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How Soft is Your Soft Call?

Call protections are designed to protect lenders' yield in the event of a repayment of debt before maturity. Depending on their scope and limitations, call protections are often characterized as "hard" or "soft." "Soft call" provisions, which are common in institutional syndicated credits, typically require payment of a one percent premium upon the "refinancing" or "repricing" of the loan within a certain period after closing that reduces the lenders' effective yield. "Hard call" provisions, in contrast, which are common in riskier credits, typically require payment of a one-to-three percent premium without discriminating as to the nature and effect of the subject prepayment. While designed to ensure that lenders receive the benefit of their bargained-for economic return, the actual reach of soft call provisions varies widely from one transaction to the next. In the current volatile leveraged loan environment, lenders should pay more attention to the terms and application of prepayment premiums, as widening margins make it more likely that sponsors and borrowers will be looking for the earliest opportunities to refinance into less expensive loans.

Below we (i) explore the key features that characterize soft call provisions, (ii) differentiate soft call provisions from prepayment premiums in second lien leveraged loans, (iii) identify certain enforceability issues that parties should consider when drafting and negotiating these provisions and (iv) conclude with some final thoughts and market data regarding the effectiveness of call protections.

Repricing Transactions and Prepayments

Last year (2015) saw repricing volume drop to a three-year low of approximately $72 billion (an approximate one-third slide from 2014). In the current market interest rates are high. Repricing volumes year-to-date are down significantly from even 2015 volumes. This environment has made repricing a rare luxury. As windows can still potentially open (albeit brief) for borrowers to negotiate lower margins, sponsors and borrowers remain vigilant for repricing opportunities. In certain circumstances, prepayments can also be a tool to cut off hemorrhaging interest costs.

In a perfect world, the inclusion and form of any call protection would cater to the intended lending audience. Institutional investors, by design, desire to earn their negotiated yield over the life of a loan. In contrast, traditional banks, whose business model revolves around fees for arranging loans, desire de-leveraging in order to free up their balance sheets for more lending capacity and lower capital costs. What we find in practice is much more influenced by market conditions.

Key Features of "Soft Calls"

A typical soft call provision provides that, "[i]n the event that a Repricing Transaction occurs on or prior to the date that is six (6) months after the Closing Date, the Borrower shall pay each Lender a fee equal to 1.00% of the principal amount of such Lender's Term Loans that are subject to such Repricing Transaction." The details that dictate when and how such a soft call provision will apply are subject to assiduous negotiation. The debate centers on (i) what type of transaction constitutes a "repricing transaction," (ii) what exemptions apply and (iii) the duration of the call protection. Each is discussed in turn below.

Scope of Coverage

For a lender to collect a prepayment premium, the applicable refinancing or amendment must qualify as a "Repricing Transaction". One definition of "Repricing Transaction" is as follows:

> "Repricing Transaction" means (a) any prepayment or repayment of Tranche B Term Loans with the proceeds of, or any conversion of Tranche B Term Loans into, any new or replacement [*tranche of first lien term loans*] [*the primary purpose*] of which is to effectively reduce the Yield applicable to such Tranche B Term Loans or (b) any amendment relating to the Tranche B Term Loans, [*the primary purpose*] of which is to effectively reduce the Yield applicable to Tranche B Term Loans; provided that any refinancing or repricing of Tranche B Term Loans in connection with [*(i) a Qualified IPO, (ii) any Transformative Acquisition or (iii) a transaction that would result in a Change of Control*] shall, in each case, not constitute a Repricing Transaction.[1]

In the above example, only a ***term loan*** that satisfies the remainder of the criteria laid out therein will constitute a Repricing Transaction. This in itself is limiting to lenders as other types of indebtedness may be disqualified. In such a formulation, a repricing/refinancing through a bond or private note instrument would arguably not qualify as a "term loan" for purposes of a Repricing Transaction. This limitation is common in the current market.[2] Narrower formulations exist in the market as well. For example, sponsor-friendly definitions of Repricing Transactions have been limited to term loans that are "broadly syndicated." In such an example, term loans that are provided by a single lender or even a "club" deal, and thus not syndicated for larger consumption, may allow the sponsor and borrower to evade the repricing premium altogether.

