**Loan Agreement provisions – Events of Default**

This element explains the nature and the purpose of the events of default clause within a loan agreement. It also considers the concept of mandatory prepayment events, and how these are treated differently from events of default. Finally, the concept of 'potential event of default' is addressed and how this differs from an event of default.

Note: Unless otherwise specified, clause references throughout this element are to the LMA Agreement. You are **not** required to read the clauses in the LMA Agreement in full, only to broadly familiarise yourself with them.

**Introduction**

* The Events of Default ('**EoD**') clause is included in a loan agreement to set out clearly a lender’s remedies if (i) a borrower breaches a clause in the loan agreement or (ii) any of the set events contained in the EoD clauses occur.
* The EoD clause provides clear contractual remedies allowing the lender to stop further lending and take steps to recover its loan, negating the need to rely on usual common law remedies where there is a breach of a term of the loan agreement.
* The EoD clause (clause 29) identifies certain clauses in the loan agreement that, when breached, trigger an EoD. Breach may be immediate or only once certain ‘grace periods’ detailed in that clause have elapsed. A summary of common EoD clauses are listed on slide 4. You should familiarise yourself with this clause in the LMA Agreement.
* An EoD usually needs to be 'continuing' for a lender to take action.
* A lender’s possible courses of action following an EoD are also set out in the EoD clause itself. This is known as the **acceleration clause** and includes the right for the lender to cancel any proposed or future drawdowns of the loan; to require the immediate repayment of the full amount of the loan that the borrower has previously drawn down (plus any accrued interest that is payable); or to put the loan 'on demand', which will convert it from a committed facility to an uncommitted facility going forward.

**Common EoD clauses include the following:**

[*Diagram box arrows pointing towards “Events of Default” at centre of page- connecting with (clockwise starting with)]:*

* Non-payment (clause 29.1)
* Breach of Financial Covenants (clause 29.2)
* Breach of other obligations in the loan agreement (clause 29.3)
* Misrepresentation (clause 29.4)
* Cross-default (clause 29.5)
* Insolvency (clause 29.6)
* Insolvency Proceedings (clause 29.7)
* Creditors' Process (clause 29.8)
* Unlawfulness (clause 29.9)
* Material Adverse Change (clause 22.19)

**We will now review each of the EoD clauses in more detail:**

Please refer to the EoD in the EniBank Precedent Loan Agreement (clause 23). These are adapted EoD based on the LMA Agreement.

**Non-payment of principal and/or interest**

Any non-payment is a crucial EoD to a lender as a non-payment could be an early sign of possible insolvency of a borrower or could raise issues with its creditworthiness. It could also be the case that the lender itself has borrowed money (on the interbank market) to fund the loan. It might, therefore, have its own repayments to make (which incur costs if it fails to repay as agreed).

**Remember -** any non-payment will cause **default interest** to accrue as a result of this. The default rate is usually expressed as a fixed rate above the normal contractual rate. For example: 1% above the interest rate payable on the loan.

**Negotiation points?**

A short grace period of 2-3 days is usually accepted but only for non-payment due to technical or administrative reasons.

**Breach of financial covenants**

This EoD occurs where a borrower does not satisfy each of the specific financial covenant tests contained in the loan agreement on any specified testing date.

As financial covenant tests are calculated by reference to the financial accounts of the business over the testing period and tested by reference to specified periods of time, it would be inappropriate for a borrower to ask for grace periods within which to satisfy those tests.

Note in some loan agreements a borrower may negotiate 'equity cure' rights which permit the shareholders of the borrower to inject additional equity into the borrower to 'cure' certain financial covenant breaches.

**Breach of other obligations (other than non-payment and financial covenants)**

This EoD is triggered where a borrower breaches any other term of the loan agreement.

To help avoid a flood of breaches, a catch-all grace period will be drafted into this EoD for a ‘breach of any other obligation which is capable of remedy’. It is also common for the lender and borrower to negotiate an agreed grace period into a particular clause.

The length of any grace period will depend on how fundamental a breach may be. A very cautious lender may exclude certain clauses from any general grace period (but this is unusual).

**Misrepresentation**

This EoD can catch any representations made by a borrower in the loan agreement or any document delivered to the Agent by or on behalf of the borrower. Where a borrower is unable to repeat a representation when due, it is the breach of the deemed representation which triggers the EoD, *not* the occurrence of the event leading to the inability to repeat the representation.

