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Loan Covenants, Events of Default and MAC Clauses

Structuring Effective Credit Agreement Provisions to Maximize Borrower Protection and Lender Remedies

TUESDAY, JUNE 26, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Aric T. Stienessen, Partner, **Hinshaw & Culbertson**, Minneapolis

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Loan Covenants, Events of Default, and MAC Clauses

Structuring Effective Credit Agreement Provisions to Maximize Borrower Protection and Lender Remedies

HINSHAW & CULBERTSON LLP

Loan Covenants

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Covenants - Introduction

- covenant, n. (14c) 1. A formal agreement or promise, usu. in a contract or deed, to do or not do a particular act.

- affirmative covenant. A covenant that obligates a party to do some act; esp., an agreement that real property will be used in a certain way. • An affirmative covenant is more than a restriction on the use of property. For the real-property sense, see affirmative covenant under covenant (4). Cf. negative covenant. [Cases: Covenants 49, 69.]

- negative covenant. (18c) A covenant that requires a party to refrain from doing something; esp., in a real-estate financing transaction, the borrower's promise to the lender not to encumber or transfer the real estate as long as the loan remains unpaid. Cf. affirmative covenant.

Black's Law Dictionary (9th ed. 2009), covenant

Covenants – Introduction

- express covenant. (17c) A covenant created by the words of the parties. — Also termed covenant in deed. Cf. implied covenant.

- implied covenant. (17c) A covenant that can be inferred from the whole agreement and the conduct of the parties. — Also termed covenant in law. See implied term under term (2). Cf. express covenant.

Black's Law Dictionary (9th ed. 2009), covenant

Covenants – Goals

- When negotiating and drafting covenants, consider the goals:
  - Full disclosure of information
  - Preservation of net worth
  - Maintenance of asset quality
  - Maintenance of adequate cash flow
  - Control of growth
  - Control of management
  - Assurance of legal existence and going concern

Zimmerman, Charles S. The RMA Journal 89.8 (May 2007): 60-64, “An Approach to Writing Loan Agreement Covenants”

Typical Affirmative Covenants

- Financial Information
  - Clause: within _____ days of the end of Borrower's Fiscal Year, provide to Lender the following: audited, consolidated, financial statements...
  - Negotiation points:
    - Number of days to provide
    - Period (annual, quarterly, monthly)
    - Audited, reviewed, compiled, GAAP
    - Tax returns – due date with or without extension
    - Certified as true and accurate (in all material respects)

Typical Affirmative Covenants

- Compliance Certificate
  - Clause: a certificate signed by ________ certifying there is no event of default or calculating metric covenants (ex. debt service coverage ratio)
  - Negotiation points:
    - Update of reps and warranties

Typical Affirmative Covenants

- Material Adverse Effect, Litigation, or Default
  - Clause: Borrower shall immediately inform Lender in writing of any event having a Material Adverse Effect, the commencement or threat of litigation, or default under the loan documents
  - Negotiation points:
    - Litigation – commencement or judgment, cure period, amount in controversy

Typical Affirmative Covenants

- Other information
  - Clause: such other information as Lender may request
  - Negotiation points:
    - Reasonably request, sole discretion
    - Right/cost to audit
    - Subject: business, litigation, default, material adverse effect
    - Non-privileged information

Typical Affirmative Covenants

- Maintain Books and Records
  - Clause: Borrower shall maintain books and records and permit inspection
  - Negotiation points:
    - Advance notice
    - Location
    - Copies
    - Costs

Typical Affirmative Covenants

- Preserve Existence
  - Clause: Borrower shall preserve and keep in full force and effect the legal existence, rights and privileges
  - Negotiation points:
    - Divest, grow
    - Material

Typical Affirmative Covenants

- Operate in Ordinary Course of Business
  - Clause: Borrower shall operate its business in the ordinary course
  - Negotiation points:
    - Divest, grow
    - Material

Typical Affirmative Covenants

- Pay Taxes
  - Clause: Borrower shall pay taxes
  - Negotiation points:
    - Good faith contest

Typical Affirmative Covenants

- Comply with Laws
  - Clause: Borrower shall comply with all applicable laws
  - Negotiation points:
    - Good faith contest
    - Materiality/material adverse effect

Typical Affirmative Covenants

- Metrics
  - Clause: Borrower shall maintain a debt service coverage ratio, total debt to EBITDA, minimum (tangible) net worth, etc.
  - Negotiation points:
    - Metrics
    - Cure
    - Period of time – rolling, end of quarter/year

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Typical Affirmative Covenants

