LECTURE NOTES: *In re* INOFIN, 455 B.R. 19 (Bkrtcy. D. Mass. 2011); TEXT Chap 12.

breaches, defaults, "DEFAULTS" AND "EVENTS OF DEFAULT" in notes, credit agreements and loan agreements and "after default" under UCC s. 9-601

Language in contract and statute for review

In re Inofin, at p. 24-25, contains an excerpt from promissory notes which contain contract language addressing "defaults". In these Lecture Notes, we review that contract language and more. You should compare that language to the sample "Events of Default" contract language at TEXT Chap 12, p. 799, the "acceleration of debt" clause at TEXT Chap 12, p. 810, and to the provisions in section 8.1 of the TiVo Corporation ABL Credit and Guaranty Agreement, p. 123 and ff. You should also review UCC s. 9-601 (see e.g. TEXT Chap 12, p. 816). *Other credit agreements filed with the SEC also may be of interest for additional variations and examples.*

Background

Most notes, credit agreements and loan agreements in commercial finance provide for the extension of credit on a "term" basis rather than on a "demand" basis. This is particularly true for larger credit facilities provided to commercial entities by banks. Parties do not spend the time and money to negotiate complicated agreements and collateral packages for a demand loan. A term loan is a loan which is due at a future date. So long as interest payments and other charges are current, no payment default exists; a payment default does not exist on these facts until the stated maturity date arrives and the debtor does not repay the loan. For these purposes, a revolving loan is a "term" loan insofar as payment of principal is not due until the commitment termination date (unless an earlier payment of a portion of principal is due based on the calculation of a borrowing base formula—see TEXT p. 10 and ff. for a description of revolving credit lines and borrowing bases). See TEXT Chap 12, 779 and ff for a description of the difference between a "time" and a "demand" obligation.

Most notes, credit agreements and loan agreements provide, however, that upon the occurrence of certain ***events*** a term loan ***may*** become due and payable prior to its stated maturity (i.e. prior to its stated "term"). These "events" are often defined as "Events of Default" and appear in a list or separate section of the credit document. **[Whether or not so defined in a credit document, I shall refer to these events as "Events of Default.]** I say '***may***' because, for most types of these events, the occurrence of the event gives the creditor the right to accelerate the maturity of the loan and demand early payment. The occurrence of the event gives the creditor an ***option*** to demand payment of the term loan just as a creditor has the option to demand payment of a demand instrument.

In effect, the occurrence of the Event of Default has the functional effect of converting a term loan into a demand loan. In some cases, however, the event is defined so that acceleration of the maturity is automatic (i.e. without a decision by the creditor); for example, some credit documents make acceleration of the maturity of a debt automatic upon the commencement of a bankruptcy proceeding against the debtor. The concern is that such an acceleration must be automatic because, following the commencement of the bankruptcy case, a creditor may not accelerate the maturity of a debt without violating the automatic stay because the acceleration notice would be an action to collect a debt.

In either case, the maturity of the loan is "accelerated" or brought forward when the condition is satisfied. If no grace period is provided for the payment of interest, for example, the acceleration is permitted immediately, and the condition is satisfied when the creditor accelerates the maturity and demands payment. (I say "demands" payment because this is how the "election" is made by the creditor.) If a grace period of 5 days is allowed for the payment of interest, the breach alone does not permit acceleration but after the expiration of the 5 day grace period, acceleration is permitted and the condition is satisfied when the creditor accelerates the maturity and demands payment. If the commencement of a bankruptcy case of a debtor is specified as an Event of Default (and acceleration is stated to be automatic), the condition is satisfied upon the commencement of the case and the debt is immediately due and payable.

A sample security agreement provision on the acceleration of debt appears at TEXT Chap 12, p. 810 (providing that "if the secured party shall so elect" the indebtedness shall "become immediately due and payable"). An example of automatic acceleration is found in the TiVo Corporation ABL Credit and Guaranty Agreement for the insolvency events specified in subsections 8.1 (f) and (g));[1] the other "Events of Default" in the TiVo Corporation ABL facility require a declaration to accelerate the maturity.

