CORPORATE LIQUIDITY ASSESSMENTS

JOHN GROUT LOOKS AT THE BACKGROUND TO THE PREVALENCE OF MAC CLAUSES AND HOW THIS HAS CONTRIBUTED TO THE CHALLENGES OF THE TREASURER AND CREDIT ANALYSTS IN EVALUATING AND COMPARING CORPORATE LIQUIDITY.

Following the Enron crisis, attention has been focused on companies' ability to continue to rely on their sources of funds following events with a negative impact on their credit profiles.

One particular aspect on which treasurers are expressing concern is the potential attitude of ratings agencies and investors towards the inclusion in loan agreements of 'material adverse change' (MAC) clauses. Such a clause is generally included in loan agreement representations required by banks (in addition to more specific financial covenants, representations and events of default) and, theoretically, can be relied upon by lenders to trigger an event of default in adverse circumstances not covered by other provisions in the loan agreement. In practice, the definition of 'material' is often at issue and the clauses have rarely been invoked, with lenders rather utilising the clause as a lever in negotiation. Consequently, the MAC is often perceived as "a comfort to a bank without being a substantial threat to the company" (*Treasurer's Handbook 2002*, p50).

This being said, the wording of the MAC clause is a key matter for negotiation between the parties to a loan agreement (see ACT advice to borrowers on the LMA standard loan documentation at **www.treasurers.org/treasury_resources/LMA_guide.cfm**). For example, MAC clauses can have different periods of operation and some may offer the banker an opportunity to withdraw funding whereas others only envisage an increase in margin. Indeed, many companies are confident that their legal teams have agreed wordings which have the effect of nullifying the ability of lenders to invoke the clause while the borrowing entity remains a going concern.

Treasurers of such corporates are naturally anxious that, when the potential impact of an MAC clause is incorporated either into an assessment of a company's liquidity or into its credit rating, a clear differentiation should be made between a representation which is worded to have an extremely narrow or even notional application and one which offers considerable scope of action to the company's lender. These treasurers are keen to point out that merely an indication of whether a MAC clause exists or not is far from sufficient to educate investors on the reliability of a company's ongoing liquidity.

■ *Sheelagh Killen, Technical Officer, ACT*

Imagine the scene. Talk over drinks after an ACT Regional Group meeting. Treasurers, bankers, financial services firms. A knot of people discussing rating agencies' newly published comments on companies' liquidity/bank back-up lines and the agencies' comments on loan agreement default and Material Adverse Change (MAC) clauses. They ask why there is no good UK case law on MAC clauses etc.

Large numbers of treasurers, bankers rating agency analysts and so on have come into the trade since the 1980s. Why things are as they are must be puzzling.

OVERDRAFTS. Until the 1970s, there were generally no medium term bank loans, revolving credits, or liquidity back-up lines available to companies. Clearing banks lent to companies on overdraft. The only documentation necessary was a five-line letter to the company saying the line was 'marked', usually for one year. However, being 'over-drawings' of current accounts, they were always subject to instant recall, without notice or explanation. They were frequently secured by a fixed and floating charge on the companies' assets, which would be separately documented.

Companies could finance 'current trade' by drawing bills of exchange for acceptance by certain eligible, ie British, banks ('accepting houses'). The acceptances were sold to 'discount houses' to provide funds for the company. For other than the biggest companies' bills, the accepting banks insisted on selling-on the acceptances themselves.

The Bank of England could buy (re-discount) these 'eligible' acceptances from the discount houses, if it wanted to inject money into the system. It could require the houses to buy bills back from it, if it wanted to withdraw money. The price at which the bank operated was an essential signal to the market.

Even if drawn against current trade, overseas bankers' acceptances were 'ineligible' for re-discount with the Bank of England. They thus cost a company more to discount. Eventually, UK branches of overseas banks became able to do eligible acceptances too. Actually, the Bank of England always did buy otherwise eligible bills accepted by some foreign banks, but this was not the sort of thing chaps talked about in public.

By the 1970s, the very biggest companies could also borrow, mostly overnight, in the short-term money markets, usually with no documentation other than of the deal itself. This was substitutional for the more expensive overdraft, but was not incremental funding.

CASE LAW. There are centuries of case law on overdrafts and bills of exchange. Bills not drawn against current trade, known as accommodation bills, are 'ineligible' acceptances. They were rarely used and, like sex before marriage, not illegal, but disapproved of. There was a general expectation that Government would have a monopoly of short term paper issuance. The exception for 'eligible' bills was because trade was 'a good thing'.

Companies in the UK were forbidden under the Control of Borrowings Order to issue sterling notes (or commercial paper) with maturities of less than two years. This was wartime Emergency Regulation, re-enacted in 1949. And, of course, under exchange controls, borrowing in currencies other than sterling was usually out of the question.

Leasing was in its infancy here. Companies could issue long-term notes (often called debentures, but debenture just means an agreement). Usually, but not in every case, debentures were secured with a first charge on assets. Thus, they required the agreement of the clearing banks that had their fixed and floating charge to support their overdrafts.

North Sea Oil development and US banks arriving in London in the 1970s brought a new idea. Medium term loans and revolving credits were available for a term of years. They were based not on charges over assets but on confidence in cash flows. They were recallable only under specified contractual conditions.

The new competition forced UK bankers to large companies away from the overdraft, other than for operational finance.

The Association of Corporate Treasurers was instrumental in getting the restriction on short-term note issuance by companies lifted in the mid-1980s and a sterling commercial paper market was allowed. Credit rating of CP required liquidity back-up lines – and this applied to US issuance too.

Long-term note (debenture) trust deeds had representations and warranties and default clauses. However, the sort of repeated reps. and warranties, like MAC clauses, under bank revolving credits or un-drawn liquidity back-up lines were new.

BACK TO MAC CLAUSES. There has not been time for enough disputes between banks and clients about MAC clauses to get to court. So there is no good body of UK case law to tell us what even some of those clauses mean, never mind the wide range found in different companies' (or banks') standard wordings.

Treasurers look, for example, for their MAC clauses to satisfy the banks' 'tick-box' mentality – but to be inoperable. They pay their solicitors for that. Banks want the MAC clause to give them the right not to make advances or revolve a revolver or provide liquidity back-up under the widest range of circumstances and brief their lawyer accordingly. Often they each feel satisfied with the same wording. Someone's lawyer's Professional Indemnity Insurance is one day going to be hit. Determining who is right is what judges are paid for. And, so far, decisions are lacking.

Pity the poor credit analyst trying to work out if a bank line is really available to provide liquidity in time of need.

John Grout was Finance Director of Cadbury Schweppes plc before retiring in 1999. John was Chairman of the Association of Corporate Treasurers 1991-1992 and had previously chaired the Association's Education Committee.
johngroutx@aol.com

*If you have a view on the impact of MAC clauses on liquidity and credit assessments, or have experience of tackling these issues in practice, please let us know at **technical@treasurers.co.uk**. For more information on ACT regional groups, visit **www.treasurers.org**.*

For more on ratings see Hotline, page 12.