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MARKET DISRUPTION CLAUSES IN SYNDICATED LOAN AGREEMENTS

BACKGROUND

Market disruption clauses, commonly found in syndicated loan agreements, set out how the interest rate applicable to a loan will be calculated in the event that either:

(1) LIBOR/EURIBOR cannot be determined (on the basis that no screen rate is available and none or only one of the reference banks nominated in the loan agreement can provide a rate); or

(2) one or more of the lenders in the syndicate notify the Facility Agent that the cost of their funding in the London interbank market in respect of that loan exceeds the LIBOR/EURIBOR rate applying to that loan under the terms of the loan agreement.

The effect of these clauses is that lenders can increase the interest rate charged to a borrower to reflect the actual costs of funds to those lenders.

Recent market events and the liquidity crisis have put market disruption on the agenda for many market participants for the first time. Lenders in respect of various Asian loans have been one of the first to invoke market disruption provisions, for example a US$1.035 billion dual-tranche loan for Taiwanese electronic parts and components manufacturer Hon Hai Precision Industry and Quanta Computer's US$360 million loan. This trend is expected to be followed in Europe and the US, raising a number of issues as to how the standard clauses work in practice.

WHO CAN INVOKE A MARKET DISRUPTION CLAUSE?

Usually, only a lender (or lenders) whose participation in a loan aggregates 30 percent or 50 percent (the specific percentage is a matter of negotiation) is entitled to trigger a market disruption.

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However, well-advised borrowers will have amended the Loan Market Association ("LMA") standard wording to make clear that the market disruption clause can be invoked only where a bank is unable to fund all or part of a requested loan as a result of "circumstances affecting the Relevant Interbank Market generally". This expressly avoids the borrower paying for a lender's own lack of creditworthiness.

THE APPLICABLE RATE OF INTEREST IN THE EVENT OF MARKET DISRUPTION

If a market disruption provision is invoked, LIBOR/EURIBOR will cease to form part of the calculation of interest, and the rate of interest will be calculated on a lender-by-lender basis using the rate notified by each lender to the Facility Agent as being that lender's cost of funding its participation in the loan (from whatever source it reasonably selects), together with the applicable margin and mandatory costs.

This revised calculation applies to all lenders in the syndicate and not just to those who invoked the market disruption. The Facility Agent is then required to calculate the interest rate payable to each lender in the syndicate by reference to the rate notified by each lender as its individual cost of funding. Unless otherwise agreed between the parties, the Facility Agent cannot apply a blended rate.

WHAT IS A REASONABLE SOURCE OF FUNDING?

In calculating its cost of funding, a lender can utilise funds from any source "it may reasonably select". In the event that a borrower disputes a lender's source of funds, loan agreements do not typically include a mechanism for resolving such a dispute, nor do they impose an obligation on the lender to demonstrate the reasonableness of its funding decision.

Furthermore, lenders are not under a contractual obligation to justify their funding decisions if asked to do so by a borrower.

DOES THE BORROWER HAVE ANY INVOLVEMENT IN SELECTING AN ALTERNATIVE BASIS OF FUNDING?

If a market disruption clause is invoked, either the Facility Agent or the borrower can require the other to enter into negotiations for a period of not more than 30 days with a view to agreeing upon a substitute basis for calculating the interest rate.

In reality, however, this negotiation right will not assist a borrower, as the Facility Agent is unlikely to agree to an alternative basis of funding which is not approved by the lenders; to be effective, any alternative basis of funding requires the approval of each lender in the syndicate.

ISSUES FOR THE BORROWER

If a lender does choose to invoke the market disruption clause, this will raise a number of issues for the borrower, including (but not limited to):

(1) the ability of the borrower's cash flow to service the increased interest payments;

(2) the strength of the borrower's financial covenant performance and whether it will be adversely affected by the change in interest rate under the loan agreement; and

(3) the cost to and the ability of the borrower to amend any existing interest rate hedging arrangements to ensure that the amount it receives under such hedging is sufficient to pay the increased interest costs under the loan agreement, given that there are typically no market disruption provisions relating to LIBOR/EURIBOR in interest rate hedging documents.

HOW LIKELY ARE LENDERS TO INVOKE A MARKET DISRUPTION CLAUSE?

To date, the market disruption clause is largely untested, and from a relationship perspective, banks have previously been reluctant to use it. In addition, there are conflicting opinions as to whether lenders should invoke market disruption clauses in the current market.

The LMA standard syndicated facility agreement provides for LIBOR and EURIBOR to be fixed by references to the applicable Reuters screen rate. The screen rate is derived from quoted rates supplied by a panel of 16 reference banks selected by the British Bankers Association which may not correlate to the syndicate in question. Being an average rate, LIBOR/EURIBOR may not be an accurate reflection of a lender's actual cost of funds.

Furthermore, there is a concern that in the current market conditions, the quotes provided by panel banks for the purposes of calculating the displayed screen rates for LIBOR and EURIBOR are not always a true reflection of those banks' costs. This is because the banks are concerned that if they quote their actual costs of funding, it may trigger discussion in the market about their own creditworthiness. Clearly it is an issue for borrowers if banks are not providing accurate information and market disruption clauses are, as a consequence, invoked. It is unpalatable for borrowers if banks can abandon the transparent system of displayed screen rates and instead charge borrowers interest rates based on the individual costs of funds of each bank. For the agent of loans, this is a cumbersome way to calculate interest on syndicated loans.

The Association of Corporate Treasurers ("ACT") believes that this current market phenomenon of LIBOR being unrepresentative of banks' cost of funds should not be a basis for lenders to invoke market disruption clauses. The ACT would expect a market disruption clause to be invoked as a last resort and only if banks are generally experiencing exceptional difficulty in raising funds in the interbank market or are paying materially more for interbank deposits than the displayed screen rates for LIBOR or EURIBOR.

However, despite the proposal of the British Banking Association, the future application of market disruption clauses is currently unclear.

IS THERE AN ALTERNATIVE TO MARKET DISRUPTION?

A possible alternative to market disruption which is currently being discussed is for interest rates to be calculated based on market-based pricing. Market-based pricing links the rate of interest to moves in the market rather than charging a fixed margin above LIBOR/EURIBOR. The margin under market-based pricing is correlated to the likelihood of default by the borrower, based on the cost of buying credit protection against that borrower through a credit default swap at the time of drawdown. The main advantage of this approach is that the margin should more accurately reflect the borrower's creditworthiness and lenders will therefore be more willing to lend to that borrower for a longer period of time. In addition, because the margin is determined at drawdown, the borrower may also benefit from any improvement in market conditions.

Another possible alternative is for both lenders and borrowers to consider reducing interest periods from the standard one-, three- or six-month periods to enable banks to quote rates for shorter periods and for all parties to benefit from the greater liquidity available at shorter maturities.

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