

How safe are your facilities?

Adopting a defensive strategy to protect against hostile creditors

In the third of a series of briefings that looks at financial management in a downturn, this note considers how borrowers can protect themselves against hostile creditors.

The toxic combination of liquidity problems in financial institutions and a fundamental macroeconomic downturn has made it more important than ever for companies to adopt a defensive strategy with respect to their financing arrangements. In addition to preserving cash and ensuring continued covenant compliance, this defensive strategy should include an understanding of any weaknesses in banking documentation which could potentially be exploited by hostile creditors. The behaviour of hostile creditors can often express itself by the making of unreasonable demands for fees, repricing and/or deleveraging for technical consents and financial covenant waivers; however it can also manifest itself with hostile creditors adopting a "loan to own" strategy and positioning themselves to be taken out of the syndicate at a premium.

This notes considers some of the ways in which hostile creditors can exploit the provisions of banking documents and which borrowers would be well advised to understand and manage.

How can a hostile creditor acquire a blocking position in the syndicate?

This will depend upon three things:

1. What is the majority lender threshold for regular lender decisions?
2. Are there any subordinated tranches which have independent voting rights? Given the size and typical holders of this paper, it will be easier to form a blocking position here.
3. What types of transactions require unanimous consent (where even a tiny holding can give a creditor a veto)?

How likely is it that a hostile creditor will be able to use its veto?

Hostile creditors will only be able to exercise veto rights if a consent is required or a default has occurred. Consider the following examples:

- Does the equity cure provide an effective remedy for a financial covenant breach? We will be distributing notes on equity cures and financial covenant re-sets shortly.
- Can new money be put in by shareholders without bank consent?
- Can new money be put in by a supportive lender with only majority consent?
- Can revolving loans be rolled over even where a default is continuing?
- Can a debt for equity swap be pushed through with just majority approval? Go to www.traverssmith.com to access a copy of our note on debt for equity swaps.

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How can hostile creditors exploit their position?

1. Demand a large waiver fee or that the loan be repriced or that an equity contribution be made or position themselves to be taken out at a premium.
2. Exercise independent enforcement rights to acquire control of a company.
3. It becomes easier for hostile creditors to acquire debt where there is a default, as typically transfer restrictions fall away in this situation.

How can companies best protect themselves against hostile creditors?

The first step is obviously to avoid a default – however this means avoiding both financial covenant breaches and 'technical defaults' given that they both carry the same rights for creditors. It is therefore vital for companies to ensure that they are not just aware of, but remain vigilant in complying with, all provisions of the banking documents.

The second step is for companies to consider different contingencies in advance before challenging situations arise and before approaching potentially hostile creditors.

How we can help

We can review your company's banking documents and identify areas of potential weakness and steps that could be taken to improve the position. We can also assist you to undertake a review in order to identify any potential financial covenant breaches or other defaults and advise on any remedial steps that could usefully be undertaken.

If you would like to discuss any of the issues covered by this note, please contact any of the following members of our Banking Department:



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