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In Practice

Authors Jennifer Calver, Liz Saxton and Andrew Barker

Defaulting and insolvent lenders in today's loan market

This article focuses on the issues that may arise when a syndicate lender fails to fund its ongoing commitment under a facility agreement and/or enters into insolvency proceedings.

The business of lending and loan documentation has historically focused on the credit risk of the borrower. In today's credit markets borrowers and market participants also need to be concerned with lender credit risk. Facility agreements in the London market tend not to address the risk of a defaulting or insolvent lender. However, the practical effects of a failure to fund by a syndicate lender can affect not only the defaulting lender and the borrower, but also the agent and the defaulting lender's potential transferees. It may also affect the other syndicate members who face the choice of stepping in to fund the shortfall or leaving the borrower with insufficient capital.

COMMITTED FACILITIES

Facility agreements invariably provide that a borrower utilises a revolving loan by delivering a utilisation request to the agent. The agent then collects funds from the syndicate members and funds the revolving loan as directed by the borrower. Each lender's commitment to make a loan under the facility agreement is a separate 'several' obligation of that lender. As a result, if a lender fails to fund its *pro rata* portion of the requested borrowing (a 'Defaulting Lender'), then: (i) no other lender is responsible for that Defaulting Lender's failure to fund; (ii) no other lender is relieved of its commitment to fund its *pro rata* share; and (iii) the borrower is not relieved of any of its obligations under the facility agreement.

This commitment to fund, for which the borrower will generally be expected to pay a commitment fee, is subject to the satisfaction of various conditions precedent the majority of which need to have been satisfied on first utilisation. Any subsequent utilisation will be subject to the further conditions precedent that there is no continuing or resulting default, and that the repeating representations are true.

The only basis on which a lender can refuse to fund future utilisations therefore is if it can demonstrate a default or misreprentation. To avoid this borrowers need to be especially vigilant that they are in full compliance with all their undertakings and representations at all times.

BORROWER RECOURSE AGAINST A DEFAULTING LENDER

Borrowers can protect themselves against Defaulting Lenders by negotiating 'yank-the-bank' provisions which permit the borrower to replace a Defaulting Lender with a new lender. However, these provisions, while increasingly common in the London market in recent years, are not standard and are not included in the Loan Market Association ('LMA') standard leveraged facility agreement.

As a practical matter, even with the protection of 'yank-the-bank' provisions it may be very difficult for a borrower to find a lender willing to assume the Defaulting Lender's revolving commitments/loans in the current credit environment, particularly since these provisions typically require the Defaulting Lender to be replaced at par.

A borrower may try to avoid repaying amounts owing to the Defaulting Lender by exercising its common law right to set off such amounts against the amounts owed to the borrower by the Defaulting Lender. However, most facility agreements will contain an express restriction on borrowers exercising any rights of set-off under a facility agreement although if the Defaulting Lender is insolvent, statutory set-off may still apply (see the section 'Insolvency of a Defaulting Lender' below).

Failure to fund by a Defaulting Lender, being a sufficiently serious breach of the facility agreement, would constitute a repudiatory breach by that Defaulting Lender. This would entitle the borrower to accept the repudiation and treat itself as discharged from further obligations owing to the Defaulting Lender with immediate effect, including the obligation to pay interest on any outstanding loans made by that Defaulting Lender.

However borrowers should be aware that in treating the failure to fund as a repudiatory breach the remedy is for the facility agreement to be terminated. This would result in the borrower being required to repay the Defaulting Lender its outstanding loans in full. Furthermore many facility agreements require that prepayments are made to all Lenders on a pro rata basis, potentially requiring the Borrower to repay all outstanding loans in full. In the event that it does not have the funds to effect such a repayment the Borrower should be careful in its conduct to show that it does not accept the repudiatory breach and affirms the contract, for example by continuing to pay interest to the Defaulting Lender on outstanding loans.

A borrower may also pursue a breach of contract claim against a Defaulting Lender if the resulting loss is quantifiable and litigation is worthwhile. Such loss could include the costs of raising alternative financing or the loss of estimated profit on an asset where an acquisition could not be completed.

The borrower will also have the right to cease to pay commitment fees in respect of the Defaulting Lender's commitment.

If a borrower has reason to believe that a specific lender will not be making future loans under a facility agreement, to the extent that there are sufficient undrawn commitments, a borrower may consider 'grossing up' the amount requested in its next utilisation request to compensate for such lender's anticipated failure to fund.

AGENT'S RECOURSE AGAINST A BORROWER

In the event that the agent has funded a utilisation request prior to receipt of funds by a Defaulting Lender (which it is not obliged to, but may do), the agent's ultimate recourse will be against the borrower and not the Defaulting Lender. Under standard LMA payment provisions, the borrower must on demand refund the defaulted amount to the agent, together with accrued interest on that amount calculated by the agent to reflect its cost of funds.

ROLLOVER LOANS

In the context of a revolving facility where 'rollover' loans are made on the relevant interest payment date, whilst in practice such loans will be made by way of book entry, most facility agreements provide for the

actual repayment and redrawing of such loans. On this basis a borrower is contractually obliged to repay any rollover loans on the relevant interest payment date (or trigger a payment default) and is exposed to a Defaulting Lender failing to re-advance such loan on the same date.

