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Feature

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To Fund or Not to Fund?

Responding to a Draw Request from a Distressed Borrower

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Since late 2015, credit markets have seen a trend of borrowers drawing their remaining available unfunded commitments under their revolving credit facilities shortly before implementing a restructuring. Borrowers in the exploration and production sector of the oil and gas industry have used this tactic frequently. With credit markets inaccessible following the severe and sustained downturn in oil prices, leveraged borrowers (including Ultra Petroleum, LINN Energy, SandRidge Energy and Paragon Offshore) have pulled down hundreds of millions of dollars representing the full undrawn capacity of their unfunded commitments, in each case shortly before commencing a voluntary chapter 11 case. The appeal of this strategy for distressed borrowers is obvious: Drawing available funds from a revolving credit facility maximizes liquidity prior to a bankruptcy filing, potentially obviating the need to obtain debtor-in-possession DIP financing to fund the bankruptcy case.

In addition to providing liquidity, a draw increases the borrower's leverage over its revolving credit lenders. With lenders' cash in hand, the borrower is better positioned to extract concessions from lenders in pre-restructuring negotiations, or even secure further financing from the same group during the bankruptcy case or in connection with exiting bankruptcy. Lender banks faced with a funding request must typically decide quickly — under many credit agreements, on the same day the request is received — whether to honor the draw. Accordingly, lenders would be well advised to understand in advance any potential grounds for a refusal to fund, and the possible consequences of such a decision, especially where the fully drawn exposure might exceed the value of the secured lenders' collateral. This article considers institutional lenders' practice of honoring the vast majority of revolver draw requests and discusses the scope of contract-based lender-liability claims arising out of refusals to fund, potential intercreditor consequences of such refusals and key considerations for deciding whether to fund.

"Banks Fund Draw Requests"

In a typical revolving credit agreement, a borrower must satisfy certain conditions precedent before it can borrow using available unfunded commitments. These conditions typically require the borrower to (1) submit a proper draw request in accordance with the credit agreement, (2) confirm that no default or event of default exists at the time of the borrowing or immediately thereafter, and (3) certify that certain representations and warranties in the credit agreement remain true and correct as of the date of the draw (known as a "bring down" of those representations and warranties). In the overwhelming majority of cases, banks honor properly certified draw requests — even where the borrower's actual compliance with applicable conditions precedent is questionable notwithstanding borrower certifications.[2] This prevailing approach is explained by two overriding concerns that are largely independent of the "merits" of whether the borrower is compliant: reputational risk and lender-liability considerations.

Reputational risk involves business considerations outside the scope of legal analysis. In short, each lender must determine as an institution whether the potential loss attributable to the increased credit exposure is outweighed by the more intangible potential loss of future business — on both a

1 The author thanks Matthew Kelsey and J. Eric Wise for their assistance.

2 *See, e.g.*, Max Frumes, "Draw First, Ask Questions Later: Why Oil and Gas Companies are Fully Tapping Their Revolvers Before Restructuring," *Forbes*, Feb. 16, 2016, *available at* forbes.com/sites/maxfrumes/2016/02/16/draw-first-ask-questions-later-why-oil-and-gas-companies-are-fully-tapping-their-revolvers-before-restructuring/#19a6e23a697b; Anthony Ruben, "Paragon Draws Down Credit Line," *Seeking Alpha*, Sept. 8, 2015, *available at* seekingalpha.com/article/3494286-paragon-offshore-draws-credit-line (last visited on April 28, 2017).

micro level by adversely impacting the bank's relationship with the borrower or its sponsor, and a macro level by discouraging future borrowers from obtaining financing from the recalcitrant bank.

Avoiding lender liability is often invoked as a basis for honoring a draw request even where the borrower's compliance with conditions precedent to a draw is uncertain. Although the possibility of compounding losses from lender liability may drive institutional decision-making, the contours of litigation threatening such liability are often not well understood. Putting aside business torts, which are generally more difficult to establish where contractual terms govern the relationship between parties, a borrower's most logical recourse against a lender rejecting a draw request would be to sue for breach of the credit agreement governing the revolving credit facility. The borrower would likely bring any such claim following a bankruptcy filing, and the claim, if colorable, might become a key asset for unsecured creditor recoveries. While refusals to fund revolver-draw requests are uncommon and reported decisions in connection with subsequent litigation are rare, several notable cases might help to guide expectations.

