KEY POINTS

- The English courts will enforce Events of Default and acceleration clauses in accordance with their terms and have held that, once a proper demand for payment has been made, there is no requirement on the part of the Lender to afford the Borrower time to organise the payment.
- The key for a Borrower is to negotiate the Events of Default and related provisions so that the acceleration right does not arise prematurely.
- A Lender deciding whether to call default and accelerate needs to call it right – it is likely to be liable in damages where wrongful acceleration results in a breach of contract (eg, its commitment to lend) or if the wrongful acceleration adversely affects the reputation or business of the Borrower.
- A key difference between the English and American approaches to acceleration is the "automatic acceleration" approach taken in most New York law credit agreements.

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Till default do us part: facility agreements and acceleration

This article considers the lender's ability to accelerate the loan in standard loan documentation and related issues, including the key difference between English and US approaches.

Facility agreements invariably set out a wide variety of events and circumstances that constitute "Events of Default". If an Event of Default has occurred (or, more usually, is "continuing"), the facility agreement will empower the Lender (or the facility agent in a syndicated deal) to take steps to protect its interests and recover the loan. These rights include declaring the loan (and accrued interest) immediately due and payable, thereby "accelerating" the loan.

Facility agreements are deliberately drafted to be self-governing and to comprehensively regulate the relationship between the Borrower and the Lender(s), both before and after the occurrence of an Event of Default. In this regard, the English courts have long accepted that provisions allowing the acceleration of outstanding principal and interest are enforceable.

However, facility agreements are likely to contain provisions to restrain and moderate the Lender's ability to call an Event of Default and, consequently, its ability to accelerate. Events of Default may be qualified by materiality thresholds or may be subject to grace periods, or may fall away entirely if remedied by the Borrower before the Lender takes any action.

THE COURTS VIEW ON ACCELERATION

Generally, the acceleration clause will provide that if an Event of Default is continuing, the Lender may immediately declare due and payable:

- the principal amount advanced;
- accrued interest, including any default interest; and
- any other amounts outstanding under the facility agreement (and other "finance documents"), including any costs and expenses incurred by the Lender and any break funding costs.

The English courts have long accepted that accelerating the payment of principal, unpaid but accrued interest and other amounts due and outstanding by the Borrower *at the time* of the default is not penal in nature and is enforceable. The obligation to repay an outstanding debt at a specified time (whether by an agreed repayment date, or immediately upon the occurrence of an Event of Default), gives the Lender a direct claim against the Borrower for a liquidated sum.

By contrast, an acceleration provision that purports to recover amounts of future interest that would have otherwise been payable over the remainder of the term of the facility agreement may constitute a penalty and be unenforceable[1]. In *Oresundsvarvet AB v Lemos (The Angelic Star)*[2], Sir John Donaldson MR held that:

> "Clearly a clause which provided that in the event of any breach of contract a long term loan would immediately become payable and that interest thereon for the full term would not only be payable but would be payable at once would constitute a penalty as being "a payment of money stipulated as in terrorem of the offending party." [3]

...an acceleration provision that purports to recover amounts of future interest that would have otherwise been payable over the remainder of the term..may constitute a penalty.

Default interest may also be payable by the Borrower where the Borrower has failed to make any payment when due. Most English law facility agreements will specify the default rate to be one or two per cent. over the interest rate otherwise payable in respect of the loan. The English courts have held that a "commercially justifiable" increase in the interest rate following a default will not constitute an unenforceable penalty. In *Lordsdale Finance*

plc v Bank of Zambia[4], Colman J approved a default interest rate of 1%, stating that:

> "There would therefore seem to be no reason in principle why a contractual provision, the effect of which was to increase the consideration payable under an executory contract upon the happening of a default, should be struck down as a penalty if the increase could in the circumstances be explained as commercially justifiable, provided always that its dominant purpose was not to deter the other party from breach."[5]

1% extra is seen as the safe haven for default interest, free from the risk of it being an unenforceable penalty.