- Insurance
  - Clause: Borrower shall maintain the following types of insurance in the following amounts of coverage, naming Lender as loss payee and additional insured and provide evidence thereof in the form of ___________ and requiring at least 30 days' advance written notice to Lender prior to cancellation
  - Negotiation points:
    - Type of evidence – certificates, declarations, policies
    - Reasonable for similar business or specify coverages

[redacted] [redacted]

ACORD™ CERTIFICATE OF LIABILITY INSURANCE

DATE (MM/DD/YYYY) 07/05/06

PRODUCER

[redacted]

THIS CERTIFICATE IS ISSUED AS A MATTER OF INFORMATION ONLY AND CONFERS NO RIGHTS UPON THE CERTIFICATE HOLDER. THIS CERTIFICATE DOES NOT AMEND, EXTEND OR ALTER THE COVERAGE AFFORDED BY THE POLICIES BELOW.

INSURED

[redacted]

INSURERS AFFORDING COVERAGE	NAIC #
INSURER A: Twin City Fire Insurance Company	[redacted]
INSURER B: Hartford Fire Insurance	
INSURER C:	
INSURER D:	
INSURER E:	

COVERAGES

THE POLICIES OF INSURANCE LISTED BELOW HAVE BEEN ISSUED TO THE INSURED NAMED ABOVE FOR THE POLICY PERIOD INDICATED. NOTWITHSTANDING ANY REQUIREMENT, TERM OR CONDITION OF ANY CONTRACT OR OTHER DOCUMENT WITH RESPECT TO WHICH THIS CERTIFICATE MAY BE ISSUED OR MAY PERTAIN, THE INSURANCE AFFORDED BY THE POLICIES DESCRIBED HEREIN IS SUBJECT TO ALL THE TERMS, EXCLUSIONS AND CONDITIONS OF SUCH POLICIES. AGGREGATE LIMITS SHOWN MAY HAVE BEEN REDUCED BY PAID CLAIMS.

INSR LTR	ADD'L INSRD	TYPE OF INSURANCE	POLICY NUMBER	POLICY EFFECTIVE DATE (MM/DD/YY)	POLICY EXPIRATION DATE (MM/DD/YY)	LIMITS	
A		GENERAL LIABILITY X COMMERCIAL GENERAL LIABILITY CLAIMS MADE X OCCUR X [redacted] GEN'L AGGREGATE LIMIT APPLIES PER: POLICY PRO-JECT LOC	[redacted]	[redacted]	[redacted]	EACH OCCURRENCE	$1,000,000
						DAMAGE TO RENTED PREMISES (Ea occurrence)	$100,000
						MED EXP (Any one person)	$Excluded
						PERSONAL & ADV INJURY	$1,000,000
						GENERAL AGGREGATE	$3,000,000
						PRODUCTS - COMP/OP AGG	$3,000,000
B		AUTOMOBILE LIABILITY X ANY AUTO ALL OWNED AUTOS SCHEDULED AUTOS X HIRED AUTOS X NON-OWNED AUTOS	[redacted]	[redacted]	[redacted]	COMBINED SINGLE LIMIT (Ea accident)	$1,000,000
						BODILY INJURY (Per person)	$
						BODILY INJURY (Per accident)	$
						PROPERTY DAMAGE (Per accident)	$
		GARAGE LIABILITY ANY AUTO				AUTO ONLY - EA ACCIDENT	$
						OTHER THAN AUTO ONLY: EA ACC	$
						AGG	$
		EXCESS/UMBRELLA LIABILITY OCCUR CLAIMS MADE DEDUCTIBLE RETENTION $				EACH OCCURRENCE	$
						AGGREGATE	$
							$
							$
							$
A		WORKERS COMPENSATION AND EMPLOYERS' LIABILITY ANY PROPRIETOR/PARTNER/EXECUTIVE OFFICER/MEMBER EXCLUDED? If yes, describe under SPECIAL PROVISIONS below	[redacted]	[redacted]	[redacted]	X WC STATU-TORY LIMITS / OTH-ER	
						E.L. EACH ACCIDENT	$1,000,000
						E.L. DISEASE - EA EMPLOYEE	$1,000,000
						E.L. DISEASE - POLICY LIMIT	$1,000,000
		OTHER					

DESCRIPTION OF OPERATIONS / LOCATIONS / VEHICLES / EXCLUSIONS ADDED BY ENDORSEMENT / SPECIAL PROVISIONS

[redacted]

Certificate holder is named as additional insured with respect to the operations at the above mentioned facility.

