HOW TO KEEP THE LOAN-TO-OWN SHARKS AT BAY

In this column, *Rumen Cholakov* of *3 Verulam Buildings* considers what a borrower can do to keep the loan-to-own sharks at bay even when facing tight covenants and hair-trigger events of default.

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RESOURCE INFORMATION

RESOURCE ID

w-037-1567

RESOURCE TYPE

Article

PUBLISHED ON DATE

6 October 2022

JURISDICTION

England, Wales

CONTENTS

INTRODUCTION

The last fifteen years since 2008 saw the emergence and boom of a new type of lender: the direct lending fund (often also referred to as "special situations"). This product was attractive to many companies who struggled to get syndicated loans for various reasons: poor financial performance, lack of appetite due to the nature of the company's work (for example, lending to a profitable porn movie business), or the presence of an unsavoury shareholder somewhere at the top of the structure. Many of these funds provide a valuable offering to a market with huge demand – according to DLA Piper's 2022 report on direct lending, 2021 saw more than US$70bn raised in the U.S. and more than €35bn raised in Europe. With the current credit squeeze by governments, it is likely that the market will expand further. But there are also some who have seen this as an opportunity to "loan to own". With tight covenants and hair-trigger events of default, is there much the company can do to keep the loan-to-own sharks at bay?

A BARGAIN IS A BARGAIN

The starting position in English law is that a contractual agreement is enforceable in accordance with its terms. Therefore, if a company has agreed that a certain act or omission is an Event of Default, the Courts would be unlikely to look behind the agreement and the lender would have the right to accelerate the loan (Lombard North Central v Butterworth [1987] QB 527; *Lombard North Central plc v European Skyjets Ltd [2022] EWHC 728 (QB)*). For clear-cut Events of Default, such as insolvency or non-payment, this is the end of the matter. However, there are others whose breach could be arguable and open to interpretation.

One example might be the breach of an obligation to deliver a "Key-Person" insurance policy. What if the reason for the failure to deliver is that after the COVID-19 pandemic such a policy became unavailable in the market for the person in question due to underlying medical history. Might it be said that this undertaking was frustrated, so that the lender can no longer rely on it as an Event of Default?

SEEKING AN INJUNCTION

A borrower could seek to restrain with an injunction. The test for granting prohibitory injunctions is the familiar one set out by Lord Diplock in American Cyanamid Co (No 1) v Ethicon Ltd [1975] AC 396 which looks at:

- Whether there is a serious issue to be tried.
- Whether damages are an adequate remedy.
- Where lies the balance of convenience.

It can be said that this test is favourable to borrowers in such situations. Finding a serious issue to be tried is a low bar, and it is likely that the borrower will satisfy that easily where the threatened acceleration is based on an Event of Default that is not clear-cut. Damages are unlikely to be an adequate remedy for losing control of the company (by enforcing over the security package) based on an Event of Default that later is deemed to not have been justified.

The key consideration, then is, as usual for prohibitory injunctions, the balance of convenience. Here, the Court is faced with a consideration of the interests of the lender protecting repayment of the underlying loan against the interests of the company and its shareholders facing an acceleration and enforcement of security with the grave consequences that this could entail. Where the balance would tip is case-specific, but it is arguable that if a company is meeting its payment obligations, stays within its financial covenants, and is not insolvent or in obvious danger of insolvency, the balance of convenience probably would lie with holding the status quo until it can resolve whether the company is in default. This is particularly the case for lenders which hold extensive security packages.

However, a borrower also would need to demonstrate to the Court that an acceleration is imminent, to warrant such an injunction. A Court is unlikely to be impressed with hypothetical dangers. The borrower also might want to consider seeking an injunction on a ‘without notice’ basis to prevent the lender from acting first.

CONSIDERATIONS FOR THE LENDER

On the other hand, if a lender thought that an Event of Default had occurred, it would be well advised to protect its position so that it cannot be said to have waived the breach (See Charlotte Eborall’s recent article on this subject: *Tips for the Terminator*). The uncanny consequence of such a reservation of rights, particularly if accompanied by aggressive communication from the lender or any action in respect of other (junior) creditors under an intercreditor agreement, is that it could be seen as preparation for enforcement and could be sufficient to be judged an imminent threat.

These decisions, therefore, could be very difficult indeed and should be fine-tuned to the realities of the commercial relationship between the parties. Mistrust and second guessing of intentions can come about very quickly in such situations where a borrower could start wondering whether the lender is about to strike to enforce its security and take over.

CONCLUSION

The real prize for a borrower from succeeding with such injunction could be that it would buy it time to seek to refinance the lender out of the deal; by the time the Court gets to hear whether the lender was right to call an Event of Default, the point could be moot altogether.

All Events of Default, therefore, are not quite equal and there are situations in which a determined company could face off an overly aggressive shark, but they are limited. A borrower’s best shield is to take good care when negotiating the credit agreement and choosing its lender.