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How to Cut Risk of Dealing with a Defaulting Lender

In the wake of recent bankruptcy filings by several prominent financial institutions, there's a growing interest in changing standard credit documentation to address the risks of defaulting lenders and nonperforming administrative agents. Here are credit agreement provisions that financial institutions, acting as swingline lenders and letter of credit issuers, can require to protect themselves against the risk of a defaulting lender. Also covered are recommendations on dealing with the risk of an administrative agent becoming a defaulting lender or not complying with its credit agreement obligations.

What credit agreement provisions can financial institutions acting as swingline lenders or letter of credit issuers require to protect themselves against the risk of a "defaulting lender" under credit facilities?

1) *Cash Collateral Provisions:* At any time a defaulting lender exists, a swingline lender or letter of credit issuer can require the borrower to enter into arrangements reasonably satisfactory to it and the borrower to eliminate its risk with respect to a defaulting lender's participation in swingline loans or letter of credit reimbursement obligations, as applicable. Most commonly, these arrangements would entail a pledge by the borrower of cash collateral sufficient to cover the defaulting lender's *pro rata* share of the outstanding principal amount of swingline loans or the face amount of each letter of credit, as applicable. Importantly, a borrower would be obligated to enter into such arrangements both (i) as a condition to the funding of any new swingline loan or the issuance of any new letter of credit and (ii) if swingline loans and/or letters of credit are then outstanding, at the time any lender becomes a defaulting lender, with any failure to comply with such obligation to constitute an event of default. These types of arrangements are required by some credit agreements but are still relatively uncommon in the marketplace as a whole.

2) *Expansion of the Definition of Defaulting Lender:* A swingline lender or letter of credit issuer can require that the definition of "defaulting lender" be expanded to include: (i) any lender which has an affiliate that is insolvent or subject to a bankruptcy proceeding, (ii) any lender which was previously a defaulting lender under the credit agreement (even if it has subsequently cured its defaulting status) and (iii) any lender which a swingline lender or letter of credit issuer believes in good faith has become a "defaulting lender" under any other credit facility to which such lender is party. The expanded definition of "defaulting lender" would apply only for purposes of triggering the cash collateral arrangements described above (and, perhaps, the "agent removal" provisions described below) and afford a swingline lender or letter of credit issuer additional protection in circumstances where a lender is at risk of becoming a "defaulting lender" in the usual sense but has not yet defaulted on its obligations to fund borrowings or declared bankruptcy. This broader definition of "defaulting lender" is not typical for credit agreements, but market pressures may force a change.

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3) *Other Swingline Loan Protections:* A swingline lender can also require:

(i) The mandatory repayment of a swingline loan on the date occurring five business days after such swingline loan is made;

(ii) An express prohibition on the use of proceeds of swingline loans to refinance other than outstanding swingline loans; and

(iii) A clean-down provision authorizing the administrative agent to apply any funds received from the revolving lenders in connection with a revolver borrowing request by the borrower (x) *first*, to the payment of any outstanding letter of credit drawings and swingline loans and (y) *second*, to the borrower.

These provisions ensure that the swingline exposure of the swingline lender has a limited duration. Many credit agreements contain similar provisions but the approach in the marketplace is mixed.

4) *Set-Off Provisions:* An administrative agent which also acts as a swingline lender or letter of credit issuer can require specific set-off provisions that clearly permit the administrative agent to set-off against amounts paid by the borrower for the account of a defaulting lender to satisfy obligations of a defaulting lender owing to the administrative agent in its capacity as a swingline lender or letter of credit issuer. A specific set-off provision of this nature is not customarily included in credit agreements but would make explicit the well-understood set-off right under New York common law.

5) *Change in Pro Rata Mechanics for Participations in Swingline Loans and Letters of Credit:* In most credit agreements, each revolving lender acquires and holds a *pro rata* risk participation in outstanding swingline loans and letters of credit based on its share of the total revolving credit commitments of ***all*** revolving lenders. In circumstances where a defaulting lender exists, borrowers and lenders may instead require that each ***non-defaulting*** revolving lender acquire and hold a *pro rata* risk participation in outstanding swingline loans and letters of credit based on its share of the total revolving credit commitments of all ***non-defaulting lenders.*** This "adjusted *pro rata* share" would initially exclude the revolving credit commitments of defaulting lenders but be capped so that in no event would any non-defaulting revolving lender have aggregate revolving credit exposure (including swingline and letter of credit participations) in excess of its revolving credit commitment. If adopted, these new mechanics would permit a swingline lender or letter of credit issuer to defer the implementation of the cash collateral arrangements described above (and the associated expense) until all revolving credit commitments of non-defaulting revolving lenders had been fully utilized.

What changes to credit agreements might the market require in the future to address the circumstances where an administrative agent becomes a defaulting lender or fails to comply with its obligations as administrative agent under a credit agreement?

1) *Agent Removal:* Most credit agreements permit voluntary resignation by an administrative agent but do ***not*** permit active removal of the administrative agent by the borrower and/or the lender group, even by way of amendment. In the future, the market may require (i) explicit removal provisions that allow a majority of the lenders to remove an administrative agent (either generally or if the administrative agent is a defaulting lender) and appoint a replacement administrative agent reasonably satisfactory to the borrower or (ii) expanded "yank-a-bank" provisions that expressly permit the borrower to replace an administrative agent which becomes a "defaulting lender" (as more broadly defined above) or breaches its obligations under the credit agreement with a successor agent reasonably acceptable to the majority lenders.

2) *Modified Payment and Disbursement Provisions:* In the wake of recent bankruptcy filings by several prominent financial institutions, both borrowers and lenders have become increasingly concerned about paying over amounts to an administrative agent that may, upon bankruptcy, fail to honor its obligation under the credit agreement to disburse amounts received to the parties entitled thereto. Neither lenders nor borrowers relish the prospect of having funds trapped in an account of a bankrupt administrative agent, an outcome which could force the parties to petition a bankruptcy court for the return of their funds. To address these risks in circumstances where an agent is a defaulting lender, new credit agreement provisions could, among other things; (i) permit lenders to fund directly to the borrower (and borrowers to fund directly to the lenders) rather than through the agent, (ii) permit lenders and the borrower to fund into an account established with another syndicate member (rather than an account of the agent) and/or (iii) require that any account maintained by an administrative agent be a segregated agency or trust account established for the benefit of the lenders and used exclusively for disbursement purposes (and in which no other funds of the administrative agent are commingled).

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