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Minimizing Risks for Co-Lenders and Borrowers Through Credit Agreements and Post-Default Remedies

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Susan C. Alker, Partner, **Reed Smith**, Los Angeles
Catherine Ozdogan, Partner, **Bracewell Guiliani**, Houston
Colleen H. McDonald, Partner, **Reed Smith**, San Francisco

Tuesday, April 6, 2010

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Posted on October 19, 2009 by Susan Alker

What to Do When a Lender Defaults - Part Two

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In our **last post** on this topic, we discussed some basic provisions that provide protection for the bank group if a lender in a syndicated loan deal defaults. Now let's take it to the next level. What kinds of things could you add to your loan agreements that would give you even more protection, and better rights, if a lender defaults?

- **Expanded Definition of Defaulting Lender.** Rather than narrowly defining a "Defaulting Lender" as one that fails to fund a loan or make a payment to the agent when required, consider adding insolvency, receivership, bankruptcy, liquidation, and takeover by the FDIC to the list of defaults. These types of events, whether affecting the lender or its parent company, will often lead to a full-stop in lending activity and can create significant problems for the borrower and the rest of the bank group, even if no loan request is pending at the time. You might also consider using an "impacted lender" standard to set the trigger for certain things (like the ability to remove or replace a lender) even

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earlier -- for example, upon the failure of the lender to adequately demonstrate that it is not going to become a defaulting lender.

- **Payment Priority.** Instead of providing that all lenders always share pro rata in payments made by the borrower, you can include a provision that overrides pro rata sharing as to defaulted lenders, in the event there are any prepayments of the loan. In this case, all the non-defaulting lenders would share (pro rata as among themselves) any prepayments made on the loan, up to the amount of the defaulted portion of the loan. Or, as in some agreements, the defaulting lender's pro rata portion of the payment could be held by the agent as cash collateral for the obligations that lender owes to the agent, and could be applied to all funding and payment shortfalls until the lender's default is cured.

- **Non-Ratable Reduction of Commitments.** Consider giving the borrower the right to non-ratably reduce and terminate the undrawn commitments of the defaulting lender. On an undrawn revolving line of credit, this would effectively eliminate the defaulting lender from the group without having to find a replacement lender willing to purchase the commitment. One downside to this approach is that the size of the credit facility will be reduced by the amount of the terminated commitment, which could pose a problem for some borrowers. Also note that if any loans are outstanding, the other lenders probably won't be willing to agree up front that the defaulting lender can be paid back in full on a non-pro rata basis, as this could be a significant, and unfair, windfall for the defaulting lender (particularly in workout situations). Outstanding loans would still need to be paid down pro rata as among all lenders, unless the lenders agreed to waive this at the time.

- **Permit the Other Lenders to Fund the Defaulted Piece.** You might consider adding provisions to the loan agreement to allow the non-defaulting lenders to step in and fund the loans that the defaulting lender failed to make. This is very helpful to the borrower, as otherwise it will receive less money than it actually needs each time it requests a borrowing and the defaulting lender fails to fund. The decision as to whether or not to fund any of these additional loans is left to the discretion of each lender, as no one is ever required to exceed their original commitment amount. Funding can be pro rata or not, if not everyone chooses to participate. It is very helpful to permit the lenders who decide to fund the defaulted portion of the loan to be paid a higher rate of interest (perhaps at the default rate) and to receive priority in right of payment as to these additional loan amounts, resulting in that the additional loans being paid back first and carrying a higher rate of return than the rest of the loans under the facility.

We've seen variations of all of these in loan agreements recently. Many lenders and agents are requiring that some form of enhanced defaulting lender terms be added when amending their existing loan agreements, as the current market continues to increase the potential for lender defaults.

Next up, we'll explain what to do when the defaulting lender has been taken over by the **FDIC**. Lots of special rules apply in that case; we'll tell you

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what they are and how to work within them.

Tags: Syndicated Loans, defaulting lender, pro rata sharing

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Reed Smith LLP

Corporate finance lawyers and attorneys of the law firm of Reed Smith, offering services related to lending transactions, mezzanine lending, syndicated finance, leveraged lending, commercial transactions and corporate debt.

