

Converging Markets: Leveraged Syndicated Loans and High-Yield Bonds

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Banks gain increased capability to manage credit risk.

The leveraged syndicated loan market and high-yield bond market compete for borrowers seeking large non-investment-grade debt. As an active secondary market for leveraged syndicated loans has developed, these two asset classes have increasingly begun to compete among institutional investors seeking above-average returns.

Background

Both leveraged syndicated loans and high-yield bond offerings are significant sources of capital for public companies that lack the necessary credit ratings to issue investment-grade bonds or to obtain investment-grade syndicated financing, for companies seeking major capital for restructuring or other corporate purposes and for leveraged buyout (LBO) transactions. To institutional investors, including insurance companies, hedge funds, mutual funds and special-purpose securitization vehicles, leveraged syndicated loans and high-yield bonds are attractive due to the higher yields offered by these two asset classes.

Fundamental Differences

There are, of course, some fundamental differences between the two forms of debt. Leveraged syndicated loans primarily bear interest at a variable rate, usually based on a margin above Libor (London interbank offer rate) or another base rate, with changes in the interest rate at intervals selected by the borrower and varying from one to six months. Because they are variable-rate products, syndicated loans are almost always prepayable without premium. Bonds, in contrast, are fixed-rate instruments and do not

freely allow prepayment. Bonds may include a call provision giving the issuer a onetime right after a set period of time (often five years) to prepay and retire the bonds, usually at a premium above par. Leveraged syndicated loans typically have a short term to maturity of one to five years. High-yield bonds are usually medium-term instruments with maturities of five to 10 years. Interest on syndicated loans is typically paid monthly or quarterly. Interest on high-yield bonds is often paid semiannually or annually. Bonds are term obligations that are fully funded at the issuance of the bonds. Leveraged syndicated loans typically include revolving credit facilities as well as term loan facilities.

The most obvious difference between the two forms of debt is that high-yield bonds typically are unsecured subordinated debt while leveraged syndicated loans are senior secured debt. Leveraged syndicated loans are typically secured by a lien on all of the assets of the borrowing entity and a lien on all assets of the borrower's U.S. subsidiaries, or at least all material U.S. subsidiaries. The borrower in a leveraged syndicated transaction is commonly either the parent corporation or a holding company owned by the parent corporation. In either case, each of the domestic U.S. subsidiaries of the borrower, both direct first-tier subsidiaries and lower-tier subsidiaries, guarantee the loan to the borrower by

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so-called upstream guarantees that are then secured by the assets of each of the guarantor subsidiaries. For tax reasons, non-U.S. subsidiaries of a U.S. corporate borrower would usually not guarantee the loan or grant a lien on their assets to secure the loan. Under Section 956 of the Internal Revenue Code, if a non-U.S. subsidiary guarantees the debt of its U.S. parent or grants a lien on its assets to secure the indebtedness of its U.S. parent, a “deemed dividend” occurs for U.S. tax purposes, and the untaxed accumulated profits and earnings of the foreign subsidiary are “deemed” to have been distributed to the U.S. borrower as a dividend and are taxed under U.S. federal income tax laws as income of the parent. U.S. tax law does permit a U.S. borrower or domestic subsidiary to pledge two-thirds, or less, of the stock of a non-U.S. subsidiary as security for the debt of the U.S. borrower without having a “deemed dividend” occur.

Despite these differences, high-yield bonds (or what were once called “junk bonds”) are often described as the closest asset class to leveraged syndicated loans, and the similarities between the two types of debt have increased at an accelerating rate over the last decade. What are the common characteristics that have led these two forms of debt to increasingly compete in the marketplace for the attention of both borrowers and investors?

Leveraged Loans and Junk Bonds: What’s in a Name?

What makes a leveraged loan “leveraged” and a junk bond “junk”?

High-yield bonds and leveraged syndicated loans share the characteristic of being classified as below investment grade. The dividing line between investment-grade debt and below-investment-grade debt depends on who is doing the rating.

