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PLANNING FOR NEGATIVE FUTURE EVENTS (OR WHAT YOU DON'T WANT TO HAPPEN) – EVENTS OF DEFAULT

This note is written in the context of DCM bond issues in the European market, governed by English law, which are being offered to professional investors and under an exemption to the registration requirements of the US Securities Act of 1933, on either a Regulation S or a Rule 144A/Regulation S basis. It is therefore a high-level overview of a complex topic, intended to provide a general overview of the issues. Prior to taking any specific actions, the particular factual circumstances of an individual bond issue and issuer should be considered and specific legal advice sought.

What is an Event of Default?

Bonds usually involve bullet repayment structures, with the principal repaid in full at maturity. However, the terms and conditions of a bond will set out certain events, the occurrence of which may be used to accelerate the repayment of the bond ahead of its stated maturity date. These events are the **Events of Default**. Provided certain conditions are met (see *What conditions must be satisfied prior to acceleration of a bond?*), the occurrence of an Event of Default therefore acts as a potential trigger to acceleration (that is, a declaration that the entire amount of the bond is immediately due and payable prior to its stated maturity).

The Events of Default serve as part of the credit protection for bondholders, allowing them to act upon the first signs of a troubling storm brewing for the issuer (e.g. a non-payment of interest) rather than waiting until the downpour, and potentially only being able to act when presenting their debt claim in an insolvency of the issuer. Of course, there is an element of the self-fulfilling prophecy about an acceleration of a bond – if the entire principal amount of an issuer's bond is immediately declared due and payable, the issuer may very well find itself facing insolvency anyway. Even if an issuer may be able to fund the repayment of one series of bonds, it may well not have access to sufficient funds to repay any other indebtedness which is subsequently triggered by a cross-acceleration provision. From the bondholders' perspective, the ability to accelerate (or threaten to accelerate) the bond so that it is immediately due and payable gives bondholders a seat at the table when the issuer is negotiating with its immediate creditors.

In periods of economic uncertainty or disruption, as have been experienced since the start of the COVID-19 pandemic, Events of Default bear careful review. This is the case both for existing issuers managing their business through difficult macroeconomic conditions, and for potential issuers ensuring that the proposed Events of Default are appropriate to their business and will remain appropriate to their business throughout the lifetime of their bonds.

It is also important to remember that Events of Default will vary depending on the type of bond instrument, the nature of the issuer (corporate, financial institution, sovereign etc.), the strength of the issuer's credit, the demands and needs of the targeted bond investors, and the structure of the bond itself (e.g. whether the bond is issued pursuant to a fiscal agency or trustee structure). This note focuses on senior unsecured bonds, which are not contractually subordinated.

Where are the Events of Default found?

The Events of Default are contained as a separate condition of the terms and conditions of the bonds. It is important to note that the legally binding terms and conditions are those set out in the relevant trust deed or agency agreement (not the offering document). Of course, the terms and conditions disclosed in the offering document should be identical to those in the trust deed or agency agreement, but it is worth remembering that the purpose of the terms and conditions set out in the offering document is to provide disclosure to investors and comply with listing requirements. Technically, should there ever be any discrepancy, the legally binding terms and conditions are those in the trust deed or agency agreement.

What type of Events of Default are customary?

Events of Default can broadly be divided into two categories:

i. events where an obligation under the bonds **has actually been breached**; and

ii. events which **anticipate a future breach of an obligation under the bonds**, indicating a looming problem or issue so significant that the right to accelerate should be triggered.

The defaults covering actual breaches are:

1. **Non-payment of interest or principal:** Notwithstanding that bonds are typically bullet maturity, non-payment of principal is included as an Event of Default in case there may be a partial early repayment of principal due. This is particularly important where an issuer may fail to pay principal due on an issuer call or investor put, where the call or put relates to only a portion of (and not the whole) bond issuance. The bonds to which the call or put did not apply would have the right to be accelerated and also declared due and payable in this situation.
2. **Breach of other obligations[1]:** This refers to all the other obligations the issuer has signed up to in the terms and conditions, including any covenants (financial or otherwise), and (if the bonds are issued with a trustee structure), the trust deed. If the bond issue is guaranteed, a failure by the guarantor to comply with its obligations (including as contained in the guarantee (whether part of the trust deed or in a separate deed of guarantee)), would also fall within the Event of Default for breach of other obligations.