Looking closely at the above definition, another condition is that the underlying "primary purpose" of the refinancing loan or loan amendment must be to reduce the effective yield on the existing term loans. A new loan or amendment that simply results in lower yield (*i.e.*, without the borrower *primarily and purposefully* seeking to achieve such result) would not constitute a Repricing Transaction. Recent research indicates that a majority of credit agreements contain this qualification.[3]

The parameters of the "effective" or "all-in" yield that are incorporated into the soft call may also be a negotiation point because they can serve as a veiled shield against the premium. Lenders seek to broadly define the effective yield to capture upfront fees, interest rate spreads, interest rate benchmark floors and original issue discount, while borrowers seek to limit the scope and ensure that such yield excludes arrangement, structuring, syndication or other related fees that are not shared with all lenders. A strong borrower may even negotiate a consent right over the determination of the effective yield.

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1 Publicly available first lien credit agreement for Concentra Inc., dated June 1, 2015 (emphasis added).

2 Based on research conducted by Xtract Research LLC in respect of 279 first-lien term B loans (from January 2015 through March 2016), Xtract observed that 68% of repricing transactions were triggered only by repricings with "secured term loans," while 32% of repricing transactions were triggered by repricings with "any debt."

3 In respect of the same sampling studied by Xtract through March 2016, Xtract identified 51% of credit agreements with the "primary purpose" qualifier and 49% without it.

In addition, if the language is not clear as to what existing term loan should be measured for purposes of any "reduction in the effective yield," the borrower could use this to its advantage. Specifically, under the right circumstances, a borrower could treat the "existing" term loan as a fungible bundle of two or more loans it has drawn. If these loans have different yields that are blended together by the borrower, the borrower may assert a lower existing yield than would have been expected by a lender, which could then affect the determination of the change in yield for the repriced loan.

Specific Exceptions

Other common features of soft call provisions are the specific, built-in exclusions to the definition of Repricing Transactions. These typically include initial public offerings, transactions that result in a change of control of the company and acquisitions or other transactions that have a transformative impact on the business and capital structure. The IPO and change of control exceptions are designed to avoid penalizing the sponsor in the event of its potential exit from the target business. It is apparent, through these exceptions, that parties recognize that the cost of a prepayment premium here would obstruct such transactions, particularly where such costs would be borne by someone other than the sponsor, and thus, chill potential interest.

As to "transformative events", these comprise acquisitions or investments that are either not permitted under the credit agreement or where the existing credit agreement provisions would not provide the borrower with adequate flexibility for continued operations. Excluding transformational events from the scope of repricing premiums reduces the cost of replacing the current loan terms with terms more suitable to the borrower's changed business circumstances. Similar to the above, parties recognize here that accretive transactions should not be dissuaded even if they deprive lenders of yield protection.

Borrowers argue that it is unfair and, in fact, prohibitive of potential value-maximizing business deals to face a penalty for pursuing them. However, some sponsors go further and insist that Repricing Transactions exclude refinancings in connection with any and all investments or acquisitions. In this construct, lenders are asked to bear the risk, but not the reward, of any value-accretive transaction.

Sunsets

In structuring a soft call provision, another consideration is the duration of such protections. Soft calls only require the payment of a premium if the subject loan is refinanced or repriced within a set time from the funding date – usually after six months or one year. Research indicates that, for leveraged loans executed in 2015 with at least one institutional (or "TLB") tranche, 53% of leveraged loan agreements contained soft calls that expired after six months, 40% expired after twelve months and 7% expired after other periods.[4] This pattern has continued through 2016.[5] Sunsets are common market flex items and, during the marketing and syndication period, are often extended to lengthier durations.

