

## DO LENDERS INCREASE CREDIT RISK BY SECURING TOO MUCH?

Multi-lender loan packages may not treat all lenders fairly in default situation

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By R. Lee Vanderpool and Elizabeth R. Tabas Carson of Pepper Hamilton LLP. For more about the authors, see the end of this article.

Could securing all of a borrower's obligations actually increase the credit risk to its lenders?

Although this question may seem counter-intuitive, we maintain that expanding the scope of obligations secured under a credit agreement can potentially misprice the true credit risk to lenders and render it more difficult for them to recover their principal in a default scenario.

The objective of this article is to help lenders and counsel evaluate and address such risks when documenting financial transactions. (Editor's Note: Tell us if your bank has considered these issues and how you've addressed them, in the comment section at the conclusion of the article.)

### Scope of obligations

As lenders remain cautious in extending new credit, they have increasingly relied on the revenue streams generated from non-lending services that they provide to their borrowers. As a condition to new or continued credit, lenders often require that a borrower:

• Maintain all deposit accounts with them or their affiliates

• Conduct interest and foreign exchange hedging through them or their affiliates.

• Perform general banking and cash management services with them or their affiliates.

These are collectively referred to as "ancillary services";

Such packaging can help lenders price loans at or below market levels, by subsidizing lower margins on the loans. Loan/service packaging can also benefit borrowers by reducing their transaction costs (including the administrative burdens associated with multiple financing and banking arrangements) and increasing their negotiating leverage to obtain better pricing and larger credit facilities.

As lenders provide more ancillary services to a particular borrower, however, they also assume greater credit exposure to that borrower. To protect themselves from such increased exposure, lenders often require that the definition of obligations include not only the indebtedness and obligations arising under the credit agreement, but also amounts owing to the lenders and their affiliates in respect to ancillary services (called "ancillary obligations").

In a bilateral credit facility, the lender is the sole beneficiary of the collateral package, and therefore has every incentive to expand the scope of obligations secured by such a collateral package as broadly as possible.

In a club or syndicated facility, however, the security package is shared among multiple lenders. As a result, multi-lender credit agreements typically contain intercreditor arrangements in the form of a sharing clause and shortfall of proceeds waterfall.

- The sharing clause requires that the lenders share payments or recoveries among themselves on a pro rata basis.

- The waterfall provision dictates how amounts received either from the borrower or upon the liquidation of the collateral are to be allocated if such amounts are insufficient to satisfy the obligations in full.

The sharing clause and waterfall provision often do not distinguish between obligations to pay principal and obligations to pay for ancillary services, meaning that all obligations are *pari passu*. ("without preference")

While this may be acceptable to the lenders in principle, most credit agreements do not restrict the ability of the borrower to incur ancillary obligations. <sup>2</sup> If the borrower only solicits ancillary services from one or a few lenders in the syndicate, those lenders would then have a disproportionate share of the obligations, all of which would be treated on a *pari passu* basis.

An unintended expansion of obligations such as the one described above could be particularly problematic in an enforcement scenario.

Although a secured loan may be over-collateralized with respect to the obligations owing in respect of principal, the same security package may be insufficient if ancillary obligations are included. In determining whether to enter into a credit facility, lenders may attempt to be conservative in calculating the liquidation value of the collateral package relative to the size of such credit facility. Even conservative lenders may fail to account for the amount of ancillary obligations that can be incurred, however, resulting in a more highly-leveraged borrower and less-palatable recovery ratios.

### An illustration of the risks

By way of example, let us assume that a borrower enters into a \$50 million credit facility with five lenders, each of which has a commitment of \$10 million. The definition of "obligations" includes amounts owing to Lender A as the sole eligible provider of ancillary services, and the credit agreement treats all obligations on a pari passu basis.

After the borrower draws down on the entire facility, the market experiences a downturn, and the borrower defaults. Because the collateral is depreciating rapidly, the lenders elect to accelerate the obligations and enforce the security package, generating \$50 million in net proceeds.

So long as the obligations are limited to the \$50 million of outstanding principal indebtedness, the lenders in this scenario would be able to realize a 100% return on principal. 3

Let us assume, however, that at the time of the default the borrower also owed Lender A \$2 million for hedging obligations; \$1.5 million for an undocumented line of credit; \$1 million of corporate credit card debt; and \$500,000 in fees for cash management services. This comes to a total amount of obligations to \$55 million.