Credit rating agencies such as Standard & Poor’s, Moody’s Investors Service and Fitch provide independent credit ratings on the creditworthiness of most corporate bond issuers. Those credit ratings are divided generally into two categories:

investment grade and speculative. Because speculative-grade bonds are considered to have a higher default risk and a lower credit quality than those issued by higher-rated, investment-grade issuers, the issuers must typically offer a higher rate of return to attract investors and are therefore classified as high-yield bonds in addition to being below investment grade. The highest quality investment-grade bonds are rated as “Aaa” by Moody’s and as “AAA” by Standard & Poor’s. Any bond rated below “Baa” by Moody’s is classified as speculative or “below investment grade,” and any bond rated below “BBB” by Standard & Poor’s is classified as speculative.

The world of syndicated loans is similarly divided into two broad categories: investment grade (or nonleveraged loans) and leveraged loans. Leveraged loans involve a higher ratio of debt to equity

and are considered to be less creditworthy than investment-grade syndicated loans. Different banks, rating agencies and investors use different methods to distinguish between the two. Bloomberg, for example, defines leveraged loans as those with a spread over Libor of 250 basis points or more. Standard & Poor’s includes in the leveraged loan category all loans with a spread over Libor of 125 basis points or more. The Loan Pricing Corporation (LPC), on the other hand, uses credit ratings to define leveraged loans and includes in that category any loans with BB, BB/B and B or lower bank loan ratings.¹

The increasing availability of credit ratings for larger syndicated loan facilities has greatly facilitated the expansion of the secondary market for these loans, particularly among institutional investors, who may lack the extensive staff and in-house capability possessed by banks for analyzing particular credits. The major rating agencies (Moody’s, Fitch and Standard & Poor’s) now provide ratings on larger loan facilities for a fee. Standard & Poor’s, for example, provided ratings on the loans of more than 1,200 companies in 2002 with a total outstanding loan balance of \$900 billion. Standard & Poor’s bank loan and recovery ratings are loan specific and focus on the anticipated percentage of recovery of principal in the event of a default. The bank loan

High-yield bonds typically are unsecured subordinated debt.

ratings are intended to supplement the traditional corporate ratings offered by Standard & Poor's that, in contrast to the bank loan ratings, involve an assessment of the overall likelihood that a company will default on its financial obligations as a whole. The bank loan ratings process focuses on a specific loan and includes an analysis of the overall quality and scope of collateral (that is, a first lien on all assets compared to a lien on selected assets), loan-to-value ratios and strength of loan covenants. If the collateral and loan covenant package is sufficiently strong, the bank loan rating may be "notched up," meaning that the loan has been given a higher rating than the overall corporate credit rating for the issuer.

From Fallen Angels to Rising Stars

Both high-yield bonds and leveraged syndicated loans share a history of having begun their lives as somewhat marginal forms of debt used primarily in highly leveraged takeover transactions and to meet the needs of cash-desperate "fallen angels" (issuers whose financial problems caused them to slip below investment grade). Since then, both forms of debt have become mainstays of corporate finance.

During most of the 1980s debt was king, and highly leveraged transactions involving junk bonds as the subordinate, mezzanine piece of the financing transaction were common as a wave of corporate takeovers in the form of LBOs and corporate restructurings took place.

There was a tremendous increase in the late 1980s in both syndicated loans and high-yield bond offerings to meet the need for financing corporate LBOs. A typical LBO finance structure might involve up to 10 percent of equity capital and 50 percent to 60 percent in bank loans secured by the acquired corporation's assets. The remainder would then be financed by high-yield bonds. In the late 1980s, approximately one-third of all syndicated loans were used to finance leveraged corporate buyouts.²

At the end of 1989, approximately \$200 billion of high-yield debt was outstanding, representing 20 percent of all publicly traded corporate debt obligations. The collapse of Drexel Burnham, which was the primary originator of junk bonds in the 1980s, and an economic recession led to a sharp decline in high-yield debt offerings in the late 1980s and early 1990s. The savings and loan crisis and the subse-

quent federal bailout of that industry, which had invested heavily in junk bonds, also played a role in the decline of high-yield bond offerings. In 1989, the Office of the Comptroller of the Currency and other federal regulators stepped in and issued guidelines on "highly leveraged transactions" (HLTs) that placed limits on banks holding loans characterized as HLTs. These guidelines helped curb the growth of the LBO market.

