

Facility Agreement Breaches: Commercial Considerations

London 21 February 2019, by Neil Fitzgerald and Iain Barbour

This paper discusses how a lender must balance mitigating relationship damage whilst not limiting legal remedies if a borrower breaches its debt facility agreement. We argue that adopting measured communication strategies to complement robust legal responses is essential and enhances the likelihood of an efficient and effective resolution.

Introduction

There are circumstances where a breach of a debt¹ facility agreement is serious enough to create a permanent fracture in the lender–borrower relationship; however, in most instances, there will be value gained through preserving an atmosphere of cooperation. This holds true even if the situation demands a robust response, when suitably sensitive implementation may avoid or at least mitigate short-term relationship pressure.

In our experience, most breaches can be put into one of the following categories:

- Failure to pay debt service;
- Failure to satisfy financial covenants;
- Failure to produce covenanted information reporting in a timely manner; and
- Failure to produce certifications and reports with the prescribed content.

Fortunately, most breaches are capable of prompt remedy; pro-active remedial management can deliver resolution, enhancing the borrower / lender relationship. However, it is not always clear to the lender, at the time of becoming aware of a breach, that the borrower has the capacity to effect remediation in a timely or agreeable manner: this promotes the need for cautionary communications throughout.

This is not to say that a robust response is not appropriate; we discuss the importance of a lender communicating clearly its position, affirming its rights and ensuring that available remedies are retained.

This Market Insight examines the steps we recommend a lender takes to optimise the chances of a satisfactory outcome.

Situational Analysis

Whether initial awareness of a breach comes about as a result of a borrower

¹ We do not distinguish in this Market Insight between different forms of debt

notification or through lender monitoring and observation, it is imperative that the lender resists any urge to take impromptu action and instead focuses on promptly evaluating the situation arising to inform the proportionality of the response.

This entails:

- *Confirming the situation arising.* Whilst this may seem to be stating the obvious, we frequently find that facility agreements leave some matters open to selective interpretations. We advocate approaching this in two key stages:
 - Establish the facts: what event has occurred or what required action has not been carried out?
 - Review the legal agreements:
 - What are the consequences of the occurrence or omission?
 - What remedies, if any, are available to the borrower and what grace periods apply to those remediation options?
- *Considering whether specialist legal, financial or technical advice is needed and, if so, when will / might this be appropriate?*
- *Review the borrower relationship:*
 - Understand borrower decision-making protocols; and
 - Identify key individuals.
- *Develop a communication strategy:*
 - Define formal (legal) communications that are / maybe required; and
 - Consider informal communication options.

Equally, the responsible lender will recognise that the breach will have created concerns for the borrower too:

- How will the lender respond?
- What costs are faced? and
- How will this affect operating activities?

It is perhaps naive not to acknowledge that any breach will have an impact on the

borrower / lender relationship. However, a well-considered and implemented communication strategy will help minimise that impact and may even enhance it. Accordingly, alongside its risk assessment, the prudent lender will wish to overlay judgement of the strength and value of its commercial relationship with the borrower (and the principals behind it); this will likely extend to the potential impact of any actions on prospects for future business retention and/or enhancement as well as on related debt facilities.

A key theme of this paper is effective communication; we observe where borrowers are transparent and open with their lenders when business challenges arise, when breaches occur as well as when things are going well, this will typically engender a spirit of greater cooperation. A pro-active approach to such communications is therefore to be encouraged.

We would anticipate that a key output from any situational analysis will be a preliminary assessment of the seriousness of the breach, its time sensitivity and the potential impact for the lender. We therefore expect a lender will develop its strategy according to the identified criticality of the situation.

We start with the most serious forms of breach and then consider how any strategy may be crafted.

Serious Breaches

In our estimation, the most serious forms of breach will typically involve ongoing payment default(s), key counterparty insolvency, material breaches of negative pledge and / or other key undertakings.

The lender's response to a 'serious' breach will demand a bespoke approach, likely informed by legal advice to guide and, in due course, implement the response strategy; this may ultimately result in the

lender enforcing its rights under the facility agreement.

It is fair to say that, in almost all instances of a serious breach, the strength of the lender-borrower relationship will be challenged. The transgressing borrower should not be surprised when the lender responds in a robust manner.

Serious breaches may require commercial judgement for the lender. Common considerations we observe are:

- What broader relationship considerations exist?
- Whether to reserve rights or commence actioning those rights?
- Whether and when to charge penalty / default interest?
- How / when to activate any fee / cost indemnity from the borrower?
- Are there reputational implications for the lender associated with any actions contemplated?

Prompt action is typically required; therefore, it is important to undertake key research and analysis of how different strategies may impact on ultimate recoveries at an early stage to fully inform decision-making relative to the above-mentioned considerations. This way the lender's remedial management strategy may be agreed, minimising impediment to the lender's rights.

'Technical' Breaches

Most professional lenders will have an instinctive view of the type of event implied by the breach description: 'technical'. However, for clarity, we thought it helpful to illustrate our definition with some examples:

- Management information received late;
- Late delivery of audited financial statements;
- Late payments – but within a grace period; and

- Late delivery of Forecasts.

