SLAUGHTER AND MAY

Financing Briefing

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Defaulting Lenders and Market Disruption: The LMA's Response To Market Conditions

*The LMA published a revised version of its recommended form of facility agreement for leveraged transactions (the "**Leveraged Agreement**") and associated leveraged primary documentation on 25th June, 2009. The most notable changes are the inclusion of:*

- *provisions addressing the potential consequences of a Finance Party default; and*
- *amendments to the market disruption and cost of funds provisions*[1].

*The LMA also published a memorandum containing instructions as to how to incorporate these provisions into its suite of recommended forms of loan agreement for investment grade borrowers (the "**Investment Grade Agreements**"). However, the LMA have not consulted the ACT on this new language, in contrast to previous practice in relation to investment grade documentation. As a result, the provisions do not carry the ACT's endorsement.*

The need for provisions of this kind became apparent at the time of the collapse of Lehman Brothers in October 2008, and in its aftermath. Generally speaking, the concepts addressed by the LMA drafting will be familiar to those who have negotiated new or amended loan documentation in recent months.

This Financing Briefing considers the LMA's changes from a Borrower's perspective.

Introduction

The bulk of the LMA's new provisions address the consequences of:

- a Lender being a "Defaulting Lender" or a "Non-Acceptable L/C Lender"; and
- an Agent being an "Impaired Agent".

In addition:

- the LMA has amended the definitions of LIBOR/EURIBOR such that parties have the option of using Reference Bank rates from the outset rather than BBA LIBOR/EURIBOR as published on screen; and

[1] A number of other changes have also been made to the Leveraged Agreement, most of which are intended to conform relevant provisions of the Leveraged Agreement with the equivalent provisions of the Investment Grade Agreements (as last published in April 2009).

- changes have been made to the market disruption provisions, which seem intended to reduce the likelihood of Lenders charging the Borrower their individual cost of funds.

The optional abandonment of screen-based LIBOR in favour of a Reference Bank rate is not expected to find much favour with Borrowers generally. The proposals addressing the consequences of a Lender being in financial difficulty, however, are to be welcomed. As ever, some Borrower-friendly adjustment of the detail is likely to be required.

Defaulting Lenders

Overview

Once a Lender becomes a Defaulting Lender, the following provisions are triggered:

- The Borrower can cancel the undrawn Commitment of the Defaulting Lender, which can be immediately or later assumed by a new or existing Lender selected by the Borrower.
- The participation of the Defaulting Lender in the Revolving Facility is automatically termed out (an optional provision).
- No Commitment Fee is payable to the Defaulting Lender (an optional provision).
- The identity of a Defaulting Lender may be disclosed by the Agent.
- The Defaulting Lender is disenfranchised to the extent of its undrawn Commitments.
- The Defaulting Lender can be forced to transfer its participation in the Facilities to a new Lender at par.
- The Defaulting Lender will be a "Non-Acceptable L/C Lender" (if its participation in the Revolving Facility can be drawn by way of Letter of Credit).
- If the Defaulting Lender is the Agent, it will be an "Impaired Agent".

These concepts have, to varying degrees and in varying formulations, been addressed in many loan transactions documented over the last nine months. They are discussed in more detail below.

What is a Defaulting Lender?

A Defaulting Lender is defined (in outline) as a Lender:

- which fails to fund, or gives notice that it will do so (or fails to provide cash collateral in relation to a Letter of Credit obligation);
- which rescinds or repudiates a Finance Document; or
- in respect of which an Insolvency Event occurs.

Many recent deals have incorporated a concept of "Defaulting Lender" along these lines, though some banks (a minority) have refused to accept the insolvency limb to the definition (which is presented as an option in the LMA's drafting).

Points to note include the following:

- A Lender will not become a Defaulting Lender as a result of failure to fund where this is caused by administrative or technical error, or a Disruption Event (disruptions to payment or communications systems or technical/systems failures beyond a party's control). In these cases there is a grace period for payment. This is similar to the carve out to the non-payment Event of Default applicable to Borrowers. The length of the grace period is to be settled between the parties. Recent deals have featured periods of between three and ten Business Days. In contrast to the Events of Default which are applicable to Borrowers, the non-payment limb of the Defaulting Lender definition also features a carve-out where the Lender is disputing in good faith whether it is contractually obliged to pay.

