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Analyzing Existing Loan Terms to Ensure Durability of Documentation Amid Economic Dislocation

June 19, 2020 | Issue No. 82

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We have read reports that loose provisions in loan documents outside of the fund finance space have led to a recent uptick in disputes among parties, so lenders and borrowers in our sector should pay heed. While the fund finance market continues to prove resilient amid the turmoil of the global pandemic, now is as good a time as ever to stress-test key terms in existing subscription credit facility documentation to ensure they remain durable through economic dislocation.

The parties can take a top-down approach to this analysis by considering how certain adverse scenarios could affect the loan documents as a whole. Or, for greater granularity, they can build their assessment from the bottom up by evaluating provisions piece by piece. It is through this latter lens that the following terms will be examined here.

<u>Borrowing Base</u>

Lenders want to set appropriate advance levels based on a pool of investors or the creditworthiness of each investor in the borrowing base. Borrowers want as much capacity to borrow as they can obtain from their collateral. Each should scrutinize how severe market conditions could impact this.

- A lender can assess advance metrics and any ratings requirements and concentration limits in its risk analysis.
- The parties might look to confirm how returned capital is added back to uncalled capital and made subject to recall under the partnership agreement and the lender's security.
- Exclusion events should be eyed against large investors and groups of investors from the same sector. In times of widespread downturn, particular focus would be on the failure of investors to maintain a certain net worth or rating; the effects of investor transfers, withdrawals and excuses; and any time periods provided to cure exclusion events for defaults.
- A lender might better protect its borrowing base risk by having a catchall for excluding investors if the lender reasonably determines there has been a material and adverse impact on the financial condition or operations of a limited partner or its ability to comply with its obligations under the partnership agreement.
- A borrower could ask for flexibility in re-including investors by having an express provision permitting the administrative agent and required lenders to waive exclusion events if the applicable limited partner has fully and timely funded two consecutive capital calls since the exclusion event.
- To regularly confirm the status of its collateral in troubled times, a lender may consider asking the borrower to more frequently provide an updated borrowing base certificate – for example, on a monthly basis rather than a quarterly basis – to the extent a certificate has not been provided during the prior month in connection with a borrowing, letter-of-credit issuance, capital call or exclusion event.

<u>Cash Control</u>

Borrowers need the ability to seed their investments and bolster their portfolios with loan proceeds to bridge capital calls while lenders seek to prevent cash leakage during defaults. The parties should assess any negative stress factors on cash availability and control that might be at play in the macroeconomic environment.

- Borrowings on committed lines are prohibited during events of default. Lenders may look for similar restrictions during any potential default because of the seriousness that they could turn into an event of default. Yet borrowers might desire that such restrictions only apply for certain potential defaults related to their ability to repay borrowings.
- Similarly, the parties might negotiate a cash-control event comprising events of default, mandatory prepayments and any potential default, or a more limited set of potential defaults related to the borrower's ability to repay loans.
- When uncertainty exists in the market, a lender might feel a need to charge any of the borrower's accounts to repay obligations during a cash-control event. A borrower, on the other hand, would prefer to sequester its other cash deposits and only allow the lender to charge its collateral accounts, and solely for overdue obligations during an event of default.
- A lender might prohibit use of loan proceeds to pay management fees if the partnership agreement has an overcall limitation on such fees. In certain circumstances, a borrower may desire or need to use loan proceeds to pay management fees. If so, a lender could consider allowing such use but implement an indemnity by the manager to repay borrowings for its fees in the event that an investor default would otherwise prevent full repayment because of the overcall limitation.
- During economic turmoil, lenders need certainty that payments among credit parties are subordinated to repayment of debt. Sponsors need certainty that they can maintain their operations. For a sponsor to ensure it can "keep the lights on," it might request that a lender permit a certain amount of management fees be paid and not be subordinated during a cash-control event. If the lender does oblige, it could require that such payments are not paid out of its collateral.
- A lender generally will restrict distributions to investors and withdrawal of funds from collateral accounts, at least during an event of default. When fiscal challenges are widespread, a lender may look to further tighten those prohibitions when any potential default exists or any mandatory prepayment has been triggered and not yet paid.