1 In a bond involving financial covenants, this Event of Default relating to Breach of other obligations is often split into two Events of Default covering (i) other obligations generally; and (ii) the conditions relating to financial covenants specifically. Any requirements for a Trustee certification of material prejudice would not usually apply to the Event of Default in relation to a breach of the conditions relating to financial covenants, whereas a Trustee certification of material prejudice requirement would typically apply to breach of other obligations.

The defaults covering anticipatory events are usually:

3. **Cross default/cross acceleration:** A specified minimum threshold amount (in aggregate) of other indebtedness is not paid when due for repayment, or it becomes either subject to: (i) cross default (i.e. *capable* of being declared due before its stated maturity as a result of default); or (ii) cross acceleration (i.e. *actually* declared due before its stated maturity due to a default). From a bondholder perspective, a cross default is preferable as it allows the bondholders to make a decision about whether to accelerate based on default on other indebtedness (and does not make the bondholders hostage to the decision-making of the creditors of the other indebtedness as to whether to accelerate and actually declare that indebtedness due and payable). There is always a debate about what is the appropriate threshold level for a particular issuer (which is often negotiated by comparison to the thresholds set in an issuer's commercial loan facilities, with some consideration also to what is a material amount given the size of the issuer's balance sheet). The definition of indebtedness is usually broad, covering all indebtedness for borrowed money (it is not limited to the "relevant indebtedness" or "capital markets indebtedness" definitions used in a standard Eurobond-style negative pledge). On occasion, there may also be a carve-out for indebtedness subject to a good faith dispute between the relevant parties about whether such indebtedness is in fact due, pending a final judicial adjudication.

4. **Unsatisfied judgments:** A specified minimum threshold amount (in aggregate, usually matching the cross default/cross acceleration threshold) of judgments creating financial obligations remain unpaid/unsatisfied. This Event of Default is required as judgments do not necessarily relate to existing financial indebtedness – for example, an unsatisfied judgment relating to a regulatory fine or penalty could potentially trigger this Event of Default. It is often worded such that the judgments or arbitration awards must not be capable of further appeal or judicial review (in which case there is no need to include a proviso that the Event of Default shall not apply if the judgment is being disputed in good faith by appropriate proceedings).

5. **Insolvency, winding-up, cessation of business:** This Event of Default may be split into separate events covering: (i) actual insolvency (see box below: *What are the tests for whether a business is insolvent?*); (ii) preliminary steps to insolvency (e.g. application or petition to appoint an administrator, liquidator, taking action for deferment of indebtedness or declaration of a moratorium, making an arrangement with creditors to defer debt); and (iii) cessation or a threat to cease to carry on a relevant part of the business. The "relevant" part of the business may be defined in a number of ways, by reference to "all or substantially all" of the business, the "majority", a "substantial part" or a "significant part" etc. Cessation of a substantial or significant part of a business is clearly a lower bar to establish that an Event of Default has occurred compared to a cessation of "all or substantially all" or the "majority" of a business (see box below: *Commonly used terms in "cessation of business" Events of Default*). Solvent group reorganisations are customarily carved out of the scope of this Event of Default.

What are the tests for whether a business is insolvent?

The term "insolvent" is usually not defined in English law terms and conditions. In England and Wales, the term "bankrupt" applies to individuals. In England and Wales, a company is liable to be wound up under section 122 of the Insolvency Act 1986 where it is **unable to pay its debts**. This is what is generally referred to as **insolvency**. Section 123 of the Insolvency Act contains the statutory definition of inability to pay debts, which includes a company unable to pass either of:

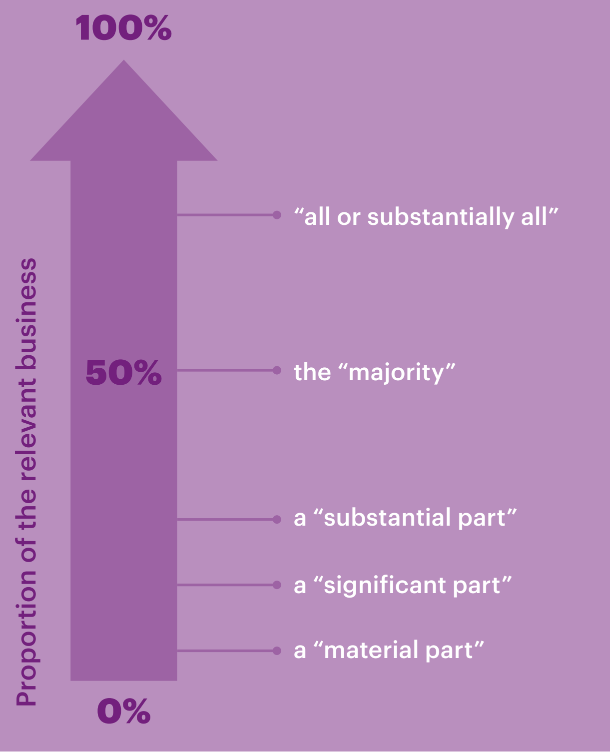
1. the **Cash Flow Test**: "A company is...deemed unable to pay its debts if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due"; or
2. the **Balance Sheet Test**: "A company is... deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities".

The Cash Flow Test extends beyond a company's immediate ability to pay and can include anticipated income and debts falling due in the reasonably near future. However, the further forward-looking the application of the Cash Flow Test, the more speculative the application of the test becomes, in which circumstance the Balance Sheet Test becomes the only sensible test.

As to the Balance Sheet Test, note this is not the usual audit balance sheet, but a balance sheet prepared on a going concern basis which should include contingent and prospective liabilities.

Where the company being assessed for insolvency is not incorporated in England and Wales, and the equivalent term for insolvency or winding-up in the relevant jurisdiction is not used in the Events of Default, the equivalent term in the relevant jurisdiction will be covered by the "analogous events" Event of Default (see (9) below).

Commonly used terms in "cessation of business" Events of Default



Market practice is to use the terminology above rather than objective percentage tests based on defined metrics, as this retains flexibility to prevent the tests being gamed, as a strictly quantitative assessment may not catch a problem that a qualitative assessment would. Thus, as there are no "bright-line" percentage tests for what these terms mean, they are best thought of in comparison to each other when negotiating and interpreting Events of Default. It is also important to take into account what aspect of the business any proportion is considering – for example, a cessation of business could occur on the basis of these terms based on a cessation which has an effect on a certain proportion of the consolidated total assets, the consolidated total revenues, or some other relevant metric. It could also be triggered by a holding company disposing of a subsidiary which conducts a particular line of business. Finally, a cessation may be considered "material", "significant" or "substantial" even if it does not have an immediate impact on financial metrics, such as total assets or total revenues – for example, sale of a key licence or transfer of a key regulatory permission. Each scenario needs to be considered on its own facts and in light of the surrounding circumstances.

6. **Enforcement of security:** Actual enforcement, or appointment of officers for enforcement of security over assets. Again, a threshold is usually set such that *de minimis* actions do not trigger an Event of Default. The threshold is often set by reference to the same terms used to describe a cessation of business.
7. **Invalidity/illegality:** Invalidity of a guarantee (where relevant) or where a guarantor claims that a guarantee is not in full force and effect, and (more often in emerging market and high-yield transactions) invalidity or illegality of the obligations of the issuer (and guarantors) more generally.
8. **Nationalisation:** If relevant to the issuer/issuer's group's business and geographical location, risks of expropriation or nationalisation may also necessitate an Event of Default triggered by any such action over a part of the business (either assessed as a percentage based on a consolidated financial metric, or by reference to the terms commonly used to describe the threshold for cessation of business).
9. **Analogous events:** Applies to all of the above Events of Default other than non-payment, breach of other obligations and cross default/ cross acceleration, and captures any event which occurs under the laws of the jurisdictions relevant to the issuer and any guarantors that has an effect analogous to Events of Default (4) to (8) above.

