

ICT SERVICES AGREEMENT SCHEDULES

SCHEDULE 7.4

FINANCIAL DISTRESS

NOTE FOR USERS OF THIS SCHEDULE

Guidance users should note that this Schedule (7.4) is currently under review and is expected to be revised for publication of Version 2.2. In the interim period, the current drafting and guidance contained in Version 2.1 continues to represent UK government policy and should therefore be applied as before.

In the event that an Authority wishes to make material changes to the current drafting, it should contact the Guidance Help Desk via the Partnerships UK guidance website:

<http://www.partnerships.uk.org/ictguidance>

This will help to ensure that OGC and PUK are able to monitor, and learn from, the continuing application of the Schedules and also advise the Authority on any revisions being considered.

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Section A

Product Description

1. PRODUCT TITLE

ICT Services Agreement - Schedule 7.4 (Financial Distress)

2. PURPOSE OF SCHEDULE

The schedule should set out the terms and conditions for dealing with Contractor financial distress in business critical or major projects. It should set out the circumstances giving rise to financial distress and the steps which the Authority can take in response.

3. COMPOSITION

- Assessment of credit rating
- Assessment of risk levels and trigger events
- Remedies available to the Authority upon the occurrence of trigger events

4. DERIVATION

- Authority Requirements
- Bidders proposal

5. RELATED CLAUSES AND SCHEDULES

Clauses: 55 (Termination Rights)

Schedules: 4.4 (Approved Sub-Contractors)

7.1 (Charges and Invoicing)

7.2 (Payments on Termination)

8.5 (Exit Management)

Guidance: Guidance Note 1 (Key Commercial Principles), section 1 - 11 (Financial Distress)

6. ALLOCATION

Standard schedule for the Authority to submit to bidders as part of the ITT. Certain blanks in the schedule to be populated from the bid provided by bidders.

7. QUALITY/REVIEW

Authority Expertise: procurement / commercial, legal, financial

Section B

Guidance

1. INTRODUCTION

- 1.1 The purpose of having financial distress provisions in the Agreement is to provide for circumstances in which the Contractor or the group of which it may be a part is subject to deteriorating financial conditions although is not insolvent. As a result, the Contractor might not be able to fund its activities, introduce changes to the Services or pay sub-contractors whose roles are vital to the successful delivery of the Services.
- 1.2 As guidance, the financial distress provisions need only necessarily be applied where:
 - 1.2.1 the total contract value is likely to exceed [£50m]; or
 - 1.2.2 the services to be provided under the contract are vital to the Authority meeting its statutory duties.

2. FINANCIAL RATING

- 2.1 It is important that consideration is given to the financial status of both the Contractor and the group to which the Contractor is a subsidiary company (if appropriate). Assessment of the group may be more pertinent given that it is common for groups to move funds out of financially strong subsidiaries to parts of the group that are in financial difficulty. Further, if a Guarantee is put in place then the financial status of the Guarantor may also need to be monitored.
- 2.2 Credit rating hurdles are specified in the Part C and should not be subject to negotiation, except in exceptional circumstances and after informing HMT/OGC Supplier Relations Division.
- 2.3 The schedule should also define the Contractor's financial position at the start of the project by reference to a credit rating. If the Contractor does not have a published credit rating (not all companies do), the Authority will have to measure the financial health of the Contractor either by commissioning an independent private rating or by reference to some agreed financial ratios (further guidance on the use of independent private ratings is due to be produced later in 2006). Financial ratios, if used, will be

drawn, in the first instance, from the most recent published accounts of the Contractor (or the Contractor's holding group company, as appropriate) at the time of contract award and will be certified by the Contractor's auditors. Such financial ratios will include Net Total Interest Cover Ratio, the Total Net Debt to Earnings (EBITDA) Ratio or the Free Cash Flow Debt Service Ratio.

- 2.4 Where financial ratios, are required the hurdle levels for each ratio can only be set on a company by company basis at the appropriate time (either at contract award or subsequently if the Contractor ceases to have a credit rating). The Authority will need expert financial advice to specify these ratio hurdle rates and the effect of the hurdle rates should be that they are a reasonable proxy for each of the credit rating hurdles.
- 2.5 Where ratios are required, the Authority should ask the OGC whether the Contractor has agreed similar ratios under any other contract with HMG within the last [6 months]. In this case, the Authority's financial advisor should determine whether these hurdles are still appropriate in current trading conditions. Similarly, when the Authority has completed the negotiation of the ratio hurdles, it should notify the OGC so that other Authorities might benefit from this work.

