TRAVERS SMITH

Lender Insolvency

How to manage your banking facilities where a lender or agent is insolvent

In the eighth of a series of briefings that looks at financial management in a downturn, this note considers some of the issues arising out of lender or agency insolvencies for borrowers.

The insolvencies of Lehman Brothers, the Icelandic banks and other financial institutions since September 2008 have resulted in significant problems for borrowers who have an exposure to those institutions. A number of borrowers (together with other lenders participating in debt syndicates) have been forced to contend with their lenders or agents becoming insolvent – some common problems include the refusal to fund under 'committed' facilities, the lack of cooperation by the insolvency office-holders of an insolvent agent in managing syndicated facilities and the risk of monies owed to a borrower or lender being entangled in the estate of an insolvent agent. Whilst a number of these issues have arisen because of the unique circumstances of the credit crunch, there is clearly no guarantee that there will be no further insolvencies of financial institutions. This is particularly so given the plethora of hedge funds and other financial institutions that invest in debt facilities and who may not be fortunate enough to receive government support. It is therefore important for borrowers and lenders alike to continue to guard against the risk of lender and agent insolvency.

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This note considers four issues in particular:

1. What happens if a lender refuses to fund under a committed facility?
2. How can a borrower (or another lender) deal with a lack of cooperation by the insolvency office-holders of an insolvent agent?
3. What are the consequences for rolling over revolving loans?
4. What protections should a borrower (and lenders generally) obtain under their current or new facilities to protect against any future lender or agent insolvency?

What happens if a lender refuses to fund under a committed facility?

This issue is relevant to unfunded facilities (such as revolving or capex facilities) where a borrower expects to make further drawings (as opposed to term facilities which have already been fully drawn), and the position will depend upon whether the facility is bilateral or syndicated.

Bilateral facilities

In the case of a bilateral facility, a borrower is in a very difficult position where the lender fails to fund because there is only one source of funding available and there are likely to be prohibitions on obtaining alternative finance in the market (absent a complete refinancing). The borrower will therefore be focused on managing its relationship with its existing lender or alternatively undertaking a full refinancing exercise. One very important consideration for borrowers here is that if a lender refuses to fund, this could amount to a repudiatory breach by the lender entitling the borrower to terminate the facility agreement – however this may not be the panacea that it first seems, as it can have the unfortunate effect of causing all outstanding debt to become immediately due and payable (subject to questions of possible counter-claims for damages as a result of the lender's breach of contract).

Syndicated or club facilities

In the case of a syndicated or club facility, the key principle is that lenders are not jointly and severally liable to make loans available to the borrower (i.e. they are not required to make good the deficiency of their fellow lender). Therefore if one lender fails to make its share of a loan available, the borrower will only receive that portion of the requested loan which is funded by the other solvent lenders. This risk can be mitigated by submitting a proportionately larger request for a loan, as long as this does not exceed the maximum amount of the available facility or otherwise breach any specific drawdown conditions. Alternatively, the borrower and other lenders may try to procure that a non-funding lender in a syndicate is replaced (perhaps by another member of the syndicate or by a third party lender) - however this may be difficult to implement in practice without their cooperation and any documentary provisions legislating for this (e.g. 'yank the bank' clauses) are likely to require that all of the non-funding lender's commitments are replaced (or prepaid) at par, which may be economically unattractive in the current environment. There will also be practical difficulties in implementing any consents, waivers or amendments that require unanimous lender consent if a lender becomes insolvent (as it will be acting by its office-holders), although in certain circumstances this can be overcome.

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How can a borrower (or another lender) deal with a lack of cooperation by the insolvency office-holders of an insolvent agent?

There are certain risks for borrowers and lenders if an agent becomes insolvent:

1. Principal and interest being distributed via the agent could get trapped in the insolvent estate of the agent (resulting in the borrower not receiving any requested loan or the lenders not receiving what is entitled to them, other than at some point in the future pursuant to the insolvency proceedings of the agent).
2. It can become difficult to implement any consents, waivers or amendments under the facilities as no one is marshalling the syndicate or, if the agent does assist, it may only do so slowly or upon payment of a fee.
3. Certain amendments to the facilities documentation require the express consent of the agent, which may be frustrated if the agent becomes insolvent.

Unfortunately, borrowers and lenders do not typically have the right to force an agent to be replaced, as the agent's cooperation is required for any replacement (and they may charge a fee for the privilege of their cooperation). However, depending on the size and nature of the syndicate, it may be possible for borrowers and lenders to by-pass an agent and agree a position directly between themselves.

"The most significant consequence of lender insolvency arises when revolving loans are rolled over to the next interest period…it could cause serious cash flow difficulties for a borrower."

What are the consequences for rolling over revolving loans?

In our view, the most significant consequence of lender insolvency arises when revolving loans are rolled over to the next interest period, as technically this constitutes a repayment and reborrowing of the revolving loan. The problem for the borrower (and other lenders) here is that if a lender receives this repayment but, because of its insolvency, is unable to make the loan available again for reborrowing, it would result in a net repayment of the revolving facility by the borrower and a consequential reduction in its available cash. This could cause serious cash flow difficulties for a borrower.

In many cases the need to move funds to repay and reborrow a rollover loan is mitigated by the operation of an automatic netting arrangement (so that the repayment cancels out the reborrowing where the amounts involved are the same, and a net repayment or reborrowing to the extent that the amounts are different), although this may just operate by way of custom rather than being an express requirement of the facility agreement. Where there is no express automatic netting provision (i.e. it only operates by way of custom) there will be a degree of legal uncertainty as to whether this netting can continue upon a lender's insolvency. Whilst it may be possible to establish practical arrangements to mitigate this legal uncertainty, there remains a residual and unsatisfactory degree of uncertainty for borrowers and lenders alike.

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What protections should a borrower (and lenders generally) obtain under their current or new facilities to protect against future lender or agent insolvency?

Many borrowers (and lenders) have been considering how best to mitigate the potential effects of lender or agent insolvency in respect of their existing facilities, particularly where there could be doubts as to the financial position of the agent or a lender in their syndicate. It will also become commonplace for appropriate protections to be introduced to new facilities going forward and the Loan Market Association have introduced a number of changes to their standard documentation. The key elements of these changes are:

1. An express automatic netting provision in respect of rollover loans.
2. A right for the borrower (and lenders) to procure a replacement of an insolvent agent (without the agent's cooperation).
3. A right for the borrower to cancel the unfunded commitments of an insolvent lender and offer them to other lenders.
4. A right for the borrower to procure the transfer of any funded or unfunded commitments of an insolvent lender in a syndicated facility to another lender.
5. A right to term out and prepay an insolvent lender's revolving loans.
6. The termination of commitment fees payable to an insolvent lender, together with their exclusion from lender votes (as regards their unfunded commitments only).
7. The holding of monies by the agent on trust for the borrower and lenders (and the ability to make payments directly between the borrower and lenders if the agent becomes insolvent), to ensure that any monies held by the agent which are owing to them do not get trapped within the insolvent agent's estate.

There are, however, certain areas where the LMA changes arguably do not go far enough – for example regarding the complete disenfranchisement of an insolvent lender (not just in relation to its unfunded commitments) and the ongoing position of the security agent if it becomes impaired.

How we can help

We can review a borrower's banking documents and recommend amendments that could be made to address lender and agent insolvency issues. We can also advise on appropriate protections for new facilities being made available to borrowers.

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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