RECENT ENGLISH HIGH COURT DECISION REAFFIRMS POWERS OF MAJORITY LENDERS: MINORITY INVESTORS SHOULD TAKE CARE

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To Our Clients and Friends:

Earlier this month, in a decision[1] that will disappoint minority lenders in English-law facility agreements, the English High Court held that lenders holding a majority of debt were able to withdraw a previously delivered notice making a debt payable on demand, without the consent of the minority lenders. Notably, affiliates of the private equity sponsor of the borrower had purchased the majority interest. In the same decision, the court held that the borrower could cure a violation of the interest cover covenant in the loan document by incurring additional debt from within its corporate group, without injecting new capital. The court also rejected an argument from a disgruntled minority lender that a default had occurred because the debtor, a Luxembourg entity, was insolvent under English law, the court holding instead that the Luxembourg legal standard of insolvency should apply, even though the loan agreement was governed by English law. Taken together, the holdings demonstrate that English courts remain generally willing to uphold the powers granted to majority lenders under an English-law facility agreement even where the majority lenders are connected with the equity sponsors. Accordingly, private equity sponsors and minority lenders should evaluate at the outset what the implications could be of majority voting provisions in English-law facility agreements, particularly in a future distressed situation.

In the case, a Luxembourg borrower (the "Company") entered into a facilities agreement, under which three entities constituted the majority lenders. Following a breach of the Company's financial covenants, the facility agent, on the instruction of the majority lenders, sent a notice to the Company stating that the Company was in breach and that the facilities were to be placed on demand. The majority lenders subsequently sold their interests to two companies affiliated with the sponsor of the Company. The new majority lenders then instructed the facility agent to withdraw the notice and to waive any breaches of the financial covenants.

Following this, Strategic Value Master Fund ("SVMF"), a minority lender, brought an action against the Company (and the sponsor affiliates) claiming that the purported withdrawal of the notice and waiver were ineffective. SVMF argued that the withdrawal of the notice was

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[1] *Strategic Value Master Fund Ltd v Ideal Standard International Acquisition S.à.r.l. & Others [2011] EWHC 171 (Ch)*

an amendment or waiver of a term of the facilities agreement, and moreover the withdrawal related to the extension of the maturity of the commitment of a lender, which under the facilities agreement required unanimous lender consent.

The court considered the distinction between the waiver of a right and the waiver of a term. The facilities agreement, as is common in syndicated loan agreements using the Loan Market Association forms, distinguished between waivers of breaches, events of default, rights and remedies, and terms. The court concluded that the majority lenders had not waived or amended a term of the facilities agreement by waiving their rights and withdrawing the notice, and that thus the majority lenders could return the loan to its original payment requirements without unanimous consent.

In addition, SVMF disputed whether the acknowledged breach by the Company of an interest cover covenant had been cured, as argued by the Company and its sponsor. The sponsor had "round-tripped" funds within the Company's group to cure the interest cover violation, in essence by rearranging intra-group debt but not injecting any "new money". The court held that this was permissible under the loan documentation, which did not require new money in these circumstances.

Finally, SVMF argued that the Company was insolvent within the meaning of the English Insolvency Act 1986, because the value of its assets was less than the value of its liabilities, and that thus there was an existing default under the facilities agreement, which provided that insolvency under any applicable law was an event of default. Despite the facilities agreement being governed by English law, it was held that the English-law balance sheet test of insolvency was not relevant for the purposes of the facilities agreement. The "applicable law" is generally the jurisdiction of incorporation (in this case, Luxembourg), but may also include the law of any jurisdiction with the power to wind a company up or to initiate equivalent procedures. The law chosen to govern the documentation, however, may not be "applicable" in this sense.

The case is of particular interest because the High Court closely analyzed several provisions commonly found in syndicated loan agreements. The decision highlights the importance of careful consideration by potential lenders, especially if they will hold a minority position, of what their rights will be if a company goes into distress. For example, if negotiating an equity cure provision, the parties should discuss whether new money should be required to cure an interest cover covenant breach. Similarly, if the parties wish particular insolvency criteria (such as those set forth in the English Insolvency Act) to constitute an event of default, they should specify those criteria in the loan documentation. In respect of the withdrawal of the notice by the new majority lenders who were affiliated with the beneficial owner of the Company, it is notable that the Loan Market Association standard form

facilities agreement for leveraged financings now includes restrictions on the voting rights of sponsor affiliates.

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Please do not hesitate to get in touch with us if you have any questions or wish to discuss the implications of this decision in more detail.

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