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[1] See p. 126 of the ABL Credit and Guaranty Agreement dated as of November 22, 2019:

Some Events of Default occur automatically: typical examples include the dissolution of the legal existence of a corporate debtor or the filing of a voluntary petition in bankruptcy by the debtor. Some Events of Default occur only after the expiration of a grace period (but do not require the sending of a notice): typical examples include the failure to pay interest within 3 or 5 days following the stated due date for the interest payment. Some Events of Default occur only after the creditor provides notice to the debtor and the debtor fails to cure the breach identified in the notice within a specified time frame: typical examples include the failure of the debtor to deliver a financial statement or a borrowing base certificate at the times specified in the credit document which is not "cured" within 10 days after notice.

Note that the occurrence of an Event of Default is not the same as the occurrence of a breach; the debtor breached the credit document when it failed to make the timely payment of interest or did not deliver a required quarterly financial statement. This type of breach is sometimes called a "default" or even defined as a "Default" in a credit document. Such a default or "Default" is not, however, a basis for a creditor to exercise remedies (i.e. it is not yet the kind of 'default' contemplated by UCC s. 9-601). It is, however, a breach of the debt contract which may mature into an Event of Default if it is not cured. It is the occurrence of the Event of Default

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> "THEN, (1) upon the occurrence of any Event of Default described in Section 8.1(f) or 8.1(g), automatically, and (2) upon the occurrence and during the continuance of any other Event of Default, at the request of (or with the consent of) Requisite Lenders, upon notice to the Borrower by the Administrative Agent, (A) each of the following shall immediately become due and payable, in each case without presentment, demand, protest or other requirements of any kind, all of which are hereby expressly waived by each Credit Party: . . ."

which typically provides a basis for acceleration. When acceleration occurs and the debtor does not repay the debt, then a 'default' has occurred as contemplated by UCC s. 9-601 and the creditor may exercise remedies.

This is not to say, however, that the occurrence of a breach, default or "Default" (such as the failure to timely pay interest or deliver a financial statement) does not have consequences for the debtor. It is customary for a loan to bear a higher rate of interest (i.e. a "default" rate of interest) following the occurrence of the breach, default or "Default". Typically, this higher interest rate applies during the continuance of the breach, but it ceases to apply following its cure. However, default interest rate provisions are not always drafted to automatically lower the interest rate once the breach is cured. This is something to watch out for if you represent borrowers/debtors.

Another consequence of the occurrence of a breach, default or "Default" is that access to revolving credit is denied until the breach is cured or waived. It is typically a condition precedent to borrowing under a revolving credit that no breach, default or "Default" exist. The borrower/debtor may not properly request a loan under a revolving credit facility if a breach, default or "Default" has occurred and is continuing.

The officer of the debtor requesting the loan under a revolving credit facility typically must certify in writing that no such breach, default or "Default" exists (*or will exist as a result of the new borrowing*).[2]

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[2] A new borrowing might cause a default, for example, if the borrower/debtor was subject to a covenant in some agreement which limited its indebtedness to a specified cap amount, or if it were subject to a financial ratio test which required a specified debt to equity ratio. The financial officer could truthfully certify to the absence of a default or event of default and, yet, the funding of the

When acceleration occurs (and the debt becomes “immediately due and payable”), a payment default exists if the debtor does not repay the loan on this earlier “accelerated” payment date. The failure to make payment on this new and accelerated payment date is a “default” within the contemplation of UCC s. 9-601. The events which provide a basis for acceleration are those agreed between a creditor and a debtor by contract.