In the late 1990s, another wave of merger and acquisition activities coupled with the "irrational exuberance" of the stock market led to an increased volume of both high-yield bonds and leveraged syndicated financings. The need for large amounts of capital by capital-intensive corporate borrowers, such as in the media and telecommunications sector, also contributed to this boom in the use of leveraged finance. Unlike the 1980s, however, many of the LBO transactions had higher levels of equity and therefore tended to have fewer financial problems than their predecessors in the late 1980s.³ Increased merger and acquisition activity has led to another jump in LBO syndicated leveraged financing in 2004 and this year.⁴

Still, the general trend has been toward an increase in the use of leveraged finance for general corporate purposes and a decrease in highly leveraged LBOs. Today, general corporate purposes account for approximately 70 percent of the total use of syndicated loan volume.⁵ Similarly, there has been an overall increase in the credit quality of most high-yield bonds since the speculative excesses of the 1980s. In 2000, for example, close to 90 percent of high-yield bonds were rated B or above.

As high-yield bonds and leveraged syndicated loans have moved to center stage and become mainstays of both corporate finance and investment portfolios, the volume of both has increased tremendously. According to the Bond Market Association, \$122.9 billion worth of new high-yield bonds were issued in the year 2003, which exceeded by more than nine times the volume of new-issue bonds in 1990. Similarly, overall leveraged lending reached a total level of \$329 billion in 2003 followed by an even more spectacular \$480 billion in 2004. Although refinancings contributed to a significant portion of this huge volume, net new issuance of leveraged syndicated credits still accounted for \$118 billion in 2003 and \$117 billion in 2004.⁶

Which Form of Debt Is Winning the Race in the Marketplace?

For an institutional investor, investments in syndicated loans are less volatile than the returns on bonds and are senior secured facilities, while bonds are unsecured subordinated loans. It has been argued by Goldman Sachs, among other observers, that when measured against other asset classes, syndicated loans provide higher returns for the same amount of risk.⁷ Moody's has found that default rates on loans are approximately 80 percent of the default rates on bonds for speculative-grade bonds and loans issued by a nonfinancial issuer that has issued both forms of debt.⁸ Moody's research also shows that cumulative loss rates over a three-year period were approximately 1.5 to 2 times as great for bonds compared to similarly rated loans in a sample composed of issuers with both bonds and loans outstanding.⁹ As a result, in part, of these attractive features for the institutional investor, the outstanding amount of leveraged syndicated loans grew from \$150 billion to \$900 billion between 1993 and 2001.¹⁰ For the same reasons, the number of institutional investors in this asset class has increased dramatically. In 1993, 40 percent of the leveraged loan market was owned by foreign banks. By 2001, the share of foreign banks fell below 20 percent and institutional investors had the largest share of the market.¹¹

The Primary Market

What Is the Primary Market in Leveraged Syndicated Loans and High-Yield Bonds?

A syndicated loan is a loan with more than one lender, and the primary market for a syndicated loan is the group or syndicate of other lenders that the lead bank or "agent" bank (which in some cases may be a task shared by more than one bank as co-agents) recruits to join the lead bank in making a credit facility available to a borrower.

Often, a syndicated loan begins with a borrower approaching one or more banks with a proposal for financing. In other cases, a bank may approach a potential borrower with a proposal. The potential

lead banks, which may or may not include a bank with which the borrower has a long-term banking relationship, negotiate with the borrower and compete with each other to win the "mandate" from the borrower to lead the syndication. A relatively small number of money-center banks dominate the lead bank position. For example, in 2004, JP Morgan, Bank of America, Citigroup and Wachovia together were the lead arrangers by dollar volume of over 70 percent of the total U.S. syndicated loan market.¹² However, many other banks, including regional banks, not only participate as members in syndicates but also act as the lead bank in arranging syndicated loan transactions.

