenders resist this request.</td>
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<td>The most aggressive sponsors sometimes push to have the debt capacity build to be at twice the rate of the RP capacity being reallocated.</td>
<td>If allowed, reallocating RP capacity to debt incurrence capacity is usually subject to the same conditions as the RP capacity, such as a no default condition.</td>
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Collateral Leakage and Designation of Unrestricted Subsidiaries

Lenders remain concerned about the potential for collateral leakage by the transfer of collateral out of credit structure and the designation of restricted subsidiaries as unrestricted subsidiaries. According to market participants, borrowers rarely object in principle to lenders' concerns about the erosion of their collateral. Lenders continue to scrutinize their loan agreement provisions to ensure that they limit (and do not inadvertently permit):

- The transfer of assets to unrestricted subsidiaries.
- The designation of restricted subsidiaries as unrestricted subsidiaries.

Limitations on the transfer of assets often apply to any assets that are material to the business of the borrower and its restricted subsidiaries. In some deals, the limitation specifically identifies assets important to the company.

Middle market lenders also continue to focus on preventing the leakage of value from the borrower’s credit structure by including restrictions resembling those in large cap deals.

Restrictions on Assignments and Debt Activism

In 2019, there was increased emphasis on assignment provisions and provisions responsive to issues raised in the Windstream litigation.

Assignment Provisions

Assignment provisions, typically, include an event of default qualifier and a borrower's deemed consent concept. Practitioners noted in 2019 sponsors continued to request maximum consent rights regarding assignments and participations of revolving loans and commitments. The negotiating strength of the sponsor may ultimately determine the issue in the face of some lender opposition, because lenders are concerned about their ability to assign and participate their loans and commitments to their affiliates without restrictions.

Practitioners report that in 2019 there was increased concern by borrowers and sponsors to make distressed vulture funds ineligible to become lenders.

Debt Activism and Windstream Provisions

In the much publicized fallout from the Windstream bankruptcy, top-tier sponsors successfully negotiated the inclusion of provisions limiting voting rights of certain lenders holding derivative positions (net short provisions) and provisions creating sunsets on how long lenders have to exercise remedies after the occurrence of an event of default.

Provisions responding to concerns over Windstream-related issues have begun to appear in large corporate and sponsored deals in particular but are not customary in other deals. These provisions include:

- **Collective action provisions.** In the most aggressive form these provisions prohibit any lender from taking any action against the borrower for any reason except with required lender consent and through the administrative agent. Although practitioners reported that in 2019 sponsors requested these provisions, lenders are resistant to provisions that limit their ability to take certain action or enforce remedies.

- **"Statute of limitations" regarding defaults.** Under these provisions, if a lender has knowledge of a default but has not taken any action regarding it for a specified period, the lender’s right to take action for the default is eliminated. Anecdotal evidence suggests that in some cases defaults are no longer actionable as little as six months after they are known to exist. These provisions were common in bonds deals but have now begun to appear in sponsored bank loans.

- **Stay language.** When a court is deciding whether a default has occurred, these clauses allow the court to effectively extend the grace period while deciding the case. Once a decision has been made the borrower has whatever grace period had not yet run when the court proceeding began, essentially the grace period does not run while the judgment is considered.

- **Net short provisions.** These provisions disenfranchise lenders that net short the credit, meaning that they hold some of the debt with which they can exercise remedies but have a greater short position (typically using credit default swaps) that allows them to make a greater profit if the credit deteriorates. It has been reported that net short provisions are being requested in every large cap sponsor acquisition financing deal and most lenders agree to their inclusion.

Tax Reform and Foreign Subsidiaries

Some market participants predicted that the deemed dividend tax reform enacted under the Tax Cuts and Job Act (Act) at the end of
2017 was likely to encourage lenders to seek additional credit support from borrowers with overseas subsidiaries. The tax law changes removed the negative tax consequences to borrowers that:

- Designate certain foreign subsidiaries (controlled foreign corporations (CFCs)), as subsidiary guarantors under the loan agreement.
- Pledge the assets of CFCs as collateral to secure the loan obligations.
- Pledge more than 65% of the equity interests of CFCs as collateral to secure the loan obligations.

Practitioners have not seen significant changes in the way overseas subsidiaries provide credit support for US loans. This may be partly because these grants can be expensive relative to their worth and create timing issues (though most lenders may be willing to make these post-closing obligations). The borrower may also need to complete a formal tax analysis before approving the requested structure, because, in part, the tax implications may change from year to year.

