SPECIAL SITUATIONS CLIENT BULLETIN

LEGAL REVIEW GUIDE FOR STRESSED/DISTRESSED CREDITS

June 2022

Although there may be differing views as to whether the U.S. economy is heading into some form of market correction, many would argue that certain warning signs have appeared that would suggest the possibility of an economic downturn. High inflation rates, an expectation of continued interest rate increases, the stubborn longevity of the uncertainties around COVID and ongoing dislocations in the supply chain (amongst other things, not least of which is the disruption caused by the current situation in Ukraine) are all factors which would give most investors and lenders a reason for pause. Some might even suggest that it is more likely than not that some borrowers (or some borrowers in certain sectors of the economy) will at least be contemplating a pre-distressed or distressed scenario in the foreseeable future.

In any event, recent challenges in the economy provide lenders a reason to reacquaint themselves with their credit exposures and the particular situations of their borrowers, including a legal review of the documentation underlying such exposures. This bulletin highlights a few areas which should be incorporated into this legal review exercise.

(i) **Corporate Structure Overview:** A good starting place for a lender's legal review is with the corporate structure of the borrower and its affiliates (or the "borrower group"). An overview of the corporate structure will, at the very least, provide a better understanding of the borrower's network of affiliates and which entities in this network are obligors under the loan documents, as well as a reference point for identifying where in this network the more valuable, or more liquid, assets are held.

(ii) **Security and Guarantee Coverage:** With a secured position, a lender should develop a clear picture of the assets and guarantees underpinning the loan. When reviewed together with the corporate structure of the borrower group, a lender can obtain a basic visualization of its credit exposure and a firmer grasp of the complexion of the issues that might arise should the loan become distressed. The specific granting language for security rights or guarantees should also be reviewed for scope and effectiveness to confirm, amongst other things, whether the guarantees are of payment and not merely collection and that there are no unintended gaps in the lenders' security coverage. This analysis should also examine whether there are any unique perfection rules applicable to the collateral or any limitations on the effectiveness of a collateral pledge due to corporate form or the nature of the underlying asset.

(iii) **Financial Covenants:** Financial covenants often function as an early warning system for lenders. The widening of the financial covenant levels and loosening of related definitions (*eg*, the addition of add-backs to the definition of "EBITDA", and sometimes without any caps) which has been accepted in certain credit agreements in recent years has lessened the efficacy of these financial covenants as early indicators of potential stress. Nonetheless, these covenants, in all instances, can still provide one of the most unequivocal events of default in a credit agreement outside of a failure to pay or a bankruptcy filing. A thorough review of the financial covenants must include a review of the financial definitions referenced therein (see below for more discussion on this point) and any applicable cure rights and any conditionality, as well as a careful read of the timeline for when specifically the breach of the covenant becomes an event of default.

(iv) **Affirmative Covenants:** A lender to a distressed (or potentially distressed) borrower needs as much information concerning its exposure as possible. The affirmative covenants, amongst other things, establish the deliverables (financial and otherwise) which the lender will be entitled to receive and which will often provide a foundation for a lender's understanding of the financial health of a borrower group. In particular, these covenants set out the specific financial statements the lenders under a credit agreement have a right to receive and the timing for the delivery thereof, as well as the substance and timing of any compliance certificates a borrower must deliver. In many instances, it will be the delivery, or the anticipation of the delivery, of the compliance certificates which will open the conversation between a borrower heading into a distressed situation and its lender(s). In addition, lenders will want to carefully review the financial covenant calculations in compliance certificates delivered by stressed or distressed borrowers to confirm technical adherence and to ensure, amongst other things, that EBITDA and the other referenced amounts have been calculated appropriately.

