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In our ongoing series of notes on legal issues arising out of the COVID-19 crisis, Jamie Riley QC and Lisa Lacob offer an overview of issues concerning Insolvency Event of Default clauses in loan facility agreements, with particular reference to syndicated loans, and consider the potential impact of the accelerated insolvency law reforms announced by BEIS on 28 March 2020.

As a result of the CV-19 extended shutdown of business, it is inevitable that many borrowers will find themselves in early discussions with their creditors and trade suppliers about rescheduling payments, without realising that the Insolvency Events of Default (IEOD) in their loan facility agreements might be triggered in these circumstances. This note considers the extent to which IEOD clauses may go further than what a borrower might consider to be a true insolvency situation, and the impact on IEODs of the March 2020 insolvency reforms announcement.

Insolvency Event of Default

The insolvency of the borrower (or another company in the borrower's group) is a standard event of default in loan facility agreements, which triggers certain key rights and remedies for lenders, including drawdown stops, putting the underlying debt on demand, declaring all or some of the debt immediately due and payable, or taking steps to enforce security. Even if lenders decide not to exercise any of these rights, the ability to do so will put the lender in a position where it can control negotiations about refinancing or restructuring the lending.

Most borrowers will appreciate that cash flow insolvency (the test under section 123(1) of the Insolvency Act 1986) will trigger an IEOD, but these clauses can, and often do, cover far earlier signs of distress.

Syndicated Loans: LMA Events of Default

Syndicated loan facilities based on standardised Loan Market Association (LMA) documentation will contain very widely-drafted IEOD clauses. These clauses reflect the fact that lenders seeking to force overleveraged debtors to the negotiating table to commence restructuring discussions do not want to wait until the borrower is facing insolvent liquidation before their rights are triggered.

Borrowers who have not taken care to review these clauses may not appreciate that an IEOD can be triggered by the insolvency of any member of the borrower's group on either a cash flow basis (where it is unable to pay its debts as they fall due) or a balance sheet basis (where the value of its assets is less than the amount of its liabilities, taking into account contingent and prospective liabilities) or where any group member suspends payment on any one of its debts. The clause can also be triggered by insolvency proceedings being initiated in relation to any group member and by reference to a single creditor or a single debt, or even where any single asset of any group member with a value in excess of a stated minimum becomes subject to a creditor's process such as execution, which is not discharged within a fixed period.

Critically, the LMA form of IEOD also includes the commencement of any discussions in relation to actual or anticipated financial difficulty, such as negotiations with any one creditor (including a company's bank lenders or its landlords or trade creditors), irrespective of the quantum of those liabilities.

The construction of LMA-type wide-ranging IEOD clauses has tested the courts on a number of occasions.

The question is whether negotiations with particular creditors occurred, not in the ordinary course of its business, but by reason of actual or anticipated financial difficulties.

Beginning negotiations to reschedule debt

Grupo Hotelero Urvasco SA v Carey Value Added SL [2013] EWHC 1039 (Comm) concerned a facility agreement with a Spanish hotel company borrower, where the events of default included (alongside a narrower IEOD), the borrower *"by reason of actual or anticipated financial difficulties, begin[ning] any negotiations with any creditor for the rescheduling of any of its indebtedness"*.

In construing this clause, Blair J stated:

> A borrower in the business context may have constant dealings with respect to its indebtedness, postponing it, renegotiating it, refinancing it, and so on. For this reason, I accept GHU's proposition that the term "rescheduling" implies a degree of formality… "rescheduling" refers to the formal deferment of debt-service payments and the application of new and extended maturities to the deferred amount.
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> However, the reference to formality may be of limited assistance to GHU in this case. This is because sub-clause 21.6(d) of the BBVA Credit Agreement provides that an event of default occurs if the company begins negotiations with any creditor for the rescheduling of any of its indebtedness. It is not limited to the commencement of negotiations with creditors generally with a view to formally rescheduling the company's whole debt book. The primary protection to the borrower against the clause being given an unreasonably wide ambit is to be found in the fact that beginning negotiations for rescheduling will only constitute an event of default if it happens "by reason of actual or anticipated financial difficulties".
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> In the context of a clause dealing in other respects with insolvency, I consider that the "difficulties" envisaged must be of a substantial nature. That aside, the true construction of such a clause must depend upon its drafting, and, in common with all questions of contractual construction, the factual matrix of the agreement in question.

