Global Financial Restructuring

Client Alert

Global | Baker & McKenzie

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Market Disruption Clauses

As the credit crisis has intensified over the last few weeks, Lenders have found it increasingly difficult to access funding for their loan book on the interbank market. Liquidity in this market is at the lowest level for decades. If funding is available to a Lender, that Lender is likely to be paying a much higher price for it. Obtaining funds at LIBOR simply is not possible for some market participants.

This alert looks at one possible mechanism a Lender may be able to use to recover the actual cost of funds if it is accessing the market above LIBOR. It discusses the issues we believe will be of most interest to all market participants - Agents, Borrowers and Lenders.

Background

The contractual term

The Loan Market Association recommended form of facility agreement contains a provision (reproduced in the Appendix to this alert) that allows a Lender, if a Market Disruption Event occurs, to notify the Agent of a rate to be substituted for the LIBOR element in the interest calculation. That notified rate should express as a percentage rate per annum the cost to that Lender of funding its participation in any relevant loan from *whatever source it may reasonably select*.

A Market Disruption Event occurs if LIBOR cannot be determined or if the Agent receives notification from a Lender or Lenders whose participations exceed a stated threshold - normally but not always between 30-50% of the relevant loans - that they can only fund at a rate in excess of LIBOR. It is the latter arm of the clause that most market participants are thinking about in the current climate. What rights and obligations does this clause create and how should they be used?

Borrowers perspective -ACT statement

The Association of Corporate Treasurers has put out a statement available here http://www.treasurers.org/marketdisruption/pressrelease to the effect that Lenders should only use their rights to trigger the clause as a last resort. Naturally enough, given the sensitivities for all sides there is a dearth of information about exactly how widespread a use is being made of the Market Disruption provision by Lenders. Anecdotal evidence suggests many Lenders are at least thinking about the point, if not actually invoking the provision. There is one press

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report that a Taiwanese borrower has had its interest bill doubled through the use of the clause. Clearly, there is sufficient at stake to make all parties nervous about the scope of their rights and obligations in this regard.

Issues

There are a number of things each party will need to think about in analysing whether to exercise these rights. In this section we will describe some major points each participant will need to focus on.

The Agent

The Market Disruption provision envisages an Agent simply receiving the relevant notifications from Lenders and adjusting the interest calculation accordingly. There is nothing in the agreement which places a positive duty on the Agent to ask Lenders whether they have considered the issue. Indeed, it is probably prudent for any Agent to simply sit back and wait for Lenders to contact it rather than actively canvassing opinions on whether to trigger the clause. To the extent an Agent receives information from a Lender it will need to adhere to the confidentiality obligations imposed upon it before using that information or passing it on to another party. Does the Agent have to pass this information on to the Borrower? We discuss this below. Some Lenders will be nervous about sensitive information being circulated both to Borrowers and other Lenders. The Lender might not want (or even be able) to give full details of the actual source of the funds it used to fund the relevant loan. Can the Lender simply certify a rate?

The Lender

Some agreements contain a boilerplate clause that may be relevant in this context. The clause states that any certification or determination by a Lender of any rate or amount under any document is conclusive evidence of the matter to which it relates in the absence of any manifest error. Can a Lender use this provision to simply force a change in rate through without giving details? The type of certification clause has certainly been used in the context of financing documents to impose liability on obligors; see *IIG Capital LLC v Van Der Merwe & Anr [2008] EWCA Civ 542* a case involving a certificate of a sum due under a guarantee. There must be some scope to argue the same applies in this context. But a Court would surely look behind the certificate if it was faced with evidence of arbitrary behaviour or bad faith on the part of the Lender in calculating the rate e.g. in order to discriminate amongst different Borrowers. There is also the requirement on a Lender to be reasonable in selecting a source of funds when making the calculation of the new rate to be charged.