**Negotiation points?**

A lender may agree to add a materiality threshold into the wording of the representation clause itself (to ensure that representations that are deemed to be non-material representations do not trigger an EoD).

**Example:**

A borrower under a revolving credit facility represented on entry into the loan agreement (and is deemed to repeat) the representation that there is no litigation over £100,000. Before the next utilisation request - when the relevant representation is due to be repeated - the borrower is served with a claim form indicating it is being sued for £170,000. If the borrower is deemed to repeat the representation at the date of the next utilisation request, that will be a misrepresentation. Therefore, the EoD would occur when the borrower makes the misrepresentation (in other words, when it would repeat the representation) rather than when it received notice of the claim.

**Cross default**

Any breach by a borrower (or any subsidiary of a borrower) of any other ‘financial agreements’, aside from the loan agreement with the lender will trigger 'alarm bells' for the lender, even in situations where the borrower is not in breach of the loan agreement itself.

The borrower’s failure to honour its obligations with other creditors could point to future problems repaying the loan and interest to the lender. To take advantage of this ‘alarm bell’, a lender will insist on a ‘cross default’ EoD in a loan agreement.

Looking at the definition of Financial Indebtedess in the LMA, you can see it is widely drafted to include most types of indebtedness (although the LMA wording does not include trade creditors because these are debts owing in the ordinary course of trade rather than true borrowings).

For the purposes of this knowledge stream, you only need to focus on 'moneys borrowed', i.e the first item in the Financial Indebtedness definition, which will catch other loan agreements a borrower may have entered into.

**Unless otherwise stated, clause references in the remainder of these slides are to the clauses found in the EniBank Precedent Loan Agreement (which is based on the LMA Agreement).**

**A lender’s rights under an (unamended) LMA style cross default EoD can arise in one of three situations:**

* Where the borrower or any of its subsidiaries *fails to pay* any Financial Indebtedness when it is due (or after any relevant grace period has ended) – see clause 23.5(a).
* When any creditor of the borrower or any of its subsidiaries:
* ***declares any Financial Indebtedness is due and payable before the date originally agreed or it becomes otherwise due and payable; or***
* ***cancels or suspends any outstanding commitment to lend*,**

and the creditor’s right to do so arises because the borrower (or any of its subsidiaries) has committed an EoD under the agreement creating Financial Indebtedness with that creditor – see clauses 22.5(b) and(c).

* When any creditor of the borrower or any of its subsidiaries ***becomes entitled to declare* *any Financial Indebtedness due and payable before the date originally agreed*** because of an EoD under the agreement creating Financial Indebtedness between the creditor and the borrower (or any of its subsidiaries) – see clause 22.5(d).
* The impact of the drafting of clause 22.5(d) is that the borrower (or subsidiary of the borrower) merely has to breach another financial agreement to cause an EoD under the loan agreement even if the creditor under the other financial agreement takes no action under its agreement. This is more fully explained in the example below.

**Cross default – borrower concerns**

**These are best explained by example.**

**Imagine a borrower has two loan agreements – one with Lender X and one with Lender Y. The clauses which are key to explaining the borrower’s objections to the cross default clause are summarised below.**

**Example:**

A borrower has two separate loan agreements (with Lender X and Lender Y) with the following clauses:

Loan Agreement X: No disposals of assets worth more than £250,000 with no cross default provision included.

Loan Agreement Y: No disposals of assets worth more than £500,000 with a cross default provision included.

The borrower disposes of an asset for the value of £325,000. This has the following effect:

It is a **breach** of **Loan Agreement X** as this disposal is of an asset over £250,000 (this is clear on the facts), leading to a default of this loan agreement.

It is a **breach** of **Loan Agreement Y** as, despite this being a disposal of an amount that is lower than the £500,000 threshold, due to (1) the inclusion of a cross default provision; and (2) the fact that the borrower here has defaulted on Loan Agreement X, this will trigger the cross default clause leading to an EoD under this loan too.

By inserting a cross default EoD clause into its agreement with the borrower, Lender Y has indirectly taken advantage of the stricter undertakings in Lender X’s agreement, even though Lender Y’s agreement appears more lenient.

The effect of having a cross default EoD clause in one of the borrower’s loan agreements is known as the **‘domino effect’** – i.e. the borrower being in breach of one agreement means it is at risk of being in breach of any of its other loan agreements which contain cross default EoD clauses.

