Proskauer

Private Credit Deep Dives – Change of Control (Europe)

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After the unprecedented boom of the immediate post-COVID era, European M&A activity has slumped in recent months. Indeed, recent market intelligence from Dealogic showed that Q1 of 2023 in EMEA saw a 68% decline in M&A volume year-on-year and the lowest Q1 level since 1997 (worse still than during the global financial crisis). Against this backdrop, private equity sponsors looking to create liquidity for their funds may need to consider more bespoke and structured solutions at asset level rather than simply selling their portfolio companies in full to third parties. As a consequence, lenders in the European market will be looking to understand what exactly constitutes a “change of control” in their credit documentation and what rights they have in the event that a “change of control” is deemed to have occurred.

This deep dive with Daniel Hendon (Partner) and Phil Anscombe (Associate), lawyers in Proskauer's Private Credit Group in London, will explain the philosophy behind “change of control” protection and what it is intended to achieve, how the trigger events are typically described and what effects they have within the documentation, and how common loopholes and exceptions may be particularly relevant in today’s market.

When performing its due diligence on a prospective financing opportunity, a lender will typically speak to both the shareholders (or persons who will acquire the shares, if an acquisition financing) and management to discuss and assess their business plan and financial projections for the business. As a result, when lenders commit to such a financing, they are in essence backing a particular vision and strategy for the business going forward. The underlying principle behind "change of control" provisions in loan agreements is that, if there is a change in the persons controlling the business (and those persons are in theory able to use their control to change that business strategy), then there has been a fundamental change in the dynamics of the investment and the lender should have the option of exiting the deal and being prepaid in full. There are a number of different concepts that feed into both how a "change of control" is defined and what its consequences are for the parties (and how these concepts are treated vary depending on the size of the deal, the sponsor involved and the commercial context of the deal) – the ways in which such concepts are treated can broadly be described as follows:

1. **What constitutes a "change"** – Traditional loan documentation operates so that if a specified group of permitted controlling investors ceases to exercise control over the group, then that is considered a "change" in the control of the group. However, the traditional approach in the world of high-yield bonds is for this to be constructed so that it is only when a certain new investor or new investors acting together in concert (which are, in each case, not permitted controlling investors) attain control of the group that a "change" is considered to have occurred. This is a subtle yet important distinction – the latter construct would allow multiple minority equity stakes to be sold (which in aggregate mean the original investors no longer control the operations of the group), while the former construct would consider this a fundamental "change" in the controlling composition of the shareholder group. The latter construct has increasingly pervaded the syndicated loan market, but private credit firms have generally been resistant to this and insisted upon the more traditional loan formulation.
2. **What constitutes "control"** – The most sponsor-friendly documents will solely define "control" as being the beneficial ownership of a simple majority (being more than 50%) of the issued voting equity in the parent company of the banking group. The rationale for this is that, while there will likely be some jurisdiction-specific factors, this is typically the level of equity ownership required in order to exercise key shareholder rights in order to maintain operational control (in particular, the right to pass resolutions to hire/fire board members). However, it is not necessarily the case that beneficial ownership will always carry these

rights – for example, proxy voting rights may be granted, or contractual arrangements may be entered into that give such rights to other persons. Traditional LMA-style loan documentation would therefore state that "control" means the ability, whether by ownership of shares, proxy, contract, agency or otherwise, to have the power to: (i) cast, or control the casting, of a majority of the maximum number of votes that might be cast at a general meeting of the shareholders of the parent company, (ii) appoint or remove the majority of the board of directors of the parent company, or (iii) give directions with respect to the operating and financial policies of the parent company, with which the directors or equivalent officers are obliged to comply. Certain private credit providers have insisted on retaining the traditional formulation (including in US loan documents), while others have been more willing to rely on the test looking solely at voting share ownership (on the basis that sponsors are perhaps unlikely to give away such control rights while they still hold a voting majority). It should be noted that this is ordinarily expressed as being "direct or indirect" control – the reason being that in most structures the equity vehicle will be above the level of the senior banking group, and so what is really being referred to is being able to exert these powers by way of indirect control down a chain of wholly-owned subsidiaries sitting below the equity vehicle.

