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ALERT MEMORANDUM

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Speak No Evil – Restructuring Discussions and Events of Default

Speed read

- Many loan agreements contain Events of Default that could be triggered by the borrower beginning restructuring negotiations with a creditor - in two recent cases the English courts have provided some guidance as to how sensitive these clauses are.
- A borrower with these provisions in its loan agreements that is contemplating the commencement of restructuring negotiations should exercise care before approaching its lenders.
- Borrowers negotiating new facility agreements should ensure that the Events of Default are appropriately drafted to allow some form of restructuring negotiations to take place in the future without triggering an Event of Default.

Background

Two recent cases, both concerning property deals that went bad back in 2007 and 2008, have provided some useful guidance on how the English courts will interpret an often-overlooked Event of Default.

In both cases, the loan agreements contained virtually identical Events of Default that would allow the lenders to accelerate the loan by reason of the borrower's financial difficulties, even before formal insolvency proceedings were started. An Event of Default would occur if:

> *"by reason of actual or anticipated financial difficulties, [any material company] begins negotiations with any creditor for the rescheduling of any of its indebtedness"*

In both cases, the financial performance of the borrower's business had not turned out as expected, and in both cases the management of the borrower had commenced discussions with the lenders or the agent bank regarding potential amendments to the loan agreements. The question was whether these discussions amounted to negotiations that would cause an Event of Default.

The meaning of 'rescheduling negotiations'

The first case[1] considered the meaning of the term 'rescheduling', and what sort of discussions would constitute 'negotiations'.

[1] *Grupo Hotelero Urvasco S.A. vs. Carey Value Added S.L.*

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The judge looked principally to an IMF guide for inspiration here, concluding that 'rescheduling' means:

> *"a formal deferment of debt service payments and the application of new and generally extended maturities"*

Perhaps more broadly, he also referred to some academic works that defined rescheduling as:

> *"altering the terms and conditions of existing loan agreements because of the inability of the borrower to meet the established interest and/or principal repayments"*

But crucially the judge recognised that there must be some element of formality. A borrower in the business context may have constant dealings with respect to its indebtedness – renegotiating it, refinancing it and possibly postponing it. The Event of Default shouldn't be triggered by a chat with a credit manager over a cup of coffee. In addition, in order to trigger the clause the negotiations should occur not in the ordinary course of business, but 'by reason of actual or anticipated financial difficulties *which must be of a substantial nature*'.

A practical example

This all sounds great for borrowers. But none of it helped in the second case[2], where the judge had to look at what exactly constituted financial difficulties of a substantial nature. In this case, the borrower and the agent had exchanged some email correspondence regarding the performance of the business as compared to the business plan, and the borrower had sent cashflow models to the agent that showed interest on one of the tranches of debt being rolled up to be paid at maturity.

The judge decided that:

- as a result of the correspondence, it was clear that by falling behind the original business plan the borrower would have insufficient cash flow to service the financing structure in the following years;
- the financing was highly leveraged at the outset with tightly drawn financial covenants, and the ability of the borrower to service the debt was dependent on the ability to perform to the standard envisaged in the original business plan;
- the anticipated inability to service the debt could not be regarded as an ordinary or expected incident of the borrower's business or an insignificant aspect of its financing arrangements;
- even absent a projected payment default, a significant erosion in the cushion of income available to meet interest due at the level of about 7-8% of the entire on-going interest burden was a substantial financial difficulty in this context.

[2] *Torre Asset Funding Limited vs. The Royal Bank of Scotland plc*

What is striking here is that the 'negotiations' were deemed to have commenced not by the submission of a formal amendment request by the borrower to the agent, but simply by the submission of cashflow forecasts that showed the roll up of interest on one of the tranches of debt. So it appears that very little in the way of 'formality' was actually required to trigger the Event of Default in this case.

Implications

- Borrowers in actual financial difficulty (and those who anticipate financial difficulty) should review their loan agreements thoroughly before communicating anything that could be construed as a restructuring proposal to their lenders. This includes models that show the effect of hypothetical amendments to the terms of the loan (e.g. extensions of maturity, reductions in interest rate or principal amount).

- When negotiating new facility agreements with a lender, a well-advised borrower should seek to de-sensitize the insolvency Event of Defaults that could be triggered by negotiations with creditors, for example by:

    - excluding negotiations with any lender under that facility from the scope of the clause; or

    - ensuring that the clause is only triggered by 'formal' negotiations 'with its creditors generally' (as opposed to any creditor).

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