Feature

KEY POINTS

- Defaulting Lender provisions and mechanics are undoubtedly better suited to traditional large syndicated loan transactions where a substitute Lender can step in, rather than to large underwritten bilateral or club transactions, which are more prevalent in the private credit market.
- Existing Impaired Agent and Cashless Rollover provisions should continue to protect Borrowers where the Facility and Security Agent role is provided by an independent loan servicer rather than a syndicate bank.
- The Defaulting Lender provisions were introduced into the Loan Market Association (LMA) senior leveraged finance precedent but do not appear in the LMA investment grade or real estate finance loan documents – and non-bank Lenders and private credit funds have acquired a significant share of the corporate loan market, particularly in the real estate finance sector.

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LMA Defaulting Lender provisions in today's growing non-bank loan market

In this article the authors consider the relevance of the Loan Market Association's (LMA) Defaulting Lender concept in non-traditional facilities such as those arranged by private credit funds and non-bank Lenders.

Loan agreements traditionally focused on monitoring the creditworthiness of a Borrower and the consequences of a Borrower default but did not often contemplate the failure of Lenders or other Finance Parties. However, in 2009 the Loan Market Association (LMA) revised its documentation to address some of the difficulties that Lenders and Borrowers encountered in the syndicated loan market in response to the bank failures and wider market turmoil encountered following the global financial crisis in late 2008.

The changes introduced by the LMA focussed on four main areas: (i) Lender default; (ii) the effects of a Facility Agent becoming subject to distress; (iii) protection for banks issuing letters of credit; and (iv) the mechanics of dealing with market disruption in the interbank funding market. This article will focus primarily on the changes concerning Lender defaults and consider whether those provisions remain suitable in the rapidly changing European loan market. This article uses capitalised terms which are commonly used in the context of LMA facility documentation.

LMA "DEFAULTING LENDER" PROVISIONS

Following the collapse of Lehman Brothers and other financial institutions in 2008, Borrowers, and in the case of syndicated loans other syndicate participants, faced having to deal with the effects of the failure of a Finance Party – either in its role as a Lender or as a Facility or Security Agent.

In practice, the failure of a Lender had the effect of that Lender failing to fund requested Utilisations or failing to respond to consent, waiver or other requests which required the approval of a requisite amount of Lenders (and indeed even posed the question of how the Facility Agent should determine the requisite number of Lenders required to approve such requests (whether all Lender or Majority Lender)).

Failure of Facility Agents had slightly different consequences for Borrowers, although from a practical perspective these were equally, if not more, significant. As well as the risk that a failed Facility Agent might decline to process Utilisation or consent requests, in the case of Rollover Loans under Revolving Facilities there was also the concern that any amounts paid to those Facility Agents, either by Lenders or Borrowers, could remain trapped as part of the insolvent estate of that Facility Agent until any insolvency process had been completed, possibly months or years later.

In each case, there was, understandably, no contingency provided for such events in most loan documentation. Following the events of 2008, the LMA introduced new concepts in order to mitigate these risks, including that of a Defaulting Lender, an Impaired Agent, and the Cashless Rollover whereby rollover loans under a Revolving Facility can be effected by way of netting and book entry.

The provisions were introduced into the LMA senior leveraged finance precedent and have now become commonplace in the market. However, it should be noted that these provisions do not appear in other LMA loan templates, such as the investment grade or real estate finance loan documents. It is therefore not uncommon for Borrowers to still be party to loans and other similar instruments which do not protect them against lender solvency or liquidity risks.

THE CHANGE IN THE EUROPEAN LENDING LANDSCAPE

The LMA Defaulting Lender and related concepts were formulated at a time when the European loan market was dominated by financial institutions and were drafted on the assumption that Lenders were banks or financial institutions. However, the very market disruption which prompted the LMA to introduce the Defaulting Lender provisions was the same catalyst which accelerated the growth of non-bank Lenders.

Over the last 15 years non-bank Lenders and private credit funds have acquired a significant share of the corporate loan market, particularly in the leveraged finance and real estate finance sectors. Private credit funds are regulated differently to banks and typically take a more bullish approach to credit risk and leverage multiples. Private credit funds are also generally more open to bespoke financing structures and to funding at different parts of the capital structure compared to some traditional bank Lenders. Private credit funds also have different sources of funding compared to traditional banks. In a similar way to a private equity fund, a private credit fund is an investment vehicle for a group of underlying investors. Ignoring potential borrowing facilities at a fund level, a private credit fund's ability to advance funding is therefore dependent on the liquidity and creditworthiness of its investors.

The quantum of assets under management between different private credit funds means that the size, scale and sophistication of non-bank Lenders varies hugely across the market. Some private credit funds are very public facing and may approach transactions in a similar manner to established financial institutions. However, some private credit funds are more private (as their name suggests) and approach transactions on an individual basis. This is relevant in the context of why banks and private credit funds may decide not to fund loans.

