In Practice

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What can a borrower do when a lender fails to fund?

This In Practice article examines market standard provisions designed to mitigate the risk posed by so called "Defaulting Lenders" and explores the options for a Borrower faced with a Lender that is unable to honour its lending commitments. Capitalised terms reflect the corresponding Loan Market Association (LMA) definitions.

LMA "DEFAULTING LENDER" PROVISIONS

The Global Financial Crisis highlighted the risk that a Lender could become insolvent and with loan documentation previously only seeking to address a Borrower's credit risk, the LMA introduced Finance Party default clauses in 2009. "Defaulting Lender" and "Impaired Agent" provisions have since appeared in the LMA senior leveraged finance facilities and have been widely adopted by market participants. However, in the interests of brevity, these clauses do not appear in other LMA loan templates. It is therefore possible that Borrowers will be exposed to loans or other debt instruments which do not protect them adequately against Lender solvency or liquidity risks. It is worth noting that the role of "Lender" is also played by a wide range of non-bank investors, including private credit funds which now dominate the mid-market landscape, each with their own funding sources.

A loan agreement could prove inflexible without "Defaulting Lender" provisions, with limited options for a Borrower. If a Lender were unable to fund, a Borrower might choose to voluntarily cancel unfunded Commitments. First, this would be irrevocable. Second, voluntary cancellation would typically reduce *all* Lenders' Commitments (including those Lenders able to fund); the right of cancellation and repayment in relation to a single Lender is typically given a limited scope, applicable only to Lenders that trigger tax indemnity or increased cost provisions. In parallel, until the relevant Facilities are cancelled in full, a Borrower would not be allowed to incur additional indebtedness beyond prescribed limits. Clearly none of these outcomes are at all helpful to a Borrower, particularly where the relevant facilities are required to complete an M&A transaction.

CAN'T FUND OR WON'T FUND?

A Lender could have many reasons to not fund its Commitments. At times of market turbulence, cashflow constraints could require it to consider its own competing creditors. In situations where a Lender remains solvent but (for whatever reason) is withholding funds, it may help to consider whether legal remedies could be deployed by a Borrower in order to compel a Lender to fund. In theory, the issue of court proceedings may of itself be enough to encourage a Lender to allocate what money it does have to the Borrower. The most likely remedies to be sought are damages and (in rare circumstances) specific performance. Damages would place the Borrower in the same position as if the Lender had fully performed its obligations and may include compensation for increased funding costs, the consequences of a cross default and potentially other losses.

COULD A BORROWER SEEK AN INJUNCTION FORCING A LENDER TO MAKE THE FUNDS AVAILABLE?

In theory, an interim mandatory injunction could be ordered against a Defaulting Lender, but there are significant legal and practical hurdles to consider. An obvious benefit is that the application can be made and an injunction granted very quickly. However, this is an expensive option; the application would entail a lot of preparatory work and, if made without notice to the Lender, would require full and frank disclosure.

A significant hurdle is that an injunction would not be available if damages could be considered an "adequate remedy". This will turn on the facts and the documentation, but could be difficult to demonstrate. It might be possible to argue that an injunction should be granted if the Borrower would otherwise be unable to complete an irreplaceable acquisition without immediate funds. There is no guarantee that a court would grant an injunction, there being few "precedents" in this area. Injunctions are discretionary and the court would need to decide whether such a grant would be "just and convenient". There are also hidden risks for a Borrower seeking an injunction: an applicant would have to provide a cross-undertaking in damages, so that if it later turns out that an injunction was wrongly granted (for whatever reason), the Borrower would have to pay damages to the Lender. This is no small risk for a Borrower.

Forcing a Lender to perform its positive obligations under a loan agreement might not provide a full solution, for instance if the Borrower has already begun to incur losses that do not fall strictly within the Lender's obligations. If the failure to fund has placed the Borrower in default under other contracts, it could suffer losses indirectly as a consequence of a series of cross defaults.

SUMMARY JUDGMENT

Assuming that an injunction is not a viable option, it may only be possible for a Borrower to claim damages from a Defaulting Lender. Faced with a pressing funding requirement, is there any other way to accelerate the court process? A Borrower could apply for summary judgment, where the court is asked to determine the case at an earlier stage and at a shorter hearing. This would save time and costs, if successful. However, it is still an onerous and time-consuming process which could take at least nine months to complete.

Nevertheless, filing proceedings could be a useful strategy if the threat of action puts the Borrower at the top of the Lender's list of people to pay out. Ultimately a court will grant a summary judgment application if the Lender's case has no real prospect of success, and

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there is no other compelling reason why the case should go to trial. Consequently, this is only appropriate in clear-cut cases where there is limited scope for a Defaulting Lender to "muddy the waters", countering with instances where the Borrower could be said to have committed minor breaches of the loan agreement. The greater the complexity, the less likely the application for summary judgment will succeed.

REPUDIATORY BREACH: WHEN CAN A BORROWER "WALK AWAY" FROM THE LOAN AGREEMENT?

