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## WEATHERING THE STORM

### I Woke up this Morning and I'm in Default. What do I do now?

#### Background

Many companies entered into their existing debt agreements before the current economic crisis. As a result, the financial covenants in their debt agreements were based upon financial projections and assumptions that are no longer appropriate or attainable. Therefore, more companies are waking up to face defaults under financial covenants that they never anticipated and are left wondering what do they do next.

Not that long ago, ample credit was available to companies looking to finance their businesses. Banks, finance companies, private equity funds, and other lenders competed to make loans (both traditional senior debt and mezzanine or subordinated debt) and wooed prospective borrowers. With the current economic crisis, fewer lenders are marketing financing products. A borrower who was once a "prized" customer and could dictate its own terms to its lender will likely find itself with fewer options when facing a potential default and will be forced to work with its existing lender to resolve the situation.

#### Potential Defaults and Other Issues

Most debt agreements include financial covenants that limit leverage or measure the borrower's ability to satisfy interest expense, debt service, and other charges or expenses. A typical leverage test compares indebtedness to earnings before interest, taxes, depreciation, and amortization ("**EBITDA**"). A typical operating test compares EBITDA to interest expense or overall debt service. Such covenants are usually tested on a quarterly basis for the trailing four (4) quarter period, but sometimes these ratios are measured as often as monthly for the trailing twelve (12) month period. Many debt agreements also have limitations on borrowings tied to a "Borrowing Base," which typically consists of accounts receivable, inventory, or other assets.

If a borrower experiences a downturn in its operating performance (because of reduced revenues, increased costs, or both) or has had to increase its borrowings to support its operations, then that borrower could find itself unable to satisfy the financial covenants in its debt agreements. Some companies may also see their Borrowing Base availability reduced as a result of lower receivables, a greater number of "aged out" receivables, concentration limitations, or credit quality issues with respect to underlying account debtors, which would have the effect of limiting or eliminating additional advances.

If a borrower believes that it is in default or that a default is likely, then it should carefully review its debt agreements. Almost every credit agreement provides that the borrower cannot request advances if a default or event of default exists. Most debt agreements require the borrower to notify the lender of the occurrence of an event of default or a potential default. In addition, the occurrence of a default may trigger restrictions on the borrower's ability to take certain actions such as paying dividends, repurchasing stock, prepaying indebtedness, or other actions outside the ordinary course of business. Borrowers should also consider whether a default under one of its debt agreements creates disclosure requirements under applicable laws (e.g., SEC reporting) or results in a cross-default under other agreements.

Even where the borrower is still in compliance with the financial and other covenants in its debt documents, most debt agreements have broad representations and warranties that the borrower must make as a condition to borrowing. For example, most credit agreements require the borrower to represent and warrant that there has not been a material adverse change in the borrower's assets, results of operations, financial condition, or prospects (a "**MAC**") as a predicate to any new advance. In addition, some debt agreements include an event of default if there has been a MAC. Whether a MAC has occurred depends upon an intense, subjective examination of the precise language of the MAC and the underlying facts and circumstances. Historically, lenders have been reluctant to rely upon a MAC, in and of itself, as a basis to refuse to make advances or to declare an event of default. In today's economic climate, more lenders may be willing to declare that a MAC has occurred.

### **Approaching the Lender**

Loan officers hate surprises. In most instances, therefore, borrowers should notify their loan officers as early as possible if the borrower knows or expects that it will not be able to comply with its loan documents. Although helpful, borrowers do not need to have a solution before approaching their lenders about an impending default. They do, however, need to be able to explain to their lenders what caused the default. Borrowers cannot expect their lenders to waive defaults or reset covenants without understanding what happened, why it happened, whether things are likely to get better or worse, and when it is likely that the borrower will be able to get back in compliance.

Note that notifying your loan officer of a default or the possibility of a default is not without risk or consequences. Once you notify a lender of an existing or impending default, the lender likely has the right to no longer advance funds under a revolving credit or other advance type facility. In addition, the borrower may lose the right to more favorable pricing options such as LIBOR. Even worse, the lender may have the right to impose a default rate. Of course, notifying the lender of the default could lead the lender to take enforcement actions such as cutting off access to bank accounts, exercising setoff rights, accelerating maturity of the loan, or proceeding to enforce liens and security interests in collateral. If a default has not yet occurred, the lender may consider the borrower's disclosure to be a MAC (as described above).

### **Potential Solutions and Lender Requirements**

The potential business solutions to deal with a financial covenant violation vary depending upon the nature and severity of the default. Typical remedial actions that the borrower or the lender may propose include:

- Restructuring operations
- Changing business model
- Cutting costs
- Selling assets
- Reducing debt
- Raising equity or subordinated debt
- Refinancing the subject facility or other facilities

Typical changes in the loan documentation to address these types of defaults include:

- Resetting financial covenants based on updated projections
- Adjusting the calculation of the covenants to account for non-recurring items
- Adjusting Borrowing Base availability

In exchange for a waiver or covenant relief, lenders may require one or more of the following:

- Reduction in the facility size
- Payment of waiver or amendment fees
- Increase in interest rates and fees
- Additional credit support (e.g., additional collateral (if available), personal guarantors, etc.)
- Prohibition of, or restrictions on the borrower's ability to make, certain types of payments (e.g., management fees, dividends, stock repurchases, prepayment of indebtedness, payments on subordinated debt, etc.)
- Further restrictions on other actions (e.g., incurrence of otherwise permitted debt)
- Additional collateral restrictions (e.g., establishing lockbox arrangements)
- More frequent or additional financial information or reporting
- New or more frequent collateral audits or appraisals
- Engagement by the borrower of a restructuring officer or engagement by the lender (at the borrower's expense) of financial or other consultants
- Release by the borrower of the lender from any claims

In most circumstances, lenders desire to resolve the problem and retain the business relationships they have established with their borrowers (particularly where the relationship has been developed over a period of many years). In some instances, however, the lender's only objective will be to get the loan repaid as soon as possible. In those instances, the loan may be moved from the historical relationship officer to a "special asset" or workout officer who typically has less loyalty to the borrower.

In light of current economic climate, a borrower in such a situation may have limited refinancing alternatives. As such, the borrower will have the unenviable task of having to convince its lender that working together will maximize the lender's prospects for repayment and that the alternatives (remedies exercises, litigation, bankruptcy, etc.) are less desirable to everyone involved.

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