

Transferring debt: the borrower/lender tug of war



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THIS BRIEFING LOOKS AT THE TENSION BETWEEN borrowers and lenders seeking to retain control of a company in difficult times. This tension is particularly evident in the negotiation of the various provisions in facility agreements governing the assignment and transfer of the debt, and the release of confidential financial information.

THE RISE OF THE SECONDARY DEBT MARKET

The incidence of syndicated lending has risen dramatically in the past few years. As such, it has become increasingly important to lenders to have freedom within the transfer provisions of the facility agreement to sell down without restriction.

In recent years, as companies across all sectors have taken advantage of record low pricing levels and revisited their finance arrangements to improve their banking deals, borrowers have gained the upper hand in the primary debt market. In such a highly competitive environment, the one area in which banks have been able to generate extra returns on their lending is in the emerging secondary debt market, a market in which hedge funds and other 'non-bank' financial institutions have become increasingly active.

Originating lenders have therefore specifically sought transfer provisions which permit the transfer of the debt not only to other banks but to any kind of financial institution. This trend has been resisted by the bigger players amongst borrowers – notably private equity sponsors in respect of debt financing for leveraged buyouts – who have specifically sought to limit transfer to non-banks.

LOSING CONTROL

The reason for this resistance is ultimately one of loss of control. Once a company's syndicated debt enters the secondary debt market, its control over whose hands that debt is passed on to is extremely limited. The primary concern for the borrower is the loss of the relationship it had with its original lender. The borrower may have no commercial relationship whatsoever with the entities which become the lenders of record, and may even have a negative relationship with some of those entities. This severely weakens the borrower's hand should it wish to renegotiate any of its covenants, seek an amendment or, in the event of an impending insolvency, need to agree a moratorium or refinancing with its creditors.

Another concern for the borrower is that potential transferees do not only include the rising number of hedge funds that make a longer-term investment in a company and hence have an interest in its future welfare and profitability. Other types of funds (often

termed 'vulture funds'), seeking to make quick profits from vulnerable companies by whatever means necessary, may also become involved.

Companies therefore need to consider the transfer provisions in their loan agreements carefully in order to ensure that they have some comfort in respect of the transfer of their debt. This needs to be balanced against the desire of the arranging banks to ensure that the debt is attractive to potential syndicate lenders. Those potential lenders will be looking to limit the borrower's level of control in respect of transfers so that they can shift the debt off their balance sheet at short notice.

TRANSPARENCY

Not only will a borrower be concerned about losing its relationship with its original lender/syndicate – it can also end up entirely out of the loop as to the extent that its debt has been traded on, and to whom. This is less of an issue where debt is on-lent to banks, because the agent bank maintains a register of transferees of the loan. Where the transferee is a non-bank, however, there is no such requirement since only lenders that are 'banks' as defined in the Income and Corporation Taxes Act 1998 are permitted to 'go on the record' and become a named lender of record.

Secondary debt trading may also be conducted entirely behind the scenes via sub-participations (where the lender sells the economic interest in the loan to a sub-participant). In this situation, it is impossible for a borrower to rely on its list of lenders in order to identify its stakeholders, as often the lenders on the record have little or no economic interest in the debt. Often, debt will have been traded several times in subdivided tranches to secondary investors such as hedge funds.

Under a sub-participation arrangement, the borrower remains in a contractual relationship with the lender of record. However, secondary investors that have the economic interest in the debt naturally demand some controls. This is often achieved by providing in the participation agreements that the lender of record must act (subject to some limitations) on the instructions of its sub-participant. These agreements can be entirely confidential as they are purely contractual, and not even the debtor or other members of the lending syndicate may know of their existence. Lenders may therefore still be influenced by 'silent' sub-participants and a borrower will have no ability to control this.

LOAN MARKET ASSOCIATION APPROACH

The real development of the secondary debt market followed the establishment of the Loan Market >

Association (LMA) in London in 1996. The LMA had the specific goal of encouraging liquidity in the secondary loan market in Europe (which was in its infancy at that time) by developing best practice and standard documentation (available to its members at www.loan-market-assoc.com). It has achieved significant success and recognition in that area, and is now active in the primary as well as the secondary debt market.

London is the dominant European financial centre for syndicated loans and so the principal LMA documentation is written under and governed by English law. In an attempt to broaden and regulate the syndicated loan market, the LMA standard terms provide for the transferability of all or part of a loan, by assignment or novation to any kind of financial institution or:

‘... trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets.’

Originally, both the investment grade and leveraged model form facility agreements provided the option for transfers to be made, either:

- (i) without the borrower’s consent (the lender’s preferred option); or
- (ii) subject to the borrower’s consent, not to be unreasonably withheld. Consent was deemed to have been given unless the borrower objected on reasonable grounds within a specified period (the borrower’s preferred option).

Although this seemed like a radical development, it was actually putting on a formal, standardised footing what was already established market practice. There was already a secondary debt market, and debt was often traded on by way of silent sub-participation.

