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NAVIGATING LOAN DOCUMENTATION IN PRE-DISTRESSED OR DISTRESSED SCENARIOS

To Our Clients and Friends:

As some sectors of the UK economy continue to falter and feel the negative impact of various macro-economic events (including depressed oil and commodity prices, low interest rates and the uncertainty caused by the Brexit referendum decision and ensuing withdrawal process), it is inevitable that a number of borrowers will find themselves in pre-distressed or distressed scenarios.

The vast majority of loan documentation governing live credits has either been entered into since the financial crisis in 2008 or reflects refinancings that have taken place since then. Far from being more lender-friendly, however, it is generally acknowledged that there has been a gradual erosion of traditional lender protections – e.g. a watering down of financial covenant protections with the emergence of covenant-loose or covenant-lite loans – together with an influx of pro-sponsor/borrower provisions, often imported from the US market.

Whilst on the one hand this is great news for borrowers – their loan documentation is, often, inherently more flexible than it once would have been and there are arguably fewer so-called early warning signs or hair triggers for lenders - it is clear that there are still a number of provisions within loan documentation that may present challenges to borrowers in pre-distressed or distressed situations. This article looks to identify and navigate through a number of these.

Material Adverse Effect, and Default or Event of Default

In analyzing loan documentation from the perspective of a pre-distressed or distressed credit, it is key to have an understanding as to the scope of the Material Adverse Effect definition, and the application of the Default or Event of Default definitions. This is because the drafting of these seemingly innocuous defined terms can have a key bearing on whether a distressed or pre-distressed borrower is able to continue to utilize its debt facilities and/or avoid having to make premature disclosure of possible financial difficulties to its lenders.

The definition of Material Adverse Effect typically acts as a qualifier for representations and/or positive covenants. In addition, an immediate Event of Default typically arises if any event or circumstance occurs which has, or is reasonably likely to have, a Material Adverse Effect, giving lenders the ability to exercise their acceleration rights.

There are customarily three limbs included within a Loan Market Association ("LMA") form of Material Adverse Effect definition, as set out below:

> "an event or circumstance which has (or is reasonably likely to have) a material adverse effect on: (a) the business, assets or financial condition of the Group (taken as a whole); (b) the ability of the [Obligors] (taken as a whole) to perform their payment obligations under the Finance Documents; and (c) the validity or enforceability of or the effectiveness or ranking of transaction security."

Of course, top-tier sponsors successfully negotiate significantly more borrower-friendly Material Adverse Effect definitions. However, it would be wrong to assume that in all instances the definition is well negotiated from the perspective of the borrower and, despite both its importance and prevalence, there are a number of recent examples of loan agreements which include one or more of the following lender-friendly concepts: (i) the inclusion of a subjective test such that the question whether the relevant event or circumstance has a material adverse effect is determined in the opinion, or reasonable opinion, of the lenders, (ii) the reach to any event or circumstance that has an effect not only on the assets or financial condition of the Group but also the *prospects* of that Group, and (iii) the material adverse effect bites on the ability of the relevant entities to perform their obligations in relation to financial covenant testing.

A subjective test should always be avoided (as is the general rule of thumb for any determination to be made by a lender or agent throughout loan documentation) as it is much more difficult to challenge a subjective determination rather than an objective one, but often the significance of either a reference to "prospects" or to the ability of the relevant entities to perform their financial covenant obligations only becomes apparent when considering a distressed or pre-distressed scenario.

Let's consider a practical example: If a company delivers to its lenders monthly financial statements that show in all likelihood that the financial covenants, which are tested by reference to the quarterly financial statements delivered at the end of the following month, will be breached, does that give the company's lenders grounds to conclude that there has been a material adverse effect on either the prospects of the Group or the ability of the relevant entities to perform their financial covenant obligations?

No two situations are the same and so, to some extent, the answer will turn on the unique facts. If a situation like this were to arise, a court would look to determine whether a reasonable person, having the same knowledge and skill as the lenders, would determine that, on those facts, an event had occurred which had, or was reasonably likely to have, a material adverse effect on the prospects of the group or the ability of the relevant entity to comply with the financial covenants. This is not a question of law but, rather, one of judgment – whilst declaring a material adverse effect in this instance would not be without risk for the lenders, it is something which they could consider. There have been very few instances where lenders have relied solely on the occurrence of a material adverse effect to call an Event of Default and exercise their rights and remedies, particularly as lenders will generally err on the side of caution, but it is not unheard of or theoretically impossible.