It is “[a]fter default”[3] that the secured creditor has the rights provided by Part 6 of Article 9, as well as the rights provided by the agreement of the parties. See UCC s. 9-601(a) and TEXT Chap 12, p. 816 and ff. Note that the UCC uses the undefined and lower-case word “default”. This can be confusing because there is an interplay between the terms used in a credit document and the UCC as described above. In contract language terms, a “default” may exist following a simple breach. However, this sort of “default” is not necessarily the type of “after default” contemplated by UCC s. 9-601. If, however, a default has matured into an Event of Default under a credit document and the creditor has accelerated the maturity of the debt and the debtor has

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very loan requested would place the borrower in breach. That is why a better drafted agreement might include the italicized language as part of the required certification.

[3] Though this is typically defined as an “event” of default and available actions are specified in the credit document, the parameters of the word “default”—if not circumscribed by contract—probably include mere defaults which would give rise to a breach of contract action at common law. But a suit to collect an entire debt is not proper unless that debt is matured or has been accelerated—which is a matter of contract. A court of equity will not imply an acceleration. See Kirk v. Van Petten, 38 Fla. 335 (1896). For example, you could sue for a missed interest payment, but not the entire amount of the debt unless accelerated. And, acceleration would be available as an option only if provided for by contract.

failed to pay the debt on the accelerated maturity, then it is clear that action may be taken by the creditor "after default" within the meaning of UCC s. 9-601.

Importantly, a payment failure is a "default" which allows a secured creditor to exercise remedies. Thus, commercial lawyers must understand how to read the provisions of notes, credit agreements and loan agreements which govern the circumstances in which a loan may become due and payable early. This is particularly true because a creditor may proceed to exercise remedies on its own initiative without prior court approval (though the creditor potentially will have liability if it proceeds in error).

Often, a note, credit agreement or loan agreement will define the events which provide for the acceleration of a stated maturity as "Events of Default" although not all credit documents include such a formal definition. An example of such a definition appears in the ABL CREDIT AND GUARANTY AGREEMENT for TiVo Corporation which we reviewed as background material at the start of the course (page 24 of this ABL credit facility contains the definition, which refers the reader to Section 8.1 of the facility, at p. 123-26).

As we shall see, the promissory notes in In re Inofin listed various events which provided for the early acceleration of the notes, though the notes apparently did not label these events with a defined term such as "Events of Default". Some events permitting acceleration occurred automatically upon the occurrence of the event, other events permitting acceleration occur only after the passage of time, and still other events permitting acceleration require notice from the Maker prior to their taking effect to allow acceleration of a maturity.

Student responses to quiz questions on these type of contract clauses typically reveal a high error rate in understanding how these types of contract clauses are drafted and operate. That being said, the particular clause governing defaults in In re Inofin is not a model of clarity (and my questions may have been opaque!). We shall consider that clause, comparing it to Section 8.1 in the TiVo Corporation ABL facility and the sample at TEXT Chap 12, p. 799.

The "defaults" clause in In re Inofin

One way to conceptualize the operation of the section on defaults in the notes in *In re* Inofin is that they are intended to convert a term note either into a demand note or into a note which allows the holder to demand payment if it deems itself insecure—with the specified events constituting those events which justify a holder in being insecure. If any one of the events occurs, then the holder is permitted to demand immediate payment as in the case of a demand note or a note allowing acceleration upon insecurity.

We can tell that the notes are based on form documents (rather than a custom drafted document) because of clause (5) which provides for an automatic event allowing for acceleration IF the Maker is a business entity such as a corporation, partnership or trust which ceases to exist.

