KEY POINTS

- The disposals covenant on European leveraged financings has become increasingly permissive for borrowers as traditional LMA-style restrictions are being replaced with more flexible commercial terms.
- There is, however, no consensus approach to the structure and scope of the disposals covenant with a complex web of approaches seen in practice.
- A simplified distinction may be made between an LMA-style disposals covenant *versus* a high yield bond-style disposals covenant – but in practice, key features of both structures may be mixed up in a "hybrid" approach.

Feature

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The changing nature of the disposals covenant on European leveraged financings: should you go LMA-style, high yield bond-style or mix it up?

In this article, the author considers the changing nature of the disposals covenant on European leveraged financings in recent years. Different approaches to the structure and legal drafting are discussed in the context of a simplified distinction between an LMA-style disposals covenant and a high yield bond-style disposals covenant.

European leveraged facilities agreements typically impose restrictions on the borrowing group's ability to dispose of assets during the life of the senior facilities (disposals covenant). In broad terms, the purpose is to protect the lenders against substantial changes to the assets of the borrowing group which may negatively affect the credit.

In the LMA standard form of facilities agreement for leveraged acquisition finance transactions (LMA Agreement), the disposals covenant is structured as a broad prohibition on any disposal of any asset by any member of the borrowing group, subject to specified exemptions. These are principally set out in the definition of "Permitted Disposals" which includes both specific permissions and a general basket for disposals not otherwise permitted. In the LMA Agreement, the general basket is proposed to be set by reference to a fixed maximum amount for all disposals in each financial year (annual cap) and over the life of the senior facilities (life-of-debt cap).

In recent years, the structure of the disposals covenant on European leveraged financings has been subject to change. Although a broad spectrum of approaches are applied, there appears to be a common trend: the disposals covenant has become increasingly permissive for borrowers. Relatedly, the requirement for a mandatory prepayment of the senior facilities with disposals proceeds has become weaker.

On some transactions, particularly larger sponsor-backed term loan B deals, the LMA-style disposals covenant has been dropped entirely in favour of a more flexible covenant akin to the one typically found in a European high yield bond. The high yield bond-style disposals covenant may be incorporated into the facilities agreement or, alternatively, set out in a separate schedule which may be construed in accordance with New York law notwithstanding that the facilities agreement is otherwise governed by English law. On other transactions, the traditional LMA structure has been retained, but amended so as to increase the flexibility for borrowers. These "hybrid" approaches vary from transactions that make only few changes to the LMA-style disposals covenant to transactions that practically build in wholesale the flexibility typically found in a high yield bond.

Table 1 over the page compares and contrasts some simplified key features of an LMA-style disposals covenant versus a high yield bond-style disposals covenant.

REGULATED TRANSACTIONS

As a starting point, an LMA-style disposals covenant prohibits any disposal of any asset by any member of the borrowing group. One then needs to look at the specific and general disposal permissions in order to confirm whether any given disposal is permitted under the covenant.

By contrast, a high yield bond-style disposals covenant only applies to transactions that constitute "Asset Dispositions". These are broadly defined as any disposal of any asset by any member of the borrowing group,[1] *provided that* certain items are *deemed* not to be "Asset Dispositions", meaning that they fall outside the scope of the covenant.

The list of excluded items in the definition of "Asset Disposition" is similar to, and effectively has embedded within it, the specific disposal permissions listed in the definition of "Permitted Disposal" in an LMA-style disposals covenant. However, the excluded items are often broader, thereby providing the borrowing group with greater flexibility to dispose of assets as discussed below.