In addition to Material Adverse Effect, the concepts of Default and Event of Default are also key. Typically, a Default is an event or circumstance which would, "*with the expiry of a grace period, the giving of notice, the making of any determination under the Finance Documents or any combination of any of the foregoing*", be an Event of Default. As we noted with the Material Adverse Effect definition above, it is the occurrence of Defaults and Events of Default which trigger certain key rights and remedies for lenders under the underlying finance documentation – including putting the underlying debt on demand, declaring all or some of the debt immediately due and payable, or taking steps to enforce security. Even if lenders choose not to exercise any of these rights following the occurrence of a Default or an Event of Default, the fact that they could do so is likely to underpin their stance towards the relevant borrower, and there may also be further consequences for that borrower as well (some of which we explore in some detail below).

Possible Default Triggers

Having regard to the above hypothetical fact pattern again, it is worth considering whether a Default or Event of Default may be deemed to have occurred following delivery of the monthly financial statements/management accounts. Let's suppose that the borrower/group is approaching impending financial distress, and the monthly financial statements suggest that some or all of the company's financial covenants may not be complied with on the next test date.

In that scenario, it is unlikely that delivery of such monthly financial statements would of itself be a Default (and therefore, also unlikely that the Borrower would be obliged to notify the agent of the occurrence of Default or an Event of Default, see further below). This view is based on a legal analysis of the typical definition of "Default" and the fact that that definition does not (as is sometimes the case) include or refer to events that "with the passage of time" would become Events of Default. It would of course be open to a company to choose to notify the lenders in any event, and/or the lenders may (incorrectly from a strictly legal point of view) consider delivery of such financials to have given rise to a "Default". Of course, if the relevant compliance certificate eventually delivered with the underlying financial statements does show a breach of all or certain financial covenants, this will give rise to an Event of Default on the date on which the covenants are tested. The key point here is to be very clear about what the definition of "Default" says in analysing whether events or circumstances that may inexorably lead to an Event of Default necessarily constitute a Default.

In a distressed, or soon-to-be distressed scenario, there are three other common events which may or may not trigger a Default or Event of Default.

First, it is often an Event of Default if the auditors of the relevant borrower or borrower group qualify the audited annual consolidated financial statements of the group, and, e.g. the grounds giving rise to the qualification would be material in the context of the financing documents, or the qualification would be adverse (or materially adverse) to the interests of the finance parties. The permutations of this Event of Default are important – rather like the Material Adverse Effect definition, there are a range of different provisions throughout the market and it is important for a borrower to understand whether any qualification is expected, and, if so, what the documentary and practical consequences of it may be – early-stage discussions and dialogue with the auditors and accountants of the group are key.

Second, will the fact that an entity is balance sheet insolvent i.e. that its assets are less than its actual and contingent liabilities, result in the occurrence of a Default? Often, the existence of a balance sheet insolvency test will be included as a Default – and usually, on an individual-company (rather than consolidated) basis. This creates the opportunity for an individual company within the group to trip a Default, notwithstanding that the company is not actually in financial difficulty, can meet its liabilities as they fall due and is not presumed insolvent under English law. Borrowers should, therefore, resist inclusion of a standalone balance sheet solvency Event of Default and should point to separate, customary lender protections e.g. an Event of Default that is triggered upon actual commencement of informal or formal insolvency proceedings, as providing sufficient lender comfort.

Third, the LMA form of insolvency Event of Default captures the commencement of informal measures (such as negotiations with creditors) in relation to actual or anticipated financial difficulty, as set out below:

(a) A member of the Group:

i. *is unable or admits inability to pay its debts as they fall due;*

ii. *[is deemed to, or is declared to, be unable to pay its debts under applicable law];*

iii. *suspends or threatens to suspend making payments on any of its debts; or*

iv. *<u>by reason of actual or anticipated financial difficulties</u>, commences negotiations with one or more of its creditors (excluding any Finance Party in its capacity as such) with a view to <u>rescheduling</u> any of its indebtedness.*

On its face, limb (iv) of the standard LMA formulation covers rescheduling of any indebtedness with any single creditor, including a company's bank lenders, its landlords and trade creditors, irrespective of the quantum of those liabilities. The extent to which any particular approach or negotiations with a single or class of creditors might trip this Event of Default will invariably turn on the factual matrix; however, it should be noted that the High Court[1] has previously held that the term "rescheduling" implies a degree of formality and relates to the formal deferment of debt-service payments and the application of new and extended maturities to the deferred debt. It is not, therefore, concerned with an informal telephone conversation with or email to a relationship or credit manager requesting "a bit more time to pay", which would be commercially unfeasible (particularly for highly leveraged entities which might have such conversations on a daily basis). Furthermore, the High Court has stated that the lead-in wording, which requires that informal negotiations be commenced by reason of "actual or anticipated financial difficulties", in the context of a clause dealing with insolvency, envisages "difficulties" of a substantial nature. Notwithstanding the foregoing, however, a court will (subject to the particular facts) find that an event of default has occurred where negotiations are or the proposed rescheduling is beyond the ordinary course of a borrower's business or is not simply a case of rolling-over existing indebtedness into new indebtedness.