The following appears in *In re* Inofin at p. 24-25:

> Additionally, the notes contained provisions relative to defaults. They provided the following:

At the option of the holder, this note shall become immediately due and payable without notice or demand upon the occurrence at any time of the following events: (1) Default in any payment of principal or interest which is not cured within seven (7) days; (2) Default, for more than 21 days after notice thereof from holder to Marker, no cure having been effected, in the performance or observance of the terms or conditions of the Security Agreement or other instruments and documents . . . securing this note; (3) Default for more than 21 days after notice thereof from holder to Maker, no cure having been effected, in the payment or performance of any other liability or obligation of the Maker to the holder; (4) Service, pursuant to trustee process, upon the holder hereof of a writ in which the holder is named as trustee of at least $10,000 of the Maker; (5) If the Maker is a corporation, trust or partnership, the liquidation, termination or dissolution of any such organization; or (6) If the Maker shall make an assignment for the benefit of creditors, or if a receiver of all or substantially all of Maker’s property shall be appointed and not dismissed within 60 days, or if a petition in bankruptcy or other similar proceeding under any law for relief of debtors shall be filed by or against . . . Maker.

Clause (1)

It is not uncommon for a creditor to allow no grace periods for monetary defaults, but to allow some grace period or cure period for non-monetary defaults. Sometimes a compromise is made in which no grace or cure period is allowed for a principal payment but some allowance is made for an interest payment. Sometimes a one-day grace or cure period is allowed for principal, with 3 or 5 days allowed for interest and other payments. A stronger case might be made for some grace period (or a longer grace period) if multiple time zones appear implicated by the contract—particularly where the event contains a notice requirement.

The seven (7) day period allowed here in *In re* Inofin for both principal and interest is quite generous. It is common to allow the payment failure to automatically mature into an event which allows acceleration—that is to say, the holder or creditor typically does not need to send a notice to start the running of the grace period or trigger the occurrence of an Event of Default. This makes sense, particularly for scheduled payments, because the Maker or debtor should be aware of those dates and can plan for the payment. In the case of a payment due based upon an unscheduled or less regular event (like a pre-payment due based on an asset sale or a borrowing base computation) a stronger case can be made to allow some sort of grace period.

On the language appearing in this form of note, an event automatically allowing for acceleration occurs IF the payment of either principal or interest is ***more*** than seven (7) days past due. I say 'more' than seven (7) days past due because the event occurs if a cure is not effected "within seven (7) days". How is that time period computed? The question arises for the basic computation of the time period. It is a further question of interpretation of what to do IF the seventh day falls on a non-business day. Does an event of default exist if payment was not made on the next preceding business day, or is the grace period extended to the next succeeding business day?[4]

Computation of time periods is a skill that every lawyer (not just every commercial lawyer) should master. The context of the computation of time period matters.

Consider the *In re* Inofin event of default as drafted—and suppose that an interest payment falls due on March 1. On these facts, the conventional interpretation would exclude the specified date of payment. Thus, if payment was due on March 1, an Event of Default would exist if payment had not been made on or before March 8. [A breach or default would exist on March 2 but it would not entitle the Maker to accelerate the maturity of the note.] After March 8, the payment would be 7 days late. Note that one would not attempt a "cure" on March 1 because no cure is needed until March 1 has come and gone without payment. Thus, it appears that seven (7) days are allowed for a cure. That seven (7) day period would expire at midnight on March 8. Thus, an acceleration of the maturity might be declared on March 9 if payment had not been made.

If March 8 fell on a Sat, Sun or holiday, the conventional contract interpretation would allow payment to be made on the next succeeding business day. That is to say, the grace period is extended. This result is

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[4] An interesting question also might arise if the first day falls on a non-business day. Suppose March 1 is a Sunday. If the payment was not due until the next succeeding business day (i.e. Monday) then does the seven (7) day grace period only start to run when payment is not made by the end of the day on March 2? That certainly seems like a plausible interpretation. The commercial lawyer needs to be alert to all these nuances of possible computation in the calculation of days and time periods.

required, as a matter of statute, by New York law pursuant to s. 25 of the N. Y. General Construction Law. See e.g. Coventry Enterprises LLC v. Sanomedics International Holdings, Inc., 191 F.Supp.3d 312 (S.D.N.Y. 2016)(applying New York General Construction Law s. 25 to the interpretation of an option contract).