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> In the present case, part of that matrix concerns the nature of the Urvasco group's business. At the end of 2007, it owed about €2.3 billion to over forty banks, mostly Spanish banks. The business, even in a benign economic climate, required constant negotiations with financial institutions. Such negotiations would not, in my view, constitute an event of default, whether or not resulting in a formal agreement. Carey (as lender) was in any case well aware of the group's position in this respect in general terms. Carey's case, it seems to me, and the case I have to decide, is whether negotiations with particular creditors for the rescheduling of any of its indebtedness occurred, *not in the ordinary course of its business*, but by reason of actual or anticipated financial difficulties.
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> (at [573-577])

This type of clause is not, therefore, concerned with an informal telephone conversation with, or email to, the borrower's bankers requesting a bit more time to pay. If it were, that would be commercially unfeasible, particularly for highly leveraged borrowers which might have such conversations on a regular basis. The concept of *"beginning negotiations with any creditor for the rescheduling of any of its indebtedness"* is, however, very wide and will capture all negotiations which are outside the ordinary course of business. For this reason, and notwithstanding the "substantial financial difficulties" qualification, Blair J found that the clause had been triggered in this case.

As to the question of whether there had in fact been negotiations for "rescheduling" of the debt, the borrower argued that what had been negotiated was simply a roll-over of existing lending into new lending. Blair J decided, however, that the request for an extension was more than a simple roll-over:

> It is artificial, in my view, to analyse the situation as the maturing of one facility, and the negotiation and entry into of a new facility. The email of 8 April 2008 makes it clear that the agreement of new terms was linked to non-payment of the existing facility, and the consequent threat of legal action.
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> (at [594])

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The *Grupo Hotelero* decision was applied in *Torre Asset Funding Limited v Royal Bank of Scotland Plc* [2013] EWHC 2670 (Ch) where again negotiations regarding rescheduling of the financing were said to constitute an event of default under the relevant finance agreement. As Sales J said there:

> "
> In my view, Dunedin's request to RBS to agree to reschedule payment of the B2 interest by rolling it up to be paid only at maturity was well outside anything which could be said to be in the ordinary course of its business in relation to the Industrious transaction and was significantly outside what the various Lenders would have expected would be likely to occur as an ordinary incident of the transaction at the time they entered into the lending agreements in relation to it.
>
> (at [137])
> "

The take-aways from *Grupo Hotelero* and *Torre Asset Funding* are that, where a loan facility agreement includes a *"beginning negotiations to reschedule"* clause, and the lender becomes aware that discussions have taken place between its borrower and other creditors, the questions the lender should consider are:

- Were those discussions prompted by financial difficulties of a **substantial nature**?
- Were the negotiations beyond the **ordinary course of the borrower's business**?
- Did the discussions concern a **formal** deferment of loan repayments, or the formal agreement of loan extensions?

If the answer is all 3 questions is yes, the lender may wish to take the initiative and swiftly engage with the borrower to ensure that value is preserved for the lender.

Balance sheet insolvency
A balance sheet insolvency trigger is also very useful for lenders. Once formal insolvency procedures are underway, restructuring options have usually been exhausted, but an early balance sheet insolvency default event may occur at a far earlier stage either from business interruption where a company's working capital is finely balanced, or where markets are volatile and there is a significant decline in the value of a company's key asset or assets.

In *BNY Corporate Trustee Services Ltd v. Eurosail-UK 2007-3BL Plc* [2013] UKSC 28 ("Eurosail"), the Supreme Court had to decide whether an event of default (in the 1992 ISDA Master Agreement) had occurred under notes issued by a securitisation vehicle. The notes provided that it would be an event of default if the issuer was deemed unable to pay its debts as they fall due *"within the meaning of section 123(1) or (2) (as if the words 'it is proved to the satisfaction of the court' did not appear in section 123(2)) of the Insolvency Act 1986"*. Section 123(2) provides that a company is deemed unable to pay its debts *"if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities."*

In the Court of Appeal, Lord Neuberger had stated that Section 123(2) is not a pure balance sheet insolvency test and a company would had to have reached a *"point of no return"* when there was an incurable deficiency in its assets, such that the directors should have to *"put up the shutters"*, before it could be wound up (p1426A-F). The Supreme Court rejected this approach and noted that the "point of no return" test *"should not pass into common usage as a paraphrase of the effect of section 123(2)"*, but did affirm that it is important to *"proceed with the greatest caution in deciding that the company is in a state of balance sheet insolvency"* (p142G).

In Eurosail, there were *"three imponderable factors"* which had a bearing on the borrower's financial position and future prospects: (1) potential currency movements, (2) potential interest rate movements and (3) the UK economy and housing market, all of which were clearly out of Eurosail's control (p.1414E). There were also more than 30 years left until redemption of the notes and the potential movements in currencies and interest rates over this period were adjudged to be *"incapable of prediction with any confidence"* (p.1428G). Deciding whether Eurosail was balance sheet insolvent was therefore *"a matter of speculation rather than calculation and prediction on any scientific basis"* (p.1425C). Ultimately, the Court was simply not satisfied that there would eventually be a deficiency in Eurosail's assets.