There is another danger for Lenders. If a number of banks in a syndicate discuss how the costs will be increased or even exchange information in order to set a rate to be substituted for LIBOR it is possible that they will infringe competition law. Lenders will need to be careful that they do not fall foul of such laws in any jurisdiction whether in looking at individual Borrowers or their loan portfolios generally.

The Borrower

Assuming a Borrower is faced with an uplift in the costs of the loan what can it do? If the certification process is followed it might be an uphill struggle to find evidence of bad faith or some arbitrary factor taken into account in establishing the new rate. The contractual provision does state that a Lender has to be reasonable in selecting a funding source in calculating the costs of funds. This might allow a Borrower some traction in arguing that details of the funding source should at least be disclosed by a Lender (particularly where the rate chosen by any Lender appears to be an outlier) but the Courts are likely to be very reluctant in the face of the contractual provisions to second guess the detail of the choices made by Lenders in this respect. It is unlikely any argument for the implication of terms (as to the use of the cheapest source for example) into this sort of contract will meet with much success; see *Socimer International Bank Ltd (In Liquidation) v Standard Bank London Ltd (No.2) [2008] EWCA Civ 116* where the Court was most reluctant to imply a term into finance documents in relation to calculation of a loss.

A Borrower might have more success where this issue is live in attempting to agree some kind of blended rate with lenders to accommodate the fact that some lenders will fund from a mixture of sources such as deposits and the interbank markets. Lenders who would otherwise run the risk of having to disclose sensitive information may be receptive to this idea.

Ultimately, if a Borrower is dissatisfied with the new pricing arrived at through an exercise of these rights by Lenders it can require the Agent to enter into negotiations with a view to agreeing a substitute basis for calculating the rate of interest. However, to become binding this new basis would need all party consent.

Guidelines

The Lender

If you are thinking of invoking the Market Disruption Clause, you should bear the following points in mind:

If your commitment is at least as much as is needed to trigger the Market Disruption Clause your notice to the Agent should:

- state the percentage of your commitment relative to the Total Commitments;
- state that you wish to invoke the Market Disruption Clause;
- state your current cost of funding your participation in any Loans under the Facility from whatever source you may reasonably select; and
- instruct the Agent to notify the Borrower that the Market Disruption Clause has been triggered and request the Borrower to notify the Agent if it wishes to either pay you your cost of funds (plus margin plus mandatory cost) or negotiate an alternative basis of interest or funding.

If your commitment is not sufficient, by itself, to trigger the Market Disruption Clause, your notice to the Agent should:

- state the percentage of your commitment relative to the Total Commitments;
- state that you wish to invoke the Market Disruption Clause if the required number of Lenders holding the requisite percentage of Commitments agree; and
- instruct the Agent to (i) notify the other syndicate banks that a bank (without disclosing who that bank is) has notified it that the cost to it of obtaining matching deposits in the Relevant Interbank Market would be in excess of LIBOR; and (ii) request the other syndicate banks whether they too wish to invoke the Market Disruption Clause.

The Agent

If the Agent receives a notice from a Lender whose commitment is sufficient to trigger the Market Disruption Event it should promptly:

- notify the Borrower that the Market Disruption Clause has been triggered and ask the Borrower whether it wishes to either pay the Lender its cost of funds (plus margin plus mandatory cost) or negotiate an alternative basis of interest or funding; and
- notify the other syndicate banks that the Market Disruption Clause has been triggered and ask each syndicate bank for that rate which expresses as a percentage rate per annum the cost to that Lender of funding its participation in the Loan from whatever source it may reasonably select.

If the Agent receives a notice from a Lender whose commitment is not sufficient to trigger the Market Disruption Event, and such notice instructs the Agent to notify the other Syndicate banks (as suggested above), the Agent should promptly send a notice to the other syndicate banks:

- stating that it has been notified by one of the banks that the cost to that bank of obtaining matching deposits in the Relevant Interbank Market would be in excess of LIBOR; and
- requesting each other syndicate bank whether the cost to it of obtaining matching deposits in the Relevant Interbank Market would be in excess of LIBOR and whether it wishes to invoke the Market Disruption Clause.