As part of obtaining the mandate, the lead bank and the borrower will agree on the basic outline of the credit, including the interest rate, the size of the loan (which may be a range), significant loan covenants and fees. The fees payable to the lead bank may include a structuring and arrangement fee, an annual administrative fee and a percentage up-front fee that the lead bank may then share as needed to secure the commitments of other lenders and induce them to join as lenders under the syndicated facility.

In addition to establishing the basic terms of the credit facility (as set out in a term sheet agreed to by the lead bank and the borrower) and fees payable to the agent bank (as set out in a separate and confidential "fee letter"), a key negotiating point between the lead bank and the borrower in obtaining the mandate to lead the syndication is whether the syndication will be on a "best-efforts" basis or a "firm-commitment" basis.

With a best-efforts syndication, the lead bank typically will commit to provide a set portion of the needed loan facility and will then agree to use its "reasonable best efforts" to secure commitments from other lenders for the balance of the credit facility. If the loan facility cannot be successfully syndicated in accordance with the term sheet despite the best efforts of the lead bank, then the lead bank typically will reserve the right to cancel the proposed syndication or, after consultation with the borrower, change the pricing, facility size and/or other terms of the credit facility as determined by the lead bank to be necessary to ensure a successful syndication on different terms.

With a firm-commitment syndication (also known as an "underwritten" syndication), the lead bank

commits to fully funding the agreed-upon loan facility amount, whether or not it is successful in fully syndicating the loan.

The adoption by most of the major syndicating banks of so-called market-flex pricing in the past several years has been an important innovation in syndicated lending. With market-flex pricing, the borrower shares part of the loan-pricing risk with the lenders by permitting the lead bank to vary the interest-rate margin (that is, the spread over the base rate) by a certain amount as determined by "market conditions" at the time of closing.

For both best-efforts and firm-commitment syndications, the lead bank will manage the syndication effort and will typically make the decisions concerning the selection and number of institutions to approach and the proposed allocation of the overall loan commitments among the lenders willing to participate in the syndi-

cation. In consultation with the borrower, the lead bank will prepare a detailed information memorandum concerning the borrower, its business and the loan terms for distribution to potential lenders who might participate in the syndicate. When a lender agrees to participate in the syndicate, it will sign a commitment for the benefit of the lead bank agreeing to fund up to a specified portion of the loan.

The lead bank and its counsel are responsible for negotiating the credit agreement and ancillary loan documents for the credit facility and for obtaining all necessary due-diligence materials from the borrower, including financial statements of the borrower and its subsidiaries, organizational documents, schedules of assets and indebtedness, insurance certificates and copies of material contracts. The lead bank also engages or requires the borrower to engage third parties to provide property appraisals, engineering reports, environmental assessments, title commitments, Uniform Commercial Code (UCC) search reports and surveys. Before the closing of the credit facility, the members of the syndicate are given an opportunity to review and comment on the final credit facility documents. After the lead bank, the other lenders and the borrower approve the final loan documents and all closing conditions are met,

the borrower and all of the lenders execute the credit agreement and the lead bank executes any ancillary loan documents requiring the lenders' signatures as agent for itself and the other lenders. If required by the loan documentation or a particular lender, the borrower then executes a separate note payable to each lender in the syndicate in an amount equal to that lender's loan commitment.

For high-yield bonds, the primary market for the bonds are the investment bankers who ultimately will resell the bonds in either a registered or unregistered offering in the secondary bond market, often referred to as Rule 144A transactions. If the initial purchase by the investment bankers is a registered

underwritten public offering, the investment bankers would be referred to as the underwriters. In practice, however, these transactions are almost always structured as an unregistered sale by the issuer of the notes to the

investment bankers who are referred to as the "initial purchasers" of the notes.