Prudent borrowers might try to limit the ambit of the above Event of Default to exclude negotiations with trade creditors; require that negotiations be with a "class" rather than single creditor; or specify that the Event of Default is triggered only on the occurrence of formal legal proceedings. Given the fact-sensitive nature of this provision, it is also important that borrowers and their advisers are alert to and carefully consider the potential to trigger a Default at the outset of a stressed or soon-to-be distressed scenario upon commencement of informal discussions with a single creditor or class of creditors.

Finally, it is always important for a company to have one eye on its repeating representations – many borrowers will be unaware that a number of representations will be given automatically (including those buried in side letters or ancillary agreements such as security documents) – e.g. on each interest payment date. Whilst a number of these representations are often technical or legal in nature, a number also extend to factual scenarios and, in some cases, to a representation that there is no Default.

Consequences of the Occurrence of a Default or Event of Default

At this juncture, it is worth noting – again perhaps obviously – that whilst as a commercial matter a distinction is sometimes drawn between a payment or "money" default and other so-called "technical" defaults (e.g. breach of undertaking, failure to deliver financial statements, etc.), as a legal matter, there is no such distinction, and there is no qualitative difference in terms of consequences between a payment or money Event of Default and any other Event of Default – the occurrence of any of them entitles the lenders to exercise the rights and remedies available to them under the relevant finance documents. Although there are a handful of exceptions, it is best practice to assume that a technical default is the same as any other default and therefore the consequences of any such default are the same. Borrowers should ensure that all Events of Default, technical or otherwise, are waived in writing and confirmed as no longer "continuing".

As to the practical consequences of a Default or Event of Default, typically in many facilities, a drawstop to funding will be the occurrence of a Default in respect of new loans, and an actual Event of Default in relation to the rollover of existing loans (although, in some documents, even the occurrence of a potential Event of Default is a drawstop to rollover loans). Clearly, if the trigger in either case is a Default, both the risk of the drawstop occurring is increased but, more practically, the company needs to be more attuned to when a Default may or may not arise. As above, this drawstop would apply equally to so-called "technical" Defaults. In some cases a funding drawstop (particularly in relation to existing or rollover loans) may be the beginning of a company's downfall – if a company requires an on-going revolving facility / working capital line such that it cannot continue trading without these facilities, if existing borrowings are draw stopped, this may signal the end. It is, therefore, particularly important to be aware of the triggers for funding draw stops, whether there is any advantage to a premature drawing of a revolving credit line (noting that this may not necessarily glean favour with the lending group) and how vital any undrawn facilities (particularly working capital facilities) are to the going concern nature of the group. It is also worth noting that any such drawstop may also apply to any overdraft facility (or equivalent) provided by way of ancillary facility.

By way of reminder, customary loan documentation will typically require a borrower to provide the following information:

- (at any time) a certificate signed by certain senior officers of the company certifying that no Default is continuing (or, if a Default is continuing, specifying the Default and steps taken to remedy the same). This is a seemingly innocuous but potentially very important tool in the lenders' armory and may be relied upon as the lenders become aware of potential financial difficulties (e.g. upon receipt of financial statements and/or compliance certificates) as a means of procuring an acknowledgment from the company that a Default has occurred and triggering the protections that arise on a Default. Borrowers and their advisers should ensure that provisions and the potential tripwires noted above are read with care to avoid responding to the lenders acknowledging a Default where, legally, and on an interpretation of the finance documents, there is no Default; and

- (promptly upon request) such further information regarding the financial condition, assets and operations of the group and/or any member of the group as any finance party may reasonably request. It is not uncommon for lenders to invoke this information request right in a stressed scenario as a means to obtaining further information; requests and responses to the lenders should be carefully considered by borrowers and their advisers, particularly to ensure that the response, if any, does not of itself constitute or give rise to a Default or Event of Default.