Posted on November 11, 2009 by Susan Alker

What To Do When a Lender Defaults - Part Three

In our **prior posts** on this topic, we focused on what your loan agreements might say about how to deal with a defaulting lender. In this post, we'll talk about what happens when a member of your bank group goes into default because it is taken over by the FDIC. Special rules apply in that case.

Automatic Stay. The **Federal Deposit Insurance Act** provides for an "automatic stay" whenever a lender is taken over by the FDIC. In part, the statute says that no one may "exercise any right or power to terminate, accelerate, or declare a default under any contract" that the failed institution is a party to, for a period of 90 days after appointment of the FDIC as receiver (45 days, if it is a conservatorship).

My colleagues **Colleen McDonald** and **Nikki Kolhoff** have **explained (pdf)** that this means **you can't do anything that would affect the contractual rights of the defaulting lender**, if such action is based solely on the insolvency or FDIC takeover. So, for example, you can still amend your loan documents, but you have to invite the defaulting lender to vote, and the amendment can't affect the rights of the defaulting lender without that lender's consent. According to McDonald, the bottom line here is "if you are going to amend your loan agreement, make sure you do it correctly." She points out that both the "D'Oench Dhume doctrine" (*D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942)) and 12 U.S.C. Section 1823(e) impose specific requirements on modifications of loans involving financial institutions taken over by the FDIC. Contracts that don't meet the requirements can be avoided altogether by the FDIC - so it's worth taking the time to make sure those requirements are met.

In addition, even if the loan agreement would otherwise permit you to stop sharing payments with a defaulting lender, if the lender is taken over by the FDIC, you'll still have to share all principal and interest payments with it -- at least, to the extent of the obligations it has previously funded. (As discussed in our **prior post**, the loan documents should ordinarily prohibit the defaulting lender from sharing in principal and interest payments relating to advances it did not fund.)

As a practical matter, the automatic stay can create significant problems for a bank group, particularly if the defaulting lender is the administrative agent for the credit facility. Since the agent manages the funding and payment processes, and often holds the borrower's bank accounts and controls other collateral for the loan, an FDIC takeover could bring everything to a halt - at least temporarily.

McDonald recommends that to help protect against these problems, **the loan agreement should include the right to declare the lender in default early -- before FDIC takeover**. This would allow the bank group to take action before the automatic stay kicks in. For example, if the agent in a syndicated loan goes into default (pre-FDIC takeover), its rights as agent could be terminated and assigned to a successor, and all the collateral could be transferred to the new agent -- thus permitting the credit facility to function pretty much as usual through the FDIC takeover. McDonald suggests including a definition of "Impaired Agent" in the loan agreement that would include an agent that fails to make payments or fund loans required under the loan documents, or that rescinds or repudiates a loan document.

Exceptions. There are other sections of the Federal Deposit Insurance Act that provide exceptions to the automatic stay, including an exception for when the FDIC as conservator/receiver fails to comply with otherwise enforceable provisions in the loan agreement. Sometimes these exceptions can provide relief for the bank group, though their full effect is as yet untested. I have a feeling we'll get the chance to test some of these provisions over the next few months.

Tags: Amendments, FDIC, Loan Transactions, Regulation, Syndicated Loans, automatic stay, defaulting lender, voting rights

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Posted on October 1, 2009 by Susan Alker

What to Do When a Lender Defaults

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Lenders often express concern about potential defaults under their loan agreements – but it's usually default by the *borrower* that they're concerned about, not default by the lenders. It's a sign of the times that this has now become a significant issue. With an increase in the number of **bank failures** and **FDIC receiverships** over the past year, we've begun to see an increase in the number of lender defaults in syndicated loan deals. If you're a lender (or a borrower) in a syndicated credit facility, you might well find yourself facing this situation.

If a lender in your bank group defaults, what can you do – and what can't you do?