(v) **Negative Covenants:** The negative covenants establish the parameters for the flexibility a borrower group will have to act when presented with a potential commercial downturn. A recurring theme with distressed companies is their search for additional liquidity, and it is largely the negative covenants in their credit agreements which will determine their ability to access it. In particular, the negative covenants will dictate whether and to what extent a borrower, or one or more of its subsidiaries, will be able to, for instance, make dividends or distributions, sell assets or incur additional indebtedness and, by extension, whether and to what extent the credit position of its lenders may be diminished or diluted in the process. In carrying out a legal review, a lender should carefully scrutinize not only the flexibility a borrower group has under its negative covenant baskets but also the precise wording of these baskets (and the referenced defined terms). The road to most (if not every) liability management transaction in recent years has travelled through the negative covenant framework, and, as such, a lender should conduct a careful review of these provisions, including the ability of those provisions to be modified or waived, in anticipation of any such (potentially compromising) transaction.

(vi) **Definitions:** In connection with its covenant review, a lender should also conduct a rigorous read of the defined terms referenced in the relevant covenants. The covenant baskets themselves are often defined terms (*eg*, "Permitted Indebtedness", "Permitted Payments" or "Permitted Investments"). Also, the financial definitions (such as "Consolidated EBITDA") may contain certain add-backs or other allowances which will limit the robustness of the financial covenants as an accurate measure of financial performance.

(vii) **Events of Default:** The occurrence of an event of default (or the prospect of the occurrence of an event of default) will be an inflection point for a change in the relationship between a borrower and its lenders. A lender should have a clear understanding of the schedule of events of default in its credit agreement: what constitutes an event of default, what will trigger an event of default and what flexibility the borrower group might have to avoid an event of default from occurring. A lender should pay special attention to any grace periods or other procedural requirements included in these provisions and review the specifics of how these provisions have been drafted.

(viii) **Consequences of Default:** In contemplation of the possible occurrence of an event of default, a lender should also consider what the resulting consequences might be under the terms of the credit agreement. The most obvious consequence of an occurrence of an event of default is that it creates the possibility of accelerating the outstanding amounts owing thereunder. Depending on what type of event of default has occurred, acceleration may be automatic or, in a syndicated credit, require the direction of a majority of the lending group. The occurrence of an event of default will also typically act as a draw-stop on any additional loans under the credit agreement (including drawings under any revolving or delayed-draw facilities), the issuance or extension of letters of credit and the making or continuation of any LIBOR/SOFR based loans. Of course, another unsurprising consequence of an event of default may be a potential increase to the interest rate as a result of the application of default interest, but any review should confirm whether such increase is automatic, optional or even limited to specific types of events of default. In its credit review, a lender will also want to confirm the amounts to which the increased default interest will apply, whether notice or any other affirmative action is required to impose default interest and the timing for when such default interest will begin to accrue. There can also be perhaps less obvious consequences of an occurrence of an event of default of which a lender will want to make itself aware. For instance, the ability of the borrower group to pay dividends or make other restricted payments or to dispose of assets under the permitted baskets in the negative covenants may be restricted; interest rates payable by reference to a schedule of margin ratchets may revert to the highest level; there may be a cross-default under other debt agreements the borrower has in place and any borrower consent rights on lender transfers of loan exposures may fall away, amongst other things.

(ix) **Intercreditor Relationships:** In credit structures with lenders with different levels of priority, the provisions (or agreements) that define the relationships between these lenders should be reviewed. In general, lenders with more senior positions will (predictably) be expected to have higher priority in terms of their security and payment rights. However, there is sometimes a level of nuance drafted into the intercreditor provisions. A credit review should confirm not only the different levels of security and payment rights amongst lenders, but also the rights of different lenders to vote, to exercise remedies, to amend their loan documentation, to appoint advisors, to receive information and notifications (*eg*, notices of default) or to drag other lender constituencies into asset sales or other material transactions in connection with a potential restructuring.