Traps for Non-Consenting Lenders

As soft call prepayment premiums apply to repricing amendments as well as refinancings, lenders should be cognizant of whether they will be entitled to a repricing premium in the event they are replaced or repaid for refusing to support an amendment. For certain amendments, the borrower will be able to utilize the "yank-a-bank" provision and replace the non-consenting lender. An unwitting lender may be surprised to learn that it is being replaced or repaid at only par, whereas consenting lenders enjoy par *plus* a premium.

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[4] Research from Xtract Research LLC.

[5] In respect of the 279 TLBs studied by Xtract through March 2016, Xtract identified 52% of agreements with a six-month sunset, 42% with a one-year sunset and 6% with other timeframes.

Prepayment Premiums in Second Lien Loans

In contrast with first-lien or senior unsecured loans which contain soft calls, lenders typically achieve stronger/harder call protection in second lien financings. Second lien loans often discard the unique triggering events and exceptions seen in soft calls in favor of more traditional premiums payable on any repayment before maturity. The prepayment charges are typically two percent (2.00%) if repayment occurs in the first year following closing and one percent (1.00%) if repayment occurs in the second year (although depending on market conditions and flex rights, such prepayment premium could be higher).

Second lien lenders justify these more stringent yield protections as a necessary counterweight to the increased risk assumed by accepting junior lien positions. However, like all other commercial issues negotiated in loan documents, relative bargaining power prevails. When capital supply outweighs deal flow demand, sponsors may negotiate second lien call protection provisions with conditions and limitations that resemble soft calls. In the current climate, with second lien facilities difficult to syndicate, lenders tend to have more leverage. As such, second lien lenders may be able to negotiate higher starter premiums and, on occasion, a flat "no call" for the entire first year after the closing date.

Like soft call protection, lenders need to understand when hard call prepayment premiums do and do not apply. The premise behind such protection is that they should be payable in any repayment scenario. To this end, to the extent a credit agreement contains a yank-a-bank provision, lenders need to ensure call protection still applies. Lenders also need to consider what happens in a default scenario where loans are called prior to scheduled maturity. Sponsors have sought to disapply call premiums where there is an acceleration of loans following an event of default, which can impact recovery in a bankruptcy, as discussed below.

Enforceability Considerations

As a general matter, prepayment premiums under a contract entered into among sophisticated parties are enforceable according to their terms.[6] Courts in recent cases have in fact heightened the focus on such terms and declared that only a tightly drafted clause that specifies that a premium will be due before or after acceleration will allow such a claim against the borrower/debtor.[7]

If a borrower negotiated an exception that the prepayment premium would not be due after acceleration, or if the call protection language was otherwise unclear on this issue, a second lien debt holder might face an uphill battle collecting on such claim. Parties can increase the likelihood that a bankruptcy court will enforce their prepayment premium through careful drafting.

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6 *See In re South Side House, LLC*, 451 B.R. 248, 268 (Bankr. E.D.N.Y. 2011) ("To protect this bargained-for yield, parties may also agree to 'no-call' provisions that expressly prohibit prepayment, or 'make-whole' provisions that provide for liquidated damages in default situations. In effect, no-call provisions memorialize the rule of perfect tender in time."); *Friends Realty Assocs., LLC v. Wells Fargo Bank, N.A.P.*, 836 N.Y.S.2d 565, 565 (N.Y. App. Div. 2007) ("It has been settled law since the early 19th century that a mortgagor has no right to pay off his obligation prior to its stated maturity date in the absence of a prepayment clause in the mortgage or contrary statutory authority.") (citing *Arthur v. Burkich*, 520 N.Y.S.2d 638 (N.Y. App. Div. 1987)); *Nw. Mut. Life Ins. Co. v. Uniondale Realty Assocs.*, 816 N.Y.S.2d 831, 835 (N.Y. Sup. Ct. 2006) (discussing enforceability of prepayment premiums as "consideration or a *quid pro quo* for the option [to prepay]" and as "alternative performance which is intended to preserve the lender's income stream or yield.").