"SPECIFIC" DISPOSAL PERMISSIONS

For these purposes, "specific" disposal permissions relate to disposals:

- of specified types of assets;
- between specified parties; and/or
- for specified purposes.[2]

The scope of the specific disposal permissions will need to be considered on a

TABLE 1: DISPOSALS COVENANT

LMA-style		Key features		High yield bond-style
Any disposal of any asset	←	*Regulated transactions*	→	Limited to "Asset Dispositions" as defined
Principally set out in the definition of "Permitted Disposals"	←	*"Specific" disposal permissions*	→	Set out (indirectly) in the definition of "Asset Disposition", whereby certain items are *deemed* not to be "Asset Dispositions"
Basket set by reference to: ➨ Annual cap; and ➨ Life-of-debt cap	←	*"General" disposal permission*	→	Uncapped so long as: ➨ the disposal is for fair market value; ➨ at least 75% of the consideration is in the form of cash or cash equivalent investments; and ➨ the net proceeds are applied for specified permitted purposes within specified time periods or, failing this, offered in mandatory prepayment of the senior facilities (asset disposition offer)
Separate from the disposals covenant itself. Any required prepayment results in a permanent reduction of the senior facilities/ cancellation of the commitments	←	*Structure of mandatory prepayment requirement*	→	Embedded within the disposals covenant itself. Any required prepayment is made by way of an asset disposition offer that lenders are free to accept or reject
Applies to the net proceeds of any disposal, other than any "Excluded Disposal Proceeds" to be agreed	←	*Scope of mandatory prepayment requirement*	→	Applies only to any "excess proceeds" (ie net proceeds from an "Asset Disposition" that have not been applied for specified permitted purposes within specified time periods), subject to a specified *de minimis* threshold and, in some cases, further subject to a leverage test

transaction-specific basis having regard to the business and commercial requirements of the borrowing group. However, there is a "core set" of specific permissions, which are included on most transactions. In recent years, the specific permissions have further been expanded, both in total number and in terms of the scope of individual permissions. This trend seems particularly clear on transactions that incorporate a high yield bond-style disposals covenant.

By way of example, it is standard to permit disposals between members of the borrowing group. In the LMA Agreement, this permission is subject to further restrictions designed to ensure that the credit support granted to the lenders remains intact. Accordingly, the permission does not extend to, among others, disposals from obligors to members of the borrowing group that are not obligors under the facilities agreement. As an intermediate solution, there may also be a cap on any disposals from obligors to non-obligors. This cap may be set on a standalone basis or aggregated with any similar "obligor-to-non-obligor" baskets for other covenants that include specific permissions for intra-group transactions.

By contrast, a high yield bond-style disposals covenant will typically permit any disposal between members of the borrowing group, whether or not they are obligors.[3]

Another illustrative example is the *de minimis* permission usually included in a high yield bond-style disposals covenant. This excludes from the definition of "Asset Disposition" any single transaction (or series of related transactions) that involves assets with a fair market value below a specified threshold. In contrast to the other specific permissions, there are no requirements as to the type of assets, the parties involved or the purpose of the disposal – it is a "general" permission within the specific permissions. To further increase the flexibility for borrowers, the *de minimis* threshold may also include a "grower" component so as to refer to the greater of (x) a fixed amount and (y) a specified percentage of the borrowing group's total assets or EBITDA (grower basket).

"GENERAL" DISPOSAL PERMISSION

The specific permissions are supplemented by a "general" disposal permission that the borrower may rely on for the purposes of any disposal not otherwise permitted under the specific permissions.

The scope of the general permission can vary greatly. At the one end of the spectrum, it may take the form of a small fixed basket, which is mainly intended as a "sweep-up" to cover minor disposals not envisaged within the specific permissions. At the other end of the spectrum, the general permission may permit the borrowing group to dispose of assets for an unlimited amount, subject only to conditions relating to the form and use of the disposal proceeds.

Table 2 over the page provides a simplified overview of different types of general disposal permissions used in practice.

Cap-based permission

As noted, the LMA Agreement envisages a cap-based permission for general disposals by reference to both an annual cap and a life-of-debt cap.