(x) **Amendment/Waiver Provisions:** As a general rule in those credits with lending syndicates, a simple majority of lenders (by principal amount of exposure, including unfunded commitments) will be able to approve most amendments and waivers. There are, however, typically a list of matters which all lenders, or all affected lenders, must approve. These "sacred rights" relate to the more fundamental aspects of the loan exposure, including changes to the economic terms, maturity dates, voting rights and sharing provisions amongst lenders. A lender should confirm how the credit agreement's voting provisions are structured and the percentages of lender consent required for particular types of matters. A thorough analysis would include determining whether there are any restrictions on amendments and waivers contained in the other relevant agreements (such as any intercreditor agreement). To the extent possible, a lender should also view the voting provisions in the context of the composition of the lending syndicate, including any discernable relationships among the lenders holding the larger exposures and between these lenders and the borrower and/or its sponsor(s). As liability management transactions have become increasingly present (if not popular) in the market, it may well be worth a lender's effort to try to anticipate the scope for any such transaction in its credit agreement or lending syndicate (*see* MVA Client Bulletin: *Quick Guide for Assessing the Potential for Disparate Lender Treatment in a Credit Agreement: The "Tyranny of the Majority"*).

(xi) **Expenses Provision:** It is standard for a credit agreement to include an expenses provision which allows the administrative agent, or the lenders themselves, to have the costs and expenses associated with an enforcement action covered by the borrower. It would be worthwhile for a lender to review the expenses provision to determine the scope of the coverage and become aware of any negotiated peculiarities relating to the ability of the administrative agent or a lender to seek reimbursement for the costs of enforcement, particularly limitations on expense reimbursement to only one counsel for all lenders. Although expense coverage is typically included as a part of a negotiated restructuring or workout agreement between the borrower and its lenders, these transactions can be drawn out and complicated, and correspondingly expensive, and, as such, a lender review should include an examination of this provision for context, if for no other reason.

(xii) **Transfer Provisions:** A lender faced with the prospect of a distressed credit exposure may choose instead to exit its position. In truth, a lender may look at the implications of a downturn in the economy and make a strategic decision to sell all or some of its credit exposures in a particular market, sector or industry in anticipation of such a downturn. In any event, a review of a credit agreement should include the transfer provisions (including any relevant consent requirements, disqualified lender lists, information-sharing provisions, etc.), so the lender can have a fuller understanding of its ability to right-size its exposure should the need arise. For a more in-depth guide to the transfer provisions in a credit agreement see MVA Client Bulletin: *Quick Guide to Credit Document Transfer Provisions for Loan Purchasers*.

(xiii) **Other Documents to Review:** A comprehensive credit review will, of course, include not only the credit agreement but other important documents as well, including any security documents, intercreditor agreements, voting arrangements and restructuring documentation.

The above list is meant as a guide to highlight a few of the more important matters to include in a credit review for a lender. Though there are certainly some common themes running through most credit agreements, each situation will have its own set of idiosyncrasies and will come with its own unique set of issues and dynamics. More often than not, lenders who anticipate difficulties with their borrowers and who are able to be more proactive in managing credit exposures that show signs of financial distress will find themselves in a better, or at least a more informed, position should issues arise.

Some early lender preparation could help avoid unexpected and potentially costly developments and increase the likelihood for a smoother, less contentious and less value-destructive path should the need for a restructuring occur. Constructing a firm restructuring strategy may prove difficult before an actual distress situation develops, but lenders can inform themselves early, begin opening up a dialogue with potentially distressed borrowers and start putting in place a few basic form documents, such as (i) a form of pre-negotiation or pre-workout agreement to be used to further any future restructuring discussions and (ii) a form of forbearance agreement which could allow the borrower some latitude upon the occurrence of an event of default in exchange for clean-up or clarifying amendments to the credit documentation, work-out fees, more frequent financial reporting, the ability to involve third-party advisors or other lender allowances.

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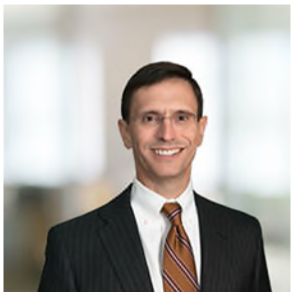

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