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# Curing a Default: When Is It Too Late?

Certain cure periods in credit agreements are regularly negotiated. For example, a borrower's failure to pay interest or fees when due normally does not result in an event of default unless the borrower fails to make the payment for some period of time after the due date. Credit agreements also typically afford borrowers a period of time (often 30 days) before the breach of certain affirmative covenants results in an event of default. In these cases, the credit agreement is specific in providing that if the borrower takes the required action within the cure period, though beyond the required deadline, an event of default has not occurred. Similarly, many private companies (particularly those owned by private equity sponsors) are permitted under their credit agreements to cure the breach of a financial maintenance covenant (commonly referred to as an "equity cure") if the borrower receives a capital contribution that, when added to EBITDA as of the last day of the test quarter, would be sufficient to cause the borrower to be in compliance with the breached covenant. Here the event of default occurred, but the credit agreement expressly deems the event of default to have been cured once the capital contribution is received.

There remains some debate, however, as to whether events of default can be cured in the absence of (or after the lapse of) an express cure period. This matters primarily because in many credit agreements (and related security documents), the lenders have the right to exercise certain remedies, such as accelerating the loan, charging default interest and foreclosing on collateral, so long as an event of default "has occurred and is continuing." This implies that events of default may occur but may cease to continue. Even in the absence of the "and is continuing" language, the general consensus among practitioners is that lenders have the ability to act on an event of default only so long as it is continuing. There is a divergence of opinion, however, when it comes to whether an event of default can be cured by the borrower rendering such event of default no longer continuing absent express language providing for such a cure. Borrowers assert that once the underlying cause of the event of default is resolved, the event of default no longer continues; for instance, if an interest payment is made even after the end of the cure period, the borrower is back in compliance. Many lenders would argue, at least in certain circumstances, that an event of default can never be cured once it occurs absent a waiver from the lenders.

## Bridging the Gap

In several recent deals, borrowers have attempted to include an interpretive "Cured Default" provision into their credit agreements that prescribes how certain types of events of default can be cured. In the case of actions required to be taken by a specified time or date, this provision says that if the borrower later takes that action, even if after the deadline, the default is deemed to be cured. Similarly, if the borrower performs a prohibited action and that action is later permitted, or the borrower later unwinds that action, this provision would say

that the default is then cured without the need for waiver or other action by any lender. The language additionally provides for the automatic and simultaneous cure of any subsequent defaults or events of default that would not have arisen had the original event of default not occurred (such as a representation that was untrue when made as a result of the original default).

Predictably, lenders are rejecting the inclusion of this language, but the efforts of such borrowers has sparked conversations and challenged assumptions over when and how events of default may or may not be cured according to the express provisions of a typical credit agreement that lacks this "Cured Default" provision—whether as an interpretive contractual question or in practice.

## Do Credit Agreements Permit Cure in the Absence of Express Cure Language?

Based solely on textual interpretation of typical credit agreement language, some events of default could more logically be expected to be curable than others—and an argument can be made that at least portions of the "Cured Default" provision do not actually change what a credit agreement otherwise provides. For instance, if an amount is paid or a document (such as a financial statement or compliance certificate) is delivered after the due date, the borrower would argue that the requirement has been satisfied so the default no longer continues. In terms of negative covenants, where the borrower is prohibited from taking certain actions, a similar argument can be made; if the borrower unwinds the prohibited transaction (for example, by repaying prohibited debt or its shareholders rescinding a prohibited dividend), it would argue that such unwind puts the borrower back in compliance with the applicable covenant. The counterargument that a lender would make is that the borrower took an action it was expressly not permitted to take and that the unwinding of the resulting transaction does not change the fact that the breach occurred.

In its guidance, the Loan Syndications & Trading Association (LSTA)[1] sits on the fence, giving the example that if a borrower fails to pay an installment of principal when due and the lenders take no action to accelerate the loans, and if the borrower later pays the defaulted principal, the event of default is then cured and the lenders may no longer accelerate. However, if the agreement does not expressly require that the breach be "continuing," once the default occurs, even if it is later "cured," according to the LSTA the borrower will always remain vulnerable to acceleration unless a waiver is delivered.

In the case of certain other events of default, it would be difficult to argue that the default can be cured based on the plain meaning of a typical credit agreement. For instance, financial maintenance covenants are tested as of a particular date and, in the absence of an equity cure provision as mentioned above, it would be impossible for the borrower to go back in time to achieve compliance with the applicable test as of that date. A borrower might argue that the default would be cured if it complies with the covenant as of the next test date—typically the end of the next fiscal quarter. But credit agreements say that the borrower must comply with these covenants as of each test date, not just the most recent test date.