- The LMA definition of an Insolvency Event is based on the ISDA "Bankruptcy" event of default. This is broad and protects the Borrower against a wide range of insolvency-type events. A notable addition is the inclusion of the exercise of the new powers under the UK's Banking Act 2009 (the stabilisation options, bank insolvency and bank administration). This provision may not, however, achieve the desired result in practice since contractual provisions triggered by an exercise of the Banking Act powers can be disapplied when the powers are exercised.

- There is no obligation on the Defaulting Lender to notify the Borrower upon becoming aware of its Defaulting Lender status. There is also no obligation on the Agent to notify the Borrower if it becomes aware that a Lender is a Defaulting Lender. One might take the view that a notification obligation is unnecessary, as the various limbs of the definition will, of themselves, mean that the Borrower will become aware at some point that the Lender is a Defaulting Lender. It is interesting to note, however, that in the context of the Letter of Credit provisions (see further below), where the same point could be made, the LMA thought it necessary (for the benefit of the Issuing Bank) for each Lender to confirm whether or not it is a "Non-Acceptable L/C Lender" on the date it joins the syndicate, and to notify the Agent and the Borrower subsequently upon becoming aware that it has become a Non-Acceptable L/C Lender. Borrowers may therefore wish to insert a similar confirmation/notification obligation in relation to Defaulting Lender status.

Cancellation of undrawn Commitment, and later assumption by a new or existing Lender

The procedure envisaged would allow the Borrower to cancel the undrawn Commitment of a Defaulting Lender, and separately arrange for that undrawn Commitment to be assumed by a new or existing Lender of its choice.

Some points of detail which may be unattractive to Borrowers are as follows:

- The right to insert another Lender may (optionally) be limited in time to an agreed number of Business Days following cancellation. It could take weeks or even months to find another Lender.

- The LMA proposal envisages (although it is optional in the Investment Grade Agreements) that the new Lender must be approved by the Agent, albeit "acting reasonably". Borrowers may argue that this is not justified. Agent approval is not required for:

  > secondary market purchases in either the Leveraged or Investment Grade Agreements (including where the purchased Commitment is not fully drawn); nor

> (in the Investment Grade Agreements) for the replacement of a Lender where the Borrower has been required to gross up payments for withholding tax, or to pay increased costs.

- In the Leveraged Agreement a new Lender assuming a Revolving Facility Commitment must be approved by the Issuing Bank. This is consistent with the provisions dealing with secondary market purchases. Nonetheless, Borrowers might argue that as long as the new Lender is not a "Non-Acceptable L/C Lender" (see below), the Issuing Bank should not be able to veto its entry into the syndicate. The same point applies in the context of the Investment Grade Agreements. Here, the Issuing Bank (optionally) is given a right of veto in relation to a new Lender under the provisions for the replacement of a Defaulting Lender and has a right of veto under the provisions for the assumption of an undrawn Commitment following cancellation.

- The new Lender cannot be a member of the Borrower Group or (in the context of the Leveraged Agreement), a Sponsor Affiliate. Borrowers may seek to resist this limitation in the context of leveraged facilities, in particular where the concept of Debt Purchase Transactions is accepted.

- The Agent may (optionally) be entitled to a fee from the Borrower, together with its costs and expenses (including legal fees). The mechanics for the introduction of another Lender in this scenario are not more onerous than those applicable on a change in Lender of record following a secondary market purchase, so the need for the fee and indemnity for costs is not clear.

- No provision is made for the payment of a fee by the new Lender to the Agent, which would usually be the case on a secondary market transfer, but the provisions do (optionally) contemplate a fee payable by the Borrower to the new Lender.

