CHANGE OF CONTROL: WHERE FINANCE AND LEGAL MEET

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Changes in the ownership or control of a borrower's business can affect the borrower's financing in a variety of ways. How can borrowers protect themselves against far-reaching Change of Control clauses? This article discusses the main characteristics of such Change of Control provisions.

A Change of Control clause is a standard provision in financing documentation. While the contents of the provision may vary from case to case, its implications can be board-room topics. In this contribution we will discuss what a Change of Control clause is, why it exists, what the role is of the in-house legal counsel, and what borrowers should consider before accepting a Change of Control clause in its financing documentation. Whereas this contribution is based on the Loan Market Association's standard financing documentation, our conclusions are also applicable to other commonly used financing documentation.

What is Change of Control clause?

There is no standard definition of Change of Control. In most transactions, however, it involves a direct or indirect change in the control structure or ownership of a company, such as when:

- a specific or ultimate legal and/or beneficial owner no longer 'controls' the borrower;
- a person or a group of persons acquires 'control';
- there is a change to the composition of the board of directors; and/or
- there is a change in the shareholders who have the right to elect a certain portion of the board of directors.

The definition used in a transaction will depend on the type of transaction, the chosen transaction structure, the corporate structure of the group to which the borrower belongs and the type of lenders.

Why do Change of Control clauses exist?

Lenders usually have strict internal know-your-customer and credit approval procedures to follow. In most cases, a lender's willingness to provide a loan will depend not only on the borrower's business, but also on its direct and indirect shareholder(s). For this reason, lenders wish to protect themselves against changes in the borrower's control structure and ownership. A Change of Control clause allows them to do so.

A Change of Control clause often includes a requirement to seek the lender's approval for a Change of Control, a right for the lender to terminate its commitment and/or demand immediate repayment of the financing in the event of an unauthorized Change of Control.

A Change of Control restriction can be agreed at different levels within a group structure: at the level of the borrower, at the level of an intermediate holding company or at the level of the top holding company. In each case, a Change of Control restriction has different consequences. If the intention is to separate the borrower's financing from that of the business unit to which the borrower belongs, the Change of Control clause is best agreed at the level of the borrower itself. However, if flexibility is required for internal relocations or reorganizations, an indirect Change of Control at the intermediate or top holding company level may be a better choice. Planned sales/divestments to third parties are a totally different ballgame and may call for an entirely different approach.

The importance of the borrower's in-house Legal Counsel

Especially in complex corporate structures, the borrower's in-house legal counsel has a crucial role. Future restructurings or Change of Control transactions are often prepared in secrecy. Besides the board of directors of the top holding company, often only the general and specific legal counsels within the group have a complete overview of such transactions, whether a Change of Control will take place in the (near) future and at what level.

In addition, the general and/or legal counsel is also often best placed to monitor cross-defaults of Change of Control clauses between different financing documents within the group. Such clauses should be strictly monitored and, if necessary, coordinated with the lenders.

This is illustrated by a recent case from our practice: a borrower had entered into a financing agreement to which the top holding company in its group was not a party. The top holding company then applied for Covid-19 financial support from the government. As a condition for that support, the top holding company's shares were pledged. Enforcement of the right of pledge on the top holding company's shares would result in an (indirect) Change of Control under the borrower's financing documentation.

Consequently, the borrower was forced to ask for a waiver from the lenders, before the application for the governmental support could be finalized.