CERTIFICATE HOLDER

[redacted]

CANCELLATION

SHOULD ANY OF THE ABOVE DESCRIBED POLICIES BE CANCELLED BEFORE THE EXPIRATION DATE THEREOF, THE ISSUING INSURER WILL ENDEAVOR TO MAIL 30 DAYS WRITTEN NOTICE TO THE CERTIFICATE HOLDER NAMED TO THE LEFT, BUT FAILURE TO DO SO SHALL IMPOSE NO OBLIGATION OR LIABILITY OF ANY KIND UPON THE INSURER, ITS AGENTS OR REPRESENTATIVES.

AUTHORIZED REPRESENTATIVE

[redacted]

ACORD 25 (2001/08) 1 of 2 [redacted] JMF © ACORD CORPORATION 1988

THIS CERTIFICATE IS ISSUED AS A MATTER OF INFORMATION ONLY AND CONFERS NO RIGHTS UPON THE CERTIFICATE HOLDER. THIS CERTIFICATE DOES NOT AMEND, EXTEND OR ALTER THE COVERAGE AFFORDED BY THE POLICIES BELOW.

[redacted] [redacted]

ACORD CERTIFICATE OF LIABILITY INSURANCE

DATE (MM/DD/YYYY) 07/05/06

PRODUCER
[redacted]

THIS CERTIFICATE IS ISSUED AS A MATTER OF INFORMATION ONLY AND CONFERS NO RIGHTS UPON THE CERTIFICATE HOLDER. THIS CERTIFICATE DOES NOT AMEND, EXTEND OR ALTER THE COVERAGE AFFORDED BY THE POLICIES BELOW.

INSURED
[redacted]

INSURERS AFFORDING COVERAGE	NAIC #
INSURER A: Twin City Fire Insurance Company	[redacted]
INSURER B: Hartford Fire Insurance	
INSURER C:	
INSURER D	
INSURER E:	

COVERAGES

THE POLICIES OF INSURANCE LISTED BELOW HAVE BEEN ISSUED TO THE INSURED NAMED ABOVE FOR THE POLICY PERIOD INDICATED. NOTWITHSTANDING ANY REQUIREMENT, TERM OR CONDITION OF ANY CONTRACT OR OTHER DOCUMENT WITH RESPECT TO WHICH THIS CERTIFICATE MAY BE ISSUED OR MAY PERTAIN, THE INSURANCE AFFORDED BY THE POLICIES DESCRIBED HEREIN IS SUBJECT TO ALL THE TERMS, EXCLUSIONS AND CONDITIONS OF SUCH POLICIES. AGGREGATE LIMITS SHOWN MAY HAVE BEEN REDUCED BY PAID CLAIMS.

INSR LTR	ADD'L INSRD	TYPE OF INSURANCE	POLICY NUMBER	POLICY EFFECTIVE DATE (MM/DD/YY)	POLICY EXPIRATION DATE (MM/DD/YY)	LIMITS	
A		GENERAL LIABILITY	[redacted]	[redacted]	[redacted]	EACH OCCURRENCE	$1,000,000
		X COMMERCIAL GENERAL LIABILITY				DAMAGE TO RENTED PREMISES (Ea occurence)	$100,000
		CLAIMS MADE X OCCUR				MED EXP (Any one person)	$Excluded
		X [redacted]				PERSONAL & ADV INJURY	$1,000,000
						GENERAL AGGREGATE	$3,000,000
		GEN'L AGGREGATE LIMIT APPLIES PER: POLICY PRO-JECT LOC				PRODUCTS - COMP/OP AGG	$3,000,000
B		AUTOMOBILE LIABILITY	[redacted]	[redacted]	[redacted]	COMBINED SINGLE LIMIT (Ea accident)	$1,000,000
		X ANY AUTO					
		ALL OWNED AUTOS				BODILY INJURY (Per person)	$
		SCHEDULED AUTOS					
		X HIRED AUTOS				BODILY INJURY (Per accident)	$
		X NON-OWNED AUTOS				PROPERTY DAMAGE (Per accident)	$
		GARAGE LIABILITY				AUTO ONLY - EA ACCIDENT	$
		ANY AUTO				OTHER THAN AUTO ONLY: EA ACC	$
						AGG	$
		EXCESS/UMBRELLA LIABILITY				EACH OCCURRENCE	$
		OCCUR CLAIMS MADE				AGGREGATE	$
							$
		DEDUCTIBLE					$
		RETENTION $					$
A		WORKERS COMPENSATION AND EMPLOYERS' LIABILITY	[redacted]	[redacted]	[redacted]	X WC STATUTORY LIMITS OTH-ER	
		ANY PROPRIETOR/PARTNER/EXECUTIVE OFFICER/MEMBER EXCLUDED?				E.L. EACH ACCIDENT	$1,000,000
		If yes, describe under SPECIAL PROVISIONS below				E.L. DISEASE - EA EMPLOYEE	$1,000,000
						E.L. DISEASE - POLICY LIMIT	$1,000,000
		OTHER					

