Here's the deal

In the light of market conditions the Loan Market Association (LMA) has been reviewing its recommended forms of loan agreement for some time. In June a revised drafting was published, which made changes in three main areas: new provisions to address the risk of finance party default, and changes to the provisions covering market disruption and the cost of funds.

Many of the concepts proposed by the LMA, outlined below, will be familiar to those who have negotiated loan documentation in recent months, and most are to be welcomed. Some aspects, though, will be less attractive to borrowers.

The LMA did not consult the ACT on the changes (as would usually be the case with the LMA's facility agreements for investment-grade borrowers), so they do not carry the ACT's endorsement.

Executive summary

- Changes to the standard LMA loan agreements cover three main areas: the risk of finance party default, market disruption, and the definition of Libor.

DEFAULTING LENDERS In short, a defaulting lender is a lender:

- that fails to fund, or gives notice that it will fail to fund;
- that rescinds or repudiates a finance document; or
- that undergoes an insolvency-type event.

The key consequences of defaulting lender status are as follows:

- The undrawn commitment of the defaulting lender may be cancelled, and later assumed by a new or existing lender subject, optionally, to agent approval and payment by the borrower of agent fees and costs and a new lender fee.
- The participation of the defaulting lender in a revolving facility will be automatically termed out. Termed-out advances will accrue interest during interest periods selected by the borrower and can be prepaid.
- The defaulting lender will not be able to vote on the basis of any undrawn commitment, although it will remain able to vote on any outstanding amounts.
- The defaulting lender can be replaced, at par (although this is presented as an option), by a new or existing lender acceptable to the agent.
- Commitment fees cease to be payable to the defaulting lender.

The LMA's new drafting also includes provisions to address the risk of an agent getting into financial difficulty and to protect issuing or fronting banks against the credit risk of letter of credit facility lenders. Finally, express provision has been made for cashless rollovers as a result of concerns that an insolvent lender might insist on cash repayment and then fail to refund a rollover advance.

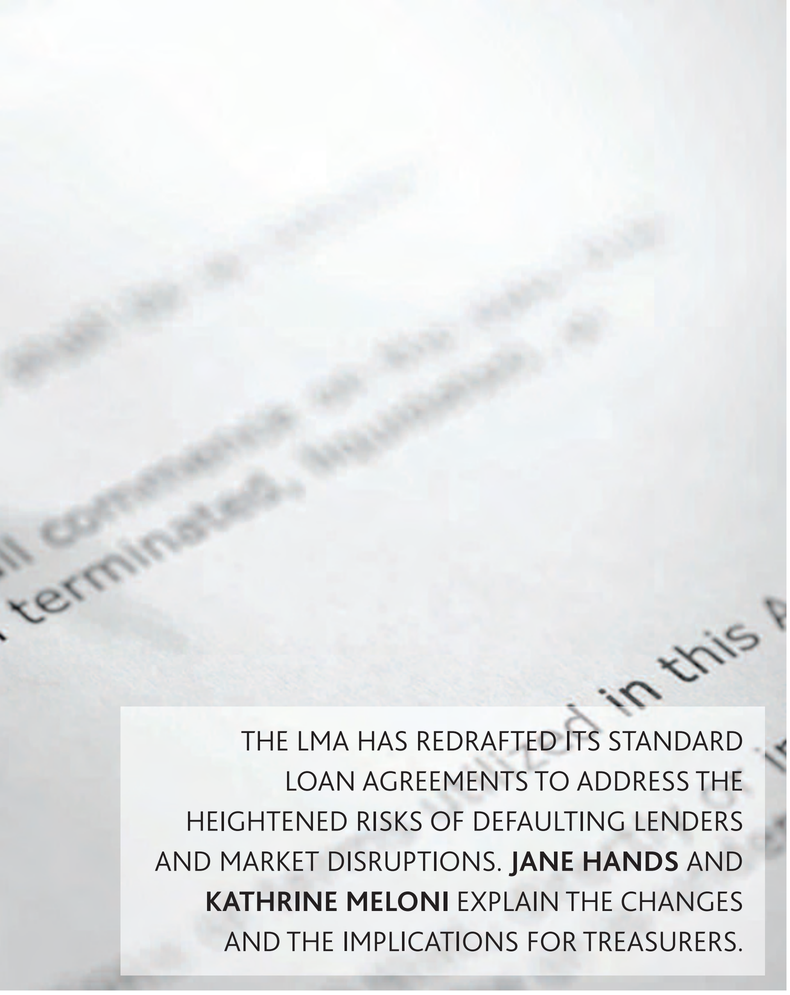
While these proposals are a positive development for borrowers, there are a number of issues.

Borrowers might want to consider the requirement for agent approval and the justification for fees/cost reimbursement when a new lender assumes a defaulting lender's commitments. Agent approval is not required for secondary market purchases and the transfer mechanics are no more onerous than on a secondary market purchase (where such fees do not apply).

