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Tips for the Terminator

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In this column, Charlotte Eborall of 3VB considers the options available to a financial institution when faced with a defaulting borrower, and the practical steps that parties to finance agreements should take to guard against waiver or loss of termination rights.

Introduction

Higher central bank interest rates, inflationary pressures, tightening credit conditions, and the threat of recession are all contributing to a squeeze on finance, both in terms of availability and ability to repay. To combat inflation, the Bank of England has now (on 4 August 2022) increased its base rate from 1.25% to 1.75%, and banks, financial institutions and other finance providers or creditors will be following suit (HMRC has already indicated that its interest rate for late payments will increase commensurately with the BoE base rate). These economic developments have led to concerns that defaults under lending facilities and other finance agreements will rise over the coming months, and perhaps even years.

When faced with a possible default, the questions a lender needs to ask are:

- Is the borrower's action (or inaction) an event of default?
- What do I need to do to terminate the loan?
- Should I terminate the agreement? Or should I negotiate with the defaulting party?

If the lender chooses not to terminate, or not to terminate immediately, it needs to avoid behaving in a way that would accidentally waive the lender's right to terminate.

Is this an event of default?

An event of default is an event, condition or circumstance, which entitles a lender to terminate a lending facility and accelerate repayment of the loan. Non-payment, i.e., a failure to pay interest or an instalment of principal when due, is the most common event of default. Other common events of default include non-compliance with loan covenants (in particular, concerning any secured assets); misrepresentation or breach of any warranties made upon entry into the facility; insolvency events; other cessation of the business; illegality; a "material adverse change" clause; and cross-default clauses. For further information, see Finance documents: events of default; Events of default: rights, obligations and risks for lenders and Material adverse change (MAC) clauses in finance documents.

The first step is to analyse the wording of your event of default clause to determine whether an event of default has in fact occurred. If you are relying on something other than non-payment (such as an insolvency event or a material adverse change clause) you will need to examine the exact wording in the facility agreement very carefully to make sure an event of default has actually occurred.

There are relatively few authorities in this area. However:

- In *BNP Paribas v Yukos Oil [2005] EWHC 1321 (Ch)*, it was held that where $3 billion of Yukos's assets had been frozen, there were no reasonable grounds for asserting that there had not been a material adverse change.
- In *Cukurova Finance International Ltd v Alfa Telecom Turkey Ltd [2016] AC 923*, the Privy Council held that a material adverse change event was established because Alfa (the finance company) honestly and rationally believed that the default had occurred. *Cukurova* was recently applied by Mr Justice Foxton in *Lombard North Central plc v European Skyjets Ltd [2022] EWHC 728 (QB)* at [121] in which iLombard had formed the honest and rational opinion that there had been a material and adverse change in the financial position of Skyjets, the borrower.

In relation to non-payment failure to pay even a *de minimis* sum may still constitute an event of default (*Bank of New York Mellon v GV Films [2009] EWHC 3315*). When the parties have made a breach of a particular obligation a condition (giving the right to terminate), that right is available *"without regard to the magnitude of the breach"* (*per* Mustill LJ in *Lombard North Central v Butterworth [1987] QB 527* at 535; cited by

Foxton J in *Lombard North Central plc v European Skyjets Ltd [2022] EWHC 728 (QB)* at [100]).

The lender should also ask whether a default must be continuing at the date on which notice of termination is given. Where payment on a specified date is of the essence and a condition of the contract, it is likely that such default cannot be cured by late payment and later payment will not prevent the lender from relying upon this as an event of default (see *Mardorf Peach & Co Ltd v Attica Sea Carriers Corporation of Liberia (The Laconia) [1977] AC 850* at 868 *per* Lord Wilberforce; applied by Foxton J in *Lombard North Central plc v European Skyjets Ltd [2022] EWHC 728 (QB)* at [79]-[83]).

What must the lender do to terminate the loan?

A contract must be lawfully terminated in order for a claim to be made. If a lender wants to terminate by notice it must strictly comply with any conditions set out in the agreement (*Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd [1997] AC 749*, 773 and 776).

In *Lombard North Central plc v European Skyjets Ltd [2022] EWHC 728 (QB)*, the lender had terminated, according to the notice given, for non-payment; but the arrears and balance outstanding figures were both incorrect. The borrower submitted that this invalidated the notice of termination. At trial, the lender also relied upon two further events of default having occurred, which it submitted it was also entitled to rely upon as grounds for terminating the loan.