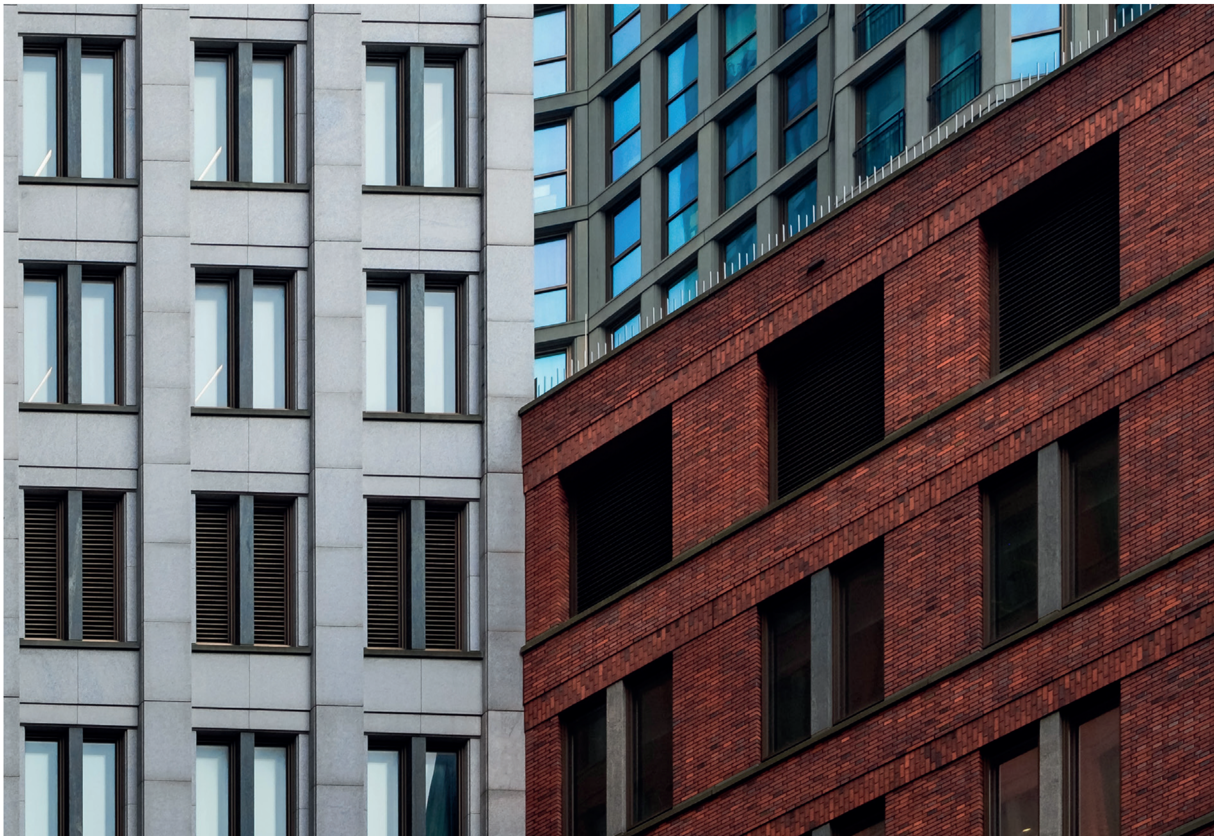
Important considerations

1. A Change of Control clause is usually included in the Prepayment and Cancellation provision and/or in the Events of Default clause. For a borrower, the first option is usually preferable. In principle, the occurrence of an Event of Default results in the possibility of accelerating the financing, i.e. declaring it due and payable on demand. Additionally, a cross-default clause (an Event of Default) can also trigger defaults under other financing or debt documentation. The financing and/or debt under that other documentation would thereby also become due and payable.

2. We list four options for the borrower for when the Prepayment and Cancellation clause provides for a Change of Control:

   First, a Change of Control could result in the cancellation of lenders' commitments. This prevents a borrower from making any more utilisations under the credit facility(ies). It is recommended to consider whether certain loans should be allowed to roll over at all times (often Rollover Loans) and thus specifically excluded from the Change of Control clause.

   Second, in the case of club or syndicated financings, a distinction can be made between mandatory prepayment, the power to cancel commitments and/or the power to approve the planned Change of Control by all lenders collectively, or only by the lender who does not agree to the Change of Control. Furthermore, those powers could be granted to the facility agent or the majority lenders. For reasons of efficiency, a borrower should strive for as few parties as possible. One should also carefully consider the term during which the relevant parties must confirm their position regarding the aforementioned prepayment, cancellation of commitments and/or approval. For the borrower, a short term is important, as this could otherwise negatively affect the progress of the potential transaction causing the Change of Control. With respect to an approval requirement of the Change of Control provision and the know-your-customer requirements of financial institutions, the conclusion in most cases is that all lenders must agree to an intended Change of Control.



Third, it is important for a borrower to agree on the longest possible notice period or period for mandatory prepayments after a Change of Control has occurred. Within that period, the borrower may be able to attract new financings to minimize any financially adverse consequences of the termination.

Finally, an obligation on all parties to consult with each other about the continuation of the financing and the conditions that the lenders want to attach to the Change of Control transaction could be considered. The period for these consultations could be linked to the aforementioned (as long as possible) period.

3. There are a number of arguments to be made against a far-reaching Change of Control clause, such as (a) that the borrower has no control over the identity of its shareholders; (b) that the borrower is not (always) aware with whom the shareholders discuss and (c) that it is difficult for the board of directors of a borrower to determine whether a Change of Control clause serves the interests of the company or contributes to the success of a business because it takes place outside the (realm of the) company and has far-reaching (financial) consequences. Please note that the Dutch Corporate Governance Code could also be relevant in this respect.

4. There are often opportunities for carve-outs to a Change of Control clause which are less disruptive to the business, such as allowing share issuances to current investors or disposing of a management participation plan within the borrower's group.

Conclusion

Change of Control restrictions can pose severe challenges. Dexterity and good analysis in the application of such provision can add greatly to a group's financial and corporate flexibility. If you have any questions in relation to a change of control clause, please contact Martijn van der Vliet, Paul van de Ven or one of our other banking law specialists.

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