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Feature

KEY POINTS

- A leveraged borrower will typically monitor its ability to comply with agreed financial covenants under its credit facility and should have advance warning of an impending breach.
- Ahead of early stage negotiations with creditors, the borrower may need to prepare for some hard decisions and these will be impacted, to a certain extent, by the exact terms in the borrower's financing documents.
- These include provisions governing confidentiality, access to revolving facilities, events of default, transfers and assignments, and ultimately voting on amendments and waivers.

Authors Clive Wells and Finn Howie

Business as "usual": how leveraged borrowers can seek a stable platform for negotiations in stressed credit scenarios

In an era of low interest rates and liquid credit markets, European leveraged borrowers have had their choice of a range of financing options offered by yield-hungry investors. However, following the peak of the credit cycle, borrowers may start to see an impact on economic performance, with a resulting negative effect on cashflows and, potentially, issues with their financings. Key to avoiding an expensive (and public) formal bankruptcy process is ensuring that the group can continue to operate, to the extent possible, on a "business as usual" basis, respond to prevailing market conditions and ultimately come to an agreement with creditors from, as far as possible, a position of strength. This article discusses how this strategy can be achieved within the terms of a typical suite of leveraged credit documentation.

THE EARLY WARNINGS

Depending on, among other things, when a financing was entered into, a leveraged credit agreement may contain one or more maintenance financial covenants, designed to test ongoing compliance with the "base case" presented to the lenders. Such covenants monitor performance indicators such as cashflow, leverage, interest cover and debt service cover. Treasury professionals should know well ahead of the next test date (and, even more so, ahead of the relevant accounts and compliance certificate being delivered to the lenders) if the group will be unable to comply.

In this crucial period, the goal should be to agree a consensual solution before an actual covenant breach. Speed is of the essence, not least because while the board is preoccupied with such negotiations, it has fewer resources to analyse and react to market pressures affecting the business.

FIRST STEPS: STABILISATION

Access to working capital

A typical leveraged credit agreement will

include revolving credit facilities, providing the group with funding certainty for day-to-day operational expenditure.

In times of stress, the general principle is that while no "new" money can be drawn, the borrower should not have these working capital lines pulled immediately. Ongoing access will be conditional upon the absence of agreed draw stops. These should be reviewed carefully to ensure that even if a potential event of default (that is, a circumstance which will turn into an "actual" event of default upon the expiry of a grace period or some other condition) subsists, the borrower can still roll over maturing revolving advances. The borrower should assess whether the revolving facilities are liable to be withdrawn prematurely owing to a breach of general, non-monetary obligations.

In isolation, these so-called "technical" defaults might not otherwise impact the borrower's ability to pay its debts, but if such a default stops the borrower accessing the group's working capital facility, it is easy to see the potential for a cascading series of defaults culminating in a payment or insolvency event of default.

The borrower should consider whether certain provisions need waivers (temporary or permanent) or amendment, ahead of a "technical" breach occurring and, possibly, tripping over the line of dominoes.

Confidentiality

Safeguarding confidential information will be crucial – to permit an orderly negotiation process and to maintain the group's standing in the market. A typical leveraged LMA (Loan Market Association) facility agreement contains a detailed confidentiality regime which sets out agreed exceptions to the lenders' general non-disclosure obligation. Even in the absence of such terms, the courts have long held that the banker's *Tournier*¹ duty of confidence protects borrowers from harmful disclosures. See, for example, the High Court's decision in *Primary Group (UK)*,² where it was held that a lender had wrongfully disclosed financial information to an industrial competitor of a borrower in severe financial distress (despite some argument as to which contractual terms applied to the disclosure).

Questions do remain about the scope of this duty, especially where not all lenders in the syndicate are registered banks. The permitted use of information can, of course, cut both ways. Commentators have argued that in a stressed scenario, the lenders' close monitoring function can result in unhelpful information asymmetry, as the lenders benefit from unique information flows that the other creditors simply do not receive (particularly where the senior debt is closely held among a small "club" of banks).³ On these occasions,

borrowers may wish to socialise information more widely in order to assist a competitive refinancing process, or even attract a "white knight" buyer. While, ultimately, there is little a borrower can do if information is leaked anonymously to a news service or the market generally, it may be worth drawing to the attention of lenders their duties of confidentiality, particularly where sensitive information is being provided or restructuring proposals made.