Bank Lenders are extremely unlikely not to fund a committed loan, whether for regulatory or reputational reasons. As history shows us, it generally takes a seismic macro-economic event such as the global financial crisis or a pandemic in order for bank Lenders to decide not to fund, or to find themselves unable to do so. Even then, such risks have often been mitigated through government support in order to try to ensure that bank Lenders continue to support businesses relevant to the domestic economy.

As we have noted above, a private credit fund has different funding sources to traditional bank Lenders and it is those private credit fund investors which will determine whether it (the private credit fund) funds. If an investor funds, it is very unlikely that those funds will not be passed on by the fund or the general partner of the fund to the Borrower. As with banks, the reputational impact would be considerable if an investor – particularly an institutional one – were to fail to fund. However, there may be other factors involved, including the investor's concern over the performance and management of the fund itself and the market in which the Borrower operates. Smaller private credit funds may also be less concerned with reputational risks and more concerned with the risks posed by deploying additional capital to a Borrower or into a sector which it no longer wishes to be as exposed to.

As well as the source of funds, the strategy behind the deployment of funds differ between traditional bank Lenders and private credit funds. Private credit funds typically seek to deploy funds at the closing of an acquisition, often on a bullet or term loan B basis, with penalties for early prepayment. Where a working capital or revolving credit facility is required, this will still often be provided by a bank Lender, usually on a super senior basis. The slight exception to this might be where the fund has agreed to fund an acquisition facility to fund the future buy and build strategy of a group, or in real estate where the fund has agreed to finance a development in stages. Bank Lenders on the other hand still very much dominate the working capital facilities market and generate additional revenue through ancillary products and deposit taking rather than simply through the long-term deployment of capital.

Considering these differences between traditional bank Lenders and private credit funds, are the LMA's Defaulting Lender provisions still relevant?

WHAT IS A DEFAULTING LENDER?

Under LMA documentation a "Defaulting Lender" is a Lender:

- which becomes subject to an "Insolvency Event" (which contemplates a broad range of different insolvency scenarios);
- which has otherwise rescinded or repudiated a Finance Document; or
- which has failed to fund its participation in a Loan (or notified of its intention to do so).

The principal consequences of becoming a Defaulting Lender are as follows:

- **Yank the bank**: The primary remedy a Borrower has is to replace a Defaulting Lender, forcing it to transfer its participation in the Facilities to a new Lender. The Borrower is responsible for finding a Replacement Lender which must be done in line with pre-agreed pricing parameters, including the need to finance the transfer at par value. These restrictions might mean that in practice it may therefore be necessary to revisit pricing and other provisions and open-up the Facility Agreement to amendments.
- **Increase Lenders**: A Borrower is permitted to cancel the undrawn Commitments of a Defaulting Lender which can then be reinstated if one or more "Increase Lenders" can be found (by the Borrower) who are prepared to fund those Commitments.
- **Term out**: Revolving Facility Loans funded by a Defaulting Lender will be automatically termed out and can be prepaid.
- **Voting**: A Defaulting Lender will be "disenfranchised" under the Finance Documents meaning that it is not permitted to vote on any part of its undrawn Commitments on the assumption that that Commitment will likely not be available to draw, and its undrawn Commitments will also be excluded from the denominator in any vote counting. Similarly, it will lose its vote on its outstanding Loans if it fails to respond in the specified time frame.
- **Fees**: A Lender will not usually be entitled to any commitment fee for any period that it is a Defaulting Lender. Any previously accrued but unpaid fees will still be payable to the Defaulting Lender.

IS THE DEFAULTING LENDER CONCEPT STILL RELEVANT?

Based on the above summary, the longstanding LMA Defaulting Lender concept is still likely to be sufficient to address the failure or non-funding of both bank Lenders and most private credit funds. However, the related Defaulting Lender provisions and mechanics are undoubtedly better suited to traditional large syndicated loan transactions where a substitute Lender can step in, rather than to large underwritten bilateral or club transactions which are more prevalent in the private credit market.

As noted above, driven by the need to deploy capital for a determinate period of time in order to generate returns for investors, private credit funds generally participate in term debt structures often fully drawn from day one. The drawing down of investor commitments does not suit the unscheduled and frequent drawing and redrawing of Revolving Credit Facilities. In those private credit transactions which require a Revolving Credit Facility, those facilities are still frequently provided by traditional bank Lenders and so the provisions relating to the terming out of Revolving Credit Facilities and Cashless Rollovers remain as relevant and functional as in all bank deals.