DESCRIPTION OF OPERATIONS / LOCATIONS [redacted]ONS ADDED BY ENDORSEMENT / SPECIAL PROVISIONS

Certificate holder is named as additional insured with respect to the operations at the above mentioned facility.

CERTIFICATE HOLDER

[redacted]

CANCELLATION

SHOULD ANY OF THE ABOVE DESCRIBED POLICIES BE CANCELLED BEFORE THE EXPIRATION DATE THEREOF, THE ISSUING INSURER WILL ENDEAVOR TO MAIL 30 DAYS WRITTEN NOTICE TO THE CERTIFICATE HOLDER NAMED TO THE LEFT, BUT FAILURE TO DO SO SHALL IMPOSE NO OBLIGATION OR LIABILITY OF ANY KIND UPON THE INSURER, ITS AGENTS OR REPRESENTATIVES.

AUTHORIZED [redacted]ATIVE

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ACORD **EVIDENCE OF PROPERTY INSURANCE** [redacted]

DATE (MM/DD/YY) [redacted]

THIS IS EVIDENCE THAT INSURANCE AS IDENTIFIED BELOW HAS BEEN ISSUED, IS IN FORCE, AND CONVEYS ALL THE RIGHTS AND PRIVILEGES AFFORDED UNDER THE POLICY.

PRODUCER PHONE [redacted]

COMPANY [redacted]

CODE: SUB CODE:

AGENCY CUSTOMER ID #: [redacted]

INSURED [redacted]

LOAN NUMBER

POLICY NUMBER [redacted]

EFFECTIVE DATE [redacted] EXPIRATION DATE [redacted]

CONTINUED UNTIL TERMINATED IF CHECKED

THIS REPLACES PRIOR EVIDENCE DATED:

PROPERTY INFORMATION

LOCATION/DESCRIPTION [redacted] ; [redacted]

COVERAGE INFORMATION

COVERAGE/PERILS/FORMS	AMOUNT OF INSURANCE	DEDUCTIBLE
Building: Special causes of loss - replacement cost	4,250,000	10,000
Business Personal Property: Special causes of loss - replacement cost	250,000	10,000
Business Income and Extra Expense	500,000	

REMARKS (Including Special Conditions)

CANCELLATION

THE POLICY IS SUBJECT TO THE PREMIUMS, FORMS, AND RULES IN EFFECT FOR EACH POLICY PERIOD. SHOULD THE POLICY BE TERMINATED, THE COMPANY WILL GIVE THE ADDITIONAL INTEREST IDENTIFIED BELOW 30 DAYS WRITTEN NOTICE, AND WILL SEND NOTIFICATION OF ANY CHANGES TO THE POLICY THAT WOULD AFFECT THAT INTEREST, IN ACCORDANCE WITH THE POLICY PROVISIONS OR AS REQUIRED BY LAW.

ADDITIONAL INTEREST

NAME AND ADDRESS

[redacted]

X MORTGAGEE

X LOSS PAYEE

ADDITIONAL INSURED

LOAN #

AUTHORIZED REPRESENTATIVE

[redacted]

ACORD 27 (3/93) 1 of 1 [redacted]

JMF

ACORD™ **EVIDENCE OF PROPERTY INSURANCE** [redacted]

DATE (MM/DD/YY) [redacted]

THIS IS EVIDENCE THAT INSURANCE AS IDENTIFIED BELOW HAS BEEN ISSUED, IS IN FORCE, AND CONVEYS ALL THE RIGHTS AND PRIVILEGES AFFORDED UNDER THE POLICY.

PRODUCER | PHONE [redacted]

ACORD™ **EVIDENCE OF PROPERTY INSURANCE** [redacted]

DATE (MM/DD/YY) [redacted]

THIS IS EVIDENCE THAT INSURANCE AS IDENTIFIED BELOW HAS BEEN ISSUED, IS IN FORCE, AND CONVEYS ALL THE RIGHTS AND PRIVILEGES AFFORDED UNDER THE POLICY.