In addition to the information undertakings/rights referred to above, loan agreements will usually also include a general undertaking requiring the group, in the event that a Default is continuing or the agent reasonably suspects such, to permit the agent and its professional advisers free access at all reasonable times and on reasonable notice (at the borrower's cost) to the premises, assets, books and accounts of each group company, and to meet and discuss matters with members of senior management. Since this undertaking extends to a situation where the agent reasonably suspects a Default may have occurred, it may be invoked by the lender group ahead of an actual Default and upon receipt of financial information which is sufficiently concerning to the lenders. It is, typically, this right which permits the lenders to commission an independent business review (or so-called "IBR") whereby a firm of accountants will be appointed to investigate and report on the financial condition of the group and which is invariably a preliminary condition to implementing a restructuring plan.

Other

In a stressed or distressed scenario, it is also helpful for a company to have one eye on the transfer provisions contained within the finance documents. Typically, where lenders are subject to restrictions on transferability – e.g. to affiliates and entities on a white/permitted list – these will fall away following an Event of Default which is continuing. In essence, this means that following an Event of Default, lenders would have the ability to transfer to distressed investors and/or so-called "vulture" or other credit funds (assuming, of course, that such entities are not already included on the White List). As result, the complexion and disposition of the relevant lender group towards the underlying credit group could change quite radically following the occurrence of an Event of Default in circumstances where one or more of the existing lenders decided to trade out of the credit and sell to "loan-to-own" or "distressed-for-control" investors whose approach and motivations may be different. In light of recent aggressive, sponsor-driven documentation, however, some borrowers may find transfers to "loan-to-own" lenders are actually prohibited or that consent to trading is still required during an Event of Default (save in relation to non-payment or insolvency Events of Default only).

Borrowers should also keep in mind the amendment and/or waiver provisions contained in the finance documents, particularly in the context of a lending syndicate where relationships with the borrower and/or treatment of the credit diverges between lenders. The traditional LMA construct provides that the vast majority of amendments and/or waivers to the finance documents require majority lender consent (typically lenders whose commitments aggregate more than $66^{2/3}$ per cent. of the total commitments). Loan documentation will usually also include customary "yank the bank", "snooze you lose" and "structural adjustment" provisions which may be used to the borrower's advantage; for example, in a scenario where the revolving facility provider is less amenable to a restructuring plan than the other lenders, subject to the ongoing working capital needs of the group, undrawn revolving commitments and amounts that are committed by way of ancillaries such as overdrafts but not actually drawn may be cancelled to adjust lender hold levels to the company's advantage. Other facilities provided by favourable lenders, e.g. capex and acquisition facilities may also be drawn to adjust lender commitment levels. Again, it may be the case that in more recent documentation, the majority lender threshold is lower (for example, 50 per cent.) or that the scope of amendments requiring only affected/participating lender consent is greater, allowing more flexibility for borrowers.

Refinancing

Borrowers should also be alive to the inclusion of potential hair triggers when undertaking a refinancing or amendment to loan documentation in a non-distressed context; often, the terms of a refinancing will provide that documentation is amended to include updates to the most recent LMA form of loan agreement, to the extent required. Borrowers should resist wholesale acceptance of such amendments, however, and take care to ensure that these are purely mechanical. For example, a recent LMA update provides that a hedging agreement shall be deemed to be a "Finance Document" for the purposes of the definition of "Default". Borrowers will, usually, have less control over and scope to negotiate hedging arrangements, and the inclusion of hedging agreements as a "Finance Document" for the purposes of the definition of "Default" will give the lenders a far earlier trigger on which to act than they otherwise had; instead, Borrowers should point to the protections built into separate ISDA documentation and to other events of default – e.g. MAE – as providing sufficient comfort for the lenders. The inclusion of new "LMA" undertakings and representations should also be closely analysed to determine any risk that the borrower might trip these.

Conclusion

Whilst it is hoped that the above provides some food for thought, the overriding message is that borrowers (and sponsors) must look to understand their financing documents – not only to regularly review compliance with repeating representations and on-going covenants, but also to ensure they know their obligations should a Default or Event of Default arise, and to understand the consequences of any such Default or Event of Default. Even if lenders do not look to accelerate the underlying debt or enforce security following a Default or Event of Default, they are more likely to use it as leverage as against the borrower, and could look to force an upward re-pricing, payment of a one-off fee or, just generally, be less amenable to agree to any required waiver or amendment.

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[1] *Grupo Hotelero Urvasco SA v Carey Value Added SL and another* [2013] EWHC 1039 (Comm) (26 April 2013).

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Global Finance practice group, or the authors:

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