Cross Default

Cross Default: Definition, How It Works, and Consequences

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https://www.investopedia.com/terms/c/crossdefault.asp

What Is Cross Default?

Cross default is a provision in a bond indenture or loan agreement that puts a borrower in default if the borrower defaults on another obligation. For instance, a cross-default clause in a loan agreement may say that a person automatically defaults on his car loan if he defaults on his mortgage. The cross-default provision exists to protect the interest of lenders, who desire to have equal rights to a borrower's assets in case of default on one of the loan contracts.

KEY TAKEAWAYS

- Cross default is a clause added to certain loans or bonds that stipulates that a default event triggered in one instance will carry over to another.
- For instance, if somebody defaults on their car loan a cross-default would also cause a default on their mortgage.
- Cross default provisions are included by lenders to encourage repayment, but may actually lead to negative domino effects.
- However, there are ways to stop that domino effect: there are provisions that allow a borrower to correct or waive the event of default on an unrelated contract so as to avoid the declaration of a cross-default.

Understanding Cross-Default

Cross-default happens when a borrower defaults on another loan contract, and it provides the benefit of the default provisions of other debt agreements. Thus, cross-default clauses can create a domino effect in which an insolvent borrower may be in default on all his loans from multiple contracts if all lenders include cross-default in their loan documents. Should cross-default be triggered, a lender has the right to refuse more loan installments under the existing debt contract.

Cross-default is caused by an event of default of a borrower on another loan. Default typically occurs when a borrower fails to pay interest or principal on time, or when he violates one of the negative or affirmative covenants. A negative covenant requires a borrower to refrain from certain activities, such as having an indebtedness to profits above certain levels or profits insufficient to cover interest payment. Affirmative covenants obligate the borrower to perform certain actions, such as furnishing audited financial statements on a timely basis or maintaining certain types of business insurance.

If a borrower defaults on one of his loans by violating covenants or not paying principal or interest on time, a cross-default clause in another loan document triggers an event of default as well. Typically, cross-default provisions allow a borrower to remedy or waive the event of default on an unrelated contract before declaring a cross-default.

Mitigating Factors for Cross-Default

When a borrower negotiates a loan with a lender, several ways exist to mitigate the effect of cross-default and provide room for financial maneuvering. For instance, a borrower may limit cross-default to loans with maturities greater than one year or over a certain dollar amount. Also, a borrower may negotiate a cross-acceleration provision to take place first before a cross-default, in which a creditor must first accelerate payment of principal and interest due before declaring an event of cross-default. Finally, a borrower may limit contracts that fall under the scope of cross-default, and exclude debt that is being disputed in good faith or paid within its allowed grace period.

SAMPLE CLAUSES

Cross-Default Provision.

Cross Default

‘Any default by Grantor in the performance or observance of any covenant or condition hereof shall be deemed a Default under each of the Loan Documents, entitling Administrative Agent, for and on behalf of the Loan Parties, to exercise all or any remedies available to Administrative Agent and the Loan Parties under the terms of any or all Loan Documents, and any Default under any other Loan Document (subject to any applicable grace periods) shall be deemed a Default hereunder, entitling Administrative Agent, for and on behalf of the Loan Parties, to exercise any or all remedies provided for herein.’

https://www.lawinsider.com/clause/cross-default-provision

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Cross-Default Provisions: Borrower Beware New York

Rizky Raditya Lumempouw

https://www.nyujlb.org/single-post/2018/12/17/cross-default-provisions

Bonds, loans, notes, and promissory notes are the debt instruments predominantly traded in financial markets. No one denies that debt has a strong impact on a country’s economy. A decade ago, the bubble in the United States financial market arising from subprime mortgages that were bundled together through securitization was the main cause of the financial crisis in 2007-2008.

In a recent article published by the New York Times, the primary problem faced in the financial market – no matter how sophisticated the debt instruments are – is that investors like risky debt instruments, and currently, most investors are going after high-risk companies. Whether it be in the financial market or in private business transactions, it is commonly understood that debt financing creates risk for the business environment.