- The right to arrange for a new or existing Lender to assume an undrawn Commitment applies not only where the cancelled Commitment is that of a Defaulting Lender, but also where a Lender's Commitment it is cancelled due to illegality. Borrowers may want to consider whether the requirement to gross up payments for withholding tax or to pay increased costs should also trigger this right to arrange for a Lender's Commitment to be assumed by another Lender.

A final point for Borrowers to note is that the cancellation of an undrawn Commitment in respect of a Defaulting Lender might trigger cross-default provisions in the Borrower's other financing documentation, depending on its terms. The sensible conclusion is that a default by a Lender is not a trigger for the Borrower's cross-default provisions, but it may be worth making it clear that cancellation via the Defaulting Lender mechanics is excluded from the scope of such provisions.

Revolving facility outstandings automatically termed-out

The participation of a Lender in a revolving facility will be automatically termed-out if it becomes a Defaulting Lender. This means that revolving advances, instead of becoming due at the end of each interest period, will not be due to be repaid until the last day of the revolving facility Availability Period or the Termination Date (whichever is selected). These advances are then known as "Separate Loans", on which interest accrues during interest periods selected by the Borrower. Separate Loans can be prepaid.

Where a Defaulting Lender is to remain in the Facilities, this is an optional provision and the detailed consequences require attention:

- The termed-out Defaulting Lender will retain voting rights in respect of its drawn Commitments. The definition of "Majority Lenders" in the Investment Grade Agreements will need to be amended to avoid the possibility of the voting power of the Defaulting Lender being dominant in a situation where the revolving facility is undrawn save for the termed-out loan (or otherwise where following the term-out, the Lenders' outstandings cease to be pro-rata). This issue arises because the definition of "Majority Lenders" in the Investment Grade Agreements operates by reference to drawn Commitments. The issue does not arise in relation to the Leveraged Agreement, where the definition of Majority Lenders is different and operates based on "Total Commitments", which encompasses both drawn and undrawn Commitments. As a result, it is suggested that Borrowers using the Investment Grade Agreements should adopt the definition of Majority Lender used in the Leveraged Agreement and make consequential amendments.

- Borrowers may wish to incorporate "snooze and lose" provisions (included in a limited form in the Leveraged Agreement but not in the Investment Grade Agreements), to operate generally, but in particular in conjunction with the term-out mechanic.
- Care will be needed to check that the Borrower's other financing documentation does not contain cross-default or even insolvency events of default which could be triggered by the operation of the term-out mechanic.

No Commitment Fee payable

No Commitment Fee is payable to a Defaulting Lender. This is an optional provision which has been conceded in some deals done to date. It is difficult to envisage a scenario in which a Borrower would not want to include it.

The identity of a Defaulting Lender may be disclosed by the Agent

Upon request by the Borrower or Majority Lenders, the Agent is obliged to disclose the identity of a Defaulting Lender to the Borrower and the other Finance Parties.

Disenfranchisement of Defaulting Lender to extent of undrawn Commitments

The principle that a Defaulting Lender should not be able to vote on the basis of any undrawn Commitment has been widely adopted in the market. It has also been accepted generally that a Defaulting Lender should not be disenfranchised in relation to its outstanding amounts. The LMA proposals reflect this position.

Where a Defaulting Lender does have voting rights, Borrowers should be aware that an insolvency practitioner may be unable or unwilling to vote. "Snooze and lose" protection could therefore be helpful which has not, to date, routinely been a feature of investment grade facility documentation.

Borrowers should also bear in mind the limitations inherent in the principle that a Defaulting Lender's undrawn Commitments should be discounted for voting purposes. Disenfranchisement will be effective in relation to a Facility only for the duration of the Availability Period, and only to the extent that the Defaulting Lender's Commitment remains uncancelled and undrawn.

There are two substantive drafting issues for Borrowers in relation to these provisions:

- As mentioned above, the disenfranchisement provision is designed for use with the definition of Majority Lenders found in the Leveraged Agreement and the definition of Majority Lenders in the Investment Grade Agreements operates differently. As a result, it may be appropriate, in the Investment Grade Agreements, to follow the Majority Lenders definition from the Leveraged Agreement (with consequential amendments), for example where the Lenders need not hold the same proportions in the Revolving and Term Facilities.