Notwithstanding the fact that Revolving Credit Facilities are not a cornerstone of the

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private credit market, it does not make the Defaulting Lender concept redundant. For those transactions with unfunded term facility elements such as acquisition facilities (in the case of leveraged financings) or development facilities (in the case of real estate finance) the provisions remain very relevant, although again the provisions would be harder to operate in a club or bilateral facility versus a large syndicated bank facility. For example, where three Lenders have equal obligations and one fails to fund, neither of the remaining two Lenders may be willing to assume the Defaulting Lender's Commitments, potentially denying a Borrower the opportunity to fund a "bolt on" acquisition or the next phase of a development. Given that the Lenders' obligations are "several", the Borrower will still be liable to pay commitment fees to the willing Lenders and yet there may be no practical value in requiring them to fund if there would still be a shortfall in the overall funds required to complete the relevant transaction.

Furthermore, whilst working capital facilities are not the cornerstone of the private credit market, they do feature, and we have seen a particular emergence of non-bank Lenders in the asset based lending space, often on "in-house" documentation which often does not include the Defaulting Lender provisions.

A further difference between traditional bank led facilities and those arranged by private credit funds is the identity of Facility and Security Agents. The growth of the private credit market has also seen a growth of independent loan servicing and agency businesses which were historically usually provided by a syndicate bank. We await the impact that the failure of an independent loan servicer might have, although at this point we foresee no reason why the existing Impaired Agent and Cashless Rollover provisions would not continue to protect Borrowers (and Lenders) in this scenario.

Beyond the Defaulting Lender provisions

The start of the recent pandemic and the phases of post-pandemic market turbulence saw examples of some solvent Lenders deciding to withhold funds, for a number of different reasons. In this scenario, are there any remedies available to a Borrower to compel a Lender to fund or more generally to comply with any of its other obligations under the Finance Documents? English law does not recognise any general legal doctrine of "bad faith". The starting point will typically be the actual terms of the agreements and whether the Lender is in breach. If so, there are a few options open to a party impacted by a Lender's default and which a Lender would need to consider before electing to withhold funds:

- **Damages:** The most common approach would be to issue a claim for damages. This would be a claim for an amount of money which would put the Borrower in the position that it would have been in had the Lender funded the required loan and/or fulfilled its other contractual obligations. This might include damages for losses suffered as a result of increased funding costs, having to incur additional adviser fees and, potentially, knock-on consequences of the failure to fund, such as losses suffered by being unable to proceed with the underlying project or transaction for which the funding was required. However, in order to be able to recover damages for such losses, the loss must have been caused by the Lender's breach, it must have been foreseeable at the point the contract was entered into and the Borrower must not have acted unreasonably by either failing to limit the amount of loss suffered or by doing something which actually increases the loss suffered (eg by failing to source appropriate alternative funding if it were possible to do so).
- **Specific Performance:** The Borrower could also seek specific performance to force the Lender to comply with its contractual obligations, including making the funds available. However, this is a less common and more complex approach than simply seeking compensation by way of damages. It is an "equitable" remedy, which means it is up to the court's discretion and it will only be awarded in circumstances where damages is not an adequate remedy. It is rare for specific performance to be ordered to force a Lender to make a loan, but it might be available in certain cases, for example if there were no readily available market substitution for the facility.
- **Declaratory Relief:** Another option available to the Borrower would be to apply for declaratory relief. This involves asking the court to make a declaration clarifying issues such as the rights and obligations of the parties, the existence of certain facts or a principle of law. For example, a Borrower could ask the court to confirm what the exact nature of the Lender's obligations are under the Finance Documents. Although this will not impose a directly enforceable obligation to comply with the declaration, as an order for specific performance would, if the Lender acted in a manner contrary to the declaration, it would put the Borrower in a much stronger position to bring a claim against the Lender. It is also a useful remedy in circumstances where the declaration might have a wider application, such as in relation to the interpretation of contractual provisions which appear in numerous agreements.

All of these remedies require some form of litigation or contentious proceedings and the outcome of any such process is in inherently uncertain. However, even the threat of litigation (and the potential financial, commercial, reputational and regulatory impact that come with it) are sometimes used successfully by Borrowers to encourage Lenders to comply or at least get them round the table to try to reach a negotiated resolution.

CONCLUDING REMARKS

The European lending market has been through a transformatory shift since the LMA originally launched its Defaulting Lender provisions in the aftermath of the global financial crisis. Whilst the provisions are still equally applicable to private credit funds and non-bank Lenders in theory, the partial shift away from large syndicated bank transactions towards large single bank and club deals certainly limits the practical application of some of the mechanics. The rise in private credit also raises the potential scenario where limited partners could find themselves funding the equity as well as the debt aspects of a transaction, which would raise an interesting tension in the event of a Lender failing to fund a transaction. ■