As no general duty of good faith is imposed under English law on the parties to a facility agreement, the Lender may strictly exercise its rights and (assuming an Event of Default is, under the terms of the facility agreement, continuing) demand immediate payment by the Borrower. The English courts have held that once a proper demand for payment has been made, there is no requirement on the part of the Lender to afford the Borrower time to organise or collect payment only sufficient time to implement the "mechanics of payment"[6]. In *Bank of Baroda v Panessar*[7], Walton J held that:

> "English law therefore … has definitely adopted the mechanics of payment test … it appears to me that a time limited to the implementation of the mechanics of payment, a short but adequate period, is to be preferred to the test of a 'reasonable time depending on all the circumstances of the case', as this would appear to be wholly imprecise, and the danger of underestimating the period from the creditor's point of view would be considerable."[8]

... there is no requirement on the part of the Lender to afford the Borrower time to organise or collect payment only sufficient time to implement the "mechanics of payment".

THE PATH TO ACCELERATION

Events of Default enable the Lender to accelerate and require early repayment of the loan. Whilst most facility agreements will include similar Events of Default, the scope and precise terms (including the nature of any qualifications and grace periods) will vary and, to an extent, depend on the bargaining power of the Borrower.

The key Events of Default *include* non-payment, breach of financial covenants and undertakings, misrepresentation, cross-default (or cross-acceleration), insolvency related defaults and material adverse change.

(a) **Non-payment:** Understandably, a Lender will expect to be paid in the specified manner and at the due time. A payment failure represents the most severe test of the relationship between the Borrower and the Lender, and perhaps constitutes the most fundamental Event of Default. Typically, English law facility agreements do not include grace periods for payment defaults other than in the case of administrative or technical errors or a material disruption to the relevant payment systems. In contrast, a New York law credit agreement may include a general grace period for the non-payment of interest.

(b) **Breach of financial covenants:** Many facility agreements include "financial covenants", which are designed to test the financial health of the Borrower on an on-going basis. They serve as an "early warning" system and, therefore, any breach of a financial covenant will constitute an Event of Default allowing the Lender the ability to accelerate the loan. However, it is now common to include an "equity cure" that allows a breach of a financial covenant to be cured by the financial sponsor injecting equity for the purpose of remedying the breach (which is recalculated on a *pro forma* basis, taking account of the injection and (usually) related prepayment). Agreements may also contain a so called "mulligan" (a term borrowed from weekend golfers!), under which a financial covenant breach is deemed cured if the covenant is met when next tested.

The precise terms of "equity cure" provisions are often the subject of lengthy negotiations. However, key considerations include:

- Is the equity injection required to be prepaid?
- Should the injected amount be added to the Borrower's cashflow or to its earnings (EBITDA)?
- The number of times the "equity cure" right may be exercised, including in consecutive periods.

(c) **Breach of general and information undertakings:** Borrowers expect to cede a certain amount of control over their affairs and the conduct of their business to the Lender in return for the loan. In this regard, facility agreements will contain a wide variety of business-related and information reporting undertakings. Other undertakings will be more legal or "boilerplate" in nature, such as undertakings to ensure legal authorisations are maintained, compliance with laws and to ensure that the Company maintains the general nature of its business. A Lender will expect a Borrower to comply with the undertakings set out in the facility agreement, as this is the only direct influence a Lender has in relation to the Borrower's business. The breach of any undertaking will be of concern to the Lender. Borrowers are often able to qualify many of their undertakings by

reference to qualitative or quantitative measures of materiality; for example, certain breaches may only constitute an Event of Default if they would have a material adverse effect on the business or finances of the Borrower (eg, compliance with environmental laws) or if they exceed a specified monetary threshold. Borrowers may also be able to negotiate grace periods pursuant to which an Event of Default will not be triggered if the breach of certain undertakings is remedied within a specified number of days.