- Where unanimity is required, the amounts of the Lenders' Commitments and outstandings are not relevant. The drafting is somewhat unclear but the LMA's position seems to be that a Defaulting Lender has a vote where unanimity is required. A strong Borrower might take a different view.

Replacement of Defaulting Lender at par

A Defaulting Lender can be replaced at par by a new or existing Lender if the Borrower is able to arrange this. This provision may not, however, be operable in practice. Following the collapse of Lehman Brothers, it proved impossible to find buyers to purchase its loan participations at par.

The provision is largely the same as the existing right to "yank" a single Lender following an increased cost or tax gross up claim or (in the context of the Leveraged Agreement only), a Lender becoming a Non-Consenting Lender. The main difference between the new provision and the existing "Replacement of Lender" mechanics is that the new provision permits the Defaulting Lender's rights and obligations under the revolving facility only (or its undrawn Revolving Facility Commitments only) to be transferred.

There are two issues of note for Borrowers:

- The replacement Lender must be acceptable to the Agent (this provision is optional in the Investment Grade Agreements). This is discussed above under "*Cancellation of undrawn Commitment*" and seems unjustified.

- The requirement for a Defaulting Lender to be replaced at par is presented as optional, but it is difficult to envisage how an alternative provision might be framed. Providing for the replacement of a Defaulting Lender at market value is one possibility, but an objective means of determining market value at the time of transfer would need to be identified.

Other issues

The LMA proposals address many of the issues that have been raised to date in relation to Defaulting Lenders, but there are issues which they do not cover, for example:

- Repayment of the Defaulting Lender alone is only permitted as an optional provision where there are Revolving Facility Loans which have been termed-out (discussed above). This is a point for Borrowers to discuss with their MLAs, as syndicates have approved a prepayment right in such circumstances, (including in relation to term facilities), with few objections.

- If a Borrower does achieve rights to prepay a Defaulting Lender it may also wish to exercise set-off rights against that Lender. The Borrower may not wish to make a payment to a Defaulting Lender free of set-off if the Borrower is then left to prove in the Defaulting Lender's insolvency for the balance of any amount owed to it by that Defaulting Lender (for example, under a hedging arrangement). LMA documentation restricts the Borrower's ability to exercise set-off rights against Lenders. This may not be a provision which can be amended at the time the Borrower wishes to exercise the set-off right if the Defaulting Lender has a blocking vote. Accordingly, Borrowers may wish to insert an exception to the restriction on set-off with regard to Defaulting Lenders, or at least provide for the ability to exercise set-off rights against a Defaulting Lender with the consent of those Lenders who are not Defaulting Lenders.

Cashless rollovers

Experience in the wake of the collapse of Lehman Brothers highlighted a potential risk for Borrowers in relation to revolving facilities.

It is market practice for revolving advances to be rolled over by book entry, without any cash payment. However, to date, loan documentation has not made express provision for this to happen automatically, and the concern for a Borrower is that the insolvency practitioner appointed in respect of a Defaulting Lender might insist on repayment in cash, and then refuse to fund.

It might be argued that the contractual terms had been changed by a course of conduct. The strength of this position would, however, be liable to be undermined by the presence in the documentation of a provision requiring all changes to be made in writing.

As a result, many revolving facility agreements signed in the last few months have included a provision of the kind put forward by the LMA. This makes clear that where a revolving facility advance is to be made to refinance another revolving advance which (i) is due for repayment on the same day as the new advance is to be made and (ii) involves the same Borrower and the same currency, the advances will be netted to the extent possible, leaving cash payments to be made by either Lenders or Borrowers to the extent of the excess, if any.

Impaired Agent

The LMA's revised drafting also includes provisions designed to protect the Borrower and the Lenders against the risk that an Agent may get into financial difficulty. They do not apply upon the insolvency or other default of a Security Agent.