To prevent this occurring, the borrower should try to ensure that there are identical undertakings in all its loan agreements. So, if in the example above the restrictions on disposals in the two loan agreements had had the same threshold figure of £1,000,000, the sale of the asset would not have breached either loan agreement.

**Cross default – possible amendments**

**Limiting ‘Financial Indebtedness’:**

A borrower may try to limit the impact of a cross default clause by limiting the clause to default under documents that provide for ‘financial indebtedness’ only (for example: documents such as loan agreements; bonds; or hire purchase agreements). In these circumstances, the definition of ‘Financial Indebtedness’ in a loan agreement is key and the LMA Agreement definition is already limited in this way.  This could also be limited to the Obligors only or the material companies (as opposed to the whole group).

**‘De Minimis Basket’:**

A common borrower ‘tool’ is to include a ‘de minimis basket’ which - in practical terms - means the inclusion of wording to allow insignificant defaults to not trigger a cross default clause. Typically, the wording stipulates that individual defaults under a certain amount (for example, £50k) and the overall total of any default do not go over a threshold (such as £250k) – in such cases, neither would trigger the general cross default clause. The level of appropriate de minimis will be deal specific.

**Cross default – possible amendments: Cross acceleration**

The borrower would prefer the cross default EoD to contain cross acceleration wording rather than cross default wording. Regardless of whether it contains cross default or cross acceleration wording the EoD is almost always called the cross default EoD. (Clause 1.2(b) makes it clear “… Clause … headings are for ease of reference only” so even if the heading says ‘cross default’, if the clause has been amended to cross acceleration wording the clause will be treated as a cross acceleration clause).

*Cross default* wording means the cross default EoD is triggered if the borrower defaults under an agreement it has with another creditor irrespective of whether that other creditor takes any action in relation to that default.

*Cross acceleration* wording however requires a further step to be taken by that other creditor before the cross default EoD is triggered – it requires the other creditor whose agreement has been breached to take steps to exercise its remedies under the ‘Acceleration’ provisions of its agreement with the borrower e.g. for the other lender to insist on immediate repayment of the loan and all interest due on it, or to exercise drawstop.

Going back to our earlier example involving Lenders X and Y, if the cross default EoD in Lender Y’s loan agreement had pure cross acceleration wording, rather than cross default wording, Lender X must take the extra step of using a remedy under the ‘Acceleration’ provisions of its loan agreement or calling a drawstop before the cross default EoD clause in Lender Y’s loan agreement is triggered. Only then would Lender Y be able to call a cross default EoD and insist on its remedies in *its* ‘Acceleration’ clause or to call a drawstop.

The borrower may argue (in favour of cross acceleration wording) that the breach under the other creditor’s agreement may be minor and therefore likely to be waived by that other creditor without the borrower’s financial position being affected at all; such a situation should not trigger a cross default EoD in other agreements the borrower has entered into.

The lender’s counter-argument to having cross acceleration wording would be that waiting to see if another lender accelerates its loan when the borrower is in default will not give the lender sufficient warning of the borrower’s problems with its finances, which would be too great a risk for the lender to accept.

The lender would rather the borrower was technically in default of its loan agreement earlier on in the process (i.e. when it defaults under any of its other financial agreements) because then the lender will be in a better position to assess the borrower’s position and the risk to the lender’s investment, and negotiate an outcome which is more favourable to the lender.

If the borrower was to argue successfully for cross acceleration in the loan agreement, clause 23.5(d) would need to be deleted. Note that no lender would accept the deletion of 23.5(a) so there will *always* be cross default for non-payment.

It is rare for most borrowers to be successful in negotiating the deletion of 23.5(d) in the cross default EoD.

Given clause 23.5(d) is rarely deleted, one question commonly asked is why clauses 23.5(a) – (c) are included given they are redundant as they are covered by 23.5(d). The clauses are in the LMA because the LMA includes the wording for all the commercially acceptable cross default EoD drafting options but it is also common practice to leave (a) – (c) in the loan agreement from a ‘belt and braces’ viewpoint, even though, strictly speaking, (a) – (c) are superfluous because of (d).

Clause 23.5(e) is the de minimis basket (as explained above) and borrowers and lenders normally agree some level of de minimis. The appropriate level will depend on the relevant factual scenario.

**Insolvency**

If a borrower (or any of its subsidiary entities) are insolvent (as defined), an EoD will be triggered.

‘Insolvency’ is where an entity cannot pay its debts as they fall due, though the definition in clause 23.6 is broader. In the situations contemplated by clause 23.6, the lender’s concern is that the borrower will be unable to pay back both the principal and interest payments under a loan agreement.