(d) **Misrepresentation:** The Lender will require the Borrower to make certain representations and warranties on the date of the facility agreement and at other times (eg, at the commencement of each interest period, on the date of each utilisation and upon the accession of a new guarantor). The purpose of representations and warranties is to make the Borrower affirm (and reaffirm) the legal and commercial basis upon which the Lender agreed to lend money to the Borrower. From the Borrower's perspective, it is better that only legal (rather than commercial) representations and warranties repeat. Many facility agreements qualify the representations and warranties by providing that an Event of Default will occur if a representation is, or proves to be, incorrect or misleading in any ***material*** respect when made by the Borrower. Some Borrowers are also able to negotiate a grace period, so that a misrepresentation will only constitute an Event of Default if the underlying circumstances causing the misrepresentation are not remedied within a specified number of days.

(e) **Cross default:** It is critical for a Lender that it should be able to accelerate if the Borrower defaults under any of its other (material) financings. From the Lender's perspective, the Borrower failing to meet its other financial obligations raises significant questions regarding the Borrower's ability to meet its obligations to the Lender and the Lender will want to ensure it gets a "seat at the (restructuring) table" at the same time as the other creditors (rather than have to wait for a payment default under its facility). Consequently, most facility agreements will include the following Events of Default:

- Any financial indebtedness of the Borrower is not paid when due (or within any applicable grace period).
- Any financial indebtedness of the Borrower is declared to be due and payable prior to its specified maturity as a result of an event of default (however described).
- Any creditor of the Borrower becomes *entitled* to declare any financial indebtedness of the Borrower due and payable prior to its specified maturity as a result of an event of default.

From the Borrower's perspective, it is better that only legal (rather than commercial) representations and warranties repeat.

Some strong borrowers are able to negotiate a narrower formulation called "cross acceleration", whereby an Event of Default only occurs if such other indebtedness is actually accelerated. In the above example, this would be achieved by removing the third bullet. There is also generally a monetary threshold (appropriate for the size of the Borrower's business) so that an Event of Default only occurs if the amount of defaulted debt exceeds such threshold.

(f) **Insolvency and insolvency proceedings:** Of obvious concern to the Lender will be the actual or near insolvency of the Borrower (or, often, any obligor or material group company) and the commencement of insolvency proceedings (or certain preparatory steps therefore) in respect of any relevant company. Most facility agreements will therefore allow the Lender to call an Event of Default relatively pre-emptively where the Borrower is in financial distress. Lenders will often seek to include as an insolvency Event of Default:

- if the value of the assets of the Borrower is less than its liabilities (taking into account contingent and prospective liabilities) most insolvency Events of Default are drafted to include such a balance sheet insolvency test (which would apply even when the Borrower is fully complying with all its payment obligations and the financial covenants); and
- if any action or step is taken for the suspension of payments, a moratorium, winding-up, bankruptcy, reconstruction, dissolution, administration or reorganisation.

Well advised Borrowers will seek a number of amendments to such clauses to ensure an Event of Default does not occur merely because the Borrower discusses its position with a creditor or because one creditor proposes a course of action in relation to the Borrower or if the proceedings are frivolous or vexatious.

(g) **Material adverse change:** A "material adverse change", or "MAC", Event of Default is often the most controversial both at the time of negotiating the facility agreement and also, and even more so, should a Lender seek to invoke the provision. It will generally apply upon the occurrence of any event or circumstance which has, or could have, a "material adverse effect" on certain specified matters, such as the business, assets or (financial) condition of the Borrower (and any other obligors). The specific scope and effect of such Events of Default vary widely. The fundamental purpose of a MAC Event of Default should be to protect

the Lender's position should there be a detrimental change in circumstances affecting the Borrower/its Group and its ability to repay the loan, that is not otherwise dealt with by the more specific Events of Default. However, a MAC Event of Default that is drafted too widely and/or is a subject test could serve as a hair trigger for an unsuspecting Borrower, exposing it to the whims of the Lender, notwithstanding the time spent negotiating the specific Events of Defaults, undertakings and representations. Some key considerations in relation to this Event of Default include:

- **Scope of obligations:** stronger Borrowers will argue that the MAC Event of Default should be triggered only where there is a material adverse effect on its ability to perform its payment obligations (rather than any of its obligations). Alternatively, references to "payment and financial covenant obligations" are common.
- **Subjective or objective test:** the Lender would prefer that the occurrence of a MAC should be determined in its opinion (or, at least, in its reasonable opinion). The Borrower will prefer an objective test that is not dependent on the opinion or discretion of the Lender. As referred to above, a subjective test does (at least without a reasonableness qualifier), expose the Borrower to the (potentially capricious) determination of the Lender, which may result in a rather different outcome than would occur with an objective test.
- **MAC "occurred" or MAC "reasonably likely to occur":** a Lender will always want (and generally get) the forward looking test on the basis that it should not have to wait until the impending "car crash" has actually happened. For the Borrower, the devil (as always) is in the detail and formulations such as "is reasonably likely to have" are preferred over some Lender-friendly formulations, such as "may have".

In *BNP Paribas SA v Yukos Oil Co*[9], the High Court considered a subjective MAC Event of Default, where the agent for a syndicate of banks accelerated a loan on the basis of certain events and circumstances occurring which, in the lenders' opinion, had or might reasonably be expected to have a "material adverse effect". The circumstances in question included the arrest of the Borrower's CEO, a significant adverse tax determination and a subsequent freezing order and judgement against the Borrower for the tax liability. The court held that the acceleration was not wrongful and that the elements of the Event of Default had been satisfied. However, Lenders should always be careful before rushing to default a Borrower on the basis of a MAC Event of Default and should ensure that all its elements are satisfied.

> ... most facility agreements will also provide for certain "intermediate" consequences where a "Default" ... or an Event of Default, has occurred.

OTHER CONSIDERATIONS

- **Agent discretion to accelerate:** Acceleration provisions in syndicated facility agreements generally will give the facility agent discretion to accelerate the loan if an Event of Default is continuing. The facility agent must accelerate if so instructed to do so by the "Majority Lenders" (generally $66^2/_3$ of the loan/commitments). In practice, a facility agent will rarely take any action without instructions, and is *very* unlikely to accelerate the loan without such majority lender instruction. Consequently, Borrowers often will seek the support of at least a blocking minority of the syndicate to prevent acceleration of the loan (at least for a short period), potentially allowing it some time to rectify the Event of Default in question or to negotiate a "deal".
- **Continuing Events of Default:** Borrowers should ensure that the Lender's right of acceleration is only exercisable where an Event of Default has occurred and is "continuing". This raises the issue of what constitutes a "continuing" Event of Default. A Borrower will argue that an Event of Default should only be continuing if it has not been remedied by the Borrower or waived by the Lender, but many Lenders will only agree to Events of Default being cured by a Lender waiver.
- **Mandatory prepayment events:** Rather than being defined as an "Event of Default", facility agreements sometimes provide that a particular event (eg, a change of control) will trigger a mandatory prepayment event. There is little difference between the two approaches, although a mandatory prepayment event, rather than a default, may avoid cross-default issues.
- **Defaults and intermediate consequences:** Whilst acceleration of the loan is the ultimate step that a Lender can take against a defaulting Borrower, most facility agreements will also provide for certain "intermediate" consequences where a "Default" (a potential Event of Default) or an Event of Default, has occurred. Whilst facility agreements vary, the occurrence of a Default or Event of Default will usually have the following consequences:
  - Triggers a draw stop on further advances and may stop the rollover of revolving credit loans. Stronger Borrowers may be able to negotiate that a draw stop on rollover loans is only triggered by acceleration.
  - The margin payable on the loan may be adjusted upwards (or any margin step-down dis-applied).
  - Additional cost and indemnity provisions may apply. The Borrower

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will be expected to pay the Lender's costs and expenses relating to the investigation of a Default.

- In the case of a payment default, the Lender will be entitled to call on any guarantee, and default interest will begin to accrue on the overdue payments.
- The Lender may be entitled to meetings with the Borrower's management and/or auditors and to further information (and access to the Borrower's premises and records).

WRONGFUL ACCELERATION

Wrongful acceleration by the Lender may arise:

- where the Lender has wrongly called an Event of Default and accelerates the loan on this basis; or
- where the Lender has not complied with the required formalities in attempting to accelerate the loan.