There are situations where one or more of the above examples will merit being treated as a serious breach; however, we expect a pragmatic approach will usually yield a response appropriate to the circumstances.

The first matter to consider is whether a grace period is stipulated in the agreement. Once an event has occurred, but assuming a grace period is operating, we commend the importance for the lender to respond proactively and advocate the following steps:

- Contact the borrower to establish the circumstances causing the breach;
- Confirm in writing that the event has occurred, memorialising mutual awareness of the situation;
- Monitor closely future compliance to validate if, and when, the matter is remedied;
- Consider any consequences of the event. For example, does the event create a 'potential event of default' that may limit borrower flexibility elsewhere?

Our second consideration is the lender's sentiment towards the borrower. There may be instances where a lender is being repeatedly tested by regular borrower transgressions and, against such a background, what may be, in isolation, a relatively minor technical breach might lead the lender to conclude that an exit strategy may be in the best interests of both parties; for the purposes of this paper we assume that this scenario is not relevant. So, assuming the sentiment is such that the lender is open to continuing the relationship, promoting this through the tone of communications is essential.

When communicating the breach, we caution the lender team to reserve the nomenclature of *technical breach* for internal discussion. This avoids the risk that the offending borrower interprets such

labelling as signifying that the infringement is regarded by the lender as trivial - not warranting any serious action in response. Whilst, in most cases, such a breach may indeed be accepted without great concern by the lender, it may be that the subject breach is the latest in a series of borrower infringements and / or that the underlying lender risk position has developed to be a matter of broader concern, reflecting other historic or current transgressions.

Communication

We have emphasised the importance of developing and implementing a communication strategy as and when a lender becomes aware of a breach.

There are many instances, however, where the lender remains unaware of a subsisting breach for a period. Lending documentation typically includes language designed to protect a lender when a breach has occurred but is undisclosed or undetected, or when an event of default has arisen, but the lender has delayed taking action in response (either deliberately or by omission). Despite these protections, it is good commercial (and typically legal) practice to take prompt action to notify a borrower in writing of a breach or event of default, or to acknowledge awareness of such a circumstance even where it is the borrower who has brought the irregularity to the attention of the lender. Key reasons for this are that such notification:

- Memorialises mutual awareness of the situation / event;
- Demonstrates good vigilance by the lender;
- Provides the borrower with an opportunity to address the issue and offer a plan for prompt remediation;
- Offers the lender a clear opening to discuss the situation which will likely facilitate resolution; and

- Provides a record for reference in any formal legal action to follow.

We emphasise that sensitivity to the method of communication may prove key to positive engagement. For example, a borrower with an unblemished record may display irritation at receiving, without warning, a formal legal notice that it is in default due to a delay of a few days in production of its regular management information – especially if such a transgression has not triggered such a response in the past. In these circumstances, the lender may wish to mitigate risk to the borrower / lender relationship by ‘managing’ the communication process with the borrower through separate personal contact ahead of, or concurrently with, the issue of any formal legal communication.

In all circumstances, great care must be taken to ensure that no language is used during any informal communications which may compromise the legal force behind any formal action contemplated, however unlikely such action is seen to be at that moment in time. Whilst, in legal terms, a breach is likely to be interpreted as a breach regardless of its nature, such an incidence does afford a lender an opportunity to pause, reflect and to discuss wider strategic lending considerations in-house, as well as with the borrower’s management.

We have emphasised the importance, in our estimation, of memorialising the actual occurrence of a breach. Such action may take several forms ranging from a simple telephone call to formal remediation action under the facility agreement. If verbal communication is the chosen route, we would typically expect such advice to be confirmed, for good order, in writing – although if the breach is promptly resolved following the verbal advice, such written

confirmation may be regarded as serving little purpose.

We also recommend creditors giving serious consideration to reserving their rights following the occurrence of an event that gives, or may give, rise to certain lender rights. Such action provides time for considered discussion amongst all parties and for a remedial strategy to be developed and implemented, likely with goodwill on all sides. If communicated well, we would expect such an approach to foster a more transparent dialogue and enhance the chances of a successful resolution.

Conclusion

Whenever a facility agreement is in breach, exercising sound commercial judgement when selecting and implementing a remediation strategy is essential. Even where the situation merits a robust legal / commercial response, clear, effective and timely communication by the lender will assist in delivering clarity to the benefit of both lender and borrower; this will likely optimise the potential for a resolution

favourable to an effective future relationship.

In the more common scenarios of less serious, technical infractions, the selection by the lender of a proportionate commercial response, and the application of good communications practices, can help cement the commercial relationship, with mutual benefit to both lender and borrower.

Key recommendations for lenders

- Document guidance for surveillance and monitoring teams on how to respond to both serious and technical breaches.
- Establish clear protocols to facilitate prompt and effective decision-making.
- Encourage prompt and clear communication with borrowers following any breach.
- Maintain a core group of 'go-to' advisers who understand your lending remediation strategy, encompassing legal, financial and certain technical services.

If you agree with our views in this Market Insight, and even if you don't, we would be delighted to hear from you

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