Another type of default that seemingly cannot be cured is the breach of a representation or warranty. Typically, it is an event of default if a representation is untrue in any material respect when made. It would not be possible for a borrower to go back in time to take some action that would have made that representation true as of the date it was made. A borrower may argue that, since the substance of many representations is parallel to a corresponding affirmative covenant,[2] its right to cure the representation should naturally follow. At least

on a textual interpretation basis, this argument is not particularly persuasive.

## What Does This Mean in Practice?

In considering whether a court would say a borrower has the right to cure an event of default in the absence of an express cure provision, it is important to consider the likely context of this litigation. It would likely arise in a situation where lenders exercised remedies (such as acceleration of the loan, foreclosure on collateral or charging of default interest), or a lender assigned its loan without borrower consent (which typically is required in the absence of an event of default), and the borrower argues that the event of default on which the lenders relied in taking such action has been cured.

In practice, there is little judicial discussion on this specific scenario. In most cases when lenders are at the point of exercising remedies, the borrower is past the point of being able to cure the event of default. Additionally, most corporate borrowers file for bankruptcy before lenders have the chance to commence foreclosure actions. However, it is instructive that courts typically decline to side with lenders that exercise remedies in reliance on an immaterial or "technical" default, notwithstanding the lender having that right under the terms of the credit agreement. *See Sahadi v. Continental Illinois Nat'l Bank & Trust Co.,* 706 F.2d 193 (7th Cir. 1983). Given that context, if a borrower's cure truly returns the situation to the status quo, it seems unlikely that a lender exercising remedies after the fact would be viewed favorably by a court.

In practice, on the other hand, if a lender is actually exercising remedies despite the borrower's action to cure, it is likely that the cure did not return the situation to status quo. For instance, if a representation was untrue when made, the lenders likely made loans to the borrower based on incorrect information. For any event of default, it is possible that a cross-default was triggered under the documentation for the borrower's other indebtedness so some other creditor of that borrower may have a resulting event of default that cannot be cured.

In the case of late payments and late delivery of information or taking of some other action, a lender may be able to show that it was actually harmed by receiving that payment late or by not having the information at the time required to be delivered—for instance, in the case of a late payment, such payment may fall within a preference period in bankruptcy allowing clawback of the payment. The best example may be the breach of an affirmative covenant to cause new subsidiaries to grant liens on their assets to secure the loan: if that subsidiary grants those liens after the required deadline, the lender's priority may be adversely affected. Lastly, in the case of many breaches, such as the agreement to pay taxes on time and not to incur debt not permitted under the agreement, it is possible that the borrower exposed itself to additional liability by the taking of (or failure to take) the prohibited action and that the lender may be harmed by that action.

In the case where lenders can demonstrate actual harm as a result of a later-cured default, or at least that the cure of an event of default did not return the parties to the same position they would be in had no default ever occurred, it seems likely that a court would determine the event of default to be still continuing at the time the lender exercised remedies. The case of *Sara Lee Household & Personal Care, UK, Ltd. v Almay, Inc.*, 1992 U.S. Dist. LEXIS 15540 (S.D.N.Y. 1992), *aff'd*, 992 F.2d 320 (2d Cir. 1993) held that any attempted cure must "completely ameliorate the default" and that the spirit of equity requires the claimant to be returned to the same position in which it would have been if no default had occurred. So, if a borrower "cures" an event of default after the point in time when that event of default can contractually be cured and the lender remains in a worse position than it was prior to the breach,

it is likely that a court would support the lender's exercise of remedies as a result.

## Conclusion

In the absence of express provisions providing that a particular event of default can be cured, whether that default can be cured may differ depending on the nature of the default. More importantly, a lender's ability to take action after a borrower takes action to "cure" an event of default absent an express cure right is likely to depend on the facts and circumstances at the time, including whether the lender's position is restored to the status quo.

From the borrower's perspective, while it is best practice to comply with the terms of the credit agreement, breaches inevitably occur in some cases. It is best to remain cautious in assuming that actions performed at a later date will always cure an event of default that had occurred in the meantime. To prevent negative treatment by lenders, borrowers should consult with their lenders before missing a delivery deadline to ensure interested parties are kept informed of the financial condition of the company. In addition, working with the lenders to obtain a consensual waiver is usually the best practice, to the extent that this is an affordable option. Such steps will demonstrate that the borrower is using efforts to protect the financial investment made by the lenders and that the lenders have not suffered as a result of the failure to deliver.

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## Endnotes

1 The LSTA's Complete Credit Agreement Guide (Events of Default - Chapter 9.1)

2 For instance, there is often a representation that the borrower has paid its taxes on a timely basis and also an affirmative covenant to pay its taxes on a timely basis.

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