Although the initial sale of the notes by the company to the initial purchasers typically is in the form of a private offering and does not require registration with the Securities and Exchange Commission (SEC), the practice, supported both by the demands of the marketplace and liability concerns on the part of both the issuer and the initial purchasers who will be reselling the notes, is for the issuer to prepare an offering memorandum that resembles, in all material respects, the statutory prospectus that would be required in a securities offering.

Under the Securities Act of 1933 ("1933 Act"), securities sold in a private placement where the securities have been transferred in a "transaction by an issuer not involving any public offering," such as high-yield debt securities sold in a Rule 144A transaction, are deemed restricted securities and can be transferred only on a limited basis (for example, to other qualified institutional buyers or accredited investors) unless the securities are subsequently registered under the 1933 Act. In addition, unless sold in the Rule 144A market to qualified institutional buyers, restricted securities must generally be held for at least one year before being resold, which limits their

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value as an investment. In order to convert these restricted securities into unrestricted securities, the common practice is to use a so-called A/B exchange pursuant to which restricted Series A Notes acquired from the initial purchasers are exchanged for Series B Notes that have been negotiated in accordance with a registration rights agreement entered into between the issuing company and the initial purchasers at the time the original restricted notes are issued to the initial purchasers.

If the issuer is not a public company that already has audited financial statements that satisfy SEC and generally accepted accounting principles (GAAP) requirements, a key part of the offering process for the issuer will be the preparation of audited financial statements. As a general rule, three years of audited financial statements are required. The offering statement presented to the initial purchasers will also include, among other things, a detailed description of the notes, a discussion of the company and its business, biographies of key executives (including their compensation and other relationships with the issuing company) and a detailed recital of risk factors related to the purchase of the notes.

The issuer and the investment bank will also negotiate an indenture, which is the bond equivalent of the credit agreement in a syndicated loan transaction. In addition to setting out the terms of the notes, the indenture will contain detailed covenants restricting the ability of the issuer and its subsidiaries to take certain actions. Typical covenants for indentures are discussed in more detail below.

Covenants

The structure and content of covenants in leveraged syndicated loan transactions are similar in many ways to the covenants in high-yield bond transactions. Some typical covenants that the two forms of debt share in common include the following: limits on indebtedness; liens; transactions with affiliates; restricted payments; the sale of assets, mergers and consolidations; and changes in ownership. In addition, most of these covenants in both types of transactions are applicable to the borrower/issuer and to the significant or "restricted" subsidiaries of the borrower/issuer. Often, in leveraged syndicated loans, the covenants may extend to all subsidiaries of the borrower/issuer. The main concern in setting

these covenants for both the lenders in a syndicated loan and the investment bankers in a bond transaction is to ensure that the borrower/issuer has sufficient funds to pay the debt, whether that comes from the borrower/issuer's business or the business operations of its subsidiaries through dividends or otherwise, and that concern is the main impetus for the covenants and how they are negotiated. This emphasis on the borrower/issuer's ability to repay its debt is important both for investors' ability to be paid in due course and to keep the value of the asset as it is traded in the secondary markets.

Covenants in both leveraged syndicated loans and high-yield bonds include a covenant limiting the incurrence of indebtedness. In both cases, there are many carve-outs and exceptions, which are called permitted debt. Permitted debt usually includes existing indebtedness and new indebtedness that refinances the existing indebtedness, indebtedness related to the transaction documents (including guarantees) and a variety of other types of indebtedness central to the borrower/issuer's business and to the underlying loan or bond documents. Indebtedness covenants in both types of transactions usually include a category of permitted debt in the form of a specific dollar amount as a catchall or "basket" for any other indebtedness that does not fall into one of the other categories of permitted debt. In leveraged syndicated loans, any indebtedness other than permitted debt is typically not allowed, but often in high-yield bond transactions indebtedness outside of the permitted debt may be allowed if the issuer meets certain financial ratios, usually a debt-to-earnings ratio (leverage ratio) or an earnings-to-fixed-charges ratio (fixed-charge coverage ratio).