In the original LMA model form document, the original transfer provisions for lenders were:

‘29.1 Assignments and transfers by the Lenders

Subject to this Clause 29, a Lender (the ‘Existing Lender’) may:

- (a) assign any of its rights; or
- (b) transfer by novation any of its rights and obligations,

under any Finance Document to another bank or financial institution or to a trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets (the ‘New Lender’).

29.2 Conditions of assignment or transfer

- (a) The consent of the Company is required for an assignment or transfer by an Existing Lender, unless the assignment or transfer is to another Lender or an Affiliate of a Lender.
- (b) The consent of the Company to an assignment or transfer must not be

CASE STUDY: *ESSAR STEEL LTD v THE ARGO FUND LTD*

In *Essar Steel Ltd v The Argo Fund Ltd*, the Court of Appeal ruled that a hedge fund whose business concerned commercial finance fell within the definition of ‘financial institution’. The loan agreement made between Essar and a syndicate of lenders provided that a lender could sell or convey its participation in the syndicated loan by assignment or by transfer. The contract provided that any transferee had to be ‘a bank or other financial institution’.

Argo was a hedge fund incorporated in the Cayman Islands, and held a portfolio of debt purchased mainly on the secondary market. It specialised in the acquisition of distressed debt at a substantial discount and then pursuing aggressive

enforcement strategies. Argo purchased a portion of Essar’s debt and then commenced proceedings in the Commercial Court seeking repayment of the entire debt plus interest.

Essar argued that Argo was not entitled to bring the claim as it was not a ‘financial institution’ within the meaning of that term in the transfer clause in the loan agreement and that the transfer of the loan to Argo was therefore void. The Courts rejected Essar’s argument at first instance and on appeal. The Court of Appeal, however, broadened the definition of ‘financial institution’ and held that the term could be construed widely. ‘A financial institution’ did not necessarily have to be involved in bank-like activities, such as the lending of money.

unreasonably withheld or delayed. The Company will be deemed to have given its consent five Business Days after the Existing Lender has requested it unless consent is expressly refused by the Company within that time.

- (c) The consent of the Company to an assignment or transfer must not be withheld solely because the assignment or transfer may result in an increase to the Mandatory Cost.'

THE SHIFT FROM BORROWER TO LENDER

Whilst borrowers have been enjoying a position of power as a result of the spiralling desire for leveraged assets (cheap loans on disadvantageous terms), the signs of a downturn in the credit cycle will inevitably harden lenders' positions, leading them to insist on the free transferability of debt. The LMA has already reflected lenders' desire for greater flexibility in respect of transfers by amending the leveraged model facility agreement to provide that the borrower 'consent' option is now just a 'consultation' option:

'29.2 Conditions of assignment or transfer

An Existing Lender must consult with the Parent for no more than [•] days before it may make an assignment or transfer in accordance with Clause 29.1 (Assignments and transfers by the Lenders) unless the assignment or transfer is:

- (a) to another Lender or an Affiliate of a Lender;
- (b) if the Existing Lender is a fund, to a fund which is a Related Fund of the Existing Lender; or
- (c) made at a time when an Event of Default is continuing.'

EXAMPLE DRAFTING

In summary, the LMA model form facility agreements offer a borrower 'consent' and 'consultation' option for transfers, and in the past year or two the latter has become the norm in the syndicated market. There are, however, other possibilities for introducing conditions widening

the transfer provisions of a facility agreement to give the borrower/lender more comfort in respect of control.

Strong borrower

A strong borrower may be able to limit permitted transferees to 'a bank or similar institution' so as to exclude non-banks, as in *Essar Steel v The Argo Fund Ltd* (see box opposite).

Strong lender

A lender that intends to syndicate, warehouse or securitise the debt may want to use more explicit language, for example:

'...a Lender (the 'Existing Lender') may assign, transfer or novate all or any of its Commitment and/or any of its rights and/or obligations under the Finance Documents without restriction to any other person (the 'New Lender'), including in connection with or in contemplation of a securitisation or a transaction having a similar effect.'

Compromise

A compromise position between lender and borrower would be to limit transfers to non-banks prior to an event of default.

A lender (the 'Existing Lender') may:

- '(a) assign any of its rights under the finance documents; or
- (b) transfer by novation any of its rights, benefits and obligations under the finance documents,

to another bank or (so long as an event of default is continuing only) financial institution (the 'New Lender').'

Specific conditions

In the context of a bilateral deal where the bank is not planning to syndicate, a borrower should be able to retain some control over transfers.

On smaller syndicated transactions, strong borrowers have some scope to negotiate specific conditions in respect of transfer, for example:

- (a) transfers may only be made after the expiry of the availability period for the facility (thereby ensuring that the original lenders actually provide the facility);
- (b) transfers are permitted without consent only if made in the course of primary syndication;

'Lenders are able to circumvent the prohibitions against assignment by declaring a trust in favour of the proposed assignee as beneficiary.'

- (c) where consent is required, it being deemed to be reasonably withheld in the event that the borrower can provide evidence satisfactory to the existing lender that the transferee is an industry competitor of the company;
- (d) imposing minimum amounts on the transfer amount to limit the number of potential transferees; and
- (e) consent is only required for transfers by the facility agent.