These provisions apply when the Agent comes within the definition of an "Impaired Agent". This is similar to the concept of a Defaulting Lender. An Impaired Agent is an Agent, in outline:

- which fails to make a payment required under the Finance Documents;
- which rescinds or repudiates a Finance Document;
- which is a Defaulting Lender; or
- in respect of which an Insolvency Event occurs.

If an Agent becomes an Impaired Agent:

- Majority Lenders can remove it, after consultation with the Borrower, by appointing a replacement Agent;
- Lenders and the Borrower can make payments to each other direct, instead of through the Agent. Alternatively, payment can be made to a trust account in the name of the person making the payment, for the benefit of the payee; and
- notices and communications can be made directly between the parties.

Finally, a new clause, which will be helpful to Borrowers, requires the Agent to provide the Borrower with a list of the names and participations of the Lenders, either on a monthly basis or in response to requests. As pointed out in the ACT Guides, this is a provision that many Borrowers seek in any event, to enable them to keep track of who is in their syndicate. This could be critical if a Borrower got into financial difficulty.

Issuing Bank protection

Where the Facilities incorporate a revolving facility which can be drawn by way of Letters of Credit, the LMA has proposed drafting to protect an Issuing Bank against the credit risk of the syndicate members.

If a Lender is a "Non-Acceptable L/C Lender":

- it is required to notify the Agent and the Borrower; and
- the Issuing Bank is given discretion to request the Lender in question to cash collateralise its Letter of Credit participation.

If the Non-Acceptable L/C Lender fails to comply with a request for cash collateral, the Issuing Bank may:

- ask the Borrower instead to cash cover the relevant Lender's participation; or
- reduce the amount of the Letter Credit requested by the amount of that Lender's participation.

A "Non-Acceptable L/C Lender" is a Lender who does not meet prescribed ratings criteria (by reference to the definition of "Acceptable Bank" or otherwise as agreed by the Issuing Bank), a "Defaulting Lender" or a Lender who has failed to make a payment to another Finance Party under a Finance Document. In respect of payment defaults, the same carve-outs apply as for Defaulting Lenders, for failures caused by administrative/technical errors and good faith disputes.

There are a number of issues for Borrowers to consider in relation to these provisions:

- If the Non-Acceptable L/C Lender fails to provide cash collateral and the Issuing Bank does not request cash collateral from the Borrower, the Issuing Bank may unilaterally reduce the amount of the Letter of Credit issued. Borrowers may consider inserting a provision obliging the Agent/ Issuing Bank to inform them of the terms of any request for cash collateral in order to anticipate a demand for cash cover or a reduction in the L/C amount and/or an obligation on the Issuing Bank to accept cash cover from Borrower if the Non-Acceptable L/C Lender fails to provide the required collateral.
- If a Non-Acceptable L/C Lender is not also a "Defaulting Lender", the consequences of Defaulting Lender status – i.e. the right to cancel its undrawn commitments or replace it etc. - do not apply. Borrowers should consider whether to extend these rights to cover Non-Acceptable L/C Lenders.
- If the provision of Borrower cash cover for Letters of Credit is contemplated, Borrowers might amend the Letter of Credit provisions to provide for cash cover requirements to be funded by loan advances under the revolving facility automatically. Additionally, in relation to the definition of "cash cover" and the related Letter of Credit fees provisions, Borrowers should consider whether to clarify that the fronting fee payable to the Issuing Bank (whose exposure is

reduced by the amount of the cash cover) is reduced by the amount of any cash cover, by virtue of the principal amount on which the fee is computed being reduced. The new LMA drafting provides that Letter of Credit fees are not payable to the Non-Acceptable L/C Lender on any cash-covered exposure but makes no reference to fronting fees. These points are explained in more detail in the current ACT Guide to the Leveraged Agreement.

