
Debt Finance law

Briefing

MACFARLANES

Borrowers and Defaulting Lenders

This briefing note aims to assist borrowers who have a line of credit provided by a lender which is in a UK administration or other UK or international insolvency procedure, is subject to a “freezing” order, or is in default of, or is expected to be in default of, its lending obligations. In this note we refer to such a lender as an “affected lender”.

The issues described in this note can apply to term, revolving, asset-based or ancillary facilities provided on either a bilateral basis or where the affected lender is a member of a syndicate.

Termination of facilities

As a (near universal) rule, under the terms of the documents governing the line of credit, a lender becoming an affected lender will not trigger an event of default or other termination event – so neither the borrower nor the lender will have a contractual right to terminate the line of credit early.

This means that loans will not normally, as a result of an affected lender’s situation, become due and payable earlier than originally specified and the borrower’s obligations to pay interest and repayment instalments will continue to apply. The commitments of the affected lender may (depending on the relevant insolvency procedure) also remain in place – however, as set out below,

practical difficulties will arise in relation to the performance of the affected lender’s future obligations.

Revolving credit facilities

Revolving credit facilities usually operate a “rollover” mechanism to simplify the reborrowing of outstanding loans. This mechanism requires the revolving loan to be repaid in full and then to be re-advanced by the lender.

This mechanism will fail if the affected lender cannot or will not comply with its commitment to re-advance the rollover loan, and if a borrower doesn’t repay the rollover loan in anticipation of such failure by the affected lender, the borrower will be in default under the facility. This in turn will mean that the “no default” condition to new lending will not be met and will result in both the affected lender and the other lenders not being obliged to re-lend. This is the case even if the borrower is confident that an affected lender will breach its obligation to re-lend.

In practice, rollover loans are often allowed by lenders to be implemented by cashless book entries only. In these circumstances, even if the use of book entries is not explicitly permitted in the facility documents, there are two possible arguments available to the borrower:

- firstly, that the historic conduct of the parties amounts to a course of

- dealing that has amended the terms of the facility documents; and
- secondly, that the affected lender is prevented (or estopped) from claiming that the borrower is in default by not repaying a rollover loan in cash strictly in accordance with the terms of the facility documents.

Borrowers should note that the success of either of these arguments will depend on the particular circumstances of the borrower’s situation.

Grossing-up drawdown requests

If a borrower believes that an affected lender will not fund its share of a drawdown request under a syndicated revolving facility, the borrower may consider “grossing-up” the amount requested in any drawdown notice to compensate for the absence of funds from the affected lender. In practice, this will only be an option for the borrower if there is sufficient headroom in the undrawn commitments for the grossed-up amount to be available in full.

Receivables financing facilities

Receivables financing arrangements frequently require that the proceeds of the receivables are paid into a blocked account with the lender, the balance of which is swept daily to the lender. The effect of this is that the borrower has no access to its daily customer receipts and must instead borrow from the lender to meet its daily cashflow needs.

If an affected lender is unwilling or unable to lend, and the borrower is cut off from its receivables proceeds in this way, this will rapidly become untenable for the borrower as its cashflow solvency will quickly deteriorate.

In this situation the borrower's options are limited, and it should seek to agree with the affected lender amendments to the facility documents to provide that if the affected lender defaults (or indicates that it will default) in its lending obligations then the borrower's obligation to pay all receivables proceeds into the blocked account is suspended while the affected lender is in default.

Obtaining such agreement from the affected lender may not be easy or speedy – see below regarding requests for consent. Nevertheless, a borrower's plea that these amendments are essential to avoid the directors being required to put the borrower into an insolvency procedure (which will be value destructive for the affected lender) should help in reaching agreement.

Affected lender is the facility or security agent

The issues here are primarily issues for the non-affected lenders in the syndicate. Their concern will be that any funds received from the borrower by the affected lender as facility agent will not be released to the syndicate members on a timely basis, or at all. The borrower and

the non-affected lenders may feel it prudent to replace the facility agent however, the facility documents may not allow the removal of the facility agent without the facility agent's consent - and even if they do, these provisions for removal and replacement may take some time to implement.

In this situation, the non-affected lenders may request that the borrower makes individual payments direct to each syndicate member rather than making payment through the facility agent. Whilst such direct payments will probably be contrary to the provisions of the underlying facility documents, on the basis that no lender would be likely to suffer a loss as a result of such direct payments, it is hard to see the basis for any viable claim by a lender against the borrower for such breach. Of course, depending on the size of the syndicate, making direct payments may be administratively burdensome for the borrower, or even not possible if relevant payment information is not obtainable.

If the affected lender is the security agent, the non-affected lenders will also want to replace it to ensure that they have a security agent willing and able to act on their instructions to enforce the security package in the event of a default, and to ensure that any proceeds realised on its enforcement are paid to them. We should note that in these scenarios complex legal issues in each relevant

jurisdiction may also need to be resolved to transfer the security to the new security agent.

Letters of credit

If a letter of credit (LC) has been issued by an affected lender, the underlying borrower may come under pressure from the beneficiary of that LC to provide a replacement LC from a more creditworthy issuer. Assuming the borrower is willing to do this and can find a suitable replacement issuer, the borrower should ensure that simultaneously with the issue of the new LC, the original LC is terminated. This is usually done by the beneficiary returning the original LC to the affected lender and expressly releasing the affected lender from its obligations under the original LC. Failure to terminate the original letter of credit may lead to the borrower being under a double counter indemnity obligation in respect of both LCs at the same time.

Tax provisions in facility agreements

An affected lender being in administration or otherwise ceasing to carry on business in the UK can result in the borrower becoming obliged to withhold tax from its interest payments to the affected lender because it would no longer be a "qualifying lender". The borrower may also be obliged to gross up its interest payments depending on the terms of the facility documents. We are aware that the Loan Market Association has raised these issues with HM Revenue and

Customs for consideration, but as yet there has been no guidance issued.

Restricted activities

A borrower is likely to be subject to covenants in its facility documents that restrict its available options in dealing with the difficulties forced upon it by the affected lender's status. Possible options that could be restricted include:

- seeking alternative finance – this is likely to be restricted or prohibited under the facility documents, although may be permitted without the consent of the affected lender up to a pre-agreed limit or if any alternative finance is provided on a subordinated basis.
- granting security for alternative finance - this is also likely to be restricted or prohibited under the facility documents. This is particularly acute in respect of existing secured facilities where a new lender is unlikely to be willing to lend without security, but may be of less importance in respect of existing unsecured facilities where a new lender simply would become another unsecured lender.

Interest rate hedging contracts with the affected lender

An affected lender being in administration or another insolvency procedure can give rise to either a mandatory or an optional early termination event under ISDA based hedging contracts where the affected

lender is the hedge counterparty, and in these circumstances it is unlikely that payments due from the affected lender to the borrower will be made. As a result, the borrower may actually, or effectively, be un-hedged.

This may trigger an event of default under the associated facility documents, which in turn will mean that the borrower will have to go through a hedging close-out procedure with the affected lender and then seek alternative hedging on then current market terms from a new hedge provider.

Requesting consent from the affected lender

This note assumes that agreeing any amendments to the facility documents, no matter how uncontroversial or sensible, will prove time consuming, if not impossible, given the status of the affected lender. Such amendments are therefore not considered at length. It may, of course, be possible to obtain such amendments, particularly if time is not a critical issue.

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