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Running to Standstill

Following our article last week on emergency liquidity for businesses acutely affected by the economic impact of the COVID-19 pandemic: https://www.dilloneustace.com/legal-updates/the-abc-and-de-of-emergency-liquidity-solutions, we take a brief look at the first item out of the financial first aid kit – the Standstill Agreement.

It's my party

As discussed last time, a standstill agreement is only effective as it extends to those creditors pursuing a business for payment. Practically, it makes most sense for a borrower to reach a compromise with each of its creditors in turn, beginning with the most aggressive. Where there is a single lender under a facility, the situation is straightforward, but allowing for syndication of the debt or dealing with a shifting body of debt securities holders is clearly more challenging. So, in bringing creditors to the table and making them a party to a standstill agreement, it is vital to ensure that those joining represent either all, or at least a 'controlling' interest in the relevant debt. Credit facility agreements and bond constituting documents frequently, but not always, provide that creditor unanimity is not a requirement to waive the breaches of and reach a compromise with the borrower or issuer – there is a form of majority rule. Nevertheless, it pays to ensure that where debt is being forgiven, rescheduled or restructured, the applicable formal requirements have been met for obtaining a resolution of a supermajority, including in some cases holding a meeting or taking a poll via the clearing systems.

The picture is further complicated when bank syndicate members or bond investors can continue to transfer interests in the debt in the midst of negotiations with the borrower / issuer or during the standstill period. In fact, experience suggests that transfers of debt that has or is about to become distressed are common: Balance

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sheet lenders might shift non-performing debt into an unconsolidated entity or sell it to a special situations fund and asset managers may switch positions from a high yield fund that they manage to a distressed opportunities one. Or there could be delay while an investment manager gets approval for and makes complicated arrangements to place affected assets in a side-pocket of the same scheme. Either way, in order for it to be effective, the creditor parties to a standstill agreement should agree either not to transfer any of their interest in the subject debt (which they will be naturally reluctant to do) or at least make any transferee subject to the agreement's provisions. Ideally, any transferee or assignee of the debt will be obliged to accede to the standstill agreement as a new party.

No contest

A properly drafted facility agreement will contain a Waiver provision to ensure that any delay by creditors in declaring the debt immediately due and payable (in banking parlance, *accelerated*) or enforcing a security interest over the borrower's assets, will not affect their ability to pursue remedies in future. Likewise, that waiving a particular breach or breaches does not constitute forgiveness of all or any defaults. Nevertheless, a standstill agreement should make it clear on its face that the borrower or issuer neither contests the occurrence or continuance of an event of default under the original agreement nor the creditors' right to accelerate the loan and enforce their security. Similarly, that creditors' rights are preserved throughout the standstill period. In other words, creditors are not relinquishing their right to collect on the debt and entitlement to go after the debtor's assets, but merely suspending them.

Time and tide

It follows therefore that creditors will agree to stand still for a finite period – six months or the end of a process of scheduled asset sales are common starting points. But how are creditors protected if the borrower's position worsens materially during the standstill period, or new events of default occur that are at least as serious as the instant ones? For this reason, distressed borrowers should expect standstill agreements to contain their own events of default. That suspended creditors will have their rights immediately restored should the debtor be subject to insolvency proceedings goes without saying. There is room here for a tailored approach with *ad hoc* events of default, for example, should the borrower fail to ensure that restructuring plans follow a timetable, scheduled asset disposals and / or cost cutting exercises are completed, management changes are made, further equity capital injected or other remedies of that kind employed. However, in the highly exceptional present circumstances, there are likely to be few cases when time allows for such delicate negotiation. Moreover, the hope is that most bank customers are experiencing a temporary liquidity shock from which they will bounce back quickly, rather than exhibiting symptoms of structural decline. Arguments that this is just a temporary blip aside, there is a case that in relation to certain industries, not least retail and travel, the current crisis has merely thrown more fundamental problems into sharp relief.

At a global level, one would expect most defaults in the near to medium term to be in the offshore oil and gas sector, as that with the highest levels of indebtedness. And we have already seen a number of restructurings in Ireland where the emphasis has been on reducing leverage. However,

when it comes to negotiating standstills with creditors of a high street fashion chains, one might anticipate slightly less emphasis on balance sheet repair and more on operational improvement. And for retail businesses of course, the single most important creditor can be the landlord. By the same token, we are already seeing a disproportionate widening of spreads on European commercial mortgage backed securities collateralized by portfolios of retail property.

Gilded tombs do worms enfold

Even or especially on the brink of signing a standstill agreement, banks and other creditors may feel that they are being asked to reach a compromise with far from perfect information. Accordingly, it should not be surprising to find a document with extensive borrower representations and warranties, especially in relation to up-to-date financial accounting, absence of adverse litigation, ownership of assets, maintenance of supply contracts, outstanding liabilities to tax and so forth.

The opposite side of this coin is that creditors can be horrified at the prospect of negotiated standstill terms reaching a wider audience. Adverse consequences can flow from the actions of secondary creditors emboldened by news of a generous accommodation with principal lenders. Perhaps worse, other customers could demand terms at least as favourable in respect of their own loans when this would be unwarranted.

The quality of mercy is not strain'd?

Creditors signing up to a standstill agreement expect a higher level of transparency and co-operation from borrowers than original lenders. Accordingly, it is not unusual to see extensive further assurance and inspection and consent rights provisions included in standstill terms. Typically, the agreement is bolstered by a covenant from the debtor to appoint an insolvency official of the company should it find itself in default of the standstill agreement.

As always where a creditor wishes to exercise a measure of control over its client's business, albeit remotely, care is required to avoid unnecessary and unwanted lender liability: Banks can land themselves in seriously hot water if the extent of their involvement in a borrower's business could be construed as acting as a 'shadow director'. Broadly, potential liability of a shadow director on insolvency is the same as that for individual appointed to the Board. The same goes, for example, for some corporate environmental and tax liabilities. Obviously, the appointment of a receiver or other insolvency official as mentioned above screens creditors, hence the desire for a receiver or examiner to spring into place. And of course the point could be moot if creditors taking voting stock and appointing representative Directors are conditions for the standstill remaining in place.

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