Given the amount of commerce now conducted on Saturdays, Sundays, and holidays there is an emerging trend in case law to not allow for an extension of time—particularly on a holiday—in the absence of a statute. See Swiss Bank Corp. v. Dresser Industries, Inc., 141 F.3d 689 (7th Cir. 1998)(Posner, J.)(interpreting Delaware law on the treatment of a state holiday in the context of an option contract). Of course, these are just default rules to apply to contract interpretation in the absence of a separate agreement of the parties. The parties might, for example count days by using a defined term of "Business Days". Alternately, contract language might specify a payment date but qualify it with language stating "or, if any such day is not a business day, on the next preceeding business day".

<u>COMPARE TEXT p. 799:</u> Section 2.1 makes any default in payment an immediate Event of Default—without a grace period for principal, interest or any other amount. <u>*In re* Inofin</u> provides seven (7) days grace for both principal and interest. Also, it seems to provide for 21 days grace (following notice!) for payment of any other amount under clause (3).

<u>COMPARE TiVo p. 123:</u> Section 8.1(a) makes any default in payment of principal an immediate Event of Default—without a grace period or notice; a three Business Day grace period is allowed for the payment of interest and other amounts, but no notice is required to start the period.

Clause (2) & (3)

Clauses (2) and (3) are a bit hard to understand in one sense: why do they need to be two different clauses? Both allow for 21 day grace periods after a notice of a default. The defaults themselves appear to be "cross-defaults—in clause (2) cross defaults to the Security Agreement and other instruments and documents related to security for the notes and in clause (3) to other obligations which the Maker may have to the holder. For starters, a 21-day grace period is very long indeed, particularly for a default under a document related to a security interest. It is not uncommon to give no grace period at all for a default which adversely impacts a security interest. The reason for this is that if there is any time period during which a security interest is unperfected the re-perfection of that security interest (i.e. the "cure" of the default) might create a voidable preference—in effect negating the protection of the security interest. A generic cross-default to other agreements which Maker might have with holder is less problematic and a grace period would not be unusual in such a case. It is, however, a bit odd to have cross-defaults to other agreements with the holder, but not cross-defaults (or, at least, cross-accelerations) to agreements with third parties. A cross-default of any sort—whether to other agreements with the holder, but particularly for agreements with third parties—creates interpretation problems which are discussed at the end of these notes.

Clause (4)

I think clause (4) is rather odd indeed. It seems like a bit of an anachronism. What is "trustee process" and why $10,000? In Massachusetts, trustee process refers to a procedure or legal process by which a third party, rather than the creditor, attaches a debtor's property. Trustee process is similar to garnishment. In

Massachusetts the third person or garnishee is referred to as the trustee. The general idea of this clause seems to be that a third-party must have obtained a judgment against the Maker for $10,000 or more and then sought to exercise remedies by attempting to “attach” or “garnish” property in the possession of holder which arguably is property of, or due to, Maker. Pretty specific—and probably the product of an outdated form which was not thought through very well. A more modern way to develop such a default is to specify a default if the Maker becomes subject to a judgment for $X (or more) which remains unsatisfied—or something to that effect. And, a default might exist if a judgment lien is asserted for $X amount (or more) which is not satisfied or released. The interesting thing about clause (4) is that it seems to have been custom made for use in the State of Massachusetts—not surprising as Inofin Corporation is/was a Massachusetts corporation. This illustrates that events of default might need to be crafted for the particular circumstances of a transaction and that a standard form will not always do. For example, you might not refer to “trustee process” for a deal in another jurisdiction.

Clause (5)

It is completely ordinary to provide that the liquidation, dissolution or termination of existence of a corporate borrower (or, indeed, a similar event with respect to any business entity who is a debtor) constitutes and event of default. It also is completely ordinary that no grace period or cure right would be allowed with respect to such an event. Sometimes such a clause is drafted to provide for the automatic acceleration of the maturity of the debt—and not even give the holder or creditor the “option” to accelerate following such an event. In that case, the clause would be drafted in the same manner as the “Events of Default” in the ABL facility for TiVo Corporation.