In no circumstances should the Agent disclose the cost of funds of one bank to another bank.

The importance of a strictly enforced Chinese Wall in these circumstances is very important. Requests from syndicate banks should always be sent to the Agency Department of the Agent and the Agent should not disclose any information it receives (whether it be the identity or cost of funds of a syndicate bank) to any colleague outside the Agency Department unless it has been expressly authorised to do so by the relevant syndicate bank. Any notices incorrectly addressed/received by an operational banker (ie, outside the Agency Department) should be forwarded immediately to the Agency Department and be treated as strictly confidential information.

Developments

In the context of new money loans, lenders are now seeking to incorporate an alternative to the normal benchmark (e.g. LIBOR, EURIBOR) rate such that where a reference bank rate is higher, the reference bank rate should apply. As a further fallback, if a requisite percentage of banks in the facility cannot fund themselves at the higher of the benchmark rate or reference bank rate, then the usual market disruption cost of funds approach will apply.

It is questionable whether such clauses are fair. On the one hand, interbank lending has traditionally been a cost-plus financing model. As has been widely reported, LIBOR and other benchmark rates are not operating properly in terms of identifying objectively the cost of funds in the market.

On the other, though, borrowers have been willing to submit to a cost-plus basis provided there is a degree of objectivity and transparency that applies to the "cost". Depending on the terms of the documentation, there would likely be little transparency in the operation of any reference bank rate.

It may be that the interests of the borrower and the lenders can be balanced in the current disturbed market by providing that any margin over LIBOR which applies by virtue of application of the reference bank rate should be limited to a certain percentage amount per annum.

Ideally, a methodology should also be identified to establish when the reference bank alternative should be disapplied, which it should be upon markets returning to something resembling normal operation.

Appendix

The following comes from the Loan Market Association Multicurrency Term and Revolving Facility Agreement (primary, investment grade) and is reproduced with their permission:

Changes to the Calculation of Interest

Absence of quotations

Subject to Clause 11.2 (*Market disruption*), if LIBOR [or, if applicable, EURIBOR] is to be determined by reference to the Reference Banks but a Reference Bank does not supply a quotation by the Specified Time on the Quotation Day, the applicable LIBOR [or EURIBOR] shall be determined on the basis of the quotations of the remaining Reference Banks.

Market disruption

(a) If a Market Disruption Event occurs in relation to a Loan for any Interest Period, then the rate of interest on each Lender's share of that Loan for the Interest Period shall be the percentage rate per annum which is the sum of:

   (i) the Margin;

   (ii) the rate notified to the Agent by that Lender as soon as practicable and in any event before interest is due to be paid in respect of that Interest Period, to be that which expresses as a percentage rate per annum the cost to that Lender of funding its participation in that Loan from whatever source it may reasonably select; and

   (iii) the Mandatory Cost, if any, applicable to that Lender's participation in the Loan.

(b) In this Agreement "**Market Disruption Event**" means:

   (i) at or about noon on the Quotation Day for the relevant Interest Period the Screen Rate is not available and none or only one of the Reference Banks supplies a rate to the Agent to determine LIBOR [or, if applicable, EURIBOR] for the relevant currency and Interest Period; or

   (ii) before close of business in London on the Quotation Day for the relevant Interest Period, the Agent receives notifications from a Lender or Lenders (whose participations in a Loan exceed [ ] per cent of that Loan) that the cost to it of obtaining matching deposits in the Relevant Interbank Market would be in excess of LIBOR [or, if applicable, EURIBOR].

Alternative basis of interest or funding

(a) If a market Disruption Event occurs and the Agent or the Company so requires, the Agent and the Company shall enter into negotiations (for a period of not more than thirty days) with a view to agreeing a substitute basis for determining the rate of interest.

(b) Any alternative basis agreed pursuant to paragraph (a) above shall, with the prior consent of all the Lenders and the Company, be binding on all Parties.

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