Usually, in order to reduce the risk of nonperforming debt, most transactions will be structured to have collateral. In case a debtor defaults, the collateral will be enforced, either in accordance with the Uniform Commercial Code or real estate law. However, in sophisticated financing transactions, the use of collateral might not be enough, and cross-default provisions might be needed. To understand the role of cross-default provisions, it is important to understand the importance of cross-default provisions in financing arrangements and how to structure a cross-default provision.

The Necessity of Cross-Default Provisions

There are several ways in which cross-default provisions are used in financing transactions. In sophisticated financing transactions where financing is channeled by several lenders to a debtor, the lenders will compete with each other for priority regarding repayment from the debtor. No lender wants to be last in line. In that case, the cross-default provision is used to trigger the borrower’s default in a financing arrangement when the borrower is in default on another obligation.

For example, a corporation (Borrower) receives financing from Bank A (Lender A) under Loan Agreement A and Bank B (Lender B) under Loan Agreement B. Instead of competing with each other, Lender A and Lender B use cross-default provisions to ensure both of them get equal rights if the Borrower fails.

Similarly, where financing is channeled to a certain part of the business that interrelates with other parts of the business, a default in one part will eventually impact the whole business. In that case, lenders usually do not want to wait until the whole business fails. Thus, cross-default provisions are used to ensure that the lender can be repaid when one part of the business fails.

For instance, the same Borrower receives financing from Lender A to build a car factory where the Borrower will engage with a contractor under the construction service agreement. Typically, Lender A wants to ensure that if there is a default on the construction service agreement, Lender A will get repayment directly. Thus, Lender A requires a cross-default provision in the loan agreement so Lender A can collect repayment directly without waiting until the Borrower is unable to repay Lender A.

It is clear from the above examples that cross-default provisions are necessary to reduce the risk to a lender of not being repaid by a borrower.

Structuring Cross-Default Provisions in Financing Arrangements

Indeed, cross-default provisions protect lenders. The problem with cross-default provisions, however, is that they may harm the borrower. Hence, in drafting cross-default provisions in financing arrangements, there are some issues that need to be taken into account: (a) whether or not a cross-default provision is enforceable; (b) whether or not entering into cross-default provisions may constitute a breach of fiduciary duty for the Company’s directors.

The Validity and Enforceability of Cross-Default Provisions

In *In Re Kopel*, the harm raised by the United States Bankruptcy Court is that enforcement of cross-default provisions would contravene the policy of providing debtors with an unrestricted right to assume and assign valuable contracts. According to the court, cross-default provisions should be enforced depending on facts and circumstances surrounding the particular transaction.

In *In re T & H Diner, Inc.*, the court reached the conclusion that cross-default provisions can be enforced because the court found that the cross-defaulted agreements were indivisible. Pursuant to *In Re Kopel*, courts have refused to enforce cross-default provisions in situations where the cross-defaulted agreements are not interrelated. In *Sanshoe*, the court declared that the cross-default provision is unenforceable when the relevant agreements constituted separate agreements that are not to be construed as a single contract under the factual circumstances of that case.

Breach of Fiduciary Duty and Cross-Default Provisions
Another problem faced with respect to cross-default provisions is that incorporating such provisions may result in a breach of fiduciary duties by the borrower's board of directors.
In general, the fiduciary duty of the board of directors covers the duty of care, the duty of good faith, and the duty of loyalty. One argument is that the use of cross-default provisions will breach the duty of care. These provisions in a financing agreement can be harmful to a company because they significantly increase the company's obligation in the event of a default on one loan. Instead of just one loan going into default at a time, the existence of cross-default provisions in multiple loan agreements means that multiple loans of the company all go into default at the same time. Thus, one can contend that the board of directors is neglecting its duty of care towards the company's business by letting the company simultaneously incur more debt.
One defense for the board of directors with respect to this is that decisions to incur more debt fall under the scope of the business judgment rule. This is a valid defense. The rest is then up to the board of directors to ensure that when they enter into financing arrangements, they have considered the business judgment rule.
In conclusion, parties to financing arrangements need to make sure that they use cross-default provisions if it is necessary and applicable. In doing so, the parties also need to consider the validity and enforceability of cross-default provisions, as well as how the board's fiduciary duties will be implicated.