Borrowers should note that the provisions described above operate to protect the Issuing Bank in the event of concerns about the credit of another Lender. They do not offer the Borrower protection against the possibility of an Issuing Bank becoming insolvent or of doubtful credit. If the Issuing Bank is also a Defaulting Lender, clearly the consequences that flow from Defaulting Lender status will apply; however, Borrowers may also consider including:

- provisions to enable the removal/replacement of an Issuing Bank; and
- (possibly), a right to terminate open Letters of Credit, if the circumstances set out in the definition of "Non-Acceptable L/C Lender" apply to the Issuing Bank (the co-operation of the beneficiary of an outstanding Letter of Credit will be required for this).

In practical terms, this is a reminder to Borrowers that it is advisable always to appoint more than one Issuing Bank (the Leveraged Agreement contemplates that Lenders who agree may become Issuing Banks by notifying the Agent).

Cost of funds provisions

The LMA is proposing that the parties should choose whether the interest rates for the facilities should be based on the BBA LIBOR or a Reference Bank rate[2].

In general, Borrowers may be expected to prefer to retain BBA LIBOR (by reference to the applicable screen rate). It has the advantages of transparency, convenience and ready availability. Furthermore, if the Borrower's hedging arrangements reference BBA LIBOR, using a Reference Bank rate in loan documentation could be disadvantageous. However, in unusual circumstances, the position could be less clear cut. Further information is set out below.

BBA LIBOR

BBA LIBOR has been the primary basis for syndicated lending since it was first launched in 1986. Until then, rates were set on the basis of quotations provided by the Reference Banks. Although there has been a great deal of debate about BBA LIBOR over the last couple of years, it has remained market practice to define LIBOR by reference to BBA LIBOR as published on screen in loan documentation, with only a few exceptions in recent months.

BBA LIBOR is calculated from the rates quoted by a panel of banks, as the rate at which:

- they could borrow funds;
- in a given currency and for a given maturity;

[2] The LMA proposals also apply to the definition of EURIBOR, where provision is made for the optional replacement of the EBF's synthesised EURIBOR rates with Reference Bank rates.

- in a reasonable market size;
- in the London inter-bank market at 11 am on a given day.

The top and bottom quartile quotations are discarded, so that the published rate is the arithmetic mean of the remainder, rounded up to five decimal places. Panel banks are selected with the aim of reflecting the balance of the market, on the basis of scale of market activity, credit rating and perceived expertise in the currency in question[3].

BBA LIBOR attracted a great deal of criticism in autumn 2008, when liquidity was under particularly intense pressure. Concerns focussed on the reliability of the quotations provided by the BBA's panel banks. However, since the beginning of 2009, these concerns have appeared to subside somewhat, as liquidity has eased and rates have come down in response to the Bank of England's base rate cuts.

Defining LIBOR: current market practice

It is current market practice in loan documentation to define LIBOR as BBA LIBOR, with Reference Bank rates as a fallback. The Reference Banks for a syndicated loan are appointed by the Agent in consultation with the Borrower. If BBA LIBOR is not available on screen, LIBOR will be (essentially) the arithmetic mean of the rates quoted by the Reference Banks, in response to a request from the Agent, rounded up to four decimal places. Reference Banks also have a role in the market disruption and mandatory costs provisions.

The extent of the potential divergence between BBA LIBOR and the Reference Bank rate will depend on a variety of factors. Chief amongst these will be the extent to which the Reference Banks appointed for the purposes of the Facilities do not reflect the characteristics of the BBA panel banks. The divergence would be expected to be very small where the Reference Banks appointed are BBA panel banks, but could be greater where the Reference Banks appointed are not as active or do not enjoy the same reputation in the London inter-bank market as the BBA panel banks, for example if most of them are smaller banks or from one particular region.

The LMA proposals: in outline

The LMA now proposes a choice for the parties to make on a deal-by-deal basis. LIBOR can remain defined primarily as BBA LIBOR, with use of the Reference Bank rate as a fall-back if BBA LIBOR is not available. Alternatively, the parties can dispense with BBA LIBOR, adopting the Reference Bank rate as the primary definition of LIBOR. This is an issue for Borrowers and Lenders to consider carefully:

- a move to Reference Bank rates could have significant effects on the effectiveness, cost and availability of interest rate hedging;
- a switch to Reference Bank rates would be more onerous for the Agent and the banks involved; and
- Reference Bank rates could also, potentially, be less reliable and less transparent, as discussed above.