Documentation for both leveraged syndicated loans and high-yield bonds usually includes a covenant restricting liens on the borrower's/issuer's assets. Both types of transactions will include carve-outs or "permitted liens" for existing liens at the time of the transaction, purchase money liens, liens for taxes and assessments and liens for the refinancing of other permitted liens. An unsecured high-yield bond transaction may commonly include more permitted liens than a secured, leveraged syndicated loan transaction.

Both leveraged syndicated loans and high-yield bonds will also include covenants restricting divi-

dend payments. Generally, all such payments are restricted unless no default would be caused by the making of dividend payments, and such payments are either by a subsidiary to the borrower/issuer or are in an aggregate amount less than some particular financial trigger. The financial trigger is often tied to the consolidated net income of the borrower/issuer. However, in some instances, leveraged syndicated loans may be more restrictive than high-yield bond offerings by including an overall cap on the dividends that may be made during the existence of the credit facility.

Covenants that provide limitations on transactions with affiliates and on the sale of assets by the borrower/issuer and its subsidiaries or certain significant subsidiaries are included in both leveraged syndicated loan and high-yield bond documentation. Both leveraged syndicated loans and high-yield bonds will require that transactions with an affiliate be on an arm's-length basis for fair market value. High-yield bond deals often go further in requiring that if there are transactions with affiliates, depending upon the size of such transactions, the parties must provide evidence of board approval and fairness opinions. Covenants restricting asset sales also require that such sales be for fair market value. Covenants in a high-yield transaction addressing sales of assets often permit such sales if the proceeds of such sale are primarily given in cash and are used to purchase new assets or to repay specified outstanding debt. On the other hand, covenants in leveraged syndicated loan transactions are often more stringent in that the bulk of permitted asset sales are limited to sales in the ordinary course of business and to sales of equipment or real estate where the sales proceeds are used to buy replacement equipment or real estate.

Financial covenants are generally found in leveraged syndicated loan transactions but not in high-yield bond deals. Whereas bond deals may weave in financial aspects such as limiting dividends or allowing indebtedness based on financial triggers, such financial aspects are implicated when some additional action has been taken by the issuer (for example, the issuer has paid dividends). Leveraged syndicated loans have explicit requirements that net worth, earnings, leverage ratios, fixed-charge coverage ratios and/or other similar financial requirements and ratios must be maintained. If the

financial requirements set out in the covenants are not met, there may be a default under the leveraged syndicated loan.

In addition, financial covenants often play a part in pricing for leveraged syndicated loans. While high-yield bond deals have fixed rates, leveraged syndicated loans have a floating rate that is commonly adjusted for a fiscal period if certain financial covenant calculation results change (alternately, the pricing may be adjusted based on the debt rating of the borrower). It is particularly common for the applicable interest rate in a leveraged syndicated loan to change based on the leverage ratio of the borrower.

As discussed, the covenants in leveraged syndicated loan and high-yield bond transactions are often very similar. To the extent that they differ, such differences may often be caused by the fact that the lenders under the loan transaction have a secured interest and therefore have an expectation of being paid first in the case of an event of a default, while the unsecured investors in a bond transaction have concerns as to which debt may be paid prior to their interests and to ensure that there are not too many liens by third parties having priority over their unsecured interests. Covenants in both loan and bond deals may be amended, but because of the structure of a loan and particularly if the lenders still have obligations to fund a revolving loan, it is often easier to amend a covenant in a loan than in a bond transaction where it may be more difficult to obtain the necessary number of investors' approvals for an amendment. In addition, the term of a syndicated loan is typically shorter than the term of a bond. Thus, if a covenant is exceptionally restrictive, at the end of the term of the loan, a different covenant may be negotiated in a new loan, whereas the bond covenants may continue through the life of multiple loans and multiple sets of loan covenants.

The Secondary Market

How Does the Secondary Market Differ from the Primary Market?

