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In Practice

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Potentially toxic clauses in loan agreements

In this In Practice article, Edward Smith and James Bell consider some key provisions in loan agreements that borrowers should be aware of in the current environment.

As Brexit negotiations progress, we will inevitably start to see winners and losers with some sectors seeing an increase in stretched credits. Since the financial crisis there has been a gradual erosion in financial covenant protection, with borrowers often being able to obtain loans with fewer financial covenants or on a covenant-lite basis. However borrowers often overlook other, less favourable, provisions which could be problematic for them, even when they remain in compliance with their financial covenants.

The risk of potentially "toxic" clauses for borrowers will usually depend upon whether the facilities track lender-friendly documents prepared by the Loan Market Association (LMA) without modification. If a borrower is in default under one of these potentially problematic clauses this will have the same consequences as a financial covenant breach, potentially handing control over to hostile creditors. It could also present difficulties in giving the requisite going concern confirmation in the company's annual accounts. We consider here some key provisions that borrowers should be aware of in the current environment. Borrowers should also beware the attempted introduction of such provisions by lenders by way of any amendment or "tidying up" exercise as part of a covenant waiver or reset.

- ***Is there a look-forward test which considers future compliance with financial covenants?*** Financial covenants are intended to give "early warning" signals to lenders. Even where a borrower is currently in compliance with its financial covenants, it could still be in default if a deterioration in its performance could result in a future breach on the next applicable test date. This point commonly hinges on the construction of the term "Material Adverse Effect" (MAE); the default LMA position includes this double look forward test. From a borrower's perspective, the MAE definition should ideally apply only to any prospective effect on *payment* obligations, not on financial covenant obligations. It is also preferable for borrowers that the existence of MAE is determined objectively, not subjectively by the lenders.

- ***Will a balance sheet deficiency (ie liabilities exceeding assets) cause a default?*** The existence of a balance sheet deficiency will often be included as a default, tested on an ongoing company by company basis. However, many companies will indeed have a balance sheet deficiency, where their actual, contingent and prospective liabilities exceed their assets at any given point in time. This may be due to historic trading losses or because of their financing structures, even though the company concerned is not itself in financial difficulty and can pay debts as they fall due. It is very important for borrowers that they are not subject to this test. A borrower's starting position should be that the lender has sufficient protection in any event, as the actual commencement of any insolvency proceedings (as opposed to a mere balance sheet deficiency) would constitute a separate event of default in a conventional facilities agreement.

- ***Will any negotiations with creditors cause a default?*** If a borrower attempts to reschedule any of its liabilities with its creditors (including landlords, suppliers etc., in addition to its financiers) as a result of actual or anticipated financial difficulties, this will commonly constitute a default. The standard LMA position is that the commencement of such negotiations with a single creditor (regardless of the value of its liability) will be a default. This poses real problems for borrowers in financial difficulty (and corporate restructuring advisers), as this is a default that can easily be tripped at a very early stage and, ironically, compromising *unsecured* creditors could be exactly the action that secured lenders would want a company to take in this situation.

- ***What is the drawstop for utilising further loans (or rolling over existing loans)?*** In many facilities the drawstop to funding will be an actual or potential event of default in respect of new loans and an actual event of default in respect of the rolling over of existing loans. Therefore any technical default will cause a drawstop on new funding or rolling over existing loans (unless waived). In some situations this drawstop can amount to a *de facto* acceleration of the facilities without lenders being formally required to take any further steps. This can be problematic particularly if the borrower has working capital requirements such that it cannot continue trading without access to those facilities. Borrowers will therefore be best placed, in the case of a rollover of facilities (ie where the lenders are not, in substance, being asked to advance "new money"), if the only condition precedent to the rollover is the absence of a "declared default".

- ***What repeating representations are given on a regular basis?*** Many borrowers will be unaware that they give a number of representations to the lenders automatically and regularly during the life of a facility (on each interest payment date and on drawing a new loan). Aside from technical legal matters, the LMA documentation includes numerous representations as to factual matters. Borrowers should therefore be aware of

what representations repeat under their facilities and whether they may be in default. They should strongly resist the inclusion of the "no material adverse change" representation, particularly if the related MAE definition (discussed above) is widely drafted.

- ***Will the cross default clause multiply the effects of a problem?*** Typically an event of default will arise as a result of the occurrence of any default under any of the group's debts (eg finance leases), some of which may be on stricter terms than the main facilities. Borrowers should therefore be conscious of this inter-relationship and the quantum of any applicable threshold. This will be particularly relevant for disparate and international groups.

- ***Is a lender entitled to withdraw an overdraft on demand, notwithstanding that there is no default?*** Borrowers commonly rely for short term liquidity on an overdraft facility provided by an "ancillary lender" as part of that lender's revolving credit facility commitment. Since overdrafts can usually be withdrawn "on demand", it is essential for a borrower to ensure that the cross-default provisions under the main facility are not triggered by an ancillary lender making a demand under an overdraft.

- ***How does the clean down of revolving loans and overdraft operate?*** Some borrowers will be subject to a "clean down" mechanism on their working capital facilities. This means that, for a period of one or two weeks in each year, they are required to reduce their cash borrowings under any working capital facilities (potentially to zero), to demonstrate to the lenders that there are no structural borrowings under these facilities. Whilst most borrowers will typically have a period in each year where they have a strong working capital position, the clean down is something that can easily be overlooked. Borrowers should try to ensure that the clean down coincides with a period in each year when they have a strong working capital position, and plan towrds it. Failure to comply will usually result in a default.

- ***Can technical defaults be remedied without an express waiver from the lenders?*** If a technical default occurs a borrower should know whether this can be remedied without requiring an express written waiver from the lenders. In some cases, borrowers are not able to benefit from this and, even though a default may have been remedied, it will still be deemed to be "continuing" for the purpose of the facility agreement until such time as it has been expressly waived in writing. This means that all of the usual rights and remedies available to lenders if a default occurs (eg acceleration, enforcement of security, withdrawal of permission for certain "permitted" activities) will remain available until such time as the default is expressly waived. Borrowers should seek to agree in new facilities that a default or event of default will no longer be "continuing" if it has been remedied or waived.

- ***Brexit-related risks:*** The prospect of Brexit introduces many uncertainties. Existing debt documents commonly include terms drafted on the assumption that a reference to the "European Union" includes the UK. For instance borrowers should check that they would still benefit from carve-outs permitting them to make acquisitions or joint ventures in both the EU and the UK. Similarly, borrowers are deemed to make repeating representations, some of which touch on compliance with EU derived laws. Such terms require review in order to avoid accidental or "technical" defaults post-Brexit. Further changes may be required to existing documentation as more detail becomes available on the consequences of Brexit for lenders and borrowers alike.

Borrowers should make sure they understand their banking documents and regularly review compliance with all their obligations under them, not just their financial covenants. Even if lenders do not wish to accelerate or enforce, they can exploit any continuing default to force a borrower to agree to a re-pricing of the facilities and the payment of fees, as a condition of any waiver. ■

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