There is no availability for any amendments or a grace period if an insolvency situation occurs.

**Insolvency Proceedings**

The ‘Insolvency proceedings’ EoD aims to catch every step in relation to an insolvency procedure (liquidation; administration; administrative receivership; suspension of payments; and enforcement of any security over the borrower’s, or any of its subsidiaries’, assets).

This enables the lender to take action as early as possible and not wait for the actual appointment of an administrator, receiver, etc.

A creditor needs to be owed at least £750 to be able to petition for a borrower’s liquidation (which is easily triggered). This is wide enough to mean that a creditor could attempt to enforce a relatively small debt through a winding-up petition.

A borrower will want to ensure that its position is **adequately protected from any ‘frivolous or vexatious petitions’** which are then discharged within a set grace period. Take a look at the exception wording at the end of clause 23.7 to see an example of this.

**Creditors' Process**

The inclusion of a ‘Creditors’ Process’ provision will mean that any remedy that is exercised by a creditor over an asset of the borrower or any of its subsidiaries (e.g. execution of a judgment debt, distress, etc) will trigger an EoD.

**Task:** Do you think it is possible to amend or include a grace period within either of the ‘Insolvency Proceedings’ or ‘Creditors’ Process’ EoD clauses?

If so, think of some possible amendments to clauses 23.7 and 23.8.

**Insolvency Proceedings and Creditors’ Process: Amendments/grace periods**

**Limiting the enforcement of any security:** A borrower might seek carve-outs for an agreed threshold value relating to the potential enforcement of security over any of its assets which will be enforced as a result of the Insolvency Proceedings EoD (see clause 23.7(d)).

**Limitation surrounding the seizing of any assets:** A similar carve-out can also be seen in clause 23.8 to ‘Creditors' process’ where the assets seized must have an aggregate threshold value for the clause to be triggered and/or a grace period is given to discharge the creditor’s process.

**Protection against similar proceedings:** Analogous (or similar) proceedings could be brought if a borrower deals overseas and has overseas creditors. Here a lender will want to protect its own ability to call the ‘Insolvency Proceedings’ EoD against these analogous proceedings and so will include language such as the last line of clause 23.7 to do try to do so.

**Unlawfulness**

It is important to distinguish **unlawfulness** (where it is unlawful for the ***borrower***or any guarantor to perform their obligations) from illegality (where it is illegal for the ***lender*** to perform its obligations).

Unlawfulness will always be an EoD and a lender will not agree to make unlawfulness a mandatory prepayment event (see below). A borrower can argue that it being unlawful for the borrower to perform its obligations could be something which is outside the control of the borrower and so it is unfair that it could trigger cross default. A lender’s response to this would be that this is an issue of risk allocation – the risk must stay with a borrower in such a situation and so unlawfulness for the borrower will remain as an EoD (under clause 23.9).

If it becomes **illegal** for the *lender* to perform its obligations or allow the loan to remain outstanding, the lender will want to be repaid the loan and any outstanding interest immediately. This is because if the lender’s obligations are illegal, the loan is unenforceable. This may be treated as an event of default or a **mandatory prepayment event** rather than an event of default (see below).

**Material Adverse Change (‘MAC’)**

Despite a solicitor’s best efforts, it is impossible to pre-empt every circumstance or event that could lead to a significant effect on a borrower’s ability to comply with its payment obligations under a loan agreement.

To counteract such an event happening, a lender will require the inclusion of a catch-all provision in a loan agreement. A ‘MAC’ EoD is also a requirement of most lenders’ internal credit committees – no lending will be allowed unless this EoD clause is included in a loan agreement.

A lender rarely uses its rights under the ‘Acceleration’ clause to call an EoD and demand immediate repayment based solely on a MAC. It is generally difficult to prove that they were justified in doing so - i.e; that a MAC had definitely occurred.

**Example of a lender drafted MAC clause:**

Each of the events or circumstances set out below is an Event of Default:

Any event or series of events occurs which in the opinion of the Lender could have a material adverse effect on:

(a) the business, operations, property, condition (financial or otherwise) or prospects of the Group taken as a whole; or

(b) the ability of an Obligor to comply with its obligations under the Finance Documents.