If this is a concern, the LMA have suggested that a borrower may protect itself by dealing with a rollover by way of netting as follows:

(a) the borrower deposits with the agent an amount sufficient to repay the Defaulting Lender's portion of the maturing loan (the 'Deposit');
(b) the borrower pays to the agent an amount sufficient to repay the balance of the maturing loan and the agent pays the same to the relevant lenders;
(c) the agent advances the whole rollover loan amount to the borrower;
(d) when the Defaulting Lender fails to fund, the agent demands from the Defaulting Lender the defaulted amount of the rollover loan paid under (c) in accordance with the payment provisions (creating a payment obligation from the Defaulting Lender to the agent);
(e) the borrower instructs the agent to apply the Deposit in repayment of the Defaulting Lender's portion of the maturing loan (creating a payment obligation from the agent to the Defaulting Lender) as the borrower has given the repayment amount to the agent to use to repay the Defaulting Lender; and
(f) the agent sets off its payment obligation to the Defaulting Lender against the payment obligation of the Defaulting Lender to the agent which has arisen as a result of the agent making the advance under (c) on behalf of the Defaulting Lender.

PURCHASING A LOAN FROM A DEFAULTING LENDER

A purchaser faces a number of risks when purchasing a loan from a Defaulting Lender in the secondary market, the key risk being whether the Defaulting Lender's loan will be considered by the market to be 'impaired'. For example there may be a risk that the purchaser could be required to fund the borrowing in respect of which the Defaulting Lender has defaulted.

Prudent purchasers should require both the borrower and agent to confirm that no right of set-off can be exercised or claim asserted against the purchaser of the loan. Purchasers should also seek an indemnity from the selling Defaulting Lender and ensure that they have the benefit of the standard provisions contained in market documentation for the purchase of distressed debt. These require the Defaulting Lender to represent and warrant that: it has complied with and performed all obligations under the facility agreement; and it has not engaged in any act or conduct (or made any omissions) that will result in the purchaser receiving less in payments or distributions than received by other lenders.

INSOLVENCY OF A DEFAULTING LENDER

Under English insolvency procedures an insolvent bank would be likely to go in to administration for the statutory one year period and may thereafter go into liquidation for winding up. A facility agreement will not generally address this scenario and as a result will simply continue in the event of the administration and subsequent liquidation of a lender.

This is less of an issue with a term loan which is fully funded (although the administrator could actively seek out grounds to call a default). In respect of a term loan with further tranches available for drawing, or a revolving facility, there is clearly the additional risk that the administrators of the lender may decide not to honour ongoing obligations to fund.

In this situation any claim for breach of contract which the borrower might pursue would constitute an unsecured claim in the ensuing administration/ liquidation of the Defaulting Lender and will be unlikely to be recovered in full, if at all.

To the extent that a borrower has deposits with or payment obligations owing to it from the Defaulting Lender which is insolvent, such borrower may have the benefit of the statutory rules for insolvency set-off set out in Insolvency Rules 1986. These rules provide that when an administrator gives notice that he proposes to make a distribution to the creditors of the company or on the liquidation of a company, there is a mandatory, automatic set-off in relation to 'mutual dealings' (including mutual credits and mutual debts) between the company in administration/ liquidation (ie the Defaulting Lender) and any creditor of that company (ie the borrower).

These automatic set-off provisions are mandatory and it is not possible to contract out of them. Consequently, any term in a facility agreement restricting set-off will not apply to statutory set-off. However, it should be noted that the insolvency set-off rules only apply in an administration when (and if) the administrator makes dividend payments to creditors, which requires court consent. No one can therefore be sure when and if statutory set-off will occur. Prior to the administrator giving notice of a distribution, any contractual provisions in respect of set-off will continue to apply and a borrower might have a long wait before any statutory set-off is exercised.

CONCLUSION

As a matter of contract, under a committed facility agreement a lender is obliged to lend subject to satisfaction of various conditions precedent. However, facility agreements tend to assume that each lender will honour its commitment and do not address the situation where a lender fails to fund. In such a situation, unless there are specific Defaulting Lender provisions, the borrower's sole remedy is a breach of contract claim against that lender. The success of any such claim will depend on the borrower being able to demonstrate quantifiable loss and whether the Defaulting Lender is subject to insolvency proceedings.

Even to the extent that there are specific Defaulting Lender provisions, a borrower's ability to exercise rights to replace a Defaulting Lender at par may prove difficult.

A Defaulting Lender which has become insolvent is much more of an issue in the context of a revolving facility or partially funded term facility. Borrowers should also be aware of the risks associated with rollover loans and should consider the LMA's netting proposal if they have any concerns. ■

Biog box

Jennifer Calver is Of Counsel in the Banking and Finance Group in Jones Day's London office. Email: jcalver@jonesday.com Liz Saxton is Of Counsel in the Banking and Finance Group in Jones Day's London office. Email: esaxton@jonesday.com Andrew Barker is a partner in the Banking and Finance Group in Jones Day's London office. Email: adbarker@jonesday.com