Because all obligations are treated pari passu under the waterfall, the \$5 million shortfall would be allocated ratably among the lenders.

The security agent would therefore pay approximately \$13,640,000 to Lender A (roughly 91% of the \$15 million owed to it by the borrower) and approximately \$9.09 million to each of the other lenders (roughly 91% of the \$10,000,000 owed to each of them by the borrower).

This example above is troubling for a number of reasons.

First, the credit agreement created a perverse incentive for Lender A to incur additional risk vis-à-vis the borrower. It did so by allowing it to spread such risk among the other members of the syndicate while retaining all of the benefits (in the form of additional fees and other payments) for itself.

Although Lender A unilaterally extended \$5 million of additional credit to the borrower, its losses were only \$450,000 greater than those of each other lender. Lender A's incentive to take on additional risk altered the basis on which the other lenders had initially decided to extend credit, resulting in their unexpectedly lower return.

Second, because most credit agreements do not require that lenders disclose the amount of ancillary obligations owed to them at any time, the lenders were unlikely to have even been aware of the amounts owed to Lender A in respect of Ancillary Obligations until they accelerated.

Even if they had been aware of such amounts, it is unlikely that they would have been in a position to restrict Lender A's ability to provide such ancillary services or attempt to protect themselves from new risk.

## How to account for risk

How, then, can lenders obtain the benefit of securing amounts owed to them without exposing themselves to unanticipated consequences?

### 1. Define "obligations" carefully.

Such definition may be tailored narrowly to include only indebtedness under the credit agreement, or it may provide for a degree of flexibility. If the lenders elect to include amounts owing under ancillary services, the scope of such ancillary services can be controlled in a variety of ways. (For example, by limiting secured hedging transactions to a certain percentage of the principal indebtedness outstanding or limiting credit card debt to a certain cap.)

### 2. Consider who will be eligible to offer ancillary services.

The credit agreement may allow any lender to provide such services, either directly or through affiliates, or it may restrict such activities to one or several lenders. Even if all lenders are able to provide cash management, credit card, and other services on a secured basis, however, lenders should keep in mind that the borrower may choose to deal with just one lender, resulting in a skewed allocation of obligations in favor of that lender.

Furthermore, even if the borrower conducts ancillary services with all or several lenders, there is often no requirement that it do so on a pro rata or other basis, meaning that those lenders who incurred fewer ancillary obligations may still be required to bear part of the burden following an event of default.

In order to provide greater visibility as to the size and scope of ancillary obligations owed to different parties from time to time, lenders may wish to require periodic accounting or consultation among the lenders with respect to their respective Ancillary Service packages.

### 3. Determine whether ancillary obligations should be paid out in the waterfall on a pari passu basis with other obligations.

• Lenders can require, for example, that obligations in respect of principal be paid in advance of ancillary obligations.

• Alternatively, the lenders may agree that certain alternative obligations (such as hedging obligations related to hedging interest on the loans), or a capped amount of alternative obligations, will be paid pari passu with the principal obligations, with the remainder paid on a second-ranking basis.

Such a tiered structure would give additional security to the lenders providing Ancillary Services with reduced risk to those lenders that either refrain from doing so or are not eligible to do so.

#### Where to go from here

Lenders should weigh business as usual carefully in this regard. True, there are evident benefits to expanding the scope of obligations to gain greater coverage from the available collateral package. However, lenders and their counsel should carefully consider the hidden implications of doing so when assessing their true credit risk and drafting the underlying credit agreement.

Failure to evaluate such risks properly when participating in loan facilities or documenting loan agreements may result in unanticipated losses that could otherwise be avoided.

When it comes to securing one's obligations, less can be indeed be more.

#### Footnotes

1 In certain credit agreements, the scope of obligations includes ancillary services provided by non-lender affiliates. Lenders and their counsel should consider whether such rights are enforceable by such affiliates insofar as they are not signatories or explicit third-party beneficiaries to the credit agreement.

2 Most credit agreements, in fact, specifically carve out obligations from the negative covenants on indebtedness.

3 Note, however, that there would still be a shortfall in this scenario for interest, fees, and other amounts owed in respect of principal.

4 The example above assumes that the loan was already fully syndicated and drawn, but lenders should also consider

how the definition and treatment of obligations might impact their ability to syndicate loans for the reasons expressed above.

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