

What are you doing this New Year's Eve?...

Financial covenants and Events of Default

For many borrowers, 31 December 2008 will be a financial covenant test date. These covenants will test how well borrowers have performed during 2008 relative to their business plans, and how successfully they have absorbed a relatively high cost of funds (given that most interest charges are calculated on a LIBOR-plus basis).

The combined effect of the unprecedented level of market turbulence in the debt and equity markets during 2008 and the anticipation of a recession throughout 2009 will focus the attention of many borrowers and lenders on these covenants, and more particularly on borrowers' compliance with - or breach of - these covenants. Many market commentators are predicting that the current mutual stand-off between borderline defaulting borrowers and their lenders must come to an end, and a borrower's failure to meet its end of year financial covenants could be the trigger for this.

It may be a truism to reiterate that the ultimate sanction available to a lender as a result of a breach of a financial covenant is to call an Event of Default and accelerate the repayment of the debt; but borrowers should prepare themselves for these circumstances by knowing:

- exactly when the Event of Default arises;
- when they can and cannot draw further advances against available commitments, particularly under revolving credit facilities; and
- what options might be available to them to delay, prevent or avoid an Event of Default arising.

This briefing note aims to provide borrowers with some answers to these issues, based on terms we would expect to see in a borrower's debt documents.

When does a financial covenant Event of Default arise?

There are three potentially relevant periods of time to consider when analysing whether an Event of Default (including both an actual and a potential Event of Default) has occurred as a result of a breach of a financial covenant to be tested on 31 December 2008:

- firstly, the period running up to 31 December 2008;
- secondly, the period running from 31 December 2008 to the date on which the financial statements relating to the testing period and the related compliance certificate (together, the "Reference Financial Information") must be delivered to the lender under the relevant financial information reporting covenant; and
- thirdly, the period falling after the delivery of this information.

This analysis is essential to allow the borrower to understand whether its rights and obligations have been affected by the occurrence of an Event of Default – for example, the borrower is likely to be keen to determine whether it can satisfy the "no default" condition precedent to drawing down further advances under its revolving credit facility to allow it to stockpile as much cash as possible before this facility ceases to be available.

In the first of these periods it is not possible for the borrower or its lender to determine with any certainty whether any of its financial covenants will be breached on 31 December 2008. This is because it is impossible to predict with complete certainty what will occur in the remainder of that period – and this is the case even if the borrower's management accounts for Q1, Q2 and Q3 give a strong indication that a breach is likely.

The borrower must use this uncertainty to its advantage to ensure that its lender is disciplined into keeping the banking facilities committed and available.

The second of these periods is a grey area – it would be an aggressive action for the lender to call an Event of Default before it has the hard information (being the Reference Financial Information for the testing period) on which to base its claim. The lender may have a better argument to claim a potential Event of Default exists, in order to stop further

advances being made - but again, without the Reference Financial Information, the borrower can seek to dispute this.

An astute lender might seek to put pressure on the borrower by demanding that the borrower confirms that it is unaware of any breach – the borrower must respond to any such request carefully and on the basis of considered advice if at that time it is in possession of conclusive information that indicates that there is a breach (for example, if its accounts are substantially finished but have not yet been audited or delivered to the lender).

It is only in the third of these periods that it will be clear whether or not there has been a breach – only then can the financial covenants be tested by reference to the financial statements delivered to the lender, with the accompanying compliance certificate stating conclusively whether or not there has been a breach.

Does an Event of Default (or a potential Event of Default) arise solely on the basis of an annual budget which forecasts a financial covenant breach occurring during the relevant year?

The borrower must comply with its obligation to deliver its annual budget by the applicable deadline, even if it delivers a budget that forecasts a financial covenant breach at some point during the year.

Although this budget could be used by the lender as ammunition in arguing that an Event of Default (or a potential Event of Default) has occurred, while still in the first of the periods described above the same result as described above should apply – until either the test date has passed or until the delivery of the relevant Reference Financial Information, no financial covenant Event of Default can be predicted with certainty.

What other terms might be relevant to a financial covenant breach?

Equity cure rights:

As soon as a financial covenant breach becomes a possibility (and not a reality), the borrower should review any rights it has to exercise an equity cure. The terms governing the availability and effect of an equity cure should be carefully reviewed, as they are often prescriptive as to:

- when the equity cure right can be exercised - often this is a window of a number of days after the delivery of the relevant Reference Financial Information;
- what the equity cure right can do – new funds can be applied in a variety of ways, some more advantageous to the borrower (such as adding pound-for-pound to EBITDA or cashflow) and others more advantageous to the lender (such as funding a prepayment of part of the debt with a commensurate re-calculation of

interest costs). In order to determine whether an equity cure is viable, the borrower must reconcile the items in its financial covenants that are likely to be breached with those items which can be “cured”; and

- how many times the equity cure right can be exercised – the borrower may have already used its quota of equity cure life lines.

The borrower should start this review as early as possible to give its shareholders sufficient time to consider the reasons why the breach has occurred and the long-term outlook for the borrower’s business, before they can decide whether they are willing to invest further equity in the borrower for this purpose.

Material adverse change:

If the lender is dissatisfied with the borrower’s performance and is frustrated by having to wait for (what it sees as) an inevitable financial covenant Event of Default, it will consider whether it has any recourse under any material adverse change Event of Default.