3. LEVELS OF FINANCIAL DISTRESS

The financial distress provisions identify three escalating levels of "financial distress" for a Contractor. Each level of distress will attract increasing levels of transparency of the Contractor's position and a set of escalating remedies designed to keep the project "solvent" until either the Contractor ceases to be in "financial distress" or the Agreement is terminated.

First level of financial distress

- 3.1 At the first level of financial distress, the Contractor must notify the Authority promptly and meet to: (i) discuss continued performance of the Services; and (ii) find a solution to ensure the performance of the Services in a manner that is satisfactory to both parties, if any of the following events occurs:
- 3.1.1 the Contractor's or its parent company's credit rating drops below investment grade (i.e. the grade given by one of the rating agencies);

- 3.1.2 the Contractor or its parent company issues a trading update that includes a profits warning to a stock exchange or makes any other public announcement about material deterioration in its financial position or prospects;
 - 3.1.3 there is a public investigation into improper financial accounting and reporting, suspected fraud or other impropriety of the Contractor or its parent company; and/or
 - 3.1.4 the Contractor commits a material breach of covenants to its lenders.
- 3.2 The Authority has a right to terminate the Agreement if the Contractor fails to notify it as specified above or if the Authority is not satisfied with the Contractor's plans to ensure continued performance of the Services.

Second level of financial distress

- 3.3 This stage deals with further decline in the Contractor's financial health and with the setting up of a joint bank account in the name of the Authority and the name of the Contractor, at the expense of the Contractor and with a bank approved by the Authority. The Authority should seek the OGC's advice in relation to the criteria that need to be applied in selecting the relevant banking institution before establishing the escrow account.
- 3.4 If any of the following events occurs:
- 3.4.1 the Contractor's or its parent company's credit rating falls below a specified threshold;
 - 3.4.2 the Contractor or its parent company do not have a credit rating from one of the rating agencies (or they cease to have a credit rating) and there is an adverse decline in the financial ratios below a specified level; and/or
 - 3.4.3 a material sub-contractor complains to the Authority of non-payment by the Contractor. The Contractor will have the opportunity to rectify this situation promptly or demonstrate that the claim by the sub-contractor was inaccurate,

then the Contractor must do the following:

- 3.4.4 set up an escrow account into which the Authority will pay any Charges due to the Contractor under the Agreement. These monies will then be released into the Contractor's general bank account only after material sub-contractors have been paid. Payment to sub-contractors will be demonstrated by monies being paid directly from the escrow account for valid invoices or an officer of the Contractor warranting that such payments have been made from the Contractor's general account;
 - 3.4.5 provide the Authority with all the financial information that it requires; and
 - 3.4.6 where appropriate, establish suitable credit support arrangements to support such payments, such as bank guarantee.
- 3.5 A subsequent improvement in the Contractor's financial position for a period of at least six months may allow the Contractor to receive monies direct rather than through the escrow account.
- 3.6 The Contractor's failure to comply with its obligations set out above gives the Authority the right to terminate the Agreement.

Third level of financial distress

- 3.7 The third level of financial distress deals with further adverse decline in the financial position of the Contractor.
- 3.8 any of the following events occurs:
- 3.8.1 the Contractor's or its parent company's credit rating decreases substantially below a specified level;
 - 3.8.2 the Contractor or its parent company does not have a credit rating issued by at least one of the rating agencies, or it ceases to have a credit rating and there is further adverse decline in financial ratios;
 - 3.8.3 there is commencement of any litigation with respect to financial indebtedness or obligation under a service contract, non payment of any financial indebtedness, any financial indebtedness becoming due as a

result of an event of default, the cancellation or suspension of any financial indebtedness,

then the Contractor must:

- 3.8.4 arrange for its auditors to inform the Authority promptly on the occurrence of any such events as set out above, taking account of stock exchange regulations where necessary;
- 3.8.5 arrange for its Chief Financial Officer to update the Authority on a monthly basis; and
- 3.8.6 instruct the bank where the escrow account is held to retain in that escrow account, for the Authority's benefit, a substantial part of the Charges (as specified by the Authority and after making payments to sub-contractors) paid into the escrow account for six consecutive months.

The amount retained in the escrow account at any point in time should not be more than six months worth of Charges. If the Authority terminates the Agreement for Contractor breach or insolvency, the amount retained in the escrow account can be used by the Authority towards the cost of re-procuring the Services and towards any compensation due.

- 3.9 The Contractor may be entitled to recover money retained in the escrow account if the financial ratios/credit rating improves for at least six consecutive months.
- 3.10 In addition to the obligations set out above, the Contractor should also provide the Authority with a plan setting out how the Contractor will ensure the continuity of the provision of the Services in the event that the Contractor (or its parent company) becomes insolvent.