The "Defaulting Lender" provisions in a loan document may give a Borrower a more concrete roadmap in terms of exiting its contractual relationship with a Lender. Outside that context, a Borrower may ask whether it is possible simply to walk away from a loan agreement and seek funding elsewhere. This hinges on the concept of "repudiatory breach". For a breach to be a repudiatory breach, it must be sufficiently serious or must be a breach of a "condition" (a term that goes to the heart of the contract). In the case of a loan agreement, a failure to fund is likely to be a repudiatory breach. As a result, the Borrower has two options: (i) accept the repudiation, which terminates the agreement, then sue for damages; (ii) affirm the contract and sue for damages.

Whilst the first option might appeal to the Borrower (allowing it to immediately seek funds from elsewhere), the situation is more complex if Loans are already outstanding; if a loan agreement is terminated for repudiatory breach, the Borrower will have to repay the Lender in full immediately. Furthermore, if there is more than one Lender under the same contract, termination will generally require the Borrower to repay all Lenders. The Borrower may therefore prefer to affirm the contract by making a clear and unequivocal representation (by words or conduct) that it is electing not to terminate. It can still sue for damages for breach of contract even if it affirms the contract. A practical consideration when a Borrower walks away from a loan agreement (assuming the debt is secured) is that security releases may require co-operation of the defaulting Lender. Even if security is held by a separate security trustee, the Borrower will need to show that the secured obligations are "irrevocably and unconditionally discharged".

LMA DEFAULTING LENDER PROVISIONS: A WORKED EXAMPLE

LMA "Defaulting Lender" provisions are triggered if a Lender:
(i) "has failed to make its participation in a Loan available (or has notified the Agent or the Parent (which has notified the Agent) that it will not make its participation in a Loan available) by the Utilisation Date of that Loan"; (ii) rescinds or repudiates a Finance Document; or (iii) experiences an "Insolvency Event". Even if a Lender is clearly unlikely to fund, in order to trigger these provisions it may therefore be necessary for a Borrower to submit a formal funding request and wait until the Utilisation Date has passed. Once these provisions are triggered, there are multiple consequences.

- Revolving Facility Loans advanced by a Defaulting Lender will be automatically termed out and can be prepaid.
- A Borrower may cancel a Defaulting Lender's undrawn Commitments. Thereafter, the relevant Commitments can be revived if one or more willing "Increase Lenders" can be found to make up the shortfall. This "increase" option is subject to a time limit, so Borrowers need to be aware that there may only be a short time available to trigger this option.
- There is no general right to prepay a Defaulting Lender (save in relation to "termed out" Revolving Facility Loans), but this option is often added in facility documentation.
- A Defaulting Lender is not usually owed a commitment fee "for any day" on which it is a Defaulting Lender. However, this means a Borrower may still have to pay a substantial sum by way of accrued commitment fee up to that point. In the case of an Acquisition/Capex Facility, it may have already paid out commitment fees for several months or years on the undrawn Facility which the Defaulting Lender ultimately fails to fund.
- A Defaulting Lender will be "disenfranchised", meaning that it is not permitted to vote on its undrawn Commitments. Likewise, under the so called "snooze and lose" provisions, it loses its vote on its drawn and undrawn Commitments if it fails to respond in the specified time frame.

A Defaulting Lender can be forced to transfer its participation in the Facilities to a new Lender at par. However, this assumes that the Borrower is able to find a "Replacement Lender" willing to step into the Defaulting Lender's shoes. It might not be possible to find a new Lender prepared to fund in line with the existing Facility pricing. The LMA provisions do not, for instance, contemplate an additional fee payable to a "Replacement Lender". In order to bring in a new Lender it may therefore be necessary to revisit pricing (or other provisions) and open-up the Facility Agreement to amendments. The transfer to a Replacement Lender is subject to a prescribed timetable and process under the LMA drafting. First, the Borrower must give notice (typically five Business Days) to the Agent. Second, the outgoing Defaulting Lender is allowed to conduct KYC checks on the Replacement Lender, for which there is no time limit.

The LMA Defaulting Lender mechanism is arguably better suited to situations where there is a problem with one Lender in a large syndicate, the drafting assumption being that an existing Lender will be willing to step in. The provisions are harder to operate in the context of a bilateral facility, for instance one made available by a debt fund. Between the two extremes lies the common mid-market scenario whereby debt is made available by a small "club" of, say, three to four Lenders and one reneges on its Commitments. The remaining Lenders may be unwilling to assume the Defaulting Lender's Commitments, potentially denying the Borrower the opportunity to fund a "bolt on" acquisition or some other time-sensitive project. Because Lenders' obligations are "several", our Borrower will owe ongoing commitment fees to the willing Lenders. However, there may be no point proceeding with drawdown from the willing Lenders if there would still be a shortfall in the total funding required to complete the desired transaction.

Another complication is that, if a "rescue Lender" is brought into an existing facility by a route not contemplated by the original facility documentation, that risks compromising the security package. This is because a revival of the cancelled Commitments of a Defaulting Lender (outside the pre-agreed LMA-style "increase" mechanism) might arguably be said to be outside the "purview" of third-party security. In such cases both the incoming Lender and any existing Lender(s) might be advised that new security should be taken. ■