Unlike the loan market, it is not typical in a bond for there to be any Events of Default based on an assessment of a material adverse change having occurred, or a misrepresentation by the issuer or guarantors.

For a bond issued by a sovereign, the Events of Default will include events (1), (2) and (3) above. In addition, events including declaring a moratorium on its external indebtedness, commencing restructuring negotiations with its creditors in relation to external indebtedness, contesting the validity of the bonds or it becoming unlawful under local law to perform its obligations under the bonds, or the relevant sovereign ceasing to be a member of the International Monetary Fund, may also be included as Events of Default in a sovereign bond.

To whom do the Events of Default apply?

The Events of Default apply to the issuer and any guarantors. Often, however, material credit support for the issuer and guarantors also comes from other group members who are not guarantors.

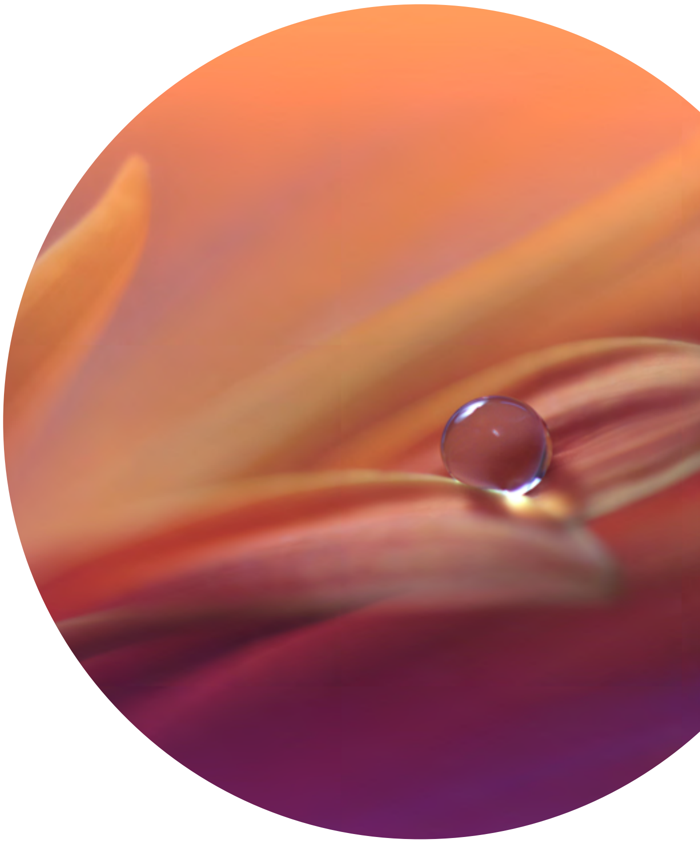
Therefore, depending on the complexity of an issuer's group and the nature of the group structure, it is common for some Events of Default to apply to either the entire group (i.e. the issuer, guarantors and all of their subsidiaries), or a subset of the entire group (i.e. the issuer, the guarantors and each of their "material subsidiaries"). A **material subsidiary** is most frequently defined by reference to a financial metric (for example, a minimum percentage of consolidated group assets or revenues, such as 5% or 10%, is frequently seen). Where this approach is adopted, then if a subsidiary (consolidated with its own subsidiaries) accounts for more than the specified percentage of either consolidated group assets or consolidated group revenues, it would be classified as a material subsidiary and directly subject to the Events of Default.

Events of Default do not apply to entities that the issuer and guarantors cannot control (such as joint ventures or affiliates), as issuers and guarantors should not be expected to bear the risk of actions by such joint ventures or affiliates triggering the Events of Default.

What conditions must be satisfied prior to acceleration of a bond?