PRODUCER | PHONE [redacted]

COMPANY [redacted]

CODE: | SUB CODE:

AGENCY CUSTOMER ID #: [redacted]

INSURED [redacted]

LOAN NUMBER | POLICY NUMBER [redacted]

EFFECTIVE DATE [redacted] | EXPIRATION DATE [redacted] | CONTINUED UNTIL TERMINATED IF CHECKED

THIS REPLACES PRIOR EVIDENCE DATED:

PROPERTY INFORMATION

LOCATION/DESCRIPTION [redacted]; [redacted]

COVERAGE INFORMATION

COVERAGE/PERILS/FORMS	AMOUNT OF INSURANCE	DEDUCTIBLE
Building: Special causes of loss - replacement cost	4,250,000	10,000
Business Personal Property: Special causes of loss - replacement cost	250,000	10,000
Business Income and Extra Expense	500,000	

REMARKS (Including Special Conditions)

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ADDITIONAL INTEREST

NAME AND ADDRESS [redacted]

X MORTGAGEE | ADDITIONAL INSURED

X LOSS PAYEE

LOAN #

AUTHORIZED REPRESENTATIVE [redacted]

ACORD 27 (3/93) 1 of 1 [redacted] JMP © ACORD CORPORATION 1993

POLICY NUMBER: [redacted]

GENERAL PURPOSE ENDORSEMENT

NAMED INSURED ENDORSEMENT

ITEM 1 NAMED INSURED TO READ:

[redacted] CONSTRUCTION [redacted]
CONTRACTOR, OWNER, ALL SUBCONTRACTORS AND LOWER TIER
CONTRACTORS AND MORTGAGEES

Typical Affirmative Covenants

- Further Assurances
  - Clause: Borrower shall do such things as Lender may require to effectuate the transactions contemplated under and intent of this Agreement
  - Negotiation points:
    - Reasonably require, sole discretion

Typical Affirmative Covenants

- Banking Products
  - Clause: Borrower shall maintain a depository account with Lender or execute an interest rate swap
  - Negotiation points:
    - Amount, timing, sole vs. one of many
    - Be careful of anti-tying

Typical Negative Covenants

- Additional Indebtedness
  - Clause: Borrower shall not incur any additional indebtedness
  - Negotiation points:
    - Amount of indebtedness
    - Trade payables
    - Purchase money
    - Capital expenditures, capitalized leases

Typical Negative Covenants

- Encumbrances
  - Clause: Borrower shall not cause or permit any of its assets to be encumbered
  - Negotiation points:
    - Purchase money
    - Permitted liens

Typical Negative Covenants

- Investments
  - Clause: Borrower shall not make any investments in another entity
  - Negotiation points:
    - Borrower group
    - Amount

Typical Negative Covenants

- Transfer, Merger, or Sale
  - Clause: Borrower shall neither transfer nor sell all or substantially all of its assets or stock or permit a merger
  - Negotiation points:
    - Borrower group
    - Inventory

Typical Negative Covenants

- Change in Control
  - Clause: Borrower shall neither cause nor permit a change in control
  - Negotiation points:
    - Defining a change in control
      - Percent of ownership interests
      - Board composition
      - Key officers

Typical Negative Covenants

- Waive Debts or Release Claims
  - Clause: Borrower shall neither waive debts nor release claims
  - Negotiation points:
    - Amount
    - Satisfaction of receivables at par

Typical Negative Covenants

- Dividends
  – Clause: Borrower shall not make and dividends or distributions
  – Negotiation points:
    - Borrower group
    - Amount
    - Pay taxes

Typical Negative Covenants

- Reverse of Affirmative Covenants
  - Affirmative Covenant: Borrower shall maintain insurance
  - Negative Covenant: Borrower shall not permit termination of its insurance coverage

Covenants - Trends

Covenants - Trends

- Violations of negative covenants are rare, nearly all technical defaults are breaches of affirmative covenants, usually accounting numbers.
- Affirmative covenants most frequently violated are net worth, working capital, leverage, interest coverage, and cash flow.

Hall, Steve C; Swinney, Laurie S. Management Research Review 27.7 (2004): 34-48, “Accounting Policy Changes and Debt Contracts”, citing Smith, C. (1993) “A Perspective on Accounting-Based Debt Covenant Violations,” The Accounting Review, 68 (April), pp. 289-303.

