

## Dealing with distress in REF

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*With interest rate and inflation rises, the cost-of-living crisis and forecasts of recession going into 2023, the economic climate is a little volatile to say the least. The expectation is that we are, therefore, likely to see increasing financial covenant breaches and non-payment defaults under credit facilities over the coming months.*

### **Bringing the borrower to the table**

During this uncertain period, it is important for lenders to maintain an open dialogue with the sponsor – lenders will have the ability to request information from the borrower pursuant to the financial information section of the facility agreement. It is also important from a borrower's point of view to keep up with their financial information obligations as failure to do so could push a lender to take further action.

In view of the likelihood of ICR covenant breaches and LTV breaches arising going into 2023, lenders will need to assess whether a cosmetic short-term fix such as a waiver or amendment or ongoing forbearance is required or whether something more substantive such as equity cures and/or deposits or, in the worst-case, acceleration action is needed. Lenders were generally willing to provide waivers during covid, however, market sentiment suggests that a firmer approach may be needed now as higher interest rates and inflation become more entrenched.

The key for lenders, as ever, is to ensure they preserve their rights through any phase of negotiation whilst working towards a satisfactory resolution of the issues.

### **Don't terminate late**

One recent case in the High Court, *Lombard North v European Skyjets*, is of importance to lenders as it serves as a reminder of how to validly terminate a loan agreement and when the right to terminate may be lost through waiver.

Very briefly, the key facts of the case for the purpose of this article are as follows:

- Lombard North Central Plc (the "**Lender**") provided a secured loan agreement for \$8.7 million to European Skyjets Limited (the "**Borrower**") for the purchase of an aircraft, to be repaid in monthly instalments.

- The loan contained the usual LMA event of default and acceleration clauses, including the right to terminate at any time following an event of default by giving notice.
- The Borrower defaulted on repayments (by frequently paying late for several years) and the Lender: (i) started applying penalties and default interest to the unpaid amount and (ii) entered into negotiations with the Borrower regarding restructuring.
- Duff & Phelps were appointed and concluded that the Borrower was insolvent.
- The Lender then terminated the loan agreement and served an acceleration notice.
- The Borrower contended that the Lender was not entitled to terminate the loan agreement as they had waived their rights to treat the late payments as events of default.

The court found that the Lender was entitled to terminate the loan agreement:

- 1) The non-payment breach did not need to be continuing – a past breach which had been remedied was sufficient to terminate the loan agreement. The key words in the loan agreement were that it could be terminated at any time after an event of default.
- 2) The Lender did waive the right to terminate for arrears: (i) from positive statements made, which meant that the Lender implicitly accepted that if payment were made, it would not seek to claim an event of default for past delays in payment and (ii) from applying and demanding default interest and penalties.
- 3) The Lender could rely on other events of default to validate its termination notice (even if they were not set out in the termination notice), such as the Borrower's insolvency. This was because the loan agreement did not stipulate that the termination notice needed to set out the event of default being relied upon.

### **Reserve your rights**

Where a breach is anticipated, it is prudent for a lender to consider whether a reservation of rights letter should be issued to the borrower without delay. A lender should also be careful not to act in a way which could waive the right to terminate, for example by demanding default interest and applying penalties.