3. **Are there additional triggers** – Certain other trigger events commonly seen in the loan market are as follows:
    a. While often not described as a "change of control" for the purposes of the definition itself, a sale of all or substantially all of the assets of the Group typically constitutes a trigger event in the same way as a "change of control" for the purposes of the loan documentation. This is to cater for a scenario in which the shareholders elect to exit their investment by way of an asset sale rather than a share sale.

    a. A common feature on almost all European loan financings is a limb within the "change of control" definition that protects the "single point of enforcement"." In contrast to the US (where there is a common insolvency regime across all states that is well understood by market participants and well tested on prior transactions), due to the diversity in insolvency regimes across Europe, transactions are typically structured so as to ensure there is a robust and protected security interest granted to lenders at the top of the banking structure that would facilitate an enforcement and sale of the entire group as a going-concern, on an out-of-court basis, in a downside scenario. To ensure the sanctity of this share security through the life of the deal, it typically constitutes a "change of control" if the chargor/pledgor ceases to hold (directly) the entirety of the issued equity

in the entity over which it is granting security. Note that US deals will still typically include a requirement that the topco "holdings" entity retain ownership of 100% of the issued and outstanding equity of the opco / borrowing entity. In lower middle-market transactions or in structures where there are material operating entities that sit underneath the primary borrower, US lenders may push for ownership prongs with respect to those subsidiaries as well, but that is a negotiated point and atypical in larger deals.

   a. Certain lenders take the view that, in addition to ensuring that the original shareholders maintain operational control, the "change of control" definition should also look to ensure that those original investors maintain sufficient economic "skin in the game". The purpose of this would be to ensure that the sponsor cannot materially reduce the extent of their financial investment and realise value (e.g., by way of a secondary sale to a third party) by disposing of non-voting equity or equity-like instruments, so as to circumvent the "change of control", e.g., a disposal of loan note instruments or preference shares. To achieve this, such lenders would require that a "change of control" be considered to have occurred if the original investors cease to own the majority of all equity (voting or non-voting) or cease to own the majority of any quasi-equity instruments (e.g., loan note instruments accruing roll-up interest) that were issued at the outset of the deal, the latter formulation of which is not common in the US. This has generally remained a feature of the European mid-market only and some sponsors are resistant to this on the basis that they consider it to unduly inhibit their portfolio management. They would also argue that it is not practically likely that a new investor would acquire the majority of the economic capital in a deal without requiring voting control at the same time.

4. **Who is a permitted controlling investor** – Traditionally, the permitted controlling investors (that were required to retain control at all times) under loan agreements were the sponsor funds invested in the transaction at closing of the deal. However:

   a. In recent years, it became common for this to be extended to affiliates and related funds of those initial funds (i.e., so as to include any other vehicles established now or in the future, provided they are managed and controlled by the same sponsor). The thesis behind this is that lenders are backing that sponsor's vision for the business, so provided the sponsor as an institution remains in control, that should be sufficient from the lender's perspective to remain in the deal. This is particularly topical in the current

market as, given the subdued M&A environment, there has been an increase in GP-led secondary trades as a method of generating liquidity for sponsor funds. What this means is that, where a particular fund is nearing the end of its life cycle and requires liquidity (but conditions are not optimal for a widely marketed sale process of a particular asset), the sponsor may set up a new and separately capitalised vehicle to acquire the asset from the original fund, so it can continue to be managed and sold at a later date. Although the sponsor remains in control of the business, an exit has nonetheless been achieved for the original fund (and value/upside realised by the investors in that fund) – in this context, certain lenders have queried whether in fact this should constitute a "change of control", so that lenders can recover value concurrently or otherwise discuss new terms to reflect the new sponsor vehicle's new investment horizon. In the US, the market has largely accepted that the "Sponsor" for purposes of the "change of control" definition will include a hardwired fund and its "controlled investment affiliates" to account for this flexibility, but this remains a hot topic of discussion and it will be seen in due course whether these sensitivities prompt a change in the approach taken by the wider market.