As an initial matter, it's important to keep in mind that default by a lender does not excuse anyone else from performance. The remaining lenders still have to fund loans when requested, and the borrower still has to make payments and comply

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with all the covenants. However, depending on what your loan agreement says, you may be able to mitigate the effects of the default. Here are some typical provisions that many loan agreements already contain:

1. **Limitation on Voting Rights.** Many loan agreements provide that a defaulting lender's commitment is not counted when determining whether a required/majority lender vote has been achieved. Some loan agreements also provide that the defaulting lender simply does not have the right to vote on any issue – even issues otherwise requiring a 100% vote (perhaps with some very limited exceptions such as for increases of that lender's commitment). This is extremely helpful, because if the lender has gone into bankruptcy or has been taken over by the FDIC, it will be very difficult, if not impossible, to get that lender to vote on even the simplest of amendments.

2. **Replacement of Lenders.** Most syndicated credit agreements permit the borrower to remove a defaulting lender from the credit facility, under so-called "yank-a-bank" provisions. Removal of the lender would be accomplished through a forced assignment of its commitments and outstanding loans to another lender. Taking the defaulting lender out of the deal would certainly solve a lot of problems. However, the practical reality is that it can be difficult to find another lender willing to purchase the commitment at par as required – and this is particularly true when the loan is trading at a large discount in the secondary market (whether due to market conditions, as has been true recently, or due to a decline in the borrower's performance).

3. **Commitment Fees.** Though some agreements are silent on this point, several credit agreements include provisions permitting the borrower to stop paying a commitment fee to the defaulting lender. This seems appropriate, as borrowers otherwise find it rather unfair to have to pay a fee for a commitment that the lender has demonstrated it will not honor. A few loan agreements provide instead for the fee to be paid in the same amount as always, but for it to be shared only among the non-defaulting lenders. This provides something of a windfall for the non-defaulting lenders - which may be why this formula is less popular.

4. **Letters of Credit and Swingline Loans.** It is relatively common to require the borrower to cash collateralize the portion of an outstanding letter of credit or swingline loan that would otherwise have been backed by the defaulting lender's commitment. This protects the issuing bank or swingline lender from having to bear additional risk for that portion of the loan/commitment, beyond its pro rata share. Some agreements provide that letters of credit cannot be issued at all (and swingline loans cannot be made) if there are any lender defaults, but this approach is used less

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frequently these days, as losing access to letters of credit can make things very difficult for certain types of borrowers.

At a minimum, you'll want to make sure your loan agreements cover these important topics. If these provisions aren't already in an existing agreement, you might consider taking the opportunity to add them the next time there is an amendment.

In our next post, we'll offer some suggestions for how to further improve protections for the bank group and the borrower in the event of a lender default, beyond these basic provisions.

Tags: **FDIC**, **Syndicated Loans**, **bank failures**, **commitment fees**, **defaulting lender**, **lender voting rights**, **receivership**, **replacement of lenders**

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The Impact of a Lending Bank's Insolvency on the Lending Group

By Nicole Herron Kolhoff and Colleen H. McDonald

In October 2006, an automatic stay was made part of the Federal Deposit Insurance Act ("FDIA") for the first time. Specifically, Section 11(e)(13)(C)(i) now provides:

> [N]o person may exercise any right or power to terminate, accelerate, or declare a default under any contract to which [a depository institution in conservatorship or receivership] is a party, or to obtain possession of or exercise control over any property of the institution or affect any contractual rights of the institution, without the consent of the conservator or receiver, as appropriate, during the 45-day period beginning on the date of the appointment of the conservator, or during the 90-day period beginning on the date of the appointment of the receiver, as applicable.

At the time the provision was passed, there wasn't much Congressional debate about the consequences of such an automatic stay in relation to a bank failure. But with the economy in tatters, and with an ever increasing number of questionably solvent Banks, the prospect of a significant number of bank failures seems more and more likely. Lenders are considering the impact of an FDIC receivership of one or more members of its lending group (each, an "Insolvent Lender"), and in particular the effect of the automatic stay, on the rights and remedies of the non-defaulting lenders under the loan documents.