[3] More detail about the calculation of BBA LIBOR is provided on the BBA's LIBOR website at www.bbalibor.com.

In certain circumstances however, the MLAs might wish to select the Reference Bank rate as the primary rate. This might be the case, for example if the initial syndicate and/or Reference Banks are not expected largely to comprise banks which are BBA panel banks. In addition, in unusual circumstances, a Borrower might prefer to rely on the quotations provided by the Reference Banks, if it felt it had grounds to prefer these over the quotations provided by the BBA panel banks. Nonetheless, BBA LIBOR remains the standard choice to date, and we would expect this to remain the position in most cases.

Market disruption

Market disruption provisions have been the subject of some scrutiny and debate as a result of the financial crisis. In the autumn of 2008, lack of liquidity in the inter-bank market and widespread criticism of BBA LIBOR as not accurately reflecting Lenders' costs of funds led many syndicates to consider whether the circumstances constituted a Market Disruption Event which would allow them to pass on their actual cost of funds to the Borrower in place of the agreed LIBOR rate (although there were no reported instances of actual cost of funds being charged in the London market).

The LMA has made extensive amendments to its market disruption provisions, the intended effect of which appears to be that Lenders must overcome an additional hurdle before they can charge Borrowers their actual cost of funds. On that basis, these changes are, in general, a welcome development for Borrowers. Aspects of the detail however demand attention.

Market Disruption Event: current market practice

In outline, as discussed above, LIBOR is defined in LMA documentation as BBA LIBOR, and, if that rate is not available, the arithmetic mean of the rates quoted by the Reference Banks.

If BBA LIBOR is not available, for example due to a significant technological problem, and one of the Reference Banks does not quote a rate as required, the rate will be determined on the basis of the quotations of the other Reference Banks.

There is a Market Disruption Event in either of the following circumstances:

- BBA LIBOR is not available on screen and none or only one of the Reference Banks provides a quotation; or

- if more than a specified percentage of Lenders say that their cost of obtaining matched funding in the relevant market would be higher than LIBOR.

Where there is a Market Disruption Event in relation to a Loan, the rate of interest payable to each Lender is the aggregate of the Margin, the Mandatory Cost and the rate notified by that Lender as its actual cost of funding for that Loan from "whatever source it may reasonably select".

As soon as a Market Disruption Event occurs, either the Agent or the Borrower can require the other to enter into negotiations, for up to 30 days, to try to agree another way of determining the interest rate. Any alternative basis agreed requires the consent of all the Lenders and the Borrower.

The LMA proposals

The LMA proposals essentially provide that:

- if a Market Disruption Event occurs, the rate will be set by reference to "Alternative Reference Banks" quotations; and
- only if an "Alternative Market Disruption Event" occurs (an event equivalent to the Market Disruption Event affecting "Alternative Reference Banks") will the Lenders' actual cost of funds apply.

As there are now two sets of conditions that must be satisfied before the Borrower has to pay the Lenders' actual cost of funds, the proposals should reduce the risk of this eventuality. The Alternative Reference Banks are thus used as a safety net before the Borrower is required to pay the Lenders their cost of funds. However, certain aspects of the new procedure require scrutiny.

- If there is a "Market Disruption Event", the Agent is required to obtain quotations from the Alternative Reference Banks. These quotations are obtained on the same basis as BBA LIBOR quotations, but rounded up to four decimal places. This is the "Alternative Reference Bank Rate". The Alternative Reference Bank Rate then applies for the Loan and interest period in question for each Lender (under the second limb of the definition of a Market Disruption Event, whether or not it has notified the Agent that its cost of funds exceeds LIBOR).