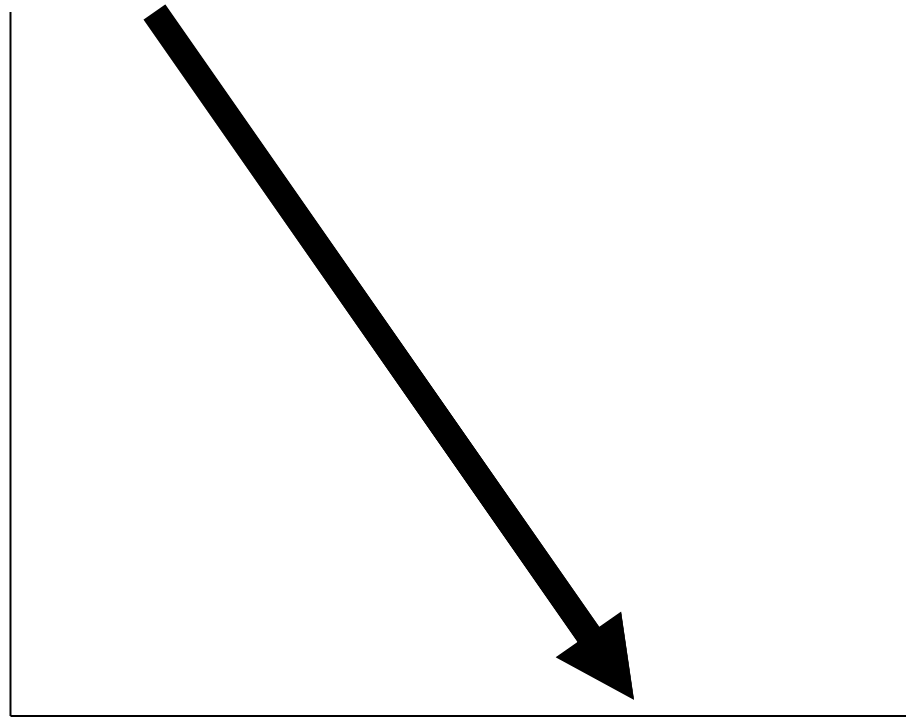
*Article discusses how accounting choices are made to avoid violating metric covenants

Covenants – Trends 2005-2007

- “A Moody’s study fund that covenant arrangements had been relaxed for many rated corporate leveraged loans between 2005 and 2007.”

Mankelow, Nat, FT Mandate, Apr 2008, “Strategies, Allocation & Performance: Syndicated Loans Market Left Reeling From Liquidity Shortage Over Two Decks

Covenants – Trends 2008



Covenants – Trends 2009

- In 2009, nearly 17% of respondents admitted to a loan covenant default during the previous two years, but 88% were happy with the bank's resolution

The Controller's Report; Mar 2010; 3, Institute of Management and Administration, citing CFO.com

Covenants – Trends 2010

- BDO USA, LLP conducted a survey of more than 100 US private equity firm senior executives with between $30 million and $35 billion in assets under management in November – December 2010
- 45% of respondents stated that less than 20% of their portfolio had loan covenant defaults and another 36% stated that their portfolio had no covenant defaults during the last 12 months (essentially 2010)
- 67% of respondents whose portfolio had a loan covenant default stated that the primary result was amendment of the covenant, 14% said the loan was refinanced, 7% said the loan was put into default, and none said the loan was called

Second Annual PErspective Private Equity Study by BDO USA, LLP

- April 12, 2010, newspaper article states "waivers of loan covenant violations are at an all-time high"

Shingler, Dan. Crain's Cleveland Business 31. 15 (Apr 12, 2010): 1. "Lenders More Amendable to Altering Manufacturing Loans", quoting Ken Latz, a turnaround consultant with Conway MacKenzie Inc.

Covenants – Trends 2011

- “So-called covenant-lite loans are borrower-friendly but have been considered risky for lenders. As it turns out, they perform no worse, or a bit better, than debt with covenants.”
- “More than 25 percent of first-lien loans issued in 2011 have covenant-lite structures, a higher percentage than for all 2007.”
- “They returned a total of 33 percent in the five years through January [2011] compared with 31 percent for covenant-heavy loans, according to [Standard & Poor’s] Leveraged Commentary and Data.”

Laughlin, L. & Hutchinson, M., New York Times, Feb 11, 2011, pg. 2, “Loan Covenants No Hedge on Risk”.

Covenants – Trends 2012

- "Covenant-lite loans are making a comeback this quarter as investors with cash to spend have driven up demand."
- "…the consensus is that the trend will continue as long as demand outstrips supply and investors continue to hunger for yield."