7 *See In re MPM Silicones, LLC*, No. 14-22503-rdd, 2014 WL 4436335, at *13 (Bankr. S.D.N.Y. Sept. 9, 2014) (recognizing an established exception to the rule barring prepayment premiums upon acceleration "when a clear and unambiguous clause calls for the payment of a prepayment premium or make-whole even in the event of acceleration of, or the establishment of a new maturity date for, the debt"); *aff'd* 531 B.R. 321, 336 (S.D.N.Y. 2015) ("Courts allowing make-whole payments under these circumstances have largely required the contract to provide explicitly for a make-whole premium in the event of an acceleration of debt or a default."). Courts in New York and Delaware continue to rely upon the *MPM/Momentive* court decisions. *See, e.g.*, *In re Energy Future Holdings Corp.*, 533 B.R. 106 (Bankr. D. Del. 2015).

Conclusion

Prepayment premiums are designed to protect yield-conscious lenders from being repaid early and having to re-invest capital. In institutional loans, they cater to a class of investors that historically have had robust make-whole or call protection in high-yield bonds. Where opportunity and motive exists, the most robust drafted soft call provision can be evaded simply by waiting until the applicable sunset to execute a Repricing Transaction.[8] Borrowers have also been able to utilize their negotiated exclusions.[9] This is one reason why there are few examples of borrowers triggering soft calls in 2015.[10] However, if premiums are to serve a purpose, lenders should closely examine the terms of the negotiated call protection and remain vigilant that the formulation achieves the commercial agreement in light of enforceability considerations, which concerns will ultimately be weighed against sponsors' and borrowers' desire for flexibility to pursue value-maximizing transactions. The right balance is necessarily one that comes as close as possible to an alignment of interests between the parties based on respective bargaining power, which, despite all the legal advice available, will fluctuate over time.

Authors

Daniel Winick
Counsel
T: +1 212 878 4918
E: daniel.winick
@cliffordchance.com

Andrew Young
Associate
T: +1 212 878 8012
E: andrew.young
@cliffordchance.com

Micah Lewis
Associate
T: +1 212 878 8275
E: micah.lewis
@cliffordchance.com

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[8] For example, S&P Capital IQ reported that in June 2015, Orion Engineered Carbons' soft call expired roughly two weeks prior to a repricing transaction for its cov-lite TLBs; in June 2015, Minerals Technologies repriced its cov-lite TLB one month after its soft call expired; in May 2015, HealthPort sought commitments for a repricing transaction shortly after the applicable soft call expired; Connolly LLC and Learning Care Group had similar outcomes for the repricing of their term loan in May 2015; and Metaldyne in April 2015. The list goes on.

[9] For example, S&P Capital IQ reported that, in connection with a first lien term loan and repricing for DTZ in August 2015, a 101 soft call would not be charged as the underlying Cushman & Wakefield acquisition constituted a transformative acquisition.

[10] Information from Xtract Research LLC, S&P Capital IQ and other public sources reveal only about a dozen such instances.

US Leveraged Finance Contacts

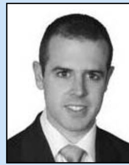
Charles Adams
Partner
T: +1 212 878 3415
E: charles.adams
@cliffordchance.com

Gary Brooks
Partner
T: +1 212 878 8242
E: gary.brooks
@cliffordchance.com

Evan Cohen
Partner
T: +1 212 878 8518
E: evan.cohen
@cliffordchance.com

Jay Gavigan
Partner
T: +1 212 878 8531
E: jay.gavigan
@cliffordchance.com

Tom Schulte
Partner
T: +1 212 878 8403
E: thomas.schulte
@cliffordchance.com



Daniel Winick
Counsel
T: +1 212 878 4918
E: daniel.winick
@cliffordchance.com

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