  "Reference Banks", usually three Lenders appointed in consultation with the Borrower, are re-named "Base Reference Banks" for the purposes of distinguishing them from "Alternative Reference Banks". "Alternative Reference Banks" are intended to be an additional and larger group of Lenders listed in a schedule.

- The definition of "Market Disruption Event" remains the same save for an amendment to the second limb of the definition. A Market Disruption Event will now occur if a Lender's "cost of funding from whatever source it may reasonably select" is in excess of LIBOR. Previously, the test was whether the cost to Lenders of obtaining matching deposits in the London inter-bank market was in excess of LIBOR.

  This second limb of the definition is designed to deal with a situation where LIBOR is available, but a significant proportion of the Lenders in the particular syndicate cannot obtain funding in London, as happened in the case of certain banks in autumn 2008. Protection is provided for Borrowers, to a certain extent, in the requirement on Lenders to select the funding source reasonably.

- The Agent is under no obligation to notify the Borrower that a Market Disruption Event has occurred. It is obliged only to notify it of the Alternative Reference Bank Rate, once this is calculated.

- If one Alternative Reference Bank fails to provide a quotation, the rate is determined on the basis of the quotations provided by the others. If however none or only one of the Alternative Reference Banks provides a quotation by the end of the Business Day following the Quotation Day, there will be an Alternative Market Disruption Event.

There will also be an Alternative Market Disruption Event if a certain percentage of Lenders notify the Agent within a fixed period that their cost of funds would exceed the Alternative Reference Bank Rate. It is intended that this percentage will be higher than that required to trigger a Market Disruption Event (see above).

- If there is an Alternative Market Disruption Event, the rate applicable for each Lender is its cost of funds "from whatever source it may reasonably select" (as would be the result under current provisions), which must be notified within a fixed period. The Agent is under no obligation to notify the Borrower that an Alternative Market Disruption Event has occurred.

- It is proposed that a Lender which fails to notify its cost of funds, or notifies a lower cost of funds than LIBOR or the Alternative Reference Bank Rate, should be deemed to have cost of funds at LIBOR or the Alternative Reference Bank Rate. This may not be acceptable to Borrowers.

- The LMA proposals retain the right of the Borrower to try to negotiate an alternative basis for 30 days, following an Alternative Market Disruption Event.

Other ideas

The most effective protection for Borrowers against the risk of market disruption provisions being invoked is probably achieved by setting the threshold percentage for triggering a Market Disruption Event as high as possible. Historically, this was often 50% of the Loan in question for investment grade Borrowers. There has been some downward pressure on this figure recently, with several deals at 30%, but stronger Borrowers remain able to resist this.

If the new provisions are adopted, Borrowers should ensure that the Agent selects Base Reference Banks and Alternative Reference Banks with great care; for example, choosing BBA panel banks for the relevant currency and maturity (or banks with similar characteristics to such BBA panel banks) might decrease the likelihood of triggering market disruption provisions.

Other protective measures which have been discussed in recent months, and which have featured in various deals, though not put forward by the LMA, include the following:

- restricting the circumstances in which Lenders may give notice that their funding costs exceed LIBOR, to apply only where a Lender suffers an increase in funding costs generally, and where the amount of the increase results in such costs exceeding LIBOR materially (for example by a specified percentage). Funding costs for some Lenders are greater than for others even in normal market conditions;

- including an obligation on Lenders to notify the Borrower of the occurrence of a Market Disruption Event, and to provide evidence of the reasonableness of the alternative source of funding selected by that Lender; and

- allowing Borrowers to prepay and cancel, or replace, a Lender which gives notice that its costs of funds exceed LIBOR.

Conclusion

With each economic downturn, loan agreements become more complex as parties seek to address the newly highlighted areas of risk. In the aftermath of Lehman, "Defaulting Lender" language has become a common feature of loan documentation, as reflected in the LMA's proposals. However, the extent to which some of the other features of the new LMA documentation will be taken up by the market, remains to be seen.

In this Briefing we have sought to highlight a selection of issues Borrowers may wish to consider in relation to the new provisions. No doubt further points will emerge as the market gets to grips with the revised documentation.

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