<u>Clause (6)</u>

If the Maker makes an “assignment for the benefit of creditors” the event providing for acceleration automatically occurs. ***This makes sense because it is a voluntary action which is in the control of Maker***.

If a “receiver of all or substantially all of Maker’s property shall be appointed and not dismissed within 60 days” the event providing for acceleration automatically occurs. However, there is a difference.

Significantly, this event contains within it a 60-day grace period within which Maker might seek to cure the event to avoid the risk of acceleration. ***This grace period makes sense, at least in the case where third parties have sought the appointment of a receiver, because that action is not within the control of the Maker***.

As the passive voice is used in drafting this clause, it also would appear to allow grace if the Maker somehow had sought the appointment of a receiver. This would be unusual and makes little sense (if indeed it is even possible under applicable state law). If Maker had initiated a state insolvency procedure, that typically would occur by Maker making an “assignment for the benefit of creditors”. It is typically third parties who petition a court for the appointment of a “receiver”.

Assuming a typical bifurcation of procedures in which a debtor would voluntarily make an “assignment for the benefit of creditors” whereas creditors would seek the appointment of a receiver (and such an appointment would not be “voluntary” or consented to by the debtor) then the structure or business deal reflected in the first part of clause (6) is easy to understand.

The second part of clause (6) is handled differently. The event providing for acceleration automatically occurs “if a petition in bankruptcy or other similar proceeding under any law for relief of debtors shall be ***filed by or against*** . . . Maker”. [emphasis supplied] Here, the event providing for acceleration automatically occurs regardless of whether the Maker voluntarily files a bankruptcy petition or whether creditors of the Maker file an involuntary petition against Maker. This business deal here is harder to understand at first blush because it creates the possibility for automatic acceleration for an involuntary occurrence—contrary to the treatment given to state insolvency proceedings earlier in clause (6). What is the reason for this difference—if indeed it even exists under the contract language?

First, the holder may want “automatic” acceleration in the case of a bankruptcy because the automatic stay applies regardless of whether or not the bankruptcy petition is voluntary or involuntary. Second, the entire section on defaults begins with the phrase “at the option of the holder” so perhaps this language is thought to soften the impact of the potential for acceleration following an “automatic” event of default. Of course, immediately after this “option” language, the section continues “this note shall become immediately due and payable ***without notice or demand*** upon the occurrence at any time of the following events” [emphasis supplied]. The import of the language is unclear—other than the idea that some grace is given to allow a

Maker to seek dismissal of the appointment of a receiver. The interplay between the “option of the holder” langauge, the reference to the note becoming “immediately due and payable” and the presence of different grace periods and notices creates a bit of uncertainty—particularly for clause (6) but, indeed, for the entire listing of defaults which alllow for acceleration. Perhaps a creditor would not want to send a notice to a debtor requesting a cure after the commencement of a bankruptcy proceeding because of concern about violation of the automatic stay. It is hard to see how this concern is any less if the creditor elects the “option” to accelerate following the commencement of the bankruptcy case. But maybe. Whether the debt is accelerated or not following the commencement of the case, the creditor will be able to file a proof of claim for the full amount of the debt, together with any other amounts accrued and unpaid as of the commencement of the case. And, a secured creditor with excess security may seek post-petition interest.