The new provisions may have cross-default implications. While a lender default should not trigger the borrower's cross-default provisions, it may be advisable to clarify that that is indeed the position. Borrowers may also want to check that the operation of the term-out mechanic does not trigger cross-default or even insolvency events of default in its financing documentation.

While voting rights are retained for drawn commitments, an insolvency practitioner appointed for a defaulting lender may be unable or unwilling to vote. "Snooze and lose" protection (to date, not a routine feature of investment-grade documentation) may be helpful here.

The definition of majority lenders in investment-grade agreements operates by reference to drawn commitments. The agreement will require amendment to avoid the possibility of the defaulting lender's vote being dominant in a situation where the revolving facility is undrawn save for the termed-out loan (or



THE LMA HAS REDRAFTED ITS STANDARD LOAN AGREEMENTS TO ADDRESS THE HEIGHTENED RISKS OF DEFAULTING LENDERS AND MARKET DISRUPTIONS. **JANE HANDS** AND **KATHRINE MELONI** EXPLAIN THE CHANGES AND THE IMPLICATIONS FOR TREASURERS.

otherwise where following the term-out, the lenders' outstandings cease to be pro rata).

It may be difficult to locate a new lender to replace a defaulting lender at par and borrowers may resist the requirement (an option in the investment-grade agreements) for agent consent. However, replacement at par is optional, so parties may agree the defaulting lender can be replaced – for example, at market value (assuming an objective means of determining market value at the time of transfer can be identified).

Prepayment of a defaulting lender is only permitted as an optional provision where revolving loans have been termed out. The right to prepay a defaulting lender in all circumstances has been included in a number of post-Lehman deals.

MARKET DISRUPTION Market disruption provisions, which set out the circumstances in which the agreed Libor rate will be displaced by lenders' individual funding costs, have been scrutinised by many lenders over the past year. In most current LMA-based loan documentation, a market disruption event occurs if:

- screen-based BBA Libor is unavailable and reference banks fail to quote; or
- a specified minimum percentage of lenders indicate that the cost to them of obtaining matched funding in the London market is in excess of Libor.

A market disruption event entitles each lender to replace Libor with its actual cost of funding for that loan from "whatever source it may reasonably select".

The LMA has revised its market disruption provisions. The most significant change is that when a market disruption event occurs, Libor will be set by reference to the rate quotes of a pre-agreed group of alternative reference banks rather than to individual lenders' costs of funds.

According to the revised provisions, lenders' individual costs of funds will apply only if an alternative market disruption event occurs. An alternative market disruption event involves the failure of the alternative reference banks to provide quotes or a certain percentage of lenders (envisaged as a higher percentage than required for a market disruption event) notifying the agent that their cost of funds exceeds the alternative reference bank rate.

The LMA proposals retain the existing right of the borrower to try to negotiate an alternative basis for 30 days, following an alternative market disruption event (which will be binding if agreed between the borrower and all lenders).

As there are now two sets of conditions that must be satisfied before the borrower has to pay the lenders' individual costs of funds, the risk of that eventuality should be reduced. However, if the new provisions are adopted, borrowers should ensure that the agent carefully selects the base reference banks and alternative reference banks. For example, choosing BBA panel banks for the relevant currency and maturity (or banks with similar characteristics to BBA panel banks) might decrease the likelihood of triggering market disruption provisions.

Borrowers should also continue to seek to set 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 this year, with several deals at 30%, but stronger borrowers remain able to resist.

COST OF FUNDS The final key change relates to the definition of Libor. Most loan documentation defines Libor as BBA Libor, with reference bank rates as a fallback. In response to widespread criticism of the accuracy of BBA Libor during late 2008, the LMA's new drafting envisages that the parties will choose whether the interest rates for the facilities should be based on BBA Libor or a reference bank rate. Incidentally, 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.

Notwithstanding the LMA's changes, in most ordinary circumstances borrowers will probably prefer to retain BBA Libor (by reference to the applicable screen rate) as the headline rate in loan documentation. Concerns about the reliability of BBA Libor have subsided, and it offers transparency, convenience and ready availability (and so is less onerous for the agent to administer). A move to reference bank rates could also have significant effects on the effectiveness, cost and availability of interest rate hedging – of concern to both borrowers and lenders.

MARKET EVOLUTION With each economic downturn, loan agreements become more complex as parties seek to address the newly highlighted areas of risk. Defaulting lender language, along the lines proposed by the LMA, has become a common feature of newer loan documentation, and market disruption and cost of funds provisions, once rarely negotiated, have been the subject of increased focus. No doubt market practice in these areas will continue to develop as participants get to grips with the LMA's suggestions.

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More detailed commentary on the LMA's proposals is available at **www.treasurers.org/LMAguide/update0709?301**