Feature

KEY POINTS

- It is generally safer to rely on "objective" event of defaults (EODs) such as failure to pay rather than subjective EODs such as material adverse change and, where possible, to rely on multiple EODs.
- Send a reservation of rights notice and avoid any express or implicit suggestion that the agreement is being affirmed or the EOD (or other rights) waived.
- Take acceleration and/or enforcement action only when you are confident that at least one relevant EOD has occurred and (if required) is continuing.
- Strictly follow all applicable notification requirements and operate on the assumption that the default could give rise to litigation as part of which the creditor's actions and communications may be closely scrutinised.

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Credit defaults: practical tips when pressing the accelerator

We consider the practical steps and considerations for creditors when faced with a potential event of default (EOD) under their credit documentation. We also assess the consequences for a creditor in taking enforcement action in reliance on an EOD that has not actually occurred, cannot be relied on, or is disputed.

THINK YOU HAVE A DEFAULT?

Increasingly tough global economic conditions mean creditors will now be considering carefully their rights and remedies against debtors. In doing so there are important steps that creditors should adopt from the outset to protect their position:

- **Gather documents and evidence**: Collate all relevant finance documents, including any amendment or waiver letters, other correspondence, and any other documents that may be required to assess whether an EOD has occurred.
- **Review EOD provisions**: Review the definition of the EOD and assess whether it has occurred or is likely to occur. Ascertain when, how and in respect of which entities the applicable criteria are to be tested. Consider whether the EOD requires notice or is subject to a grace period.
- **Are EOD criteria met?** Review the evidence of the EOD. Is it an objective EOD, of which you have direct evidence, such as a failure to pay? If the event does not directly involve you, such as a cross-default, how reliable is your evidence? Does the event require subjective judgment, such as cessation of business?
- **Is the EOD continuing?** Review the agreement to determine whether an EOD needs to be "continuing" before it may be relied on and what "continuing" means. Some EODs may be curable (so may not be continuing) while others may be irremediable and only cease to be continuing if waived. An EOD is generally continuing if the state of affairs which triggered it subsists, regardless of whether its effects may still be felt by the creditor.
- **What rights arise and who may exercise them?** Determine what rights the creditor has following the occurrence of an EOD. Not all EODs afford a right to accelerate. Consider who is entitled to exercise those rights, particularly in the case of syndicated facilities or bonds, where an agent or trustee will typically have the right to take action on the instructions of a particular group of creditors; or leveraged structures, where a creditor's rights will depend on its ranking and security position.

RESERVE YOUR RIGHTS WHILST YOU CONSIDER YOUR NEXT MOVE

If a creditor considers that an EOD may have occurred, typically its next move will be to carefully assess the situation, gather more information, and speak to other parties including other creditors and/or the debtor. During this period a creditor is at risk of waiving the EOD where it:

- **Waives by election or affirms**: Takes steps that indicate it has chosen to affirm the agreement. For example, the creditor continues to accept payments from the debtor over an extended period of time after a right to accelerate has arisen.
- **Waives by estoppel**: Represents to the debtor (including implicitly) that it is prepared to waive its right to accelerate and the debtor relies on that representation. For example, the creditor suggests that it will allow the debtor additional time to pay with the implication that it will not accelerate if those payments are duly made, and the debtor relies on that arrangement in making the payments.

To help avoid waiver it is important (notwithstanding any "non-waiver clause") to send a reservation of rights notice at the earliest opportunity. Reserving rights reduces the risk of inadvertently implying that the creditor intends to affirm the agreement or waive its right to accelerate. It is important that such notice is drafted carefully to extend to the situation at issue. However, neither a non-waiver clause nor a reservation of rights notice provides watertight protection if, in substance, a creditor demonstrates an intention to affirm the agreement or waive its right to accelerate. In particular, it is generally unwise to try to "bank" an EOD by continuing to accept payments in the expectation that it will remain possible to rely on the EOD to accelerate in the future.

NEGOTIATE AND PREPARE AN ENFORCEMENT PLAN

A debtor faced with a potential EOD may proactively seek a waiver or forbearance of such EOD from its creditors. When

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responding it is important that creditors consider what they want to achieve in the short, medium and long term. Is this a one time "blip" that a creditor is happy to waive or likely indicator of an inability to repay in the future?