There is little guidance as to how to address the issues facing co-lenders because we are still in the early stages of the first bank crisis since the FDIA automatic stay was passed. Against that backdrop, lenders should take a close look at their loan documents to ensure that the mechanics for the on-going operation of the syndicate are in place notwithstanding the existence of an Insolvent Lender in the syndicate. In addition, lending syndicates should consider various options for pre-insolvency termination of a troubled lender in order to avoid the impact of the automatic stay. The time for lenders to act is now. Once an automatic stay goes into effect, non-defaulting lenders will be unable to amend the documents where such an amendment would affect the contractual rights of the Insolvent Lender or the Insolvent Lender's vote is required to pass the amendment.

Funding and Payment Mechanics during the Automatic Stay

A lending syndicate can make meaningful revisions to their loan documents in the areas of the Insolvent Lender's relationship with the administrative agent (the "Agent") and the non-defaulting lenders in the context of funding loans and applying payments.

Most loan documents already provide if a lender fails to fund its share of a requested advance such lender is considered a "Defaulting Lender". However, to provide certainty as to which lenders are required to fund in the event of a takeover of a lender by the FDIC, the definition of a "Defaulting Lender" should be expanded to include insolvency of a lender and a lender being placed under FDIC receivership or conservatorship.

Special attention should be paid to loans providing for swing line advances and letters of credit. Since swing line loans and letters of credit are funded by the swing line lender and the letter of credit issuer (the "Issuer") on behalf of the lenders, and later reimbursed by the lenders, both the swing line lender and the Issuer will want to limit their funding exposure to the Defaulting Lender. The loan agreement should state that the swing line lender is not obligated to fund the Defaulting Lender's portion of any swing line loan. Furthermore, the non-defaulting lenders should be required to reimburse the swing line lender based on the non-defaulting lender's share of the requested amount, and not the funded amount (which has already been reduced by the Defaulting Lender's share), so that the swing line lender is reimbursed in full. The Issuer should not be required to issue the Defaulting Lender's portion of any requested letter of credit unless the borrower posts cash collateral for the Defaulting Lender's portion. Then, if there is a drawing under the letter of credit, the Agent can apply the cash collateral to the Defaulting Lender's share and seek reimbursement from the non-defaulting lenders based on their share of the issued letter of credit.

The Agent and the non-defaulting lenders will also want to limit their exposure to the Defaulting Lender. The Agent should not be required to make any advances on behalf of the Defaulting Lender. Furthermore, the non-defaulting lenders should have the discretion (but not the obligation) to make advances not funded by the Defaulting Lender (such advances, "Defaulted Amounts").

Lenders should check the definitions that govern the allocation of interest and principal payments to the lenders so that a Defaulting Lender isn't entitled to receive interest and principal relating to advances it did not make. A lender's share of a requested advance should be calculated based on the percentage a lender's commitment bears to the aggregate commitment of all lenders (frequently called, the "Pro Rata Share"). On the other hand, a lender's share of the principal and interest payments received from the borrower should be calculated based on the percentage such lender's loans bears to the aggregate loans funded by all lenders (the "Percent Outstandings").

If the non-defaulting lenders decide to fund the Default Amount, the lenders may consider requiring the Defaulting Lender to pay an increased rate of interest (the "Default Rate") on the Defaulted Amount to the non-defaulting lenders, and subordinate payments otherwise due to the Defaulting Lender to repayment of Default Interest and the Defaulted Amount to the non-defaulting lenders. With respect to principal, all principal amounts received by the Agent that would otherwise be payable to the Defaulting Lender shall be paid pari passu to the non-defaulting lenders until the Defaulted Amount has been repaid in full.

While it is unlikely that the Agent can withhold interest and principal payments from the Defaulting Lender during the automatic stay because such actions would “affect the contractual rights” of the Defaulting Lender, after the expiration of the automatic stay, any Defaulted Amounts funded by the non-defaulting lenders would receive interest at the Default Rate and priority over the Defaulting Lender’s loans when it comes to repayment of principal.