Some Examples of Time and Default Computations

Students should be generally aware of the presence of statutes and rules of procedure which provide for the computation of time periods. While not every state has a statute like New York’s General Construction Law, often parties will argue for a particular contract interpretation by analogy to a rule of court procedure, an administrative rule or a local rule. An example of one such rule of computation appears in the Federal Rules of Bankruptcy Procedure:

[start rule of procedure]

Federal Rule of Bankruptcy Procedure

Rule 9006. Time

(a) Computation

In computing any period of time prescribed or allowed by these rules or by the Federal Rules of Civil Procedure made applicable by these rules, by the local rules, by order of court, or by any applicable statute, the day of the act, event, or default from which the designated period of time begins to run shall not be included. The last day of the period so computed shall be included, unless it is a Saturday, a Sunday, or a legal holiday, or, when the act to be done is the filing of a paper in court, a day on which weather or other conditions have made the clerk's office inaccessible, in which event the period runs until the end of the next day which is not one of the aforementioned days. When the period of time prescribed or allowed is less than 8 days, intermediate Saturdays, Sundays, and legal holidays shall be excluded in the computation. As used in this rule and in Rule 5001(c), "legal holiday" includes New Year's Day, Birthday of Martin Luther King, Jr., Washington's Birthday, Memorial Day, Independence Day, Labor Day, Columbus Day, Veterans Day, Thanksgiving Day, Christmas Day, and any other day appointed as a holiday by the President or the Congress of the United States, or by the state in which the court is held. **[end rule of procedure]**

Notice the particular rule with respect to time periods for less than 8 days. How would you compute a grace period of 5 days under this rule? In effect, it functions a lot like a “Business Day” definition insofar as non-business days which occur appear to be excluded—although even here I wonder about the use of the word “intermediate”. What does “intermediate” do if the first day of the period of computation is a Saturday, Sunday or legal holiday? Hmm. A Business Day definition might handle this better if drafted well.

Cross Defaults

Another very tricky problem of computation and contract interpretation comes when one tries to determine whether or not an Event of Default exists or has been cured and how that relates to the interplay between different agreements which specify “Events of Default”.

It is common for a note, credit agreement or loan agreement to contain a clause known as a “cross-default”. In general concept, a cross-default is like a most favored nation’s clause in which creditor no. 1 wants to piggy-back on the defaults and covenants negotiated by other creditors, for example creditor no. 2. Creditor no. 1 uses a cross default so that no other creditor, such as creditor no. 2, has a default which might be the basis for an acceleration when creditor no. 1 does not have that same right. The practical reason is that creditor no. 1 wants to be involved at the earliest possible stage in any work-out or restructuring negotiations involving the debtor. If creditor no. 2 is at the table negotiating a waiver or amendment in light of the debtor’s financial difficulty, creditor no. 1 wants to be at that negotiating table too. The presence of the cross-default language insures this result.

The following examples illustrate the “cross-default”—assume the cross-default clause appears as an “Event of Default” in credit agreement no. 1 and that credit agreement no. 2 satisfies the applicable definition of Material Indebtedness:

(ver. # 1) *the Borrower shall fail to make any payment of principal, interest or other amount in respect of Material Indebtedness [e.g. defined as indebtedness owed to a third party with a principal amount of $100,000 or more, or some greater or lesser amount] when and as the same shall become due and payable;*

Comment: ver. # 1 creates an event of default under credit agreement no. 1 even prior to an event of default existing under credit agreement no. 2 because the cross-default is triggered by a mere payment default or payment breach under credit agreement no. 2. This is because no allowance is made for the grace period under credit agreement no. 2. Borrower should be reluctant to agree to such a cross-default because it has the effect of taking away the benefit of any grace periods for payments which it negotiated in credit agreement no. 2. While the lender under credit agreement no. 2 may not accelerate until after the expiration of a grace period, the lender under credit agreement no. 1 may accelerate the loan under credit agreement no. 1 immediately following the payment default under credit agreement no. 2.

(ver. # 2) *the Borrower shall fail to make any payment of principal, interest or other amount in respect of Material Indebtedness when and as the same shall become due and payable**, which is not cured within any applicable grace period therefor**;*

Comment: ver. # 2 creates an event of default under credit agreement no. 1 only when, and at the same time as, an event of default exists under credit agreement no. 2. This is a preferred formulation of a cross-default from the perspective of the Borrower. It does not deprive the Borrower of the grace periods which it negotiated with lender no. 2.