TABLE 2: GENERAL DISPOSAL PERMISSION

General disposal permission	Key features
Cap-based permission	Permission to dispose of assets up to an annual cap and/or a life-of-debt-cap
	Annual cap may be fixed or a grower basket
	Annual cap may be subject to increase by "carry-forward" and/or "carry-back" permissions
Leverage-based incurrence test	Permission to dispose of assets subject to compliance with a leverage test on a *pro forma* basis
	"Event of Default"-blocker and other conditions may apply, including requirements for the disposal to be on arms' length terms, for fair market value and/or substantially for cash consideration
Uncapped proceeds-based permission	Uncapped permission to dispose of assets so long as: ■ the disposal is for fair market value; ■ at least 75% of the consideration is in the form of cash or cash equivalent investments; and ■ the net proceeds are applied for specified permitted purposes within specified time periods or, failing this, offered in mandatory prepayment of the senior facilities (asset disposition offer)
	Obligation to make an asset disposition offer only applies if there are any "excess proceeds" above a specified *de minimis* threshold, which may be fixed or a grower basket
	Obligation to make an asset disposition offer may further be subject to a leverage test

In practice, the annual cap will often take the form of a grower basket to increase the flexibility for borrowers. The annual cap may also be subject to increase by an option for the borrower to "carry-forward" unused amounts from prior financial years and/or "carry-back" amounts from future financial years, in whole or in part. Absent such flexibility, the annual cap will effectively constitute a hard cap on any single disposal by the borrowing group.

Leveraged-based incurrence test

A leveraged-based incurrence test permits general disposals for an unlimited amount, subject to compliance with a leverage test.

The leverage test is often based on the borrowing group's total net leverage or senior secured net leverage and calculated after giving *pro forma* effect to the disposal in question, including *pro forma* application of the proceeds therefrom. In terms of timing, the test may apply as of the date the borrower legally commits to the disposal rather than the closing date. This approach may be preferable from the borrower's perspective to avoid any risk of changes to leverage in the period between signing and closing which could potentially cause a breach of the disposals covenant.

The leverage-based incurrence test may be coupled with an "Event of Default"-blocker. There may also be conditions relating to the disposal proceeds similar to those discussed below, including requirements for the disposal to be on arms' length terms, for fair market value and/or substantially for cash consideration.

Uncapped proceeds-based permission

A high yield bond-style disposals covenant permits general disposals for an uncapped amount,[4] subject only to the following conditions as to the form and application of proceeds therefrom:

- the disposal must be for fair market value;
- at least 75% of the consideration must consist of cash or cash equivalent investments; and
- the net proceeds must be applied for specified permitted purposes within specified time periods or, failing this, offered to the lenders in mandatory prepayment of the senior facilities (asset disposition offer).

Fair market value

It is usually for the borrower to confirm whether the disposal is for fair market value, *provided that* the borrower must make such determination "acting reasonably" or "in good faith". Independent third-party verification is not required.

Cash consideration

For purposes of the 75% cash consideration requirement, a number of items are typically deemed to be "cash". Among others, this may include third-party debt assumed by the transferee for which a member of the borrowing group is being released and shares or securities received from the transferee which are converted into cash or cash equivalent investments within a short time period, typically 90-180 days.

In addition, a specified amount of non-cash consideration may count towards the 75% cash consideration requirement by virtue of the concept of "Designated Non-Cash Consideration". This permits the borrower to designate the fair market value of any non-cash consideration received as Designated Non-Cash Consideration, subject to a basket for the aggregate fair market value of all such Designated Non-Cash Consideration at any time outstanding. The basket may be a grower basket.

Application of proceeds

The borrower typically has the option to apply the net proceeds for one or more specified permitted purposes within specified time periods (optional applications). Failing this, the borrower must mandatorily prepay, or rather offer to prepay, the senior facilities in an asset disposition offer.

The optional applications usually include permission for the borrower to apply the net proceeds for the purposes of re-investment in replacement or additional assets and/or for capital expenditure. The re-investment period is generally 12 months (sometimes 450 days) and may be subject to an extension of up to six months where a binding commitment to make such re-investment has been entered into within such 12-month period.