While there has always been a secondary market for high-yield bonds, the big story with syndicated credits, and leveraged syndicated credits in par-

ticular, has been the development of a secondary market for syndicated loans and the rapid expansion of that market.

The volume of trading of syndicated loans in the secondary market increased from \$8 billion in 1991 to \$110 billion in 2001. In 1991, most of the trading involved distressed loans. By 2001, most of the loans being traded were priced at par.¹³ Most of that growth in the secondary market has involved leveraged loans. For example, between 2001 and 2003, more than 80 percent of the secondary market involved trades of leveraged loans.¹⁴

To develop an active market in any product (including loans), information about the product and the other products it competes with needs to be available to potential purchasers. In the earlier stages of syndicated lending, the lenders in the syndicate typically held their respective loans until maturity. Except for mandatory disclosures of “material contracts” and the components of liquidity by public companies in SEC filings, very little information about the terms of a particular loan were available to anyone beyond the original parties to the loan transaction. These early syndicated loans, like bilateral loans, were illiquid assets, and information on key provisions such as interest rates, covenants and pricing was not generally available to potential purchasers, particularly to purchasers outside the banking community. In addition, institutional investors (other than banks) often lacked the credit departments and other personnel needed to evaluate the creditworthiness of particular nonpublic borrowers or to determine the strengths or weaknesses of particular credit transactions (for example, the sufficiency of the collateral package and the covenant structure). In short, these earlier forms of syndicated lending were primarily “relationship” loans based on the lead lender’s deep knowledge of and relationship with a particular borrower.

During the 1990s, and particularly during the last 10 years, an active secondary market has developed for syndicated leveraged loans. This development has been prompted by a number of factors, including the entry into the market of institutional investors

identifying syndicated leveraged loans as an asset class with higher returns, the availability of key information concerning these loans to investors, the development of a network of trading desks for these credits, the availability of credit ratings from national rating agencies, the implementation of standard methods for pricing loans and the growth of standard trading practices and arrangements, encouraged by the Loan Syndications and Trading Association (LSTA) and investors in the secondary market.

Credit agreements for syndicated loans now fully anticipate that interests in the loans will be traded in the secondary market and contain detailed provisions concerning the transfer of interests in the loan

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by assignment or participation. With respect to a transfer by assignment, an existing lender in the syndicate transfers all or part of its interest in the loan to a new lender who becomes a direct lender to the borrower. The new lender assumes the obli-

gations to the borrower for the portion of the loan commitment that it acquires and becomes a party to the loan agreement. The assignee obtains a note (if required by the loan documents) from the borrower for the portion of the loan it has purchased and is the beneficiary, like the original lenders in the syndicate, of the representations, warranties and covenants made by the borrower and any guarantors. Before the occurrence of an event of default, the consent of the borrower is typically needed for an assignment of an interest in the loan.

With the sale of a participation interest, on the other hand, the participant who purchases all or part of an existing lender’s interest in the loan does not become a lender under the loan agreement and has no contractual or other legal obligations to the borrower. The participant also acquires no direct rights against the borrower for payment or otherwise. The participant’s rights and obligations with respect to the loan run solely between the participant and the lender who sold the participation right. Pursuant to a participation agreement, the participant agrees to fund its agreed percentage share of any advance required to be made by the lender from which it acquired the participation and in exchange receives

from that lender (and not from the borrower) its share of loan repayments, including its share of the proceeds of any foreclosure.

As discussed earlier, both the original syndicate members in a leveraged loan and the investment bankers reselling the notes in a high-yield debt offering rely on Rule 144A, which the SEC adopted in 1990 to permit the resale of securities that have been issued in a private offering to certain qualified institutional buyers (QIBs) without the need for a registration. QIBs include insurance companies; registered investment companies; employee benefit plans; certain dealers; investment advisors registered under the Investment Advisors Act of 1940, as amended; and certain other institutional investors, provided that each of such purchasers, acting for its own account or the accounts of other QIBs, owns and invests in the aggregate on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with the entity.