**Negotiation points relating to MAC clause example above:**

A borrower may want to restrict the clause to events that *have* or *will have* a material adverse effect on the borrower's *ability to repay the loan* and such that only the effect on the *borrower's* position is taken into account, rather than those of the wider 'Group'. The borrower could therefore**:**

* change the word 'could' in the first line to 'will', although it could compromise at 'is reasonably likely to';
* change reference to the lender's opinion to 'in the *reasonable* opinion of the Lender' so that the test requires some element of objective careful consideration even if it is still ultimately a subjective determination;
* delete paragraph (a) (which is unlikely to be accepted), or limit to the Group's financial condition; and/or
* insert the words 'material payment' or 'material' before the word 'obligations' in paragraph (b).

**Mandatory Prepayment Events**

As there are certain events which are outside the control of a borrower, it will not want such events to be treated as events of default because then something not within the borrower's control could be an EoD and could trigger a cross-default in the borrower's other loan agreements.

A lender will still require the ability to cancel its commitment under a loan agreement to make further funds available to a borrower and will instead require prepayment of all money currently borrowed if any of these certain events occur.

This is achieved by stipulating certain events as '**mandatory prepayment events**' in the loan agreement.

The following events are most commonly (but not always) deemed as mandatory prepayment events.

* + **Illegality**: Where it becomes illegal for the lender to continue lending to the borrower (see clause 12.1 of the LMA  Agreement).
  + **Change of control**: For example, a scenario where a borrower company has no control over its parent shareholder selling its shares (see clause 13.1(b)(ii) of the LMA Agreement). In some loans this may instead be treated as an event of default.

**Mandatory Prepayment Event - Illegality**

**Illegality:** Whereby it is illegal for a **lender** to perform its obligations under the loan agreement

If a scenario occurs where it becomes illegal for a lender to either perform its obligations or allow the loan to remain outstanding – in such a situation a lender will want to be repaid the loan alongside any outstanding interest immediately. This is because if the lender’s obligations are illegal, the loan is unenforceable.

The lender’s starting position may (rarely) be to treat illegality for the lender to perform its obligations as an EoD. However, as this is an event beyond the borrower’s control and it does not seem fair to allocate the risk of lender illegality to the borrower, the borrower would prefer it to be a ‘mandatory prepayment event’. This would prevent it from triggering any cross default provisions in the borrower’s other financial agreements. In the LMA **illegality** for the *lender* is a mandatory prepayment event (see clause 12.1 of the LMA Agreement).

**Mandatory Prepayment Event - Change of Control**

A borrower’s wider group structure (such as its parent or subsidiaries) can be of particular interest to a lender and could have played a key part in the lender’s decision to provide the loan. If so, a lender will want to ensure that this group structure does not change throughout the life of the loan.

If the ownership of a borrower changes, this will be deemed to be a **change in the control of the borrower** and a lender may want to treat this as an EoD. This will allow a lender to assess the change and negotiate with the borrower.

One possible consequence of a 'change of control of the borrower' being treated as an EoD, is it  may help a borrower to prevent a hostile takeover bid ('poison pill'). A hostile takeover would itself trigger an EoD and the party seeking to take over the borrower would then risk the lender accelerating the loan. This is risky as the loan could be key to the borrower’s business (meaning that any acceleration of the loan would need to be re-financed by the takeover party, which is not an ideal situation).

A borrower can say that a change of control is something that is outside its control and therefore unfair for this to be deemed as an EoD (as it could trigger a cross default EoD in its other loan agreements, as discussed earlier).

Instead, a borrower would prefer change of control to be deemed as a **mandatory prepayment event** as mentioned.  Clause 13.1(b)(ii) of the LMA Agreement treats it as this.

The likelihood of a change of control being treated as an EoD will depend on how creditworthy that borrower is – the less creditworthy it is, then the more likely it is to see a change of control treated as an EoD. If the current ownership of the borrower is very important to the lender’s credit assessment, the lender will want the change of control to be an EoD.

**Summary**

* Events of Default (‘EoD’) in loan agreements set out a lender’s remedies if a borrower breaches a clause in a loan agreement or if any of the set events contained in the EoD clause occur.
* The EoD clause identifies certain clauses in the loan agreement that, when breached, trigger an EoD either immediately or on expiry of ‘grace periods’ (as detailed in that clause).
* There are certain events which are outside the control of a borrower and so it will not want such events to be treated as EoD.  They are treated as ‘mandatory prepayment events’ which on occurrence will allow a lender to require prepayment of all money currently borrowed and cancel any further lending obligations.