The fundamental conditions that must be satisfied prior to a bond being capable of being accelerated for an Event of Default are, based on the usual drafting of Eurobond terms and conditions, that:

1. the "event" falling within one of the Events of Default must have **occurred**;
2. if required by the drafting (and this is usually the case in the Eurobond market), the event must **be continuing** (an event that has been remedied cannot be used to trigger acceleration and, on the other hand, once a bond is accelerated, it is too late to remedy the event)[2];
3. any applicable **grace periods must have expired** (see box: *Frequently Observed Grace Periods*); and
4. (in the case of a bond issued with a trustee structure) any requirements for a determination of **material prejudice** by the trustee have been satisfied (see box: *Trustee Certification of Material Prejudice*).



2 It is, of course, possible to draft an Event of Default that is triggered based solely on an event having "occurred", regardless of whether it is continuing (and such an Event of Default would therefore be incapable of remedy). However, the usual drafting in the Eurobond market is that the event must have both "occurred" and "be continuing" in order for a bond to be able to be accelerated.

Frequently Observed Grace Periods	
Event	**Common Grace Periods**
1. Non-payment of principal, non-payment of interest	3-7 days for principal, 7-14 days for interest. Once these grace periods have expired, if the event is still continuing, there is an Event of Default, regardless of the reason for the non-payment (i.e. there is usually no exception in bonds for non-payments due to administrative or technical errors). The rationale is that any administrative or technical error should be remedied within the applicable grace period.
2. Breach of other obligations	30-45 days after notice of breach. However, in bonds issued with a trustee structure, this grace period is not applicable if the trustee considers that the breach is not capable of remedy. There is often a debate in bonds with fiscal agency structures as to whether a reference should be included that the event must be in relation to a "material" obligation to avoid an Event of Default in relation to a trivial breach. Conceptually, a reference to "material" should be resisted, as it would be difficult to define and consequently determine what are the "material" obligations and thus whether or not an Event of Default has occurred.
3. Cross acceleration / cross default	The cross acceleration/cross default provision would typically specify that it is only triggered if that other indebtedness is not paid within any originally applicable grace period. No further grace period would be included.
4. Unsatisfied judgments	Often around 60 days (or, if later, the date specified in the judgment as the deadline for payment). Also note good faith disputation of the judgment may delay the event arising.
5. Insolvency, winding-up, cessation of business	Usually none, apart from in relation to applications and petitions by third parties for winding-up, in which case anywhere from 14-60 days are often permitted for such application to be dismissed (even up to 90 days in some cases).
6. Enforcement of security	Depending on the jurisdiction, and how readily an issuer can be expected to dispense with a frivolous purported enforcement, a short grace period may be permitted. However, the issuer's protection mainly comes from the threshold amount over which security must be enforced and often there are no grace periods.
7. Invalidity/illegality	Usually no grace periods.
8. Nationalisation	Usually no grace periods.
9. Analogous events	No additional grace period on top of any grace period for the relevant event.
Grace periods can be highly negotiated and can vary significantly across transactions. They depend on the negotiating strength of the issuer, the jurisdiction of the issuer and the nature of the particular bond. The above table presents a high-level "typical" guide only.	
References to days in grace periods are usually to calendar days. Business days are best avoided when they are determined by reference to multiple jurisdictions – in a potential default situation, when parties are considering critical decisions under time pressure, there is significant value in the simplicity and certainty of grace periods being expressed in calendar days.	
It is also worth noting that when an event has occurred and a grace period is running, there will be a **Potential Event of Default**. A Potential Event of Default is usually defined as an event or circumstance which could with any one or more of the giving of notice, lapse of time, issue of a certificate or fulfilment of any other requirement provided for in the Events of Default condition, become an Event of Default. If a Potential Event of Default has occurred, the issuer would usually be obliged to provide immediate notice of the Potential Event of Default to the trustee, as well as providing notice to its bondholders, via a public announcement on the relevant stock exchange and/or via the clearing systems. The trustee will usually have certain additional rights under the trust deed in this situation (such as requiring the paying agents to act as agents of the trustee etc.).	

Trustee Certification of Material Prejudice

In bonds issued with a trustee structure, certain Events of Default will usually be drafted to require the trustee to form a view (and certify so in writing to the issuer), that the event is, in its opinion, materially prejudicial to the interests of the holders of the bond. This requirement is never included in bonds with a fiscal agency structure, as it would not be appropriate for a fiscal agent (as an agent of the issuer) to make that decision and, indeed, no fiscal agent would be willing to do so.