The LSTA's and LPC's Contribution to the Secondary Market in Syndicated Loans

The availability to investors of key financial information has greatly influenced the growth of the secondary market for syndicated leveraged loans. The LPC and the LSTA have been primary contributors to this availability of information and facilitating this secondary market. The LPC collects and organizes data on the syndicated loan market through the DealScan database and GoldSheets publication. For example, DealScan provides to a user quick search abilities based on dates, deal size, agents, pricing, security, industry, purpose for transaction and a multitude of other factors as well as, in many instances, copies of the related loan documents. This information is helpful to investors in both the primary and secondary markets.

The LSTA has been a major contributor in the growth of the secondary market and continues today its original goal when it was formed as a trade association in 1995 to develop standard settlement and operational procedures, market practices and other mechanisms to more efficiently trade the increasing volume of par and distressed bank debt (*www.lsta.org*). The LSTA publishes policies, practices and

instructions for trades in the secondary syndicated loan market. Additionally, the LSTA publishes forms of agreements for par and distressed trades and for participations. The standardization makes easier the process of completing trades for the various parties. As both banks and institutional investors become familiar with the practices and forms published by the LSTA, the associated research and related costs can be reduced for subsequent transactions, thereby further encouraging syndicated loans as a traded asset class. As this standardization occurs, its effect has spilled over into the primary market. The LSTA also publishes model credit agreement provisions and a form of assignment agreement that are often integrated into the documentation of the loan in the primary market. Both the LPC and the LSTA continue to expand their products and make available information in ways that benefit the market participants in syndicated loan transactions.

What Exactly Is a CUSIP?

In 2004 the LSTA, together with Standard & Poor's, introduced CUSIP (Committee on Uniform Securities Identification Procedures) numbers to the syndicated loan market. These individual identifying numbers for syndicated loan transactions are assigned upon application to each syndicated loan transaction. CUSIP numbers are touted as aiding the syndicated loan market by providing the following:¹⁵

- The precise exchange of information for draw-downs, repayments and fundings
- Improved reconciliation for inquiries and investigations
- Improved communication of information to the national banking regulators for Shared National Credit reviews
- Ease in using Internet-based trading and settlement platforms to exchange trade information and documents
- Increased efficiencies and improved settlement times for secondary assignments of loans
- Improved communication between front/middle/back office and counterparties regarding traded assets
- Enhanced reporting capabilities related to the settlement process
- Updated mark-to-market valuation information and, ultimately, automated feed of that information

■ Assistance in providing automated feeds for updating ratings assigned by credit-rating agencies

The CUSIP numbers are designed to apply separately to various credit facilities and loan tranches (for example, one CUSIP number will apply to the loan transaction or “deal” and separate numbers will apply to any revolver, tranche (for example, Tranche A, Tranche B, *etc.*) or facility that is part of the loan transaction). Syndicated loan CUSIP numbers may be listed or unlisted. The availability of unpublished CUSIP numbers is particularly important in the syndicated loan market where much of the information provided to lenders by privately owned borrowers is not public information.

Conclusion

The increase over the last 10 to 15 years in both the primary and secondary markets for syndicated leveraged loans has benefited banks, investors and borrowers. It has allowed larger banks to increase their market share as the lead arrangers of syndicated debt through their expertise in originating and servicing secured loans and their expertise in particular industry sectors. For a smaller bank participating in a syndication, the syndicate structure allows the bank to diversify its portfolio in certain geographic regions or industry sectors. For institutional investors, the development of leveraged syndicated loans as a new asset class provides investors seeking higher returns with an alternative to high-yield bonds and other unsecured debt instruments. Finally, for corporate borrowers, the availability of leveraged syndicated

facilities provides a flexible financing option with some of the best features of both the traditional bilateral loan and the public bond market.

Endnotes

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- ¹² LPC League Tables.
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- ¹⁴ Yago, *supra* note 1.
- ¹⁵ *The LSTA and Standard & Poor's Expand CUSIP Numbers to Syndicated Loans*, PRNEWswire (Jan. 6, 2004).

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