As a result, except in deals with significant foreign assets, in 2019 there was no consistent trend of US borrowers being required to designate foreign subsidiaries as subsidiary guarantors or being required to pledge the assets of foreign subsidiaries or more than 65% of the equity interest in foreign subsidiaries.

For more information, see Article, Expert Q&A on Tax Reform Updates and the Leveraged Loan Market, Practical Law, at http://us.practicallaw.tr.com/w-020-5977.

Looking Forward

In 2019, the loan market experienced positive developments for both borrowers and lenders. Lenders closely scrutinized weaker credits and pushed back on the inclusion of the more borrower-favorable provisions. Meanwhile, stronger borrowers and sponsors continued to obtain borrower-friendly provisions that give them significant flexibility in the way they operate their businesses. Market participants widely expect this to continue in 2020.

As the phasing out of LIBOR steadily approaches, many expect to see in 2020 developments in terms of addressing the likely replacement of LIBOR with SOFR.

In the wider world, the US presidential election in November 2020 is bound to generate a level of uncertainty that will impact the economy more broadly and, by extension, the domestic loan market as the year unfolds. Also, given the government responses and corporate reactions to the developing crisis, fears of a global pandemic of the Covid-19 virus abound at the time of writing, with the prospect that the economic consequences of the virus could create more uncertainty during the remainder of the year.

The market statistics cited in this article (unless otherwise stated) were provided by Refinitiv LPC.

UCC Spotlight

By Carl S. Bjerre and Stephen L. Sepinuck

The purpose of this column is to identify some of the most disconcerting judicial decisions interpreting the Uniform Commercial Code or related commercial laws. The purpose of the column is not to be mean. It is not to get judges recalled, law clerks fired, or litigators disciplined for incompetence. Instead, it is to shine a spotlight on analytical errors, and thereby provide practitioners and judges with reason to disregard the decisions.

Landress v. Sparkman

2020 WL 561893 (E.D.N.C. 2020)

Partnership and limited liability company (LLC) interests are often subject to contractual or statutory anti-assignment provisions that prevent the creation, perfection or enforcement of a security interest. U.C.C. §§ 9-406 and 9-408 override many anti-assignment provisions – but the Article 9 overrides often do not apply to an LLC or partnership interest, depending on a multifaceted analysis that generally seeks to respect the “pick-your-partner” principle inherent in LLC and partnership law. In Landress v. Sparkman, the court made a mistake on the choice-of-law facet of this analysis, and thereby incorrectly concluded that the Article 9 overrides did apply.
The debtor, Mason, was the guarantor of a loan made to an entity in which he had a stake, and Mason secured this guaranty with his economic rights, including distribution rights, in a Delaware limited liability partnership (LLP) in which Mason also had a stake. He later filed bankruptcy, and the trustee objected to the lender’s purportedly secured status. The bankruptcy court granted the trustee’s objection, reasoning as follows: (a) the partnership agreement prohibited assignments of partnership interests to secure any debt without consent of the partnership’s Board, which had not been given for Mason’s transaction; (b) Delaware law governed the partnership agreement and should also, under the “internal affairs doctrine,” govern the validity of the anti-assignment clause; (c) Delaware partnership law upholds the partnership agreement’s anti-assignment clause, even though, in the court’s view, the uniform version of the Article 9 overrides would have otherwise invalidated it. In re Mason, 600 B.R. 765 (Bankr. E.D.N.C. 2019); see also 6 Del. Code Ann. § 15-503(f).

On appeal, the District Court reversed, based solely on the idea that the internal affairs doctrine, which governs “intra-firm relationships,” should be not “stretched” so as to govern the rights of the lender, which in this case was not a partner. Instead, thought the court, the validity of the anti-assignment clause should be controlled by the governing-law clause in the security agreement (implicitly relying on U.C.C. § 1-301(a) which generally provides freedom of contract for governing-law clauses). In this case, the security agreement provided for New York law to govern, and New York does not have a non-uniform exception for partnership interests. Hence the lender prevailed.