Borrowers in the current economic climate will be comforted by this ruling, which means that an IEOD referring to balance sheet insolvency will not be automatically triggered by a pure negative net asset calculation, and that borrowers will not easily be seen to be incapable of meeting long-dated liabilities in circumstances where markets are in a great deal of flux. The *Eurosail* decision does, however, leave less room for the argument that the IEOD has not been triggered because the borrower has not reached the *"point of no return"*. Eurosail involved a cashflow solvent, non-trading single purpose securitisation vehicle, with extremely long-dated maturities; this was a very particular factual situation.

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Potential impact of BEIS Insolvency Law Reform

In 2018, the Department for Business, Energy and Industrial Strategy (**BEIS**) issued a consultation paper with proposals for changes to the UK corporate insolvency framework. As part of its Response, BEIS included a proposal to introduce the prohibition of so-called ipso facto clauses permitting termination for IEOD. Under this proposal, the prohibition would prevent enforcement by **suppliers** in **contracts for goods and services** where the clause allows termination on the basis that the counterparty is subject to a formal insolvency process or has entered either the new moratorium procedure or the new restructuring plan, both of which are also included in the proposals set out in the government's response.

As a consequence of the prohibition, suppliers would have to continue to fulfil their commitments under the contract with the debtor company. However, it is proposed that suppliers would retain the right to terminate on other grounds for example by giving contractual notice or for reasons unconnected with the company's financial position.

These rules reflect the US approach to so-called "executory contracts" in Chapter 11 proceedings. However, the important distinction between the Chapter 11 provisions and the UK proposals is that the latter only cover "supplier agreements" not general commercial contracts.

The UK Government's Response states that certain types of financial products and services would be exempt as "special cases" although no further details are given. In addition, licences issued by public authorities, such as regulatory licences, would not be covered by the ipso facto provisions.

An important aspect of the proposal is that where a supplier is significantly adversely affected by these measures, it could apply to the court to exercise a right to terminate on grounds of undue financial hardship. In considering such an application the court would need to assess:

- Whether or not the supplier would be **more likely than not to enter an insolvency procedure** as a result of being compelled to continue to supply; and
- Whether exempting the supplier from the obligation to supply would be **reasonable in the circumstances** having regard to the effect of non-supply on the debtor company and the prospects of corporate rescue.

Therefore, the threshold will be a high one to meet for the supplier and, in the case of lenders caught by the prohibition, they are unlikely to be able to resort to this safeguard based on financial hardship.

In considering these ipso factor provisions (or supplier termination clauses), the following points should be noted:

- In principle the ipso facto provisions apply to all suppliers including suppliers of financial services and products. This contrasts with the current regime which only provides for continuity of supply of **essential services** such as utilities and IT.
- It is not apparent from the UK Government's Response how broad the definition of "goods and services" and the scope of exemptions from the provisions will be. In particular, it is not clear whether and, if so, to what extent, financial products and services will be exempt. Therefore, the position is unclear, for example, in relation to loan facility agreements (syndicated or otherwise), letter of credit facilities and asset finance arrangements.
- Therefore, depending on the scope of the termination provisions, lenders may start developing a trend towards negotiating earlier termination triggers in contracts to counteract the restrictions on invoking IEOD.

Despite the current lack of clarity in the proposed reforms, the supply of capital is, in our view, so critical to the economy that it would make little sense to prevent other essential suppliers from enforcing their contracts to preserve the company if the lenders could simply swoop in and terminate on the basis of an IEOD. Therefore, it seems inevitable that some financial services at least are likely to be caught under the new measures.

As for the timing of these developments, in its Response the UK Government announced that it would introduce the new legislation *"as soon as parliamentary time permits"*. In various quarters it had been assumed that the complexities of Brexit might impede the progress of the new legislation through Parliament. However, on 28 March 2020, the UK Government announced that it would fast track the introduction of its insolvency reforms including the prohibition against enforcing ipso facto clauses, to protect companies and businesses facing major funding and operational difficulties in the current COVID-19. Therefore, for both borrowers and lenders alike it is a case of watch this space but with the reforms having such potentially important consequences, the wait is bound to be a nervous one.

Conclusion

Pending clarity on the extent to which the reform of insolvency law will cover IEODs in loan facility agreements (if at all), borrowers in financial difficulty may wish to seek an express waiver of rights from lenders under their IEOD clauses before entering into any discussions with other creditors or suppliers, or before commencing any formal asset revaluation process. The effect of any limited waiver or forbearance in exercising its rights by the lender is the subject of another note in this series.

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