Hedging contracts

Hedging contracts should be reviewed to ensure that events of default and termination events (which allow the hedge counterparty to close out hedging transactions prematurely) are not liable to be triggered earlier than under the other financing documents. Such early termination can impose onerous close-out costs on a borrower. In a syndicated financing, the borrower might gain an indirect benefit from two things: first, any intercreditor provisions which limit the termination rights of hedge counterparties in a distressed situation; second, where the hedge counterparties are also lenders, such a counterparty will want to consider its overall exposure (ie under its loan commitment and under its hedging positions). This may discourage the bank's derivatives desk from taking aggressive steps which could jeopardise prospects of full recovery.

Review of events of default

The borrower should conduct a review of the events of default and other provisions which are most vulnerable to a "technical" breach. In a well negotiated credit agreement, the borrower should benefit from longer remedy periods for such technical defaults, but these provisions need to be considered in light of the specific situation and the precise terms of the default. For example, the group's auditors may qualify their audit opinion if there is significant doubt as to the group's ability to trade as a going concern. Such was the case, for instance, in the context of an expedited restructuring of a distressed automotive

group in *Saltri III Ltd v MD Mezzanine SA Sicar*.⁴ The qualification of an audit report will often constitute an event of default in itself, although this may of course be subject to a "material adverse effect" qualifier.

Another pertinent clause will be the insolvency event of default. Balance sheet insolvency is often not the primary concern in stressed scenarios, even where future assets and liabilities cannot be ascertained with certainty (as was the case in *Eurosail-UK*,⁵ where the Supreme Court held that a borrower was not balance sheet insolvent despite long-term exposures to currency and interest rate fluctuations). Such concerns often take a back seat to the more immediate issue of cashflow insolvency, and at this stage the directors may need to consider regular liquidity forecasts and take separate legal advice as to wrongful trading risks. As a practical matter, borrowers should also be careful not to trip an insolvency default which has been extended to cover the commencement of negotiations with creditors "with a view to rescheduling indebtedness by reason of actual or anticipated financial difficulties" by initiating such discussions with the lenders (if that scenario has not been carved out in the drafting).

BETTER THE DEVIL YOU KNOW: KEEPING THE KEY LENDERS ON SIDE

Depending on the make-up of the syndicate (and the size of the hedging debt), the borrower's main relationship lenders may be crucial drivers of a successful negotiated outcome. They can be expected to guide negotiations within the syndicate and, together with the agent, intermediate between the syndicate and the borrower/sponsor. It may, therefore, be worth limiting preliminary discussions to such key lenders.

Contractual exit restrictions

Well negotiated transfer provisions may prevent a borrower's debt being acquired by industrial competitors or vulture funds, seeking to gain strategic controls over the business. However, such protection is not absolute, particularly where:

- transfer restrictions are generally lifted when an event of default is continuing, which unfortunately is when the borrower is most vulnerable to such a strategic play; or
- a proposed transfer requires only consultation with the borrower, as opposed to a full consent requirement; or
- a requested transfer is subject to a deemed consent provision, following the elapse of a prescribed time period (such period being aligned with secondary debt trading documents). The borrower will need to be aware of any such deadlines in order to respond appropriately. The English courts have interpreted such provisions strictly, such as in *Barbados Trust v Bank of Zambia*⁶ where a loan assignment conducted prior to the elapse of the time period was held to be ineffective (despite the borrower consenting to the transfer after the fact).

Ultimately, therefore, it may not be possible to retain a friendly syndicate, but it is worth at least determining who within the syndicate is amenable to assisting a negotiated deal and finding ways to get and use their support.

Sponsor support

In addition to group-level actions, such as operational restructuring, cost-cutting initiatives or asset divestment plans, a key possibility for a borrower is obtaining the support (ideally financial support) of the sponsor. If such operational measures are insufficient, the sponsor will need to determine if and when additional equity or subordinated loans should be injected. Pre-default, the credit agreement will typically restrict the borrower's ability to issue new shares or incur further subordinated indebtedness. Following a covenant breach, however, equity cure provisions will allow the sponsor to remedy a covenant breach by injecting a "cure amount".