The optional applications may also allow the borrower to "voluntarily" prepay the senior facilities and other third-party indebtedness.[5] The scope of any such prepayment permission varies and should be considered on a transaction-specific basis, including any appropriate restrictions as to:

- the type of indebtedness, which may be prepaid;
- any requirement for a *pro rata* prepayment of the senior facilities;
- the price of the prepayment;
- whether there needs to be a permanent reduction of indebtedness (including, in the case of revolving credit indebtedness, cancellation of the corresponding commitments); and/or
- whether an offer made to the relevant creditors providing them with an option to be prepaid is sufficient to satisfy the requirements.

Any amount of net proceeds not applied in accordance with the optional applications within a specified time period of generally 12 months (sometimes 450 days) will constitute "excess proceeds". If the amount of such "excess proceeds" exceeds a specified *de minimis* threshold, the borrower will be required to make an offer to prepay the senior facilities out of the "excess proceeds". The borrower may further have the option to extend this asset disposition offer to other indebtedness ranking *pari passu* with the senior facilities on a *pro rata* basis.

To further increase the flexibility for borrowers, the obligation to make an asset disposition offer may be subject to a leverage test similar to the one discussed above. The leverage test may also take the form of a "ratchet" whereby the percentage of "excess proceeds" to be applied in mandatory prepayment of the senior facilities will decrease from 100% at the highest levels of leverage with step-downs to, eg 50% and 0% as and when leverage falls below certain specified thresholds. On some transactions, a leverage test has also been incorporated into the optional applications, eg to permit the borrower to prepay subordinated debt and/or pay out dividends, subject to compliance with a specified leverage test on a *pro forma* basis.

> The optional applications may also allow the borrower to "voluntarily" prepay the senior facilities and other third-party indebtedness.

Any "excess proceeds" not required to be used in mandatory prepayment of the senior facilities may usually be retained by the borrower for application in any manner not otherwise prohibited under the facilities agreement. This is so whether such surplus arises by virtue of a *de minimis* threshold or a leverage test or because one or more lenders have declined prepayment pursuant to an asset disposition offer.

MANDATORY PREPAYMENT REQUIREMENT

In addition to the disposals covenant, the LMA Agreement requires the borrower to apply the net proceeds of any disposal in mandatory prepayment of the senior facilities. This prepayment requirement is subject to a carve-out for any "Excluded Disposal Proceeds" to be agreed.

The "Excluded Disposal Proceeds" may permit the borrower to retain proceeds, which are below a specified *de minimis* amount (either per disposal or an annual basket) or otherwise re-invested in the business within a specified period of time. The scope of the "Excluded Disposal Proceeds" may also tie in with the definition of "Permitted Disposals" by excluding from the prepayment requirement any proceeds of disposals falling within one or more specific disposal permissions. Nevertheless, in the LMA Agreement the mandatory prepayment requirement remains separate from the disposals covenant itself: it needs to be considered *first* whether the disposal is permitted under the covenant and *second* whether the net proceeds of any disposal so permitted must be applied in mandatory prepayment of the senior facilities.

By contrast, a high yield bond-style disposals covenant has a mandatory prepayment requirement embedded within it, although this will only kick in subject to a number of tests as discussed above. Accordingly, the borrower may have ample flexibility under a high yield bond-style disposals covenant to avoid a prepayment of the senior facilities if the borrower so desires.

In some circumstances, the borrower may actually wish to apply the net proceeds of a disposal in prepayment of the senior facilities. As the prepayment requirement is structured as an *offer*, each lender will be free to reject prepayment, for example, where the debt is trading above par or where the lender has no attractive alternative investment option. Nevertheless, the borrower may "force" lenders to be prepaid by way of a voluntary prepayment, which is typically permitted at any time. The borrower may be able to make such voluntary prepayment at no additional cost even during any period of time when the lenders benefit from call protection to the extent this takes the form of a "soft call".