Clouse, Carol J., American Banker, May 3, 2012, 2, "Covenant-Lite Loans Stage a Comeback"

Events of Default

Cross-Default

- Default Provision:
  - Any default in any debt to lender or other creditor
  - Carve-outs (ex. unsecured trade debt, default in loans of a certain size, uncured for a specified number of days)
- Significance: allow the lender to pursue its enforcement remedies as timely as other lenders and minimize cherry-picking by borrower regarding which loan gets paid (minimizing exposure)
- Challenge is learning when other defaults have occurred – rely on borrower’s obligation to disclose?
- Consider intercreditor issues

Insolvency-Related Events

- Default Provision:
  - Voluntary (no cure period) or involuntary (cure period) party to a case:
    - under bankruptcy laws, or
    - seeking appointment of a receiver or custodian
  - Be unable to pay its debts when due
  - Applied to: borrower, its subsidiaries, guarantors, guarantors' subsidiaries (market trend away from unrestricted subsidiaries)
- Significance:
  - similar to cross-default, minimize exposure
  - Borrower is about to become subject to someone else's control with the authority to restructure debt
- Ipso Facto Clause – bankruptcy law may make such provisions unenforceable

Change of Control

- Default Provision:
  - Change in % ownership of all equity
  - Change in % ownership of voting equity
  - Equity becomes encumbered by a security interest
  - Change in majority of directors
- Significance: lender underwrote loan based upon the ownership, leadership, or both from a competency or philosophy perspective or from a creditworthiness perspective (guarantors)
- Carve-outs:
  - Approved estate or succession plan for closely-held companies
  - Restructurings
  - Public offerings

Material Adverse Change (Material Adverse Effect)

- Default Provision:
  - Material change in assets, liabilities, revenue, expenses, business, operations, condition, prospects, etc.
  - Qualitative vs. Quantitative test
- Significance: lender's risk has materially changed from when the loan was underwritten but no particular default covenant (other than the MAC/MAE) is triggered
- Can be difficult to prove

Change in Business

- Default Provision: Change in the nature of the borrower's business
- Significance: change in business since underwritten resulting in a change in the risk
  - Integration risk
  - Competency risk (borrower and lender)
- Carve-outs: natural extension of borrower's existing line of business

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Other Defaults

- Lender Insolvency Default Provisions (Current Market)
  - Lender fails to fund or becomes insolvent (maybe unenforceable ipso facto clause in bankruptcy)
  - Similar to borrower provisions, fails to fund other loans or affiliates become insolvent
  - Provisions
    - “Yank-A-Bank” – force a lender to sell its interest (challenge is finding a buyer)
    - Pay-off the defaulting bank (without prepayment fee)
    - Loss of voting rights (ex. amendments)
    - Liquidated damages

Other Defaults

- Payment Defaults (any grace period – time before it becomes a default, or cure period – time to cure a default before enforcement)
- Financial Covenants (interval vs. continuing)
- Affirmative Covenants (ex. maintain bankruptcy remoteness)
- Negative Covenants (ex. transfer assets)
- Representations and Warranties

Other Defaults

- General Trends Applicable to Defaults (Current Market)
  - Fewer carve-outs (ex. negative covenant on incurring debt and no carve-out for refinancing, intercompany, acquisition)
  - No unrestricted subsidiaries
  - Equity Cures (cash contribution to cure financial covenant breaches; ex. applied to EBITDA or prepay debt) – reducing the number of permissible cures
  - Junior liens more permissible
  - Express provision for credit bidding at collateral sale

Other Defaults

- General Negotiating Points
  - Grace Periods (before default or before remedies)
  - Notice
  - Opportunities to Cure (time, bonds, cash contributions, pursue defense or cure)
  - Carve-outs (exceptions, such as permitted debt, affiliated/consolidated group transactions, ordinary course of business)
  - Be mindful of interrelationships (overlaps and gaps) among default provisions

Expanded Waiver and Other Special Clauses

Expanded Waiver Clause – Punitive and Consequential Damages

- Waiver of punitive and consequential damages
- In business transactions, parties may waive punitive and consequential damages assuming there is a conspicuous waiver.
- There has been a proliferation of claims of fraud in the inducement or promissory estoppel when there has been a claimed breach in order to avoid local statutes similar to an economic loss rule which preclude non-breach of contract damages.
- A waiver of punitive and consequential damages acts as a preventative measure to forestall efforts to rescind agreements in order to magnify damages.