Whether or not an Event of Default occurs in these circumstances will depend on:

- the wording of the relevant clause – a well-advised borrower should enjoy sufficient materiality, objectivity and generality in these words to allow uncertainty to protect it from its lender relying on this Event of Default.

Clearly the borrower will be more exposed to this action if the wording is tested on a subjective basis (ie as determined by the lender in its discretion). An objective testing (ie factually, has it or has it not occurred) means it is not a determination that the lender can conclusively make, and any disagreement between the lender and the borrower as to whether or not a material adverse change has occurred would ultimately have to be decided by a court; and

- the borrower's circumstances - in some cases there may be little room for disagreement as to whether a single, catastrophic event constitutes a material adverse change (eg Enron).

As a result, the general consensus is that it would be an aggressive lender that takes this action on the basis solely of trading underperformance – most would prefer to wait for the certainty that a financial covenant Event of Default will (eventually) bring.

Debt buybacks:

The recent availability of debt in the secondary market trading at a discount from par significantly below a value that reflects the creditworthiness of the underlying borrower has provided an opportunity for some borrowers (or their owners) to acquire their debt for a fraction of its face value.

The various ways of structuring a debt buyback by either the borrower or its owners are beyond the scope of this note; but in the context of a group facing the possibility of a financial covenant Event of Default it is worth mentioning that, although likely to need lender consent and/or to present legal, contractual and tax issues which can be difficult to overcome, a debt buyback (if it can be structured in such a way as to reduce levels of leverage and/or debt service and if done well in advance of the relevant testing date) could be a more powerful option than the exercise of an equity cure right.

To illustrate the potential of a debt buyback, consider firstly the exercise of an equity cure right. Here, each £1 invested as further equity can (if carefully structured and permitted under the terms of the relevant finance documents) result in a £1 reduction in the borrower's debt and a saving of interest payments on that £1.

Contrast that to a debt buyback strategy where the borrower's debt is trading at 60p/£1 – here, each £1 invested can (again, if carefully structured and permitted and subject to applicable tax charges) result in a £1.66 reduction in the borrower's debt and a saving of future interest payments on that £1.66.

What other issues might arise in relation to a financial covenant Event of Default?

Insolvency issues:

These might arise if the borrower's financial position deteriorates to such an extent that not only does it expect to breach its financial covenants, but it also ceases to have a reasonable prospect of avoiding formal insolvency or becomes unable to pay its debts as they fall due. If this is likely to occur, the borrower (and its directors) should take immediate advice as other Events of Default might be triggered as a result, and statutory duties and responsibilities to the borrower's wider stakeholders will become relevant.

If the borrower has forecast a financial covenant Event of Default, it should ensure that it receives legal advice on any reports, projections, budgets, etc. it provides to the lender, to ensure that it does not admit an inability to pay its debts - this in itself could be used as the basis of calling an Event of Default under the wording of many insolvency related Events of Default.

Auditors:

The borrower's auditors may refuse to issue a clean sign-off of the borrower's annual accounts if they foresee the possibility of a financial covenant Event of Default arising in the following year, or may sign off only with a heavy going-

concern qualification, an emphasis of matter or a statement of fundamental uncertainty – and any of these could itself trigger an Event of Default.

Borrowers should expect their auditors to be more concerned (and in all likelihood, more conservative) about this forward-looking issue; and at best expect their auditors to require more information and time to consider it thoroughly. Any delay in auditors resolving this issue could cause an Event of Default if the borrower is late in delivering its audited accounts and could cause the borrower to breach its obligations under the Companies Acts.

What are the immediate consequences of a financial covenant Event of Default?

The most important and direct consequences are that the lender can:

- refuse to make any further advances and refuse to roll-over existing revolving loans;
- demand access for itself and its advisers (often including accountants, lawyers and valuers) to the borrower's records, accounts, premises and management;
- claim under indemnities for costs and expenses (including legal, valuation and accounting expenses) incurred by it while investigating the Event of Default;
- exercise its "further assurance" rights, demand the borrower takes further action to perfect and protect any security and exercise greater control over the borrower's assets or cash;
- exercise blocking rights on a range of financial and corporate matters, such as acquisitions, disposals and the payment of dividends; and
- accelerate the repayment of the debt in full and, if payment is not forthcoming, exercise its creditor and security enforcement rights.

There will also be other indirect consequences:

- the Event of Default can trigger an obligation to notify the Pensions Regulator, the borrower's pension fund trustees and any relevant supervisory or regulatory bodies;
- cross-defaults can be triggered in other debt, hedging, leasing and trading contracts;
- on hearing that the borrower is in default, suppliers, customers, counterparties and credit insurers can become concerned about the creditworthiness of the borrower and seek to amend their terms of business;
- internal public relations with employees and external public and press relations may need to be carefully managed;

- directors should consider carefully whether they could be at risk of wrongful trading, and whether any of the borrower's subsequent actions could be regarded as being either at an undervalue or a preference – directors might need appropriate legal advice on these issues; and
- the cover provided by D&O insurance should be checked to ensure it is still valid.

Contact details

If you would like any further information or specific advice please contact your usual Macfarlanes contact, or **Christopher Lawrence**
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