<u>Representations and Warranties, Covenants</u>

There are numerous protections afforded to lenders in the standard suite of loan document representations, warranties and covenants. In times of distress, the parties should redouble their efforts to make sure they continue to properly function. Often the devil is in the details with these provisions.

- If there is market disturbance, lenders should give extra focus to the representations and warranties provided at the time of borrowing, and related to no material adverse event on the credit parties, no legal proceedings, solvency of the borrower, and no events of default or potential default.
- Basic covenants that take on increased significance in a downturn include the credit parties maintaining their existence and the liens of the lenders, providing access to their books and records, complying with the borrower's partnership agreement, and not entering other agreements that could impact their ability to control capital calls.
- Reporting requirements are also critical for the parties to ensure they have open communication in case of adverse circumstances. A lender might want to tighten the time periods for providing notices of defaults, material adverse events, investor withdrawals, transfers and excuses, and other significant events that impact their collateral. Borrowers should confirm that they can comply with such timing requirements to protect against making a foot fault.
- To effectuate pivots induced by societal hardship, borrowers may seek enhanced flexibility to amend their partnership agreements and investor side letters without lender consent. Lenders are always concerned that such amendments could negatively impact their collateral, and they may be even more steadfast in such circumstances.
- Two other covenants that could require increased scrutiny by the parties in difficult times are restrictions on reinvestment during an event of default before loan obligations are paid, and limitations on the credit parties exercising remedies against defaulting investors with written consent of administrative agent. Each of these covenants cuts both ways – a borrower may want the ability to move forward with these activities while a lender wants to restrict them without its consent.

<u>Lender Defaults</u>

Although a defaulting lender would be an extreme rarity in our market, a global pandemic is (or was), too. So borrowers and administrative agents alike should re-review provisions governing lender defaults, especially for syndicated deals. The parties often must balance the interests of lender liquidity in assignments of loans with the borrower's interests in having a credit facility with the lenders it chooses. Borrowers typically have the ability to force out defaulting lenders and to consent to lender assignments. An administrative agent might forecast scenarios where there is a payment or bankruptcy event of default, or an event of default has continued for longer than 30 days, as situations where the borrower should not have such a consent right.

Events of Default and Remedies

Events of default and the exercise of remedies may be the most critical provisions for parties to evaluate when economic volatility is pervasive.

- Each party will want to analyze which defaults may be susceptible to cure and how much time should be given to cure such defaults. For any covenants that already contain specific notice or cure periods, the parties might consider reducing any cure period provided in the related event of default.
- Change of control is frequently an event-of-default trigger. The parties ought to confirm the appropriate level in the fund structure at which a change of control should result in an event of default.
- A lender usually will have its preferred menu of events of default that it can rely on to accelerate its loans, if needed. One that is particularly suitable in dealing with uncertainty is whether the lender can declare an event of default if it reasonably determines that a change to the fund’s business or condition would result in a material adverse effect.
- In an event of default, the borrower might prefer to have the first crack at remedying the situation. Borrowers can look to add standstill provisions that permit them to call capital on their investors to repay outstanding loan obligations before the lender can exercise most of its remedies. The lender might be amenable to such a provision on the notion that investors will find a call from the partnership more palatable than an initial call from the lender. A lender could negotiate this in spite of the standstill; it would be permitted to exercise its remedies if there is a bankruptcy default and to take exclusive control of the collateral accounts in a cash-control event.
- A lender should confirm that it has a broad set of remedies at its disposal if there is an event of default. In such circumstances, a particularly powerful remedy is the power of attorney usually granted by the credit parties to take action in their name and on their behalf. The lender should confirm the scope of such power of attorney.

Lenders and borrowers can use the above as a checklist to stress-test their deals. With these analyses, they can further hone and craft an agreement that is mutually beneficial. In troubled times, it is often open dialogue and communication between counterparties that will pay the most significant dividends.