Cross-Default and Cross-Collateralization
https://messerlikramer.com/hot-topics-in-commercial-lending-cross-default-and-cross-collateralization/

As lenders' counsel in loan transactions, we see a variety of transaction structures and methods for securing loans. This article is meant to highlight some of these provisions and to offer practice tips for handling such provisions, along with amendments to loan documents.

Cross-Default

It is relatively common for a commercial loan agreement to contain a cross-default provision, which provides that a borrower is in default under the current loan if the borrower defaults on another loan. Cross-default provisions may relate to all loans of the borrower with the lender, or they may relate to a specific loan. The enforcement of these provisions is highly dependent upon careful drafting and proper inclusion within the loan documents.

One manner of cross-defaulting a loan is to include a broad standalone provision in the loan agreement or security instrument stating that a default by the borrower under another loan results in a default under the current loan.

Another stronger manner of cross defaulting a loan is to include across default provision in the events of default section of the loan agreement and/or security instrument. To enhance the effectiveness of the cross-default provision, the lender may make specific reference to the loan by date, amount. collateral secured by the loan, and other defining characteristics of the loan. Doing so provides the lender with an enhanced basis for enforcement especially the only event of default is a default under the Cross defaulted loan.

Practice Tip: Cross-defaulting is a tool that can be utilized by lenders to call a loan in default when a related loan is not performing, so that all loan defaults with a common principal can be dealt with at one time.

Practice Tip: Given that many borrowers form special purpose entities, the lender should consider crafting cross-default language to include guarantors and/or common principals .

Cross-Collateralization

Cross-collateralization clauses provide that collateral for one loan is used as collateral for two or more loans made by the lender. Cross-collateralization can be achieved using various methods. One method is to add language in the security instrument that the collateral shall serve as security for two or more loans. Another method is to draft an additional security instrument, with the additional security instrument utilizing collateral from another loan to secure the new loan. A third method is to combine borrowers and loans in the security instruments themselves. The last method is more complex and time consuming to document and may be resisted by borrowers as unrelated borrowers are now making representations, covenants, and warrants arguably for the other borrower and its property.

Cross-collateralization is a useful tool for underwriting purposes and for solving collateralization issues, but it can also lead to additional complexity and confusion for borrowers and the lender.

Practice Tip: Lenders must be careful to properly and adequately document the cross-collateralization of risk unnecessary complexity and potential enforcement issues in the future.

Loan Amendments

In recent years, there has been an increase in the utilization of cross-collateralization of loans. During the count of a loan, certain collateral may become stronger or weaker, be sold or exchanged, and depreciate or appreciate in value. Most notably for this discussion, when amending a loan, the lender sometimes will add collateral to or remove collateral from the loan or seek to use collateral from another loan as security for the current loan. There are risks and pitfalls that can occur under all of these scenarios. Therefore, the lender must be careful to correctly document changes to loans and collateral as failure to do so can cause issues enforcement becomes necessary.

One example is when the lender attempts to modify or extend an existing loan to add collateral from another loan. Another example is when the lender attempts to utilize collateral and an existing security instrument as security for a new loan. When this occurs the lender may seek to simply add a reference to a prior security instrument in the amended or new loan agreement or promissory note, and then declare the same to be collateral for the amended or new loan. However, this method of collateralizing the amended or new loan is insufficient, and often can lead to enforcement issues down the road. The lender must not skip over the requirement of amending the security instrument is to refer to the loan for which it will be security and, when applicable, recording or filing the amendment documents.

Practice Tip: When amending a loan to add remove or replace collateral, it is important to determine what amendment to the underlying security instruments is warranted. When the underlying security instrument contains specific references to a loan, the underlying security instrument should be amended to add the additional loan for which the collateral will serve as security.

Conclusion

Lenders certainly will continue to utilize cross default and cross collateralization as tools for securing and enforcing loans in a highly competitive market. However, lenders should carefully and properly document such provisions in loan documents, and when amending loan documents so as to ensure the viability and enforceability of such documents and provisions.

Learn more about our attorneys:

Thomas J. Hainje

Holm E. Belsheim