It may also be necessary for the sponsor to inject more equity into the deal as part of a restructuring proposal. Inevitably, the

Feature

Biog box

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sponsor will weigh up if this is likely to save its investment or is simply throwing good money after bad and it is better off "handing the keys" to the lenders.

AN OFFER YOU CAN'T REFUSE: MAKING THE PROPOSAL TO CREDITORS

Identifying the "ask"

The borrower will need to empathise with the overall restructuring strategy, including the exit considerations, of the disparate members of the creditor group. The severity of the borrower's position will guide the decision as to whether to propose a covenant reset, a maturity re-profiling, or a debt write off or debt-for-equity swap (or a combination of those).

Perhaps as a result of different standards of bank prudential regulation, commentators have noted that the least liquid banks will be the most impatient creditors. They will try to exit faster than other creditors, be less likely to "hold out" and may be more susceptible to offers of partial refinancing.⁷

Which option has the most likely prospect of success depends on the particular circumstances driving the need for the restructuring. To briefly take each in turn:

- A simple covenant re-set may have more success where only a particular covenant or covenants are at risk of breach.
- A request to extend the loan maturity is best suited to a borrower with long-term prospects of an earnings recovery or a material asset sell down. In a review of publicly disclosed stressed debt transactions carried out in the last 12 months, approximately one third of covenant re-sets were accompanied by an agreement to extend debt maturities.

- Where the parties (usually on the advice of an independent financial adviser engaged by the borrower) believe that the debt load is not sustainable in the long term, the borrower may request a write down or debt-for-equity swap, or the sponsor may attempt a discounted debt repurchase. For the lenders, this is a last resort which recognises there are no reasonable prospects of recovering that principal.

All such proposals will come at a cost to the borrower. The borrower and its sponsor will need to consider what "sweeteners" to offer. These include one-off consent, participation and amendment fees, increases to the margin and line fees or, in some cases, equity. Leaving aside direct financial costs, going forward the borrower can also expect less flexibility and greater information requirements and oversight.

Implementing the deal

This will involve navigating the disparate interests of the creditors. Syndicate democracy is regulated by the majority lender voting regime. In European deals the approval of lenders with two thirds of total commitments is the standard requirement for amendments, consents and waivers. For more fundamental changes, particularly those concerning the scope of the security package, all lender approval or a super majority vote (commonly 85%) is required, which brings with it the issue of holdout creditors.

These may need to be addressed by deemed consents or "yank-the-bank" provisions applicable to non-consenting lenders. Here it is important to appreciate the limits to what can be achieved outside a formal insolvency process such as a scheme of arrangement. In particular, the exercise of a yank-the-bank right may not be economically

realistic given that it allows the holdout lender to be prepaid or to transfer its position at par value.

Long-term opportunities?

In conclusion, it is worth remembering that the borrower's stressed position may be caused by negative conditions affecting the market generally. For sponsors who take a long term view of the investment, this may mean it is an optimal time to acquire strategic assets more cheaply. The problem will be convincing the lenders (who will be expecting less, not more, investment expenditure) to grant any necessary consents! ■

- 1 *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461.
- 2 *Primary Group (UK) Ltd v The Royal Bank of Scotland Plc* [2014] EWHC 1082 (Ch).
- 3 Brunner, A. and Krahen, J.P, "Multiple lenders and corporate distress: Evidence on debt restructuring", 2002.
- 4 *Saltri III Ltd v MD Mezzanine SA Sicar & Ors* [2012] EWHC 3025.
- 5 *BNY Corporate Trustee Services Ltd and others v Eurosail-UK 2007-3BL PLC and others* [2013] UKSC 28 (9 May 2013).
- 6 *Barbados Trust Co v Bank of Zambia* [2007] EWCA Civ 148; [2007] 1 Lloyd's ep 495.
- 7 Wright, L.J and Pitchford, R., "Holdouts in sovereign debt restructuring: a theory of negotiation in a weak contractual environment", 2011.

Further Reading:

- Potentially toxic clauses in loan agreements [2017] 5 JIBFL 308.
- We need to talk: information flows when restructuring listed debt [2017] 2 JIBFL 80.
- LexisPSL: Banking & Finance Practice note: debt waivers, extending maturity and debt rescheduling.