

Lender and Agent Discretion in Credit Documentation

Presentation to

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Overview

- In Relation to Borrowers, Lenders/Agents Want as Much Discretion As Possible To Determine:
 - When they are obligated to close and fund the deal
 - When they are obligated to make subsequent revolving loans and open letters of credit
 - Advance rates and borrowing base collateral in an asset-based loan
 - Whether an event of default exists
- Borrowers Want as Little Lender/Agent Discretion in These Areas as Possible

Overview (cont.)

- In Relation to the Lender Group, Agents Want as Little Discretion as Possible To Determine:
 - Whether conditions to lend have been satisfied
 - Whether a default or event of default exists
 - Whether to exercise remedies
- Related to an agent's desire for almost complete exculpation and indemnification from the lender group except for instances of its own gross negligence or willful misconduct.

Lender/Agent Discretion in Relation to Borrowers: To Close and Fund

- Lenders/Agents will try to include a “catch-all” provision in the closing/initial funding conditions:
 - “Lender/Agent shall have received such other documents and agreements as Lender/Agent may [reasonably] require.”
- Discretion to close/fund also found in the condition that there has been no MAC since last audit or another date
 - This is because at least some of the components of a MAC are usually “determined by the Lender/Agent in its [reasonable discretion].”

Lender/Agent Discretion in Relation to Borrowers: To Make Revolving Loans/Open Letters of Credit

- Usually see discretion in the ongoing conditions to funding that may contain:
 - A requirement that no MAC has occurred since last funding (see slide 4)
 - A requirement that no Default or Event of Default exists (see slide 7)
- Also can see (usually in single lender ABL deals) discretion right in the language in which the lender agrees to make loans:
 - “Lender, in its [sole and absolute discretion], may make loans”
 - Factoring transactions almost always documented like this

Lender/Agent Discretion in Relation to Borrowers: To Determine Advance Rates and Borrowing Base Collateral

- Advance rate may be worded as “up to X%” of whatever the collateral type is rather than as a fixed advance rate
- Eligibility criteria may be worded as guidance rather than as definitive:
 - “Eligible Inventory means Inventory of a Borrower that the Agent determines in its [reasonable credit judgment] is Eligible Inventory. Without limiting the foregoing, no Inventory of a Borrower will be Eligible Inventory that is”
- Borrowing base “reserves” may be worded similarly.

Lender/Agent Discretion in Relation to Borrowers: To Determine Whether a Default/Event of Default Exists

- Most obvious place to see this is in the “insecurity” default that appears in some loan agreements:
 - “Lender/Agent determines in its [sole and absolute discretion] that Borrower may not be able to repay the loans.”
 - “Any event shall occur that in Lender’s/Agent’s determination based on its [good faith credit judgment] could result in an MAE.”
- Also see in determining whether a rep/warranty is untrue because there are so many MAC/MAE qualifiers contained in reps/warranties

Agent Discretion in Relation to Lenders

- Agents usually have their cake and eat it too when it comes to discretion:
 - They usually have broad discretion to protect collateral and exercise remedies, but . . .
 - Are entitled to rely solely on the Required Lenders to tell them when defaults have occurred and conditions to lend have been met . . .
 - “Agent shall not be deemed to have any knowledge of any Default or Event of Default, or of the failure to satisfy any of the conditions in Section X, unless it has received written notice from a Borrower or the Required Lenders specifying the occurrence and the nature thereof.”
 - and when they should exercise remedies
 - “If any Event of Default exists, Agent may in its discretion (and shall upon written direction of Required Lenders) take any of the following actions”

Standards of Discretion: All Over The Board

- Sole and Absolute Discretion
 - Clearly the lender's/agent's decision without any other influencing factors
- Good Faith Credit Judgment
 - Introduces an outside influence in the form of “good faith” that will be discussed later
 - Whose “credit judgment”?
- Good Faith Credit Judgment *Based on the Lender's/Agent's Customary Credit and Collateral Considerations*

Standards of Discretion: All Over The Board (cont.)

- What About “Reasonable Judgment”?
 - How do you determine what’s reasonable?
 - Reasonable in relation to what?
- What About “Reasonable Judgment (Determined From the Perspective of a Secured Lender)”
 - Better
 - Would rather stay away from a “reasonableness” standard in determining Agent/Lender discretion, but if pressed, qualify extensively
- Can There Be Such a Thing as “Reasonable Discretion”?
 - Contradictory in my opinion

Legal Backdrop for Exercise of Agent/Lender Discretion

- The Big Picture
 - Freedom of contract between sophisticated parties is a central component of commercial transactions . . .
 - Thus lenders and their borrowers are free to craft language reflecting their deal, and that language in most cases will be enforced as written
 - BUT a general requirement of *good faith* in connection with the performance and enforcements of all contracts limits parties' actions regardless of what the contract actually says

Legal Backdrop for Exercise of Agent/Lender Discretion (cont.)

- What is “Good Faith?”
 - The UCC defines it as “honesty in fact *and* the observance of reasonable commercial standards of fair dealing.”
 - Subjective component/objective component
 - UCC not applicable to loan agreements but instructive nevertheless
 - Most states have a similar concept of good faith in their case law that governs the performance and enforcement of contracts other than those controlled by the UCC
 - The requirement of good faith fills the gaps that are left open in contract performance and enforcement
- Lack of Good Faith = Breach of Contract (Possibly More)
 - Possible unfair and deceptive trade practice (treble damages)
 - Possible tort liability (punitive damages)

Practical Impact of Good Faith Requirement on Lender/Agent Discretion

- Give advance notice in writing before discretionary changes and state business reason for change
 - Reduction in advance rates (if not pre-programmed)
 - Removal of previously eligible collateral from borrowing base (if not pre-programmed)
 - Addition of new borrowing base reserves (if not pre-programmed)
 - Unwillingness to fund additional loans or open new LCs
 - Notice of event of default before taking remedial action
 - LESS/NO NOTICE REQUIRED IN CASE OF EXIGENT CIRCUMSTANCES (E.G., DISCOVERY OF FRAUD, ETC.)

Practical Impact of Good Faith Requirement on Lender/Agent Discretion (cont.)

- Evaluate alternatives and attempt to minimize negative impact on borrower of discretionary decisions
 - Lender/Agent has permitted discretion to cut off funding for a borrower which likely will result in bankruptcy – is this necessary to address “the problem?”
- Internally document deliberations over taking discretionary actions and especially the need for urgent action
 - Avoid emotion and personal attacks on borrower personnel
 - Urgent action in exigent circumstances likely to invite litigation, so be ready
- Follow lender’s procedures and policies
- Do what you said you were going to do

Conclusion

- Lender/Agent discretion is a valuable tool to manage a credit but must be employed properly or else it becomes the proverbial rope with which to hang both yourself and your employer.

THANK YOU!

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