Lender Liability: Breach-of-Contract Claims

A recent decision in the *LyondellBasell* bankruptcy case demonstrated that limitation of liability provisions in the applicable credit agreement may foreclose potential damages for failure to fund a draw request in whole or in part.[3] In 2008, AI International, the assignee of the sole lender in LyondellBasell's unsecured revolving-credit facility, declined to fund a $750 million draw request. AI asserted that its obligation to fund was excused based on its knowledge that the borrower had retained restructuring advisors, which, according to AI, constituted a "material adverse change" (MAC) in the business that prevented the borrower from being able to satisfy the condition precedent of representing that no MAC had occurred since closing. In partially granting a motion to dismiss, the bankruptcy court found that a provision in the credit agreement foreclosing lender liability for "special, punitive, indirect or consequential damages" was enforceable under New York law. Accordingly, the court held that plaintiffs could recover, at most, restitution damages of $12 million in lender commitment fees paid under the facility.[4]

Regardless of whether damages for breach of contract are expressly limited by the credit agreement, courts have found that whether a refusal to fund is a breach of the credit agreement is largely a question of fact.[5] In the *LyondellBasell* case, nearly eight years after the commencement of litigation and following a full evidentiary trial, the court ruled against the non-funding lender, awarding $7.2 million of restitutionary damages to the debtor's estate (representing the lender's $12 million of commitment fees, less a 40 percent reduction accounting for the lender's funding a 40 percent draw prior to declining the draw request).[6] The court rejected the lender's argument that the borrower's bankruptcy preparations constituted a MAC, reasoning that such an interpretation would inappropriately stretch the MAC clause to include an ongoing solvency requirement for all draws even though the agreement only required a solvency representation upon closing.[7]

Standing requirements may further limit the scope of potential lender liability. The Eleventh Circuit Court of Appeals has held that only a borrower (or its successor-in-interest, such as a bankruptcy trustee) has standing to bring a breach-of-contract action against a non-funding lender.[8] In a dispute arising out of the *Fontainebleau* bankruptcy, a syndicate of revolving lenders refused to honor a $350 million draw request on grounds that the borrower's delayed-draw term loan commitments had not yet been fully drawn, claiming that a full-term loan draw was a condition precedent to their obligation to fund. Following the issuer's bankruptcy filing, the lenders were sued for breach of contract by both the borrower and term lenders (whose loans were issued under the same credit agreement). The court held that under New York law, the term lenders lacked standing to sue the revolving lenders for the alleged breach because the agreement contained no express indication that lenders were beneficiaries of promises to fund the borrower.[9] Based on certain ambiguities in the agreement, the court also denied the borrower's motion for summary judgment on its breach-of-contract claim.[10]

Intercreditor Disputes: Genuity Litigation

While limitation of liability provisions and standing considerations may limit potential liability through direct breach-of-contract actions, litigation risks remain in the form of potential intercreditor disputes involving defaulting lender and *pro rata* sharing provisions in the applicable credit agreement. Specifically, if a court finds that a lender's failure to fund was unjustified, the administrative agent may implement a distribution priority that disadvantages lenders who chose not to fund. Although such disputes are rarely litigated to the point of decision, one notable high-stakes case arose in connection with the bankruptcy case of *Genuity*, an internet company.[11]

Several months before its bankruptcy filing, Genuity sought to draw the full $850 million of availability under its revolving credit facility. While eight of the nine syndicate banks honored the request, Deutsche Bank (DB) refused to advance its $127.5 million share. DB claimed that certain events of default had occurred under the credit agreement, excusing the obligation to fund. Genuity filed for bankruptcy shortly thereafter, triggering a draw on an outstanding $1.15 billion letter of credit issued under the revolving credit facility, which was funded by all the syndicate banks (including DB). The bankruptcy court confirmed a liquidation plan without resolving the intercreditor dispute arising out of

3 *In re Lyondell Chem. Co. (Weisfelner v. Blavatnik)*, 544 B.R. 75 (Bankr. S.D.N.Y. 2016).

4 *Id.* at 91-92.

5 *See, e.g., JPMorgan Chase Bank NA v. Luxor Capital LLC*, 938 N.Y.S.2d 227 (N.Y. Sup. July 25, 2011) (concluding that issues of fact precluded summary judgment in action for breach-of-contract claims brought against lender that refused to fund draw request).

6 *Weisfelner v. Blavatnik (In re Lyondell Chem. Co.)*, No. 09-01375 (MG), Dkt. No. 919 (April 21, 2017), at 161-63.

7 *Id.* at 159-61.

8 *Ave. CLO Fund Ltd. v. Bank of Am. NA*, 709 F.3d 1072 (11th Cir. 2013).

9 *Id.* at 1078-79.