Another point to note is that any obligation to make an asset disposition offer will only arise following a reasonably long period of time (noting that the borrower may be entitled to make the offer earlier if desirable). In the interim period pending final application of the proceeds, the borrower will typically be permitted to invest the proceeds as the borrower sees fit and with no requirement for the proceeds to be paid into an LMA-style "mandatory prepayment account" or "holding account" or otherwise ring-fenced for the benefit of the lenders.

STRUCTURAL CONSIDERATIONS

The changing nature of the disposals covenant in recent years gives rise to

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structural considerations, both commercially and with respect to the legal drafting.

When adopting a permissive high yield bond-style disposals covenant, arrangers/lenders may wish to consider whether disposals of certain "core" assets should be *prohibited* by way of exception to the general permission. To some extent, this reverses the traditional position reflected in the LMA Agreement, which takes as its starting point that any disposal is prohibited and then with the permissions to be commercially agreed. Arrangers/lenders may also wish to consider whether the guarantor coverage test should be "refreshed" upon any disposal of the shares in a guarantor and/or other significant parts of the borrowing group and its assets.

Application of the disposals covenant to assets subject to transaction security may also require commercial consideration. To facilitate such disposals, mechanics for release of the security will need to be included in the facilities agreement and/or any related intercreditor agreement. This may in turn negatively impact on the validity and enforceability of the security under applicable local law.

A permissive disposals covenant may further have spill-over effects on the application of other covenants and events of default. For example, larger disposals could lead to a change in the nature of the borrowing group's business and therefore require a carve-out from any covenant which prohibits changes to the business, assuming that the commercial agreement is that the disposals covenant should take precedence.

This article has made a simplified distinction between an LMA-style disposals covenant versus a high yield bond-style disposals covenant, which is helpful for the purposes of mapping and navigating the changing nature of the disposals covenant in recent years. However, it is important to appreciate that the commercial scope of the disposals covenant is not contingent on whether it is, as a matter of legal drafting, structured LMA-style or high yield bond-style.

As to the specific disposal permissions, the flexibility typically found in the definition of "Asset Disposition" for a high yield bond-style disposals covenant can easily be transposed into the definition of "Permitted Disposal" for an LMA-style disposals covenant. Similarly, the flexibility to make general disposals under a high yield bond-style disposals covenant can be incorporated into the definition of "Permitted Disposal" with corresponding conforming changes to the mandatory prepayment provisions. To mirror the concept of an "asset disposition offer", which may seem alien to a facilities agreement, a similar commercial position may be achieved by including an option for the lenders to *reject* a mandatory prepayment. These "hybrid" approaches are seen in practice and may ultimately provide the borrower with the same (or even greater) commercial flexibility as a "true" high yield bond-style disposals covenant. ■

1 If the facilities agreement incorporates high yield bond-style covenants, it may also include the concept of "unrestricted subsidiaries" typically found in a high yield bond. If so, the disposals covenant will not apply to any member of the borrowing group, which has been designated as an "unrestricted subsidiary".

2 The specific disposal permissions also include what may be referred to as "technical" permissions. These are permissions for various transactions that are principally regulated in other covenants, but which may technically constitute a disposal for purposes of the disposals covenant. An illustrative example is disposals arising as a result of any "Permitted Security".

3 The permission will, however, not extend to disposals to any "unrestricted subsidiaries" (see fn 1 above).

4 The "outer limit" for disposals will typically be the sale of "all or substantially all" of the assets of the borrowing group. Such transaction will usually constitute a change of control/exit event under the facilities agreement and be regulated as such.

5 The definition of "net proceeds" may also (indirectly) include a prepayment permission by excluding from the net proceeds certain prepayments of indebtedness, eg any third-party indebtedness secured on the assets disposed of.

Further Reading:

- Permitted acquisitions: how much flexibility can borrowers expect? (2018) 5 JIBFL 308.
- The evolution of "soft cap" covenant baskets in the European loan market (2016) 5 JIBFL 285.
- LexisPSL: Banking & Finance: Practice Note: Negotiating general undertakings in acquisition finance transactions.