Material prejudice here means prejudicial in a more than trivial way to the bondholders' rights to receive principal and interest on time and in full (as well as ancillary rights that the bondholders have in order to protect that entitlement to principal and interest).

The requirement for a certification of material prejudice does not usually apply: (i) to those Events of Default that are clearly prejudicial to the interests of holders of the bonds (such as non-payment, winding-up, insolvency etc.); or (ii) where the terms and conditions themselves indicate a monetary threshold above which an event triggers an Event of Default (such as cross default, cross acceleration or any financial covenant, where the negotiation of the terms and conditions has determined that an amount above that threshold is materially prejudicial to the bondholders).

Who can accelerate a bond following an Event of Default?

In a bond issued pursuant to a fiscal agency structure, each holder of the bonds has the individual right to accelerate the bonds that they hold following an Event of Default if the required conditions are satisfied (see above: *What conditions must be satisfied prior to acceleration of a bond?*). It is worth noting, however, that sovereign bonds are an exception to this right of individual action, as they contain **collective action clauses (CAC)**. A collective action clause requires holders (in the standard ICMA and EU CAC) representing not less than 25% of the principal amount of the outstanding bonds to act collectively to accelerate the bonds following an Event of Default (and all bonds in the issue, not just those of the holders delivering the acceleration notice, are declared due and payable). Such a notice of acceleration may be cancelled by holders of more than 50% of the principal amount of the outstanding bonds in the standard ICMA and EU CAC.

In a bond issued pursuant to a trustee structure, following an Event of Default and if the required conditions above are satisfied, the customary provision gives the trustee (not the holders of the bonds) the power to accelerate the bonds (although a specified percentage of holders may direct the trustee to use that power). As in sovereign bonds, the action is collective and all the outstanding bonds of the issuance are accelerated together. The standard provision states that the trustee, at its own discretion, may, or if directed by holders representing more than 20% (usually, for non-sovereigns) of the bonds, or by an extraordinary resolution of the holders, shall (if indemnified, secured or pre-funded to its satisfaction), accelerate the bonds.

If a bond is accelerated, what is due?

In a bank facility, acceleration may trigger not just principal and accrued interest to become due and payable, but also potentially default interest and break costs (e.g. to cover hedging unwind costs) depending on the terms of the loan. By comparison, acceleration of a bond simply causes the bond to become immediately due and payable at its principal amount, together with accrued interest. The pre-default rate of interest (i.e. the usual rate of interest on the bond) is usually expressed to continue to accrue on the bond until the date of payment. If the bond amount is awarded via a judgment, from the date of judgment the High Court judgment debt rate would apply (currently 8%). It is possible to provide that the higher of the pre-default rate of interest and the High Court judgment debt rate would apply after any judgment in respect of the outstanding amount of the bond being due and payable.

What is the alternative to the occurrence of an Event of Default and potential acceleration?

In the current economic climate, with issuers in certain industries facing distinctly adverse and abnormal trading conditions, and economies across the world still adjusting to the ongoing effects of the COVID-19 pandemic, some issuers are faced with the prospect of actual or potential Events of Default under the terms of their bonds, arising from circumstances out of their control. Active engagement with holders of the bonds, the seeking of temporary relaxations and waivers to certain Events of Default, or more permanent amendments to bond terms and conditions may be necessary. Changes to bond terms via liability management exercises (such as consent solicitations – public requests for bondholder approval to amend the terms of a bond) are crucial tools to avoid triggering an Event of Default in a challenging business environment (but, of course, involve their own challenges as amendments to bond terms and conditions are procedurally more difficult to obtain than equivalent changes to bilateral or syndicated loan terms).

The devil is in the detail...

If you do wish to discuss further the drafting or interpretation of Events of Default, liability management exercises to manage concerns arising from Events of Default in the ongoing disrupted economic environment of the COVID-19 pandemic, or any other issues in the debt capital markets, please feel free to contact any of the Dentons Debt Capital Markets team. We are happy to chat, on the phone or via video-conference.

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