(ver. # 3) *the Borrower shall fail* ***(i)*** *to make any payment of principal, interest or other amount in respect of Material Indebtedness when and as the same shall become due and payable, or* ***(ii)*** *to comply with any other covenant contained in such Material Indebtedness, or (iii) any event or condition exists under Material Indebtedness which allows for the acceleration of the maturity of such Material Indebtedness;*

(ver. # 4) *the Borrower shall fail* ***(i)*** *to make any payment of principal, interest or other amount in respect of Material Indebtedness when and as the same shall become due and payable which is not cured within any applicable grace period therefor, or* ***(ii)*** *to comply with any other covenant contained in such Material Indebtedness with is not cured within any applicable grace period therefor, or (iii) any event or condition exists under Material Indebtedness which allows for the acceleration of the maturity of such Material Indebtedness;*

Comment: ver. # 3 and ver. # 4 each expand the cross-default to cover not only payment defaults but also other covenant defaults (in (ii)), as well as other matters giving a right to accelerate (in (iii)), such as breaches (such as of a representation or warranty). The cross-default can be drafted either to give the Borrower the benefit of its grace periods as in ver. # 4 or to deprive the Borrower of the benefit of those grace periods as in ver. # 3. A strong and powerful “big bank” might want to take away grace periods so that it has a chance to speak with the Borrower about financial difficulties even before it seeks a waiver from the lender under the agreement which gave rise to the default in the first place.

Note that these cross-default provisions differ from a softer “cross-acceleration” which simply provides for the acceleration of creditor no. 1’s debt if any other creditor, such as creditor no. 2, accelerates the maturity of his, her or its debt. A cross-acceleration might be automatic or simply give creditor no. 1 the option to accelerate the creditor’s debt if any other creditor has accelerated. The cross default is stronger in the sense that it allows creditor no. 1 to accelerate creditor no. 1’s debt IF any other creditor has a default (or, in milder cases, an event of default) under the other note, credit agreement or loan agreement. This stronger cross-default provision can create problems (not presented by a cross-acceleration), as the following examples show.

Examples of a Cross-Default Conundrums

Example 1 assumes the following:

Loan agreement for creditor A includes as an event of default a mere "default" of cross-default under Material Indebtedness as in ver. # 3.

Loan agreement for creditor B includes as an event of default the "event of default" of cross-default under Material Indebtedness as in ver. # 4.

Assume that “Material Indebtedness” is defined in in loan agreement A to include the debt under loan agreement B, and that it is defined in loan agreement B to include the debt under loan agreement A.

The Borrower is required to pay interest on June 15 under loan agreement B.

The Borrower has a grace period under loan agreement B for interest payments of five days.

If the interest payment is due on June 15 under loan agreement B and the borrower does not make the payment, then on June 16, there is a "default" under loan agreement B which triggers an "event of default" under loan agreement A. The event of default under loan agreement A, in turn triggers an event of default under loan agreement B on June 16 because an event or condition has occurred which allows for the acceleration of Material Indebtedness (as defined).

In the absence of the stricter type of cross-default under loan agreement A, there would not be an event of default under loan agreement B until five days later, as provided in loan agreement B. The stricter cross-default in loan agreement A renders the five-day grace period with respect to interest payments in loan agreement B meaningless.

Example 2 assumes the following:

The borrower makes the interest payment on June 17.

As a result, the default under loan agreement B is cured.

Although the default under loan agreement B was cured, it does not change anything because there was an event of default under loan agreement A on June 16. Moreover, there is also an event of default under loan agreement B arising from the cross-default. As a result, the borrower is in the odd position of being subject to acceleration under both agreements for a matter that (except for the cross-default) would otherwise have had no adverse consequences for the borrower under either loan agreement.

This situation is made worse for the borrower if both agreements have the second and stricter type of cross-default since the borrower is almost always subject to acceleration and the highly negotiated notice and grace periods in both agreements become entirely meaningless.