In the context of larger syndicated loans, a borrower's ability to impose any conditions on the transfer provisions will be very limited.

FURTHER CONSIDERATIONS

Where the borrower is able to ensure that its consent to a transfer/assignment is required (not to be unreasonably withheld), *Barbados Trust* (see box below) illustrates that lenders should be vigilant to ensure that they comply with the terms of the assignment. This case also emphasised the importance of carrying out comprehensive due diligence before purchasing debt on the secondary market.

Avoiding prohibitions on assignment

Lenders are able to circumvent the prohibitions against assignment, however, by declaring a trust in favour of the proposed assignee as beneficiary. Previously, where a trustee refused to sue in its own name on behalf of a beneficiary, the beneficiary

under that trust could sue the obligor itself by adding the trustee as a defendant – this is known as the *Vandepitte* procedure (after *Vandepitte v Preferred Accident Insurance Corp of New York*). Whilst the court in *Barbados Trust* held that the prohibition on assignment did not prevent the declaration of trust over the benefits of the contract in favour of a beneficiary, the beneficiary was prohibited from suing the obligor as a beneficiary of the trust under the *Vandepitte* procedure.

A buyer in the secondary loan market should therefore be cautious of sub-participation agreements and trusts, as they may not be able to enforce their rights without first forcing the trustee to act on their behalf. This may also adversely affect borrowers, because lenders will be more resistant to prohibitions on assignment and borrowers may be less able to retain control over trading on of their debt.

Excluding certain transferees

Another tactic used is for the company to agree a list of transferees on a name-by-name basis. Companies even try to exclude specific hedge funds known to be tough negotiators from deals, by producing a blacklist and negotiating trading restrictions in the credit documentation. This makes it more difficult for the debt to be syndicated and may harm banks themselves in the long run, as restrictions on selling the debt will leave banks lumbered with those loans if the company runs into difficulties. Side letters to the agreements can also be used to prevent funds acquiring the debt in the secondary market from voting.

CASE STUDY: BARBADOS TRUST COMPANY LTD

In *Barbados Trust Company Ltd (formerly known as CI Trustees (Asia Pacific) Ltd) v Bank of Zambia and Bank of America NA*, the Court of Appeal upheld the right of borrowers to control the assignment of loans made to them. The Court ruled that, where a facility agreement required the prior written consent of the borrower for the loan to be assigned, prior actual or deemed consent must be received for an assignment to be valid. This was even though consent was deemed to be given by the borrower – in this case, Bank of Zambia – shortly after the assignment had been made.

The facility agreement provided that a lender could assign its rights and benefits to another bank or financial institution although such assignment could only be effected with the prior

written consent of the borrower. Such consent was not to be unreasonably withheld and was to be deemed to have been given if no reply to a request for consent was received from the borrower within 15 days. Consent was sought from the borrower before the assignment of the debt and no reply was received, but the assignment was executed before expiration of the 15-day deadline.

Barbados Trust Company sued the borrower for the debt, but the Court held that it had no title to sue because it was an invalid assignment. The Court agreed that it would be possible for a borrower to waive the need for consent in circumstances where the borrower knew that an assignment had been made before any deemed consent period had expired.

FINANCIAL INFORMATION

There is also tension over the confidentiality of a company's financial information. Lenders participating in syndicated loans are often granted access to additional market details or sensitive financial information regarding the borrower, which they could then pass on to other banks and institutions. The borrower may be reluctant to release that kind of detailed financial information in case it is transmitted to the wider market and ends up in the hands of competitors. On the other hand, the lender may want the borrower to provide that financial information so that it can more easily syndicate the debt.

The compromise that is often reached is to insert express provisions in the facility agreement detailing the extent to which confidential information can be disclosed. The best compromise is to agree that confidential information can be provided on the basis that the recipient agrees to keep it confidential. There is a model form LMA confidentiality agreement which can be used for this purpose. This satisfies the lender's desire to ensure that the necessary financial information will be forthcoming from the borrower, whilst providing comfort to the borrower that its sensitive financial information will not be bandied around the market.

Barbados Trust Company Ltd (formerly known as CI Trustees (Asia Pacific) Ltd) v Bank of Zambia and Bank of America NA [2007] EWCA Civ 148

Essar Steel Ltd v The Argo Fund Ltd [2006] EWCA 241

Vandepitte v Preferred Accident Insurance Corp of New York [1933] AC 70

CONCLUSIONS

Negotiating and drafting assignment and transfer positions in facility agreements is a difficult exercise for borrowers in the current shifting economic climate. Whilst the balance of bargaining power was for a brief time in the hands of the borrower, it is now swinging back in favour of lenders. What has remained constant is tension between the parties over what should be recognised as a sensitive and important area of facility agreement negotiation. Borrowers in particular need to be aware of the consequences of raising syndicated debt in the primary market which can be traded on the secondary market.

It will be interesting to witness how the secondary loan market responds if the wave of defaults from across the Atlantic spreads to the UK, which would result in an increase in the number of companies that are left in a position of distress.

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