a. On more aggressive transactions (particularly on larger deals), sponsors commonly request a more expansive list of permitted controlling investors. They will often push for all institutional equity investors at closing (for example, any seller that is rolling over all or a portion of its investment into the new structure but as a minority shareholder, or any other new minority co-investor introduced by the sponsor) and all management shareholders to be included in the numerator of the calculation. This evidently does not require that the sponsor itself retains control and calls into question what happens if the sponsor itself reduces below 50% and subsequently has a fall-out with management (for example) over the future strategy of the business. This could lead to a dead-lock situation that would be value destructive – a situation that lenders would look to avoid. Sponsors would argue, however, that they are entirely aligned with lenders in protecting their controlling voting rights going forward. Where it is requested that co-investors (or, more generically, limited partners of the sponsor) be included, lenders will often request that they be explicitly named in the documentation to ensure it is clear who has been approved. Where that is not possible (for example, where the sponsor intends to syndicate a portion of its equity post-closing or between commitment and completion) and lenders are willing to accommodate that flexibility, they will generally offer a time-capped period only in which such co-investors can be brought in

(e.g., 6 months from closing) or, in the US, a pre-agreed "white" list of investors who may come in. Lenders also sometimes agree for LPs/co-investors to count as permitted controlling investors but only to the extent all of their voting rights are at all times controlled and exercised by the sponsor (i.e., they are fully silent and passive co-investors only). The purpose of these various parameters is to ensure that there are no significant loopholes in the construct – given the diversity of the LP base in many private equity funds (many of which LPs may well also have a direct investment arm themselves), it would otherwise be difficult to regulate whether this flexibility could inadvertently permit what would otherwise be considered a true third-party sale.

5. **Is it a control investment** – It should be noted that the above analysis assumes that the relevant transaction is a regular "control" majority equity investment by a private equity sponsor. If it is a sponsor-less transaction, there will clearly need to be a more bespoke analysis undertaken and reflected in the drafting (perhaps by reference to the shareholdings of key founders/members of management). If the transaction in question still represents an investment of private equity capital but on a minority basis, lenders (including in the mid-market) are generally more amenable to including specified co-investors or members of management as at closing alongside the sponsor in the "permitted controlling investors" definitions. However, lenders may look to supplement this by requiring an additional limb of the definition, stating that the sponsor itself must retain a certain proportion of its own equity investment. They may also require that a limb be inserted requiring that the sponsor must retain all of the minority rights it has under the shareholders' agreement as at closing. A sponsor investing on a minority basis may negotiate with the other shareholders so that it has certain step-in rights upon the occurrence of trigger events pertaining to underperformance (possibly including swamping rights, facilitating the sponsor to take control of the board) and lenders may seek to ensure that loss of such fundamental rights (whether due to the sponsor selling its stake below a certain ownership threshold or otherwise) would also constitute a "change of control". In certain US deals where specific individuals are important to the ongoing business, lenders may sometimes push for prongs requiring that such "key" individuals either retain some portion of the equity or retain certain positions or responsibilities. This is particularly relevant where a lender's underwriting is focused on an individual officer's relationships with customers or vendors, for example.

6. **Is there a portability concept** – While still an uncommon feature in the market, occasionally loan documents will contain a "portability" concept. This is effectively an exception to the "change of control" regime, such that the debt can be