Section C

Pro-forma/Example schedule

4. BACKGROUND

This schedule provides for the assessment of the financial standing of the Contractor and the establishment of trigger events relating to changes in such financial standing which if breached will have specified consequences.

5. CREDIT RATING

5.1 The Contractor warrants and represents to the Authority for the benefit of the Authority that as at the Effective Date the long term credit rating issued for the Contractor and its [holding company] (as defined in sections 736 and 736A of the Companies Act 1985) by [complete] was [complete], for [complete] was [complete], and for [complete] was [complete].

[Guidance: Examples of the types of company's which can be used to measure credit ratings include Standard and Poor's, Moody's and Fitch..]

[Guidance: Where no rating is provided by one of the recognised ratings agencies then an appropriate financial ratio test will need to be developed. Such tests could relate to any of the following for the Contractor or its holding company: net total interest cover ratio, the total net debt to EBITDA ratio and/or the free cash flow debt service cover ratio.]

5.2 The Contractor shall regularly monitor the Contractor's and its [holding company's] credit ratings with [complete] and shall report promptly (and in any event within three (3) Working Days of the relevant event occurring) to the Authority any downgrading or upgrading of the Contractor's or the [holding company's] credit rating.

5.3 Where neither the Contractor nor its [holding company] has a credit rating or ceases to have such rating, the Contractor shall ensure that its auditors calculate [complete] either [at the end of each [Contract Year]] or [for the last Contract Year in which a credit rating was available] *[Guidance: as appropriate]*.

6. RISK LEVELS

6.1 [The Contractor shall, from time to time, consider its risk level against the criteria specified in the table below. If any event occurs at any time which will [(or may)] trigger a change in the risk level of the Contractor from that existing as at the Effective Date (and for the avoidance of doubt the parties agree that the risk level of the Contractor at the Effective is [nil]) or any risk level applicable to the Contractor from time to time then the Contractor will immediately notify the Authority in writing.]

6.2 If any one or more of the factors specified against each risk level apply then the Contractor shall be determined as having that risk level. For the avoidance of doubt, the risk level shall be determined to be the highest risk level indicated in respect of at least one of the factors.

Risk Level			
	1	2	3
Credit rating	The Contractor or its [holding company's] credit rating drops below [] [<i>Guidance: This is intended to refer to Investment grade – that is, rated at “BBB” by Standard and Poor’s or Moody’s</i>]	(i) The Contractor or its [holding company's] credit rating falls below []; or (ii) The Contractor or its [holding company] do not have a credit rating from one of the rating agencies (or they cease to have a credit rating) and there is an adverse decline in the financial ratios below a specified level	(i) The Contractor's or its [holding company's] credit rating decreases substantially below []; or (ii) The Contractor or its [holding company] does not have a credit rating issued by at least one of the rating agencies, or it ceases to have a credit rating and there is further adverse decline in financial ratios
Profit warning	The Contractor or its [holding company] issues a profits warning to a stock exchange and the Contractor fails to promptly (which in any event shall not be more than ten (10) Working Days) demonstrate to the Authority that the profit warning relates to a general reduction in trade in the relevant industry sector and that it will not result in the Contractor becoming unable, within the next 12 months, to		

	pay the Sub-contractors.		
Public investigation	There is a public investigation into improper financial accounting and reporting, suspected fraud or other impropriety of the Contractor or its [holding company]		
Breach of lenders covenants	There is a material breach by the Contractor or its [holding company] of covenants to its lenders		
Non payment of a Material Sub Contractor by the Contractor		A [material] Sub-contractor complains to the Authority of non-payment by the Contractor and the Contractor fails to rectify this situation promptly (which in any event shall not be more than ten (10) Working Days) or demonstrate that the claim by the Sub-contractor was inaccurate	
Commencement of financial indebtedness litigation against the Contractor or its [holding company]			Commencement of any litigation against the Contractor or its [holding company] with respect to financial indebtedness or obligation under a service contract, non payment of any financial indebtedness, any financial indebtedness becoming due as a result of an event of default, the cancellation or suspension of any financial indebtedness

[Guidance: The Authority should consider on a case by case basis as to whether further tests should be included. Examples of other tests which could be included are: (i) listing specific levels of a specific credit rating against each of the risk levels; (ii) movement in specific credit ratings by specified amounts; (iii) levels of liquidity; (iv) levels of profit margin; (v) gearing level]

7. REMEDIES

7.1 In the event that the risk level of the Contractor is set at either 1, 2 or 3 then the following consequences shall apply.