However, the non-defaulting lenders are unlikely to fund the Defaulted Amounts to a borrower with a questionable credit profile because they don't want to increase their own exposure. Instead, the borrower will have to request another advance (which will also be partially unfunded by the Defaulting Lender) to obtain the desired funds. In this case, the loan document should provide that interest payments received by Agent will be apportioned to each lender based on its Percent Outstandings and not its Pro Rata Share, and (b) principal payments received by the Agent will not be paid to a Defaulting Lender until such time as the non-defaulting lenders have been reimbursed for advances, on a pari passu basis, such that the Percent Outstandings of all lenders, including the Defaulting Lender, is equal to their Pro Rata Share.

Lender Action during the Automatic Stay

The automatic stay restricts the non-defaulting lenders from taking action to “affect any contractual rights of” the Insolvent Lender. Although there is scant precedent as to how the FDIC will exercise this new power, we know from other bank receiverships that the FDIC has taken a broad view of its power under the FDIA.[1] Whether the documents contain outright prohibitions on voting by an Insolvent Lender or provide a threshold for lender consent during the automatic stay that does not include the Insolvent Lender, it is likely to be viewed by the FDIC as restricting the Insolvent Lender from enforcing its contractual rights during the automatic stay period, in contravention of the automatic stay.

How can the non-defaulting lenders continue business as usual under the loan documents without violating the automatic stay? One approach would be to make changes to the documents that would not otherwise require the consent of the Insolvent Lender. Amendments that only require the consent of requisite lenders, as opposed to all lenders, should be valid so long as they have enough support without the Insolvent Lender’s vote. Another approach is to move away from taking an action against the Insolvent Lender based upon the insolvency or the lender’s resultant inability to fund, to the extent applicable, and instead focus on events

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[1] In the receivership of NextBank, N.A. the FDIC took the position that an automatic event, default, acceleration or early amortization based solely on insolvency or it’s appointment as receiver was not enforceable against it. The court upheld the FDIC’s position

prior to the take over by the FDIC, such as a ratings downgrade, the lender being placed on the FDIC's watch list or volatility in the lender's stock price, which indicate trouble for the lender. Although this would be a significant shift in the lender's way of thinking about their rights if they were to agree to transfer or suspend their voting rights upon the occurrence of certain "bad" events, there is a plausible argument that actions taken by the other lenders pursuant to the provisions of the documents prior to insolvency would not violate the automatic stay.

The lending syndicate should also focus on preserving the ability to take action on behalf of the Agent during the automatic stay period. The operation of the automatic stay would render the loan documents unworkable in the event of the receivership or conservatorship of the lender acting as Agent. As with the voting rights discussed in the preceding paragraph, identifying early warning signs of an impending insolvency as triggers for removing the rights the lenders seek to preserve during the automatic stay, is the most obvious solution.

By way of example, the loan documents could provide for termination of the Agent upon events similar to those set forth for the voting rights above. Upon termination the Agent would automatically assign its rights and duties as agent to a successor Agent to be selected by the non-defaulting lenders. Collateral such as bank accounts held in the name of the Agent would then be moved prior to the receivership. In any event, there should be a power of attorney in favor the lender group permitting any one of the non-defaulting lenders to act as successor Agent and move the accounts.

There is ample precedent for transfer of administrative functions prior to insolvency events. For instance, in securitization transactions much attention is focused on servicer termination prior to a servicer bankruptcy due to the executory nature of the servicing contract provisions.

Conclusion

It is difficult to predict the impact that the new FDIA automatic stay will have on lending syndicates. There are exceptions to the automatic stay, one of which is that the provision does not allow the FDIC as conservator or receiver to fail to comply with otherwise enforceable contractual provisions. This legislation, however, could be interpreted to prohibit lenders from taking certain actions to implement contractual provisions.

What we do know is that funding obligations in revolving facilities will be impacted and that can be detrimental to the co-lenders and Agent in the credit facility. The impact can be mitigated if loan documents are reviewed and amended proactively. Lenders and Agents should review provisions relating to the definition of a defaulting lender, funding mechanics, payment mechanics and voting to ensure as much flexibility as possible should one of the lenders become an Insolvent Lender.