If it is the latter, the creditor should consider discussing with the debtor and other creditors a potential restructuring. Any waiver or forbearance to facilitate those discussions should only be agreed if the debtor accepts conditions which strengthen the creditor's position. For example, increased reporting and/or access to information, appointment of financial advisers to carry out a business review, and fee coverage for creditors or a creditors' committee. Waivers or forbearance should usually only be given for a limited period to allow creditors to take stock of available information and advice and consider next steps. Any such waiver or forbearance, and any conditions attached to it, should be carefully documented to avoid later disputes about the intended scope. In particular, if the intention is that the creditor should retain the right to accelerate due to an EOD and is only agreeing to do so while attempting to find an alternative solution, this should be spelt out in writing.

In addition – and perhaps in parallel to negotiating – a creditor should consider planning the enforcement steps that it will take if required. This involves considering whether and how to enforce any security, including where necessary taking local law advice (eg in respect of the place of incorporation or centre of main interests of the debtor, the *lex situs* of the secured assets or the governing law of the security). A creditor should, if applicable, also decide how it will respond if the debtor makes a utilisation request to draw further on the funding.

DO NOT TRIP UP ON NOTICE FORMALITIES

In any default scenario a creditor will likely need to serve formal notices. It is important to remember that for a notice to be effective it must comply strictly with the contractual requirements. This is an area where seemingly trivial errors can have serious consequences.

When giving notice carefully consider not only what the notice provisions require expressly but also whether any terms would be implied. It is prudent to assume that it is necessary to identify correctly the EODs relied on and the outstanding amounts even if this is not prescribed expressly. Also consider whether any changes to the notice provisions (eg change of address) have taken effect.

ASSESS THE RISK OF GETTING IT WRONG

Creditors will want to assess the risk of wrongly relying on an apparent EOD and/or right to accelerate. This will be a particular concern where a creditor is considering placing reliance on an EOD in circumstances where – perhaps because of a lack of relevant evidence or inherently subjective criteria – it cannot have complete confidence that the criteria are met or that the EOD has not been cured.

A notice of default or notice of acceleration wrongly dispatched when the relevant conditions have not been met is generally unlikely to give rise to a claim against the creditor. Unless the terms of agreement provide otherwise, the notification is simply a nullity.

A creditor will also not generally attract liability if it wrongly relies on an EOD in circumstances where it has, or could have, validly relied on a different EOD. This illustrates why it is always preferable to act only where it appears that multiple EODs have occurred, particular if subjective tests or a lack of sufficient information makes it hard to be sure that each EOD has been triggered.

In addition, assuming the right to accelerate has arisen, that right is generally, subject to the precise terms of the agreement, an absolute discretion is not subject to a duty of good faith, a requirement to act for a proper purpose, or a materiality threshold.

The risk for a creditor comes in taking further action based on an incorrect belief that an EOD has occurred or that the debt has been validly accelerated. In those circumstances, a creditor might wrongly decide to reject a binding utilisation request or take steps to enforce security. At this point the creditor will usually be in breach of contract and risks liability for the consequences of that breach (subject to the usual principles of causation, remoteness and mitigation).

Unfortunately for creditors the consequences of such a breach have the potential to be very significant. For example, the creditor might find itself liable for the incremental cost of more expensive replacement financing. Or, in the extreme case, it could potentially be liable for loss of profit or even losses stemming from insolvency of the debtor where those are foreseeable consequences of withdrawing the credit.

TREAT ANY ENFORCEMENT AS A POTENTIAL LITIGATION EVENT

Whenever a creditor accelerates there is a real risk that a dispute – and potentially litigation – may follow. For this reason, once a suspected default has occurred a creditor should adopt a litigation mind set:

- Seek legal advice at the outset whenever an EOD might have occurred and throughout the enforcement process.
- Draft all communications that are not covered by privilege as if they will have to be disclosed to the debtor and may be reviewed by a court, tribunal or regulator. Stick to the facts and do not give opinions or speculate.
- Keep a record of everything that is sent or said to the debtor or other parties and document the decision making process, particularly when making judgments such as relying on subjective EODs. ■
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Further reading:

- Till default do us part: facility agreements and acceleration (2013) 9 JIBFL 571.
- An update on ineffective acceleration (2004) 11 JIBFL 411.
- LexisPSL: Banking & Finance: Practice Note: Events of default.