“ported” and remain in place notwithstanding the sale of the group to a new sponsor. Clearly, this feature is very attractive to sponsors, as in theory it would make a sale of the business easier to manage (as an incoming buyer would not need to arrange its own package of debt financing). Given the current difficult environment for raising debt finance, it may be that sponsors in fact look for portability features more frequently than they did when credit markets were buoyant. Where the concept is seen in the European and US private credit markets, it is usually subject to tight parameters, which may include a time limit (e.g., the loan is only portable for the first 2 years following closing, which should ensure any incoming sponsor’s investment horizon is not wildly out of kilter with the tenor of the loan), a limited list of incoming sponsors that may benefit from the portability option (typically sponsors with which the lender has a good relationship or which have strong experience in the sector), a condition requiring that the option is subject to a pro forma leverage test (e.g., set at opening leverage from the original deal, so the deal cannot be ported in a downside scenario) and that a specified minimum equity condition must be met (e.g., a pro forma equity cushion of 50% following the new sponsor’s investment) and that a fee must be payable at the time of the portability option is exercised (somewhat akin to an origination/underwriting fee, though sometimes with a discount to regular new money fees). In the US, lenders will also limit the number of so-called “permitted” “change of control” transactions, such that only one can occur over the life of the facility, to avoid a situation in which the company changes hands repeatedly. Call protection would also typically be re-set once the debt has been ported and on some transactions lenders might offer a tenor extension in connection with the exercise of the portability option. Requests for portability are most commonly seen on refinancing transactions, where a sponsor already owns the asset and expects to exit within a relatively short period of time after the refinancing deal (and has at least some visibility as to likely buyers) and is looking to simplify and/or reduce the cost of the debt-raise process for prospective buyers. In the US, portability historically has been limited to upper market deals, particularly in prior years where sponsors had more bargaining power given the historic level of M&A activity and related competition. However, the US market has since largely pushed back on this concept, and as of now it remains rare in true middle market transactions. That being said, this may become a trend in the current market, as difficult M&A conditions have meant many sale processes have been postponed until the market recovers (but refinancings/dividend recaps may still be proceeding in the meantime). It is worth noting that, even where portability features are included, it remains relatively uncommon for them to be utilised in practice. Whilst the existence of the feature clearly means the lender has to come to the table if an eligible transaction has been proposed, in practice, most incoming sponsors will have their own views on appropriate terms and

structure and will prefer to refinance the existing facilities under a new document, rather than rely on the prior sponsor's negotiated terms.

7. **What is the result of a "change of control"** – Traditional European loan documentation operates so that a "change of control" causes all amounts outstanding under the finance documents (including principal and all accrued but unpaid interest) to become immediately due and payable. A "change of control" will constitute an event of default in US credit agreements, but will not trigger automatic acceleration (or an automatic "mandatory prepayment") outside of older lower middle-market transactions. In addition, the significant majority of private credit transactions in the European market require that call protection be due in connection with a "change of control" transaction – as such (and if within the call protection period), such a premium would also crystallise and become due and payable at that time. However, on European large cap transactions (where there have commonly been very large and diverse banking syndicates where debt investors may have varying views on a new incoming sponsor) it has become more common for the result of a "change of control" to be structured as a lender put option. The way that this works is that the group must notify the agent of the proposed "change of control" (and the agent then promptly notifies the lenders) – each individual lender will then have a certain period in which to confirm whether it is electing to exercise its "put" and be prepaid in full (in the same way as set out above) or whether it is happy to continue to remain a lender to the group. While the outcome should be substantively the same if the lender wishes to be prepaid, it puts the procedural risk (albeit a small risk) of an issue in the agent failing to notify a lender (or the lender missing such notification) or the lender failing to notify the group, onto the lender in question. Clearly the ramifications for a lender that wishes to exit but is not ultimately able to do so may be significant – however, private credit lenders on larger transactions have increasingly become comfortable with this. In the US, because a "change of control" will not necessarily trigger a prepayment requirement as noted above, a related prepayment will instead constitute a "voluntary" or "optional" prepayment, which will be subject to the applicable prepayment premium. However, the market has moved toward incorporating a discount on prepayments in connection with changes of control. As such, the company will only owe 50% of the premium that would have otherwise been payable in connection with a typical voluntary prepayment. It should be noted that, irrespective of which formulation is used, it is important that a "change of control" itself cannot be waived by the majority of the lenders and that the definition and operative provisions cannot be amended by the majority of the lenders (as these matters should always be sacred all-lender matters).

Given the difficult environment for raising new finance and the likelihood of private equity sponsors pursuing bespoke opportunities to realise liquidity for their funds, it seems highly likely that “change of control” provisions will remain in sharp focus for lenders and borrowers alike during the course of 2023. For any related questions on this topic, please reach out to your contact within Proskauer’s Private Credit Group.

About Proskauer

Proskauer’s Private Credit Group consists of over 90 dedicated professionals, located in London, New York, Boston, Chicago and Los Angeles, and the team consistently executes some of the largest number of private credit financings in the market (closing 250 direct lending deals globally in 2022, representing nearly $85 billion of new capital).

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