Risk Level - 1

7.2 If the risk level of the Contractor is determined to be one (1) then the Contractor shall notify the Authority promptly and meet with the Authority to:

7.2.1 discuss continued performance of the Services; and

7.2.2 find a solution to ensure the performance of the Services in a manner that is satisfactory to both parties.

7.3 If:

7.3.1 the Contractor fails to notify the Authority as specified in paragraph 7.2 above; or

7.3.2 the Authority is not satisfied (acting reasonably) with the Contractor's plans to ensure continued performance of the Services,

then the Authority shall be entitled to treat such event as an adverse financial event which may have a material affect on the provision of the Services for the purposes of clause 55.1.5.8(b) (Termination for Cause by the Authority).

Risk Level - 2

7.4 If the risk level of the Contractor is determined to be 2 then:

7.4.1 the Contractor shall provide the Authority with all the financial information that it reasonably requests;

7.4.2 the Contractor shall set up a joint escrow account (the "Escrow Account") in the name of the Contractor and the Authority with a reputable bank reasonably acceptable to the Authority. Any interest which accrues on any amounts in the Escrow Account shall (subject to paragraphs 7.6 and 7.9 below) be apportioned to the Contractor and any penalties or charges incurred or overdraft in respect of the Escrow Account shall be the sole responsibility of the Contractor who shall promptly pay such penalties or charges and repay such overdraft in full; and

7.4.3 the Authority will pay any Charges due to the Contractor under the Agreement into the Escrow Account and such monies will only be

released into the Contractor's general bank account after the Contractor has demonstrated to the satisfaction of the Authority that its [material] Sub-contractors have been paid. Payment to [material] Sub-contractors will be demonstrated by monies being paid directly from the Escrow Account for valid invoices or an officer of the Contractor warranting that such payments have been made from the Contractor's general account.

7.5 A subsequent improvement in the Contractor's financial position for a period of at least six consecutive months shall allow the Contractor to receive monies direct rather than through the Escrow Account.

7.6 If:

7.6.1 the Contractor fails to comply with its obligations as specified in paragraph 7.4 above; or

7.6.2 [the Authority is not satisfied (acting reasonably) with the Contractor's plans to ensure continued performance of the Services,]

then the Authority shall be entitled to treat such event as an adverse financial event which may have a material affect on the provision of the Services for the purposes of clause 55.1.5.8(b) (Termination for Cause by the Authority) and the Authority will be entitled to withdraw the balance of any Charges in the escrow account as payment for any amounts owing to the Authority together with any interest which has accrued on those amounts and retain such amounts for itself.

Risk Level - 3

7.7 If the risk level of the Contractor is determined to be 3 then the Contractor shall:

7.7.1 arrange for its Chief Financial Officer to update the Authority as to its financial standing on monthly basis;

7.7.2 provide the Authority with a plan setting out how the Contractor will ensure the continuity of the provision of the Services in the event that the Contractor [(or its holding company)] becomes insolvent; and

7.7.3 instruct the bank where the Escrow Account is held to retain in that Escrow Account for the benefit of the Authority such part of the Charges

as the Authority shall specify (which the parties acknowledge shall be a substantial part of the Charges after making payments to Sub-contractors and) for six consecutive months.

[Guidance: Other remedies which may be relevant include: (i) Increased levels of monitoring of the performance of the Contract with / without passing on the cost of such monitoring to the Contractor; (ii) Seconding Authority staff to shadow Contractor staff; (iii) Linking risk levels to the step in provisions; (iv) Requiring the Contractor to provide an on-demand bank guarantee; (v) Allowing the Authority to purchase any assets used by the Contractor in the provision of the Services; (vi) Linking levels of risk to release of source code from escrow; and (vii) Allowing the Authority to solicit staff from the Contractor.]

7.8 A subsequent improvement in the Contractor's financial position for a period of at least six consecutive shall allow the Contractor to receive monies direct rather than through the Escrow Account and also entitle it to receive any balance remaining in the Escrow Account.

7.9 If:

7.9.1 the Contractor fails to comply with its obligations as specified in paragraph 7.7 above; or

7.9.2 [the Authority is not satisfied (acting reasonably) with the Contractor's plans to ensure continued performance of the Services,]

then the Authority shall be entitled to treat such event as an adverse financial event which may have a material affect on the provision of the Services for the purposes of clause 55.1.5.8(b) (Termination for Cause by the Authority) and the Authority will be entitled to withdraw the balance of any Charges in the escrow account as payment for any amounts owing to the Authority together with any interest which has accrued on those amounts and retain such amounts for itself.