TRAVERS SMITH

Looking beyond financial covenants

An analysis of potentially toxic clauses in facilities agreements

In the seventh of a series of briefings that looks at financial management in a downturn, this note considers the "Top 10" potentially toxic clauses that can be found in facilities agreements.

In the current economic downturn a number of borrowers have found it increasingly challenging to comply with their financial covenants. Where financial performance isn't meeting expectations, the primary focus is understandably on financial covenants and ensuring continued compliance with these provisions. However there a number of other provisions in banking documents which can cause problems for borrowers, even when they remain in compliance with their financial covenants. The extent to which such problems will exist for borrowers will usually depend upon whether the facilities are documented on the basis of lender-friendly documents prepared by the Loan Market Association ("LMA") or whether these standard documents have been appropriately modified.

If a borrower is in default under one of these potentially toxic clauses this will have the same consequences as a financial covenant breach – i.e. it could hand control over to potentially hostile creditors and it could also present difficulties in giving the requisite going concern confirmation in the company's annual accounts. This note considers some key provisions under facility agreements 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 re-set.

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1. Is there a look-forward test which considers future compliance with financial covenants?

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 of its financial covenants, even though those financial covenants will not be tested until the applicable test dates. This amounts to an early warning signal of a financial covenant breach for lenders (whereas lenders will tell borrowers that the actual financial covenants themselves are intended to be the early warning signal). This point will be determined by the construction of the term "Material Adverse Effect" and the default LMA position includes this double look forward test. From a borrower's perspective, the "Material Adverse Effect" definition should ideally apply only to any prospective effect on payment obligations, not on financial covenant obligations.

2. What constitutes a material adverse change in a borrower's condition and who determines this?

The occurrence of an event or circumstance which has (or may have) a material adverse effect on a borrower's financial condition or its ability to comply with certain obligations under the banking documents will typically constitute a default. The exact formulation of this test will vary from facility to facility with significant consequences and borrowers should be familiar with their particular position. The default LMA position is that any material adverse change will be determined in the bank's judgment alone, without regard to whether this is a reasonable judgment or what the company's view is. It is preferable for borrowers if the position is determined objectively, not subjectively by the lenders, and without any look forward element.

3. Will a balance sheet deficiency (i.e. liabilities exceeding assets) cause a default?

The existence of a balance sheet deficiency will often be included as a default, which will be tested on an ongoing company by company basis. However, a large number of companies will indeed have a balance sheet deficiency at any given point in time (perhaps because of historic trading losses or because of their financing structures), even though the company concerned is not itself in financial difficulty. Borrowers should therefore be careful whether they are subject to this test and whether they are therefore in default. It is very important for borrowers that they are not subject to this test – and lenders have sufficient protection in any event, as the actual commencement of any insolvency proceedings (as opposed to the mere existence of a balance sheet deficiency) would constitute a separate event of default in a conventional facilities agreement.

4. 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 under a facilities agreement. The default LMA position is that the commencement of such negotiations with just a single creditor (regardless of the value of its liability) will be a default. In our view this is highly inappropriate and can cause real problems for borrowers in financial difficulty, because it is a default that can be tripped very easily and at a very early stage, and ironically the stretching of unsecured creditors could be exactly the action that secured lenders would want a company to take in this situation.

5. 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 a financial covenant breach or any other 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 the bank being formally required to take any draconian steps or, in a syndicated facility, requiring a collective decision of the majority lenders to cancel the facilities), particularly if the borrower has a working capital requirement at that time and cannot continue trading without access to those facilities. Borrowers will therefore be best placed, in the case of a rollover of facilities (i.e. 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 actual acceleration.

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6. 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). These representations should just be limited to technical legal matters, but the LMA documentation includes a representation that there has been no material adverse change (which is generally undefined and is wider than the "Material Adverse Effect" concept referred to above) since closing and the date of the latest accounts delivered to the agent. There may also be other representations as to factual matters. Borrowers should therefore be aware of what representations repeat under their facilities (and whether they may be in default) and strongly resist the inclusion of the "no material adverse change" representation in new facilities.

7. Will the cross default clause multiply the effects of a problem?

Facilities will typically include a cross default provision, under which an event of default will arise as a result of the occurrence of any default under any of the group's debts (e.g. finance leases), which may be on stricter terms than the main facilities. Borrowers should therefore be conscious of this inter-relationship between different facilities and the quantum of any applicable threshold. This will be particularly relevant for disparate and international groups.

8. Is a lender entitled to withdraw an overdraft on demand, notwithstanding that there is no default?

Most borrowers will take advantage of an overdraft facility provided by one of their syndicate banks. However it is important to ensure that this facility cannot be withdrawn 'on demand' by the bank at any time of their choosing and that it is available on a committed basis (such that it

can only be withdrawn if the bank is otherwise entitled to accelerate the facilities). If it is not made available on a committed basis then the bank may be able to precipitate an acceleration of committed facilities, because demanding uncommitted facilities will usually constitute a "cross-default" under the committed facilities. An overdraft will typically be committed where it is formally constituted as an 'Ancillary Facility' under the facilities agreement.

9. 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, which means that for a period of 1 or 2 weeks in each year they are required to reduce their cash borrowings under any working capital facilities to zero or other agreed threshold (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, this clean down mechanism is something that can easily be overlooked. Failure to comply with the clean down will usually result in a default.

10. Can technical defaults be remedied without a express waiver from the lenders?

If a technical default occurs with respect to a borrower, it will be useful to know that this can be remedied by the borrower without requiring an express written waiver from the lenders. However, 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 by the lenders. This means that all of the usual rights and remedies available to lenders if a default occurs (e.g. acceleration, enforcement of security, withdrawal of permission for certain activities) will remain available to the lenders 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.

Borrowers should also make sure they understand their banking documents and regularly review compliance with all their obligations under them (not just 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.

How we can help

We can review a borrower's banking documents to identify any potentially toxic clauses and advise on ways to ensure continued compliance with the facility agreement and avoid technical defaults. We can also assist in negotiating new facility agreements which mitigate the effect of these potentially toxic clauses.

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