The decision of the House of Lords in *Concord Trust v Law Debenture Trust Corporation plc*[10] confirmed that, in a bond context, a wrongful notice of an event of default by the bond trustee to the issuer would not give rise to a breach of contract, nor (other than in the case of fraud or bad faith) liability in tort, as such a notice would have no effect. However, notwithstanding that decision, a Lender under a facility agreement is still likely to be liable for breach of contract where wrongful acceleration has resulted in a breach of its contractual commitment to lend, or if the wrongful acceleration has adversely affected the reputation or business of the Borrower.

In English-law facility agreements, acceleration generally will not be automatic and will require the Lender to provide notice to the Borrower. It is essential that the Lender's notice strictly complies with both the terms of the acceleration clause and the requirements of the notices provisions set out in the facility agreement, as otherwise, the acceleration may not be effective.

ENGLISH AND US APPROACHES: A KEY DIFFERENCE

A key difference between the English and US approaches to acceleration is the "automatic acceleration" approach taken in most New York law credit agreements.

As noted above, in English law facility agreements, the Lender's right to accelerate is not automatic and will require the Lender to notify the Borrower that the loan is immediately repayable. By contrast, in most New York law credit agreements, the Borrower's insolvency will result in the automatic acceleration of the loan, so as to avoid the automatic stay under s 362 of the Federal Bankruptcy Code, which prohibits any action by the Lender following a voluntary or involuntary bankruptcy petition in respect of the Borrower. The automatic acceleration mechanic avoids the application of such stay, as the Lender does not need to give notice or take any other action as a result of the insolvency default. Some Lenders also ask that automatic acceleration be expanded beyond insolvency based events of default.

THE MORAL(S) OF THE STORY

From a Lender's perspective, the right of acceleration is a fundamental (albeit, "last-resort") contractual right under a facility agreement. Whilst in many circumstances a Lender will gain little by rushing to call an Event of Default and accelerate the loan, its right to accelerate (or the threat of it) serves as a useful "stick" to exercise significant control over the affairs of the Borrower and to influence its conduct, particularly in relation to any subsequent restructuring or workout. Where an Event of Default requires a determination to be made (in particular if the relevant provisions also require the Lender to act reasonably) the Lender needs to be very careful in making that determination.

Borrowers need to pay close attention to the construction and formulation of the Events of Default (and the undertakings and representations). Whether (and when) a Lender will be able to call an Event of Default will depend on the specific terms negotiated by the parties, and the existence of thresholds, grace periods and other qualifiers will play a major role in defining the relationship between the Borrower and the Lender in a distress or other default situation. It is also critical that the Borrower understands the effect a Default will have on it and its business. At the end of the day, any Borrower that fails to pay all amounts due and to otherwise comply with its obligations under the finance documents should expect to be defaulted and, potentially, accelerated (or to be restructured on a distressed basis) – the courts will allow Lenders to exercise their sanctions, including to accelerate but how pre-emptively that may happen, and how much opportunity the Borrower may have to avoid those consequences, are matters the Borrower can seek to address in the negotiations. ■

... a Lender ... is still likely to be liable for breach of contract where wrongful acceleration has resulted in a breach of its contractual commitment to lend...

1 See the decisions in: *County Leasing Ltd v East* [2007] EWHC 2907 (QB); *Oresundsvarvet AB v Lemos (The Angelic Star)* [1988] 1 Lloyd's Rep. 122; *Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited* [1915] AC 79.

2 [1988] 1 Lloyd's Rep. 122.

3 [1988] 1 Lloyd's Rep. 122, at p 125.

4 [1996] QB 752.

5 [1996] QB 752, at 166 167.

6 See the decisions in: *Bank of Baroda v Panessar and others* [1986] BCLC 497; *Toms v Wilson* (1863) 122 ER 524 and *Brighty v Norton* (1862) 122 ER 116.

7 [1986] BCLC 497.

8 [1986] BCLC 497, at 508 509).

9 (2005) EWHC 1321.

10 [2005] UKHL 27.