Expanded Waiver Clause – Punitive and Consequential Damages

Sample Clause:

As a material inducement for entering into this Loan Agreement, Borrower hereby knowingly, voluntarily and intentionally waives any right that it may have to obtain punitive, consequential or exemplary damages from the Lender based on any rights, claim or action that the Borrower may have against the Lender, including, but not limited to, any right, claim or action arising out of (a) the Loan Agreement or any loan documents, (b) any transaction contemplated by the loan documents or any agreements involving the Borrower and the Lender, or (c) any aspect of the relationship between the Borrower and the Lender.

Expanded Waiver Clause – Bankruptcy Stay

- The automatic stay in bankruptcy forestalls enforcement against collateral securing the debt.
- If there has been a default and there is a subsequent workout or forbearance or if a loan has matured and then is extended, bankruptcy courts will often honor and enforce a waiver of the effectiveness of the automatic stay if the borrower files a subsequent bankruptcy proceeding.
- This should not be a boilerplate provision, and should recite that it is a material inducement for the forbearance, restructuring or extension of the indebtedness.

Expanded Waiver Clause – Bankruptcy Stay

Sample Clause (used only in forbearance agreements and loan modifications)

As a material inducement for entering into this [loan modification agreement] [forbearance agreement], Borrower hereby covenants and agrees that in the event there is an uncured monetary default in connection with the obligations due to the Lender, and if a proceeding is then filed by or against the Borrower under title 11 of the United States Code and an order for relief is entered against the Borrower, the Borrower authorizes the Lender and its counsel to file a copy of this Agreement with the bankruptcy court to indicate the Borrower's consent to any motion filed by the Lender seeking the modification of the automatic stay in bankruptcy in order to take possession of and/or liquidate the collateral securing the Lender's debts due by the Borrower.

Lender’s Authority to Execute Documents

- Many times a secured creditor needs to take action after a loan has closed in order to complete ministerial acts to perfect liens on collateral. It is important that the lender be given a full power of attorney to execute those documents when such action is needed.

Lender’s Authority to Execute Documents

Sample Clause

Borrower hereby makes, constitutes and appoints Lender its true and lawful attorney-in-fact to act with respect to the Collateral in any transaction, legal proceeding or other matter in which Lender is acting pursuant to this Agreement. Borrower: (a) specifically authorizes Lender as its true and lawful attorney-in-fact to execute and/or authenticate on its behalf and/or file financing statements reflecting its security interest in any Collateral and any other documents necessary or desirable to perfect or otherwise further the security interest granted to the Lender; (b) specifically authorizes Lender to act as its true and lawful attorney-in-fact to execute and/or authenticate any third party agreements or assignments to grant Lender control over the Collateral, including third-party agreements between Borrower, Lender, and depository institutions, securities intermediaries, and issuers of letters of credit or other supporting obligations which third-party agreements direct the third-party to accept direction from the Lender regarding the maintenance and disposition of the collateral and the products and proceeds thereof, such power of attorney to be exercised after the occurrence and during the continuation of an event of default or after Borrower's failure to so execute and/or authenticate after Lender's request thereof.

Waiver of Commercial Reasonableness in Disposition of Collateral

- Most states will not enforce a general or blanket waiver of the requirement of commercial reasonableness in the disposition of collateral by a secured lender.
- Most states will, however, act consistent with emerging case law that so long as the disposition of collateral is commercially reasonable, the fact that a higher price could have been obtained will not invalidate the sale or place a deficiency claim in jeopardy.
- The inclusion of this type of waiver language provides additional protections to the secured lender.

Waiver of Commercial Reasonableness in Disposition of Collateral

Sample Clause

After default, in the event that the Lender disposes of any personal property collateral in accordance with the applicable provisions of Article 9 of the Uniform Commercial Code, and said sale or disposition is consistent with industry practices and is commercially reasonable, the Borrower knowingly and specifically waives any claim against the Lender for the disposition of the collateral even if a higher or better price could have been obtained by the Lender for the collateral.

Declaration of Default Without Acceleration

- Many times, a lender needs to avail itself of the right to declare a default, but it does not want to accelerate the entire indebtedness. Acceleration of the indebtedness can trigger other cross-defaults or other fallout.
- A provision that clearly permits a declaration of default without acceleration asked to preclude any claim of waiver.

Declaration of Default Without Acceleration

Sample Clause

In the event after default the Lender chooses to notify Borrower of such default but fails to specifically direct that the indebtedness due to the Lender is accelerated and is then due and owing in full, such willingness to forbear from accelerating the debt on the part of the Lender shall not be deemed to be a waiver and shall not impair any such right, remedy or power or any other right, remedy or power to be exercised at a later time to accelerate the indebtedness or to exercise any other right or remedy available to the Lender after default.