However, the choice-of-law rule applicable to anti-assignment clauses in a partnership or operating agreement is not, as the District Court thought, a false dichotomy between the internal affairs doctrine on one hand and a governing-law clause in the assignment document on the other. Instead, the validity of the anti-assignment clause should be governed by the law that governs the partnership or operating agreement — not on internal affairs grounds, but on the grounds that the law specified by the partnership or LLC agreement is the only central and germane body of law that can be known to and anticipated by all relevant parties. Specifically, in this case, the prospective secured party could easily have consulted Delaware law before advancing funds, but Mason’s fellow partners could not have consulted and planned around New York law, let alone every other body of law that Mason and some lender might eventually specify in their security agreement.

This choice-of-law rule is not expressly provided by Article 9. However, in reference to anti-assignment clauses and related matters, the official comments do observe: “it might be inappropriate for a designation of applicable law by a debtor and secured party under Section 1-301 to control the law applicable to an independent transaction or relationship between the debtor and an account debtor.” U.C.C. § 9-401 cmt. 3. It is also strongly consistent with the well-accepted idea that a governing-law clause should not affect other important aspects of third parties’ rights. See, e.g., In re Eagle Enterprises, Inc., 237 B.R. 269 (E.D. Pa. 1999) (equipment lease specified that it was governed by German law, but this did not result in German law rather than the U.C.C. governing characterization of the transaction as a security interest).

Moving beyond the choice-of-law focus of this case, secured parties must be cautious about prospective collateral that consists of partnership or LLC interests, even when the correctly applicable law has no special protection for the pick-your-partner principle. The potential pitfall for contractual restrictions on assignment of such collateral is that the Article 9 overrides might not apply for one or both of two reasons. First, these overrides apply only when an anti-assignment clause is “in an agreement between an account debtor and an assignor.” In the partnership or LLC context, the account debtor is the partnership or LLC itself, and these organizations are not generally a party to their own partnership or operating agreements. See U.C.C. § 9-102(a)(3). Second and similarly, the overrides invalidate anti-assignment clauses that “require[] the consent of the account debtor” to the assignment; but most clauses require the consent of the debtor’s fellow partners or members, and they are not the account debtors, because again, the account debtor is the partnership or LLC itself. The Permanent Editorial Board of the U.C.C. is considering issuing a report about these and other aspects of U.C.C. §§ 9-406 and 9-408 as applied to the partnership and LLC context. In Landress itself, the facts were unusual because the LLP was indeed a party to the partnership agreement, and consent to the assignment was required from the LLP’s Board rather than from Mason’s fellow partners. So, if the District Court had not gone astray in its decision to apply New York law, its conclusion that the lender was secured because of the operation of the Article 9 overrides might have been correct. But on more typical facts, the overrides by their own terms may well not apply.

More broadly still, some partnership and LLC interests are payment intangibles, and others are ordinary general intangibles (i.e., general intangibles that are not payment intangibles), depending on whether the account debtor’s “principal obligation” to the debtor is a monetary obligation. See U.C.C. § 9-102(a)(42), (61). Depending on the facts, the distinction can implicate differences between §§ 9-406 and 9-408 that are not explored here. Moreover, partnership or LLC interests can also be securities, if the organization opts in under U.C.C. Article 8. See U.C.C. § 8-103(e). Against the background of these and other complications, the uniform versions of U.C.C. §§ 9-406 and 9-408 were amended in 2018 so as to exclude collateral consisting of ownership interests in general partnerships, limited partnerships or limited liability companies, though these changes have not yet been enacted in any state. See Carl S. Bjerre, Daniel S. Kleinberger, Edwin E. Smith and Steven O. Weise, LLC and Partnership Transfer Restrictions Excluded From UCC Article 9 Overrides, Business Law Today (February 2019) (discussing all these points).

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2. The UCCLA-W listserv is sponsored by West Group, publisher of the “UCC Reporting Service.” The listserve is an e-mail discussion group focusing on the Uniform Commercial Code. To subscribe to the UCCLA-W listserv, go to [http://lists.washlaw.edu/mailman/listinfo/ucclaw-l](http://lists.washlaw.edu/mailman/listinfo/ucclaw-l)


5. Gonzaga University’s new Commercial Law Center has a variety of links to useful sites and can be accessed at [https://www.law.gonzaga.edu/centers-programs/commercial-law/](https://www.law.gonzaga.edu/centers-programs/commercial-law/)

6. The International Association of Commercial Administrators (IACA) maintains links to state model administrative rules (MARS) and contact information for state level UCC administrators. This information can be accessed at [http://www.iaca.org](http://www.iaca.org)


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