Foxton J held that:

- On a proper construction of the contractual right of termination, the lender's failure to properly state the sum due did not prevent the demand for repayment being effective (see *Bank of Baroda v Panessar [1987] 1 Ch 335 at 346-347*; Skyjets at [108]); and
- The lender was also entitled to rely upon events of default not identified in the notice of termination, because both the loan agreement and the mortgage merely required that event of default to have "occurred" (see Skyjets at [104]-[107]).

Although Skyjets submitted that this was a one-sided reading of the contractual provisions, Foxton J disagreed, noting that the conclusion he had reached, "reflects hornbook principles of contract law" (Skyjets, at [110]-[111]).

The position will not be the same in every case. Where the contract prescribes how notice is to be given (and to whom), failure to comply will invalidate the notice (see *Struthers v Davies (t/a Alastair Davies Building) [2022] EWHC 333 (TCC)*, in which the notice was sent to the wrong party). The lender may also be contractually obliged to give the defaulting party the opportunity to remedy a breach before termination (see *Interserve Construction Ltd v Hitachi Zosen Inova AG [2017] EWHC 2633 (TCC)*).

A terminating party must pay close attention to the express terms of the relevant provision.

Should the lender terminate the loan?

A lender will not always want to terminate a loan in response to a default. Events of default may trigger a cross-default in other facility agreements or contracts held by the borrower, compounding their financial stress. Directors of a corporate borrower may also be wary of continuing to trade for fear of later allegations of wrongful or fraudulent trading, where that event of default indicates that the corporate borrower cannot pay its debts as they fall due. For these reasons, calling a default is often regarded as a last resort, as it may lead to the demise of the borrower. Instead, a lender may use those events of default as a platform for renegotiation with the borrower to reach a workable solution.

Whether to exercise a termination right depends upon several factors, including the following:

- Viability, financial strength and prospects of the borrower – if the borrower is generally in a state of financial stress, the lender may be better served calling its loan in before an insolvency event occurs.
- The nature of the default – linked with the foregoing factor, the event of default may indicate a systemic problem within the borrower, or simply a blip in repayment obligations.
- Whether the relevant facility is secured, and the value and saleability of that security.
- The presence of, and security held by, other creditors.
- Market conditions, the conditions of lending, and the remaining term of the loan – where the market is changing, a lender may prefer to renegotiate and re-price the debt, rather than call it in on earlier terms.
- Reputational impact upon lender and borrower of default and termination – there may be sensitivity on either or both sides regarding enforcement of a loan (often in the consumer sphere).

How can a lender avoid waiving an event of default and the right to terminate?

Facility agreements may include "no waiver" clauses, under which a lender's rights are expressly reserved

and any lack of action is not to constitute a waiver of those rights. However this may not be enough to prevent a waiver, as Foxton J. said in *Lombard North Central plc v European Skyjets Ltd [2022] EWHC 728 (QB)* at [89]:

> "I do not accept ... that the ritual incantation of this language can prevent anything said or done in the preceding letter from having its objective effect."

There is a real risk that, during discussions and negotiations regarding any event of default, the innocent party may offer to overlook earlier events of default, and when those negotiations stall, find itself with no grounds upon which to exercise the right to terminate.

To guard against this risk, lenders should consider the following:

- Continued silence in the face of multiple events of default, coupled with an ongoing relationship under the original agreement may be sufficient to constitute an affirmation of the contract and/or to estop the lender from relying upon those events of default. It is preferable for each event of default to be expressly acknowledged as having occurred, even if the lender chooses ultimately not to terminate as a result of that event of default.
- Expressions of goodwill, forbearance or other latitude given to a defaulting party should be expressed with caution (if used at all) and with the understanding that this could be construed as a waiver of those rights.
- Any communications and discussions should be documented contemporaneously and that note exchanged between the parties to ensure miscommunications do not occur.
- Formal variations to an agreement should be documented carefully, even if there is no "NOM" (no oral modification) clause and oral variations are (implicitly) permitted by the contract.
- Be aware of any time limits specified in the contract concerning the giving of notice of an event of default, to prevent inadvertent loss of rights.