

# The Defaulting Lender in Today's Loan Market

By Nicholas A. Whitney and Douglas R. Plante

Volatile markets often highlight underlying risk factors and force market participants to re-examine cherished assumptions. The business of lending has historically focused on a borrower's credit risk. Today, in a credit market turned upside down, borrowers must analyze lender credit risk as well. In a credit agreement the risk of a defaulting lender is from a legal perspective a borrower's risk, but the practical effects of a "failure to fund" by a syndicate member affect not only the defaulting lender but the borrower, the administrative agent and the defaulting lender's potential assignees. This memorandum addresses the issues that may arise when a lender fails to fund its revolving commitment under a credit agreement.

## Background

Credit agreements provide that a borrower initiates the draw of a revolving loan by delivering a borrowing notice to the facility's administrative agent. The administrative agent notifies each revolving lender of the borrower's request, and within a few days of that notice, each revolving lender is required to fund to the administrative agent its "pro rata share" of the requested revolving loan pursuant to that revolving lender's agreed upon revolving commitment. The administrative agent then collects funds from the syndicate members and funds the revolving loan into the borrower's account.

Each lender's commitment to make a revolving loan under the credit agreement is a separate "several" obligation of that lender. If a lender fails to fund its pro rata portion of the requested borrowing (a "Defaulting Lender"), then (i) no other lender is responsible for the failure of the Defaulting Lender to fulfill its revolving commitment, (ii) the Defaulting Lender's failure to fund its pro rata share of the requested revolving

loan will not relieve any other lender of its commitment to fund its pro rata share of the requested revolving loan and (iii) the borrower will not be relieved of any of its obligations under the credit agreement.

## Consequences of a Defaulting Lender's Failure to Fund

Despite the fact that the rights and obligations of the borrower and the non-defaulting lenders continue uninterrupted after a failure to fund by a Defaulting Lender, the consequences of such failure can be quite harsh for the Defaulting Lender. In most cases, a Defaulting lender is stripped of certain of its rights under the credit agreement. Defaulting Lenders may (i) be prohibited from voting on amendments and waivers – even amendments to "fundamental rights" such as a decreases in interest rates, waiver of payments, etc., (ii) lose rights to receive their ratable share of voluntary or mandatory prepayments or commitment reductions made by the borrower and (iii) forfeit any commitment fee paid in respect of its revolving commitment.

## Borrower Recourse against a Defaulting Lender

Borrowers generally remain obligated to fully perform all of their obligations under a credit agreement, even when there is a Defaulting Lender. Borrowers protect themselves against Defaulting Lenders through the "yank-a-bank" provision contained in most credit agreements. Yank-a-bank provisions permit the borrower to replace a Defaulting Lender with a new lender that is ready and willing to assume the obligation to fund the Defaulting Lender's revolving commitments and outstanding revolving loans via an assignment.

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## Memorandum

October 9, 2008

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As a practical matter, even with the legal protection of the yank-a-bank provision, it may be very difficult for a borrower to find a lender willing to assume the Defaulting Lender's revolving commitments and outstanding revolving loans in the current credit environment. Yank-a-bank provisions typically require the borrower to replace the Defaulting Lender at par, but it is unlikely that the borrower will find a replacement lender willing to purchase the Defaulting Lender's revolving commitment and outstanding revolving loans at par in the current credit environment. A borrower may try to avoid paying amounts owed to the Defaulting Lender by exercising a common law right to set off amounts "owed to" the Defaulting Lender against the amounts "owed by" the Defaulting Lender in connection with the funding obligation under the revolving commitment. However, the "lender-friendly" contractual setoff provisions contained in a credit agreement generally apply only to amounts that a borrower owes to a lender and rarely to amounts owed by a lender to a borrower. Of course, a borrower may pursue a breach of contract claim against a Defaulting Lender if the loss resulting from the failure to fund is quantifiable and litigation is warranted.

### **Administrative Agent Recourse against a Borrower**

As a general rule, an administrative agent may, acting on the assumption that all of the syndicate members will fund their ratable share of the requested revolving loan, fund the full amount of the revolving loan to the borrower prior to actual receipt of each lender's pro rata share of the requested borrowing. If an administrative agent funds the full borrowing request and a lender subsequently defaults on its commitment to fund its pro rata share of the borrowing request, the administrative agent's ultimate recourse is against the borrower and not the Defaulting Lender. Promptly upon a demand to the borrower, the borrower must return the defaulted amount to the administrative agent, together with interest accruing from the borrowing date through the date of repayment. Interest payable to the administrative agent typically

accrues at the prime rate, known as "ABR" or "Base Rate" under the credit agreement. If the borrower fails to repay the defaulted amount to the administrative agent, the administrative agent may exercise its right of setoff against any obligations (including future funding obligations) that the administrative agent may owe to the borrower.

### **Purchasing a Loan from a Defaulting Lender**

Purchasing a loan from a Defaulting Lender in the secondary market (as part of the yank-a-bank framework, or otherwise) creates a number of risks for a purchaser. The most basic issue is whether the Defaulting Lender's loan will be considered by the market to be "impaired" in comparison with the other loans outstanding under the credit agreement. Will a purchaser be required to fund the borrowing not funded by the Defaulting Lender? Will the borrower and the administrative agent agree that no right of setoff or other remedy will be exercised against the purchaser of the loan?

In addition to obtaining comfort from the borrower and the administrative agent that no claims will be asserted against the purchaser of the loan, prudent purchasers will seek an indemnity from the selling Defaulting Lender. If a purchaser purchases the revolving commitment and any outstanding revolving loan on distressed documentation, the Defaulting Lender will be required to represent and warrant that (i) it has complied with and performed all obligations under the credit agreement and (ii) it has not been engaged in any act or conduct (or made any omissions) that will result in the purchaser receiving less in payments or distributions than received by other lenders. Significantly, no such protection exists for a purchaser that purchases loans pursuant to standard par documentation.

### **Conclusion**

Credit agreements assume all lenders will honor their several commitments to fund a loan once the conditions to a borrowing are satisfied. Most credit

agreements also contemplate the possibility of a lender defaulting on its commitment. Defaulting Lender provisions attempt to provide the borrower and the administrative agent with rights against the Defaulting Lender. However, the provisions were designed for another time. In today's market, a borrower's ability to exercise rights to replace a Defaulting Lender at par may be difficult and unlikely in the current credit environment. We expect greater clarity with regard to these issues as the Defaulting Lender provisions in credit agreements are applied in the context of the current secondary market conditions.

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

**Nicholas A. Whitney**

New York, NY  
212 530 1956  
nwhitney@rkollp.com

**Douglas R. Plante**

New York, NY  
212 530 1804  
dplante@rkollp.com

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