

IN THE KNOW

Leveraged Finance Newsletter

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NOT JUST A MATTER OF INTERPRETATION: BEWARE WHAT IS LURKING IN THE "BOILER-PLATE"

The construction provisions contained within the interpretation section of a facilities agreement have traditionally been viewed as "boiler-plate"; those provisions in the document that are necessary for it to work mechanically, but which do not tend to be heavily negotiated. However, a trend has begun to emerge whereby the construction sections seen in leveraged facilities agreements incorporate provisions that go beyond clarifying the construction of commonly used terms and include material adjustments to the substantive provisions of those agreements.

In this edition of In the Know, we look at two ways in which the scope of the construction provisions in leveraged facilities agreements is being broadened; **firstly**, through attempts to embed bespoke definitions of certain commercial terms and, **secondly**, through including substantive commercial provisions. Given the potential ramifications of this trend for both borrowers and lenders, it is important that all parties to facilities agreements are aware of the broadening scope of the construction provisions and its potential impact on the operative provisions of these agreements.

Traditional Position

Historically, the role of the interpretation section in facilities agreements was relatively limited. The definitions and construction provisions contained in this section were used to define the key terms used in the agreement, and to ascribe a particular meaning to a narrow class of commonly used generic terms (for example, terms such as "persons" and "assets"). Although the list of generic terms included within construction provisions has now expanded somewhat, the LMA's current form of senior/mezz leveraged facilities agreement largely continues to reflect this limited scope. However, when you move beyond the LMA's template facilities agreement into the more tailored sponsor precedent facilities agreements that form the basis of most sponsor-backed financings within the European leveraged loan market, it becomes apparent that the construction provisions are now being used for more than purely definitional or constructive purposes.

The Codification of Common Law Concepts

The first way in which the construction provisions in facilities agreements are beginning to have more of an operative effect is through embedding certain bespoke definitions of terms that would otherwise carry a different meaning under common law. The purpose of the construction provisions (which appear immediately after the defined terms in the interpretation section in the facilities agreement) has historically been to attribute a commonly accepted meaning to a generic term in order to avoid ambiguity, which potentially could lead to litigation or make the facility overly cumbersome for the day-to-day running of the underlying business. To the extent terms are used but not defined within the agreement, the default position would be to revert back to market practice and potentially common law. For example, terms such as "person" are commonly attributed a particular meaning within the construction clause to avoid any potential argument between parties as to what



that term is intended to capture. However, recent examples of facilities agreements within the European leveraged loan market are demonstrating a trend towards defining terms of art that would otherwise have an unambiguous or commonly understood meaning at common law in such a way as to modify that existing interpretation. By defining certain terms which would otherwise not be defined, this effectively crystallises definitions which would, if undefined, fall back to accepted common law concepts developed by case law, could be interpreted or understood differently and which could potentially change over time (as relevant new case law could affect such interpretations).

One example of such an attempt is the trend in some leveraged facilities agreements of defining the term "arm's length terms". In some recent deals, the construction provisions include a definition of "arm's length terms" that incorporates a safe harbour by deeming any transaction which was approved by a majority of disinterested directors (being directors who did not have any personal financial interest in a transaction) to have been conducted on arm's length terms. This is a departure from traditional common law and statutory conceptions of an arm's length term, which focus on the terms being

consistent with those of a transaction carried out between independent parties. Viewed in this light, attempts to codify a definition of "arm's length terms" in this way have the potential to impact lenders by permitting value leakage from a group through transactions that are conducted on what might not normally be considered arm's length terms.

The Inclusion of Substantive Commercial Provisions

The second way in which the construction provisions are starting to have more of an operative effect is through the inclusion of substantive commercial provisions amongst existing, more commonly accepted, construction provisions. Some common examples of this trend are the inclusion of covenant cure language, EBITDA add-backs/synergies and basket adjustments (all terms that would traditionally have been included within the financial covenants, calculation adjustments provisions or "permitted" definitions, respectively) within the construction provisions.

The ever-expanding scope of EBITDA add-backs/synergies has been a much commented-on feature of the European leveraged loan market for some time.

These provisions are usually negotiated in the context of the financial covenants, and for that reason are generally located in the financial definitions or calculation adjustments provisions or, where New York law high yield covenants are scheduled to the facility agreement, in those covenants and the related definition section. However, some recent leveraged facilities agreements have incorporated qualifications to the EBITDA add-back provisions (including hard caps and sunset periods for potential EBITDA synergies and add-back items) within the construction provisions.

The manner in which these qualifications are drafted may affect a borrower's ability to comply with its financial covenants, and it is important that both borrowers and lenders are aware of their scope in order to ensure that they do not (inadvertently or otherwise) cut across the operative covenant provisions that have been negotiated within the financial covenant section itself. Additional care should be taken in the context of the convergence of the high yield bond and the leveraged loan markets, for example in credit agreements where New York law governed high yield incurrence-based covenants are scheduled in the back (and may include another set of definitions), as those



provisions will need to be considered in conjunction with the construction provisions and the operative provisions of the credit agreement.

In a similar vein, the inclusion of EBITDA grower language in the construction provisions for the purposes of inflating EBITDA-based basket permissions is another increasingly common feature of leveraged facilities agreements. The construction provisions of a number of facilities agreements within the European leveraged market in recent years have contained wording that provides "upside only" benefits to a borrower in circumstances where certain covenants

within the facilities agreement include a soft capped EBITDA grower basket. Again, it is important that all parties are aware of the commercial effect that these clauses can have upon the operation of the covenant package, and that this is consistent with the commercial agreement reached with respect to those covenants.

Conclusion

The increasing trend in recent years of facilities agreements including construction provisions that go far beyond purely mechanical interpretation to incorporating what are substantially commercial provisions is an interesting phenomenon

for both lenders and borrowers. Whether through impacting the scope of covenants by adopting a specified definition of a term that would otherwise carry a potentially different meaning at common law, or by altering the operation of a cure or basket permission, the expanded construction provisions that we are seeing in the European leveraged loan market are something that all parties should be aware of when negotiating facilities agreements to ensure that the operative provisions of an agreement that have been at the heart of negotiations are not eroded by what would otherwise be considered "boiler-plate".



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