

# What's Market: 2015 Year-End Trends in Large Cap and Middle Market Loan Terms

ERIC GOODISON OF PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

## AN EXPERT'S VIEW: MIDDLE MARKET LOANS

*Eric Goodison of Paul, Weiss, Rifkind, Wharton & Garrison LLP reviews developments in middle market loan deals:*

### **What were the key developments in loan documentation that occurred in middle market loan deals in 2015?**

We continue to see an expansion of the trends that have impacted middle market loan documentation since the end of the financial crisis. Middle market loan documentation continues to be affected by trends in both the broadly syndicated loan market and in the M&A market. Middle market lending is not a homogenous market and the trends in the broadly syndicated loan market and M&A market influenced large middle market deals (loans of between \$100 million and \$500 million) more than traditional middle market deals (loans of less than \$100 million).

In many respects, the documentation process for large middle market deals is comparable to broadly syndicated deals. Normally, borrower's counsel prepares the first draft of both the commitment papers and the loan documentation (based on an agreed-upon precedent identified by the borrower). Borrowers may also designate lender's counsel or, at least, consent to the lender's choice.

In the commitment stage for large middle market deals we see limited conditionality with as little daylight as possible between the borrower's obligation to close the acquisition and the lender's obligation to fund. In return for providing this level of certainty, lenders require certain protections from the borrower and the seller. These limited condition commitments are provided in return for the seller agreeing to include "Xerox" provisions in the purchase agreement.

Borrowers are not just using the commitment process to tighten conditionality. They are using it to smooth and facilitate the process for the definitive documentation. The commitment letter may spell out in detail the representations, covenants (including basket sizes and incurrence tests), and defaults. This specificity, when combined with a documentation precedent or a set of documentation principles, can result in a quicker and more reliable documentation process.

The documentation process for traditional middle market loans has not swung as far in the borrower's favor as it has for large middle market loans, although it is still impacted by these trends. Borrower's counsel may not produce the first drafts, but borrowers may still be able to specify a precedent. If borrowers cannot designate lender's counsel they can object to certain counsel or be consulted in the selection. We still see limited conditionality for traditional middle market loans with perhaps a bit more daylight, including possibly a maximum leverage condition.

### **With increasing pressure to close loan deals quickly, is the Know Your Customer (KYC) process (including the collection and dissemination of the required documentation) creating any issues in deals?**

The KYC process has become more involved and is not well coordinated. Accordingly, there does seem to be the potential for a deal to not timely close because a lender has not completed its KYC process, even though the closing conditions in the purchase agreement have been satisfied and the loan documentation has been completed. Every lender has its own requirements and the arranging banks are passing the information requests through to the borrower and its counsel. This increases the borrower's legal costs and results in duplicative requests. Some of the requests are for items that are delivered only at closing, such as certified charter documents or incumbency certificates.

Often the information requests seem to be very formulaic and lacking an understanding of the borrower's organizational or ownership structure, the relationship of the borrower to entities that are approved customers of the lenders, or the particular transaction. It also seems that the KYC team may not be speaking to, or coordinating with, the deal team at the lender.

The KYC process would benefit from both standardization and customization. It would be helpful if the requests were more uniform across the industry, as well as coordinated through the arranger or arrangers to make them relevant to the particular borrower and transaction, therefore avoiding unnecessary cost and duplication.

## Are there particular issues in middle market loan agreement negotiations that you think will garner increased attention in 2016?

Negotiations that could garner increased attention in 2016 will likely depend on regulatory developments and market conditions. The leveraged lending markets were in turmoil at the end of 2015. If this continues into 2016 and the sources of capital for middle market lending dry up, the remaining lenders may try to take away some borrower-friendly documentation terms.

If this happens, lenders are more likely to push on the terms of the debt, such as incremental debt, incurrence tests, covenant baskets, covenant-lite terms, and equity cures. Lenders are probably less likely to push on limited conditionality as this seems to have become a more fixed structure in the way transactions are done between leveraged buyers and sellers. Conversely, if the leveraged lending markets stabilize and the current conditions are temporary, borrowers will likely continue to push for greater flexibility in terms.

Regardless of market conditions, as lenders continue to face regulatory pressures (especially around anti-corruption and anti-money laundering laws, and in the case of European-based lenders, bail-in provisions), they may continue to beef up the representations and covenants they seek from borrowers. For some borrowers, especially smaller ones with less infrastructure, it may be difficult to take on greater obligations in this area.

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