10 *Id.* at 1081. While the reasoning of this ruling forecloses direct litigation by lenders, a creditors' committee in a borrower's bankruptcy case could potentially sue on behalf of the debtor if the debtor declines to sue and the committee obtains derivative standing. *See Official Comm. of Unsecured Creditors of Cybergenics v. Chinery*, 330 F.3d 548 (3d Cir. 2003).

11 *Deutsche Bank AG v. JPMorgan Chase Bank*, 2007 WL 2823129, at *1 (S.D.N.Y. Sept. 27, 2007), *aff'd*, 331 Fed. App'x 39 (2d Cir. 2009).

DB's failure to fund the draw request and its potential status as a "defaulting lender." Distributions for lenders were paid to the administrative agent for the facility, with a portion placed in escrow pending resolution of the dispute.

Following confirmation, DB sued the agent seeking a distribution, granting it a recovery on its letter of credit advance *pro rata* with other lenders' recoveries based on commitment percentages (and apparently disregarding its failure to fund the initial draw). The agent argued that because DB failed to fund the initial draw request, it had already effectively recovered 100 percent on the advance that it declined to make and that a truly "ratable" distribution would have to provide the other lenders with a full recovery on their portions of the initial advance. The difference between the competing proposals was approximately $50 million.

After discovery, the district court entered summary judgment against DB, finding that no event of default had occurred as of the date of the draw request such that DB's failure to fund rendered it a "defaulting lender." Notably, the court rejected DB's argument that the borrower defaulted by failing to satisfactorily respond to the bank's requests under the credit agreement's information-requesting provision on the day the draw request was received, because the requests were not relayed through the agent as required under the agreement — and in any event, the borrower had five days to respond. Thus, the borrower had more time to respond to information requests than its lenders had to determine whether to honor the draw request.

The court upheld the agent's proposed distribution scheme, which repaid the eight funding banks' revolver loans in full and provided all banks with a *pro rata* recovery of 22.6 percent on amounts outstanding under letters of credit.[12] The result of this protracted litigation illustrates the additional risks of declining to fund a draw request where all or a majority of other lenders have decided to fund — particularly where the agent might be aligned with funding lenders.

Be Prepared

A clearer understanding of common bases for a refusal to fund and the potential consequences thereof places bank lenders in a position to make a quick decision and reduces the risk of encountering the prisoners' dilemma often faced by the members of a revolving credit facility syndicate. This can be summarized into three of the most common bases.

First, lenders should confirm that the borrower's draw request is in order — *i.e.*, that the request itself fully complies in all material respects with the procedures for a draw request set forth in the credit agreement. Second, lenders should determine whether the borrower is out of compliance with any of the credit agreement's covenants, including both applicable financial covenants (such as a springing leverage covenant tested on a *pro forma* basis upon the draw) and those of a more technical nature (such as reporting obligations or a requirement to join certain newly formed subsidiaries as guarantors). Even if a formal event of default has not ripened, borrowers are generally required to certify that no "default or event of default" has occurred, and a covenant breach or technical default could qualify as a so-called "small d default," providing a basis on which to decline funding. Third, lenders should carefully review the representations and warranties that the borrower is required to bring down to draw and, to the extent possible through available information, ensure that the borrower is able to comply with each.[13]

The representation that the borrower is solvent is of particular relevance, although many recent credit agreements provide that a solvency representation need only be true and correct as of the facility closing date. Another representation potentially subject to challenge is the representation that no event or circumstance having a material adverse effect on the loan parties has occurred since the facility's closing date, although the recent *Lyondell* decision may have undermined the viability of this approach. Lenders and agents should also assess their own conduct in connection with any potential basis for noncompliance, which may undermine or mitigate claims on which the borrower has defaulted.

Without advance planning, by the time a draw request arrives, it might be too late to undertake a complete analysis of whether the borrower has complied with applicable conditions precedent beyond examining the borrower's certifications in connection with the draw. Under many credit agreements, lenders' rights to request information from the borrower give the borrower more time to respond than lenders are given to decide whether to fund a draw request. Given the complexity of the analysis and the very short time frame in which lenders must decide whether to honor a draw request, lenders in pre-distressed credits should investigate and understand their options ahead of time. abi

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12 The court cited the agent-authorization provision of the credit agreement, which authorized the agent "to exercise such powers and discretion under this Agreement as are delegated to the Agent by the terms hereof, together with such powers and discretion as are reasonably incidental thereto." *Id.* at *20. More recent credit agreements generally provide a narrower grant of authority to the agent, conferring only expressly delegated powers and reasonably incidental powers.

13 In addition to information obtained in the ordinary course through reporting covenants, credit agreements typically include a provision that allows lenders to obtain (through a request via the administrative agent) other information regarding the operations, business affairs and financial condition of the borrower, or compliance with the terms of the loan documents.